



*Improvements to the
Modernized e-File System Will Help Provide
Intended Benefits to the
Internal Revenue Service and Taxpayers*

June 18, 2008

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 18, 2008

MEMORANDUM FOR DEPUTY COMMISSIONER FOR OPERATIONS SUPPORT
DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements to the Modernized e-File System
Will Help Provide Intended Benefits to the Internal Revenue Service
and Taxpayers (Audit # 200720035)

This report presents the results of our review of the processing and capabilities of the Modernized e-File system. The overall objectives of this audit were to assess the accuracy and completeness of data processed by the Modernized e-File system and determine whether the system provides the intended benefits to the Internal Revenue Service (IRS) and taxpayers. This review was part of our Fiscal Year 2007 Annual Audit Plan for reviews of the IRS Business Systems Modernization¹ efforts.

Impact on the Taxpayer

The Modernized e-File system is a replacement of the current IRS tax return filing technology with a modernized, Internet-based electronic filing platform. The IRS can make improvements to the system to provide intended benefits that will help enhance and expedite service to taxpayers. These improvements will help ensure that taxpayers use appropriate tax returns and report accurate and complete tax return information.

Synopsis

The Modernized e-File system has been successful in processing electronically filed tax returns for corporations, partnerships, and exempt organizations. The number of tax returns filed

¹ See Appendix VII for a Glossary of Terms.



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through the Modernized e-File system increased 127 percent in 2007 to approximately 2.23 million from 982,000 in 2006. This system facilitates taxpayer account processing and also allows electronically filed tax information to be accessed for use in tax administration compliance activities by the IRS business operating divisions.

The Modernized Tax Return Database is the legal repository for original electronically filed tax returns received by the IRS through the Modernized e-File system. Some of the data from each of the electronically filed tax returns are sent from the Modernized Tax Return Database to the taxpayer's account residing on the IRS Business Master File. Information received through the Modernized e-File system and stored in the Modernized Tax Return Database properly matched the information stored in the IRS Business Master File for 97.5 percent of the tax returns processed from January 1 through June 30, 2007. The remaining 2.5 percent either did not match because of changes made by the IRS during the processing of submitted tax returns or because taxpayers filed a different type of form or used a different tax period from prior tax returns submitted.

The IRS does not have a formal process for identifying, reporting, and resolving issues related to tax returns processed by the Modernized e-File system, nor does it have a process for submitting and tracking issues requiring attention by the Wage and Investment Division's Submission Processing function and the Electronic Tax Administration office. In addition, available front-end tax return validation controls were not being used. These controls can prevent unnecessary tax return processing, error resolution activity by the Submission Processing function, and correspondence with taxpayers.

The Modernized e-File system makes electronically filed tax return data available to the business operating divisions and allows authorized users to access, print, and download tax return information. However, because of system limitations, users must also access other IRS systems to obtain the tax return information they need.

The Modernized e-File Integration project was initiated in 2005 to provide the IRS with more convenient access, print, and download capabilities for the business operating divisions. However, these capabilities were not delivered, primarily because funding was not available. As a result of the system limitations, the Large and Mid-Size Business Division and the Tax Exempt and Government Entities Division use their own applications to access Modernized e-File system filed tax return data. The Small Business/Self-Employed Division generally does not use electronic versions of tax returns but recently started using electronic display capabilities to identify tax returns for examination. Nevertheless, the Small Business/Self-Employed Division does not use the Modernized e-File system for tax return control, delivery, or examination processes, nor does it capture cost data for the printing, shipping, and handling of tax returns filed using the Modernized e-File system.

With the Department of the Treasury electronic filing mandate for corporations and exempt organizations and the migration of tax return filing from paper to the electronic form, the IRS



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can expect increases in the number of electronically filed tax returns. The increases will also add to the number of tax returns that require manual resolution by the Submission Processing function.

In recognition of the increased number of electronically filed tax returns, the business operating divisions are exploring possibilities for developing systems to take advantage of the electronic format of tax returns and tax return information. However, only a small portion of these ideas and plans have been developed, and these concepts have not been incorporated into the IRS Information Technology Modernization Vision and Strategy.

Recommendations

To address the Modernized e-File system processing issues, we recommended that the Commissioner, Wage and Investment Division, require that the Director, Submission Processing, and the Director, Electronic Tax Administration: (1) develop a formal process for identifying, reporting, and resolving Modernized e-File system application processing issues that require subsequent tax return and account adjustment activity; and (2) perfect the validation controls in the Modernized e-File system to verify that taxpayers file the correct tax form based on their established filing election.

To address the limitations the IRS business operating divisions have in using electronically filed tax information for compliance purposes, we recommended that the Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement ensure that the business operating divisions and the Modernization and Information Technology Services organization coordinate the capabilities of the Enterprise Return Retrieval system and the Small Business/Self-Employed Division's Technology and Data Integration Plan into the Information Technology Modernization Vision and Strategy. The Information Technology Modernization Vision and Strategy is the IRS effort to determine the priorities around modernizing front-line tax administration, and it leverages existing systems and new development to optimize capacity, manage program costs, and deliver business value.

Response

The Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement agreed with our recommendations. Planned corrective actions include developing a formal process for identifying, reporting, and resolving Modernized e-File system application processing issues that require subsequent tax return and account adjustment activity. Further, the IRS has implemented validation controls to help ensure corporations and partnerships file appropriate tax forms through the Modernized e-File system. The IRS has decided to postpone implementing the validation control for Sub-Chapter S corporations at this time due to process and system limitations. We concur with management's decision to postpone



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implementing the validation control for Sub-Chapter S corporations until process and system improvements allow this action. In addition, the Small Business/Self-Employed Division will submit future releases of the Enterprise Return Retrieval project as investment proposals for corresponding Information Technology Modernization Vision and Strategy cycles. The Small Business/Self-Employed Division's Technology and Data Integration Plan will communicate the approach for using technology to achieve the Division's business objectives and supporting organizational priorities. This Plan is not an enterprise plan, but the Small Business/Self-Employed Division will use it to collaborate with other business operating divisions and, where possible, maximize the application of technological initiatives. Management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Preston B. Benoit, Acting Assistant Inspector General for Audit (Information Systems Programs), at (202) 622-5894.



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Abbreviations

IRS

Internal Revenue Service



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Background

The Modernized e-File system is a replacement of the current Internal Revenue Service (IRS) tax return filing technology with a modernized, Internet-based electronic filing platform. The Modernized e-File system supports and facilitates the IRS' commitment to achieve the IRS Restructuring and Reform Act of 1998¹ goal of receiving at least 80 percent of all tax returns in electronic form. This system also serves to streamline filing processes and reduce the costs associated with paper tax returns.

Development of the Modernized e-File system aims to increase electronic tax return filing through a system that is efficient and easy to access, use, and maintain.

In February 2004, the IRS deployed the initial Modernized e-File system release,² which provides an option for Internet-based filing of the U.S. Corporation Income Tax Return (Form 1120), the U.S. Income Tax Return for an S Corporation (Form 1120S), and the Return of Organization Exempt From Income Tax (Form 990). Subsequent enhancements added more forms associated with corporations, the public disclosure capabilities required by the Tax Exempt and Government Entities Division, and the ability to file extensions for Forms 1120 and 1120S. The Modernized e-File system also developed the Federal/State Single Point Filing System platform and the Federal/State components for Forms 1120 and 990. The Federal/State Single Point Filing System platform permits tax return transmitters to submit multiple Federal and State tax return types within one electronic transmission.

In January 2005, the Department of the Treasury issued regulations mandating electronic filing requirements for corporations and exempt organizations. Corporations and exempt organizations filing at least 250 tax returns with assets of \$10 million or more with taxable years ending on or after December 31, 2006, must file electronically.

In January 2007, Release 4 of the Modernized e-File system went into production and added the U.S. Return of Partnership Income (Form 1065) and the U.S. Return of Income for Electing Large Partnerships (Form 1065-B) as well as Federal/State Single Point Filing System access for partnership tax returns. The IRS also plans to add individual tax returns to the Modernized e-File system in three phases beginning in August 2009, with planned completion in January 2011.

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

² See Appendix VII for a Glossary of Terms.



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The Modernized Tax Return Database is the legal repository for original electronically filed tax returns received by the IRS through the Modernized e-File system. This repository allows for more efficient processing and analysis and multiple inquiries of the tax return information. Some of the data from each electronically filed tax return are sent from the Modernized Tax Return Database to taxpayers' accounts residing on the IRS Business Master File. The Employee User Portal allows IRS employees to access data on the Modernized Tax Return Database and on tax administration processing systems and financial information systems in a secure, authenticated session.

This review was performed at the Modernization and Information Technology Services organization facility in New Carrollton, Maryland, during the period September 2007 through February 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This review was part of the Treasury Inspector General for Tax Administration Fiscal Year 2007 Annual Audit Plan coverage under the major management challenge of Modernization of the IRS. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

The Modernized e-File System Generally Provides Complete and Accurate Tax Return Information for the Internal Revenue Service's Processing Operations

The Modernized e-File system has been successful in processing electronically filed tax returns for corporations, partnerships, and exempt organizations. The total number of tax returns filed through the system increased 127 percent in 2007 to approximately 2.23 million from 982,000 in 2006. The Modernized e-File system expeditiously facilitates taxpayer account processing and also allows electronically filed tax information to be accessed for use in tax administration compliance activities by the IRS business operating divisions.

The volume of tax returns filed electronically through the Modernized e-File system more than doubled from Calendar Year 2006 to Calendar Year 2007, while experiencing relatively few processing inaccuracies.

We analyzed tax returns filed electronically using the Modernized e-File system from January 1 through June 30, 2007. We found that the information received through the system and stored in the Modernized Tax Return Database properly matched the information stored in the IRS Business Master File for about 97.5 percent of the 936,026 tax returns processed during this period. The remaining 2.5 percent did not match because of changes made during processing. These changes were made by the Wage and Investment Division's Submission Processing function to correct errors, such as mathematical miscalculations, and omissions of required information such as taxpayer filing status.

A Formal Process Is Not In Place to Identify, Report, and Resolve Problems Related to Modernized e-File Tax Return Processing

The IRS' Enterprise Life Cycle³ requires new releases of the Modernized e-File system to pass application and system integration and testing prior to deployment into the IRS tax return processing operations. However, we found that after a new Modernized e-File release is deployed, the IRS does not perform error detection or trending to identify systemic or processing problems with tax returns filed through the system. By not having a formal process in place, needed improvements and enhancements to the system could be delayed, reducing its effectiveness.

³ See Appendix VI for Enterprise Life Cycle Overview.



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Our analysis of tax returns electronically filed through the Modernized e-File system from January 1 through June 30, 2007, found that the information received through the system and stored in the Modernized Tax Return Database did not match the information stored in the IRS Business Master File for approximately 2.5 percent (23,188) of the tax returns filed. The mismatches consisted of 11,601 tax returns that did not have matching information and an additional 11,587 tax returns that did not post to the Business Master File. We analyzed the Modernized Tax Return Database tax returns that did not post to the Business Master File and identified several conditions. See Appendix V for an analysis of these tax return populations.

Invalid tax returns submitted through the Modernized Tax Return Database did not post to the Business Master File

Taxpayers may elect to convert between a Form 1120 corporation, Form 1120S corporation, or Form 1065 partnership. Because these various entities treat business income and taxes differently, it might be in the taxpayers' best interest to convert from one type of entity to another depending on their specific tax and business situations. To make these conversions, taxpayers must notify the IRS of their election to change from one entity to another and receive approval prior to filing their tax returns.

The Modernized Tax Return Database and the Business Master File did not always agree on the taxpayer's entity information, such as the taxpayer's qualification to file as a Form 1120 corporation, Form 1120S corporation, or Form 1065 partnership, or with the tax periods reported by the taxpayer. However, procedures were in place in the Submission Processing function to perfect tax return information sent from the Modernized Tax Return Database to the Business Master File. These procedures require correspondence with the taxpayer to resolve issues around the propriety of the tax return type necessary for filing. The taxpayer has 60 calendar days to respond and must either provide proof of his or her election for the form type filed or resubmit the correct form. If the taxpayer does not respond in 60 calendar days, the Submission Processing function converts the tax return for filing using the taxpayer's previous filing status as reflected in the Business Master File.

The taxpayers identified by the IRS as not meeting the criteria to convert to another filing status create processing problems that the IRS must resolve.

Of 11,587 tax returns we analyzed that did not post to the Business Master File, the Submission Processing function properly resolved the 34 exempt organization returns included in this population. The remaining 11,553 tax returns consisted of 11,005 Form 1120 and Form 1120S corporation tax returns, and 548 Form 1065 partnership tax returns. The Submission Processing function has resolved or is in the process of resolving these tax returns. From this population, we analyzed a sample of 124 Form 1120 and Form 1120S tax returns and 74 Form 1065 tax returns filed through the Modernized e-File system that did not post to the Business Master File.



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The majority of the tax returns that did not post involved the tax return filing status or tax period. Other reasons for the tax returns not posting could not be identified from the posting records. However, the Submission Processing function resolved most of the tax returns and posted the corresponding Modernized Tax Return Database tax return information to the Business Master File. Figure 1 presents the reasons for the tax returns that did not post and the time period required by the Submission Processing function to perfect the accounts with either acceptance of the original tax return or processing the taxpayer's subsequent submission of the correct tax return.

**Figure 1: Analysis of Resolutions for the Tax Return Information
on the Modernized Tax Return Database and the Business Master File**

IRS Resolution	Corporate Tax Returns (Forms 1120 & 1120S)		Partnership Tax Returns (Form 1065)	
	Number of Tax Returns	Average Days to Resolve	Number of Tax Returns	Average Days to Resolve
Changed Filing Status	71	132	52	146
Changed Tax Period	11	154	9	149
Other Processing Actions	35	51	7	183
Total Tax Returns Corrected and Average Days to Resolve	117*	110	68*	150

Source: Treasury Inspector General for Tax Administration extract of tax return account data from the Modernized Tax Return Database and the Business Master File for the period January 1 through June 30, 2007.

*As of January 23, 2008, the Submission Processing function was in the process of resolving tax returns that did not post to the Business Master File relating to seven corporate tax returns and six partnership tax returns. These tax returns are not included in the above totals.

The tax return receipt dates did not always agree on the Modernized Tax Return Database and the Business Master File

Of the sampled 124 Form 1120 and Form 1120S tax returns filed through the Modernized e-File system, 42 accounts (34 percent) subsequently posted to the Business Master File with different receipt dates compared to the Modernized Tax Return Database receipt dates. The IRS issued these taxpayers a notice informing them that they did not qualify to file the form because they did not notify the IRS in a timely manner of their election to file as that type of taxpayer entity (e.g., to use Form 1120 or Form 1120S). For these accounts, taxpayers had to resubmit the originally filed tax information on another type of tax return.



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If a taxpayer did not reply to the notice, the Submission Processing function converted the tax return to the taxpayer's qualified filing status and manually input the refiled tax return received date in the Business Master File. However, the correct received date for tax returns filed using the Modernized e-File system is the date the tax return was accepted by the Modernized e-File system.

Management Action: After we notified the Submission Processing function of this condition, interim guidance was issued on October 11, 2007, and the Internal Revenue Manual was updated effective January 1, 2008, to ensure that the correct received date is used.

Some corporate tax return information filed through the Modernized e-File system is not correctly processed and reported

Depreciation Expense Calculation Errors: Taxpayers often report depreciation expense totals on Form 1120 or Form 1120S. However, Modernized e-File tax returns with depreciation entries on multiple supporting forms are incorrectly added together to calculate the total depreciation expense. The Submission Processing function has to correct this error during tax return processing.

From January 1 through June 30, 2007, taxpayers submitted 4,403 Modernized e-File Form 1120 and Form 1120S tax returns that resulted in different depreciation expenses reported on the Modernized Tax Return Database and the Business Master File for the tax returns filed. We analyzed a sample of 60 tax returns with different depreciation expense totals reported. Of the 60 tax returns, 49 included multiple depreciation entries that were incorrectly added together in calculating the total depreciation expense. The Submission Processing function identified and corrected these depreciation calculation errors.

Because of the nature of this condition, the Submission Processing function brought this issue to the attention of the Wage and Investment Division's Electronic Tax Administration office in August 2007. Although a formal process is not in place to communicate the types of errors it identifies, the Submission Processing function provided email messages to the Electronic Tax Administration office about this problem. The Electronic Tax Administration office did not formally control the referral from the Submission Processing function. The Electronic Tax Administration office uses the Information Technology Assets Management System to control issues relating to the adequacy of electronic tax administration, but the referral of the depreciation expense problem was not entered and controlled on this system. Consequently, this problem has not been resolved and the Submission Processing function must continue to manually identify and correct the depreciation expenses on the tax returns.

Corporate Shareholder Distribution Reporting Errors: The Modernized e-File system is not correctly reporting income distributions for Forms 1120 with an attached Consent Plan and Apportionment Schedule for a Controlled Group (Schedule O). A Schedule O reports the income distribution for each of the shareholders. The Modernized e-File system tax return processing did not always capture the correct taxable income distribution.



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The Submission Processing function also provided email messages to the Electronic Tax Administration office about this problem. This problem was controlled on the Information Technology Assets Management System, and the Modernized e-File Project staff stated that this problem was fixed. The Information Technology Assets Management System shows that the problem was resolved in May 2007.

From January 1 through June 30, 2007, taxpayers submitted 883 Modernized e-File Form 1120 tax returns with different income distributions from Schedule O reported on the Modernized Tax Return Database and the Business Master File for tax returns filed. We analyzed a sample of 64 of these tax returns with different income distributions from Schedule O. Of these 64 tax returns, 18 tax returns with a Schedule O reporting inconsistency were not identified for correction by the Submission Processing function.

The Electronic Tax Administration office also related that tax returns filed with a 2006 Schedule O or prior version might continue to have this problem. However, the 2007 version will require all taxpayers to use the new format, which will alleviate this processing problem.

Several reasons caused the mismatches in tax information

Subsequent to project release testing, the IRS does not have a formal process for identifying, reporting, and resolving Modernized e-File system processing issues. Further, the Submission Processing function's program reviews attributed inventory level variances and the need for training staff to process these cases as reasons for not meeting its criteria for correctly processing tax returns with mismatched conditions within 3 months. Resolution of mismatch conditions for corporate tax returns required an average of more than 3 months, and resolution of partnership tax returns required an average of 5 months. Actions were taken in June 2007 that began to reduce the over-age inventories.

In addition, available front-end tax return validation controls are not being used to prevent inaccurate tax returns from being accepted by the Modernized e-File system. These controls notify taxpayers that they did not meet the qualifications for the entity or tax period used in filing and would need to file a different form. This control prevents unnecessary tax return processing, error resolution activity by the Submission Processing function, and correspondence with taxpayers.

According to the Modernized e-File Project team and the Electronic Tax Administration office, available front-end validation controls were not used because significant numbers of tax returns were rejected for processing. The reason cited was that the National Account Profile (a compilation of Master File information used as a reference to validate taxpayer entity information) did not include current information, resulting in the significant number of rejected tax returns.

The National Account Profile administrators stated that this information is updated weekly with the latest Business Master File information. The National Account Profile is made available to



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IRS users including the Modernized e-File system. The administrators also stated that it was the Modernized e-File Project team's responsibility to capture the latest National Account Profile information.

Mismatched information conditions will affect the IRS' ability to provide timely and effective customer service in the future

With the Department of the Treasury electronic filing mandate for corporations and exempt organizations and the migration of tax return filing from paper to the electronic form, the IRS can expect increases in the number of electronically filed tax returns. The increases will also add to the number of tax returns that require manual resolution by the Submission Processing function.

The IRS Office of Research has developed projections of the number of electronic tax return filings the IRS can expect to receive through 2014. According to these projections, the numbers of electronic tax returns for the Large and Mid-Size Business Division and the Small Business/Self-Employed Division will increase approximately 290 percent each, while the Tax Exempt and Government Entities Division can expect a 969 percent increase (Figure 3 on page 13 presents the basis for these projections).

Without implementing validation controls as part of the Modernized e-File system processing, the increase in tax return filings requiring resolution by the Submission Processing function will demand an increase in staffing, counter-balancing some of the benefits of electronic filing. Considering the projections in electronic filing by the Office of Research and the rate of occurrence of tax return rejections because of the need for conversion to the appropriate filing status or the need to correct the tax return filing period, approximately 142,475 corporate and partnership tax returns could be processed more efficiently over the next 5 years with installation of front-end validation controls. Figure 2 presents an analysis of Modernized e-File system processed tax returns requiring filing status or tax period correction.



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**Figure 2: Analysis of Modernized e-File Processed Tax Returns
Requiring Filing Status or Tax Period Correction**

Form Type	Tax Returns Needing Correction		
	Filing Status	Tax Period	Total
Corporate (Forms 1120/1120S)	117,255	18,166	135,421
Partnership (Forms 1065/1065B)	6,013	1,041	7,054
Potential Number of Tax Returns Needing Correction			142,475

Source: Treasury Inspector General for Tax Administration extract of tax return account data from the Modernized Tax Return Database and the Business Master File for the period January 1 through June 30, 2007. The number of tax returns needing correction reflects a projection of the potential number of tax returns that may be filed with these conditions from 2008 through 2012.

The lengthy period needed to work with taxpayers to determine the proper filing status and posting the taxpayers' correct tax returns might result in the IRS' inability to provide timely customer service. Without providing this level of customer service, the IRS may be unable to perform timely and appropriate compliance efforts.

Finally, Modernized e-File system weaknesses have the following potential effects:⁴

- Incorrect received dates in taxpayers' account records may result in barred assessments or collections because of statute expirations. Based on the rate of occurrence of this condition in our sample, almost 77,000 tax returns might require review over the next 5 years if the planned solutions are not effective.
- Incorrect reporting of depreciation expense calculations to the Modernized Tax Return Database requires the IRS to devote resources to the error resolution process. Based on the rate of occurrence of this condition in our sample, almost 67,000 tax returns might require correction over the next 5 years. This condition will continue if the reason for the miscalculations is not determined and adjusted to capture the appropriate depreciation information.
- Incorrect processing of Schedule O in the Modernized Tax Return Database requires the IRS to devote resources to correct the account information for processing by the Business

⁴ See Appendix IV for the details of these outcome measures.



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Master File. Based on the rate of occurrence of this condition in our sample, almost 6,000 tax returns might require correction over the next 5 years if the planned solutions are not effective.

Recommendations:

Recommendation 1: The Commissioner, Wage and Investment Division, should require the Director, Submission Processing, and the Director, Electronic Tax Administration, to develop a formal process for identifying, reporting, and resolving Modernized e-File system application processing issues that require subsequent tax return and account adjustment activity. This control process will provide a means for identifying significant Modernized e-File system tax return issues and provide the IRS with the ability to develop corrective actions. This control can also be used to notify IRS staff of processing issues to enable appropriate compliance actions.

Management's Response: The Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement agreed with this recommendation and will use the Wage and Investment Division Submission Processing function's Hot Topics application, currently under development, to provide a mechanism for identifying, elevating, and resolving issues. In addition, as the Submission Processing function's Hot Topics evolve, the Wage and Investment Division Submission Processing function will determine how to gather and analyze the information to identify trends.

Recommendation 2: The Commissioner, Wage and Investment Division, should require the Director, Submission Processing, and the Director, Electronic Tax Administration, to perfect the validation controls to verify that taxpayers file the correct tax form based on their established filing election. After perfecting the control, they should notify the Modernized e-File Project team to implement the validation in processing tax returns through the Modernized e-File system. This control will prevent the Modernized e-File system from accepting the incorrect tax forms filed by taxpayers and, therefore, reduce the number of tax returns requiring Submission Processing function staff involvement.

Management's Response: The Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement agreed with the recommendation for Form 1065 and Form 1120 and have implemented the proposed validation controls. The Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement proposed not implementing the validation control for Form 1120S at this time due to process and system limitations.

Office of Audit Comment: We concur with management's decision to postpone implementing the validation control for Form 1120S until process and system improvements allow this action.



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The Modernized e-File System Is Not Being Used to the Extent Originally Planned, and the Intended Benefits to the Business Operating Divisions Are Not Being Achieved

The Modernized e-File system makes electronically filed tax return data available to the business operating divisions and allows authorized users the ability to access, print, and download tax return information. However, because of limitations in the system, users must access the information via another system (the Employee User Portal), which limits viewing to one document per command and printing and downloading to 15 documents per command. Accessing additional information requires the user to continue navigating through the tax return via the Employee User Portal. This is especially cumbersome when some corporate tax returns can consist of several hundred pages.

The Modernized e-File Integration project was initiated in 2005 to provide the IRS with more convenient access to data from Modernized e-File system tax returns. Early requirements for the Modernized e-File Integration project showed that it planned to deliver the access, print, and download capabilities for tax returns processed through the Modernized e-File system. However, sufficient capabilities were not delivered. According to the Modernized e-File Integration project team, funding was not available to allow the Modernized e-File Integration project to deliver the access, print, and download capabilities for the business operating divisions.

Users developed alternative applications to access tax return data

The Modernized e-File system is not being used to the extent originally planned, and the intended benefits to the business operating divisions are not being achieved. As a result of the data access limitations, the Large and Mid-Size Business Division and the Tax Exempt and Government Entities Division are using their own systems to access Modernized e-File system filed tax return data.

- The Statistics of Income office developed a process to create Portable Document Format images of tax returns for use by the Large and Mid-Size Business Division. The Large and Mid-Size Business Division entered into a partnership with the Statistics of Income office and, subsequently, with the Modernization and Information Technology Services organization. The current version of the Large and Mid-Size Business Imaging Network was the result.
- The Tax Exempt and Government Entities Division obtains a weekly download of Forms 990 from the Modernized Tax Return Database. The information is moved to the Tax Exempt and Government Entities Division's electronic data warehouse and populates the Tax Exempt and Government Entities Division Returns Inventory and Classification System database.



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For the Large and Mid-Size Business Division and the Tax Exempt and Government Entities Division to access Modernized e-File system data via these other systems, the data must go through lengthy conversion and formatting processes. Conversion of data from a Modernized e-File system tax return to the business operating divisions' systems takes from several weeks to several months. Delays of business operating division access to Modernized e-File system data have caused:

- The Large and Mid-Size Business Division to delay examinations of several major corporations while waiting for tax return delivery. Also, there have been instances of Large and Mid-Size Business Division examination teams asking corporate taxpayers for paper copies of electronically filed tax returns because the teams did not want to wait for the Large and Mid-Size Business Image Network system to deliver the tax return image.
- The potential postponement of a major Fiscal Year 2008 Tax Exempt and Government Entities Division examination project on hospitals and universities.

The Small Business/Self-Employed Division is making only limited use of Modernized e-File system data in its inventory and classification processes

Recently, the tax return data in the Modernized e-File system have been used to identify tax returns for examination activity. However, employees expressed concerns about performing this activity with an electronically displayed tax return. Among the concerns, employees stated that it takes them twice the time to analyze a tax return electronically as compared to performing this analysis with a paper tax return.

The Small Business/Self-Employed Division generally does not use electronic versions of tax returns filed through the Modernized e-File system.

After the electronic tax return examination identification process is completed, the IRS campus operations print the electronic tax returns selected for examination. The paper versions of the electronic tax returns are controlled with a paper document transmittal form and shipped to the appropriate offices for examination. The Small Business/Self-Employed Division does not use the Modernized e-File system for tax return control, delivery, or examination processes, nor does it capture cost data for the printing, shipping, and handling of tax returns filed using the Modernized e-File system.

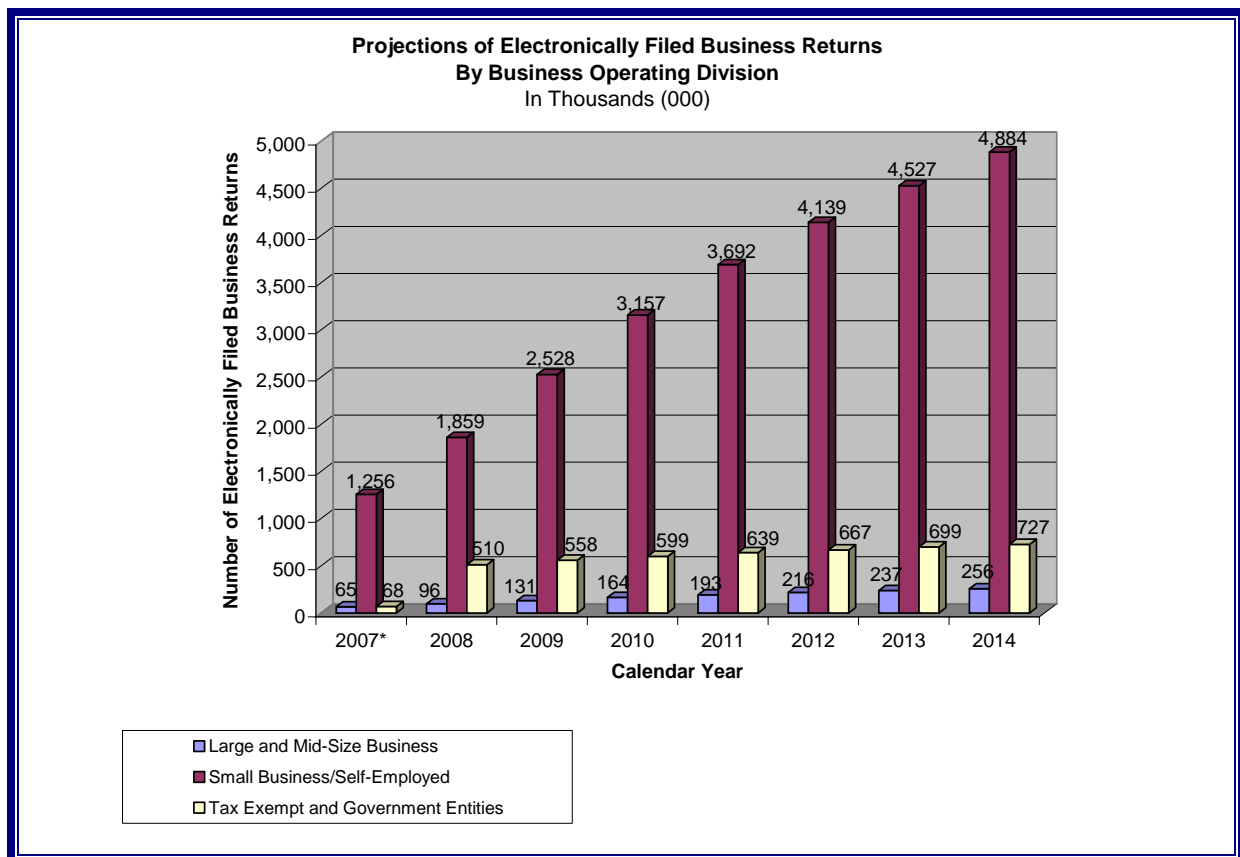
Electronic tax return filing is projected to have a significant effect on the Small Business/Self-Employed Division's inventory. The Small Business/Self-Employed Division informed us that it currently does not receive a significant number of electronically filed tax returns in its potential inventory. However, it actually receives a substantial number of these tax returns. In 2007, Small Business/Self-Employed Division taxpayers submitted almost 1.26 million electronically filed business tax returns. According to IRS Office of Research projections, the number of electronically filed corporation and partnership tax returns the Small Business/



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Self-Employed Division will receive in the next 7 years will increase by almost 290 percent to approximately 4.88 million (this is in addition to the 33.41 million electronically filed individual tax returns it is projected to receive). Figure 3 presents the projections of electronically filed corporate, partnership, and exempt organization tax returns through 2014.

Figure 3: Projections of Electronically Filed Corporate, Partnership, and Exempt Organization Tax Returns



Source: IRS Office of Research Calendar Year Return Projections for the United States and IRS campuses CY 2007-2014 [Document 6186 (revised December 2007)]. Calendar Year 2007 presents actual tax returns filed. Projections for 2008 through 2014 are based on the 2007 ratios of tax returns assigned for the different business operating divisions' activities and the Office of Research's projected future number of electronically filed tax returns.

The Small Business/Self-Employed Division's ability to effectively and efficiently manage the increasing volume of electronic tax returns may be strained under the current paper tax return based processes. To address this condition, it is currently developing plans and initiatives to work with electronic tax returns. These plans and initiatives are referred to as the Technology and Data Integration Plan, which will be a comprehensive, working document that outlines current business environment issues affecting the gathering, storage, manipulation, and



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presentation of electronic tax account and tax return information. According to preliminary information provided to us about the Technology and Data Integration Plan, only very limited aspects of this initiative are included in the IRS Information Technology Modernization Vision and Strategy. The Information Technology Modernization Vision and Strategy is the effort the IRS has developed to determine the priorities around modernizing front-line tax administration, and it leverages existing systems and new development to optimize capacity, manage program costs, and deliver business value.

On an enterprise-wide basis, the IRS is developing the Enterprise Return Retrieval system. This system is intended to provide the capabilities originally planned for the Modernized e-File Integration project (access, print, and download of Modernized e-File tax returns). The IRS has spent \$1.5 million toward planning for development of the Enterprise Return Retrieval system project and had planned to spend \$5.25 million more in Fiscal Year 2008 for development activities. However, the Enterprise Return Retrieval system is not currently funded for development and is not incorporated into the Information Technology Modernization Vision and Strategy.

Recommendation

Recommendation 3: The Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement should ensure that the business operating divisions and the Modernization and Information Technology Services organization coordinate the capabilities of the Technology and Data Integration Plan initiative and the Enterprise Return Retrieval system into the Information Technology Modernization Vision and Strategy. Coordinating the Technology and Data Integration Plan and Enterprise Return Retrieval system with the Information Technology Modernization Vision and Strategy will help the IRS to achieve enterprise-wide capabilities for the identification, control, and analysis of electronic tax return and taxpayer account information for customer service and compliance purposes.

Management's Response: The Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement agreed with this recommendation. The Small Business/Self-Employed Division submitted and prioritized the Enterprise Return Retrieval system project's Release 1 investment proposal as part of the Fiscal Year 2010 Information Technology Modernization Vision and Strategy. The Small Business/Self-Employed Division will also submit future releases of the Enterprise Return Retrieval system project as investment proposals for corresponding Information Technology Modernization Vision and Strategy cycles.

The Small Business/Self-Employed Division is developing the Technology and Data Integration Plan. This Plan will communicate the approach for using technology to achieve the Small Business/Self-Employed Division's business objectives and supporting organizational priorities. This plan is not an enterprise plan, but the Small Business/



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Self-Employed Division will use it to collaborate with other business operating divisions and, where possible, maximize the application of technological initiatives.



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Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to assess the accuracy and completeness of data processed by the Modernized e-File system and determine whether the system provides the intended benefits to the IRS and taxpayers. To accomplish these objectives, we:

- I. Determined whether the information processed by the Modernized e-File system to the Modernized Tax Return Database¹ properly reported tax return information to the Business Master File.
 - A. Identified and reviewed processes used by the Wage and Investment Division's Submission Processing function to perfect tax return information from the Modernized Tax Return Database to the Business Master File.
 - B. Compared the tax return information from the electronically filed tax returns received by the Modernized e-File system and maintained in the Modernized Tax Return Database to the tax return data posted to the Business Master File Business Return Transaction File. To perform the comparison, we:
 1. Obtained information for 936,026 tax returns electronically filed using the Modernized e-File system from January 1 through June 30, 2007, and identified 11,601 tax returns with differences.
 2. An additional 11,587 tax returns filed through the Modernized e-File system could not be located on the Business Master File by the tax return identification number.
 3. Using a random interval selection process, selected samples of 713 electronically filed corporate, tax-exempt organization, and partnership tax returns from the 23,188 returns (11,601 tax returns with differences plus 11,587 tax returns with no matching return identification number on the Business Master File) and analyzed the status of the tax return information as of January 23, 2008.
 - a) Divided these samples based on attributes such as type of tax return and tax issue. When we sampled the corporate, tax-exempt organization, and partnership returns, we used a 90 percent confidence level with a precision of 10 percent to determine the error rates in these populations.

¹ See Appendix VII for a Glossary of Terms.



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- b) Performed complete reviews of accounts with attributes such as tax return line item differences between the Modernized Tax Return Database and Business Master File that were made up of relatively small populations.
 - c) Used random sampling to ensure that each account had an equal chance of being selected, which enabled us to obtain sufficient evidence to support our results. Appendix V provides details about the sampling attributes and populations of Modernized e-File system tax returns filed and analyzed during our review period.
- C. Interviewed staff from the Modernized e-File Project, the Wage and Investment Division's Submission Processing function, and the Electronic Tax Administration office to determine why there were differences in data posted to the Modernized Tax Return Database and the information recorded in the Business Master File.
- D. Reviewed the Modernized e-File system user requirements to determine whether any of the differences identified in postings to the Modernized Tax Return Database and the Business Master File were based on the system requirements.
- II. Determined whether the Modernized e-File system was effectively utilized and met the intended benefits of its customers. To make this determination, we:
- A. Interviewed Large and Mid-Size Business Division, Small Business/Self-Employed Division, and Tax Exempt and Government Entities Division staff and obtained documentation to determine the effectiveness of the Modernized e-File system in meeting customer needs and requirements.
 - B. Reviewed and analyzed the process examiners use for accessing tax return information, including the Modernized e-File system, and user requirements for retrieval, display, printing, and downloading tax return information.

Validity and reliability of data from computer-based systems

We obtained corporate, tax-exempt organization, and partnership tax return data processed by the Modernized e-File system and stored on the Modernized Tax Return Database. We compared these data to information processed and stored in the Business Master File. We used the tax return identification number--called the document locator number--as the control to validate the accuracy of the matching of the tax return information stored on the Modernized Tax Return Database and the Business Master File. Our reviews found the data were sufficiently reliable to perform our audit analyses.



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Appendix II

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff
Chief Information Officer OS:CIO
Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Tax Exempt and Government Entities Division SE:T
Commissioner, Wage and Investment Division SE:W
Associate Chief Information Officer, Applications Development OS:CIO:AD
Director, Office of Research, Analysis, and Statistics RAS:O
Director, Office of Research RAS:R
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
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 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Tax Exempt and Government Entities Division SE:T
 Commissioner, Wage and Investment Division SE:W
 Associate Chief Information Officer, Applications Development OS:CIO:AD
 Director, Program Oversight OS:CIO:SM:PO



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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 142,475 tax returns affected (see page 3).

Methodology Used to Measure the Reported Benefit:

When Modernized e-File system tax returns are not posted in a timely manner to the Business Master File,¹ a taxpayer might be asked to provide to the IRS copies of the tax return or evidence that the tax return was filed, even though the taxpayer electronically filed the tax return using the Modernized e-File system and received acceptance from the IRS. If validation controls are added to the Modernized e-File system, invalid tax returns filed through the system would be rejected and the taxpayer would be notified that the tax return needs to be corrected to be accepted by the IRS. Based on the rate of occurrence from our sample of tax returns filed using the Modernized e-File system from January 1 through June 30, 2007, taxpayers might be contacted regarding the correct filing requirement for 142,475 tax returns filed from 2008 through 2012.

Form Type²	Correction Needed	Number of Tax Returns
Form 1120/1120S	Filing Status	117,255
Form 1120/1120S	Tax Period	18,166
Form 1065/1065B	Filing Status	6,013
Form 1065/1065B	Tax Period	1,041
	Potential Number of Tax Returns Needing Correction	142,475

¹ See Appendix VII for a Glossary of Terms.

² The subsequent narrative defines the Form titles.



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U.S. Corporation Income Tax Returns (Form 1120) and the U.S. Income Tax Returns for an S Corporation (Form 1120S) filed in which the tax return type does not match the taxpayers filing status recorded in the Business Master File

600,983	Population of Forms 1120/1120S filed using the Modernized e-File system from January 1 through June 30, 2007.
11,005	Number of Forms 1120/1120S filed using the Modernized e-File system from January 1 through June 30, 2007, that did not have a matching tax return control number in the Business Master File.
1.8312%	Percentage of Modernized e-filed Forms 1120/1120S filed using the Modernized e-File system from January 1 through June 30, 2007, that did not have a matching tax return control number on the Business Master File. (11,005/600,983)
11,183,000	Projected number of Forms 1120/1120S to be filed from 2008 through 2012 using the Modernized e-File system. (Projected number of tax returns based on IRS Office of Research Calendar Year Return Projections for the United States and IRS campuses CY 2007-2014 [Document 6186 (revised December 2007: 2008 – 1,296,100; 2009 – 1,803,600; 2010 – 2,291,900; 2011 - 2,715,200; 2012 - 3,076,200)
204,783	Projected number of Forms 1120/1120S to be filed from 2008 through 2012 using the Modernized e-File system that might not have a matching tax return control number in the Business Master File. (11,183,000 x 1.8312%)
57.2581%	Percentage of tax returns based on our samples of Forms 1120/1120S filed using the Modernized e-File system from January 1 through June 30, 2007, that were rejected for processing because the filed tax return did not match the filing status recorded in the Business Master File. These tax returns required additional research by the Submission Processing function. (71/124)
117,255	Projected number of Forms 1120/1120S to be filed from 2008 through 2012 that might be rejected for processing because the tax return type does not match the taxpayers filing status recorded in the Business Master File. (204,783 x 57.2581%)

U.S. Return of Partnership Income (Form 1065) and the U.S. Return of Income for Electing Large Partnerships (Form 1065-B) filed in which the tax return type does not match the taxpayers filing status recorded in the Business Master File

319,671	Population of Forms 1065/1065B filed using the Modernized e-File system from January 1 through June 30, 2007.
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548	Number of Forms 1065/1065B filed using the Modernized e-File system from January 1 through June 30, 2007, that did not have a matching tax return control number in the Business Master File.
0.1714%	Percentage of Modernized e-filed Forms 1065/1065B filed using the Modernized e-File system from January 1 through June 30, 2007, that did not have a matching tax return control number on the Business Master File. (548/319,671)
4,992,400	Projected number of Forms 1065/1065B to be filed from 2008 through 2012 using the Modernized e-File system. (Projected number of tax returns based on IRS Office of Research Calendar Year Return Projections for the United States and IRS campuses CY 2007-2014 [Document 6186 (revised December 2007: 2008 – 659,300; 2009 – 855,900; 2010 – 1,029,100; 2011 - 1,169,200; 2012 - 1,278,900)
8,557	Projected number of Forms 1065/1065B to be filed from 2008 through 2012 using the Modernized e-File system that might not have a matching tax return control number in the Business Master File. (4,992,400 x 0.1714%)
70.2703%	Percentage of tax returns based on our samples of Forms 1065/1065B filed using the Modernized e-File system from January 1 through June 30, 2007, that were rejected for processing because the filed tax return did not match the filing status recorded in the Business Master File. These tax returns required additional research by the Submission Processing function. (52/74)
6,013	Projected number of Forms 1065/1065B to be filed from 2008 through 2012 that might be rejected for processing because the tax return type does not match the taxpayers filing status recorded in the Business Master File. (8,557 x 70.2703%)

Form 1120/1120S filed in which the tax return tax period does not match the taxpayers' tax period recorded in the Business Master File

204,783	Projected number of Forms 1120/1120S to be filed from 2008 through 2012 using the Modernized e-File system that might not have a matching tax return control number in the Business Master File. (11,183,000 x 1.8312%)
8.8709%	Percentage of tax returns based on our samples of Forms 1120/1120S filed using the Modernized e-File system from January 1 through June 30, 2007, that were rejected for processing because the filed tax return did not match the filing tax period recorded in the Business Master File. These tax returns required additional research by the Submission Processing function. (11/124)



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18,166 Projected number of Forms 1120/1120S to be filed from 2008 through 2012 that might be rejected for processing because the tax return tax period does not match the taxpayers' tax period recorded in the Business Master File. (204,783 x 8.8709%)

Form 1065/1065B filed in which the tax return tax period does not match the taxpayers' tax period recorded in the Business Master File

8,557 Projected number of Forms 1065/1065B to be filed from 2008 through 2012 using the Modernized e-File system that might not have a matching tax return control number in the Business Master File. (4,992,400 x 0.1714%)

12.1622% Percentage of tax returns based on our samples of Forms 1065/1065B filed using the Modernized e-File system from January 1 through June 30, 2007, that were rejected for processing because the filed tax return did not match the filing tax period recorded in the Business Master File. These tax returns required additional research by the Submission Processing function. (9/74)

1,041 Projected number of Forms 1065/1065B to be filed from 2008 through 2012 that might be rejected for processing because the tax return tax period does not match the taxpayers' tax period recorded in the Business Master File. (8,557 x 12.1622%)

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 5,923 tax returns affected (see page 3).

Methodology Used to Measure the Reported Benefit:

The Modernized e-File system is not correctly reporting income distributions for Form 1120 or Form 1120S with an attached Consent Plan and Apportionment Schedule for a Controlled Group (Schedule O). If a Schedule O with an incorrect processing of income distribution is not identified for review by the Submission Processing function, the apportionment information for the taxpayer will be incorrectly recorded in the Business Master File. Based on the rate of occurrence from our sample of tax returns, 5,923 taxpayer accounts from 2008 through 2012 might report incorrect apportionment information.

129,634 Population of Forms 1120 filed using the Modernized e-File system from January 1 through June 30, 2007.

883 Number of Forms 1120 filed using the Modernized e-File system from January 1 through June 30, 2007, that included a Schedule O.



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0.6811%	Percentage of Forms 1120 that included a Schedule O that were filed using the Modernized e-File system from January 1 through June 30, 2007. (883/129,634)
3,092,000	Projected number of Form 1120 tax returns to be filed from 2008 through 2012 using the Modernized e-File system. (Projected number of tax returns based on IRS Office of Research Calendar Year Return Projections for the United States and IRS campuses CY 2007-2014 [Document 6186 (revised December 2007: 2008 – 364,900; 2009 – 508,100; 2010 – 640,300; 2011 – 747,100; 2012 – 831,600)
21,060	Projected number of Forms 1120 to be filed from 2008 through 2012 using the Modernized e-File system that will include a Schedule O. (3,092,000 x 0.6811%)
28.125%	Percentage based on a sample of Forms 1120 that included a Schedule O that were filed using the Modernized e-File system from January 1 through June 30, 2007, and were not identified for error correction. (18/64)
5,923	Projected number of Forms 1120 to be filed from 2008 through 2012 that might report incorrect apportionment information for taxpayers. (21,060 x 28.125%)

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 76,948 tax returns affected (see page 3).

Methodology Used to Measure the Reported Benefit:

Form 1120/1120S corporate tax returns filed through the Modernized e-File system that are converted to a different tax form type do not always include the correct received date in the Business Master File. The incorrect received date could result in a potential loss of interest, penalties, and assessments due to statute expiration. Based on the rate of occurrence from our sample of tax returns, 76,948 taxpayer accounts have the potential to include an incorrect received date in the Business Master File for tax returns filed from 2008 through 2012.

117,255	Projected number of Forms 1120/1120S to be filed from 2008 through 2012 that might be rejected in processing because the tax return type does not match the taxpayers filing requirement in the Business Master File. (See calculations for Taxpayer Burden outcome measure.)
65.625%	Percentage of tax returns based on our samples of the Forms 1120/1120S filed using the Modernized e-File system from January 1 through June 30, 2007, that were converted to a different tax form type and might not have the correct received date in the Business Master File. (42/64)



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76,948

Number of Forms 1120/1120S to be filed from 2008 through 2012 that have the potential to have an incorrect received date. (117,255 x 65.625%)



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Appendix V

Analysis of Modernized e-File Tax Return Sample

Tables 1 through 4 present the results of our analysis of corporation, partnership, and tax-exempt organization tax returns filed using the Modernized e-File system from January 1 through June 30, 2007.¹ The tables include the population of tax returns, the number of tax returns filed using the Modernized e-File system that did not have a matching return identification number in the Business Master File,² the number of returns with return differences between the Modernized Tax Return Database and the Business Master File, and the number of tax returns we reviewed in our samples.

We sampled the corporate, tax-exempt organization, and partnership tax returns with a 90 percent confidence level and a precision of 10 percent to determine the error rates in these populations. We also performed complete reviews of accounts with attributes such as tax return line item differences between the Modernized Tax Return Database and the Business Master File that were made up of relatively small populations. We used random sampling to ensure that each account had an equal chance of being selected, which enabled us to obtain sufficient evidence to support our results. The following tables include details about the sampling attributes we used to determine the reported error rates.

¹ The tax returns analyzed were filed using the U.S. Corporation Income Tax Return (Form 1120), the U.S. Income Tax Return for an S Corporation (Form 1120S), the Return of Organization Exempt From Income Tax (Form 990), the U.S. Return of Partnership Income (Form 1065), and the U.S. Return of Income for Electing Large Partnerships (Form 1065-B).

² See Appendix VII for a Glossary of Terms.



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**Table 1: Corporation Tax Returns Filed Using the Modernized e-File System
From January 1 Through June 30, 2007**

	Form 1120	Form 1120S	Totals for Form 1120/1120S
Modernized e-File Corporation Tax Returns Filed	129,634	471,349	600,983
Modernized e-File Corporation Tax Returns Not in the Business Master File	1,970	9,035	11,005
Sampled	71	53	124
Modernized e-File Corporation Tax Returns With Differences	5,413	5,249	10,662
Sampled	169	151	320
Total Modernized e-File Corporation Tax Returns Sampled	240	204	444

Source: Treasury Inspector General for Tax Administration extract of tax return account data from the Modernized Tax Return Database and the Business Master File for the period January 1 through June 30, 2007.

Sample Parameters:

- **Modernized e-File Corporation Tax Returns Not in the Business Master File** – We statistically sampled 41 Forms 1120 and 23 Forms 1120S using a 90 percent confidence level with a 10 percent precision. The remaining 30 Forms 1120 and 30 Forms 1120S were used as preliminary samples to review attributes of these tax returns. Because significant issues within these preliminary samples were not identified, no further testing was required.
- **Modernized e-File Corporation Tax Returns With Differences** – We statistically sampled 64 Forms 1120 using a 90 percent confidence level with a 10 percent precision. The remaining 105 Forms 1120 and 151 Forms 1120S were used as preliminary samples to review attributes of these tax returns. Because significant issues within these preliminary samples were not identified, no further testing was required.



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**Table 2: Partnership Tax Returns Filed Using the Modernized e-File System
From January 1 Through June 30, 2007**

	Form 1065	Form 1065B	Totals for Form 1065/1065B
Modernized e-File Partnership Tax Returns Filed	319,663	8	319,671
Modernized e-File Partnership Tax Returns Not in the Business Master File	548	0	548
Sampled Modernized e-File Partnership Tax Returns Not in the Business Master File	74	0	74
Modernized e-File Partnership Tax Returns With Differences	440	8	448
Sampled Modernized e-File Partnership Tax Returns With Differences	65	8	73
Total Modernized e-File Partnership Tax Returns Sampled	139	8	147

Source: Treasury Inspector General for Tax Administration extract of tax return account data from the Modernized Tax Return Database and the Business Master File for the period January 1 through June 30, 2007.

Sample Parameters:

- **Modernized e-File Partnership Tax Returns Not in the Business Master File** – We statistically sampled 61 Forms 1065 using a 90 percent confidence level with a 10 percent precision. We reviewed the remaining 13 Forms 1065 that were included in the Business Master File with a different return identification number.
- **Modernized e-File Corporation Tax Returns With Differences** – The 65 Forms 1065 and 8 Forms 1065B were used as preliminary samples to review attributes of these tax returns. Because significant issues within these preliminary samples were not identified, no further testing was required.



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Table 3: Tax-Exempt Organization Returns Filed Using the Modernized e-File System From January 1 Through June 30, 2007

	Form 990	Form 990EZ	Form 990PF	Totals for Form 990/990EZ/990PF
Modernized e-File Tax-Exempt Returns Filed	11,088	2,514	1,770	15,372
Modernized e-File Tax-Exempt Returns Not in the Business Master File	34	0	0	34
Sampled Modernized e-File Tax-Exempt Returns Not in the Business Master File	34	0	0	34
Modernized e-File Tax-Exempt Returns With Differences	381	93	17	491
Sampled Modernized e-File Tax-Exempt Returns With Differences	40	31	17	88
Total Modernized e-File Tax-Exempt Returns Sampled	74	31	17	122

Source: Treasury Inspector General for Tax Administration extract of tax return account data from the Modernized Tax Return Database and the Business Master File for the period January 1 through June 30, 2007.

Sample Parameters:

- **Modernized e-File Tax-Exempt Organization Returns Not in the Business Master File** – We reviewed all 34 Forms 990 that were included in the Business Master File with a different return identification number.
- **Modernized e-File Tax-Exempt Organization Returns With Differences** – The 40 Forms 990, 31 Forms 990EZ, and 17 Forms 990PF were used as preliminary samples to review attributes of these tax returns. Because significant issues within these preliminary samples were not identified, no further testing was required.



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**Table 4: Tax Returns Filed Using the Modernized e-File System
From January 1 Through June 30, 2007**

	Totals for Form 1120/1120S	Totals for Form 1065/1065B	Totals for Form 990/990EZ/ 990PF	Totals for All Modernized e-File Returns
Modernized e-File Tax Returns Filed	600,983	319,671	15,372	936,026
Modernized e-File Tax Returns Not in the Business Master File	11,005	548	34	11,587
Modernized e-File Sampled Modernized e-File Tax Returns Not in the Business Master File	124	74	34	232
Modernized e-File Tax Returns With Differences	10,662	448	491	11,601
Sampled Modernized e-File Tax Returns With Differences	320	73	88	481
Total Modernized e-File Tax Returns Sampled	444	147	122	713

Source: Treasury Inspector General for Tax Administration extract of tax return account data from the Modernized Tax Return Database and the Business Master File for the period January 1 through June 30, 2007.



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Appendix VI

Enterprise Life Cycle Overview

The Enterprise Life Cycle¹ is the IRS' standard approach to business change and information systems initiatives. It is a collection of program and project management best practices designed to manage business change in a successful and repeatable manner. The Enterprise Life Cycle addresses large and small projects developed internally and by contractors.

The Enterprise Life Cycle includes such requirements as:

- Development of and conformance to an enterprise architecture.
- Improving business processes prior to automation.
- Use of prototyping and commercial software, where possible.
- Obtaining early benefit by implementing solutions in multiple releases.
- Financial justification, budgeting, and reporting of project status.

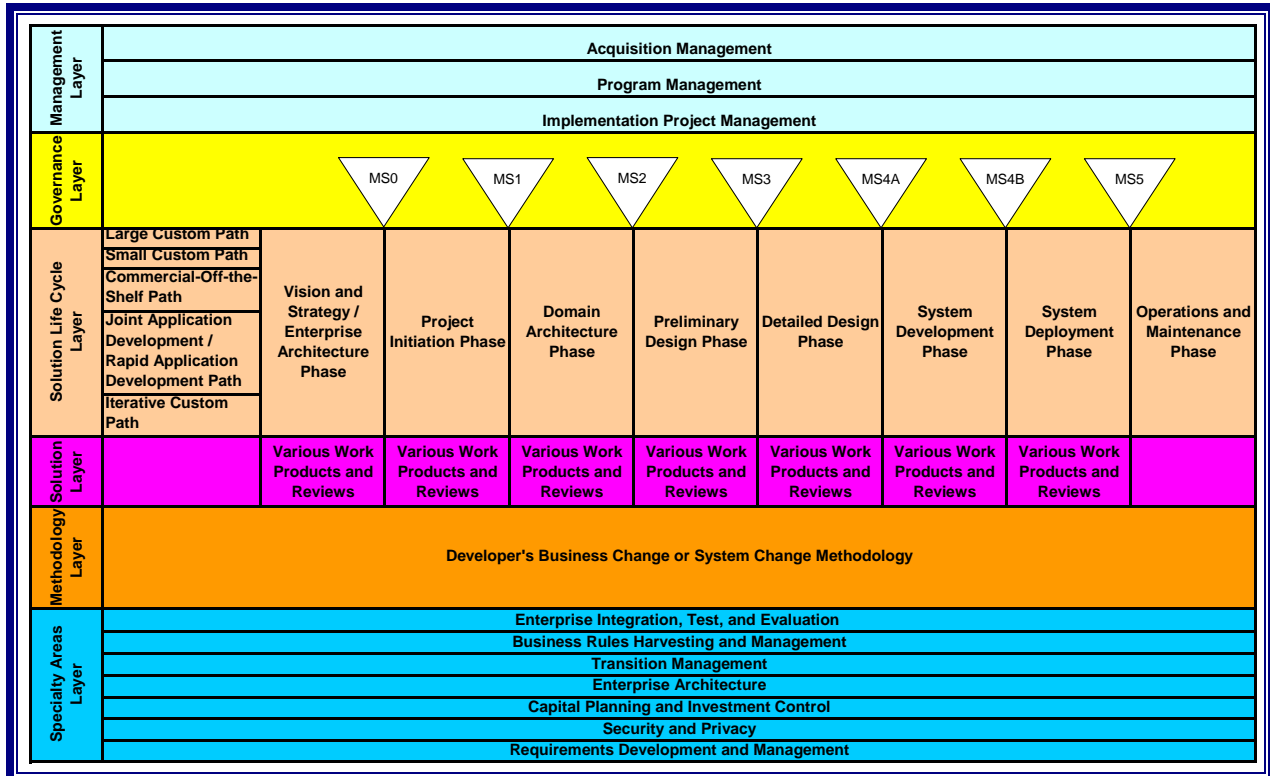
In addition, the Enterprise Life Cycle improves the IRS' ability to manage changes to the enterprise; estimate the cost of changes; and engineer, develop, and maintain systems effectively. Figure 1 provides an overview of the layers, paths, phases, and milestones (shown as "MS" in Figure 1) within the Enterprise Life Cycle Framework.

¹ See Appendix VII for a Glossary of Terms.



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Figure 1: Enterprise Life Cycle Framework



Source: Graphical representation of the Enterprise Life Cycle Framework modified from the Enterprise Life Cycle Guide.

Enterprise Life Cycle Layers

The Enterprise Life Cycle is a framework for organizing and using IRS directives, processes, procedures, templates, and standards to accomplish business change. It is organized as a set of six interacting layers.

- The **Management Layer** specifies how to plan and control business change programs, projects, acquisitions, and solutions throughout the Enterprise Life Cycle.
- The **Governance Layer** specifies additional controls imposed from outside the project or program.
- The **Solution Life Cycle Layer** specifies what should be done, but not how to do it.
- The **Solution Layer** manages the solution as it is produced, including providing standards for consistent solution specification and formal review of solution content.



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This Layer provides control over work products that may be produced by multiple internal and external developers using differing methodologies.

- The **Methodology Layer** details how to do the work and specifies a unique set of work products to be produced. Specific methodologies are not part of the Enterprise Life Cycle Framework.
- The **Specialty Areas Layer** provides additional guidance for areas of particular importance within the IRS. These areas include Enterprise Integration, Test, and Evaluation; Business Rules Harvesting and Management; Transition Management; Enterprise Architecture; Capital Planning and Investment Control; Security and Privacy; and Requirements Development and Management.

Enterprise Life Cycle Paths

A path specifies a unique “philosophy” or orientation for performing the work. Although the Enterprise Life Cycle specifies a standard for the work required to produce and operate business change solutions, there are multiple ways to approach and accomplish the required work. Paths are like alternate roads, each of which crosses different terrain, but all of which lead to the same destination. The Enterprise Life Cycle provides five distinct paths or approaches to developing systems:

- The **Large Custom Path** is for large projects.
- The **Small Custom Path** is for small projects.
- The **Commercial-Off-the-Shelf Path** is a commercial software-based approach.
- The **Joint Application Development/Rapid Application Development Path** is a highly accelerated, prototyping-based approach for very small, standalone solutions or solution components.
- The **Iterative Custom Path** is a hybrid approach that combines elements of the other approaches.

Enterprise Life Cycle Phases and Milestones

A phase is a broad segment of work encompassing activities of similar scope, nature, and detail and providing a natural breakpoint in the life cycle. Each phase begins with a kickoff meeting and ends with an executive management decision point (called a milestone) at which IRS executives make “go/no-go” decisions for continuation of a project. Project funding decisions are often associated with milestones.



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Figure 2: Enterprise Life Cycle Phases and Milestones

Phase	General Nature of Work	Concluding Milestone
Vision and Strategy/ Enterprise Architecture Phase	High-level direction setting. This is the only phase for enterprise planning projects.	0
Project Initiation Phase	Startup of development projects.	1
Domain Architecture Phase	Specification of the operating concept, requirements, and structure of the solution.	2
Preliminary Design Phase	Preliminary design of all solution components.	3
Detailed Design Phase	Detailed design of solution components.	4A
System Development Phase	Coding, integration, testing, and certification of solutions.	4B
System Deployment Phase	Expanding availability of the solution to all target users. This is usually the last phase for development projects.	5
Operations and Maintenance Phase	Ongoing management of operational systems.	System Retirement

Source: The Enterprise Life Cycle Guide.



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Appendix VII

Glossary of Terms

Term	Definition
Business Master File	The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
Business Systems Modernization	Begun in 1999, it is a complex effort to modernize IRS technology and related business processes.
Campus	The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
Computing Centers	Support tax processing and information management through a data processing and telecommunications infrastructure.
Employee User Portal	A web-hosting infrastructure that supports an Intranet portal that allows IRS employees to access business applications and data.
Enterprise Life Cycle	A structured business systems development method that requires the preparation of specific work products during different phases of the development process.
Federal/State Single Point Filing System	Permits tax return transmitters to submit multiple Federal and State tax return types within one electronic transmission and to receive acknowledgement of the transmission from the IRS.
Information Technology Asset Management System	Delivers an inventory system that enables tracking, reporting, and management of information technology assets.



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Term	Definition
Information Technology Modernization Vision and Strategy	Establishes a 5-year plan that drives investment decisions, addresses the priorities around modernizing front-line tax administration and supporting technical capabilities, and leverages existing systems (where possible) and new development (where necessary) to optimize capacity, manage program costs, and deliver business value on a more incremental and frequent basis.
Large and Mid-Size Business Imaging Network	The workload delivery system that captures scanned images of currently filed U.S. Return of Partnership Income (Form 1065) and U.S. Corporation Income (Form 1120) tax returns and delivers them to examiners in an electronic format. It also delivers Modernized e-File system tax returns.
Master File	The IRS database that stores various types of taxpayer account information. It includes individual, business, and employee plans and exempt organization data.
Modernized e-File Integration	A project to provide the IRS with convenient access to timely data from Modernized e-File system processed tax returns for classification, workload management, compliance research, examination, and other purposes.
Modernized Tax Return Database	The legal repository for original electronically filed tax returns received by the IRS through the Modernized e-File system.
Platform	A computer system on which application programs can run.
Portable Document Format	A fixed-layout document format used for representing two-dimensional documents in a manner independent of the application software, hardware, and operating system.
Release	A specific edition of software.
Returns Inventory and Classification System	Enables query, research, and reporting access to Return of Organization Exempt From Income Tax (Form 990) series Modernized e-File system data.



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Term	Definition
System Integration and Testing	Verifies that each individual work product (such as application software, technical infrastructure, facility, documentation, or training material) still meets requirements when integrated with the rest of the release and the business system.
Technology and Data Integration Plan	A comprehensive, working document in development by the Small Business/Self-Employed Business Division that will outline current business environment issues affecting the gathering, storage, manipulation, and presentation of electronic tax account and tax return information.



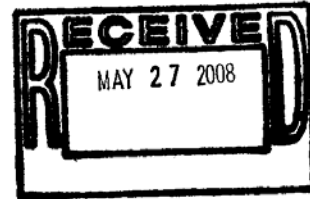
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Appendix VIII

Management's Response to the Draft Report



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



May 27, 2008

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Linda E. Stiff *Linda E. Stiff*
Deputy Commissioner Services and Enforcement

SUBJECT: Draft Audit Report – Improvements to the Modernized e-File
System Will Help Provide Intended Benefits to the Internal
Revenue Service and Taxpayers (Audit #200720035)

Thank you for the opportunity to review your draft audit report and to meet with the audit team to discuss earlier draft report observations. As a result of our meetings, the audit team has incorporated some of our suggestions into the draft report.

I appreciate your comments and observations that acknowledge the Modernized e-File (MeF) system's success in processing electronically filed tax returns for corporations, partnerships, and tax exempt organizations. I was pleased your report highlights the 127 percent increase in tax returns filed through the MeF system. Thank you for your thoroughness and your recognition of the functionality MeF provides our business operating units by making electronic data available for their varied uses.

I also acknowledge and appreciate the audit team's advice on ways to further improve the process. We agree with Recommendations #1 and #3, and the attachment to this memo details our planned actions to implement your suggestions. We partially agree with Recommendation #2 and have described in the attachment the actions taken to implement our solution.

Your continued support and the assistance and guidance your team provides have been a valuable resource to our business units. If you have any questions, please contact me at (202) 622-6860 or Perry Robinett, Director of Program Oversight, at (202) 283-6283.

Attachment



*Improvements to the Modernized e-File System
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Attachment

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RECOMMENDATION #1: The Commissioner, Wage and Investment Division, should require the Director, Submission Processing, and the Director, Electronic Tax Administration to develop a formal process for identifying, reporting, and resolving Modernized e-File system application processing issues that require subsequent tax return and account adjustment activity. This control process will provide a means for identifying significant Modernized e-File system tax return issues and provide the IRS with the ability to develop corrective actions. This control can also be used to notify IRS staff of processing issues to enable appropriate compliance actions.

CORRECTIVE ACTION #1: We agree with the recommendation. We will use the Wage and Investment (W&I) Submission Processing (SP) Hot Topics application, currently under development, to provide a mechanism for identifying, elevating, and resolving issues. In addition, as the SP Hot Topics evolve, we will determine how to gather and analyze the information to develop trends.

IMPLEMENTATION DATE: March 15, 2009

RESPONSIBLE OFFICIAL: Director, Submission Processing, W&I

CORRECTIVE ACTION MONITORING PLAN: We enter accepted Corrective Actions into the Joint Audit Management Enterprise System (JAMES). These Corrective Actions are monitored on a monthly basis until completion.

RECOMMENDATION #2: The Commissioner, Wage and Investment Division, should require the Director, Submission Processing, and the Director, Electronic Tax Administration, to perfect the validation controls to verify that taxpayers file the correct tax form based on their established filing election. After perfecting the control they should notify the Modernized e-File project team to implement the validation in processing tax returns through the Modernized e-File system. This control will prevent the Modernized e-File system from accepting the incorrect tax forms filed by taxpayers and, therefore, reduce the number of tax returns requiring Submission Processing function staff involvement.

CORRECTIVE ACTION #2: We agree with the recommendation for Forms 1065 and 1120 and have implemented the proposed validation controls.

We propose not implementing the validation control for Form 1120S at this time due to process and system limitations. Implementation of the proposed control at this time would prevent legitimate first-time Form 1120S filers from filing electronically. In cases where taxpayers are filing their first Form 1120S, the IRS may have accepted and processed the proper Form 2553 application, but the taxpayer's filing requirement is not



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updated until a Form 1120S is processed. The updating of the filing requirement is delayed to prevent an unpostable condition that would result from the filing of a final Form 1120 (after the acceptance of Form 2553).

IMPLEMENTATION DATE: January 1, 2008

RESPONSIBLE OFFICIAL: Director, Submission Processing, W&I

CORRECTIVE ACTION MONITORING PLAN: N/A

RECOMMENDATION #3: The Deputy Commissioner for Operations Support and the Deputy Commissioner for Services and Enforcement should ensure that the business operating divisions and the Modernization and Information Technology Services organization coordinate the capabilities of the Technology and Data Integration Plan initiative and the Enterprise Return Retrieval system into the Information Technology Modernization Vision and Strategy. Coordinating the Technology and Data Integration Plan and Enterprise Return Retrieval system with the Information Technology Modernization Vision and Strategy will help the IRS to achieve enterprise-wide capabilities for the identification, control, and analysis of electronic tax return and taxpayer account information for customer service and compliance purposes.

CORRECTIVE ACTION #3: We agree with this recommendation. Small Business/Self-Employed (SB/SE) submitted and prioritized the recently completed Enterprise Return Retrieval (ERR) Release 1 investment proposal as part of the Information Technology Modernization Vision and Strategy (MV&S) FY 2010 select cycle. SB/SE will also submit future releases of ERR as investment proposals for the corresponding MV&S select cycles. Full coordination with the Business Operating Divisions and MITS has taken place and will continue as ERR is an investment proposal for an enterprise solution for the retrieval and delivery of tax return data in a usable format to authorized users.

SB/SE is developing the Technology and Data Integration Plan (TDIP). The TDIP is the SB/SE organizational document that will communicate the planned approach for using technology to achieve SB/SE's business objectives and supporting organizational priorities. This plan is not an enterprise plan, but SB/SE will use it to collaborate with other Business Operating Divisions (BODs) and, where possible, maximize the application of technological initiatives.

IMPLEMENTATION DATE: December 1, 2008

RESPONSIBLE OFFICIAL: Director, Research, SB/SE



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3

Attachment

**Draft Audit Report – Improvements to the Modernized e-File System Will Help
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CORRECTIVE ACTION MONITORING PLAN: To coordinate the capabilities of the Technology and Data Integration Plan initiative into the Information Technology Modernization Vision and Strategy, SB/SE will complete the TDIP and will share it with the appropriate ESCs and Executive Advisory Boards during the appropriate MV&S cycle.