

**Internal Revenue Service Oversight Board
Electronic Filing Annual Report to Congress
September 2001**

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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.

Because this is the first year that the IRS Oversight Board is in existence, this is its initial report. The Oversight Board notes that 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, nor were the members of the Oversight Board chosen for their expertise in electronic filing issues, as were the ETAAC members. 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.

The IRS is currently undertaking a series of initiatives to improve customer service. For example, the Organization Modernization program has reorganized the IRS into four operating divisions that are designed to better serve the taxpayer segments they support. The Business Systems Modernization (BSM) program is intended to replace IRS legacy systems

and technology with modern business systems that are far more capable of meeting taxpayer service needs. The congressional goal of higher levels of e-filing has much in common with these programs—they are all intended to improve customer service and build a more effective IRS.

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. 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 all e-filed returns, with the exception of TeleFile returns, are prepared 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. These improvements result in an overall error rate for e-filed returns of one percent, compared to twenty percent for paper returns. Additionally, the

ETAAC reports that, over time, electronically-filed returns can be more readily checked for fraud than paper returns, and will become a superior vehicle for detecting and deterring instances of fraud.

III. Results of the 2001 Filing Season

As reported by the ETAAC, the year 2001 filing season, as of June 21, 2001, experienced a 4.7 million increase in electronically filed returns over the year 2000 filing season. This increase represents an overall 13.4 percent growth in electronic filing over the previous year. However, this increase compares to a projected increase of approximately 19 percent. Trends within each component of electronic filing were as follows:

- **Practitioner electronic filing** increased nearly as projected (14.8 percent actual vs. 15.6 percent projected).
- **On-line electronic filing** (e-filing by self-preparers) grew by 36 percent. While this is a significant increase, it falls short of the projected growth rate of 66 percent. The base of on-line electronic filers is small relative to the base of practitioner electronic filers, driving the need for higher growth rates to achieve IRS goals. Online filers represent 17 percent of total electronic filers, whereas practitioners file 72% of all electronic returns.
- **TeleFile** use decreased by 15.4 percent, continuing a trend started in 1998.

Overall, e-filing growth in Individual Tax returns is less than projected, largely due to the reduction in returns filed via Tele-File and the lower-than-expected growth in on-line filing. Table 1 shows how this growth compares to the previous four years.

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

Year	Total Returns	On-line Returns	Practitioner Returns	TeleFile Returns	Total Electronic Returns	Percent returns e-filed	Percent growth of e-filed returns
2001	130.3*	6.8**	28.7**	4.4**	39.9**	30.5	13.4%
2000	127.4	5.0	25	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%
1997	120.8	0.4	14.4	4.7	19.5	16	29.1%

(*Projected)
(**Actual through 6/21/01)

At an aggregate level, the 2001 filing season results indicate a significant reduction in the rate of increase of electronic filing. This decrease was not unexpected to the ETAAC, which reported that the biggest gains in e-filing should be expected in the early years of the program.

The early years of IRS e-file resulted in rapid growth as many early adopters took to the technology and the new opportunity to file primarily paperless returns. Changes that the IRS has made to encourage the use of e-filing include the acceptance of most forms in electronic format, an increase in advertising and public communications to inform the public and professional practitioners of the advantages of e-filing, and the establishment of a Personal Identification Number (PIN) program.

The Oversight Board notes that the IRS has done an excellent job in understanding taxpayer needs and designing e-filing products to be responsive to those needs. The IRS has introduced a number of very positive initiatives that encourage taxpayers to e-file, including:

- The introduction of national and field-based Account Managers
- Creation of the ETAAC and E-Business Steering Committee
- The development and distribution of improved electronic marketing materials and value-added services for e-filers

- The overseeing of specific programs and technology developments specifically focused on electronic tax administration
- Electronic signature prototypes that make e-filing paperless
- Acceptance of additional forms and schedules electronically

IV. Recommendations for Further Action

The Oversight Board believes now is the time to examine additional changes to push the number of taxpayers that e-file to higher levels.

As noted by ETAAC, 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. Although the ETAAC sees the goals as difficult to obtain, it takes the position that this is as it should be, and sees the goals as attainable. The IRS 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. However, 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. The Oversight Board believes that ultimately the 80 percent goal for e-filing is attainable, although the timetable of 2007 may not be. 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.

Moreover, the Oversight Board also recognizes that the efforts to increase e-filing levels are linked to the BSM program, and the speed of e-filing growth is related to the speed at which the BSM program is implemented. A thoughtful, balanced approach is to pursue implementation of the BSM program aggressively, and use this program to increase the attractiveness of e-filing. For example, the Customer Account Data Engine, (CADE) project offers the benefit of allowing the IRS to issue refunds to taxpayers that file electronic returns in approximately two or three days, which should provide further incentive to e-file. This capability is planned to be available to most electronic filers starting in 2003.

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. The Oversight Board generally endorses these recommendations, and, as it carries out its responsibilities to oversee the IRS, intends to encourage the IRS to adopt these recommendations where possible and within the authority of the IRS to do so.

The Oversight Board would caution restraint on the ETAAC recommendation to phase out TeleFile. While the number of taxpayers that use TeleFile is declining, most likely in favor of Internet-based e-filing, taxpayers that qualify for TeleFile only need a telephone to use the system. Thus, for some segment of taxpayers, it might be the only channel for e-filing available to them. To ensure the availability of one channel of e-filing for qualifying taxpayers without computers, the Oversight Board would recommend retention of the TeleFile system.

However, there are three recommendations in the ETAAC report that are particularly broad in scope. These three recommendations not only require legislative action to implement, they also carry with them a need for additional funding. The Oversight Board would like to highlight these recommendations, not necessarily for endorsement, but 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.

- **Extend Filing and Payment Deadline for E-filers**

As an incentive for taxpayers and practitioners to e-file, the ETAAC recommends the legal deadline for all taxpayers to file and pay any balance due be extended for taxpayers that e-file. Extensions should be especially appealing to taxpayers with balance due returns that heretofore have not realized a benefit through e-filing as have taxpayers that are due refunds. Taxpayers who wait until April 15th to submit payments with their balance due tax returns currently have a float period before their check is deposited in a government account. Extending the filing deadline to the end of the estimated float period would probably not carry great costs to the government. The ETAAC recommendation that any due date extension on

a balance due return be contingent on an electronic debit should also reduce the cost of the extension. This concept has been previously proposed by the National Commission on Restructuring the IRS, but a thorough understanding of the impact it will have on Treasury, IRS, tax practitioners, and taxpayers should be made prior to any implementation decision.

Of the three recommendations being highlighted, the IRS Oversight Board believes this recommendation has the most potential for achieving higher levels of e-filing with minimum costs. The extent to which refund taxpayers also take advantage of this capability, and the cost savings associated with electronic payment both assist in minimizing the cost impact of the extended due date. The Oversight Board believes this recommendation warrants further examination of the costs and benefits, both to taxpayers, the Treasury Department, and tax practitioners.

- **Registration of All Tax Practitioners.**

The ETAAC recommends that all paid tax preparation firms and independent tax practitioners that are not already registered as Electronic Return Originators (EROs) be required to register with the IRS and meet the same standards required of EROs. Under current law, professional tax practitioners that are not regulated under Treasury Circular 230 (e.g., Certified Public Accountants and Enrolled Agents) or registered as EROs escape virtually all regulation. The ETAAC believes that IRS registration of all tax practitioners would remove the significant disincentive that now exists for tax practitioners to become EROs. The ETAAC believes that if all tax practitioners were subject to registration requirements and regulations similar to those imposed on EROs, this barrier to participation would be greatly diminished.

The Oversight Board recognizes that standards for all practitioners similar to those imposed on EROs has potential for serving the public good, providing additional protection to taxpayers, and possibly providing additional safeguards against fraud. Countering these potential benefits are the costs associated with this recommendation, both in terms of administrative cost to IRS and additional regulatory burden on currently unregistered practitioners. The impacts of this recommendation go beyond the scope of electronic filing, and should be discussed in a much broader

perspective. Because of the impact to professional tax practitioners, comments from all segments of this population should be sought, and the impact thoroughly understood prior to final consideration.

- **Tax Credit for E-filing.**

The ETAAC recommended a selective tax credit for individual taxpayers that e-file, and presented several options. A tax credit would encourage the marketplace to provide additional products for taxpayers and place pressure on professional tax practitioners to enroll as EROs to meet the increased customer demand for e-filing that a tax credit would likely create.

Offsetting the benefits of a tax credit is the recognition that, depending on the option chosen, it causes a significant decrease in tax revenues. The IRS Oversight Board believes that of the three recommendations highlighted, this recommendation most likely incurs the highest cost to implement. As such, it should only be considered after less expensive incentives are first implemented and given an opportunity to produce the desired results. Under any circumstances, an understanding of the costs and benefits of a tax credit must be analyzed, including the consideration of alternative ways of spending the same funds, and the benefits of alternative actions prior to implementation.

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 ETAAC has also reported that it strongly urges the Congress not to try to force attainment of the goals through statutory mandate.