IRS Oversight Board
Electronic Filing 2006
Annual Report to Congress

February 2007

Executive Summary

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98) requires the IRS Oversight Board to submit to Congress an annual report on electronic filing. It addresses the progress the IRS is making toward meeting the electronic filing goal in RRA 98 and other related electronic tax administration (ETA) issues. A similar responsibility is shared by the Electronic Tax Administration Advisory Committee (ETAAC), whose members are chosen for their expertise in the electronic exchange of tax administration information. The Oversight Board used the 2006 ETAAC report submitted to Congress as a foundation for its report and offers additional perspective and strategic comments, including the Board's view of key ETAAC recommendations.

The Board believes that tapping electronic tax administration's full potential is key to modernizing the IRS. RRA 98 established the policy that paperless filing should be the preferred and most convenient means of filing federal returns. Moreover, it set an ambitious 80 percent electronic filing (e-file) goal for the IRS to achieve by the year 2007. In formulating its strategic plan for 2005-2009, the IRS went beyond return filing and promoted an even broader vision for electronic tax administration. It covers the major types of interactions that taxpayers have with the IRS and recognizes that such "e-government" efforts are a vital part of ultimately achieving the agency's broad strategic goals.

Based on actual return filing trends through calendar year 2006, the IRS will not meet the 80 percent e-file goal by 2007. Still, while falling short of the challenging target set by Congress, it is the Board's view that the IRS and its private sector partners have achieved continuous and significant progress over the years, very much in keeping with RRA 98's intent. This solid progress includes increased taxpayer usage of existing e-file and other electronic tax administration services, as well as the introduction of new "e-products."

For example, since the passage of RRA 98, overall e-file participation for individual income tax returns has increased every year — growing from around 20 percent in 1998, to about 54 percent in 2006. This includes the receipt of over 73 million individual e-file tax returns during the 2006 filing season and the second year in a row that the IRS has received more individual tax returns electronically than on paper. In addition, the IRS experienced significant growth in e-filing of corporate income tax returns, receiving over half a million such returns in filing year 2006 — more than double the 2005 volume. Just as importantly, in 2006 the IRS successfully implemented the first year of mandatory e-filing for the nation's largest corporations using its new modernized e-file platform.

Significantly, the Board is also pleased to report that the IRS continues to make progress in using electronic tax interaction with taxpayers to improve customer service. For example, visits to the IRS.gov web site increased nearly 10 percent in 2006, to more than 193 million visits. Meanwhile, the Government Accountability Office (GAO) reported that the IRS' 2006 reconfiguration of IRS.gov made it easier for taxpayers to locate items on the web site and contributed to a measurable increase in satisfaction among the IRS web site users, based on American Customer Satisfaction Index (ACSI) scores.

Nevertheless, the Board points out that the IRS still has a long way to go in achieving the 80 percent e-file goal in RRA 98 and the ETA vision articulated in the IRS strategic plan. Of particular concern is the actual decline in 2006 in the number of e-file returns received from individual taxpayers who self-prepared their taxes. The drop can be attributed in part to the IRS' decision to discontinue the Form 1040EZ TeleFile program while simultaneously being unable to migrate a large number of these former TeleFile users to the alternative Free File program. Also contributing to the weak 2006 numbers in self-prepared e-file returns was the new $50,000 adjusted gross income (AGI) limit for Free File eligibility. It prompted a 23 percent drop in the number of e-file returns received through Free File, according to the Treasury Inspector General for Tax Administration (TIGTA). The Board will pay particular attention to these areas during the 2007 filing season to see if the setbacks in 2006 were largely a one-time event, or signs of a more troubling trend.

On the plus side, the Board believes that the 80 percent e-file goal set by RRA 98 has been a major contributing factor to the growth in electronic filing, which in turn has resulted in substantial resource savings for the IRS and burden reduction for taxpayers. It is the Board's view that having clearly-defined and measurable long-term goals galvanizes attention and fosters consideration of new strategies by both the IRS and key external partners in tax administration. Therefore, the Board recommends that Congress revise current law to extend the 80 percent e-file target to the year 2012.

In particular, the Board recommends that Congress and the President enact into law a specific long-term e-file measure and goal the IRS proposed this past summer. This proposal would set a goal that 80 percent of all major tax returns filed by individuals, businesses and tax-exempt entities be transmitted electronically to the IRS by the year 2012. By broadening the proposed e-file measure to also include major business and tax exempt returns, the IRS increased the challenge it would set for itself — a test the Board sees as difficult but achievable. By adopting this long-term but realistic goal, Congress will ensure the agency's commitment and raise the probability of attaining the desirable 80 percent e-file rate.

The Board also offers its views on the eight key recommendations highlighted in the 2006 ETAAC report to Congress. Some of the more controversial include e-file mandates for tax practitioners, upgrades to the legacy computer systems for individual e-file returns, and the elimination of the special filing extension for information returns transmitted electronically.

With regard to e-file mandates, the Board does not recommend that Congress enact specific mandates for preparers of individual returns. Rather it suggests that Congress simply repeal the prohibition and grant the IRS the discretion to implement such mandates at a future point in time — but only after certain conditions are met. These should include a requirement that the IRS first thoroughly exploit all reasonable incentives it has to promote greater voluntary participation in e-file before imposing any mandates on preparers. The Board does not want mandates to become a substitute for making electronic filing more convenient and attractive.

The conditions should also include a requirement that before implementing any such e-file mandate for individual returns, the IRS must carefully examine the potential burden on the preparer community. As is conveyed in various charts and other information presented in the Board's report, the tax preparer community has been a major contributor to the success in e-file to date. The data also show that broadly-defined mandates could have an impact on a large number of preparers in a manner disproportionate to the additional e-file returns generated. In addition, while the Board agrees that mandates for tax practitioners could be used to quickly and substantially reduce paper return volumes and further the attainment of the 80 percent e-file goal, they would have no effect on the significant volume of paper returns currently filed by individual taxpayers who self-prepare their taxes.

The ETAAC report also recommends that should the transition to the new modernized e-file (MeF) computer platform be deferred beyond the year 2008, the IRS make upgrades to the existing electronic management system (EMS) currently used by the IRS to receive e-file individual returns. The Board notes that there has been congressional recognition of the importance of moving ahead with the IRS Business Systems Modernization (BSM) initiatives relating to the MeF platforms for electronically-filed returns. The Board continues to encourage Congress to allocate adequate IRS funding for such mission-critical information technology initiatives. However, in the event the IRS is unable to provide a modernized e-file system for individual income tax returns by 2008, the Board expects that the IRS will follow the new approach to technology investment decisions articulated in its *IT Modernization Vision and Strategy* in determining whether to upgrade the EMS legacy application.

The ETAAC further recommended that those who file information returns electronically, such as Forms W-2 and 1099, should be required to submit their data to the IRS (or the Social Security Administration in the case of Forms W-2) by the end of February, the original due date for such filings. Presently, those who e-file such information returns are afforded a one-month extension to file, typically until the end of March. The Board notes that, under RRA 98, this filing deadline was extended as an incentive to entice more filers to use electronic transmissions; a result that has now been largely achieved. However, should the due date be moved back to February, the IRS and the SSA must be certain that their e-file systems for information returns have the capacity to handle potentially higher peak volumes.

The Board's comments on the other key ETAAC recommendations are contained in Section IV. The Board joins ETAAC in encouraging the IRS and Congress to continue to take actions that increase the degree to which tax administration matters are handled in a secure electronic environment.

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I. Introduction

Under the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98), the IRS Oversight Board is required to submit this annual report to Congress addressing the progress the IRS is making in meeting the electronic filing goal specified in RRA 98 and other related issues. A similar responsibility is also shared by the Electronic Tax Administration Advisory Committee (ETAAC), whose members are chosen for their particular expertise in the electronic exchange of tax administration information.[1]

The Oversight Board regards the ETAAC as an expert resource on the matter of electronic tax administration and does not wish to duplicate its efforts. Rather, the Oversight Board has used the 2006 ETAAC report submitted to Congress as a foundation from which to offer additional perspective and strategic comment, including the Board's view of key recommendations put forth by the ETAAC.

II. Importance of Electronic Tax Administration

1. Key to Making the IRS a Modern Institution

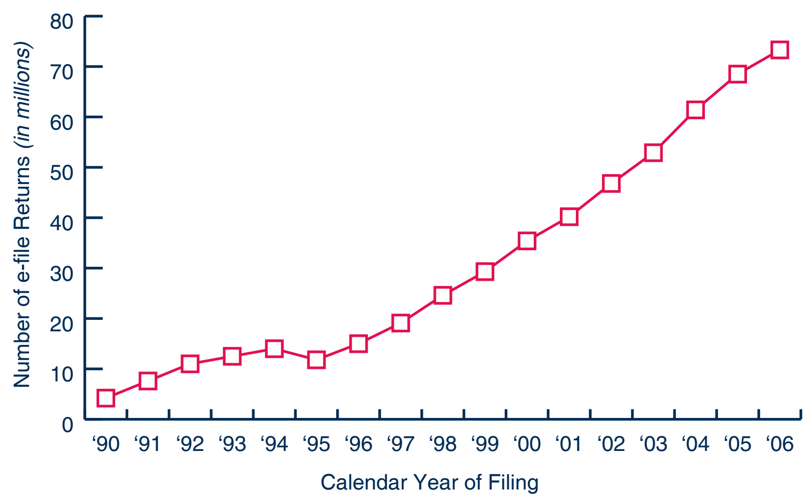
Tapping the full potential of electronic tax administration is key to modernizing the IRS. The enactment of RRA 98 established the explicit policy that paperless filing should be the preferred and most convenient means of filing federal returns. In addition, the *IRS Strategic Plan 2005–2009* promotes an even broader vision for electronic tax administration. It establishes numerous objectives and strategies designed to expand opportunities for taxpayers to receive tax assistance, update their account information, file and pay their taxes, all electronically — and in support of the IRS' strategic goals to improve taxpayer service, enhance enforcement and modernize its processes.[2]

In a similar vein, the Government Accountability Office (GAO) has testified how "e-government" can build better relationships between government and the general public by facilitating timely and efficient interactions with citizens.[3] In addition, the IRS, in collaboration with the Oversight Board and the National Taxpayer Advocate, is completing work on its Taxpayer Assistance Blueprint (TAB) — a comprehensive five-year plan for improving customer service that includes better electronic self-service options.[4] There is no doubt that to carry out federal policy on electronic filing and to satisfy taxpayer needs and expectations, the IRS must more vigorously pursue electronic tax administration options.

2. Recent Progress

Overall, the IRS is making solid progress in furthering electronic tax administration, both in terms of increased taxpayer usage and the introduction of new and useful products. For example, as shown in Figure 1, the IRS continues to experience growth in the total number of individual income tax returns filed electronically, with over 73 million e-file returns received during the 2006 filing season. As noted in the ETAAC report, this reflects the second year in a row that the IRS received more individual tax returns electronically than on paper.[5] The IRS will record an e-file participation rate of approximately 54 percent for individual return filings in calendar year 2006, up from about 51 percent for 2005.

Figure 1: **TOTAL INDIVIDUAL E-FILE TAX RETURNS**



Source: IRS

The IRS also experienced significant growth in e-filing of corporate income tax returns, receiving over half a million such returns in filing year 2006 — more than double the 2005 volume. Just as importantly, the IRS was also successful in implementing the first year of mandatory e-filing for the nation's largest corporations. Using its new modernized e-file platform, and the active engagement of private sector partners, the IRS smoothly processed more than 12,500 tax returns in 2006 from corporations with $50 million or more in assets.[6]

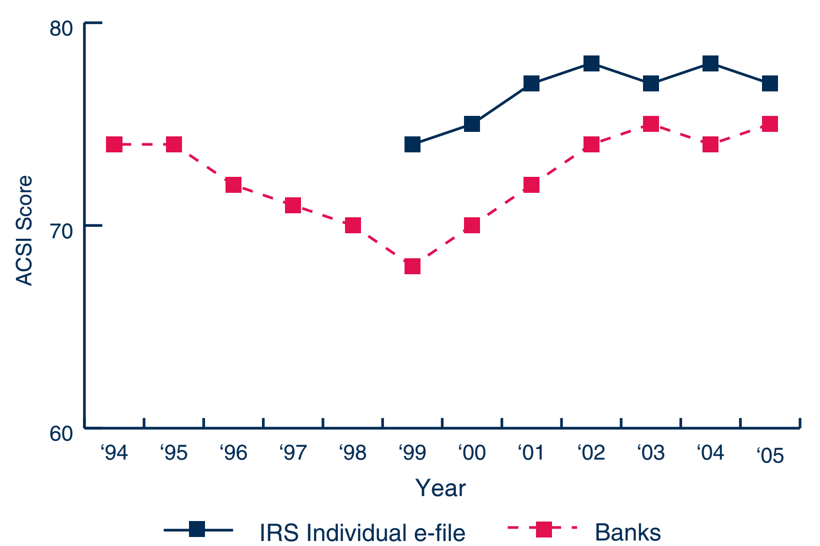
In addition, the IRS continues to make progress in using electronic interactions with taxpayers as a key to better customer service. For example, the IRS reported that visits to its IRS.gov web site increased nearly 10 percent in 2006, to more than a record 193 million visits. In the process, taxpayers increased their use of the IRS online tool to check on the status of their refunds by nearly 12 percent in 2006, with 24.7 million such inquiries in 2006 compared to 22.1 million in 2005.[7] Not surprisingly, an Oversight Board survey in early 2006, *Taxpayer Customer Service and Channel Preference Survey Special Report*, found that a quarter of U.S. taxpayer households had visited the IRS web site at least once within the last two years.[8]

A good example of expanded IRS electronic service offerings came in October 2006 when the IRS announced its new online payment agreement application. Using IRS.gov, many individuals who owe delinquent taxes are now able to apply online for a payment agreement — including an option to set up a monthly payment plan. The application allows eligible taxpayers to self-qualify, apply for, and receive immediate notification of approval.[9] The GAO also reported in its audit of the 2006 filing season that the IRS' recent reconfiguration of IRS.gov made it easier for taxpayers to locate items on the web site and also contributed to a measurable increase in satisfaction among IRS web site users, based on American Customer Satisfaction Index (ACSI) scores.[10]

3. Resource Savings and Customers Satisfaction with e-File

The increased use of electronic filing has generated meaningful benefits to both the IRS and taxpayers. As the GAO noted in its report on the 2006 filing season, the growth in individual electronic filing resulted in significant cost savings. Since 1999, the IRS eliminated approximately 1,600 staff years and closed two processing centers for paper tax returns, with a third one scheduled to close in 2007. Meanwhile, customer satisfaction with individual electronic filing remains quite high. As shown in Figure 2, satisfaction with electronic filing among individuals (measured by the ACSI scores) remains higher than that of overall customer satisfaction with banks.[11]

Figure 2: **AMERICAN CUSTOMER SATISFACTION INDEX SCORES**



Source: www.theacsi.org

4. Vision of a Highly Electronic Tax Environment Remains Unfulfilled

Clearly, the IRS has made significant strides in advancing electronic tax administration in general, and e-filing in particular. However, the agency still has a long way to go to meet RRA 98's e-file goal or the vision articulated in the IRS strategic plan. Existing e-file trends, while encouraging, imply a longer time horizon for reaching the 80 percent goal. Also, the 2006 Oversight Board survey of taxpayers revealed that virtually all who visited the IRS web site over the prior two years did so solely to gather information. Only two percent of taxpayers who visited the IRS web site did so for account management matters, such as the need to resolve a tax dispute or respond to an IRS notice.

In addition, a review by TIGTA found that the IRS' decision to discontinue the Form 1040EZ TeleFile program at the end of the 2005 filing season did not subsequently lead to the large migration of these taxpayers to the Free File program for which the IRS had hoped.[12] Instead, the IRS now estimates that more than half of the former 3.3 million electronic filers who used TeleFile reverted back to filing paper returns in 2006.[13] TIGTA also concluded that the new $50,000 adjusted gross income (AGI) limit on Free File eligibility implemented in 2006 led to a 23 percent drop in the number of e-file returns received through the Free File program during the 2006 filing season.

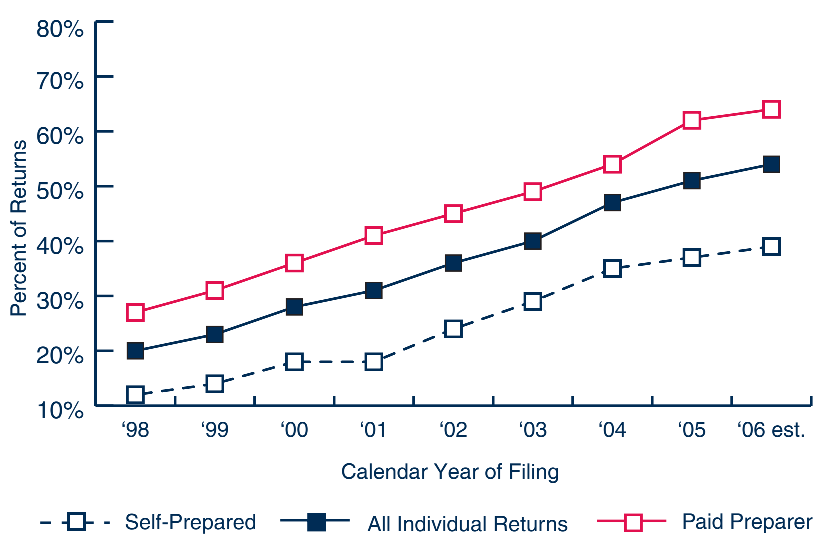
III. Electronic Filing Goal and Trends

1. RRA 98 e-File Goal

RRA 98 established a goal that at least 80 percent of all tax returns should be filed electronically by the year 2007. That goal will not be met. However, while falling short of the ambitious target set in 1998, it is the view of the Board that the IRS, in partnership with private sector stakeholders, has achieved continuous and significant progress over the years, very much in keeping with the RRA 98 intent.

Figure 3 provides some perspective on the degree to which taxpayers and their representatives have increased e-file participation overall. The data in the chart present the e-file rate for all individual returns, along with the corresponding rates among the subsets of returns prepared by paid tax professionals versus those self-prepared by taxpayers.[14]

Figure 3: **PERCENT OF INDIVIDUAL RETURNS FILED ELECTRONICALLY**



Source: IRS

Since the passage of RRA 98, overall e-file participation for individual income tax returns increased every year — growing from around 20 percent in 1998, to about 54 percent in 2006. E-file participation is higher among individuals who use tax professionals than for taxpayers who self-prepare their returns. For example, the e-file rate for preparer returns is around 64 percent in 2006, compared to about 39 percent for self-prepared returns. This is one indication of the added support for e-file coming from the preparer community. Still, both segments show continued progress toward greater e-file participation.

There has also been a steady upward trend in the share of returns prepared on a computer (i.e., using tax preparation software) that are ultimately filed electronically — which was another RRA 98 intent. When the Act was passed in 1998, only about 30 percent of all individual returns prepared using tax software were actually e-filed. By 2006, that share has doubled to approximately 63 percent.

2. The Value of Extending the 80 Percent Electronic Filing Goal

As noted in its 2005 e-file report, the Board believes that the 80 percent e-file goal set by RRA 98 has been a major contributing factor to the increase in electronic filing and that this growth, in turn, has resulted in substantial resource savings for the IRS and burden reduction for taxpayers. The GAO pointed out that:

> *Long-term goals that are focused on results or outcomes are critical for holding agencies accountable and helping agencies and Congress make strategic trade-offs … Long-term goals can help an agency meet its goals by setting targets and providing incentives to meet them …*[15]

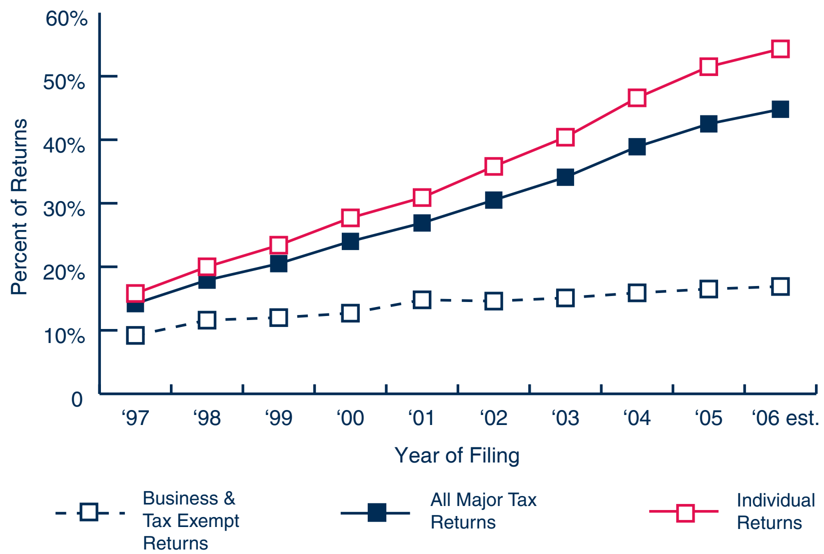
However, since the IRS will not likely attain the 80 percent e-file goal by 2007, the Board again encourages Congress to amend current law to extend the target date to a more realistic future point in time. As the GAO, the Board and other key stakeholders have noted, having clearly defined and measurable long term goals galvanizes and focuses attention on new strategies by the IRS and key external tax administration partners. In addition, such a goal enacted into public law places real-world pressures on the IRS to produce and should promote more strategic and disciplined management decisions.

3. Board Recommends Congress Extend the 80 Percent e-File Goal to 2012

In last year's e-file report, the Board recommended that the 80 percent e-filing goal be extended to the year 2011. That revised target date focused on e-filing of individual income tax returns, and was recommended as a realistic time frame based on the assumption that the IRS and its electronic filing partners could maintain the steady growth in e-file participation experienced from 1999 to 2005. However, since last year's report, Congress has yet to act and the Board subsequently modified its recommendation. The Board now recommends that Congress reset the 80 percent e-file goal for the year 2012.

The reason behind this change is the development of an enterprise-wide, long-term measures package the IRS proposed to the Board in 2006. It would be used to evaluate the IRS' progress in achieving the strategic goals established in its strategic plan.[16] This package of long-term measures included one specifically for e-file — 80 percent of all major tax returns filed electronically by individuals, businesses and tax exempt entities by the year 2012. Although there are far more individual income tax returns filed in any given year, compared to the major business/tax exempt return filings (around 133 million versus 46 million based on filings for 2005), e-file participation is significantly lower among the latter — as shown in Figure 4.

Figure 4: **PERCENT OF MAJOR TAX RETURNS ELECTRONICALLY FILED**



Source: IRS

The Board views such realistic long-term goals as more effective and that by extending the 80 percent e-file goal to 2012, Congress would establish just such a standard — one that also matches the challenging goal the IRS has proposed for itself. In turn, this action should ensure the agency's commitment and raise the probability of attaining the desirable end state of 80 percent of all major tax returns filed electronically.

4. An 80 Percent e-File Goal by 2012: Challenging Yet Attainable

There is little doubt that achieving an 80 percent e-file rate for all major tax returns by the year 2012 would be a major test for the IRS. As indicated in Figure 4, the e-file rate for all major returns is nearly 10 percentage points lower than the current e-file rate for individual returns alone (i.e., approximately 45 percent versus 54 percent, respectively). This translates to a substantially lower "starting point" for attaining such a new goal. Also, merely continuing the historical growth trend in e-file participation from the past six years, over the succeeding six, would result in an e-file rate of only around 66 percent for all the major tax returns by 2012. Thus, the proposed goal would promote development of a more aggressive strategy.

In addition, the IRS may face in the years ahead a sustained slowdown in the growth rate for individual e-filing. Individual e-file has been in place for two decades and the IRS may encounter difficulties as it tries to draw additional electronic filers from the remaining pool of paper return filers. The Board's *Taxpayer Customer Service and Channel Preference Survey* lends further credence to this potential problem. It found that 30 percent of taxpayers strongly agreed or somewhat agreed with the statement "I don't feel comfortable filing my taxes electronically."

Signs of a slowdown in electronic filing among individual taxpayers are also present in the e-file results for 2006. As noted by the GAO in its report on the 2006 filing season, the year-over-year percentage growth in individual electronic filing slowed to a level lower than any of the previous three years. It is clear that the IRS and its external partners must devise effective strategies to shrink the pool of individuals reluctant to e-file if they are to have any hope of attaining the 80 percent goal by 2012.

Still, while a major challenge, reaching 80 percent e-file participation for all major tax returns by 2012 seems achievable. For example, the IRS has yet to even offer an e-file option for some major business return types, such as excise tax returns. In addition, as delineated in the 2006 ETAAC report to Congress, the system for filing individual income tax returns is an older legacy computer application with some known limitations that deter e-file participation. However, IRS plans in the immediate years ahead to expand its modernized e-file (MeF) platforms to accept more types of business returns electronically, and to replace and upgrade its e-file system for individual returns to make it more customer-friendly. As it does so, these new MeF developments should facilitate even greater e-file participation.

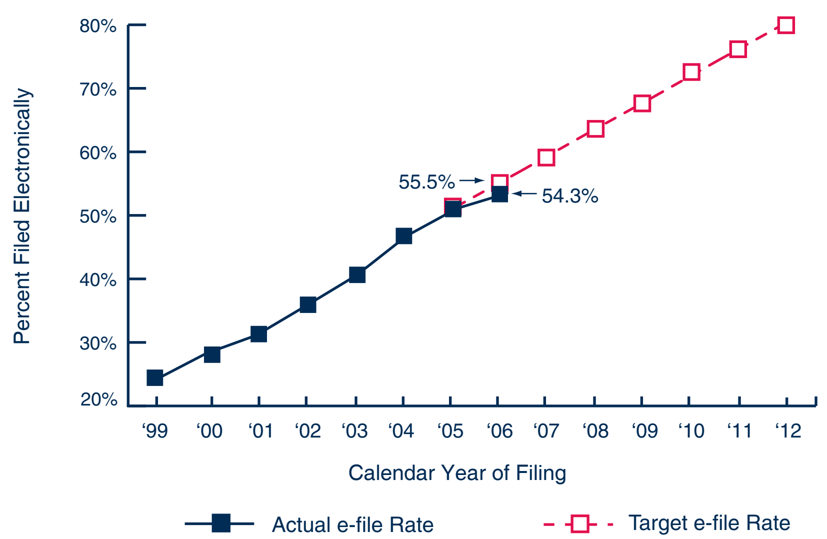
Also, the slowing of the growth in the individual e-file volume in 2006 may be more of a one-time event tied to the termination of the Form 1040EZ TeleFile program and the new AGI eligibility threshold for the Free File program rather than a fundamental change in the underlying upward trend in the e-file participation rate.

Furthermore, available IRS data indicate that the vast majority of individual income tax returns are already prepared on a computer using tax preparation software. Based on a sample of returns filed through the end of August, well over 85 percent of all individual income tax returns filed in 2006 were initially prepared on a computer — including approximately 98 percent of individual returns filed via paid preparers.[17] Because the vast majority of individual tax returns already exist in an electronic format, finding new strategies to turn significantly more of these returns into actual e-file transmissions seems plausible and something that the IRS and industry could realistically accomplish during the years leading up to 2012. This, in turn, would go a long way in meeting an 80 percent e-file goal by 2012. Such strategies could include new incentives and/or filing options for taxpayers who prepare their returns using tax software. It might even warrant e-file mandates for certain paid preparers of individual returns — as discussed further in the section concerning comments on the ETAAC recommendations.

5. Annual Tracking of the Goal Based on Individual Tax Returns
In last year's report, the Board presented a table showing how the historical trend in the individual e-file rate (i.e., the percent of individual tax returns filed electronically) exhibited a steady growth rate. That table also provided the Board's estimates of how that trend line would grow through the year 2011 — based on a least squares regression analysis. To help track this important outcome measure on an annual basis, the Board now offers in Figure 5 a revised version of that trend pattern which can help monitor the IRS progress in attaining the 80 percent goal relative to individual returns.

Using 2012 as the new target date and 2005 as the base point for measuring progress, Figure 5 presents the linear trend line in e-file participation for the years 2006 through 2012 needed to attain the 80 percent goal by the final target year. Against this target trend line is also plotted the actual 2006 experience (derived from results covering most of the calendar year). As indicated in Figure 5, the actual e-file rate for 2006 is below the Board's target level by about one net percentage point (i.e., 54.3 percent versus 55.5 percent, respectively). In preparing updates of this chart in future reports, the Board will be interested to see how subsequent actual results track against this targeted trend line and whether the IRS made up the 2006 shortfall, or fell further behind the target e-file levels.

Figure 5: **INDIVIDUAL E-FILE RATE: ACTUAL VS. TARGET (FOR 80% BY 2012)**



Source: IRS Oversight Board analysis

IV. Comments on the ETAAC Key Recommendations

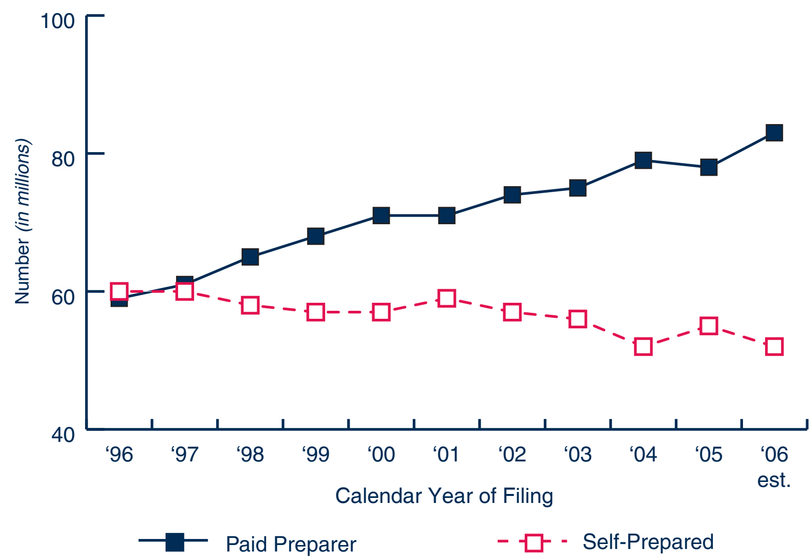
1. Call for e-File Mandates for Tax Practitioners

For the past three years, the ETAAC has recommended in its annual report to Congress that e-filing by tax practitioners be mandated. The GAO recently joined in that recommendation, stating in its recent report on the 2006 filing season that Congress mandate electronic filing by paid preparers who meet such criteria as filing a certain number of tax returns. The GAO notes that the IRS has already used mandates to require large corporations to file electronically, and that twelve states have e-file mandates for paid preparers of state tax returns. However, as the GAO further observes, the IRS is prohibited by law from requiring electronic filing of income tax returns for individuals, estates and trusts — hence the ETAAC and GAO recommended that Congress change the law and approve such mandates.

Both the ETAAC and the GAO cite the benefits to be gained by the IRS from e-file mandates. According to the 2006 ETAAC report, if all tax practitioners e-filed the returns they prepared, the IRS would receive around 28 million fewer paper returns and realize a more than 75 percent electronic filing participation rate. Similarly, the GAO stated that if 90 percent of returns submitted on paper by paid preparers were filed electronically, the IRS would save about $68 million per year.

Federal e-file mandates for return preparers would also likely generate future additional benefits since the share of returns filed with the help of paid preparers is growing and is likely to continue. Figure 6 presents data from 1996 to 2006 on the number of individual tax returns filed with a paid preparer signature versus the number of self-prepared returns. As is apparent, the share of individual income tax returns filed through paid preparers grew fairly steadily over the past decade — from around 50 percent in 1996 to about 60 percent in 2006.

Figure 6: **NUMBER OF INDIVIDUAL RETURNS FILED USING PAID PREPARERS VS. SELF-PREPARED**



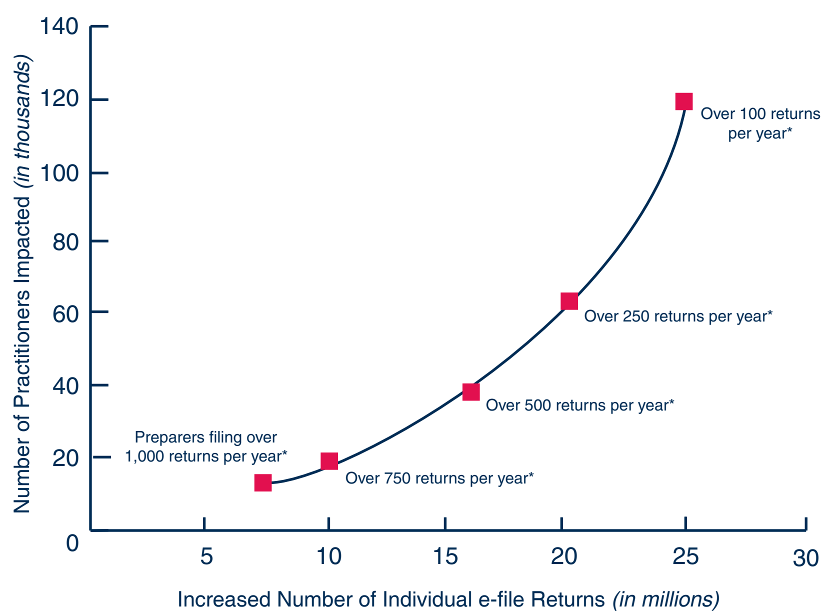
Source: IRS

State e-file mandates differ, but typically require tax practitioners who prepare over a certain number of state tax returns per year (e.g., over 100), to file those returns electronically. Recent tabulations compiled by IRS staff provide further insight into how many tax practitioners/firms would be affected by a comparable federal e-file mandate on preparers of individual returns, at alternative threshold levels. These calculations include the associated increases in the number of e-file returns that would be expected.[18] The results are presented in Figure 7.

As indicated in Figure 7, a federal e-file mandate for tax professionals who prepare over 1,000 individual returns annually, a relatively high threshold in terms of the size of the preparer/firm, would apply to about 11,000 tax practitioners and generate around seven million additional electronic filings — or about a quarter of the roughly 28 million paid preparer returns currently filed on paper. In contrast, an e-file mandate for those preparing over 100 returns per year, a relatively low mandate threshold, would have an impact on around 124,000 paid preparers/firms and result in nearly 25 million more individual e-filed returns — or nearly 90 percent of the volume of paper returns currently filed by tax professionals.

As is also revealed by the curve depicted in Figure 7, the relationship between the number of preparers affected by a federal e-file mandate for individual returns and the additional e-file returns generated is non-linear (i.e., not a straight line). As the threshold is lowered, the percentage increase in tax practitioners affected is higher than that of additional e-file returns generated. For example, lowering the mandate threshold from preparers submitting over 250 returns per year, to those filing over 100 returns per year, increases the number of tax preparers affected by nearly 90 percent (from about 66,000 to 124,000), while increasing the additional e-file volumes by only about 25 percent (from 20 million to 25 million).

Figure 7: **TRADE OFF BETWEEN PRACTITIONERS IMPACTED AND E-FILE VOLUMES INCREASED UNDER ALTERNATIVE E-FILE MANDATE THRESHOLDS***



* Each data point represents an alternative e-file mandate threshold, based on size of preparer, as noted in chart.

Source: IRS

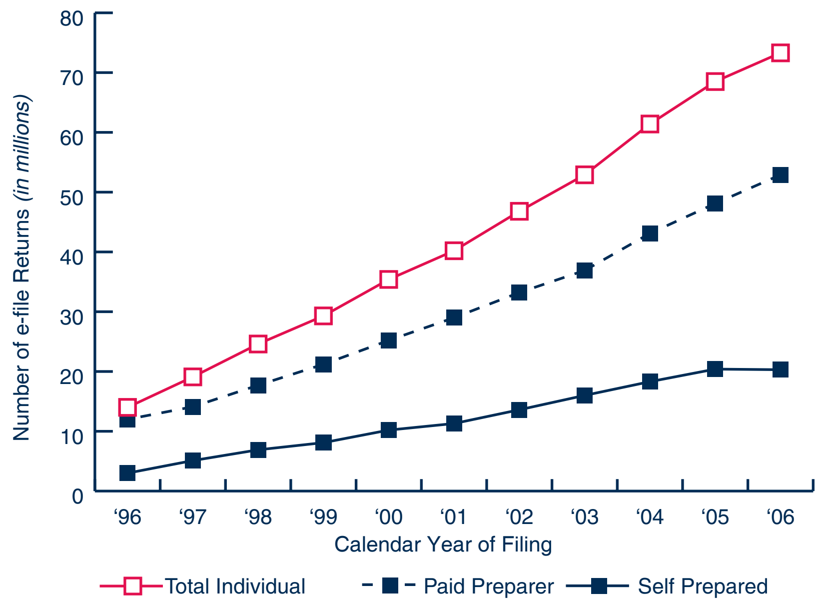
Should Congress want to quickly and substantially increase the number of e-filed tax returns in pursuit of the 80 percent goal, mandates for paid return preparers of individual returns would clearly be an effective choice. As regards the specific recommendation put forth by the ETAAC, the Board joins it in recommending congressional action. However, rather than proposing that Congress enact specific mandates for preparers of individual returns, the Board would recommend instead that Congress simply repeal the prohibition and grant the IRS the discretion to implement such mandates at a future point in time — but only after certain conditions are met.

These conditions should include a requirement that before imposing any mandates on preparers, the IRS first thoroughly leverage all reasonable incentives to create greater voluntary e-file participation. The Board does not believe that mandates should become a substitute for making electronic filing more convenient and attractive. In addition, a substantial share of paper returns (over 30 million in 2006) are self-prepared and mandates for preparers will do nothing to address the gap in electronic filing among these taxpayers. Rather, new strategies to generate greater e-file participation among self-preparers will also be needed.

The Board further believes that before any mandates are allowed, Congress should require the IRS to carefully examine their potential burden on preparers. That analysis should include a solid rationale for the mandate threshold selected, in light of the tradeoff between the number of preparers affected and the additional e-file returns generated. The examination should also address whether the new Form 1040 MeF platform — with its more customer-friendly computer technology — should first be in place before the IRS considers implementing any mandates.

While mandates may appear to be a “silver bullet,” it is also worth noting that the slower growth in the number of electronically-filed individual returns in 2006, as compared to recent prior years, is largely attributable to a decline in the number of e-file returns from taxpayers who self-prepared their returns. The number of self-prepared returns filed electronically fell from 20.4 million in 2005, to 20.3 million in 2006 (see Figure 8). By contrast, the number of e-file returns submitted by tax practitioners grew about 4.8 million in 2006 to around 52.9 million, about the same growth as in the prior year.

Figure 8: **NUMBER OF INDIVIDUAL E-FILE RETURNS BY PREPARATION METHOD**



Source: IRS

Admittedly, it is also true that the growth in e-file returns from tax practitioners at the federal level in recent years was boosted by e-file mandates imposed by certain states including California, New York and Michigan. But nevertheless, the recent e-file experience among self-preparers still points to the need for the IRS and its business partners to devise additional e-file strategies aimed at restoring and ultimately increasing e-file participation among key taxpayer segments who are not served by the preparer community, and whose rate of e-file participation is less than two-thirds of those who use professional return preparers.

2. Upgrades to Legacy System if Form 1040 MeF Deferred Beyond 2008

If the transition to the new MeF computer platform is deferred beyond the year 2008, the ETAAC recommends that upgrades be made to the existing electronic management system (EMS) currently used to file individual returns electronically. The upgrades sought by the ETAAC would allow for additional forms to be filed electronically and add other functionality that would encourage greater e-file participation.

The Board notes that there is recognition in Congress of the importance of moving ahead with the IRS Business Systems Modernization (BSM) initiatives relating to the MeF platforms for electronically filed returns. In particular, the FY2007 Senate Appropriation Committee report for the IRS states that:

> *Based on the views of the GAO and the IRS Oversight Board, the Committee has included an additional $32,690,000 for the BSM program. The Committee directs that these additional funds be used for the Modernized e-File program based on the recommendation of the IRS Oversight Board.*[19]

The Board continues to encourage Congress to allocate adequate IRS funding including the BSM resources needed for a new IRS e-file system for Form 1040 series returns by 2008. However, for a Form 1040 MeF system to be available by 2008, Congress would have to appropriate additional funds for that BSM component in fiscal year 2007. In the event the IRS does not receive the funding and is unable to provide a modernized e-file system for individual income tax returns by 2008, the Board would expect the IRS to follow its new approach to technology investment decisions, as articulated in its *IT Modernization Vision and Strategy*, in deciding whether to upgrade the EMS legacy application, or not.[20]

3. IRS and SSA Need to Collaborate to Improve Information Exchange

The ETAAC recommends that the IRS and the Social Security Administration (SSA) collaborate more closely and improve how they exchange information returns and the timeliness of those exchanges. The ETAAC wants to make it easier for electronic transmitters of information returns to use both the SSA and the IRS applications, and to increase the number of such transmitters.

The Board supports more IRS collaboration with the SSA that creates opportunities for further innovation in electronic services to taxpayers. However, that support is conditioned on both agencies remaining vigilant in properly protecting taxpayer data and the associated computer systems.

4. Eliminate the Special Filing Extension for Information Returns Filed Electronically

The ETAAC further recommends that those who file information returns electronically, such as Forms W-2 and 1099, should be required to submit their data to the IRS (or the SSA in the case of Forms W-2) by the end of February, the original due date for such filings. Currently, those who e-file such information returns are afforded a one-month extension to file, typically until the end of March. The ETAAC maintains that the earlier February date would give the IRS more time to process the data and eventually open up opportunities for new e-services to taxpayers in the future.

The Board observes that this filing deadline was extended for electronic filers as part of RRA 98 and was intended as an incentive to attract more filers to use electronic transmissions. That result has been largely achieved. Since the passage of RRA 98, there has been an approximate six-fold increase in information returns filed electronically with the IRS (up from the 121.5 million received in 1999 for tax year 1998) — and exclusive of the Form W-2 data supplied to the SSA.[21] As a result, it appears to the Board that the need for the extension as an inducement to e-file has been greatly reduced. However, the IRS should work closely with information return providers to ensure the elimination of the extension does not entail excessive burden on the transmitters or result in reduced quality information reporting. Also, should the due date be moved back to February, the IRS and the SSA must be certain that their e-file systems for information returns have the capacity to handle potentially higher peak volumes.

5. Support for the Free File Agreement Amendment Effective in 2006

The ETAAC expresses support for the Free File Agreement Amendment that became effective with the 2006 filing season. The report notes that while the new agreement limits eligibility to those taxpayers with an adjusted gross income under $50,000 in tax year 2005, it still provides coverage for 70 percent of all individual taxpayers. (The eligibility threshold is raised to $52,000 for tax year 2006 returns to be filed in calendar year 2007.) The ETAAC also states that the new agreement addresses several previous program shortcomings relative to privacy, security, disclosure and quality, and lays the groundwork for significant future e-file growth.

The Board supports the Free File program and the benefits it conveys to many taxpayers, particularly those affected by the elimination of the Form 1040EZ TeleFile program. However, the Board is also concerned by the more than 20 percent decline in overall Free File volumes in 2006 as compared to 2005, particularly since the termination of TeleFile should have significantly boosted the number of Free File users. The Board will be monitoring to see if Free File resumes an upward filing trend in 2007.

The Board notes that Members of Congress have also pointed to shortfalls in the Free File program during the 2006 filing season.[22] However, the Board was pleased to see that the IRS and its private sector partners have since addressed one particularly troublesome area: the recently announced agreement to remove ancillary offerings such as Refund Anticipation Loans (RALs) from the Free File program.[23] The Board commends the IRS and industry for this decision and urges them to continue to work together to resolve as many of the other identified problems as possible.

6. Retain the Debt Indicator

The ETAAC report states that a significant number of taxpayers like bank products such as RALs and refund deposit accounts which in turn help drive e-file growth. The report further states that the “debt indicator” is needed to continue the public’s access to these bank products.[24] Through the e-file return acknowledgement process, the IRS notifies transmitters as to whether an anticipated refund will be offset to repay certain delinquent debts. As a result, the ETAAC recommends that the debt indicator be preserved and enhanced in a manner that could lower the costs of these bank services to taxpayers.

It appears to the Board that the elimination of the debt indicator would make RALs more risky — a condition that would neither serve borrowers nor lenders. If additional regulations of RALs are desired, this would best be accomplished without making them more risky, which would only increase the costs to those taxpayers who received them. It is the Board's view that the most straightforward and desired approach to reducing the number of RALs is to replace as quickly as possible the antiquated IRS Master File system with the new Customer Account Data Engine (CADE) so the IRS could issue refunds more quickly, thereby reducing the demand for RALs.

7. Treat Electronic Systems at the IRS as Mission Critical

The ETAAC report states that the growth in e-filing and e-services requires that the IRS take corresponding steps to ensure that electronic systems are treated as mission critical. In particular, the IRS must provide the capacity, availability, security and recoverability for these electronic systems in a manner consistent with expectations in industry-standard on-line environments.

The Board agrees with the ETAAC that the IRS computer systems providing e-filing and e-services are mission critical and the key to the IRS becoming a modernized institution. The IRS should afford these systems all the capabilities and security consistent with industry standards. Just as importantly, Congress should provide the IRS with adequate information technology funding to enable them to do so.

8. Preserve Taxpayers' Ability to Share Their Return Information

The ETAAC agrees with the need to modernize existing privacy rules under Internal Revenue Code (IRC) Section 7216 to protect taxpayer data and ensure taxpayer consent before any return information is disclosed to a third party. However, it recommends that any revisions to these rules continue to allow taxpayers to make this type of election, without overburdening the process with unnecessary paperwork.

The Board recognizes that the existing privacy rules under IRC Section 7216 were written long before today's widespread use of information technology and require updating. However, the primary consideration in updating these rules should be the protection of the taxpayers' privacy rights, and not the need to become a driver of electronic filing. The 80 percent e-file goal cannot be achieved by sacrificing taxpayer privacy.

V. Conclusion

Creating a tax administration system in which all taxpayer interactions with the IRS are predominantly electronic is key to making the Internal Revenue Service a modern, 21st Century agency. Congress provided the initial impetus with the passage of the IRS Restructuring and Reform Act of 1998 and the establishment of the challenging goal of an 80 percent e-file rate by the year 2007.

Although the IRS will not meet the deadline for this aggressive goal, it has nonetheless made solid and noteworthy progress towards it. Today, more than half of individual taxpayers file their taxes electronically. In addition, electronic tax administration now figures largely in all of the agency's present and planned future activities and is a critical element of its strategic plans and for providing greater efficiencies in a time of tight budgets. The e-file goal established in RRA 98 almost a decade ago was clearly a major reason for the success to date.

A similar view was echoed in a recent case study of the IRS e-file program completed by Stephen H. Holden, Ph.D., of the University of Maryland, in which he noted:

> *[T]he congressional attention and support surrounding the attainment of the goal would appear to be an important factor in the improvements in e-file between 1999 and 2006. It is that rate of improvement that makes IRS e-file such a compelling case for deeper understanding in the hopes that other federal agencies might replicate some of IRS's success.*[25]

However, as discussed in this report, the IRS must build on this success. Many challenges and much hard work remain. Along with Business Systems Modernization, the IRS must seek and execute new strategies and incentives to bring those remaining taxpayers and practitioners into the e-file ranks.

The Board also firmly believes that the RRA 98 e-file goal has proven its effectiveness and value and can continue to do so in the future. To this end, the Board recommends that Congress extend the 80 percent goal to the more realistic 2012 target. If the IRS and all interested parties stay focused and committed to that goal, the Board is convinced that it can be achieved.

Endnotes

1. United States Congress, Report 105-599. “Internal Revenue Service Restructuring and Reform Act of 1998,” June 24, 1998.
2. Internal Revenue Service, “IRS Strategic Plan: 2005–2009,” Publication 3744 (revised 6-2004).
3. Government Accountability Office, Testimony Before the House Government Reform Subcommittee on Technology and Procurement Policy, Electronic Government (GAO-02-1083T), September 18, 2002.
4. Internal Revenue Service, IRS Oversight Board and National Taxpayer Advocate, “The 2006 Taxpayer Assistance Blueprint: Phase I,” April 24, 2006, Publication 4525 (revised 4-2006).
5. Electronic Tax Administration Advisory Committee, “Annual Report for Congress: June 2006,” Publication 3415 (revised 6-2006).
6. IRS Press Release (IR-2006-147), “More Than 12,500 Large Corporations E-filed 2005 Tax Returns in First Year of New Requirement,” September 20, 2006.
7. Internal Revenue Service, “Fiscal Year 2006 Enforcement and Service Results: Statement by IRS Commissioner Mark W. Everson,” November 20, 2006.
8. IRS Oversight Board, “Taxpayer Customer Service and Channel Preference Survey: Special Report,” November 2006.
9. IRS Press Release (IR-2006-159), “IRS Announces Online Payment Agreement Application,” October 16, 2006.
10. Government Accountability Office, “Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings (GAO-07-27),” November 2006.
11. Source for ACSI Scores: www.theacsi.org, retrieved 12-4-2006. It should also be noted that the ACSI scores for IRS individual e-file cover only one type of customer transaction, whereas the overall ACSI scores for banks reflect an assessment of the full range of transactions offered by these financial institutions. Thus, care should be taken when interpreting the comparison shown in Figure 2.
12. Treasury Inspector General for Tax Administration (TIGTA), “Use of the Free File Program Declined After Income Restrictions Were Applied “(Reference Number 2006-40-171), September 29, 2006.
13. Internal Revenue Service, “Calendar Year Return Projections for The United States and IRS Campuses,” Document 6186, (revised 11-2006).
14. Data were compiled from various IRS sources including selected editions of the SOI [Statistics of Income Division] Bulletin, IRS weekly filing season reports, Calendar Year Projections of Individual Returns by Major Processing Categories (IRS Document 6187), and the SOI Taxpayer Usage Study (TPUS). Some of these data are based on sampling, reflect estimation from partial year data, or entail other caveats. As a result, data in Figure 3 should be interpreted as approximations.

15. Government Accountability Office, “Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Tax Administration: IRS Improved Some Filing Season Services, but Long-Term Goals Would Help Manage Strategic Trade-offs” (GAO-06-51), November 2005.
16. Internal Revenue Service memorandum from Deputy Commissioner for Operations Support, to IRS Oversight Board Chairman, dated May 31, 2006.
17. Based on the “SOI Tax Year 2005 Taxpayer Usage Study” (Report Number 15), which reflects a representative sample of individual returns filed between January 1 and August 25, 2006.
18. Based on IRS data for filings in calendar year 2005 as compiled for the Oversight Board by staff in the Office of Research, Small Business/Self-Employed Division.
19. United States Senate, Report 109-293, Transportation, Treasury, Housing and Urban Development, The Judiciary, and Related Agencies Appropriations Bill, 2007, July 26, 2006.
20. Internal Revenue Service, “Internal Revenue Service IT Modernization Vision & Strategy,” October 2006, Document 12417 (10-2006).
21. Based on actual and projected IRS data on electronic information return volumes as prepared by IRS staff within the Research, Analysis and Statistics organization.
22. Associated Press, “Senators Criticize IRS Filing Program,” November 2, 2006.
23. IRS Press Release (IR-2006-187), “RALs Removed on Free File; 93 Million Eligible for Program,” December 5, 2006.
24. Although not explicitly stated in its report, the ETAAC likely addressed this issue in response to proposed Senate Bill S. 324 (“Taxpayer Abuse Prevention Act”) which included a provision requiring termination of the debt indicator program.
25. Stephen H. Holden, “Innovation Series: IBM Center for The Business of Government, A Model for Increasing Innovation Adoption: Lessons Learned from the IRS e-file Program,” 2006.