IRS Oversight Board
Electronic Filing 2008
Annual Report to Congress

January 2009

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Executive Summary

The electronic filing of tax returns is part of a broader range of electronic tax administration (ETA) activities which are the foundation for a modernized Internal Revenue Service (IRS) that provides secure, convenient, timely and accurate services to taxpayers and tax professionals and the IRS employees who serve them. The full vision for ETA is to make electronic interactions among taxpayers, tax practitioners, and the IRS the norm. It remains the means by which the IRS can evolve into a truly modern organization that can deliver world-class quality service.

The ETA vision was reflected in the IRS Restructuring and Reform Act of 1998 (RRA 98) that included several provisions designed to spur the IRS and the professional tax community to work together to advance this common cause. In particular, RRA 98 established the goal that 80 percent of returns be filed electronically by the year 2007. This was an extremely challenging goal given that only 20 percent of individual income tax returns were electronically filed at the time the law was enacted. RRA 98 also required the IRS Oversight Board to submit an annual report to Congress addressing the progress the IRS is making in meeting the 80 percent goal and placed a similar reporting responsibility on the Electronic Tax Administration Advisory Committee (ETAAC).

The IRS did not reach the 80 percent electronic filing (e-file) goal by the year 2007; instead it achieved a rate of around 57.5 percent electronic filing for individual tax returns and about 48 percent e-file for the aggregate of all major individual, business, and exempt organization tax returns combined. Nevertheless, the 80 percent e-file goal was a successful catalyst for change and, in the view of the Board, the IRS and its partners in the professional tax community have made significant progress since the law's passage. In particular, the IRS and its tax partners have steadily increased the share of tax returns filed electronically and created many new and useful electronic tax products and services over the past decade.[1]

In early 2007, the Board approved a new, IRS-proposed long-term goal that recommits the agency to the 80 percent e-file target. The new goal calls for a combined electronic filing rate of 80 percent by the year 2012 for all major tax returns filed by individuals, businesses, and tax exempt organizations. The Board approved the goal as part of long-term measures for the IRS' strategic plan and it is now a definitive expectation.

Many challenges must be overcome to achieve the 80 percent e-file rate by 2012 and the broader ETA vision. For example, research shows that those individuals who file paper returns are less comfortable with the idea of electronic filing than those who have already switched to e-file. Still, it is the Board's view that the IRS can meet those challenges with the support of its tax partners and policymakers in the Administration and Congress. Federal policymakers must provide the IRS the necessary resources, legal flexibilities, and oversight that will enable the agency to establish a truly modern electronic tax administration system. For their part, the IRS and its tax partners must continue to plan, manage, and deliver innovative electronic tax products and services that are secure and improve service to taxpayers. In this regard, the Board applauds the announcement by two major producers of retail tax preparation software to no longer charge a fee to electronically file individual federal tax returns. This action will certainly help achieve the 80 percent e-file goal.

Progress is being made. In 2008, individual returns filed electronically grew more than 12 percent and will reach nearly 90 million. Business and tax exempt e-filed returns also increased—about 5.5 percent with an estimated yearly total to exceed nine million. The Board estimates that more than 58 percent of individual tax returns will be electronically filed by the end of 2008 and the combined total for all major individual, business, and tax exempt returns will come in around 49.5 percent.

In addition, the Economic Stimulus Act of 2008 resulted in the one-time filing of more than 14 million individual tax returns by certain Social Security and veteran benefits recipients so they could receive their economic stimulus payments. Most of these returns were filed on paper, which lowered the e-file rate in 2008 than would otherwise have been the case. However, this effect is temporary and the Board estimates that minus these returns, the e-file rate for individual returns would likely be a few percentage points over 60 percent. Similarly, the e-file rate for the combined total of all returns would be at least several net percentage points higher—placing it well over 50 percent.

Beginning with this report, the Board will track the IRS' progress against its 2012 e-file goal of 80 percent. To help with that tracking, the Board has developed targeted e-file rates by year to gauge IRS' progress toward that 80 percent level. Through 2008, the estimated result for the combined e-file rate remains several net percentage points below the targeted value, even when adjusted to eliminate the temporary effect of the economic stimulus returns. While the Board believes it is possible for the IRS to make up the gap in the future, the Board's tracking results nevertheless reinforce the need for the IRS, its tax partners, and federal policymakers to take still more substantive actions to advance e-file and the broader ETA vision.

Several potential actions worth considering come from the ETAAC *Annual Report to Congress* for 2008, and the Board commends the ETAAC for its recommendations. As it has done in the past, the Board uses part of this report to provide additional perspective and strategic comment on some of the major recommendations put forth by the electronic tax administration experts on the ETAAC. Many reflect practical advice to the IRS and policymakers that should help advance electronic filing, such as steps to ensure a smooth and successful roll-out of the IRS' new Modernized e-File (MeF) platform for individual returns.

More detailed explanation of the Board's views on key ETAAC recommendations is presented in the latter section of this report. But on a broader level, the members of the Board and the ETAAC share a common view that electronic tax administration is the foundation for a truly modern IRS that serves taxpayers, tax professionals, and IRS employees efficiently and effectively.

Introduction

Purpose and Scope

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98) set a goal that called for 80 percent of returns to be filed electronically by the year 2007. RRA 98 also required the IRS Oversight Board to submit an annual report to Congress addressing the progress the IRS is making in meeting the 80 percent goal. RRA 98 placed a similar reporting responsibility on the Electronic Tax Administration Advisory Committee (ETAAC), whose members are chosen for their particular expertise in the electronic exchange of tax administration information.

The IRS did not reach the 80 percent electronic filing (e-file) goal for tax returns by the year 2007. Nevertheless, in the view of the Board, the IRS and its private sector partners in the professional tax community have made significant progress since the passage of RRA 98 to increase e-file volumes and establish a more modern electronic tax administration environment. In addition, in early 2007, the Board approved a new, IRS-proposed long-term goal that recommits the agency to the 80 percent e-file target. The new e-file goal calls for a combined electronic filing rate of 80 percent by the year 2012 for all major tax returns filed by individuals, businesses, and tax exempt organizations. The Board approved this IRS recommitment to the 80 percent e-file goal as part of long-term measures for the IRS' strategic plan.

Beginning with this report, the Board will now track the IRS' progress against its 2012 e-file goal of 80 percent, as well as update Congress on other important electronic tax administration matters. As it has in the past, the Board will also use this report to provide additional perspective and strategic comment on key recommendations put forth by the electronic tax administration experts on the ETAAC in their 2008 report to Congress.[2] In the view of the Board, what was essentially a congressional challenge to the IRS in RRA 98 to achieve an 80 percent e-file rate is now a definitive expectation for the agency as part of its strategic plan.

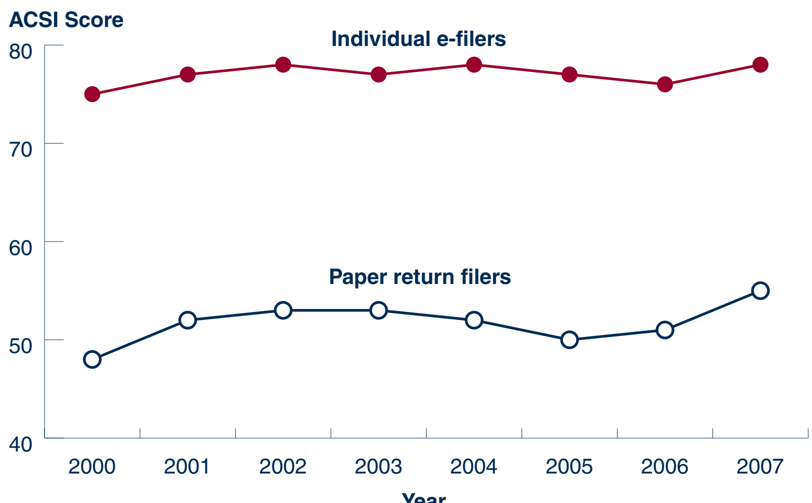
Importance of Electronic Tax Administration

The electronic filing of tax returns is only part of a broader range of tax-related activities embedded in the concept of electronic tax administration. Electronic tax administration (ETA) is the foundation for a modernized IRS that provides secure, convenient, timely, and accurate services to taxpayers, and to the tax professionals and IRS employees who serve them. The full vision for a modern ETA environment goes beyond just e-filing and seeks to make electronic interactions among taxpayers, tax practitioners, and the IRS the norm. These electronic interactions include the entire range of pre-filing, filing, and post-filing tax activities which taxpayers and their representatives may engage in with the IRS, including the ability to resolve taxpayer account issues over the Internet.

The ETA vision in which the vast majority of tax interactions are handled electronically was embraced by the IRS Restructuring Commission and incorporated into RRA 98. It is also in keeping with the E-Government Act of 2002, which seeks to promote the use of the Internet and other information technologies to improve government services for citizens and internal government operations.[3] The ETA vision is further embedded in IRS long-term planning initiatives, including the *IRS Strategic Plan 2005-2009*, the *Taxpayer Assistance Blueprint*, and the *IRS Information Technology (IT) Modernization Vision and Strategy*. But at its core, ETA remains the means by which IRS can evolve into a truly modern organization that can deliver world-class quality service.

Individual taxpayers who file their returns electronically consistently report a much higher satisfaction level with the filing process, than do the individuals who file their returns on paper (see Figure 1). In 2007, the latest year for which data are available, the American Customer Satisfaction Index (ACSI) score for individual e-filers was 78 compared to 55 for paper filers.

Figure 1. ACSI Scores 2000-2007



Source: www.theacsi.org

Notable Developments in Electronic Tax Administration During 2008

New MeF Applications for Business and Tax-Exempt Returns

The IRS continued to make a number of notable advancements in electronic tax administration during 2008. Early in the year, the IRS introduced its new Form 990-N e-file application. This new e-file system was built as another of the IRS' Modernized e-File (MeF) platforms that use highly-flexible modern systems technology. The application enables small tax-exempt organizations to meet their new annual filing requirement for Form 990-N, and to e-file that simple form ("e-postcard") directly with the IRS' web site. During 2008, the IRS also released its Form 1120F MeF application allowing applicable companies to file their U.S. Income Tax Return of a Foreign Corporation electronically, and received its first set of Quarterly Federal Excise Tax returns electronically via its new Form 720 MeF application.

New and Expanded Applications to Assist Taxpayers

The IRS also made enhancements to its Online Payment Agreement application during 2008. This application enables taxpayers and their authorized representatives to set up installment agreements via the Internet to pay outstanding tax liabilities. Enhancements to the Online Payment Agreement tool implemented during the year include the ability for individuals to revise their payment dates, the amounts on existing agreements, and/or their method of payment such as payroll deduction or direct debit. In addition, the IRS deployed new or enhanced modernized systems internally during the year to improve the productivity of IRS operations. These systems include new modernized Customer Account Data Engine notice processing capabilities and the Account Management Services Release 1.2A, which distributes electronic transcript cases to IRS campuses.

Impact of the Economic Stimulus Program

As a result of the Economic Stimulus Act of 2008, the IRS was responsible for distributing over 115 million economic stimulus payments to taxpayers during the year. The implementation of this legislation had a noticeable affect on the IRS in 2008, including electronic tax administration. For example, through late September 2008, the IRS delivered over 42 million economic stimulus payments through electronic direct deposits.[4] The legislation also affected IRS' website usage, IRS toll-free telephone service, and the number of individual returns filed on paper and electronically.

Through mid-May 2008, visits to IRS.gov for the year were well over 205 million. This volume reflected a 44 percent increase over the comparable period the year before and was driven, in part, by taxpayer inquiries associated with the Economic Stimulus Payment program. To address taxpayer questions about these special payments, the IRS not only updated its website with relevant information, but it deployed two new tools on IRS.gov during 2008, the Economic Stimulus Payment (ESP) Calculator and the "Where's My Stimulus Payment?" application. These two new applications helped address millions of taxpayer inquiries in a responsive and efficient manner.

Nevertheless, IRS efforts to steer taxpayer inquiries about the economic stimulus payments to the self-help tools on IRS.gov were still unable to divert a significant volume of taxpayers away from the traditional IRS toll-free telephone channel. Instead, the massive influx of calls on economic stimulus payments substantially degraded the IRS level of service (LOS) on its customer service phone lines, resulting in a LOS of around 53 percent for fiscal year 2008, compared to the 82 percent level the IRS had targeted in the absence of the ESP program.[5]

The ESP program also added to the number of individual tax returns filed during 2008, including those filed electronically. The law authorized special tax rebate checks for most individual return filers, plus millions of additional Americans with certain qualifying income from Social Security or veterans' benefits who normally have no reason to file tax returns. To receive their stimulus payments, benefit recipients in these latter groups were required to file a one-time-only return in 2008. The IRS estimates that it received more than 14 million additional individual tax returns as a result of the ESP program[6], of which only 800,000 to 900,000 were submitted electronically with the remainder filed on paper.

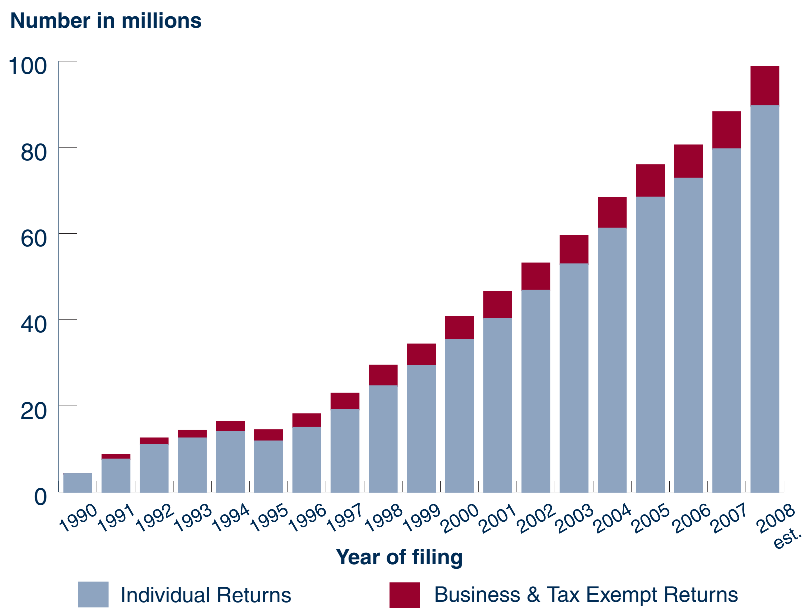
2008 e-File Results and Longer-Term Trends in Electronic Filing

Overview

The IRS fell short of the RRA 98 goal of 80 percent e-file by 2007. Instead, it achieved an e-file rate of around 57.5 percent for individual income tax returns, and a rate of nearly 48 percent for the aggregate of all major tax returns (i.e., for all major individual, business, and tax exempt returns combined). However, the Board does not see this as a failure. Real progress has been made since the passage of RRA 98 to increase e-file volumes and establish a more modern electronic tax administration environment. The 80 percent goal was a catalyst for the IRS and its private-sector partners in the tax community to come together and take deliberate and focused action to increase electronic filing. It provided an energizing effect that resulted in steady and significant progress in advancing electronic filing over the past ten years.

As shown in Figure 2, the volume of major tax returns filed electronically more than tripled since the passage of RRA 98, from 29.4 million in 1998 to nearly 99 million in 2008. This growth has been driven particularly by the electronic filing of individual tax returns, which increased from 24.6 million in 1998 to well over 89 million for 2008.

Figure 2. Number of Electronically Filed Returns: Individual and Business & Tax Exempt

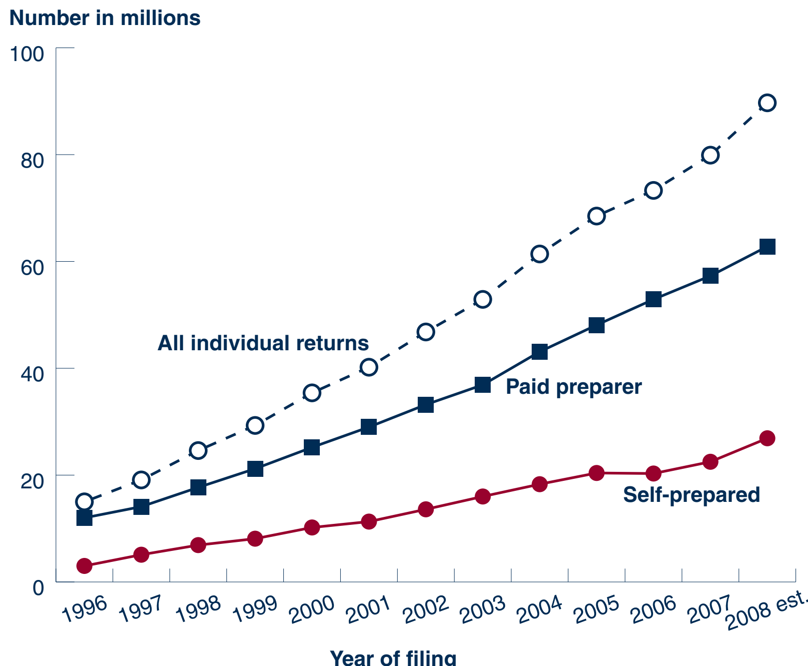


Source: IRS

Number of Individual e-File Returns

Individual returns filed electronically continued to show relatively strong growth in 2008. As indicated in Figure 3, based on actual filing results for most of the year, the IRS will receive nearly 90 million individual e-file returns during calendar year 2008. This reflects growth of around 10 million returns over 2007—more than a 12 percent increase. The estimated growth rate in 2008 compares favorably with previous years. In fact, it exceeds the increases achieved in the three prior years, i.e., the nine percent increase in 2007, the seven percent increase in 2006, and the 11.5 percent increase in 2005. The Board also estimates that the percentage growth in individual e-file in 2008 would still be in the double digits even if the added electronic returns from the ESP program were excluded.

Figure 3. Number of Individual e-File Returns by Preparation Method



Source: IRS

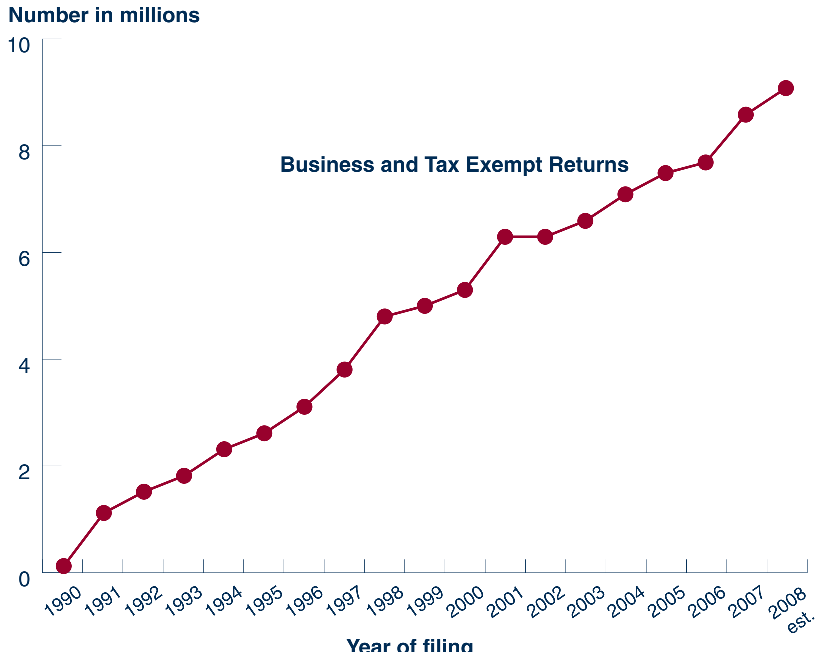
This strong increase in individual electronic filing in 2008 is reflected in both the shares submitted by those who self-prepared their own returns using software and those submitted through paid tax preparers. As further indicated on Figure 3, electronic returns submitted through paid tax preparers rose more than nine percent to approximately 63 million in 2008, an increase of around 5.5 million returns compared to the year before. Meanwhile, self-prepared returns submitted on-line grew to approximately 27 million in 2008, up over four million from 2007 (or more than 19 percent). The growth in the subset of on-line filed returns submitted via the free Internet-based e-file options offered by the Free File Alliance also grew strongly in 2008. Through mid-summer 2008, the volume of returns submitted via Free File was nearly 4.7 million—about 23 percent above the comparable point in time from the year before.

The overall trends in Figure 3 are also encouraging, indicating continued steady growth in electronic filing by both individuals who use paid preparers and those who self-prepared their taxes.

Number of Business and Tax Exempt e-File Returns

The number of major business and tax exempt returns filed electronically also grew in 2008, although at a more modest pace than for individual income tax filers. As depicted in Figure 4, the number of business and tax exempt e-file returns is estimated to reach just over nine million in 2008. This reflects growth of around 500,000 returns, or about 5.5 percent, compared to 2007. This estimated growth rate for 2008 is noticeably smaller than the increase of 11 percent achieved in 2007. However, it is roughly in keeping with the growth experienced in the other immediately preceding four years, which ranged from three percent (in 2006) to seven percent (in 2004).

Figure 4. Number of Electronically Filed Business and Tax Exempt Returns



Source: IRS

Furthermore, a unique program development masks what would otherwise be more impressive gains in 2008 relative to the growth in business and tax exempt e-file. In particular, a regulatory change took effect in 2008 that resulted in a significant number of certain trusts that previously filed Form 1041 tax returns to switch to filing Form 1099 series information documents.[7] In the past, these particular trusts were regular users of the Form 1041 business e-file application, and the regulatory change essentially lead to a drop of over 600,000 Form 1041 business e-file returns in 2008. Also, because information documents, including Form 1099s, are not included as part of the universe of major business tax returns considered for purposes of the 80 percent e-file goal, the net effect of this regulatory change is to slow the growth in electronically-filed business returns than would otherwise have been recorded in 2008.

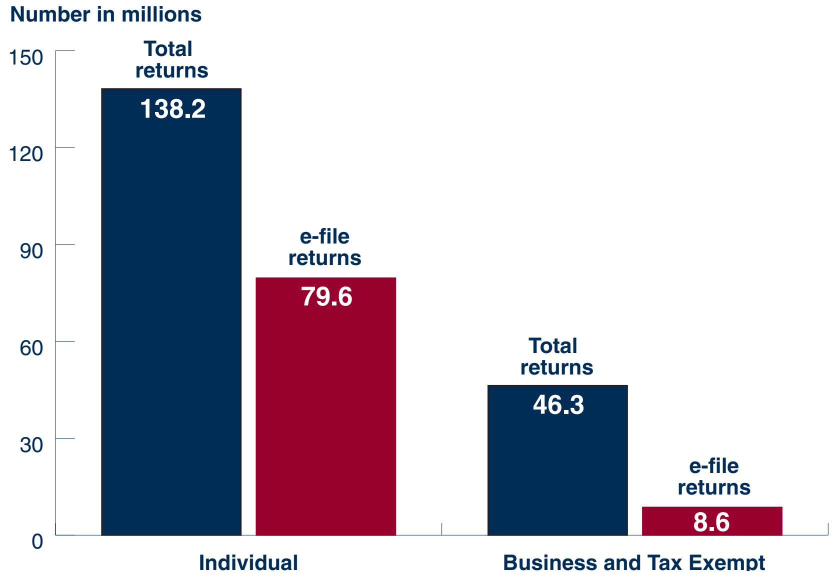
Nevertheless, the net volume of business and tax exempt e-file returns grew in 2008. This is due in large part to tremendous growth in the number of corporation income tax returns filed electronically, and the implementation of the new Form 990-N "e-postcard" application for small tax exempt organizations. Relative to corporate filers, the IRS now has MeF platforms in place for the major corporation income tax returns (including Forms 1120, 1120S, and 1120F), and these capabilities enabled the estimated number of corporation e-file returns to grow by more than 400,000 in 2008. This reflects a greater than 50 percent increase in corporation e-file in 2008 over 2007. Also encouraging is the estimated 166,000 Form 990-N e-file returns received in 2008—the first year for this new return filing requirement and its associated MeF platform.

Relative Shares of Individual Returns versus Business and Tax Exempt Returns

The IRS recommitment to the electronic filing goal is now centered on achieving an 80 percent e-file rate by filing year 2012 for the combined total of all major individual, business, and tax exempt returns.[8] Individual income tax returns (Form 1040 series) comprise nearly three-quarters of this combined total. For example, based on filings in fiscal year 2007, individual tax returns accounted for 138.2 million of the nearly 184.5 million major tax returns in total. The remaining share reflected 45.4 million business tax returns (e.g., Forms 941 and 1120) and just under one million tax exempt and government entity returns (e.g., Form 990).

As illustrated in Figure 5, a larger share of individual returns is e-filed compared to business and tax exempt returns. Based on data for 2007, about 79.6 million out of 138.2 million individual returns in 2007 were filed electronically—an e-file rate of 57.6 percent. This compares to only 8.6 million electronically filed out of 46.3 million for business and tax exempt returns in total—an e-file rate of only 18.5 percent. Given this current state of relative e-file participation, the attainment of the 80 percent e-file goal by 2012 may hinge on the IRS exceeding the 80 percent e-file level among individual returns so as to compensate for a potentially lower e-file level among the business and tax exempt returns.

Figure 5. Individual and Business/Tax Exempt Returns: Total and Electronically Filed during 2007

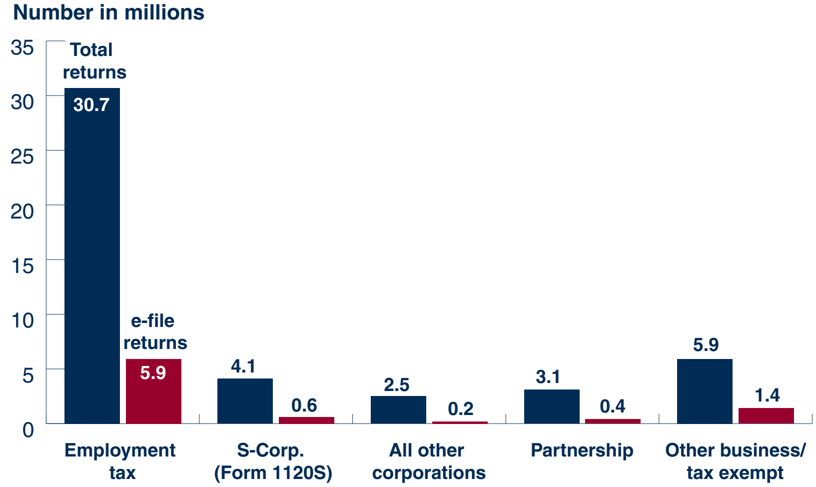


Source: IRS

A major reason current electronic filing rates are higher among individual return filers than among business and tax exempt filers is the issue of refunds. The desire to receive a tax refund more quickly creates a major incentive to e-file compared to filing a paper return. However, while about 80 percent of individual return filings entail a refund, the comparable figure for business and tax exempt returns is less than ten percent.[9] Thus, in the case of business and tax exempt returns, a powerful incentive to e-file is clearly not present.

Still, there are other unique circumstances associated with business returns that create opportunities to increase substantially their associated e-file rate. For example, as revealed in Figure 6, a sizable majority of the business and tax exempt returns are employment tax returns, i.e., approximately 30.7 million out of the roughly 46.3 million returns based on 2007 filings. In addition, as Figure 6 shows, only 5.9 million of those employment tax returns, less than 20 percent, are currently filed electronically. However, employment tax returns consist primarily of Forms 941, 944, and 940, which are relatively short and simple tax returns compared to other types of business returns such as Forms 1120 and 1065. Their relative simplicity would seem to render employment tax returns conducive to a switch to e-filing. Thus, if effective strategies can be implemented that substantially increase electronic filing among employment tax returns, they would contribute greatly to achieving the 80 percent e-file goal by 2012. The ETAAC recommendations include some suggestions to increase electronic filing in the employment tax area. The Board offers some additional thoughts on this matter in the latter section of this report.

Figure 6. Major Business and Tax Exempt Returns by Form Type: Total and Electronically Filed during 2007



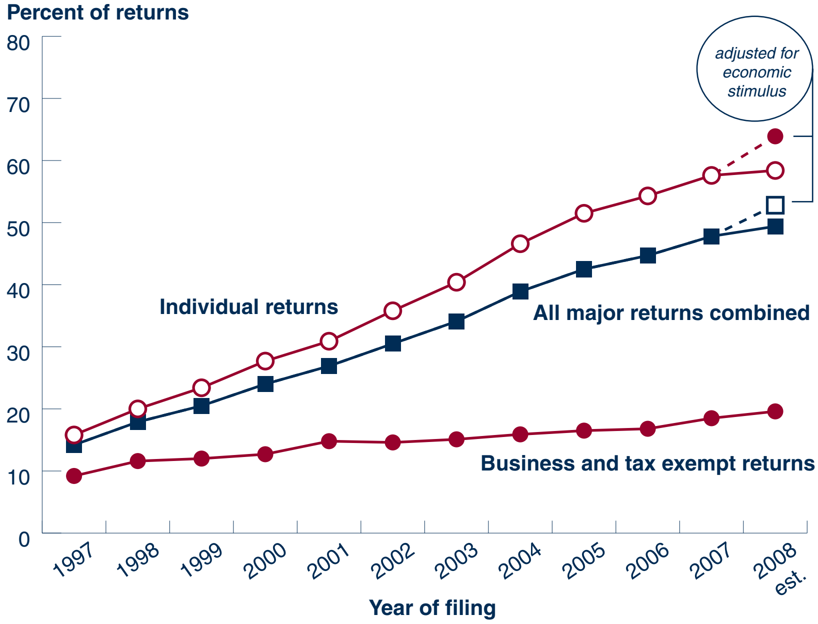
Source: IRS

Percent of Tax Returns Filed Electronically

Presented in Figure 7 are the long-term trends through 2008 in the percent of returns filed electronically for individual returns, business and tax exempt returns, and all major tax returns combined. The results for 2008 are estimated based on partial-year filing data but nevertheless point to a continued steady upward trend. As of 2008, the e-file rate for individual returns stands at more than 58 percent, compared to around 20 percent for business and tax exempt returns. For the combined total of all major tax returns, the e-file rate through 2008 stands at around 49.5 percent. Ten years ago, in 1998, these respective e-file participation rates stood at 20 percent for individual returns, 11.6 percent for business and tax exempt returns, and 17.9 percent for all major returns combined. While the Board would prefer to see even higher e-file rates, particularly in the business and tax exempt area, overall we find these results encouraging and a sign that the IRS continues to make steady progress in advancing e-file participation.

It is also important to note again unique circumstances in 2008 that served to reduce the e-file participation rates than would otherwise have been recorded. The most significant is the economic stimulus law which resulted in an influx of over 14 million additional individual tax returns in 2008, the vast majority of which were filed on paper due to their simplicity. The submission of these one-time only returns served to lower the recorded 2008 e-file rate for individual returns and the corresponding figure for all major tax returns combined.

Figure 7. Percent of Major Tax Returns Filed Electronically

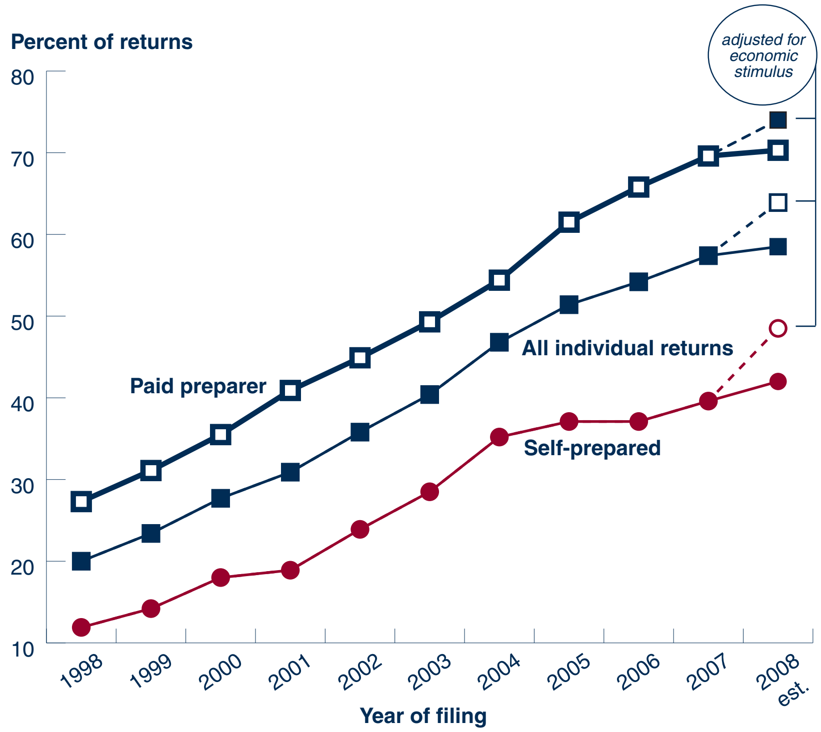


Source: IRS and IRS Oversight Board Analysis

Although data limitations prevent an accurate estimate, the Board developed an approximation of the impact of the economic stimulus. The e-file rates with the adjustments for this estimated impact of the economic stimulus (i.e., removing its effect) are also presented in Figure 7 and provide a clearer picture as to the underlying trends. These adjustments indicate that the corresponding e-file rates in 2008 would be at least several net percentage points higher had there been no economic stimulus.

The data in Figure 8 present the trends in the individual e-file. These trends are broken out by those submitted over the Internet by taxpayers who self-prepared their returns using tax software (including Free File returns) versus the e-file returns submitted through paid preparers. The Board developed estimates of the impact of the economic stimulus within the on-line and preparer e-file components. As a result, all three trend lines presented in Figure 8 include data points for 2008 with and without the impact of the economic stimulus.

Figure 8. Percent of Individual Returns Filed Electronically by Preparation Method



Source: IRS and IRS Oversight Board Analysis

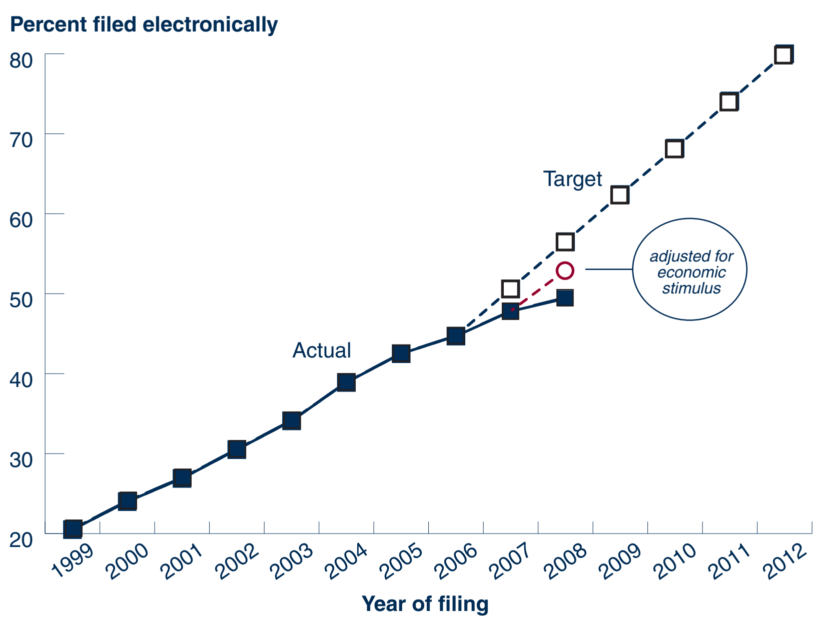
The results in Figure 8 reveal yet more encouraging patterns for the expanded use of electronic filing. In particular, the underlying trends (i.e., adjusting for the estimated impact of the economic stimulus) continue to show solid growth in e-file participation among both the tax preparer community and among taxpayers who self prepare their returns. Setting aside the temporary impact of the economic stimulus, it appears that the percentage of individual returns filed electronically among the paid preparer community today is now in the low-to-mid 70's range, up from around 27 percent a decade ago when RRA 98 become law. Similarly, adjusting for the economic stimulus, today e-file participation among those who self-prepare their returns is now approaching the 50 percent mark—compared to only 12 percent in 1998.

For 2008, e-file participation among all individual taxpayers is likely to be a few percentage points over 60 percent—if one excludes the temporary impact of the economic stimulus return filings. In 1998, the e-file rate for individual returns in total was only 20 percent. Considering all the e-file trend data, it is clear that each year a greater share of individual, business, and exempt organization taxpayers avail themselves of the benefits of electronic filing. However, a question remains as to whether the overall trend in e-file participation is on track to meet an 80 percent electronic rate by 2012—as is now embedded in the IRS strategic plan. This issue is discussed in the next section.

Tracking Progress on the 80 Percent e-File Goal

In recent editions of this annual report to Congress, the Board has offered a trend analysis that helps to monitor the IRS' progress in attaining the 80 percent e-file goal—now defined more explicitly as 80 percent of the major tax returns submitted by individuals, businesses, and tax exempt organizations. Presented below in Figure 9 is an update of that trend analysis focused on the e-file rate for all major tax returns combined. Using 2012 as the target date for reaching the 80 percent e-file level, and 2006 as the base point for measuring progress, Figure 9 presents the linear trend line for e-file participation for the years 2007 through 2012 needed to attain a steady progression toward the 80 percent goal. The base year of 2006 was selected to measure progress as it reflects the last year of actual e-file experience prior to the Board approving the long-term IRS measure.

Figure 9. e-File Rate for All Major Tax Returns Combined: Actual vs Target



Source: IRS Oversight Board Analysis

The results in Figure 9 are less encouraging than much of the data presented earlier in this report. Based on the final data likely to be recorded for 2008, which includes the impact of the economic stimulus, the actual e-file participation rate for all major returns combined is around seven percentage points below the targeted level, i.e., a target of 56.5 percent versus an estimated actual of 49.5 percent. As Figure 9 further indicates, factoring in an adjustment for the economic stimulus helps to cut that gap roughly in half, but still leaves it below the targeted level for 2008.

In addition, with or without the adjustment for the economic stimulus, the gap for 2008 appears to be growing compared to 2007 when it stood at only 2.8 percentage points. While it is certainly possible for the IRS to make up some or all of this gap in future years, Figure 9 shows that the IRS is not yet on a clear trend to meet the 80 percent e-file goal. This in turn reinforces the need for the IRS, its tax partners, and federal policymakers to take more substantive actions—including some of those recommended by the ETAAC—to make the 80 percent e-file level and the broader ETA vision a reality. In the immediate years ahead, the Board will also closely monitor two additional trends in particular: (a) the growth in on-line filed individual returns to gauge the impact of the recent decision by two major producers of tax preparation software not to charge a fee to electronically file[10]; and (b) the growth rate in electronically-filed business/tax exempt returns as organizations gain greater familiarity with the newer, more flexible MeF applications.

Challenges to Achieving the Vision for Electronic Tax Administration

Despite IRS progress on a number of its e-file and related Business Systems Modernization (BSM) efforts, the federal tax administration environment of today is still a far cry from the ETA vision in which the vast majority of tax interactions are handled electronically. Many challenges must still be overcome; some are noted below.

Remaining Paper Individual Return Filers Less Comfortable with e-File

Research indicates that converting the remaining paper individual return filers into e-filers in the future will be more difficult than in prior years. In a Board-sponsored survey of American taxpayers in 2006, nearly half of those who filed their latest tax return on paper either “somewhat agreed” or “strongly agreed” that they did not feel comfortable filing their taxes electronically. In contrast, less than 15 percent of the e-filers in that survey expressed any such discomfort.[11]

IRS Still Tied to Weekly Master File Processing

The IRS is also handicapped in achieving more fully its ETA vision because it must continue to rely upon its antiquated master file processing systems for years to come. The IRS does not expect to retire the individual master file with its Customer Account Data Engine (CADE) system sooner than 2012, as a result of funding constraints for BSM and management control capacity. Furthermore, longer range IRS budgeting efforts for CADE have yet to offer a potential schedule for replacing the business master file.[12]

Both the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO) note that long-term issues continue to challenge the CADE project. For example, TIGTA has noted that the IRS needs to update its estimate of the processing and storage requirements for CADE, including the related costs, to support its long-term objectives and goals.[13] The GAO has stated,

> *IRS has continued to make progress in implementing BSM projects and improving modernization management controls and capabilities. However, further improvements are needed. For example, the agency has yet to develop long-term plans for completing BSM and consolidating and retiring legacy systems.*[14]

The IRS' continued reliance on master file processing for the foreseeable future restricts many of its core tax accounting operations to weekly updating—denying the agency the IT infrastructure it needs to deliver the full range of service expected from a modern financial institution. For example, weekly processing precludes the more rapid issuance of refunds that could reduce the demand for costly Refund Anticipation Loans (RALs). It also prevents account management actions IRS could take to reduce taxpayer burden and increase customer satisfaction, such as providing more accurate and timely computation of account balances.

Modernized e-File Platform for Form 1040 Will Take Years to Complete

Another handicap to achieving the full ETA vision arises from the timeline for replacing the decades-old e-file system for individual Form 1040 series returns. According to the implementation schedule reported in the latest ETAAC report, the IRS plans to deliver its new Form 1040 MeF platform in phases starting in late 2009 and ending in early 2012. Compared to the current legacy e-file technology for individual returns, the Form 1040 MeF platform will provide a much more flexible system, enabling the IRS to receive and process returns in an Internet format, provide real-time processing of e-file acknowledgements, and streamline error detection. It will also give taxpayers the capability to attach PDF documents and accommodate year-round processing. Such improvements should serve as a strong inducement for even greater e-file participation among individual return filers. However, the planned three-year phase-in of Form 1040 MeF delays the day the IRS will have a modern e-file system fully in place for individual taxpayers and the tax professionals who serve them. It creates yet another barrier to the IRS achieving its broad ETA vision and its specific 80 percent e-file goal.

Need to Address Identity Theft

The potential for identity theft raises still more difficulties for the IRS in achieving its goals of a secure and smooth-flowing electronic tax administration environment. E-mail scams and other Internet-based criminal activities designed to trick taxpayers into revealing personal and financial information frequently masquerade as official IRS communications. For these reasons and others, the IRS must now regularly advise taxpayers on the dangers of identity theft and the means to avoid it; build applications and take other actions that thwart the efforts of would-be identity thieves; and implement IRS practices and procedures that responsively serve those taxpayers who are victimized. As a result, another prerequisite for the IRS achieving its ETA vision now includes an effective response to the threats posed by identity theft, so that taxpayers feel confident that their personal information is being protected.

Rising to the Challenge

The challenges the IRS and the professional tax community face in achieving the vision for electronic tax administration are real and significant. However, it is the Board's view that the IRS can meet those challenges with the proper support of its tax partners in the private sector and policymakers in the Administration and Congress. The IRS and its tax partners must continue to plan, manage, and deliver innovative electronic tax products and services that are secure and improve service to taxpayers. The Board applauds the announcement in September 2008 by two major producers of retail tax preparation software to no longer charge a fee to electronically file individual federal tax returns. This action will certainly help in the efforts to achieve an 80 percent e-file rate. Available data indicate that well over 10 million individuals currently self prepare their returns using tax preparation software but elect to file their computer-prepared returns on paper. This cost savings may lead more individuals to e-file.

The Board also notes the IRS' release of the first phase of its study to advance e-file, which provides a comprehensive compilation of existing research on individual electronic filing, and insights into the motivations and concerns of taxpayers relative to e-file.[15] This initial research is to be followed by a second phase study, which will analyze various expanded e-file options the IRS might consider, including assessments of their effect on taxpayers, third parties, and IRS operations, as well as the estimated costs associated with each. The Board is hopeful that these research efforts will lay the foundation for a long-term plan to advance e-filing.

In addition, federal policymakers must also provide the IRS the necessary resources, legal flexibilities, and oversight that will enable the agency to establish a truly modern tax administration system that serves America's taxpayers better and reduces the administrative burdens placed on them. The recommendations put forth by the ETAAC in its 2008 report to Congress contain a number of thoughtful ideas and suggestions to advance the ETA vision, including several for policymakers. The Board supports a number of these recommendations and offers its comments on key ETAAC suggestions in the following section.

Comments on Key Recommendations from the Electronic Tax Administration Advisory Committee

In their 2008 report to Congress, the ETAAC offered many thoughtful recommendations to further increase e-file participation and the advancement of the ETA vision. The Board finds merit in many of the suggestions put forth by the ETAAC, and commends them for their innovative thinking. However, the Board's views differ somewhat from those of the ETAAC with regard to certain recommendations. Those differences and other clarifications about the Board's positions are presented in the discussion below.

Regulation of Tax Return Preparers

The ETAAC recommends congressional action that would require the testing and licensing of all non-Circular 230 tax preparers, phased in over a two- to three-year period, and with the IRS setting the requirement for competency and ongoing training. Over the years, the Board has received much input on the benefits and problems of regulating all preparers of federal tax returns. This includes formal input on the topic at the Board's 2008 public meeting from representatives of the professional tax community and other knowledgeable stakeholders; Board discussions with groups of tax professionals at various IRS Nationwide Tax Forums; and Board-sponsored surveys of the American public.

Most of the views expressed to the Board support the general proposition that preparers of federal tax returns should be required to meet certain standards, and therefore, should be subject to some type of regulation. In addition, based on the Board's *2008 Taxpayer Attitude Survey*, 73 percent of adult Americans said that it was "very important" that tax preparers be required to meet standards of competency in order to enter the tax preparation business, while an additional 21 percent said it was "somewhat important."[16] It is also worth noting that a recent analysis by the GAO of the IRS National Research Program data on reporting compliance further supports the potential value of regulating return preparers. That GAO analysis found some evidence that the federal tax returns submitted by filers in the State of Oregon, which regulates all tax return preparers in their jurisdiction, and places stringent educational and testing requirements on them, reflected some increased tax return accuracy.[17]

The Board agrees that expanding regulation of return preparers to include the pool of preparers not covered by Circular 230 or other professional accreditation regime (such as those for certified public accountants and attorneys) has the potential to improve the quality of professional tax services provided to taxpayers—the majority of whom rely on paid return preparers to meet their filing requirements. Thus, the Board supports the basic principle that all preparers of federal returns should be subject to some type of regulation. However, the Board is also aware that there are approximately a half-million return preparers who currently operate under no formal professional accreditation system. This contrasts with a current pool of less than 50,000 enrolled agents for whom the IRS presently must administer qualifying examinations, grant enrollments, and monitor.[18] Thus, the Board does not believe the IRS is currently in a position to effectively administer a new program of such massive scope. It is also concerned that the imposition of federal regulation of all return preparers could disrupt the marketplace and conceivably hurt the taxpayers such a move is intended to benefit.

As a result, the Board continues to recommend that consideration by policymakers of such universal preparer regulation be done in a fully collaborative environment with input from all the major stakeholders. This collaboration must include the views and needs of taxpayers, the government, tax practitioners currently covered by Circular 230, and those currently not covered by Circular 230 who would be targeted by the new regulations. The Board also notes there are potential structures for regulating return preparers that would not rely exclusively on the IRS as the administrator. The Board also believes it is critical that the costs to both the taxpayers and the government of implementing preparer regulations be well understood and properly funded, perhaps through the imposition of user fees. The Board also agrees with the ETAAC that any such move to regulate all return preparers would need to be phased-in over multiple years so as to provide for a sensible transition for taxpayers, preparers, and administrators alike.

More Oversight of Electronic Return Originators

The ETAAC proposes six specific recommendations designed to enable the IRS to better screen and monitor Electronic Return Originators (EROs), i.e., the principal persons and responsible officials who are formally authorized by the IRS as e-file providers and who serve as the conduit for taxpayers and paid preparers to transmit returns electronically to the agency. These recommendations include that the IRS: (1) require all persons submitting the application to become an ERO to do so electronically; (2) complete criminal background checks on all individuals required to submit fingerprints as part of the application; (3) assign a single IRS operating division the responsibilities to both screen ERO applications and monitor their performance; (4) evaluate whether credit bureau data would be helpful in determining the acceptability of ERO applicants, and if so, establish a policy on its use; (5) provide more funding for IRS staff to conduct more ERO monitoring visits; and (6) assess an annual fee on EROs and tax preparers to cover the IRS costs associated with accomplishing these recommendations.

The Board likes many of these recommendations and is in agreement with the ETAAC that more can and should be done by the IRS to screen and monitor EROs. A properly screened and monitored cadre of EROs is needed to ensure taxpayers receive adequate service when they elect to e-file, and to help address the issue of tax fraud associated with some electronic filings. It is also worth noting that closer regulation of EROs is a step toward increased regulation of a larger segment of paid return preparers, in as much as most EROs are also tax return preparers themselves. As of 2007, the IRS reported around 259,000 authorized EROs.[19] Of course, the regulation of EROs is focused on keeping unscrupulous persons from participating in the e-file program and not on ensuring their competency to prepare tax returns.

The Board notes that several of the ETAAC recommendations relative to EROs place no significant additional resource demands on the IRS, and the Board suggests these be given priority consideration. However, some of the recommendations do require additional resources, such as more ERO monitoring visits. For those, the Board believes the funding should come from either additional budget appropriations or the user fees on EROs and tax preparers recommended by the ETAAC, and not by raiding resources already allocated to existing service or enforcement programs.

e-File Mandate for Form 1040 Paid Preparers

The ETAAC recommends that Congress enable the IRS to require paid preparers who submit more than 50 individual returns per year to e-file. The ETAAC has made similar recommendations in years past, and further notes that the GAO supports a federal e-file mandate for individual return preparers as well. There is no doubt that such an e-file mandate could substantially increase the volume of returns filed electronically, dependent upon the threshold set in any such requirement. For example, an analysis offered in the Board's 2006 e-file report to Congress (and based on return filings in 2005) noted that an e-file mandate threshold for preparers submitting over 250 returns per year would increase the number of electronically-filed individual returns by 20 million.[20]

The Board supports the gist of this ETAAC recommendation and agrees that Congress should lift the statutory prohibition on electronic filing mandates for individual returns, and give the IRS the discretion to implement such e-file mandates in the future as might be appropriate. However, the Board believes in doing so, such legislation should also specify that the soonest the IRS could impose any individual e-file mandate would be the year the Form 1040 MeF platform is fully in place. This would preclude the IRS from imposing a mandate that would force return preparers to use the rigid and outdated information technology currently in place for individual e-file.

The Board further believes that any legislation allowing the RS to implement an e-file mandate for individual returns should also require the IRS to first carefully study the trade-off between the expected benefits from the marginal increase in e-file versus the burden imposed on individuals and their preparers, before setting the specific mandate threshold level. The Board would not want a threshold level for an e-file mandate to be set too low for fear it would impose an unnecessary degree of burden for a minor increase in e-file volumes. In this regard, the Board is specifically concerned that the 50-return threshold for mandatory e-file recommended by the ETAAC is too low—based on the data and analysis presented in the Board's 2006 e-file report to Congress.

e-File Mandates and New Electronic Products for Businesses and Employers

The ETAAC report contains several recommendations that call for new IRS e-file services for businesses and employers, and that would place on them new or expanded requirements to engage in mandatory electronic tax transactions. Some of the recommendations address the electronic filing of tax returns. Others are directed at ancillary activities in tax administration, such as tax deposits and information documents. These include the ETAAC's recommendations that: (1) the current 250-return threshold for required electronic filing of Forms W-2 (employee wage and withholding statements) be lowered; (2) reporting agents (companies that perform payroll services for other businesses) filing employment returns be required to submit tax deposits electronically via the Electronic Federal Tax Payment System (EFTPS); (3) employers required to file Forms W-2 electronically also be mandated to e-file their Forms 941; and (4) the IRS develop and deploy free Internet-based solutions for businesses/employers to e-file their Form 941 tax returns and their Form 1099-MISC information reporting documents.

In the view of the Board, these recommendations from the ETAAC are thoughtful, could advance the achievement of the broader ETA vision, and warrant serious consideration by the IRS and policymakers, as applicable. Some of these steps could increase e-file participation substantially. Others could create the potential for new electronic products that serve taxpayers better, or reduce tax administration burden on the parties concerned.

The Board finds the recommendations relating to ideas to increase the electronic filing of Forms 941 of particular interest, given the earlier analysis in this report. That analysis showed that increased e-filing of employment returns (of which Forms 941 are the majority) would have the greatest effect in raising the current, relatively modest, e-file rate among business and tax exempt returns, and thereby enhance the chances the IRS can achieve its 80 percent e-file goal. The idea of a free on-line application for filing Forms 941 is further intriguing to the Board, given that it could be viewed as simply a replacement for the former Form 941 TeleFile program that was discontinued by the IRS in 2005. In addition, the IRS success in deploying the free Internet filing solution for the Form 990-N "e-postcard" further suggests the agency may be in a position to eventually deliver a similar e-file application for the relatively simple Form 941 return.

The Board recognizes that from a historical perspective, societal and economic considerations have long resulted in laws that place more tax administration requirements on businesses and employers than are placed on individuals. Examples include the requirement that employers withhold taxes on the wages they pay to employees and that businesses meet numerous tax information reporting requirements, to name just a few. As a result, the Board is open to sensible recommendations that might place a more robust set of e-file or other ETA requirements on businesses and employers, if such requirements are not onerous and if the benefits are expected to exceed the associated costs.

However, as noted in last year's e-file report to Congress, the Board remains concerned that such e-file related requirements for businesses and employers are being drafted in a piecemeal fashion. In particular, when the ETAAC included recommendations in its 2007 report calling for broader e-file mandates relative to corporation, partnership, and other business returns, the Board provided an illustration in its subsequent commentary on why both the existing and the ETAAC proposed changes were inadequate. In its 2007 report, the Board showed how both the existing e-file mandate Form 1065 partnership return filers and the revisions being proposed by ETAAC would still only apply to a small minority of the total Form 1065 return population, and have little effect in raising the e-file rate for partnership filers. The Board also pointed to similar limitations to the *de facto* scope of several other existing e-file mandates for major business and exempt organization tax returns, including those for Forms 1120, 2290, and 990.

As was the case last year, the Board once again agrees with the underlying assumption implied by many of the ETAAC recommendations, i.e., that significant changes and additions to existing business e-file and other related requirements are needed. However, the Board also reiterates its view that IRS and policymakers need to act in a strategic fashion in determining appropriate changes in the business and employer tax arenas. Such a broad strategic approach should certainly consider the many thoughtful recommendations put forth by the ETAAC in their current and past reports to Congress. But it must do so in a comprehensive fashion that carefully considers all the major business returns and other related filings and tax activities; gauges the totality of the scope and marginal impacts of alternative mandate requirement scenarios; and arrives at a set of legislative and regulatory changes for businesses, employers, and tax exempt organizations that best furthers the e-file goal and the broader ETA vision. Such a comprehensive tact would not only focus on the most effective path to raise electronic participation rates for business and tax exempt returns in pursuit of the 80 percent e-file goal, but would also consider such important matters as the burden the new requirements would impose, and how the increased data in electronic form would be leveraged to improve service to taxpayers and other stakeholders, and/or improve tax compliance.

Considerations for the Form 1040 Modernized e-File Project

The ETAAC makes three specific recommendations relating to the new Form 1040 MeF project under development. That new e-file system will eventually replace the current legacy electronic filing system for Form 1040 series individual returns, which has been in place for approximately two decades. The ETAAC recommends that Congress and the IRS view this project and related funding as mission critical, and take actions needed to ensure its final phased-in delivery occurs as planned in January 2012.

The ETAAC also makes recommendations that seek to ensure IRS properly resolves key technical aspects of the new e-file application prior to its initial release in August 2009, such as system integration and performance issues; and that look to guarantee that IRS engages key stakeholder groups in the many aspects needed for a smooth and successful roll-out of this major change in how individual returns will be filed electronically in the future. The Board fully supports these excellent ETAAC recommendations designed to make the Form 1040 MeF project a success. As pointed out earlier in this report, the Board views the current legacy e-file system for individual returns as a handicap in achieving the ETA vision, and the successful delivery of the Form 1040 MeF platform as absolutely critical to IRS meeting its 80 percent e-file goal and establishing a truly modern e-file system for individual taxpayers and the tax professionals who serve them.

Conclusion

In the view of the Board, electronic tax administration is the foundation for a truly modern IRS that serves taxpayers, tax professionals, and IRS employees efficiently and effectively. Having secure, comprehensive, and easy-to-use systems for the electronic filing of major tax returns in place and in use is an extremely critical component of that ETA vision. However, it is clear that major challenges remain in attaining this vision. The IRS still has more to accomplish to deploy a full array of modernized e-file applications and other electronic tools and services needed to support an ETA environment where most tax-related interactions are handled electronically. The IRS also has not yet achieved the level of e-file participation that policymakers expect.

Nevertheless, the Board believes the IRS, with the active support of its many partners in the tax administration community, has made solid progress on the road to the ETA environment envisioned under the landmark RRA 98 legislation. Today, the IRS has in place MeF platforms for most of the major business and exempt organization returns, along with solid plans to deliver the MeF application for Form 1040 individual returns over a multi-year period starting in 2009 and ending in 2012. It also has deployed many electronic products and services on IRS.gov that are of great assistance to taxpayers and tax professionals and which help to reduce the burden taxpayers face in complying with our tax laws. In addition, setting aside the temporary impact of the economic stimulus, the overall 2008 e-file rate for all major individual, business, and tax exempt returns should surpass the 50 percent mark by several percentage points once full-year filing data are recorded.

With the Board's approval, the IRS has also recommitted itself to the 80 percent e-file goal first promulgated in RRA 98. The agency is now committed to achieving an overall 80 percent e-file participation rate for all major tax returns combined by the year 2012—and the Board intends to hold the agency to that commitment. Reaching that 80 percent e-file rate will not be easy, as is indicated by the Board's analysis of current trends through 2008, which show e-file participation performing lower than certain target levels. However, the gap is not insurmountable; and with continued IRS innovations, support from policymakers, and the help and advice of key tax partners including insightful recommendations put forth by the ETAAC, the ETA vision can indeed come to fruition.

Endnotes

1. For a summary of the major electronic tax administration products and services introduced since the passage of RRA 98, see IRS Oversight Board, *Electronic Filing 2007 Annual Report to Congress*, February 2008, pp. 20-21.
2. Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 19, 2008, Publication 3415 (Revised 6-2008).
3. The United States Government Accountability Office, *Electronic Government: Federal Agencies Have Made Progress Implementing the E-Government Act of 2002*, GAO-05-12, December 2004.
4. Internal Revenue Service, *Economic Stimulus Activity Report*, September 25, 2008.
5. Based on IRS business performance review documentation from October 2008 shared with the IRS Oversight Board.
6. Internal Revenue Service, Research, Analysis and Statistics, *Calendar Year Projections of Individual Returns by Major Processing Categories*, Document 6187 (Revised 7-2008).
7. Internal Revenue Service, Research, Analysis and Statistics, *Fiscal Year Return Projections for the United States: 2008-2015*, Document 6292 (Revised 9-2008).
8. The major tax forms included for purposes of the 2012 e-file goal are those in which the filers account for income, expenses and/or tax liabilities—as was proposed by the IRS. While refinements may be needed over ensuing years if new tax forms are introduced by the IRS, the universe of applicable forms currently consists of the following: individual income tax returns (Forms 1040, 1040A, 1040EZ, 1040NR, 1040NR-EZ, 1040C, 1040PR and 1040SS); employment series returns (Forms 940, 940-EZ, 940-PR, 941, 941-PR, 941-SS, 943, 943-PR, 943-SS, 944, 945, CT-1 and 1042); corporation series returns (Forms 1120, 1120-A, 1120-S, 1120-F, 1120-POL, 1120-H, 1120-C, 1120-FSC, 1120-L, 1120-ND, 1120-PC, 1120-REIT, 1120-RIC and 1120-SF); partnership returns (Forms 1065 and 1065-B); trust, estate and gift returns (Forms 1041, 1041-QFT, 706, 706-NA, 706-GS(D), 706 GS(T), and 709); real estate mortgage investment conduits (Form 1066); exempt organization returns (Forms 990, 990-EZ, 990-N, 990-PF, 990-T, 4720 and 5227); and excise tax returns (Forms 2290, 720, 730, 11-C and 5330). Major returns excluded from this universe include amended returns, payment vouchers and requests for filing extensions.
9. Internal Revenue Service, Research, Analysis and Statistics, based on selected editions of *Calendar Year Projections of Individual Returns by Major Processing Categories*, Document 6187, and projections of business tax refunds provided through internal IRS memoranda.
10. On September 23, 2008, H&R Block and Intuit Inc. announced that their tax preparation software for individual taxpayers (i.e., Tax Cut and Turbo Tax, respectively) would now include free electronic filing of federal tax returns. Bureau of National Affairs Daily Tax Report, *Electronic Filing: H&R Block and Intuit Eliminate All Fees for Electronically Filing Federal Tax Returns*, September 24, 2008.
11. Analysis of data reported by IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report*, November 2006.
12. Based on selected IRS budgetary documentation shared with the IRS Oversight Board for fiscal years 2008, 2009, and 2010.
13. Treasury Inspector General for Tax Administration, *Customer Account Data Engine Project Management Practices Have Improved, but Continued Attention Is Needed to Ensure Future Success*, Reference Number: 2008-20-151, September 11, 2008.
14. The United States Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2009 Budget Request*, GAO-08-620T, April 16, 2008.
15. Internal Revenue Service, *Advancing E-file Study Phase 1 Report*, September 30, 2008.
16. IRS Oversight Board, *2008 Taxpayer Attitude Survey*, report pending.
17. The United States Government Accountability Office, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation*, GAO-08-781, August 2008.
18. Internal Revenue Service, *OPERA Paid Preparer Review*, internal IRS memorandum dated September 10, 2007; and other internal IRS data provided to IRS Oversight Board.
19. Treasury Inspector General for Tax Administration, *Better Screening and Monitoring of E-File Providers Is Needed to Minimize the Risk of Unscrupulous Providers Participating in the E-File Program*, Reference Number: 2007-40-176, September 19, 2007.
20. IRS Oversight Board, *Electronic Filing 2006 Annual Report to Congress*, February 2007.

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