

Electronic Filing  
**Annual Report to Congress**





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## Introduction

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98) requires the IRS Oversight Board to submit an annual report to Congress that addresses progress the IRS is making on meeting the electronic filing goals established by the RRA 98, and related issues.

The Electronic Tax Administration Advisory Committee (ETAAC), whose members are chosen for specific electronic tax administration expertise, also has the responsibility to submit a similar report. The Oversight Board does not wish to duplicate the effort of ETAAC, whose members were chosen for their expertise in electronic filing issues. The Oversight Board regards the ETAAC as an expert resource on matters relating to electronic tax administration, and has used the ETAAC report as input from which to make broad programmatic recommendations based on enterprise-wide business considerations.



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## The Importance of Electronic Tax Administration

Title II of the RRA 98 provided the IRS with the following policy statement with respect to electronic filing:

1. Paperless filing should be the preferred and most convenient means of filing federal tax and information returns;
2. It should be the goal of the Internal Revenue Service to have all returns prepared on computer filed electronically by 2003, and at least 80 percent of all returns filed electronically by the year 2007; and
3. The Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of such returns.

The view of the IRS Oversight Board, as shared by the ETAAC, is that the purpose of these goals is to encourage the IRS to use electronic means of tax administration to deliver improved service to taxpayers. Just as many private sector institutions, especially financial institutions, have moved towards increased delivery of customer services by electronic means, the establishment of goals for electronic filing was intended to push the IRS to do likewise.

The benefits of electronic filing go beyond the cost savings realized by the IRS in processing electronic returns, and include burden reduction for both the taxpayer and the IRS. Once procedures are established, electronic filing offers taxpayers and practitioners a convenient way to submit returns to the IRS, with acknowledgement of receipt by the IRS. Because e-filed returns, with the exception of TeleFile returns, are prepared on computers using tax software, the possibility of math errors is greatly reduced. Manual transcription of data from paper returns by the IRS is no longer required, which eliminates errors caused by this labor-intensive process. The elimination of these types of errors reduces the opportunity for time-consuming and burdensome post-filing enforcement activity, such as responding to incorrect notices sent to taxpayers caused by errors introduced during tax return processing.

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## Results of the 2002 Filing Season

The 2002 filing season resulted in a 6.5 million increase in e-filed individual tax returns over 2001, for a total of 46.3 million e-filed returns as of May 30, 2002. This represents a 16.3 percent increase over 2001, which was the first filing season to fall short of projections for individual tax returns. Individual segments experienced the following change:

- On-line filing increased 38.8 percent
- Practitioner e-filing increased 14.3 percent
- Tele-file use decreased by 4.5 percent, continuing a trend started in 1998

Because e-filing growth fell in 2001, the growth rate for e-filing in 2002 took on added significance. Although the growth rate exceeded projections, it did not return to the 20 percent growth rate of the 1998 to 2000 period, and did not grow sufficiently to offset the slow growth of 2001. The ETAAC projects that at the rate of increase experienced over the past two years, it appears the IRS will not achieve the goal of 80 percent e-filing by 2007 and will fall short of the goal to achieve 100 percent e-filing of computer-prepared returns by 2003. In 2002, only approximately 50 percent of computer-prepared returns were electronically filed. Attracting the first 46 million e-filers was relatively easy compared to what it will take to attract the next 66 million, required to meet the 80 percent goal by 2007.

Table 1 shows this year's e-filing growth in the context of the five-year pattern of electronic filing. The trend is toward lower annual growth rates in e-filing than was experienced in the early years of the program and the number of returns filed via TeleFile continues to decrease. The ETAAC offers two explanations for the slower growth. First, as the base of total filers and e-filers grows, the number of new e-filers needed to sustain the same growth rate increases. Second, the filers most easily attracted to e-filing have now made the switch from paper filing—the more difficult target population remains to be converted.

The ETAAC identified the following programs that it believed spurred the growth of individual e-filing during the 2002 tax filing season:

- Increased national and local marketing
- Improved availability and convenience
- Expanded State/Federal e-filing
- Practitioner Personal Identification Number (PIN) Program



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**Table 1. Five-year Growth of Electronic Filing for Individuals Tax Returns (in millions)**

Year	Total Returns	On-line Returns <sup>1</sup>	Practitioner Returns	TeleFile Returns	Total Electronic Returns	Percent Returns E-filed	Percent Growth of E-Filed Returns
2002	132.7*	9.3	32.8	4.2	46.3*	34.9	16.3
2001	130.3	6.8	28.7	4.4	39.9	30.5	13.4
2000	127.4	5.0	25.0	5.2	35.2	28	20.8
1999	124.9	2.4	21.1	5.7	29.3	23	20.1
1998	122.5	0.9	17.6	5.9	24.4	20	25.1

(\*Actual through 5/31/02)

With respect to e-filing of business returns, the ETAAC reported that business return e-filing levels are relatively low and e-filing is not yet available for many business return forms. However, the IRS' business e-file initiatives that have been implemented generally have been well received, particularly where the e-file process added value and did not increase administrative burden or cost. For example, the Form 1065 partnership return e-filing program is popular with many practitioners, growing at a rate of 16 percent per year.

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<sup>1</sup>On-line filers are taxpayers who prepare and e-file their own returns using tax software.

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## Discussion of Last Year's Recommendations

In its 2001 report to Congress, the IRS Oversight Board generally agreed with the ETAAC's recommendations, and made recommendations on three strategic issues raised by the ETAAC in its 2001 report:

- An extended filing and payment deadline for e-filing
- Registration of all practitioners
- A tax credit for e-filing of individual tax returns

The Oversight Board's recommendations made last year and the current status of these recommendations are discussed in the subsequent paragraphs.

Both ETAAC and the Oversight Board supported an extended due date for individual e-filers. The Board believed that of the three strategic issues identified above, this one had the highest potential for raising e-filing levels. The Administration has now supported this recommendation and provisions to extend the due date for electronic filers were included in H. R. 586, which has passed the House of Representatives and is awaiting Senate action.

ETAAC recommended the registration of all tax preparers and the Board recognized the potential this recommendation has for serving the public good, but noted the impacts goes beyond the scope of electronic filing, and should be discussed in a broader forum. Although this recommendation has not been included in this year's ETAAC report, the Oversight Board believes that a broad discussion of this idea between Congress and affected stakeholders is warranted. Because all Electronic Return Originators (EROs) must register with the IRS, the intent of this recommendation could be achieved to the extent that the vast majority of tax practitioners register as EROs.

Although the ETAAC recommended a tax credit for individual e-filers, the Board saw this as the most costly recommendation to implement, which should be considered only after other options are given an opportunity to produce the desired result. This recommendation was not included this year's ETAAC report, and has not been supported by this Administration.

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## Recommendations for Further Action

The IRS Oversight Board believes that the goals established in the RRA 98 are strong, positive motivators for focusing IRS efforts and developing innovative e-filing products, and they continue to serve their intended purpose.

The Oversight Board recognizes the effort the IRS has put into making e-filing a more convenient and attractive option for taxpayers, and acknowledges the positive effect the goal has had on the IRS in the last several years. The Board also recognizes that little information was available when the goal was initially set, and there is still little information known about the level of e-filing that is truly attainable. Because of the positive impact that the e-filing goal has had on the IRS, the Oversight Board does not believe the goal needs to be reset at this time, and the IRS should be encouraged to pursue its e-filing goals vigorously. The Oversight Board believes that ultimately the 80 percent goal for e-filing is attainable, although the timetable of 2007 may not be.

The Oversight Board believes that the key to successful e-filing is to make electronic tax administration the logical and smart decision for taxpayers, practitioners, and businesses. Continuing to make e-filing attractive for all taxpayers involves offering new products, making progress with the Business Systems Modernization (BSM) program, and introducing process changes.

New initiatives to broaden e-filing are considered as part of the IRS strategic planning and assessment process. The Oversight Board participates in this process and approves the IRS budget submissions to the Treasury Department, and supports the expansion of e-filing so that virtually all filing and payment transactions between taxpayers and the IRS can be made using a convenient, cost-effective electronic method. Moreover, the Oversight Board also recognizes that the efforts to increase e-filing levels are linked to some extent to the BSM program, and the speed of e-filing growth is related to the speed at which the BSM program is implemented.

Within the next several years, the Oversight Board expects that the following changes, which are now being considered or are under development, will combine to offer powerful new incentives for e-filing. These changes are:

- The implementation of the EZ File initiative to offer free tax preparation and e-filing to over 78 million taxpayers.

- An extended due date for electronic filing that will encourage taxpayers who owe money to the IRS to file electronically, and motivate tax practitioners to enroll as Electronic Return Originators (EROs) to offer this service to their clients.
- The implementation of the Customer Account Data Engine project that will provide e-filers who receive direct deposit to have their refunds available to them in three to five days after filing, thus providing more incentive to file electronically and lowering the cost of rapid refunds by significantly lowering the need to use expensive Refund Anticipation Loans (RALs).

These enhancements represent, respectively, a change in business practice, tax policy, and IRS technology. Collectively, they will combine their effects to increase the convenience and lower the cost of e-filing. Further enhancements beyond these can do even more to encourage e-filing.

However, there are three recommendations in the ETAAC report that are particularly broad in scope. The Oversight Board would like to highlight these recommendations because of their significance, the effect these recommendations may have beyond e-filing, and the need for these three recommendations to receive a thorough analysis of the cost and benefits associated with them.

#### ***EZ File initiative***

On July 31, 2002, the Treasury and the Office of Management and Budget (OMB) announced a proposed new agreement that would provide easy, secure, and free opportunities for as many as 78 million Americans to file their taxes via the Internet at no cost. The impetus for the proposed agreement came as a result of the EZ Filing initiative proposed earlier in the year by the OMB. The agreement will be with a consortium of private sector companies that will work together to offer free online tax filing services, and could benefit some 60 percent of taxpayers. Taxpayers will find links to the online tax filing services through a single, centrally-located Web portal at [www.irs.gov](http://www.irs.gov) and available through [www.firstgov.gov](http://www.firstgov.gov).

The proposed agreement is expected to produce the following advantages for both taxpayers and the IRS:

- 78 million taxpayers will no longer have to pay to file their tax returns online. Currently, taxpayers who choose to file online can pay an average of \$12.50 in filing fees in addition to the cost of purchasing tax preparation software.
- Taxpayers who file electronically will get their refund checks twice as fast on average as those who file on paper.
- Electronic filing reduces government processing costs and improves efficiency.

The Oversight Board fully supports this initiative and expects that it will encourage millions of taxpayers who self-prepare their returns to take advantage of these free services. The agreement opens up new avenues of cooperation between the IRS and the tax software industry that the Oversight Board expects will have long-term benefits.

***Extended due date for e-filed returns***

The Administration has proposed an extended due date of April 30th for individual taxpayers that file electronically. The concept of an extended due date for electronic filers goes back at least to 1997 when it was recommended by the National Commission on Restructuring the IRS.

One reason for this extended due date is that a notable advantage for e-filers is the speed of the refund, an advantage that will increase as the IRS implements new systems allowing it to issue refunds even faster to electronic filers. However, the advantage of a rapid refund is meaningless to taxpayers that owe a balance due to the IRS, approximately 30 percent of the filing population. A due date of April 30th to file and pay income taxes for electronic filers is expected to create some benefit for this segment of the filing population. A requirement to be eligible for the extension is that taxpayers will also have to pay electronically.

The Oversight Board fully supports the Administration proposal to extend the filing date to April 30th for electronic filers, and expects this change, in conjunction with other major changes in e-filing, will attract additional taxpayers to electronic filing, and, more importantly, will attract more practitioners to become EROs so they can offer this service to their clients.

***Modernized e-filing systems***

The ETAAC has recommended that the IRS modernize its e-file platform for both individual and business returns. Its report states that modernization of the 1040 e-file platform is critical to ensuring that the IRS can meet future e-file performance commitments, provide faster acknowledgments and improve services to self-filers and practitioners, and points out that the existing 1040 family e-filing platform was built in the mid-1980s. This platform is not capable of supporting the future volumes and required functionality of e-filing, including online, interactive e-filing services.

The ETAAC has made a parallel recommendation for the IRS business e-filing platform. It recommends that the IRS develop e-filing capabilities for business returns that focus on products that capture the highest volume first, so that limited resources are allocated to the areas of greatest benefit. Programs to date have focused on electronic transmission of payroll reports and related payments, fiduciary income tax returns (form 1041 and related K-1's) and partnership income tax returns (form 1065 and related K-1's).

The Oversight Board believes, much like ETAAC, that the goal for business e-filing is to provide an environment in which all business transactions with the IRS can be done in a convenient and cost-effective electronic transaction.

This pair of recommendations, to modernize the individual and business e-filing platforms, further illustrates the linkage between the BSM program and electronic tax administration. The speed at which new electronic tax administration products and services can be rolled out to service both individuals and businesses is directly related to the progress of the BSM program. The Oversight Board believes that the BSM program needs to be accomplished as quickly as possible, within the constraints of good management. Full funding for this program will speed the implementation of products and services needed to create the electronic tax administration environment that will make e-filing attractive to individuals and businesses.

The Oversight Board encourages the IRS to continue to “think outside the box” and develop products that deliver improved levels of service and offer inducements to use electronic services. The ETAAC report contains a wide variety of recommended actions that can be used to spur the growth of e-filing. Virtually all of its recommendations can be categorized as making e-filing the logical and smart decision for taxpayers, and they seem consistent with the IRS’ existing program to modernize its electronic tax administration services. Without endorsing the individual recommendations, the Oversight Board supports the goal of making electronic filing easier for taxpayers, and encourages the IRS to give the ETAAC recommendations due consideration as it modernizes. The Oversight Board encourages the IRS to adopt these recommendations where it is cost-effective and within the authority of the IRS to do so.

There is one item that the ETAAC addressed for which the Oversight Board would also recommend caution. The ETAAC recommended that the IRS should assess the feasibility and costs, both to the IRS and the software development industry, of requiring software developers to include a two dimensional (2D) barcode printing facility in their tax software. The Oversight Board believes the use of the 2D barcode, while making paper returns easier to process, may also impede the growth of e-filing. Although states have had some success with 2D barcodes, the Oversight Board believes the ETAAC is correct when it suggests that the full costs and other liabilities for using this technique in the federal environment need to be understood prior to any consideration of asking software developers to include this capability in their products.

One initial application of 2D barcodes that may warrant evaluation is the use of 2D barcodes on information returns, such as forms W-2 and 1099, so that tax practitioners could scan information from these forms and save data entry. An application such as this could encourage e-filing because tax practitioners have noted that e-filing requires additional data entry from these forms compared with paper filing. If such an application proves feasible, the IRS and industry could then take the next step of evaluating the use of 2D barcodes on the form 1040 tax return.

Lastly, the Oversight Board believes Congress was wise not to attempt to achieve high levels of electronic filing through the broad use of mandates on professional tax practitioners or taxpayers. In many cases, the imposition of mandates relieves the implementing agency from considering convenience and service as the primary drivers for using electronic systems, and the concept of providing better customer service becomes overshadowed by the mandate. The Oversight Board does not believe that mandates would be an effective way at this time for the Congress to achieve higher levels of e-filing, especially with the new initiatives being introduced in the next several years.



For more information, please contact:

IRS Oversight Board  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220  
Ph: 202-622-2581