IRS Oversight Board

Electronic Filing
Annual Report to Congress
2004

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1. 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 the 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 material from which to make broad strategic recommendations based on enterprise-wide business considerations.

2. The Importance of Electronic Tax Administration

Title II of the RRA 98 provides 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 at least 80 percent 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 financial institutions, have increasingly moved towards delivery of customer services by electronic means, these goals are intended to encourage 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. Electronic filing offers taxpayers and practitioners a convenient way to submit returns, with acknowledgement of receipt by the IRS. Compared with the processing of paper returns, electronic filing greatly reduces errors, which in turn reduces the occurrence of burdensome post-filing activities caused by errors introduced during tax filing processes.

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

On a broader perspective, tax administration would become easier for the IRS and less burdensome for taxpayers if every transaction between the IRS and taxpayers had an electronic option. Achieving this vision still requires much work, but the e-filing goal established by Congress has provided the IRS and its private sector partners the boost to examine the entire tax administration environment and realize the benefits of an all-electronic environment.

3. Results of the 2004 Filing Season

3.1 Individual Tax Returns

The 2004 filing season resulted in an 8.3 million increase in e-filed individual tax returns over the previous year, for a total of 61.0 million e-filed returns as of August 27, 2004. This represents a 15.8 percent increase over the 2003 filing season. Individual segments experienced the following changes:

- On-line filing (taxpayers filing from a home computer) increased 18.0 percent;
- Practitioner e-filing increased 17.5 percent; and
- TeleFile use decreased by 6.4 percent, continuing a downward trend started in 1998.

Table 1 illustrates this year's e-filing growth in the context of the six-year pattern of electronic filing. Based on the trends experienced during this period, the Oversight Board believes that the IRS will not achieve the goal of 80 percent e-filing by the year 2007.

Table 1: Growth of Electronic Filing for Individual Tax Returns 1999-2004
(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
2004[2]	128.0	13.8	43.4	3.8	61.0	47.7	15.8
2003	130.7	12.0	36.4	4.0	52.9	40.5	13.3
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	13.4
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

Sources: ETAAC 2003 Report, IRS 2003 Data Book, and IRS Tax Year 2003 Taxpayer Usage Study Report Number 15

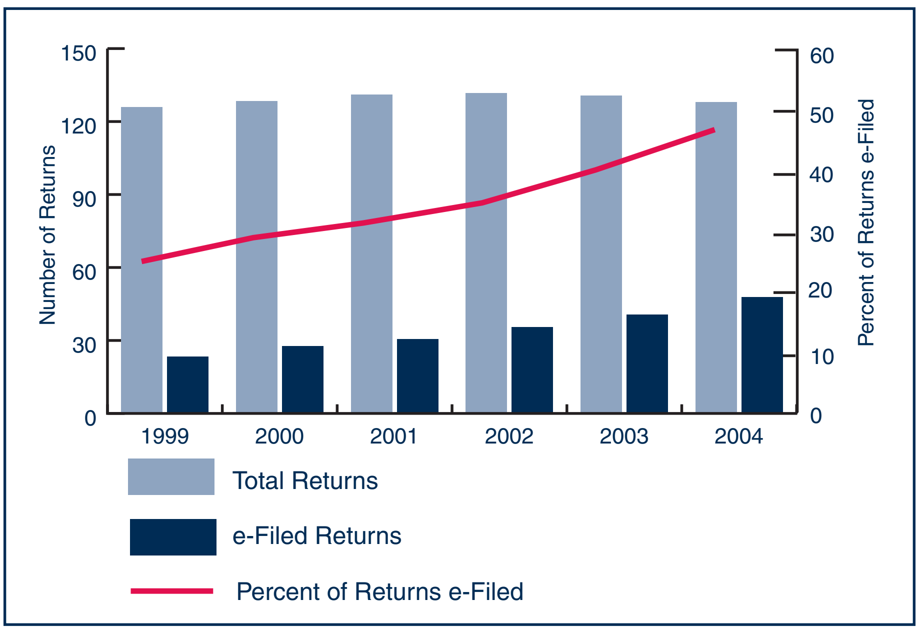
Note 1: On-line returns are filed by taxpayers who prepare their returns using tax software and then file the returns electronically using the features of the tax software product.

Note 2: Year 2004 return numbers are through August 27, 2004.

The Board believes that the IRS has shown remarkable progress in achieving the e-filing growth shown in Table 1. However, this rate of growth will not allow the IRS to reach the 2007 goal unless some new incentives are implemented. Section 4 discusses some additional incentives that will make e-filing more attractive, but these incentives are unlikely to increase the growth sufficiently to reach 80 percent e-filing by 2007. Figure 1 below shows the e-filing growth during this period in graphic form.

Last year was the second year of operation for 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 through the Internet to qualified taxpayers. In the aggregate, the Free File Alliance offers free tax preparation and electronic filing to over 60 percent of taxpayers. This opportunity is targeted primarily at taxpayers who prepare their own tax returns without the assistance of a tax professional. Each consortium member establishes its own taxpayer eligibility requirements, which generally are based on factors such as age, adjusted gross income, state residency, military status, or eligibility to file a Form 1040EZ.

Figure 1: Growth of Form 1040 e-Filing for Calendar Years 1999-2004
(in millions)



Source: ETAAC 2003 Report, IRS 2003 Data Book, and IRS Tax Year 2003 Taxpayer Usage Study Report Number 15

3.2 Business Returns

Business return e-filing levels in general are relatively low, and until recently, e-filing was not available for all business returns. Those business e-file initiatives that have been implemented have been well-received, especially where the e-file process added value and did not increase burden or cost. E-filing results for common business returns are shown in Table 2. E-filing data for Forms 1120, 1120S, and 990 are not yet available.

Table 2. Business Returns Filed Electronically in 2003-2004
(in milions)

	2003			2004		
Tax Return	**Total Number**	**Electronically Filed**	**Percent Electronic**	**Total Returns**	**Electronically Filed**	**Percent Electronic**
941	23.53	3.55	15.1	23.90	4.67	19.5
940	5.71	0.35	6.3	5.67	0.37	6.5
1065	2.38	0.05	2.1	2.48	0.88	3.5
1040	3.79	1.30	34.2	3.85	1.41	36.7
K-1 (1065)	14.38	4.19	29.2	14.45	5.55	38.4
K-1 (1041)	4.14	1.97	47,6	4.17	1.88	45.1

Source: Draft IRS E-Strategy for Growth, September 2004

4. Discussion of e-Filing Progress and the ETAAC Report

The IRS Oversight Board has reviewed the ETAAC report and the IRS' e-filing progress during the recent filing season and offers the following observations and recommendations.

4.1 Meeting the 2007 e-Filing Goal

The Oversight Board praises the IRS for the solid progress it has achieved towards promoting and advancing the use of e-filing. In 2004, 61 million taxpayers filed their returns electronically, a 16 percent increase from the previous year. However, the Board acknowledges that the IRS will not meet its congressionally-mandated goal of 80 percent of all returns filed electronically by 2007. In this past filing season, 48 percent of returns were filed electronically.

Nevertheless, the Board strongly believes that setting the 80 percent goal was important and worthwhile. Establishing clear goals can have an energizing effect on the organizations that own them, and the IRS proved to be no exception. Although the agency will not reach the 2007 e-file goal, no one can doubt the very positive changes it engendered and the efficiencies and cost savings it continues to produce. Recent reallocations of IRS resources to critical enforcement efforts are directly tied to the closing of a major paper tax return processing center made possible by e-file growth.

The e-file goal has also prompted many of the IRS' stakeholders to focus their attention and resources on electronic filing. Filing and paying taxes electronically is a natural extension of using personal computers and the Internet, so a variety of software manufacturers have worked closely with the IRS to develop tools that make it easier for taxpayers to perform these functions.

4.2 Continued Outlook for e-Filing

The Free File Alliance is a particularly successful partnership forged between the federal government and the private sector. Launched two years ago by a consortium of private sector companies to make available e-file options to taxpayers who meet various qualifications, it provides a valuable service to over 60 percent of taxpayers by allowing them free access to Internet-based tax preparation services and e-filing. The Board strongly recommends that it be maintained and kept under continued IRS supervision.

Because of these very positive trends, the Board is confident that electronic filing will continue to grow in the future. However, such continued growth will not happen by itself; it will require the same focus, dedication, and resources that created such strong e-file progress to date.

Moving forward will require incremental steps to ensure that e-filing is supported and accepted at all levels of the tax administration system. In its 2004 Annual Report to Congress, the ETAAC argued that the IRS must reinvent its internal business model across all four operating divisions to one that embraces standardized electronic interactions. Currently, electronic initiatives tend to be centralized in the IRS' Electronic Tax Administration (ETA) organization, which oversees all aspects of the exchange of electronic information among the agency, taxpayers, and practitioners.

The ETAAC stated in its report: "ETA must, with the visible support of the Commissioner and other executives, develop a top-down driven strategy to make electronic administration the rule, rather than the exception to the rule, within the IRS. This will require a cultural shift within the agency regarding preconceived notions of how returns are processed, and how the IRS communicates internally, as well as with taxpayers, tax preparers, employers and other primary sources of tax information, such as state revenue agencies."

The Board agrees with the ETAAC's recommendation and urges that additional electronic options be vigorously pursued and promoted at every level of the tax administration system. Their greater acceptance and use must be strongly promoted amongst all taxpayers and practitioners. However, the Board also believes that it is vital to maintain paper channels during this evolutionary process.

In a recent letter to the Board, Janet Spragens, Professor of Law and Director of the American University Federal Tax Clinic in Washington, DC, pointed out that, "Although … technological enhancements may be a desirable improvement for the many who have Internet access, … by and large, low income taxpayers – and to some extent seniors – are not part of the information age and do not have competency in or access to computers or other technological advances."

Professor Spragens is correct and her astute observations touch upon the larger issue of how the IRS can best deliver quality customer service in a way that meets the needs of all taxpayers. When its reorganization began almost seven years ago, the IRS discarded the "one size fits all" customer service philosophy and adopted a tailored approach to fulfill different taxpayer needs while still seeking greater efficiencies and cost savings.

For example, although tens of millions of taxpayers prefer to get their tax information through self-serve applications, such as over IRS' popular Web site, or by calling one of its toll-free lines, still others prefer the ability to meet face-to-face with an IRS representative at one of the agency's walk-in sites.

The Board strongly believes that these taxpayers should still be afforded this choice, just as they should have a choice between paper and electronic filing.

However, at the same time, the IRS should continue to seek innovative ways to reach out to individuals who do not have computer access or technological know-how so they too may enjoy the benefits of e-filing.

4.3 Disparate Paper and Electronic Processing Channels

The IRS cannot work at cross purposes when it comes to encouraging additional e-filing. It should find ways to make it easier and more efficient for taxpayers to switch to e-filing, not place additional hurdles or disincentives in their path. The ETAAC report identifies a number of situations where IRS processes may be making it more difficult to file electronically than by paper. For example, any return that requires a form that is not available electronically represents a burden to a potential e-filer or practitioner, and represents a disincentive to make the switch to e-filing. The IRS should adopt a principle of equal processing of both sets of returns and evolve both paper and electronic processing so that equal treatment is achieved.

The same principle should apply to post-filing functions. The IRS must also work to overcome the myth that taxpayers who e-file are more likely to be audited. Although this is false, this belief occasionally gains currency and must be dispelled.

4.4 Additional Incentives for e-Filing

The Board believes that the IRS must create and offer incentives, such as extending the due date for electronic filers, to encourage taxpayers to e-file balance due returns. However, the ETAAC sees a different reason why balance due taxpayers are not joining the e-file ranks. It criticizes the IRS' draft *E-Strategy for Growth* for lacking a marketing plan to reach balance due taxpayers and demographic groups that show the most potential to switch to electronic filing.

The Board understands the importance of marketing electronic filing to practitioners and taxpayers, but is concerned that the ETAAC may be placing too much weight on marketing and communications to reach the 80 percent goal, and insufficient emphasis on new and better electronic products and services that taxpayers want. Again, balance is the key, and the Board would expect this balance to be demonstrated by the IRS as it finalizes the *E-Strategy for Growth.*

The Board believes that extending the due date for electronic filing would attract additional electronic filers. That belief is based on taxpayer surveys taken by the IRS. This proposal has also won strong support from the Administration, the U.S. House of Representatives, and, in past years, by the ETAAC. Although the ETAAC has reversed its position this year, the Board continues to believe that the due date change would be an effective tool in attracting additional e-filers and urges Congress to revisit and pass the proposal when it reconvenes in January 2005 for the 109th Congress.

With the exception of those described below, the Board generally agrees with the tenor of the other ETAAC recommendations to promote e-filing acceptance and use. For example, there is little if any visible progress towards electronic filing of employment tax returns and the IRS has yet to devise any incentives to address this market. The absence of such inducements should be addressed as soon as practicable.

The Board is particularly intrigued by the ETAAC's finding that most, if not all of the increase in electronically-filed returns for the 2004 filing season was in direct correlation to those states that enacted state-mandated requirements for e-filing. The ETAAC observed that, "Federal e-file growth may now be entirely dependent on what states may be doing rather than because of incentives offered by the IRS."

The table below shows the growth of e-filing by state. Seven states have mandated the electronic filing of state returns by practitioners: California, Connecticut, Michigan, Minnesota, New Jersey, New York, and Wisconsin.

Table 3. Electronic Individual Tax Returns by State During 2004

State	Returns	Percent Growth	State	Returns	Percent Growth
Armed Forces Americas	4,447	-14.2	Wisconsin	1,532,341	11.0
Armed Forces Pacific	69,685	-5.1	District of Columbia	111,009	11.1
Armed Forces Non-Americas	96,710	-3.3	Florida	3,587,525	11.2
			Pennsylvania	2,356,621	11.8
			Oklahoma	735,991	11.9
South Carolina	1,051,082	6.6	Virginia	1,557,060	12.0
Indiana	1,420,675	7.6	Wyoming	120,166	12.1
Georgia	2,009,467	7.7	Arizona	1,048,206	12.3
Mississippi	651,727	7.8	New Jersey	1,348,068	12.3
Louisiana	923,865	7.9	Utah	465,818	12.3
Iowa	843,376	8.0	Delaware	177,832	12.4
Tennessee	1,402,525	8.2	New York	2,858,415	12.4
Arkansas	625,703	8.4	Montana	218,572	12.6
Texas	4,334,695	8.6	Washington	1,270,076	12.6
North Carolina	1,785,992	9.0	Maine	239,339	12.8
Kentucky	917,472	9.1	Maryland	1,055,358	12.8
Missouri	1,317,125	9.5	Hawaii	218,438	12.8
Alabama	1,001,904	9.5	Oregon	704,480	13.5
Illinois	2,556,328	9.5	South Dakota	179,633	13.8
Kansas	609,640	9.6	North Dakota	160,317	14.7
West Virginia	344,237	9.8	Nevada	488,469	15.0
Colorado	868,757	10.3	Alaska	146,975	15.6
Connecticut	631,682	10.3	Idaho	302,008	16.7
New Mexico	397,528	10.4	Minnesota	1,515,859	16.9
New Hampshire	278,441	10.5	Rhode Island	191,738	17.8
Ohio	2,472,703	10.6	Vermont	115,106	19.1
Massachusetts	1,197,792	10.8	Michigan	2,713,862	39.5
Nebraska	417,797	11.0	California	7,425,252	52.9

Source: IRS Report, *Location of Taxpayer by State*, ELF 1557, data as of September 27, 2004.

Two of these states, California and Michigan, with growth rates of 40 percent and 53 percent respectively, experienced growth that was much higher than any other state. The other five states that mandated e-filing of electronic returns did not stand out significantly. More analysis is required to understand better what caused these results.

To this end, the IRS should work closely with more states to encourage e-filing at the state level. The Board is pleased that the IRS recognizes this need and is committed to a close collaboration with the states on the shared goal of increasing the use of electronic products for tax administration. The IRS has made a good start but needs to do more.

4.5 Reservations with Three ETAAC Recommendations

The Board has some reservations about three ETAAC recommendations. First, the Board has spoken forcefully and consistently for IRS funding so that it may meet its strategic goals, including 80 percent e-filing by 2007. However, the Board does not agree with the ETAAC's recommendation to specifically earmark funding for Modernized e-File, or for that matter, any specific project.

The implementation of Modernized e-File, like other Business Systems Modernization (BSM) projects, has been delayed. The Board, among others, has recommended that the IRS reduce the number of BSM projects it manages. The ETAAC has pointed out that in some cases this delay forces both the IRS and external stakeholders to use and support three processing systems – the legacy e-file systems, Modernized e-File, and paper. The completion of Modernized e-File will eliminate this burden. The ETAAC argues that additional earmarked funding, as well as eliminating the TeleFile program, will allow for Modernized e-File to reduce the timeline for incorporating Form 1040 to no more than three years.

The Board recognizes the importance of e-file projects, the benefits they offer to millions of taxpayers, and the efficiencies they produce. However, the Board also believes that Modernized e-File must compete with all other BSM projects using established BSM procedures for prioritizing projects. The BSM program, consistent with Office of Management and Budget policy, uses a business case analysis process to identify the costs and benefits of competing projects prior to allocating funds to any project. Not only does this process identify the highest priority projects, it establishes a baseline for program evaluation.

With the recent passage of the FY2005 omnibus appropriations bill, resource issues now loom large for the entire BSM program. The IRS FY2005 budget will be $184 million less in BSM spending than it was the previous year. Given this shortfall, the Board believes that the IRS must use its existing prioritization process to determine how to best manage the BSM portfolio in a time of fiscal austerity and make the hard choices that lie ahead. The Board believes that the e-Services and Modernized e-File projects should compete for funding and not be specifically earmarked for funding through the legislative process.

The Board also wants to stress that the IRS must continue to make solid progress replacing the IRS legacy master file system and begin to move taxpayer records from it to the modern reliable database called the Customer Account Data Engine (CADE). The Board has repeatedly stated that the IRS cannot continue to operate with the antiquated and inefficient systems and processes it uses today. Over time, the existing tape-based legacy systems will become impossible to maintain and at that point, the ability to administer our nation's tax system will be in grave danger. Such a catastrophic risk to our country is unacceptable and replacing the master file system must remain our top priority.

The ETAAC has also recommended that Congress mandate e-filing by paid preparers. Although there is precedent for mandating the electronic filing of certain forms by practitioners, this move would represent a monumental change from the current incentive-based e-file strategy and will likely prompt a strong reaction from many quarters. The Board has an open mind on this recommendation but urges a full and open debate prior to making this initiative public policy to ensure that all aspects of the change are considered.

Although not addressed in the ETAAC report, the electronic filing of business tax returns offers potential cost, speed, and accuracy benefits to both the IRS and taxpayers. With the introduction of e-Services and Modernized e-File this year, the IRS has the capability to receive forms 1120, 1120S, and 990 electronically. As this method of filing business taxes becomes more common, the IRS is encouraged to study the costs and benefits of mandating the electronic filing of business tax returns for selected classes of businesses. There is precedent for mandating the electronic exchange of information between businesses and government, both within and outside the IRS. The Board believes it is best for all parties to evaluate the possible imposition of mandates now and remove speculation and uncertainty from the marketplace. The IRS is urged to engage affected stakeholders, such as businesses, tax software companies, and tax practitioners, in the evaluation process so that informed decisions can be made.

Lastly, the ETAAC states that it interprets the goal of RRA 98 to maximize paper tax and information return filing so as to eliminate the data entry associated with paper. In this regard, the ETAAC would view the filing of a magnetic document to be the equivalent of an electronic return. However, submitting magnetic tapes requires IRS staff to receive and physically handle the submission, which is labor intensive. Moreover, the serial nature of magnetic files make updating of information more complex than electronic files. The Oversight Board therefore recommends that the IRS continue to emphasize real electronic interactions, and not consider magnetic files an equivalent substitute.

5. Discussion of Last Year's Recommendations

In its 2003 report to Congress, the IRS Oversight Board addressed five issues that the ETAAC raised in its 2003 report:

- Vision of an electronic tax administration environment
- Broadening e-filing educational and marketing efforts
- Role of benefits and incentives in promoting e-filing
- Future of TeleFile
- Regulation of preparers

Progress made with respect to each issue is mixed. The IRS continues to make steady progress in its Electronic Tax Administration efforts, despite the fact that it is unlikely the IRS will achieve its 80 percent e-filing goal by 2007. The issues raised by the ETAAC last year continue to be important components of the larger e-filing goal. However, perspectives and views of the Board and ETAAC are somewhat different, both are committed to the IRS' efforts to improve services to taxpayers and their representatives, reduce errors, and foster increased compliance with our tax laws.

5.1 Vision of an Electronic Tax Administration Environment

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 a broader electronic tax administration program.

Last year the Board discussed its vision of the future direction of electronic tax administration, which included an integrated 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. Although this vision is far from being a complete reality, there are signs that the IRS and its external stakeholders are moving in that direction.

For example, the Free File Alliance completed another successful year in partnership with the IRS, offering a large majority of taxpayers free options to prepare and file their taxes electronically. In addition, the IRS offered a number of services that illustrate the effectiveness of electronic tax administration beyond e-filing of individual tax returns. These services include self-service applications for individual filers such as *Where's My Refund*; e-services offered to professional tax practitioners that meet certain criteria; and the Modernized e-File program that now accepts Forms 1120, 1120S, and 990 business tax returns electronically.

These programs all make evolutionary progress towards establishing a network of electronic tax administration options for all taxpayers. Much must still be done, including the extension of the Modernized e-File architecture to the Form 1040 family of individual returns, and the development of additional electronic options for tax administration, such as providing taxpayers with the ability to have secure access to their own tax account information.

Last year, the ETAAC 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. As noted in last year's report, implementing a return-free system, even for a small segment of taxpayers, is not practical until the IRS modernizes its information technology systems. However, California plans to conduct a return-free system for a limited group of taxpayers next year, and this experiment may reveal some benefits and problems of such a system.

5.2 Broadening e-Filing Educational and Marketing Efforts

Last year, the Board agreed with the ETAAC recommendation that a continued educational and marketing effort is needed to convince more taxpayers and preparers of the benefits of e-filing. This recommendation was seen as a step in reversing the slowing growth trend in e-filing, and included the establishment of a "Speakers Bureau" and the use of practitioners to advocate the benefits of e-filing to other practitioners.

The IRS Stakeholder Partnerships, Education, and Communication (SPEC) organization continues to promote electronic filing by taxpayers, but the Board is not aware of programs that were aimed specifically at implementing the ETAAC recommendations. The Board does note that the growth of e-filing has increased this year to 15.8 percent from 13.3 percent the previous year. Much of the growth, however, can be attributed to two states, Michigan and California, which mandated the e-filing of state returns for certain paid preparers, and increased e-filing of federal returns by 40 percent and 53 percent, respectively.

The Board recommends that IRS SPEC continue its promotion of e-filing by all practical means, including the two described above.

5.3 Role of Benefits and Incentives in Promoting e-Filing

Last year, the Board, as well as the ETAAC, supported the Administration's proposal to extend the filing due date to April 30th for individual taxpayers that file electronically. It sees the extended due date as a powerful incentive in particular for balance due filers, and other taxpayers who make a habit of procrastination. IRS research indicates that this change will modify taxpayer behavior and result in additional e-filed returns.

The ETAAC has reversed its position this year, and now opposes this change. However, no new research has been conducted to indicate that this change would not be effective, and the Board continues to support it. The House of Representatives included this change in H.R. 1528, which it approved in July

2004. However, this provision was not included in the corresponding Senate Bill, S. 882.

The Board also noted last year that the IRS had several modernization projects, such as e-Services and Modernized e-File, that provided additional benefits to e-filers. These projects have been successfully implemented and are providing additional benefits to e-filers and tax practitioners.

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. This project delivered its first release this year, but this initial release is only processing tax returns for certain 1040EZ filers. Once additional releases are implemented, they 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.

Last year, the ETAAC also proposed monetary incentives to increase the e-filing of business returns. The Board believed at the time that more data is needed before the Board could endorse the use of financial incentives for e-filing business returns, and continues to take this position.

5.4 Future of TeleFile

Although TeleFile continues to be used by fewer taxpayers each year, the Board continues to believe that TeleFile provides valuable access to an electronic medium for taxpayers with simple tax returns. Last year, and again this year, the ETAAC has noted the decline in the number of taxpayers using TeleFile and the growing cost of maintaining the TeleFile system.

As the number of TeleFile users continues to decline and per unit processing costs increase, the Board recognizes that the IRS must examine this program more critically to determine whether its cost is commensurate with the benefits it provides to taxpayers. IRS budget cuts for FY2005 place pressure on the IRS to reduce services that do not deliver as much value to taxpayers as other programs that compete for the same cost dollars. In evaluating whether TeleFile should continue, the Board expects that the IRS will include an assessment of taxpayers' needs and any impact on electronic filing goals established by Congress in the evaluation process.

5.5 Regulation of Preparers

Last year, the ETAAC report discussed the regulation of tax preparers and raised concerns about the poor quality of tax preparation by some paid preparers. The Board noted last year that although these concerns applied to preparers of electronic returns, the issue of the quality of tax preparation was much broader than electronic filing. The same issue was raised by the National Taxpayer Advocate in both her 2002 and 2003 reports to Congress, in which she made some broad recommendations to remedy the situation, including licensing and testing of all tax preparers.

Our system of tax administration depends on the contributions of many participants, and taxpayers lives can be affected by problem preparers just as much, if not more, than problems experienced with the IRS. Thus, the Board found it appropriate during this past year to examine this potential issue more closely.

During its public meeting in January 2004, the Board dedicated a panel specifically to this topic, discussed the issue with local tax preparers at its July field meeting in Kansas City, and discussed the matter with tax preparers and IRS employees at all six Nationwide Tax Forums. The Board found the issue to be of high interest to preparers with a wide diversity of tax practices. Both preparers and IRS employees alike generally agree about the need to address problem preparers, but there was not a broad consensus about what should be done, although there was consensus on several issues. Practitioners believe that it is important the IRS knows who is preparing tax returns and should at least have a registration system. Practitioners also believe an honest practitioner community is one of the IRS' biggest allies in the achievement of high voluntary compliance.

In general, specific issues where there seems to be general agreement are:

- A need exists to do something to address problem preparers
- Suitability requirements for preparers are a good foundation upon which to build additional requirements
- Any solution must be developed in conjunction with stakeholder organizations
- Some policing mechanism is necessary
- The IRS should conduct a public awareness campaign designed to provide taxpayers with information about selecting a competent tax return preparer

However, the Board found that there was no broad consensus on the following issues:

- What type of registration should be required
- Whether competency testing should be required
- What continuing professional education should be required
- Whether practitioners should be required to have professional liability insurance
- How the new system would be regulated and what sanctions should be imposed

Other findings that came from these meetings include:

- Tax professionals and IRS employees favor some type of program that would curtail incompetent or unscrupulous preparers, but see many complications in developing and administering one.

- Professional organizations at the public meeting recommended the formation of a task force of federally-authorized tax practitioners to work with the IRS to discuss the professional responsibilities of tax practitioners. They said that tax professionals have an ethical responsibility to do their part to restore public confidence in the tax system.

- Circular 230 tax professionals are concerned about the impending retirements of large numbers of experienced tax professionals. They suggest that there is too much dependence on tax software and an attitude among many inexperienced practitioners that all it takes to prepare tax returns is a computer and a software program.

- Practitioners also feel the IRS should tighten Electronic Return Originator standards, and do a better job of enforcing preparer penalties. They expressed frustration with the appearance that the IRS does not take any action upon receiving a report about a problem preparer, and suggested that the IRS develop a process for practitioners to report preparer incompetence or unethical behavior. Regulation without enforcement will not solve the problem.

- Practitioners note that legitimate professionals who handle money are required to be regulated or certified in some manner, and most carry liability insurance to protect themselves and their clients.

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