

Electronic Filing
Annual Report to Congress

November 2003



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I. 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 electronic tax administration expertise, also has the responsibility to submit a similar report. The Oversight Board regards ETAAC as an expert resource on matters relating to electronic tax administration, and does not wish to duplicate its effort. The Board has used the ETAAC report as input from which to make broad strategic recommendations based on enterprise-wide business considerations.

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II. 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. The goal of the Internal Revenue Service to have at least 80% of all such 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.

These goals are intended to encourage the IRS to use electronic means of tax administration to deliver improved service to taxpayers. Just as many private sector institutions, especially in the financial services industry, have increasingly moved towards delivery of customer services by

electronic means, these goals are 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. They include burden reduction for both the taxpayer and the IRS. Electronic filing offers taxpayers and practitioners a convenient way to submit returns to the IRS, with acknowledgement of receipt by the IRS. Compared with the processing of paper returns, the possibility of errors is greatly reduced, which in turn reduces the occurrence of burdensome post-filing enforcement activity, such as responding to notices sent to taxpayers caused by errors introduced during tax return processing.

Savings in IRS tax processing costs are being realized as well. The IRS will close its Brookhaven paper processing pipeline in 2003 and plans to close the Memphis paper processing pipeline in 2005. As electronic filing continues to grow, additional closings are expected.

III. Results of the 2002 Filing Season

Individual Tax Returns

The 2003 filing season resulted in a 5.8 million increase in e-filed individual tax returns over 2002, for a total of 52.2 million e-filed returns as of June 30, 2003. This represents a 12.5 percent increase over 2002. The IRS projected that a total of 53.8 million returns would be electronically filed in 2003, so the result achieved was 97 percent of projections. ETAAC reported that individual segments experienced the following changes:

- On-line filing increased 26.8 percent
- Practitioner e-filing increased 10.6 percent
- Tele-file use decreased by 4.8 percent, continuing a trend started in 1998

Table 1 illustrates this year's e-filing growth in the context of the five-year pattern of electronic filing. Based on the trends experienced during this period, the ETAAC reports that it believes the IRS will not achieve the goal of 80 percent e-filing by the year 2007. The ETAAC further states that attracting the first 50 million e-filers was relatively easy compared to what it will take to attract the next 60 million or more e-filers needed to meet the 2007 goal of 80 percent.

The Board believes that growth rates experienced in the last three years are likely to continue unless some new incentives are implemented. Section 5 discusses some additional incentives that may serve to increase the growth rates contained in Table 1.

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

Year	Total Returns	On-line Returns ¹	Practitioner Returns	TeleFile Returns	Total Electronic Returns	Percent Returns E-filed	Percent Growth of E-Filed Returns
2003 ²	124.1	11.8	36.4	4.0	52.2	42.1	12.5
2002	131.7	9.4	33.1	4.2	46.7	35.5	16.4
2001	131.0	6.8	28.9	4.4	40.1	30.6	13.3
2000	128.4	5.0	25.2	5.2	35.4	27.6	20.8
1999	126.0	2.4	21.2	5.7	29.3	23.3	20.1

Note 1: On-line returns are filed by taxpayers who prepare their returns using tax software and then file the returns electronically using the features of the tax software product. **Note 2:** 2003 return numbers are through 6/27/03 and the percentage growth is based on a comparison to the same period in 2003.

In 2003, one new development for individual taxpayers was the formation of the Free File Alliance, LLC, a private-sector consortium of tax software companies that entered into an agreement with the federal government to provide free tax preparation and electronic filing to qualified taxpayers. This opportunity was targeted primarily at taxpayers who prepare their own taxes without the assistance of a tax professional. Each consortium member established its own taxpayer eligibility requirements, which generally were based on factors such as age, adjusted gross income, state residency, military status or eligibility to file a Form 1040EZ or for the Earned Income Tax Credit.

ETAAC reports that of the 11.8 million taxpayers who filed returns on-line, approximately 2.7 million were prepared and e-filed using Free File. This program had an auspicious start during its first year, and contributed to the 26.2 percent growth rate for on-line filing. The Board believes that continued operation of the Free File Alliance will contribute to the growth of on-line filing as more taxpayers become familiar with this opportunity. Although initially targeted for those taxpayers who cannot afford to pay for tax preparation and e-filing, the members of the Free File Alliance offer their services to a wide range of qualifying taxpayers who prepare their own taxes.

Business Return

ETAAC reported that business returns e-filing levels in general are relatively low and e-filing is not yet available for many business returns. The business e-file initiatives implemented have been well-received, especially where the process added value and did not increase burden or cost. Electronic filing of Form 1065 partnership returns was highlighted as a success. As reported by the ETAAC, the business returns shown in Table 2 were filed electronically in 2003.

ETAAC further reported that the IRS is aggressively making up ground and expects to introduce modernized business e-filing systems in the future. The Board believes that the Modernized e-File system, planned for implementation in 2004, will provide a needed boost to the e-filing of business returns. This system will provide the capability for business taxpayers to e-file corporate tax returns, Forms 1120 and 1120S.

Payments are also received electronically by the IRS, and more than 94 percent of all federal employment deposits were paid electronically. The IRS received over 80 million electronic payments from 4.4 million enrollees using the Electronic Federal Tax Payment System (EFTPS).

Table 2. Business Returns Filed Electronically in 2003

Return Type	Status
Information Returns	543 million information returns were filed electronically.
Form 940 Employer's Annual Unemployment Return	Only six percent (324,000) of the 5.4 million Form 940s filed with the IRS were filed electronically. Paper accounted for the vast majority (86 percent), with the remainder (eight percent) being filed on magnetic media.
Form 941 Quarterly Federal Employer's Tax Return	Of the 23.5 million Form 941s filed, 15 percent (3.5 million) were electronic, 81 percent paper, and four percent magnetic.
Form 1065 Partnership Returns	Although only one percent (230,000) of the 2.3 million partnership returns were e-filed, these filings included over four million K-1 attachments, over 17 percent of all K-1s filed.

IV. Discussion of Last Year's Recommendations

In its 2002 report to Congress, the Oversight Board reported 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. Despite the slightly slower growth in e-filing from 2002 to 2003, the Board continues to believe the e-filing goals have a positive impact on IRS performance.

Nonetheless, the Board recognizes that the IRS is unlikely to meet the 80 percent goal by 2007. Although potential incentives such as the extension of the filing due date for e-filers and the implementation of additional services for tax preparers that e-file in large volumes will give e-filing a boost and enable the IRS to come closer to the goal, reaching the 80 percent goal at this point requires a major and most likely unrealistic change in tax preparer and taxpayer behavior.

In its 2002 report, the Oversight Board generally agreed with the ETAAC's recommendations, and made recommendations on three strategic issues raised by the ETAAC in its report:

Recommendation 1:

Implement the EZ File initiative

Last year the Oversight Board fully supported the Office of Management and Budget (OMB), Treasury, and IRS efforts to implement an agreement with the private sector that would

provide easier, secure, and free opportunities for millions of Americans to file their taxes via the Internet at no cost. The impetus for this agreement came as a result of the EZ Filing Initiative proposed earlier in the year by the OMB.

The Oversight Board supported the proposed agreement because it was expected to produce the following advantages for both taxpayers and the IRS:

- Over 78 million taxpayers will be eligible to file their tax returns on-line for free. Currently, taxpayers who choose to file on-line 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.

As a result of the EZ Filing Initiative, the Free File Alliance, LLC, was formed. As reported in the previous section, approximately 2.7 million taxpayers were able to prepare and electronically file their tax returns for free. The IRS, Department of Treasury, ETAAC, and private sector software companies who formed the Free

File Alliance should be commended for its rapid implementation and smooth operation of this new capability. These organizations exhibited great teamwork and expertise in achieving so quickly some very aggressive goals.

Recommendation 2:
Extend the April 15th due date
for electronic filers

The Oversight Board in last year's report supported the Administration's proposal to extend the filing due date to April 30th for individual taxpayers that file electronically. This year, in response to questions raised at the Oversight Board's public meeting in January, the Board revisited this issue to ensure that this continues to be a sound recommendation. Based on surveys the IRS has made of taxpayers, the Board continues to believe that the proposed due date change would be effective in attracting additional electronically filed returns, and continues to support the proposed extension. The Board reaffirmed this position in its testimony to the House Ways & Means Subcommittee on Oversight.

House bill, H.R. 1528, the Taxpayer Protection and IRS Accountability Act of 2003, which passed the House of Representatives on June 19, 2003, contains a provision to extend the filing date to

April 30 for those taxpayers that file (and pay, if required) electronically. The bill awaits Senate action and will most likely be considered in the fall of 2003.

Recommendation 3:
Implement the Customer Account
Data Engine

Last year, the Board and ETAAC recommended that the IRS modernize its e-file platforms for both individual and business returns. This recommendation illustrates the linkage between electronic tax administration and the Business Systems Modernization (BSM) program. 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 IRS expects to implement its Modernized e-File (MeF) system in early 2004. This system will provide a modern platform for filing Forms 1120, 1120S, and 990. By expanding the number of business returns that can be filed electronically, the IRS takes a big step towards establishing an environment in which all business transactions with the IRS can be done in a convenient and cost-effective electronic manner.

V. Integrating E-Filing into a Broader Vision of Electronic Tax Administration

The IRS Oversight Board continues to believe that the goals established in RRA 98 for electronic filing motivate both the IRS and the private sector to broaden the range of e-filing products and to explore ways in which electronic tax administration can be made available to increasing numbers of taxpayers. The Board is convinced that e-filing is only one component of electronic tax administration, which provides improved services to taxpayers and their representatives, reduces errors, and fosters increased compliance with our tax laws.

The Board's vision is consistent with the ETAAC's lead in seeing the future of electronic filing as dependent on the confluence of several strategic elements: a vision that views e-filing as one element of a broader electronic tax administration environment; a broadened e-filing educational and marketing effort; and the role of incentives in promoting e-filing.

The Board also wishes to comment on two other issues addressed in the ETAAC report: Telefile and the regulation of preparers. In the Board's view, the Telefile program will, for the foreseeable future, continue to provide electronic filing opportunities to a segment of taxpayers who otherwise would not have access to electronic filing. The regulation of tax preparers encompasses a range of issues beyond the scope of e-filing, but was addressed in the ETAAC report and should be considered to assure that taxpayers maintain their confidence in the integrity of e-filing products.

Vision of an electronic tax administration environment

The Oversight Board's vision is broad and foresees a tax administration environment based on modernized business processes and information technology that offers all taxpayers a variety of electronic tax administration products and services that complement and extend current paper-based services. This vision includes the offering of electronic filing options for all taxpayers, with emphasis on free electronic options for taxpayers who can't afford it, but available to all taxpayers by promoting marketplace partnerships and competition.

The Board's vision is that the IRS will implement systems that reduce burden on taxpayers, their intermediaries, and the tax software industry. Despite numerous delays in the modernization program, the Board continues to strongly support the IRS systems modernization efforts, including the need for a modernized e-filing environment.

The implementation of the Modernized e-File system will provide a modern platform for e-filing of business tax returns. It will also simplify e-filing for the tax preparation community by providing a standardized set of error codes for all electronically filed tax forms. After this system is successfully operational, the IRS plans to use the Modernized e-File system architecture and design concepts to modernize the Form 1040 platform. Although the modernization of the 1040 platform is not

currently scheduled, when the IRS undertakes this project it should consider the benefits and costs of implementing a direct filing portal through which the IRS can receive tax returns prepared by commercial tax software without the use of a third party to transmit the information. In the Board's view, such a system would serve to further increase private sector competition and allow the private sector to reduce their costs, ultimately lowering the cost to their customers, the taxpayers.

The Board's and ETAAC's visions converge in their belief that the future direction of electronic tax administrations depends on integrating a network of players that includes the IRS, taxpayers, tax practitioners, on-line filing providers, software developers, payroll agents, state tax agencies, other government agencies, and financial institutions. However, the ETAAC puts more emphasis on possible steps the private sector may take. Its vision would include privately-based, central repositories for all data filed electronically. These databases would be accessible to taxpayers and their authorized representatives and would always be under the ultimate control of the taxpayer. In ETAAC's view, such a central repository could be made available through private industry offerings with multiple partnerships or available in a controlled manner through a government site. Although the Board cannot endorse a specific approach as to how the private sector might form partnerships to reduce the burden of taxpayer record-keeping using commercial tax software, it encourages the private sector to work with the IRS to develop systems that reduce taxpayer burden.

The ETAAC has recommended that the IRS consider the potential risks and benefits of a return-free system, and RRA 98 requires the IRS to develop procedures for the implementation of such a system for appropriate individuals

by 2008. Implementing a return-free system, however, even for a small segment of taxpayers, is not practical until the IRS modernizes its information technology systems.

Broaden e-filing educational and marketing efforts

The Board agrees with the ETAAC that a continued educational and marketing effort is needed to convince more taxpayers and preparers of the benefits of e-filing. As a step in reversing the slowing growth trend in E-filing, especially in the preparer community, ETAAC suggests that the IRS develop and maintain a "Speakers' Bureau." The bureau, which would result from a partnership between the IRS' electronic tax administration and electronic return originators (EROs), would capitalize on the experience of ERO of the Year nominees - recognized by the IRS as examples of outstanding e-filing entities - to promote and encourage non e-filing entities to accept e-filing as a pathway to improve their businesses.

The Board believes that tax practitioners who have converted their practices to all electronic filing would make compelling advocates. The ETAAC should seek out such practitioners in partnership with practitioner organizations and identify a cadre of such practitioners who would be willing to share their experiences with other practitioners. During the National Tax Forums, the Board has encountered many practitioners who say that converting to 100 percent e-filing has transformed their practice. Possibly, the ETAAC can sponsor the development of several case studies to document these situations and provide to various practitioner groups the lessons learned from these cases. The Board agrees that expanding recognition for exemplary EROs is desirable to create more visible role models for practitioners that do not yet e-file the majority of their returns.

The Board also agrees with the ETAAC that reaching the 36 million self-prepared paper filers is not a single-strategy proposition. The Board encourages the IRS to continue its market research to delve into the issues affecting particular sub-segments of paper filers. The research into the motivation of paper filers need not be limited to IRS activities. ETAAC recommends that a limited pilot program designed to tutor a small group of paper filers in e-filing should be conducted and evaluated. The ETAAC should consider sponsoring such a pilot through partnerships with industry groups.

The IRS should activate a partnering program with schools, libraries, community facilities, tax practitioners, software providers and other interested parties to provide free Internet access and assistance in teaching the fundamentals of on-line filing. ETAAC can assist the IRS by identifying additional partnering opportunities for its consideration.

Recent research by IRS has shown that taxpayer behavior plays an important role in the decision to e-file returns. This research also suggests that people will adopt specific technologies even before they have reached emotional acceptance of the technology. To gain a better understanding of the attitudes and behaviors that might inhibit the usage of e-filing, IRS research increased the ways in which it segmented taxpayers.

For example, attitudes toward and acceptance of technology serve as a useful way to understand what motivates taxpayers to use e-filing. An IRS study of the 2003 filing season shows that taxpayers can be divided into three broad segments, depending on their willingness to embrace technology and the level of trust they accord technology. Among those taxpayers who fully embrace technology (about 44 percent of taxpayers), 88 percent are willing to consider e-filing. Among those taxpayers who distrust technology (about 31 percent of taxpayers), 57

percent cannot imagine filing in any form but paper. However, even the latter group shows a 61 percent willingness to consider e-filing, thus suggesting that with the right approach they can be convinced to e-file.

The same study found that taxpayers can also be segmented into two camps: e-file believers and e-file skeptics. Users of e-filing tend to be e-file believers and generally have a firm belief in the benefits of e-filing while non-users are characterized by both a somewhat weaker awareness of e-filing and a sharply higher skepticism of e-file benefits. For these non-users, their level of belief in the specific benefits of e-filing is only one-third to one-half that of e-file believers.

IRS' research studies, both past and future, should help it to reach out to taxpayers in ways that make them more informed about the benefits of e-filing. These studies are already showing there are often several factors at work that affect the taxpayers' e-filing decisions and that the marketing approaches will often need to be more discretely designed to address a variety of factors that together can influence a taxpayer to e-file.

Role of benefits and incentives in promoting e-filing

The IRS has made good progress in advancing the use of e-filing, but there is much more that can be done to provide additional benefits and incentives to taxpayers, including changes in filing deadlines and implementation of modernized systems that provide additional products and services. The Board supports and encourages new business practices and systems that provide taxpayers and tax practitioners additional incentives to e-file.

The Board continues to support the Administration's proposal to extend the filing due date to April 30th for individual taxpayers that

file electronically as a powerful incentive for one segment of the population. IRS research indicates that this change will modify taxpayer behavior and result in additional e-filed returns.

Based on the results of the survey conducted in late 2001 and early 2002, IRS estimated that the number of taxpayers who would e-file if offered an extension would increase significantly, ranging from six million taxpayers at the low end, to about 9.1 million taxpayers at the mid-range, and about 12.2 million taxpayers on the high side. The survey was divided into three strata: late filers, paper balance-due returns, and all other returns. As might be expected, the demographics of the survey present a marked contrast between younger and older taxpayers. Close to 30 percent of the taxpayers from all three strata in the age group 18-30 said they would e-file if the deadline were extended. This number would fall to less than 10 per cent of those in the 51-65 age group.

In addition, the IRS has several modernization projects that will provide additional benefits to e-filers. The e-Services system will initially provide a number of incentives to preparers who electronically file over 100 returns, including electronic account resolution, disclosure authorization, and transcript delivery. The Board envisions that the implementation of secure electronic account resolution services as part of the e-Services system will be a valuable tool for tax preparers and eventually taxpayers that need to resolve taxpayer account issues, and will provide a meaningful incentive to file electronically.

Ultimately, the more incentives the IRS can reasonably provide to all types of electronic filers, the more it will encourage e-filing. In the Board's view similar electronic services should be extended to other third party partners such as payroll providers, as both the IRS and the third party providers will benefit from quicker, less error prone electronic services.

The successful implementation of another modernization system, the Customer Account Data Engine, replaces IRS' current master file and offers additional incentives by providing taxpayers with refunds within three to five days after e-filing their returns. Once this system is fully implemented, it will provide the IRS with an important tool to design other ways in which electronic access to IRS' central database records can be used to provide incentives for tax preparers and taxpayers to e-file

Both the Board and ETAAC see potential to use 2D barcodes on information returns to bring new efficiencies to tax practitioners. Discussions with tax practitioners have affirmed that the inclusion of a 2D barcode on information returns that would allow practitioners to scan into their tax software the information on these returns would bring improved efficiencies to their workplace.

The ETAAC report recommends a number of practical ways in which the IRS might provide incentives to promote e-filing. Some recommendations, such as record retention, go beyond the scope of electronic filing. The Board recognizes that the issue of record retention is an important aspect of electronic tax administration and urges a further dialogue between the IRS and interested stakeholders. One specific ETAAC recommendation for which the Board urges caution is extending the waiting period to 40 days for refunds resulting from paper returns. The costs may exceed the benefits and fairness issues need to be thoroughly examined.

The ETAAC also proposes monetary incentives to increase the e-filing of business returns. The Board agrees that in some cases electronic filing may appear to be more costly to the business taxpayer than paper filing, but feels that the savings to business taxpayers that can be achieved by e-filing have not been sufficiently explored. At this time, more data is needed before the Board could

endorse the use of financial incentives for e-filing business returns.

Future of Telefile

The Board believes that Telefile will continue to provide valuable access to an electronic medium for taxpayers with simple tax returns. Although the IRS may find that it can in the long term phase out the Telefile program, the near term picture suggests that the IRS should continue to seek out ways to expand taxpayer eligibility to participate in the TeleFile Program. As the Treasury Inspector General for Tax Administration pointed out in a report to the IRS in March 2003, nearly half of all taxpayers with incomes less than \$35,000 do not have access to the Internet. The National Taxpayer Advocate's report to Congress at the end of 2002 characterizes "access" to the IRS, especially among low income taxpayers, as a major problem. The report emphasizes that the concept of "access" is fundamental to effective tax administration. In this regard, Telefile leaves open a convenient mode of filing for a significant portion of the population that does not necessarily have electronic access to the IRS.

Regulation of preparers

In its report, the ETAAC includes a discussion of the regulation of tax preparers and the concerns raised concerning poor quality of tax preparation by some paid preparers. Although these concerns apply to preparers of electronic returns, the issue of the quality of tax preparation is much broader than electronic filing. The National Taxpayer Advocate's 2002 report to Congress has made some broad recommendations to remedy the situation.

A broad range of options, with accompanying benefits and costs, is available to public policy-makers to increase both the quality of tax preparation and compliance. The Board has found at the National Tax Forums that the issue of regulating tax preparers, both pro and con, is of interest to a broad range of stakeholders, and may present opportunities to strengthen IRS enforcement efforts. The Board supports full exploration of all issues regarding tax preparer regulation. Changes to current policy would likely require legislation, which also emphasizes the need for full discussion of the issues. The Board suggests that the tax preparer industry could contribute to the debate by considering ways in which self-regulation could be effectively implemented.

For more information, please contact:

IRS Oversight Board
Charles Lacijan, Staff Director
1500 Pennsylvania Avenue, NW
Washington, DC 20220
Ph: 202-622-2581
Fax: 202-622-7944

www.irsoversightboard.treas.gov