IRS Oversight Board
Electronic Filing 2007
Annual Report to Congress

February 2008

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I. Executive Summary

Electronic tax administration (ETA) is the foundation for a modernized Internal Revenue Service (IRS) that provides quality, convenient, timely, and accurate services to the vast majority of taxpayers. In today's IRS, ETA is not an afterthought, but an important method for taxpayers to interact conveniently with the IRS. Expanding electronic tax administration is woven throughout the *IRS Strategic Plan 2005-2009* and its 2006 *Taxpayer Assistance Blueprint* (TAB), and is an essential element of a healthy tax administration system.

One of the IRS' objectives is to maximize the taxpayer and partner value of the IRS Web site, making the electronic channel the first choice of taxpayers and stakeholders for obtaining the information and services they need to comply with their tax obligations. This objective is good government at its best; adopting proven best practices and modern technology to deliver real world benefits to taxpayers while reducing burden and costs for both taxpayers and government.

However, the question remains as to whether the IRS is making progress quickly enough to achieve its vision of electronic tax administration. Since 2003, it has been evident to the IRS Oversight Board and others in the tax administration community that the IRS would not reach the IRS Restructuring and Reform Act of 1998 (RRA 98) goal of 80 percent electronically filed tax returns by 2007. Achievement of this goal has been commonly measured by the number of individual tax returns filed electronically.

However, the Board does not view this result as a failure on the IRS' part. This goal was clearly an extremely challenging target. Nevertheless, in the nine years since the enactment of RRA 98, the percentage of individual e-filed returns nearly tripled–from 20 percent in 1998 to about 58 percent in 2007. Particularly impressive has been the growth in individual returns prepared by tax professionals and filed electronically, which increased from approximately 27 percent of paid preparer returns in 1998 to around 70 percent today. There also has been steady growth in the percent of self-prepared individual returns filed electronically, including an 11 percent increase in 2007 over 2006 in the number of Form 1040 returns prepared and filed from a home computer. This is real progress that is consistent with RRA 98's intent. As the Electronic Tax Administration Advisory Committee (ETAAC) noted in its 2007 e-file report to Congress, this progress is very gratifying as it indicates that e-file is catching on with those who had previously resisted it.

The Board agrees with the ETAAC that electronic tax administration is not just about electronic filing of individual tax returns. The IRS ETA vision is to offer taxpayers a broad range of electronic products and services. For the first time, taxpayers were able to take advantage of the Modernized e-File system to file their Form 1065 and Form 1065-B partnership tax returns electronically. Taxpayers can now use an online tool to determine whether they may owe the Alternative Minimum Tax. Also, new businesses can now request an Employer Identification Number through a Web-based system that processes requests and generates identification numbers in real time.

The Board remains cautiously optimistic about the future success of ETA. For example, given current progress and strategic planning, the Board believes that the IRS can meet an 80 percent e-file goal by 2012–but will need the help of the professional tax community and Congress to do so. Also, the TAB has now provided a roadmap to the longer term vision of an electronically-based delivery system for customer service.

A major portion of this report entails a strategic assessment of recommendations put forth by the ETAAC report in support of the IRS vision for ETA. The Board favors the vast majority of ETAAC's thoughtful, prudent and practical recommendations. Among these are many suggestions for increasing participation in electronic filing, for delivering other electronic services to customers based on specific customers' needs, and for better protecting taxpayers and the tax administration system from those who engage in fraudulent tax activities. Also valuable are the ETAAC's identification of the key "gaps" in current IRS electronic service delivery systems most in need of attention so a to attain the objectives delineated in the TAB.

The Board also commends the ETAAC for raising the important issue of the need for Congress to revise requirements relative to the mandatory electronic filing of certain tax returns and information documents. Although the Board has reservations about the effectiveness of some current and potential e-file mandates, there is nevertheless agreement on several key points. In particular, the Board supports the ETAAC recommendation that Congress lift the prohibition on the IRS' ability to require electronic filing of Form 1040 tax returns, and grant the agency the discretion to implement e-file mandates for paid return preparers at a later date, if needed to reach the 80 percent goal. However, as the Board made clear in last year's e-filing report, it recommends that Congress attach two conditions in granting IRS the discretion to mandate electronic filing of certain individual returns: (1) that IRS first exhaust all reasonable steps to maximize voluntary participation in individual e-file and (2) that IRS carefully study the trade-offs between the expected benefits from increased e-file and the burden imposed on filers and their preparers—before setting specific mandate criteria.

The Board agrees with the intent of the ETAAC recommendations to make the existing requirements for electronic filing of business-related returns and information documents more effective. However, the Board would prefer that policymakers act to change the mandatory electronic filing requirements in the business and information returns area based on a more strategic approach. Such an approach would fully understand the benefits, opportunities, challenges, interrelationships, and taxpayer burdens associated with alternative mandates/thresholds, and set new standards that strike a balance between these sometimes competing interests.

The IRS Oversight Board and the ETAAC share a common strategic vision for electronic tax administration. It is no longer a hypothetical environment for the future. It is something real that affects taxpayers today and that the IRS must expand and further leverage to provide America's taxpayers the tax products and services they expect in this modern age.

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.

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 2007 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. The Key to a Modern IRS

Electronic tax administration (ETA) is the foundation for a modernized Internal Revenue Service (IRS) that provides quality, convenient, timely, and accurate services to the vast majority of taxpayers. Even before passage of the IRS Restructuring and Reform Act of 1998, there was a growing realization that a robust electronic tax administration program had to be integrated into any strategy to modernize the IRS and bring it into the 21st Century.

Oversight bodies, including the National Commission on Restructuring the IRS, made a compelling case for such a capability. The Commission saw ten years ago that ETA could help support the IRS' current strategic goals of improving customer service, enhancing enforcement, and modernizing processes. In its final report, the Commission noted: "With a cohesive plan to market and implement electronic filing, the IRS can improve its customer service capabilities, modernize its processing functions and facilitate more efficient compliance efforts." [1]

Today, ETA is not an afterthought or add-on, but an integral part of IRS' strategic planning. Its role has only grown in importance and encompasses much more than just electronic filing of tax returns. ETA is woven throughout the *IRS Strategic Plan 2005-2009* and the *Taxpayer Assistance Blueprint* (TAB), and is essential to a healthy tax administration system. In fact, one of the TAB objectives is to "maximize the taxpayer and partner value of the IRS Web site, making the electronic channel the first choice of taxpayers and partners for obtaining the information and services they need to comply with their tax obligations."[2]

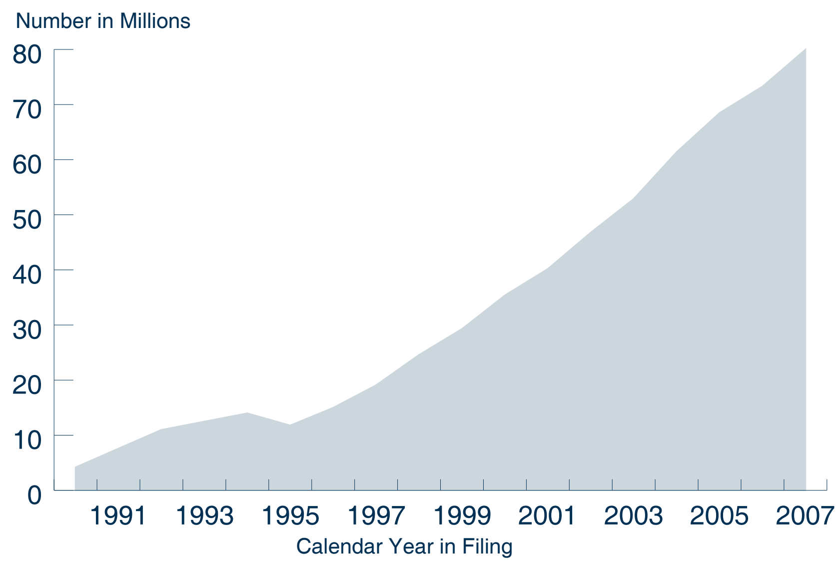
2. Recent Progress

Electronic tax administration is part of a larger, agency-wide e-government program. Bev Godwin, Director of USA.gov and Web Best Practices, at the U.S. General Services Administration recently observed, "The government recognizes that time-crunched Americans want to conduct business with the government when and where it's convenient for them. Self service is a growing trend across industries and we are making great strides towards addressing this need by focusing on the top tasks of our web visitors."[3] This is good government at its best; adopting proven best practices and modern technology to deliver real world benefits to taxpayers while reducing burden and costs for both taxpayers and government.

The IRS is to be commended for its efforts to date. The e-file program, in particular, is held up as a model for other government agencies to emulate in their own electronic administration programs. In his presentation at the 2006 Council for Electronic Revenue Communication Advancement Conference, Stephen Holden, Assistant Professor in the Department of Information Systems at the University of Maryland, Baltimore County, stated that “IRS e-file has emerged as one of the premier e-government programs of the federal government.”[4]

The statistics on IRS e-file volumes are impressive. Electronic filing of individual tax returns began as a pilot program in 1986 in three metropolitan areas with 25,000 returns filed electronically–a miniscule .02 percent of all returns filed that year. However, as shown in Figure 1, individual e-file has since grown to 80 million in 2007–or about 58 percent of all individual returns. In addition, a record 22 million taxpayers e-filed from a home computer in 2007, up 11 percent from the previous year.[5]

Figure 1: **E-Filed Individual Tax Returns by Year**



Source: IRS

Also, progress has not been limited to individual taxpayers; a growing number of businesses are filing their tax returns electronically. The IRS announced in October 2007 that more than 800,000 of the nation’s businesses had electronically filed their corporation income tax returns in 2007, a 60 percent increase from last year.[6] IRS also reports that visits to IRS.gov during the 2007 filing season climbed almost ten percent to more than 140 million.[7]

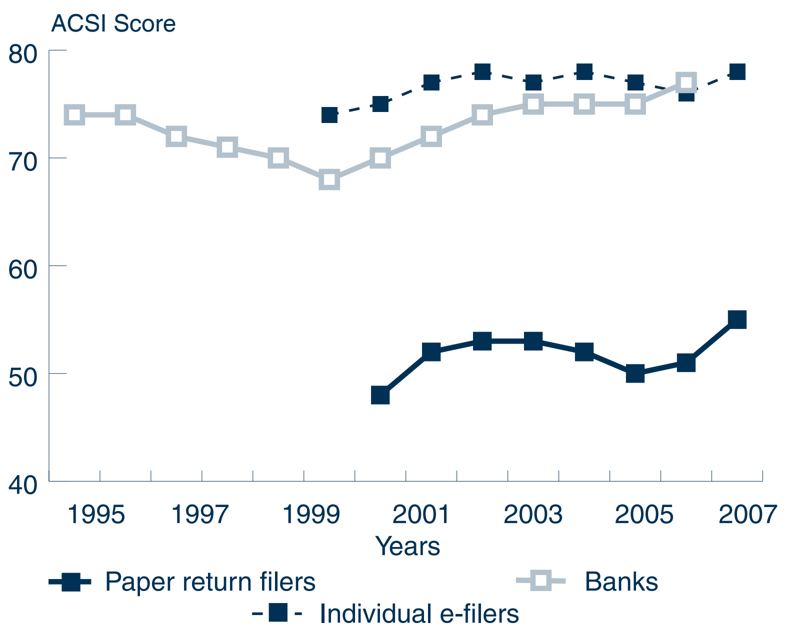
The IRS also has recently introduced more electronic products and services over IRS.gov. For example, during 2007, taxpayers were able to take advantage of the Modernized e-File (MeF) system for the first time to file their Form 1065 and Form 1065-B partnership tax returns. In addition, individuals can now use an online tool to determine whether they may owe the Alternative Minimum Tax, and new businesses can apply for an Employer Identification Number through a Web-based system that processes requests and generates identification numbers in real time.

ETA is also helping taxpayers with payment and other compliance issues. In 2007, the IRS launched four new Web-based information tools, known as "Life Cycles," to help guide tax-exempt organizations through the federal tax rules and requirements that pertain to them. Also, taxpayers who want to enter into an installment agreement can now benefit from recent enhancements to the interactive Online Payment Agreement application on IRS.gov which allows eligible taxpayers or their authorized representatives to self-qualify, apply, and receive immediate notification of approval for installment agreements. In addition, the IRS and the State of Illinois successfully piloted an enhancement to the Electronic Federal Tax Payment System (EFTPS) that allows employers to pay both federal and state liabilities concurrently. These new electronic tools help taxpayers to more quickly understand and meet their tax responsibilities, and thus reduce taxpayer burden.

3. Customer Satisfaction and Cost Savings Still Strong

One of the measures used to gauge IRS' progress in delivering quality service is the American Customer Satisfaction Index (ACSI) score. For 2007, the ACSI satisfaction score among individual electronic filers stood at 78. The comparable score for individuals filing paper returns is 55. Also, this ACSI score for IRS e-filers essentially ranks on a par with customer satisfaction with commercial banks in general (as indicated in Figure 2), and actually

Figure 2: **ACSI Scores 1994-2007**



Source: www.theacsi.org

exceeds the individual scores for some of the best known national financial institutions. As ASCI commentary notes, "The upward trend for [all individual] tax filer satisfaction is attributable to an ever increasing number of filers turning away from the less satisfying paper methods to the vastly more satisfying electronic format."[8]

The GAO also noted in testimony before the Senate Appropriations Subcommittee on Financial Services and General Government:

> *An independent weekly study by Keynote, a company that evaluates Web sites, reported that, as of April 9, 2007, IRS's Web site has repeatedly ranked in the top 6 out of 40 government agency Web sites evaluated in terms of average download times. Last year, IRS consistently ranked second for the same time period. Average download time remained about the same for IRS compared to last year, indicating that IRS is not performing worse but that other government agencies are performing better.*[9]

However, satisfaction with all federal Web sites, including IRS.gov, has slipped slightly in subsequent quarterly ACSI surveys. Part of the reason for the small dip in the IRS' numbers can be attributed to the huge and diverse U.S. taxpayer base. Larry Freed, president and CEO of ForeSee Results, which analyzes and produces the e-government report in partnership with the University of Michigan, noted, "Top-performing sites maintain a laser focus on meeting the needs of their target audience, a task that can be much harder for agencies with diverse audiences."[10]

It also bears repeating that e-file provides cost-savings that the IRS can reinvest in other customer service and enforcement initiatives. The GAO reports that IRS saves $2.38 on every Form 1040 return that is filed electronically.[11] In 2006, GAO further reported that IRS used 36 percent fewer staff years for processing returns than in 1999, saving the agency a total of $78 million in salary benefits and overtime.[12] By the end of 2007, IRS will have closed its third submission processing site for individual returns as a direct result of the growth in e-file and corresponding decline in paper returns.[13]

4. ETA: A Vision Still Unfulfilled

Looking at the broad picture, the Board agrees with the ETAAC that electronic tax administration is not just about e-file. There is a far larger vision; one instilled by the IRS Restructuring Commission and RRA 98, and reflected in both the IRS Strategic Plan and the TAB, that seeks to make electronic interactions among taxpayers, practitioners and the IRS the norm. These electronic interactions would span the entire range of pre-filing, filing and post-filing activities taxpayers and their representatives may engage in with the IRS, including the ability to resolve taxpayer account issues securely over the Internet.

This vision is much along the lines of what customers of large financial institutions can already do today but is still, for the most part, unavailable to taxpayers. Even in the e-file area, where IRS has long been engaged in efforts to achieve the e-file goal set forth in RRA 98, the agency has come up short. The *Taxpayer Assistance Blueprint* acknowledges the gap that the IRS faces in achieving its vision relative to customer service:

> *As technology continues to advance, taxpayers expect the government to keep pace. The IRS currently provides electronic services and continues to modernize vast information systems. However, the electronic services offered by the IRS are limited relative to those available in the wider marketplace.*[14]

A tremendous amount of hard work lies ahead for the IRS to be able to deliver even the most basic of self-serve electronic services, let alone the full range of electronic products and services. Still, as the TAB goes on to add:

> *Acknowledging these strategic challenges enhances the ability of the IRS to better position its service resources.*[15]

In addition, the TAB has now provided a better roadmap to that future vision of electronic tax administration as it relates to customer service. This includes recommended initiatives to address such critical areas and gaps as service governance, content management, end-to-end portal and application monitoring, Web site design and usability, online support tools, publication search capability, evaluation of Frequently Asked Questions, and authentication for account-related tools.

III. Electronic Tax Administration: A Retrospective View

While the vision of a thoroughly modern world of electronic tax administration remains unfulfilled, the Board also believes that it is important to step back and take a look at where electronic tax administration was in 1998 and where it stands today. Such a retrospective view helps answer such important questions as what was accomplished, and importantly, was it worth it?

As the Board has stated on many occasions, the 80 percent e-file goal had an energizing effect on the IRS and the professional tax community. Prior to the passage of RRA 98, electronic filing and payment options were still tentative programs. Today, they are the preferred way of doing business for tens of millions of taxpayers including a solid majority of individual tax filers. In addition, the volume of electronically filed returns continues to grow at a healthy pace each year.

But more than just boost the e-file rate, the 80 percent target stimulated the IRS' thinking and receptivity to innovation. It pushed the IRS to accommodate electronic signature alternatives and many additional forms and schedules on its e-file systems. Today, major individual, business, and tax exempt tax returns and information documents can all be filed electronically. It also encouraged the IRS to create new interactive applications on its Web site, such as "Where's My Refund?" and the option to apply online for a payment agreement and receive immediate notification of approval.

Businesses and tax professionals also have witnessed an enormous increase in the number of electronic options. The centerfold chart on pages 20 and 21 highlights a number of key milestones for the IRS' electronic tax administration program over the years as the number of electronically filed returns has substantially grown. As another example, in 2006, the nation's largest tax return–from General Electric–was e-filed. It would have been 24,000 paper pages long.[16] It is a legacy of success that was clearly worth the effort and that provides an excellent foundation upon which to build.

IV. Electronic Filing Goals and Trends

1. RRA 98's e-File Goal Not Met but Progress Appreciable

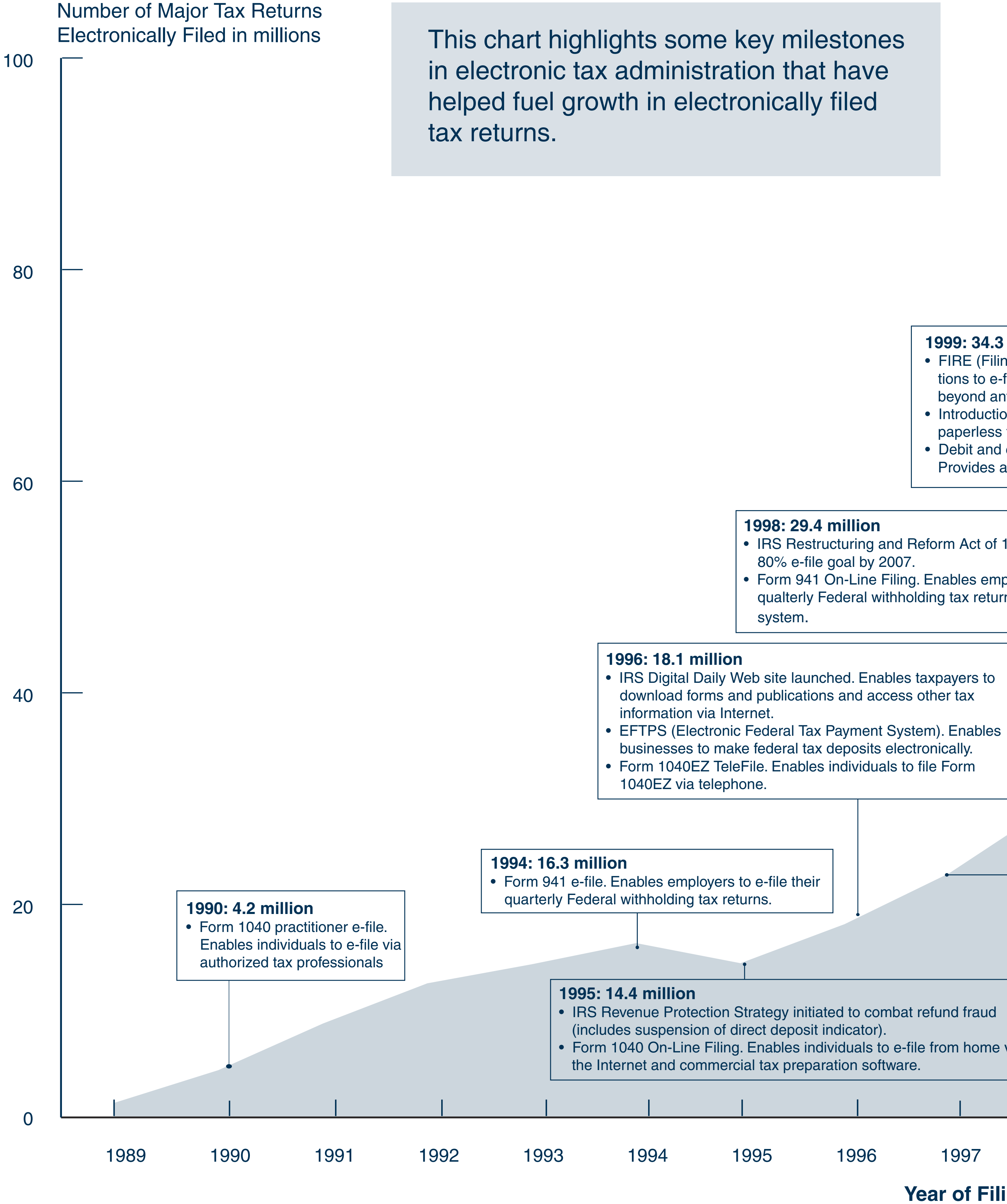
Since 2003, it has been evident to the Oversight Board and others in the tax administration community that the IRS would not reach the RRA 98 80 percent e-file goal by 2007. Available data for the 2007 filing year confirm that the goal will not be met. The data indicate that around 58 percent of individual income tax returns will be filed electronically by the end of 2007, far short of the congressionally-mandated target.

However, in the Board's view, this should not be seen as a failure on the IRS' part. As shown in Figure 3, in the nine years since the enactment of RRA 98, the percentage of individual e-filed returns has nearly tripled–from 20 percent in 1998 to about 58 percent in 2007.

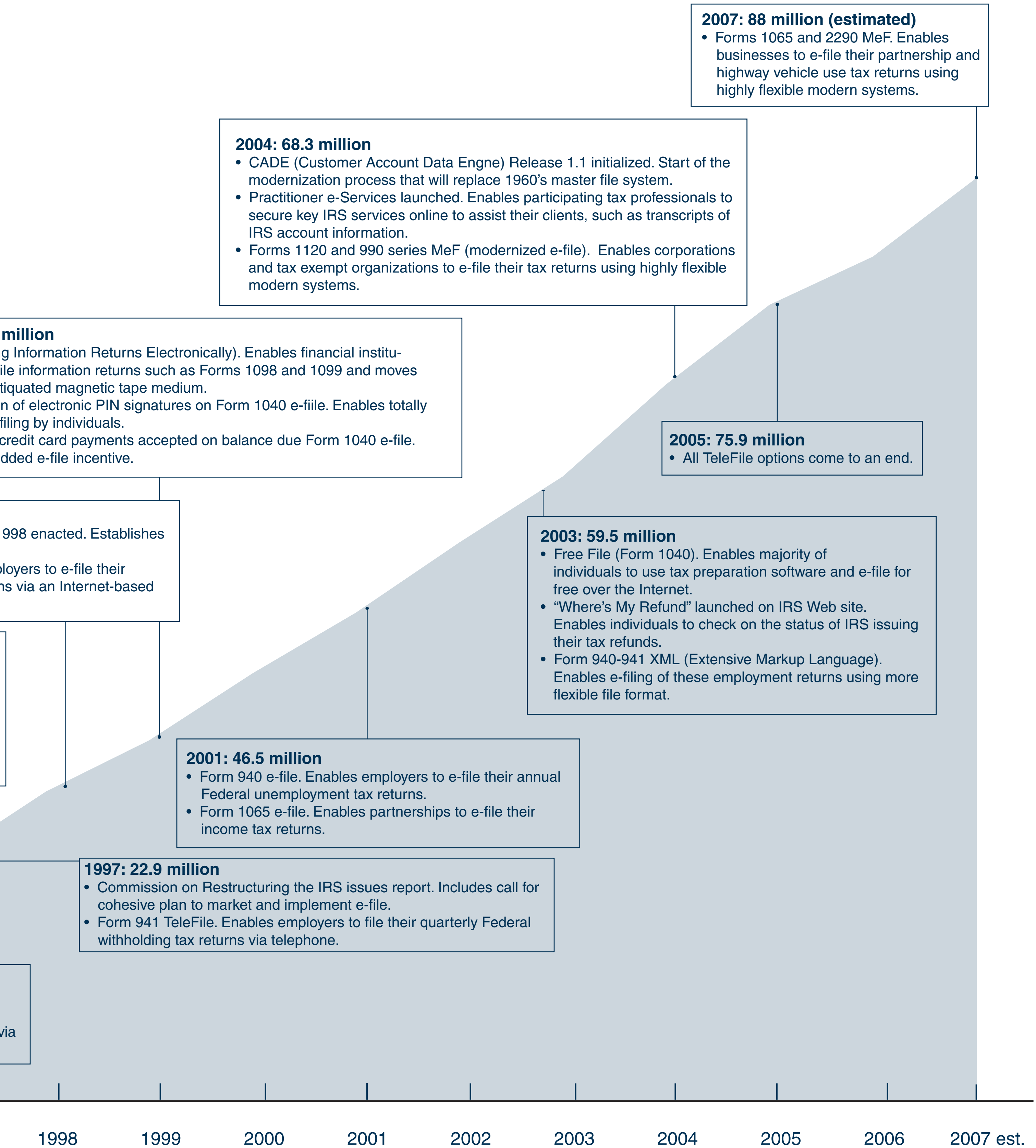
The volume of business and tax exempt tax returns filed electronically has also grown over this same period, although not as steeply as for individuals, from around 12 percent to a little over 18 percent, respectively.[17] Combining all major individual, business and exempt organization tax returns, the overall e-file rate stands at around 48 percent for 2007–indicating that the IRS now receives nearly half of all its major tax returns electronically. In the opinion of the Board, this reflects steady and significant progress on the part of the IRS and the tax administration community, even though it falls short of the extremely challenging goal set out in RRA 98.

Electronic Tax Administration: Milestones and Progress

This chart highlights some key milestones in electronic tax administration that have helped fuel growth in electronically filed tax returns.



Note: Milestones generally reflect year of nationwide availability.



2007: 88 million (estimated)
• Forms 1065 and 2290 MeF. Enables businesses to e-file their partnership and highway vehicle use tax returns using highly flexible modern systems.
2004: 68.3 million
• CADE (Customer Account Data Engne) Release 1.1 initialized. Start of the modernization process that will replace 1960's master file system.
• Practitioner e-Services launched. Enables participating tax professionals to secure key IRS services online to assist their clients, such as transcripts of IRS account information.
• Forms 1120 and 990 series MeF (modernized e-file). Enables corporations and tax exempt organizations to e-file their tax returns using highly flexible modern systems.
million
g Information Returns Electronically). Enables financial institu-
ile information returns such as Forms 1098 and 1099 and moves
tiquated magnetic tape medium.
n of electronic PIN signatures on Form 1040 e-fiile. Enables totally
filing by individuals.
credit card payments accepted on balance due Form 1040 e-file.
dded e-file incentive.
2005: 75.9 million
• All TeleFile options come to an end.
998 enacted. Establishes
loyers to e-file their
ns via an Internet-based
2003: 59.5 million
• Free File (Form 1040). Enables majority of individuals to use tax preparation software and e-file for free over the Internet.
• "Where's My Refund" launched on IRS Web site. Enables individuals to check on the status of IRS issuing their tax refunds.
• Form 940-941 XML (Extensive Markup Language). Enables e-filing of these employment returns using more flexible file format.
2001: 46.5 million
• Form 940 e-file. Enables employers to e-file their annual Federal unemployment tax returns.
• Form 1065 e-file. Enables partnerships to e-file their income tax returns.
1997: 22.9 million
• Commission on Restructuring the IRS issues report. Includes call for cohesive plan to market and implement e-file.
• Form 941 TeleFile. Enables employers to file their quarterly Federal withholding tax returns via telephone.
via
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007 est.

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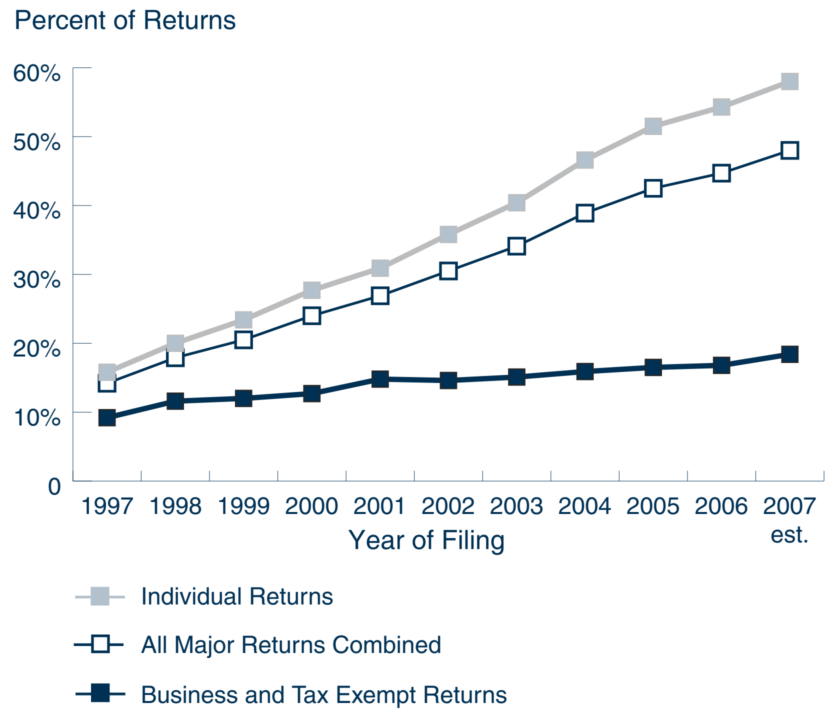
Figure 3: **Percent of Major Tax Returns Electronically Filed**



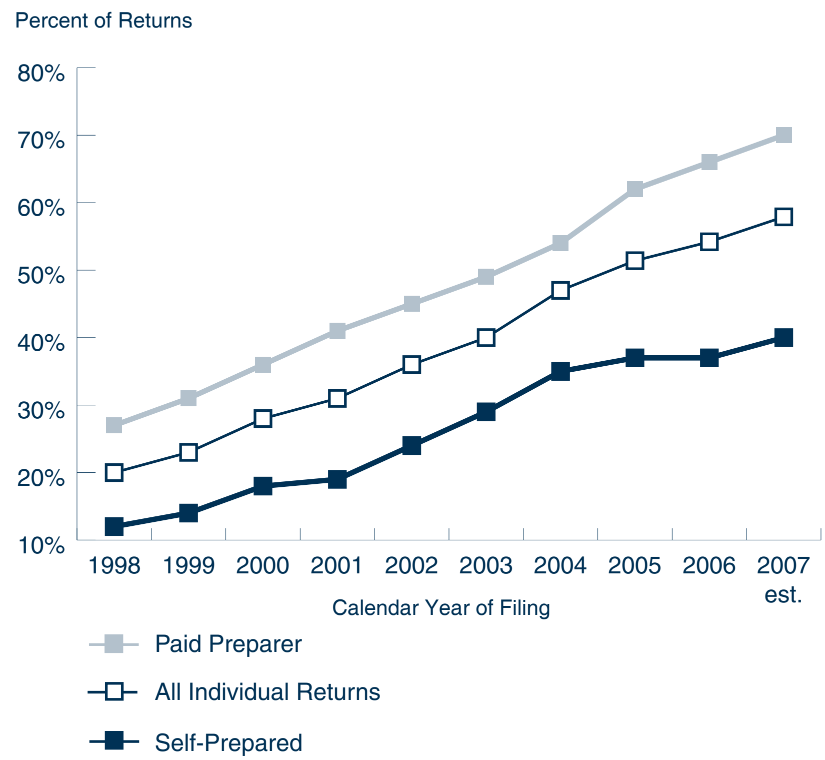
Source: IRS

In addition, the less dramatic increase in the e-file rate among business returns masks other real progress in the area. In particular, IRS has recently introduced modernized systems for electronic tax filing a series of major business and tax exempt return types including Forms 1120, 1120S, 1120-POL, 990. 990EZ, 990-PF, 1065, 1065-B, 2290 and 7004, and with more expected to follow soon. These modernized systems for business returns lay the ground work for potentially strong e-file growth in the immediate years ahead, if past growth patterns for the introduction of new e-file options holds true. Also, many of the business returns filed electronically in prior years were received on such antiquated media as magnetic computer tapes that were inflexible and required significant IRS staff resources to process. However, these return filings on magnetic tape have since been replaced by modern electronic transmissions over such flexible and efficient channels as XML (Extensible Markup Language) file formats and the MeF platforms.

Within individuals returns, the recent e-file trends through 2007 also remain encouraging for both self-prepared returns and those submitted through paid return preparers. As shown in Figure 4, the share of returns prepared by tax professionals and filed electronically continues to increase steadily every year and stands at around 70 percent in 2007. This trend is particularly encouraging since the overall number of individual returns submitted through paid preparers also continues to climb and now stands at nearly 60 percent of all individual income tax returns filed in 2007.

The Board is also encouraged to see that both the share of self-prepared individual returns filed electronically and the absolute number of self-prepared e-file returns increased in 2007. As indicated in Figure 4, about 40 percent of self-prepared returns were e-filed in 2007, up from around 37 percent in 2006. In addition, the number of self-prepared e-filed returns (which are filed on-line from a home computer) increased 11 percent in 2007 to nearly 22.6 million, as shown in Figure 5. This is particularly important, for as the Board noted in last year's report, the combined effect of the discontinuance of the TeleFile program and the new adjusted gross income limit for use of Free File resulted in an absolute decline in 2006 in the number of e-file returns from taxpayers preparing their own forms. It now appears that the use of e-filing among self-preparers is increasing again.

Figure 4: **Percent of Individual Returns Electronically Filed by Preparation Method**

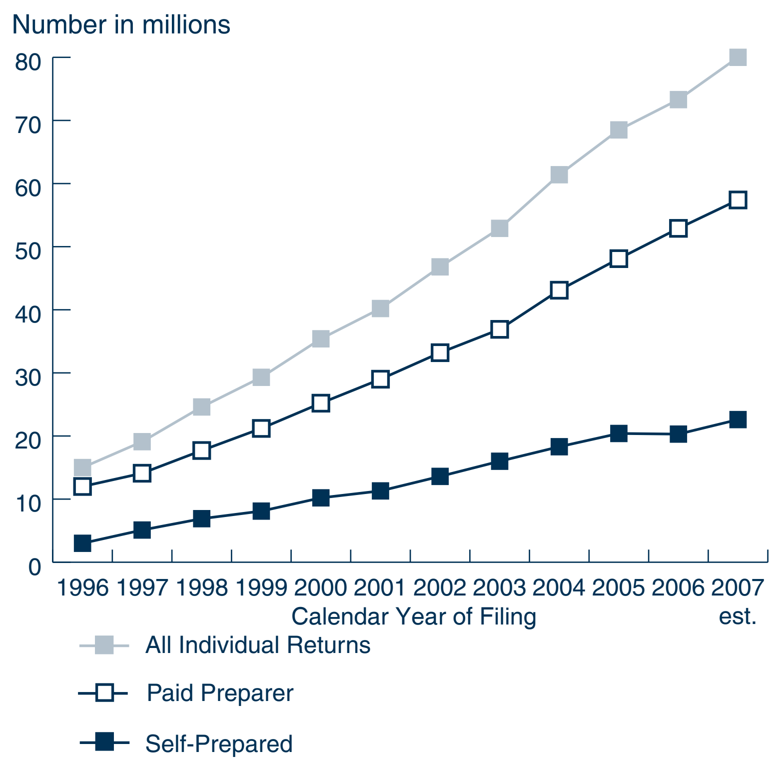


Source: IRS

However, this is not to say that all the setbacks in self-prepared e-file returns have been overcome. Compared to 2006, Free File usage dropped by 2.2 percent, the second year in a row it has declined. In addition, according to TIGTA, a little over four percent of eligible taxpayers actually participate in the Free File program. Also, approximately 48 percent of the two million former TeleFile users reverted to filing paper tax returns, increasing the chance for errors and delaying refunds. TIGTA further estimated that more than 541,000 of these taxpayers paid $23.6 million to prepare and file their returns in 2006.[18]

There remains a significant pool of individuals who self-prepare their tax returns but who do not find the current array of e-file options accessible or sufficiently enticing.

Figure 5. **Number of Individual e-file Returns by Preparation Method**



Source: IRS

2. The Value of Measures: Extending the 80 Percent Electronic Filing Goal to 2012

The use of long-term measures and strategic goals is critical if the IRS is to succeed in all parts of its mission, including electronic tax administration. The Oversight Board has approved enterprise-wide, long-term measures and targets to track the IRS' progress in meeting strategic objectives and goals. One of these long-term goals is a recommitment to the challenge laid out in RRA 98, i.e., to have 80 percent of all major tax returns (individuals, businesses and tax exempt organizations) filed electronically by 2012.

The importance of goal setting is demonstrated by the IRS' solid progress toward meeting the e-filing goal in RRA 98. It is doubtful the IRS would have made such progress without the congressional mandate. Having that goal enacted into public law put real world pressure on the IRS and its stakeholders to come together and take deliberate and focused action in pursuit of that desired end state. It provided Congress and other policymakers and oversight bodies with a clear standard by which to hold the IRS accountable for its decisions in the e-file area and to measure progress.

By extending that 80 percent goal to the more realistic date of 2012 as part of the IRS strategic planning efforts, the Board now hopes to ensure continued commitment and discipline by the IRS and its stakeholders to achieving the 80 percent e-file objective. In the view of the Board, what was essentially a Congressional “challenge” to the IRS in RRA 98 now becomes a definitive expectation.

3. Achieving 80 Percent by 2012 Will Be Difficult but Doable

The IRS’ inability to meet RRA 98’s original e-file goal was affected by a number of internal and external factors, including problems and delays with the IRS’ Business Systems Modernization program and a public wariness about transmitting personal data over the Internet. However, given current progress and strategic planning, the Board believes that the IRS can meet the 80 percent e-file goal by 2012–but it will not be easy.

Although e-file volumes continue to grow, attaining 80 percent e-file participation will be a challenge. Those most willing to convert to e-file, such as tech-savvy taxpayers and practitioners, have already done so and the IRS must find innovative ways to persuade the remaining taxpayers and tax professionals to join the ranks of e-filers.

Persuading these remaining taxpayers will require the IRS to expand its current strategy to address taxpayer attitudes. The Board’s 2006 *Taxpayer Customer Service and Channel Reference Study* revealed reluctance among certain taxpayer segments to embrace electronic options such as e-filing. Concerns over security and privacy as well as fees, computer access and literacy must be addressed. Indeed, very real tax scams masquerading as legitimate IRS electronic tax administration programs have been perpetrated on taxpayers to steal their refunds and/or personal identities, and is a matter that requires constant IRS vigilance.[19] In addition, some tax professionals have also been reluctant to use e-filing.

However, there is reason for optimism. As noted earlier, the number of tax professionals who prepare and then e-file their client’s returns continues to increase yearly. That so many do so demonstrates that more and more tax professionals are seeing the real value in the e-file service. An upward trend in the use of e-file among individuals who self-prepare their returns has resumed after the unique disruption in 2006.

Although there was an 11 percent jump in 2007 in the number of self-prepared returns filed on-line, it has been vexing that many individuals who use commercial tax preparation software still print out and mail their returns to the IRS. However, GAO testified early this year that the IRS could turn this problem into an opportunity:

> *Some taxpayers electronically prepare their returns but they choose to print and mail the tax return to the IRS. These taxpayers are known as 'v-coders' because IRS codes these returns with a 'v' for processing purposes and to track separately from other paper filers…[Out] of the 58.3 million paper returns submitted last year, approximately 42 million were v-coded returns. V-coders are an attractive target for conversion to e-filing because these taxpayers already have access to computers and electronically prepare their returns, both prerequisites for electronic filing.*[20]

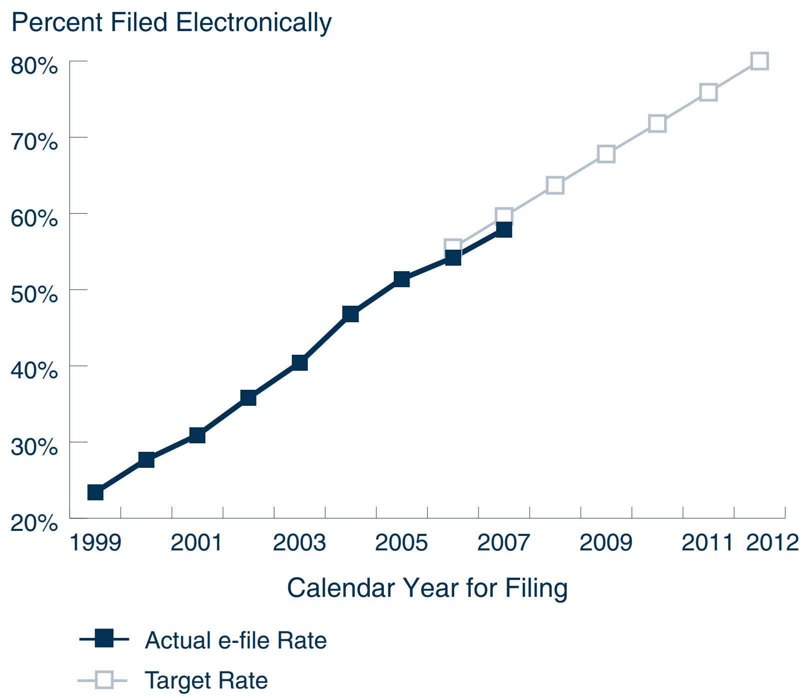
The Board sees the opportunity even more keenly. Around 90 percent of all the individual tax returns filed in 2007 were initially prepared on a computer, including nearly 99 percent of individual returns filed through tax professionals. However, only about two-thirds of these returns prepared on a computer are currently e-filed. The challenge for the IRS and its stakeholders is to turn a significant number of these returns into actual e-file transmissions. This would go a long way to meeting the 80 percent goal by 2012.

4. Annual Tracking of the Goal Based on Individual Tax Returns

In last year's report, the Board offered a trend analysis which can help monitor the IRS' progress in attaining the 80 percent goal relative to individual returns. Using 2012 as the target date for 80 percent electronic filing and 2005 as the base point for measuring progress, Figure 6 presents the linear trend line for e-filing for the years 2006 through 2012 needed to attain the 80 percent level by 2012. Against this target is plotted the actual 2006 and estimated 2007 results. As indicated in Figure 6, the actual e-file rates for the past two years are slightly below the Board's target levels—with the results through 2007 now 1.7 net percentage points below the target (i.e., an actual of around 57.9 percent versus the target of 59.6 percent). While this difference is relatively minor, it reflects a small increase in the gap from the net difference of 1.4 percentage points in 2006. To make steady progress toward the 2012 goal, the gap needs to be closed in the years ahead.

Individual income tax returns comprise around three-quarters of the total number of major tax returns filed with the IRS. Thus, they are key to attaining the 80 percent e-file goal. However, the Board intends to monitor future IRS progress in increasing the e-file rate for business and tax exempt returns as well, given that these forms are also covered by the newly recommitted goal for 2012.

Figure 6: **Individual e-file Rate: Actual vs. Target**
(for 80% by 2012)



Source: IRS Oversight Board analysis

V. Comments on the ETAAC Key Recommendations

The following section provides the IRS Oversight Board's strategic assessment of the major recommendations made by the ETAAC in its 2007 Report to Congress.[21] Overall, the Board favors the vast majority of the thoughtful proposals put forward by the ETAAC. However, the Board expresses some reservations on the ETAAC recommendations relative to e-file mandates and offers a somewhat different, more strategic approach to this very important issue in tax administration.

The ETAAC's most far-reaching recommendation was its call for registration and suitability screening of tax preparers. The Board agrees that such a recommendation has the potential to offer significant benefits to taxpayers. However, the Board also recognizes that the imposition of federal standards for paid tax preparers can be disruptive to the marketplace and conceivably harm the taxpayers such standards are intended to protect. The Board recommends that the consideration of such standards be done in a collaborative manner that fully considers the views of all stakeholders, and that the costs to both taxpayers and the government of implementing such standards be well understood and not exceed the expected benefits.

The Oversight Board strongly supports the ETAAC's view that electronic tax administration is more than electronic filing and welcomes their advice on the broad array of ETA issues including the delivery of taxpayer assistance. As previously noted, the vision contained in the IRS Strategic Plan and TAB encompasses making available to taxpayers a wide variety of choices for electronic interactions with the IRS, including additional customer service and account management options. The IRS must take steps to expand these types of electronic services. The ETAAC's advice will help the IRS achieve this vision.

1. E-File Mandates for 1040 Preparers

The IRS Oversight Board supports the ETAAC recommendation that Congress lift the prohibition on the IRS' ability to require the electronic filing of Form 1040 returns, and give the IRS the discretion to implement e-file mandates for individual returns in the future—particularly for those returns prepared by paid tax professionals. The Board agrees with the ETAAC that sizable volumes of returns prepared by tax practitioners using computer software are nevertheless filed on paper, and that mandates for certain paid preparers to e-file these paper returns would be an effective means toward achieving the 80 percent e-file goal.

However, the Board has always preferred voluntary e-file participation and views mandates as a last resort. Therefore, it further recommends that Congress attach two conditions or prerequisites before the IRS imposes any such e-file mandates on paid return preparers: (1) that the IRS must exhaust all reasonable steps to maximize voluntary participation in individual e-file first; and (2) that it must carefully study the trade-offs between the expected benefits from increased e-file and the burden imposed on filers and their preparers before setting specific mandate criteria. The Board made this same recommendation in its 2006 e-file report and presented data showing the trade-off between the number of practitioners impacted and e-file volumes increased at various mandate threshold levels.[22] This type of analysis must be done prior to the imposition of preparer mandates.

Figures 4 and 5 show that preparers have provided solid support for Form 1040 e-file without federal mandates (although e-file mandates at the state level have played a role); and that a greater challenge exists with the lower e-file rate among the self-prepared returns where preparer mandates would have no effect. It has been the Board's long-held position that the IRS should not allow mandates to become a substitute for making e-file more attractive, a comment echoed by the ETAAC in its 2007 report. A preferred approach is for the IRS to use innovative and effective strategies to increase the voluntary e-file participation among both paid and self-preparers, along with Congressional elimination of the prohibition against IRS e-file mandates for individual returns in case this option is needed as the year 2012 grows near.

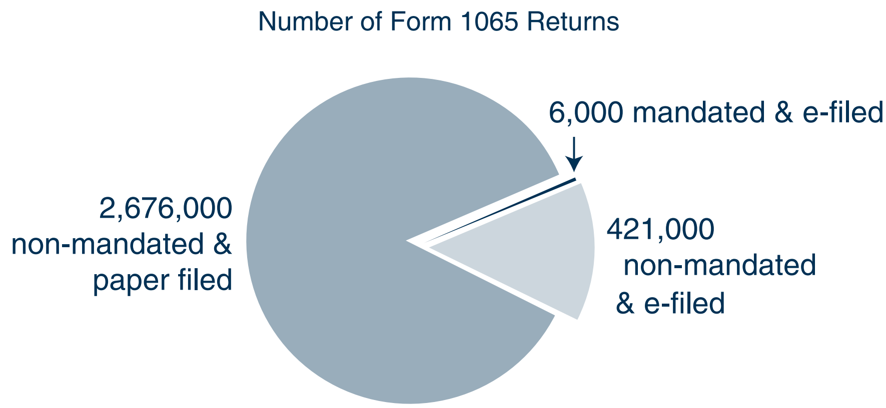
2. e-File Mandates for Certain Business and Information Returns; A More Strategic Approach Needed

The ETAAC also calls for modifying the current mandatory electronic filing requirements for corporation and partnership income tax returns, and for certain information returns, as well as for imposing new e-file mandates for Forms 940 and 941 employment tax returns. It proposes a detailed list of new threshold criteria for each. The Board recognizes that many of the current mandates on businesses and tax exempt organizations to submit returns electronically have negligible reach, at least in terms of the relative number of returns covered, and need revision. Opportunities exist for new electronic services to taxpayers and for more effective IRS compliance programs if additional information returns were filed electronically. The Board commends the ETAAC for using its 2007 report to focus more attention on these important electronic filing matters that relate to businesses and employers.

However, the Board is concerned because there appears to be no broad strategic IRS approach to the issue of e-file mandates for business return filers in recent years. Rather, it appears that only piecemeal attempts at business return e-file mandates have been made; steps which have yielded negligible results in many instances. The Board is further concerned that at least some of the ETAAC recommendations will only perpetuate this problem.

The following example illustrates some of the Board's concerns. The current Form 1065 e-file mandate applies to partnerships with more than 100 partners. However, as Figure 7 depicts, this e-file mandate only applies to around 6,000 partnership returns out of the roughly 3 million Forms 1065 filed each year. Over 420,000 Form 1065 tax returns were e-filed voluntarily in 2007, showing that e-file mandates for partnership income tax returns play a miniscule role as it relates to increased e-file volumes.

Figure 7: **Limited Reach of Current Partnership Form 1065 e-file Mandate**



Source: IRS Oversight Board analysis based on IRS partial year 2007 data

Furthermore, IRS data show that lowering the threshold for mandatory e-filing of Forms 1065 to those partnerships with more than 10 partners, as the ETAAC recommends in its latest e-file report, would only extend that e-file mandate coverage to around 165,000 partnerships.[23] While the ETAAC's recommended threshold appears to expand noticeably the number of partnerships required to e-file compared to the current mandate, in actuality it would still apply to only around 6 percent of the total number of partnership returns. Also, many of these 165,000 partnerships may already be filing their Form 1065 electronically given that there are currently over 420,000 Form 1065 e-file returns filed voluntarily—furthering reducing the potential marginal increase in Form 1065 e-file volumes from the new threshold recommended by ETAAC.

The unique circumstances and limited reach of the current and ETACC-proposed e-file mandate criteria for Form 1065 returns are only illustrative of the limitations that are of concern to the Board. The Board understands that several other e-file mandates for major business and tax exempt organization tax returns have similar limitations, in terms of the number required to be e-filed, once all related legal provisions are considered. These include the e-file mandates for Forms 1120, 1120S, 2290, 990 and 990PF.

The Board agrees with the intent of the ETAAC recommendations to make the existing requirements for electronic filing of business-related returns and information documents more effective. The Board also agrees that increases in the receipt of such returns filed electronically can serve other important purposes beyond just a reduction in returns processing costs, including reduced taxpayer burden from fewer error notices, more effective compliance programs, and opportunities for promising new services to taxpayers.

However, the Board would prefer that policymakers act to change the mandatory electronic filing requirements in the business and information returns area based on a more strategic approach to the issue than is reflected in the specific ETAAC recommendations. That strategic approach would fully identify the benefits, opportunities, challenges, interrelationships, and taxpayer burdens associated with alternative mandates/thresholds, and set new standards based on the following considerations:

- How does the IRS intend to leverage the additional data and speed of its receipt/availability;
- How many taxpayers and returns will be affected;
- What are the core benefits the IRS intends to achieve through increased e-file;
- What are the benefits to the taxpayers;
- What new services to taxpayers might be offered;
- What improvements in compliance can be achieved; and
- What are the costs and burdens imposed on businesses and/or tax practitioners under various criteria or thresholds?

The Board recognizes that the IRS has made some efforts along these lines. For example, the President's FY2008 budget request contains a legislative proposal that seeks to alter the e-file mandates for business filers of Forms 1120 and 1065 series returns. The proposed changes would link the e-filing requirement to those corporations and partnerships also required to file a Schedule M-3. Importantly, the proposal is part of the broader strategy to reduce the Federal tax gap. However, in the view of the Board, more strategic thinking is needed in setting e-file mandates for businesses.

3. Invest in Marketing Free File

The Oversight Board acknowledges the real challenges and risks the IRS would face if it attempted to provide a direct e-file portal as described in the recent GAO report on comparable state offerings. As GAO noted, an attempt by the IRS to provide a free on-line return filing platform would further stretch it's capacity to manage computer systems development efforts—an area GAO has already identified as "high risk".[24] However, the Board also recognizes the common sense appeal of taxpayers being able to accomplish electronically, and for free, one of their most basic civic obligations. Some members of Congress are proposing that the IRS provide a free, direct e-file portal for individual return filers.

The Board would prefer to see a vibrant Free File program, or similar private sector-based program, serving a growing pool of taxpayers filing for free, rather than have the IRS' resources diverted to the delivery of a direct e-file portal. Consequently, the Board supports increased marketing for Free File as the ETAAC suggests.

In addition, the Board agrees with the ETAAC and GAO that Congress should proceed with caution in compelling the IRS to provide its own Internet filing portal. The MeF system for Form 1040 filers needs to be delivered first before any IRS project be started to build a direct e-file portal, given that the current legacy system that serves nearly 80 million individual e-filers is in need of an upgrade. However, should policymakers decide that the IRS must provide such a portal, the Board would then recommend that Congress task the IRS with delivery of an application of reasonably limited scope, comparable to TeleFile.

4. Reduce Number of e-file Rejections

The ETAAC notes that about nine percent of electronically submitted returns are initially rejected because of validation checks or social security number mismatches, but that most of these filers successfully retransmit their returns electronically after correcting their errors. However, the ETAAC also notes that an estimated 1.8 million of these taxpayers who initially attempted to e-file eventually revert to paper. As a result, the ETAAC recommends that the IRS evaluate its more than 600 validation controls with the goal of increasing e-file acceptance rates while also mitigating erroneously-filed returns, and encourages the IRS to collaborate with software developers to further reduce controllable e-file rejects.

The Board views the validation checks for e-filed returns as a key benefit of electronic filing because it enables the taxpayers and IRS to promptly and efficiently resolve problems on legitimate returns, and because it helps to stop fraudulent returns. However, the process the IRS uses for resolving the errors on the attempted e-file transmissions should be user friendly and done in a way that does not create an incentive for these filers to revert to paper. Any revisions to the IRS error correction process should employ these principles.

5. Tighten ERO and Preparer Suitability Standards/ Oversight Processes

While stating its belief that the vast majority of tax professionals are honest and help their clients to file a truthful return, the ETACC proposes a number of steps to improve the oversight of Electronic Return Originators (EROs) and return preparers to address those who engage in fraudulent tax activities. These recommended steps include such IRS actions as conducting criminal background checks on all ERO applicants; centralizing oversight of EROs into one IRS operating division; and aggressively pursuing fraudulent return preparers.

As noted earlier, the Board agrees that registration and suitability screening of tax preparers has the potential to offer significant benefits to taxpayers. Over 60 percent of taxpayers use a paid preparer and the majority of these returns are prepared by unregulated tax preparers. In meeting with tax preparers, the Board has heard similar recommendations and in its 2007 Taxpayer Attitude Survey, the vast majority of respondents supported the development of competency and ethical standards for paid tax preparers. Moreover, the issue has Congressional attention as several bills have been introduced in Congress in the last three years to impose some form of regulation on the tax preparer industry and this issue is under active consideration by the Senate Finance Committee.

However, the Board also recognizes that the imposition of federal standards for paid tax preparers can be disruptive to the marketplace and conceivably harm the taxpayers such standards are meant to protect. The Board recommends that the consideration of such standards be done in a fully collaborative environment that considers the views and needs of taxpayers, the government, tax preparers who are currently covered by regulation (primarily enrolled agents, certified public accountants, and tax attorneys), and tax preparers who are not currently covered by regulation. Numerous professional associations exist that have both regulated and unregulated tax professionals as members, and their views on various approaches should be sought and considered. It is also critical that the costs to both taxpayers and government of implementing standards be well understood, and not exceed the benefits expected to be realized.

6. Comprehensive eService Vision

The Board concurs with ETAAC's "eServices" vision that includes an integrated approach to electronic service delivery. That vision entails a framework where all stakeholder and system components would work together to reduce tax administration burden. The TAB also identified eight "gaps" between where the IRS is currently and where it needs to be in the future to deliver eServices. Of the eight, the ETAAC believes that four "gaps" warrant heightened attention:

- Website Management – A governance structure for policy, project priority and funding decisions;
- End-to-End Portal and Application Management – A process to ensure 24/7 service;
- Online Support Tools – More online services and tools to meet a broader scope of service needs, e.g., resolution of account issues; and
- Authentication of Account-Related Tools – A process that allows users to sign on one time and access multiple services.

The Board agrees these "gaps" warrant the heightened attention recommended by the ETAAC.

7. Deliver eServices that Meet End Users Needs

The current effort to restructure and modernize the IRS, which began with RRA 98 almost 10 years ago, was predicated in part on the belief that "one size does not fit all." Rather, the IRS had to be customer-focused and provide services tailored to the specific needs and expectations of different taxpayer segments. For example, what is helpful to an individual taxpayer may not be needed by a small business taxpayer, and vice versa.

The ETAAC observes that in the context of tax eServices, not all services will be used by each customer segment. The IRS must refine its ETA vision, strategy, priorities, and implementation plans based on user feedback and a better understanding of customer segment needs. The ETAAC points to examples of how the IRS can better deliver such eServices in the future, such as enabling taxpayers to view and conduct transactions online and to use their tax preparation software to import information from various sources directly into their tax return. The Board finds the ETAAC recommendations to better tailor eServices to customer needs consistent with the TAB and the IRS Strategic Plan.

8. Develop Long-term Effective Information Technology (IT) Strategies

While much remains to be accomplished, the IRS is now making progress through its Business Systems Modernization (BSM) program. It must follow through on BSM-related recommendations from the GAO and TIGTA[25], and constantly take advantage of new technology and best business practices, just as the best financial services institutions do today.

In this regard, the ETAAC makes several important points. First, given the fundamental importance of IT to the IRS, the ETAAC calls for funding not only to create new systems, but for a long-term improvement process to prevent them from becoming obsolete. Second, the ETAAC is concerned that resources, funding and systems to meet the expected benefits of the modernized e-file projects, and which are critical to the IRS being able to implement a broad spectrum of eServices, are not being fully supported by the IRS or Congress. The Board has raised similar concerns in its annual budget reports to Congress and concurs with the ETAAC that the IRS must plan for the long term support of IT projects and that funding for MeF initiatives must be given high priority.

9. Address Taxpayer Barriers to E-filing

The IRS still faces enormous challenges in converting taxpayers to e-file and other electronic services. As the *IRS Oversight Board Taxpayer Customer Service and Channel Preference Survey* found, the reasons taxpayers do not e-file include concerns over privacy, security and reliability of the transmission, as well as general comfort with paper filing.[26] The ETAAC further points out that many paper filers believe that e-filing increases their chance of being audited.

The ETAAC recommends that the IRS develop education and public relations initiatives with messages targeted to overcome these types of barriers. The Oversight Board agrees with this recommendation. Many taxpayers still need a compelling reason to switch to electronic tax administration channels.

10. Drive IRS Organizational and Cultural Changes

The ETAAC believes that the IRS and its employees must become more proactive and move from gathering facts to implementing strategy, and that the TAB lays out an ambitious eServices strategy leveraging technology and the Internet. It further believes that delivering on the vision in the TAB requires people who embrace and are energized by change. It recommends that the IRS follow the lead of the private sector in meeting the expectations and needs of its customers through re-engineering processes, investing in technology, and training and hiring employees who embrace the challenges of an eServices world. The Oversight Board has approved the *IRS Strategic Plan 2005-2009*, the TAB, and the *Modernization Vision and Strategy* (MV&S), all of which set organizational goals and objectives to modernize the IRS so it can meet taxpayers' needs in an increasingly electronic world.

11. Invest in the Highest Priority Projects

In a time of tight federal budgets, it is imperative that the IRS make the best use of its limited resources. The ETAAC states that while it believes its recommendations merit funding because of their potential benefits, it is ultimately up to the IRS to prioritize its projects. However, once a commitment to a project has been made, the ETAAC notes that controls must be put into place to ensure accountability, something that the ETAAC believes is lacking in many projects. The ETAAC also states that once expectations for new electronic services have been set, Congress must provide adequate funding for the initiative as long as the business case exists. The Board has consistently supported additional budget resources for the IRS' BSM program and has identified information technology as one of the IRS' highest priorities. In approving the IRS' MV&S plan, the Board has emphasized the importance of information technology modernization and full accountability for IT investments.

VI. Conclusion

The IRS Oversight Board believes that electronic tax administration is the foundation for a modernized Internal Revenue Service that provides quality, convenient, timely and accurate services to the vast majority of taxpayers. The IRS is making tangible progress to providing those services, particularly when it comes to e-filing.

Although it did not meet the RRA 98 goal of 80 percent e-file by 2007, the Board commends the IRS for the significant achievements it has made to date in steadily increasing e-file participation, and credits the establishment of the 80 percent goal under RRA 98 as a key motivating factor that propelled the agency ahead. The Board is cautiously optimistic that with the right actions, incentives and strategies, including many of the insightful recommendations put forth by the ETAAC, the IRS will be able to reach the 80 percent goal by 2012 and thereby move closer to its full vision for electronic tax administration.

As the TAB rightly observes, technological advances in the marketplace have shaped taxpayer expectations regarding the IRS' delivery of service, but the IRS has not kept pace with those expectations. As a result, achieving its ETA vision in which electronic interactions among taxpayers, tax professionals and the IRS is the norm, remains one of the greatest challenges for the agency, but also holds the greatest potential reward for taxpayers and our tax administration system.

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