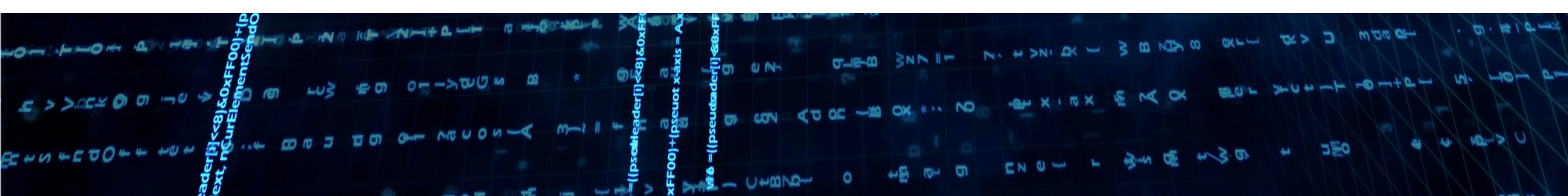
IRS Oversight Board

Electronic Filing 2013
Annual Report to Congress

FEBRUARY 2014



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Executive Summary

In keeping with the *Internal Revenue Service (IRS) Restructuring and Reform Act of 1998* (RRA98), this report provides an update on the progress being made in electronic filing (e-file) through 2013. It also highlights other major developments in electronic tax administration (ETA) during the year and enhancements planned for 2014. This report discusses key challenges and opportunities to attain a more modern ETA environment commensurate with the expectations of taxpayers and tax professionals. Electronic tax administration provides easier electronic solutions to accomplish the myriad of pre-filing, filing, and post-filing interactions required of taxpayers to meet their federal tax obligations and to make those electronic interactions the norm. Electronic tax administration is the means by which the IRS can evolve into a truly modern organization that delivers world-class service, saves taxpayers money by enabling the IRS to work more efficiently, and enhances voluntary compliance through better service and enforcement programs.

Progress continued to be made on electronic filing and other ETA capabilities during 2013. The electronic filing rate for individual income tax returns in 2013 increased over 2012 to approximately 83 percent—maintaining a level above the goal originally set as part of RRA98. The e-file rate for business and tax exempt returns also increased in 2013 over 2012 to around 42 percent—resulting in an overall e-file rate of about 73 percent in 2013 for all major individual, business, and tax exempt returns combined.

> *The electronic filing rate for individual income tax returns in 2013 increased to approximately 83%.*

A number of new or significantly improved ETA products and services were delivered in 2013. Among these were the successful handling of all individual electronically filed returns by the Form 1040 Modernized e-File (MeF) application and the retirement of the legacy individual e-file system, the removal of the IRS Business System Modernization (BSM) program from the Government Accountability Office's "High Risk" list, and the introduction of the *Where's My Amended Return* application on the IRS website, which enables taxpayers to track the status of any recently filed amended individual income tax return (Form 1040X).

Also noteworthy and commendable in 2013 was the tremendous resiliency shown by the IRS and the tax professional community in opening the 2013 filing season for most taxpayers within only four weeks after the passage of the *American Taxpayer Relief Act of 2012* on January 2, 2013. The ability to do so required a highly-effective communication and coordination strategy, along with the skill of tax experts and software developers within the IRS and industry. While there were some adverse impacts from this late-passed legislation, the achievement in delivering a relatively prompt and smooth 2013 filing season was only made possible by the strong ETA foundation established by the IRS and industry, an achievement that would have been inconceivable under the paper-based filing system of the past.

Additional improvements in ETA products and services are planned for 2014, and a few of these expected developments are highlighted in this report. Among these is the scheduled introduction of the new *Get Transcript* application in 2014 on the IRS website. The *Get Transcript* application will enable individual taxpayers to view transcripts of their IRS tax account information online, achieving a long-standing requirement of RRA98.

The Board is pleased to report that the state of electronic tax administration continues to show progress and has certainly made major strides since the passage of RRA98. However, in the Board's opinion, the current state of electronic tax administration is not where it should be, and nowhere near where it could be. This is not intended as a criticism of the IRS or private industry, which delivered much within the resources and constraints they face when it comes to electronic tax administration. However, when considering the rather limited and precarious nature of the electronic products and services the IRS can currently support within its resource constraints, versus the ideas and desired electronic services the IRS and industry wish to provide, it seems fair to conclude that America's taxpayers deserve better.

In the view of the Board, the IRS budgetary operating environment in recent years with its steep budget cuts, employee furloughs, including a 16-day government shutdown at the start of fiscal year (FY) 2014, is a disservice to American taxpayers. This environment has handicapped the delivery of more advanced electronic tax services and fraud prevention actions the IRS and industry could have pursued—and which taxpayers expect in today's technology-enabled society. In recent meetings with the Board, IRS officials have identified more than 20 current information technology (IT) projects deemed "essential," and then further informed the Board that the likely IT funding for FY2014 for these projects would be approximately $700 million less than needed.

Such a funding gap is alarming, when you consider that the likely shortfall is over 30 percent greater than the roughly $2.1 billion in total appropriations anticipated in FY2014 for IRS information technology. The essential IT projects impacted by this gap support filing season readiness, implementation of the *Affordable Care Act* and the *Foreign Account Tax Compliance Act*, identity (ID) theft prevention and victim assistance, Customer Account Data Engine (CADE) 2 development, and other vital tax administration programs. While the two-year budget agreement for FY2014 and FY2015 achieved in December 2013 by policymakers enables the IRS to plan ahead, it does not alleviate the projected shortfall for IRS IT needs in FY2014.

> *In the view of the Board, the IRS budget environment in recent years is a disservice to American taxpayers.*

The Board wishes to emphasize that cutting funding from the IRS simply punishes taxpayers in the form of less service for those needing IRS assistance and less fairness for honest taxpayers as more noncompliance, including fraud, is allowed to occur. The Board believes policymakers should provide the IRS the necessary funds to carry out the tax administration responsibilities assigned to the agency. At the same time, the IRS must practice good stewardship over the funds it receives and ensure they are used in the most efficient and effective manner possible to meet legal requirements and further voluntary compliance.

The Board also wishes to emphasize that not all needed actions to help address the major challenges facing electronic tax administration are monetary. One such action the Board believes is particularly key is the need for the IRS to articulate a clear vision of where it wants electronic tax administration to be over the next decade, the role IRS partners in the private industry play in helping achieve that ETA vision, and the measures by which IRS plans to assess progress toward that vision. Leveraging the talent and resources within the private sector is particularly important, for time and again the Board has heard from stakeholders in the tax professional community about their ideas and eagerness to assist the IRS in delivering better ETA solutions. Only in partnership with industry can the IRS hope to provide an ETA environment that is truly world class. The Board looks to the new IRS strategic plan to help frame the future vision for electronic tax administration.

Trends in Electronic Filing Through 2013

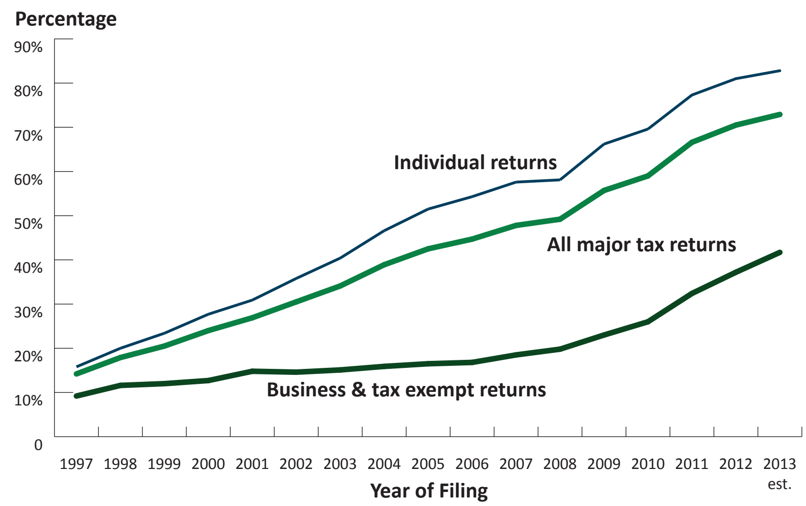
Recognizing the many benefits increased electronic filing (e-file) would provide taxpayers and tax administration, policymakers set a goal that 80 percent of individual returns be filed electronically in the *Internal Revenue Service Restructuring and Reform Act of 1998* (RRA98).[1] That law also required the IRS Oversight Board, as well as the Electronic Tax Administration Advisory Committee, to report to Congress annually on the progress being made toward that goal. The 80 percent e-file goal contained in RRA98 reflected an extremely challenging target given that, at the time, only 20 percent of individual income tax returns were filed electronically.

Looking back over the 15 years since the passage of RRA98, the focus created by that goal has proven to be an effective catalyst for coordinated efforts by the IRS, the tax professional community, and Congress. This has led to tremendous progress in electronic filing. A chronology of those efforts over the years has been highlighted in prior Board reports, particularly those for filing years 2007 and 2012.[2] Today, the IRS provides electronic filing options for all of the major individual, business, and tax exempt income tax returns and nearly all the large volume supplemental documents such as requests for filing extensions. The concerted efforts to advance e-file, along with the cooperation of taxpayers, has led to steady yearly increases in the share of returns filed electronically, including attainment of the RRA98 80 percent e-file goal for individual returns in filing year 2012.

In addition, this steady progress in electronic filing continued in 2013. As illustrated in Figures 1 and 2, e-file has brought about a dramatic change in how the major tax returns are submitted to the IRS. Based on actual filing results for most of 2013, the Board now

FIGURE 1.

Percentage of Major Tax Returns Filed Electronically



SOURCE: IRS with IRS Oversight Board 2013 estimates

The percentage of all major tax returns filed electronically stood at approximately 73% in 2013, led by an e-file rate of 83% for individual income tax returns.

[1] Public Law 105-206, 105th Congress, July 22, 1998.

[2] See IRS Oversight Board, *Electronic Filing 2007 Annual Report to Congress* (February 2008) pp. 20-21; and *Electronic Filing 2012 Annual Report to Congress* (December 2012) pp. 6-7.

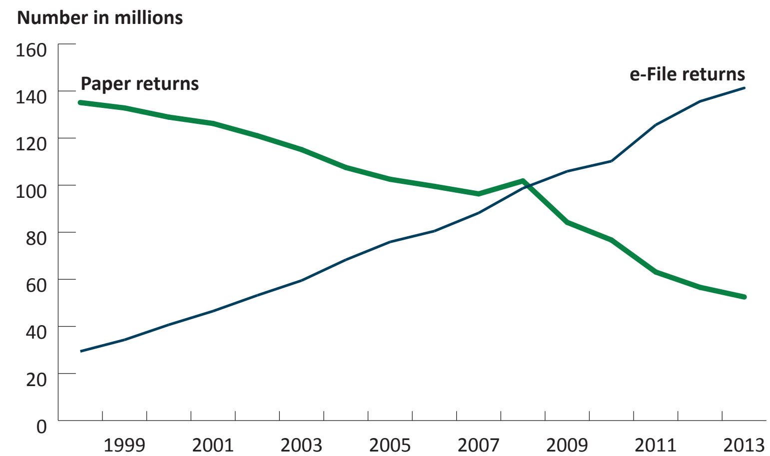
estimates that roughly 73 percent of all major tax returns were filed electronically in 2013.[3] This steady progress includes approximately 83 percent of individual returns and 42 percent of business and tax exempt returns (see Figure 1).

In absolute terms, the number of major tax returns filed electronically has grown from approximately 29 million in 1998 to 141 million in 2013 (see Figure 2). Meanwhile, the number of returns filed on paper has dropped from around 135 million returns in 1998 to 53 million in 2013.

The composition of electronically-filed returns remains predominately individual tax returns (see Figure 3). This reflects both the greater number of individual tax returns filed in total compared to the total population of business and tax exempt returns, and a higher e-file rate for individual taxpayers. Still, the share of e-file returns reflecting business and tax exempt filings continued to grow in more recent years.

FIGURE 2.

Number of Major Tax Returns: e-File versus Paper

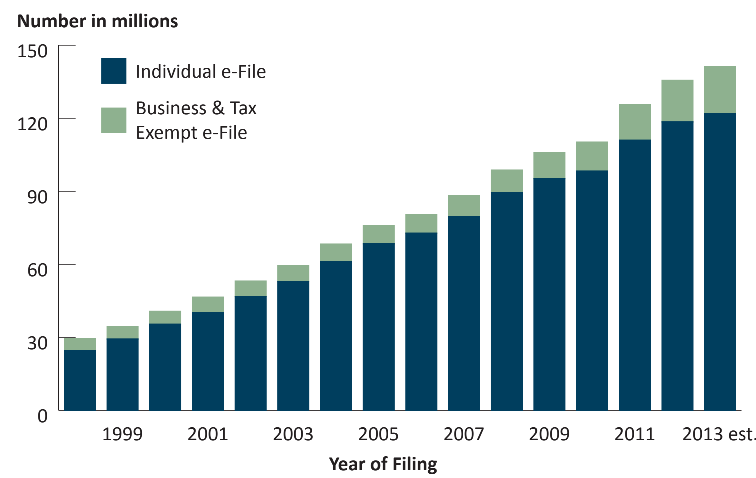


SOURCE: IRS with IRS Oversight Board 2013 estimates

Every year, fewer taxpayers file their returns on paper.

FIGURE 3.

Number of Electronically Filed Returns: Individual, Business & Tax Exempt



SOURCE: IRS with IRS Oversight Board 2013 estimates

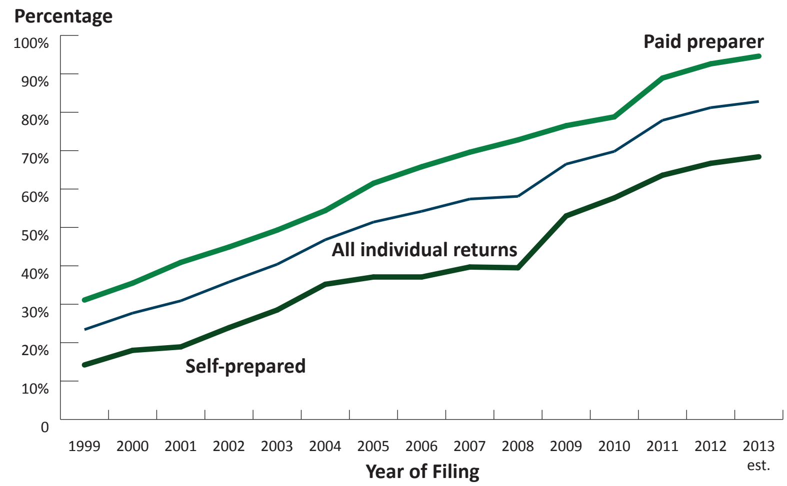
Out of 141 million total returns e-filed in 2013, about 122 million were individual income tax returns.

[3] The major tax return form types considered in this report are those in which the filers account for income, expenses, and/or tax liabilities. In general, these consist of: individual income tax returns; employment tax returns; corporation income tax returns; partnership returns; trust, estate and gift tax returns; real estate mortgage investment conduits; exempt organization returns; and excise tax returns. Returns excluded from this universe include amended returns; payment vouchers; and requests for filing extensions.

Considering the e-file rate for individual returns by return preparation method (i.e., self-prepared versus use of a paid return preparer), results through 2013 show continued improvement for both methods (see Figure 4). The Board estimates that about 68 percent of self-prepared returns were filed electronically in 2013, up almost two percentage points from the year before. Meanwhile, the long-established commitment to e-file among the tax professional community, combined with the e-file mandate for preparers of individual tax returns, has served to raise the e-file rate among individual returns with paid-preparer signatures to approximately 95 percent; also about two percentage points higher than in 2012.

FIGURE 4.

Percentage of Individual Returns Filed Electronically by Preparation Method



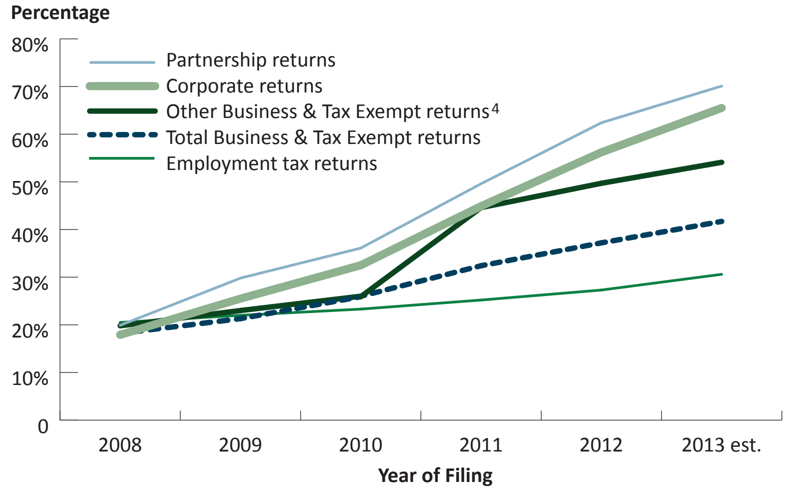
SOURCE: IRS with IRS Oversight Board 2013 estimates

Approximately 68% of self-prepared returns and 95% of returns submitted through a paid preparer are e-filed.

While the percentage of business and tax exempt returns filed electronically varies by form type, it also continued to grow through 2013 for each of the major return groupings. As shown in Figure 5, the e-file rates for three of the four major return groupings exceeded the overall average for business and tax exempt returns in total. These three include partnership tax returns with a 2013 e-file rate of about 70 percent, corporate income tax returns with an e-file rate of over 65 percent, and other business and tax exempt returns with an e-file rate of approximately 54 percent.[4] In contrast, the percentage of employment tax returns filed electronically remains below the overall business and tax exempt average, with an e-file rate of approximately 31 percent.

FIGURE 5.

Percentage of Business and Tax Exempt Returns Filed Electronically by Form Type



SOURCE: IRS with IRS Oversight Board 2013 estimates

The percentage of all business and tax exempt returns filed electronically grew in 2013 to about 42%. The e-file rates were particularly pronounced for partnership returns and corporate returns. The share of employment tax returns filed electronically remained relatively low.

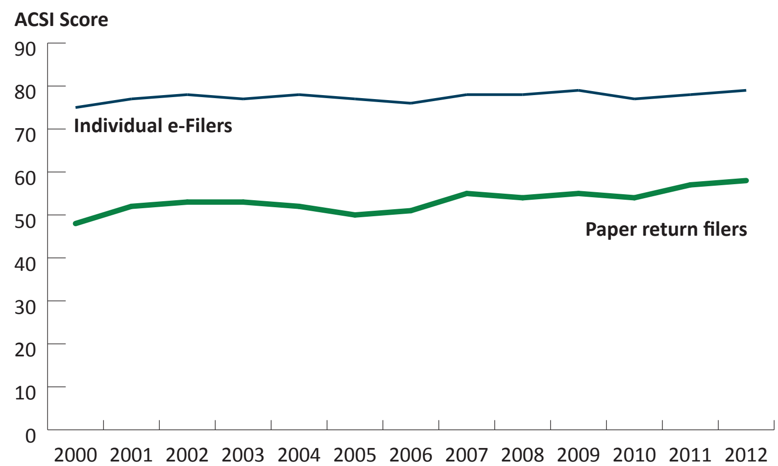
[4] Other business and tax exempt returns consists primarily of estate and trust Form 1041 returns, excise tax returns such as Form 2290, and the exempt organization Form 990 series returns. In addition, the e-file mandate for paid preparers of individual returns, now set at 11 or more returns, also applies to preparers of Form 1041 returns; and this has contributed to a noticeable increase in Form 1041 e-file in 2011 and 2012 (and the associated return segment for Other Business and Tax Exempt e-file presented in Figure 5).

The strategic importance of e-file derives in part from its benefits to taxpayers. These benefits include no need to mail paper returns, faster refunds, greater return accuracy, confirmation the tax return has been received, and secure and confidential submission of highly personal return information. Customer satisfaction data further confirm the value of e-file to taxpayers. As shown in Figure 6, individuals 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—based on the American Customer Satisfaction Index (ACSI) score for individual return filers compiled by private industry researchers.

Electronic filing also substantially reduces IRS submission processing costs, resulting in productivity savings that are typically reinvested into other IRS programs providing additional service to taxpayers. For example, IRS budget submissions indicate direct savings in excess of $69 million for the past five years as a result of the increase in e-file. The lower error rate on e-file returns reduces burden on taxpayers

FIGURE 6.

American Customer Satisfaction Index Scores: Individual e-Filers and Paper Return Filers



SOURCE: www.theacsi.org, IRS

Individuals who e-file consistently report higher satisfaction with the return filing process.

and avoids additional processing costs for the IRS. In addition, e-file lays the groundwork for further improvements in tax administration because it accurately captures the information on returns in a digital fashion.

The IRS is still a few years away from attaining the long term goal of an 80 percent e-file rate for all major tax returns, as articulated in the *IRS Strategic Plan 2009-2013*. However, if the underlying historical trend continues, and the IRS successfully implements and markets the new Modernized e-File (MeF) application for employment tax returns in 2014, the Board expects the IRS to attain its long term goal for all major tax returns in the near future.

Electronic Tax Administration: Notable Developments During 2013

The 80 percent e-file goal and other advancements in the electronic exchange of tax information called for in RRA98 not only fostered the growth in electronic filing, but also contributed to progress toward the broader electronic tax administration (ETA) vision. It seeks to provide electronic solutions to accomplish the myriad of pre-filing, filing, and post-filing interactions required of taxpayers to meet their federal tax obligations and to make those electronic interactions the norm. ETA is the means by which the IRS can evolve into a truly modern organization that delivers world-class service, saves taxpayers money by enabling the IRS to work more efficiently, and enhances voluntary compliance through better service and enforcement programs.

A vibrant ETA environment requires a steady stream of adaptations and innovations from both industry and government. In 2013, a number of new or significantly improved ETA products and services were introduced. In addition, even in the face of unique difficulties in 2013, the IRS and its partners in the tax professional community leveraged technology in important ways to address a series of unprecedented challenges. The Board wishes to highlight some of these unique ETA developments and challenges during 2013.

Form 1040 Modernized e-File (MeF) Handles All Individual Electronic Returns

In 2012, the Form 1040 MeF system handled about 60 percent of the individual income tax returns filed electronically, with the outdated legacy e-file system processing the rest. In the 2013 filing season, the Form 1040 MeF system received and processed 100 percent of the individual e-file tax returns—enabling the IRS to retire the legacy e-file system. As reported by the Government Accountability Office (GAO), the Form 1040 MeF system operated smoothly during the 2013 filing season with no noteworthy issues.[5] In addition, the Treasury Inspector General for Tax Administration (TIGTA) acknowledged in a press release that the retirement of the decades-old legacy e-file system for individual returns was a significant milestone for the IRS and its MeF program.[6] As further documented by TIGTA, the success of the Form 1040 MeF system in 2013 can be attributed in large part to the IRS' preparation for the 2013 filing season, including a significantly enhanced testing strategy and the introduction of a new Internet portal with increased bandwidth.[7]

IRS Business Systems Modernization Removed from GAO's High-Risk Series

Since 1990, the GAO has maintained a list of major government operations that it considers "high-risk" due to various reasons, including vulnerabilities to mismanagement and waste or the need for transformation to address efficiency and effectiveness challenges. In 1995, the GAO added the IRS information technology (IT) Business Systems Modernization (BSM) program to its high-risk series due to serious management and technical

[5] United States Government Accountability Office, *Internal Revenue Service: 2013 Tax Filing Season Performance to Date and Budget Data*, GAO-13-541R, April 15, 2013.

[6] Treasury Inspector General for Tax Administration Press Release, *TIGTA Report: Transition of e-Filed Tax Returns to the IRS's Modernized e-File System Was Successful during 2013 Filing Season*, December 4, 2013.

[7] Treasury Inspector General for Tax Administration, *Enhancements Made to the Modernized E-File System in Release 8 Should Improve System Performance for the 2013 Filing Season*, Report Number: 2013-20-039, April 22, 2013.

weaknesses that jeopardized the successful completion of the program, and kept it on the high-risk list in later years because of the many challenges that remained. Among these was the need to improve IRS processes for delivering modernized IT systems within cost and schedule, and to address weaknesses in information security.

In its biennial update to its high-risk series in 2013, the GAO removed the IRS BSM program from its list, noting the progress the IRS made in addressing significant weaknesses in IT and financial management capabilities. Key examples of this progress cited by the GAO included delivery of the initial phase of the Customer Account Data Engine (CADE) 2 program involving the daily processing of individual taxpayer accounts and plans for the second phase of CADE 2, which were intended to address financial material weaknesses involving unpaid tax assessments. GAO also cited important IRS progress in addressing IT-related internal information security controls and improvements in IT management capabilities.[8]

Introduction of the "Where's My Amended Return" Application

In March 2013, the IRS introduced a new application on both the IRS website (www.IRS.gov) and its toll-free telephone assistance line that enabled taxpayers to track the status of any recently filed amended individual income tax return (Form 1040X). Each year, over four million individuals file Form 1040X to correct their previously submitted tax returns. They do so based on updated or overlooked tax information the taxpayer or their preparer may have uncovered, or in response to an IRS notification informing the taxpayer of certain potential misreporting on their return. The IRS reported as of September 30, 2013, it provided over 5.8 million responses on its new *Where's My Amended Return* application.

New Online Registration System for Financial Institutions Subject to Foreign Account Tax Compliance Act (FATCA)

In August 2013, the IRS launched a redesigned and updated online registration system for financial institutions that need to register with the IRS under provisions of the FATCA. This law requires foreign banks, investment funds, and insurance companies to report on the offshore accounts held by Americans worth more than $50,000. The law also requires firms to register by April 25, 2014 to avoid certain penalties. The IRS plans to begin collecting customer account information in 2015.[9]

Retirement of Registered User Portal (RUP); Discontinuance of Disclosure Authorization (DA) e-Service

In September 2013, the IRS transitioned its outdated RUP to its Integrated Enterprise Portal (IEP). This component is the technology platform used by tax professionals and taxpayers to do business with the IRS electronically through a secure Internet environment. The IRS notes that the new IEP makes it possible to provide a more robust suite of online services to taxpayers and tax professionals in the years ahead, including better electronic authentication procedures which will enable greater taxpayer access to their tax account information over the Internet. However, in the course of this transition, the IRS made a decision not to replicate all of the e-Services applications previously on the RUP, due in part to limited available resources within the constrained budget of the IRS.

The discontinuance of two particular e-Services applications, effective with the termination of the RUP in September 2013, led to an outcry from several tax professional associations. The two applications of concern were

[8] United States Government Accountability Office, *High-Risk Series: An Update*, GAO-13-283, February 2013.
[9] Patrick Temple-West, Reuters, *IRS Debuts Online Registration for Firms Ahead of FATCA Law*, August 19, 2013.

the DA tool (which enabled the expedited transmission, processing, and acceptance of Form 2848, *Power of Attorney and Declaration of Representative*) and the Electronic Account Resolution (EAR) application, which enabled the electronic exchange of certain account resolution inquiries between authorized tax professionals and the IRS. The frustration expressed by tax professionals primarily centered on the slower manual-processing solutions that would be required in lieu of the DA and EAR applications, and the manner in which the IRS deliberated and decided these matters without gathering stakeholder input. The IRS has stated its intent to replace the DA application with a better automated system in the future and also expressed a commitment to involve outside stakeholders as it develops the replacement application.[10] The Board will monitor how well the IRS carries through on this commitment.

Late Legislation Delays 2013 Filing Season Creating Challenges and Some Adverse Impacts

The enactment of the *American Taxpayer Relief Act of 2012* on January 2, 2013 significantly reduced the time the IRS, tax preparers, and tax software developers had to implement the changes contained in the legislation. The start of the 2013 filing season for all individuals was delayed from January 22nd to January 30th. In addition, millions of individuals and sole proprietors filing certain forms and schedules were unable to file until March 4th. These delays were necessary to enable the IRS and industry software developers to update forms and instructions, complete software programming, and test processing systems in response to the applicable provisions within the late-passed tax legislation.

In the view of the Board, the IRS and industry showed tremendous resiliency in opening the 2013 filing season for most taxpayers within a mere four weeks of the passage of the law. To do so required a highly-effective communication and coordination strategy, along with the skills of tax experts and software developers within the IRS and industry. This achievement was made possible by the strong foundation of ETA established by the IRS and industry; an achievement that would have been impossible under the mostly paper-based filing system of the recent past.

Nevertheless, some adverse impacts ensued during 2013 from the late-passed tax law. Millions of taxpayers experienced a delay in the receipt of their tax refunds. In addition, there was no corresponding delay in the individual return filing due date of April 15th, which meant most tax professionals had to condense the delivery of their return preparation services to clients into fewer weeks. The Board also received feedback from industry about the severe difficulty they faced in developing and properly testing the necessary revisions to their tax software.

Sequestration and Government Shutdown Hurts Advancement of Electronic Tax Administration

The federal budget sequestration and related funding cuts reduced the IRS budget in FY2013 by approximately $600 million, or 5.2 percent, compared to FY2012. As part of the cost-cutting efforts needed to meet the sequestered level, the IRS placed its entire workforce on furlough for three days during FY2013. Aggravating this troubled budget posture for the agency, most IRS employees were furloughed again during October 2013, during a 16-day federal government shutdown at the start of FY2014.

In the view of the Board, such an unstable budgetary operating environment for the IRS is a disservice to the nation. The IRS delayed the start of the 2014 filing season as a result of the lost time during the government shutdown that would otherwise have been devoted to testing the tax processing systems for 2014.[11] In addition, the Office of Management and Budget estimated the halted IRS operations in October 2013

[10] Letter from Ivy S. McChesney, Director, Accounts Management, IRS Wage and Investment Division to Michael Nelson, National Association of Enrolled Agents, dated August 6, 2013.
[11] IRS News Release IR-2013-82, *2014 Tax Season to Start Later Following Government Closure; IRS Sees Heavy Demand as Operations Resume*, October 22, 2013.

delayed collections of enforcement revenue by about $1 billion per week.[12] Furthermore, an inadequate budget for the IRS also forces undesirable trade-offs among critically needed electronic services that would otherwise be delivered to advance the agency's mission. The inability of the IRS to fund the replacement systems for the DA and EAR applications are but examples of needed ETA products and services that were precluded due to resource constraints.

Other ETA Developments in 2013

There were a number of other major developments in electronic tax administration during 2013, including new or expanded applications on the IRS website, additional services to combat refund fraud and assist victims of tax-related identity theft, and various pilot projects designed to better inform future IRS electronic service offerings.

Other Major ETA Developments in 2013

- Improved version of *Where's My Refund* application enables taxpayers to track their refunds
- Conducted pilot projects in the areas of stolen identity refund fraud and taxpayer requests to send IRS tax transcripts to a third party
- Introduced a Spanish version of the *IRS2GO* mobile application
- Added "Tumblr" to IRS' tax information offerings on social media
- Implemented the Information Reporting Document Matching program to process new information documents on credit card payments to merchants and stock basis reporting
- Launched the Income and Family Size Verification project in support of the new health care marketplaces under the *Affordable Care Act*
- Initiated pilot projects on an online system to accept applications for tax exempt status under Internal Revenue Code Section 501(c)(3)
- Continued testing two-way video communications technology to conduct virtual IRS examinations and Appeals conferences

[12] William Hoffman, Tax Notes Today, *Shutdown Delayed $1 Billon per Week in IRS Enforcement Revenue, OMB Says*, November 8, 2013.

Electronic Tax Administration Developments Planned for 2014

Looking to 2014, the IRS plans to deliver a number of new or improved Electronic Tax Administration (ETA) initiatives designed to enhance taxpayer service and tax compliance, and advance the underlying IRS technology infrastructure. Many of these reflect yearly improvements to existing applications such as additional tax information available on the web, more IRS service offerings for mobile devices, and enhancements to filters used to identify fraudulent tax returns. A few of the major ETA developments expected in 2014 are highlighted below.

Introduction of the "Get Transcript" Application

In January 2014, the IRS launched a new self-service tool on the IRS website (IRS.gov) to enable individual taxpayers to view transcripts of their IRS tax account information online. The *Get Transcript* application is available to taxpayers worldwide. The transcripts requested by the taxpayer are provided in a PDF (Portable Document Format) file for viewing online, downloading, or printing by the taxpayer.

Various economic transactions, such as certain loan and rental applications, require individuals to provide a copy of an IRS transcript. The need for transcripts created a significant demand for customer assistance from the IRS on its toll-free telephone lines and at its walk-in offices. The IRS hopes this new *Get Transcript* self-service application proves to be an easier and more efficient option for both taxpayers and the agency.

Looking to 2014, the IRS plans to deliver a number of new or improved ETA initiatives designed to enhance taxpayer service and tax compliance, and advance the underlying IRS technology infrastructure.

Release 2 of eAuthentication

The eAuthentication program provides a common framework to prove the identity of, register, and provide credentials for any taxpayer seeking electronic access to IRS systems and applications. The *Get Transcript* application is dependent on IRS Release 2 of eAuthentication, which uses "out of wallet" information to verify the identity of the taxpayer and will include other improvements over Release 1, such as increased reporting functionality as recommended by TIGTA.[13] A successful roll-out of the *Get Transcript* application based on a properly operating Release 2 eAuthentication system will enable the IRS to achieve a longstanding requirement of RRA98: to develop a means to allow taxpayers to review their IRS tax account information securely. Release 2 will also be the basis for delivering other Internet-based IRS applications in 2014, and if successful, sets the foundation for future IRS account resolution applications.

Introduction of the Form 94x and Form 1041 Modernized e-File (MeF)

In 2014, the IRS will introduce its new MeF applications for filing employment tax returns and estate and trust income tax returns (Form 1041). Like other

[13] Treasury Inspector General for Tax Administration, *While Efforts Are Ongoing to Deploy a Secure Mechanism to Verify Taxpayer Identities, the Public Still Cannot Access Their Tax Account Information via the Internet*, Report Number 2013-20-127, September 25, 2013.

IRS MeF applications, the "94x" MeF and Form 1041 MeF systems will now enable Internet-based filing of these types of returns and provide other advances such as real-time processing of e-file acknowledgements. However, the distinct nature of the taxpayers and payroll service providers who file employment tax returns present some unique challenges for increasing electronic filing of Form 94x series returns even with the planned introduction of the MeF application in 2014—as is discussed in more detail later in the report.

Second Deployment of the Customer Account Data Engine (CADE) 2 Relational Database

In July 2012, the IRS implemented its initial version of the CADE 2 relational database (RDB)[14] in production mode. Through the execution of a complex series of computer programs, involving 28 days of processing time, the IRS successfully extracted and transformed all the data from the legacy Individual Master File (IMF) system and loaded it on to the new CADE 2 RDB. This "initialization" process involved transforming hundreds of billions of specific data fields for over 270 million taxpayer accounts. Later in calendar year 2012, the IRS further demonstrated the ability to accomplish daily processing on the CADE 2 RDB to synchronize it with the current information on the IMF, and the ability to feed information to certain IRS downstream systems.

After demonstrating these CADE 2 abilities in production mode, the IRS suspended the operation of the CADE 2 RDB at the end of calendar year 2012. The suspension was done as a risk mitigation measure, in part to deal with data quality problems in the downstream information feeds from the CADE 2 RDB. It was also done in part to help conserve IRS resources for other possible challenges in the face of the potential government-wide breach of the "fiscal cliff" (government default) at the time. During calendar year 2013, IRS efforts on the CADE 2 RDB centered on identifying the longer-term requirements of the system and on improving and testing the computer programs used to initialize and update the RDB and to ensure the quality of the data to be fed to downstream IRS systems.

In early 2014, the IRS plans to initialize a second iteration of the CADE 2 RDB into production mode and begin the daily updating routines. Later in the year, the IRS plans to begin feeding data to downstream systems. Much work still remains to be done under the CADE 2 program before the IRS can hope to retire the IMF and the many legacy software applications embedded in it. Initializing the CADE 2 RDB in 2014 and keeping it in production mode thereafter remains a critical milestone and ongoing challenge for the IRS.

Initializing the CADE 2 RDB and keeping it in production mode remains a critical milestone and ongoing challenge for the IRS.

IRS Direct Pay and Online Payment Agreement Web Options

Following an initial launch during the first quarter of FY2014, the IRS expects to deliver the second release of its new *IRS Direct Pay* online application during the 2014 filing season with a fuller array of features. This new application will offer taxpayers more easy-to-use, less costly electronic payment options to submit estimated taxes and various other tax payments. For example, dependent upon the option chosen, taxpayers can eliminate the need to secure a "PIN" code by mail in advance of making a payment, or select an electronic payment route that avoids processing fees associated with paying by credit card.

In addition, the IRS expects to release a new version of its *Online Payment Agreement* application in March 2014. This update is

[14] A relational database refers to a modern, organized way to store information electronically via a set of formally described tables reflecting rows and columns format, with links between tables which enable the data to be accessed easily.

designed to improve the usability of the application by reducing the amount of information the taxpayer must enter, cutting the amount of time needed to complete the installment agreement. The *Online Payment Agreement* application provides taxpayers with an electronic, self-service option to resolve their balance due accounts, potentially eliminating the need for taxpayers to call the IRS Accounts Management or Automated Collection System operations.

Significant ETA Enhancements Planned for 2014

- Introduce the *Get Transcript* online application
- Implement Release 2 of eAuthentication
- Launch the Form 94x (employment tax) Modernized e-File (MeF) platform and Form 1041 (estate and trust return) MeF platform
- Deploy the second iteration of the CADE 2 relational database
- Launch Release 2 of *IRS Direct Pay* online application
- Update *Online Payment Agreement* application
- Enhance the *IRS2GO* mobile application, including locations for free return preparation
- Improve electronic fraud detection and prevention methods
- Expand availability of Identity Protection Personal Identification Numbers to protect victims of identity theft and enable them to e-file future returns

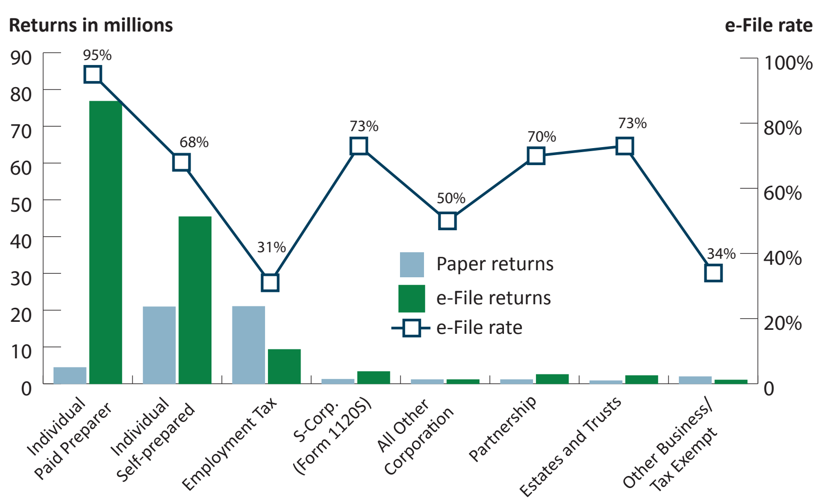
State of Electronic Tax Administration: Challenges and Opportunities

While the state of electronic tax administration has clearly made major strides since the passage of RRA98, it is not where it should be—and certainly nowhere near where it could be, in the view of the Board. This view is not intended as a criticism of either the IRS or industry, for both have developed and deployed an array of electronic products and services that make possible today's resilient tax administration system. However, when you consider the rather limited and precarious nature of the electronic products and services the IRS can currently support within its resource constraints, versus the ideas and desired electronic services the IRS and industry wish to provide, it seems fair to conclude that America's taxpayers deserve better.

There are many challenges to delivering a more expansive and accessible ETA environment. A few of the challenges the Board believes are particularly salient are discussed below, along with existing opportunities that could help mitigate these challenges to some degree.

FIGURE 7.

Number of Returns and e-File Rates by Major Type–Estimated Filing in 2013



Source: IRS Oversight Board estimates based on partial-year IRS data

69% of all employment tax returns are still filed on paper.

Need to Increase Electronic Filing of Employment Tax Returns

The percentage of returns filed electronically continues to grow each year. Nevertheless, the overall e-file rate for all major individual, business, and tax exempt returns remains below the IRS long-term goal of 80 percent. Since its electronic filing report for 2006, the Board has emphasized the need to increase electronic filing of business returns. In the ensuing years, the Board, the Electronic Tax Administration Advisory Committee (ETAAC), the Council for Electronic Revenue Communications Advancement (CERCA), and other stakeholders have emphasized that a major challenge to achieving the 80 percent e-file goal is increasing the e-file rate for employment tax returns. As Figure 7 illustrates, the e-file rate for employment tax returns remains low compared to the other major return types, and also reflects a sizable volume of the returns still filed on paper.

The introduction of the Form 94x MeF platform in 2014 is an important milestone in the efforts to increase electronic filing of employment tax returns, for it will enable the direct filing of these returns via the Internet. However, previous research on employment tax filers compiled by the ETAAC revealed that the employment tax return filing community is highly fragmented, with many who submit only a few such returns each year and see little economic incentive to e-file.[15] The Board also received feedback from stakeholders in industry indicating the need for a less burdensome electronic signature process for submitting employment tax returns via the new Form 94x MeF system.

It is incumbent on the IRS, working cooperatively with industry, to develop strategies, products, and services to address these barriers and attract more employment tax filers to e-file. For example, the 2013 e-file report from ETAAC recommends an incentive program (tied to the waiver of a certain penalty) as one possible idea to encourage greater electronic filing of employment tax returns.[16] It has also been suggested to the Board that a free electronic filing option, modeled after the current Free File program for individual returns, might be pursued by the IRS and industry to advance electronic filing of the Form 94x series returns.

Various mandates to electronically filed employment tax returns could also be considered; however, industry stakeholders have cautioned the Board that such requirements should not be pursued until an easy-to-use e-file system with a non-burdensome signature solution has been put in place. While the Board finds merit in these and other ideas, the bottom line remains the need for a collaborative long-term strategy, which carefully considers the roles the IRS, industry, and policymakers can play in the effort to boost the electronic filing of employment tax returns.

Need for a Strategic Vision for Electronic Tax Administration that Includes Measures and Partnering with Private Industry

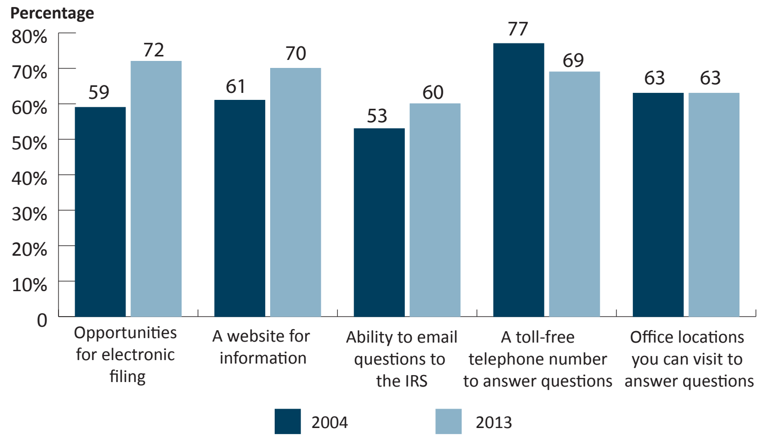
The Board believes one of the paramount achievements of RRA98 was how it articulated a desired future state for tax administration in which nearly all returns were filed electronically. Also significant was how the law encouraged a cooperative partnership between the IRS and private industry so as to achieve that vision, and how the law established a clear and concise measure by which to gauge progress in the form of the long term goal of an 80 percent individual e-file rate. Because of this forward thinking, the IRS and its partners in industry have largely achieved the vision for electronic filing articulated in RRA98. This success gives rise to a new and even bigger challenge: articulating the future strategic vision for electronic tax administration over the next decade; one that encompasses much more than just electronic filing.

The Board believes the IRS could benefit from a clear and comprehensive long term vision or corporate e-strategy for electronic tax administration, and the development of measures to assess progress toward that vision. The IRS will likely continue to face significant budget constraints in the years ahead, so a strategic vision for ETA is critical to determining priorities among competing alternative IT investments. Significantly improving the electronic services available to America's taxpayers will, in many instances, require the cooperation and innovation of private industry. However, that cooperation and innovation is only possible if IRS' partners in the tax professional community have an active tole in identifying and delivering ETA priorities. In addition, having meaningful long-term measures with clear goals provides accountability and an

[15] The Electronic Tax Administration Advisory Committee, *Electronic Tax Administration Advisory Committee Annual Report to Congress*, IRS Publication 3415, June 2011.
[16] The Electronic Tax Administration Advisory Committee, *Electronic Tax Administration Advisory Committee Annual Report to Congress*, IRS Publication 3415, June 2013.

FIGURE 8.

Percentage of Public Who Say It Is Very Important IRS Provide Certain Service Channels

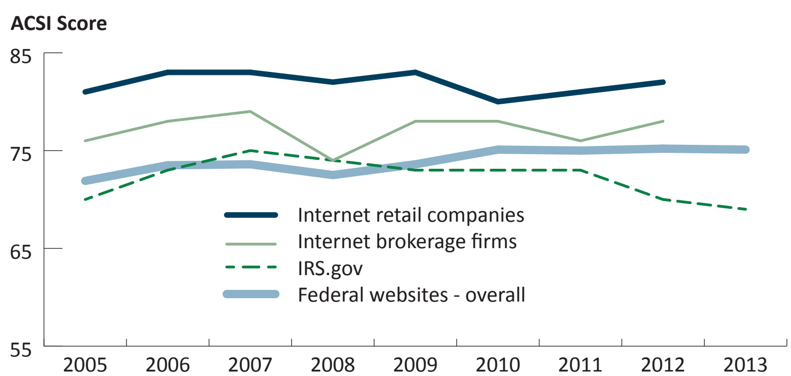


Source: *IRS Oversight Board Taxpayer Attitude Surveys*

The importance of IRS electronic, self-service channels has grown over the past decade.

FIGURE 9.

Selected e-Government and e-Commerce American Customer Satisfaction Index Scores



Source: www.acsi.org

Customer satisfaction for IRS.gov is declining and lags behind the average for federal websites and certain private sector websites.

ability to assess progress toward the new ETA vision.

The capabilities of technology change rapidly and the Board's annual surveys of the general public capture the progression in favor of more technology-based, self-service tax tools. As illustrated in Figure 8, the percentage of the general public who think it is very important that the IRS provides service through electronic channels, including e-file, the IRS website, and email, has grown noticeably over the past decade. In contrast, the percentage citing as "very important" the more traditional "live" assistance channels based on telephones and IRS walk-in offices has declined or remained unchanged since 2004. In fact, the share of the public in 2013 who think it is very important that the IRS provide e-file opportunities (72 percent) and a website for tax information (70 percent) is now higher than for live service via the telephone (69 percent) or walk-in assistance (63 percent).

As noted in a 2013 GAO report, the service options available on the IRS website today are limited and mainly static in nature—reflecting mostly information search and retrieval applications, or one-way digital transmissions to the IRS.[17] However, based on personal experiences with online banking, shopping, and other Internet-based commercial transactions, today's taxpayers and tax professionals expect a much broader array of digital tax

[17] United States Government Accountability Office, *IRS Website: Long-Term Strategy Needed to Improve Interactive Services*, GAO-13-435, April 2013.

services, including the capability for secure two-way interactive communications with the IRS. The Board believes that the inability of the IRS to meet these expectations is a key reason that taxpayer satisfaction with the IRS website continues to fall behind corresponding levels for federal government websites overall and for major business sectors actively engaged in e-commerce. This conclusion is based on the American Customer Satisfaction Index (ASCI) scores (see Figure 9).

To meet the challenge of articulating a vision for the future of electronic tax administration with meaningful long term measures and goals requires a thoughtful reckoning of the needs and desires of taxpayers and the professionals in the tax community. Input from both is critical to identifying alternative ETA services and determining the priorities for the associated IT investments of IRS staff and budget. The IRS should also consider the contributions private industry can make in delivering those services and achieving that vision. Time and again, the Board has heard from stakeholders in the tax professional community, such as members of the Council for Electronic Revenue Communication Advancement (CERCA), about their ideas and eagerness to assist the IRS in delivering ETA solutions. This includes ideas for secure digital two-way communications, fraud prevention, and better customer service. Only in partnership with industry can the IRS hope to provide an ETA environment that is truly world class. The Board looks to the new IRS strategic plan to help frame that future vision for ETA.

Need to Prevent Large Scale Tax-Related Identity Fraud and to Assist Victims

Statistics on refund fraud arising from identity (ID) theft and its resulting victims indicate a very large and growing problem. Because most individual income tax returns are filed electronically, the problem of ID theft constitutes a major challenge for electronic tax administration. In terms of victims of ID theft, IRS data reported by TIGTA indicate that 1.2 million taxpayers were affected in calendar year 2012, and an additional 1.6 million during the first six months of 2013.[18]

In terms of the extent of refund tax fraud, available data from the IRS for the first three-quarters of calendar year 2013 indicate IRS fraud prevention filters stopped nearly 6.5 million suspicious returns, compared to about 5.1 million during the same period in 2012. The IRS further reports that the confirmed revenue protected (i.e., the amount of stolen identity fraudulent refund claims uncovered and not issued) for the first three-quarters of 2013 was in excess of $14.3 billion—with an estimate of billions of dollars more protected on e-file returns rejected by the IRS at the time of initial e-file transmissions. The Board also notes that some refund fraud goes undetected by the IRS, and while hard to estimate, TIGTA indicated it could be in excess of another $2 billion per year.[19]

The data on ID theft and tax fraud, which reveal millions of victims and tens of billions of dollars in attempted fraud, are sobering. While electronic filing and electronic refund payment programs enable this fraud to be attempted on a large scale, ETA also provides the means by which to thwart it. For example, the methods IRS uses today to spot fraudulent returns and stop the issuance of refunds are based heavily on technology applications such as the Electronic Fraud Detection System (EFDS) and the Identity Protection Personal Identification Number (IP PIN) application. Meanwhile, the IRS continues its work on the Return Review Program (RRP), which will replace EFDS in the future and which is expected to provide much keener analytical capabilities to detect fraud and the ability to implement refined fraud filters much more quickly, based on those analytics.

In addition, private industry has worked closely with the IRS and identified various additional electronic steps that could be jointly taken to further reduce the electronic tax systems vulnerability

[18] Treasury Inspector General for Tax Administration, *Case Processing Delays and Tax Account Errors Increased Hardships for Victims of Identity Theft*, Report Number 2013-40-129, September 26, 2013.
[19] Treasury Inspector General for Tax Administration, *Stolen and Falsely Obtained Employer Identification Numbers Are Used to Report False Income and Withholding*, Report Number 2013-40-120, September 23, 2013.

to fraud, such as leveraging information about the "device ID" of the computers used to submit e-file returns, and a real time tax system where documents are matched before refunds are issued. The budget bill passed by Congress at the end of 2013 also contains a provision that will limit public access to death records released by the Social Security Administration, which should further help in the fight against stolen identity refund fraud. In terms of better service to victims of ID theft, the IRS is launching an additional program based on IP PINs in 2014. That program will enable a certain group of taxpayers who are victims of ID theft to use an online tool to authenticate themselves as the valid filer and enable them to e-file future returns and receive any refund due in a prompt fashion.

Need to See CADE 2 through to Full Fruition

While the IRS demonstrated a production version of its relational database under the CADE 2 program, there is still much work to be done in the years ahead before the IRS can end its dependency on the antiquated master file systems and associated computer code. This work includes bringing the CADE 2 relational database into full production mode so that it feeds all applicable downstream IRS processing systems. This will allow the replacement of the IMF-based service and compliance processing applications written in outdated computer languages with new applications built on modern programming languages that leverage the CADE 2 relational database. This will also allow the retirement of the IMF, enabling the IRS to turn its attention to replacing the Business Master File (BMF)—drawing from the lessons learned from the IMF CADE 2 program.

It is hard to overstate the magnitude of the resources and effort still required to accomplish the remaining work needed on CADE 2. Until the old master file systems are replaced, they will continue to handicap the IRS in terms of financial reporting and the delivery of a broader and more adaptable array of ETA service and compliance capabilities. Also very problematic is the risk of the IRS continuing to rely on its 1960s-era IMF and BMF systems as the core, underlying foundation for America's tax processing system.

The risk of the IRS continuing to rely on its 1960s-era technology as the core, underlying foundation for America's tax processing system is problematic.

The IRS has made progress in building the foundation for the CADE 2 relational database. In reality, the IRS is not where it aimed to be with the program at this point in time. Additionally, significant challenges remain, particularly in terms of the internal competition for IT budget and staff resources from other priority IRS system needs. To help mitigate some of the risk in these challenges, the IRS recently recruited and began training a cadre of employees to program in the old Assembler Language Code (ALC) so as to enable ongoing support for the legacy master file systems. IRS officials conveyed to the Board that the need to do so is a bit of a setback for their preferred strategic direction.

Need to Balance the Available Pool of Highly Skilled IT Staff Among Competing Programs

Budget constraints limiting hiring, along with the many pressing technology program demands within the IRS, are creating significant challenges for the IRS in the form of competition for the limited pool of highly skilled IT personnel. This "people risk" is particularly acute as experienced staff who understand the intricacies of IRS legacy systems such as the IMF and ALC programming continue to retire from both the IRS and industry, and the remaining pool of these unique experts consequently shrinks. As a result of this challenge, the IRS must find a workable balance for its IT staff because the same experts needed to help undertake or guide the work in maintaining the legacy systems are often the same experts needed to identify the requirements and guide the work for the new systems.

Need for Adequate Budget Funding for IRS Information Technology Investments

While it is clear that some of the challenges facing electronic tax administration are not monetary, it is equally clear that inadequate funding of the IRS budget for technology is a major problem. At a December 2013 meeting with Board members, IRS officials listed more than 20 current IT projects they deemed "essential." Among these projects in critical need of IT support include filing season readiness, implementation of additional provisions of the ACA and FATCA, ID theft prevention and victim assistance, CADE 2 development, eAuthentication and other IRS website services, IRS financial reporting, technology refresh, and the system for receiving information returns electronically.

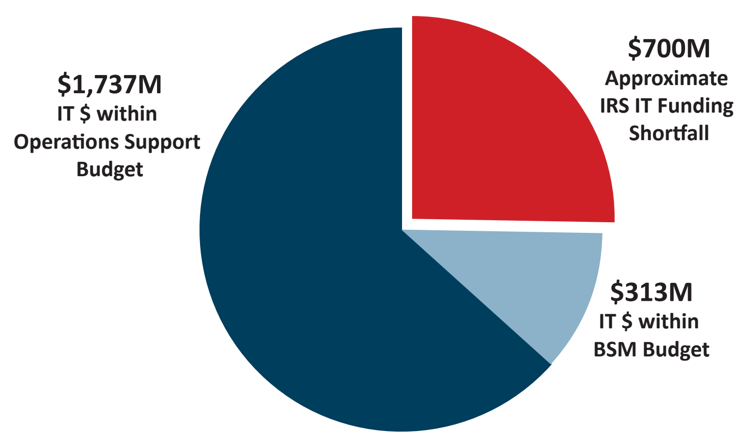
At the same meeting, the IRS further conveyed that its likely IT funding for FY2014 would be roughly $700 million less than the projected needs for those 20-plus essential projects. This is an alarming gap when you consider that this likely shortfall is about 33 percent greater than the roughly $2.1 billion in total appropriations in FY2014 expected for IRS information technology (see Figure 10).[20] Also, while the two-year budget agreement for FY2014 and FY2015 announced by Congressional leaders at the time this report was being prepared was viewed by the Board as a positive development in terms of enabling the IRS to plan, it does not alleviate the projected shortfall for IRS IT needs.

It is important to recognize that well over 80 percent of IRS funding for information technology staff, software and equipment, is encompassed within the IRS budget account for "Operations Support." While the IRS also has an IT budget account for Business Systems Modernization (BSM), this account covers only a few specific IT programs such as CADE 2 and MeF, and is far smaller than the IT funding within Operations Support. After rising roughly $480 million from FY2006 to FY2010, the total amount appropriated for IRS IT peaked at around $2.14 billion in 2010. Since then, and despite an increase in responsibilities from new tax laws and other program demands, the appropriations for IRS IT actually declined by roughly $90 million through the end of FY2013—with most of this decline embedded in the IT funding within the budget for Operations Support.

The Board wishes to emphasize that cutting funding from the IRS simply punishes taxpayers in the form of less service for those needing IRS assistance and less fairness for honest taxpayers as more noncompliance, including fraud, is allowed to occur. The adverse impacts of failing to adequately fund the IRS IT

FIGURE 10.

IRS Appropriations for Information Technology and Approximate Funding Shortfall in FY2014



Source: IRS Congressional Budget Submissions; IRS CFO and Board analysis

The IRS has a significant shortfall in IT funding.

[20] The $2.1 billion figure reflects the combination of the likely amounts appropriated for Business Systems Modernization plus the funding for IT within the IRS budget account for Operations Support.

needs manifest themselves in many ways, seen and unseen. For example, more effective means of preventing stolen identity refund fraud go unpursued, more robust and customer-focused web applications get postponed, more effective compliance programs get delayed, innovations identified by the IRS and private industry get stifled, and the morale and engagement levels of employees decline. Insufficient funding also forces IT projects to be stretched out over much longer periods of time before new systems can be delivered in full and legacy systems retired—incurring an added expense as IRS resources are expended to support both the old and new systems.

The Board believes policymakers should provide the IRS the necessary funds to carry out the tax administration responsibilities assigned to the agency. At the same time, the Board expects the IRS to practice good stewardship over the funds it receives. IRS leaders must ensure funds provided to the IRS are used in the most efficient and effective manner possible to meet legal requirements and to further voluntary compliance. This includes the funding for IT that undergirds the electronic tax administration system.

Major Challenges in ETA

- Increasing electronic filing of employment tax returns
- Developing and articulating a strategic vision for electronic tax administration that includes measures and partnering with private industry
- Preventing tax-related identity fraud and assisting its victims
- Seeing the Customer Account Data Engine 2 program through to full fruition
- Balancing the available pool of highly skilled IRS information technology staff among competing programs
- Making e-filing and electronic interactions with the IRS easier and secure for taxpayers
- Funding IRS information technology investments adequately

Conclusion

The Board views electronic tax administration as the foundation for a truly modern IRS that serves taxpayers, tax professionals, and IRS employees efficiently and effectively. Electronic tax administration is the means by which the IRS can deliver world-class service, save taxpayers money by enabling IRS to work more efficiently, and enhance voluntary compliance through better service and enforcement programs.

The IRS continued to show steady progress in electronic filing in 2013. The electronic filing rate for individual income tax returns increased over 2012 to approximately 83 percent—maintaining a level above the goal originally set as part of RRA98. The e-file rate for business and tax exempt returns also increased in 2013 over 2012 to around 42 percent—resulting in an overall e-file rate of about 73 percent in 2013 for all major individual, business, and tax exempt returns combined.

The IRS continued to show steady progress in electronic filing in 2013. However, it also experienced some setbacks and faces many other significant challenges to advancing ETA capabilities in the years ahead.

The goal of electronic tax administration is not just to receive more information electronically, but ultimately to improve service to taxpayers and tax professionals and to enhance tax compliance. The IRS made improvements to its ETA service offerings and other infrastructure components in 2013, and plans to deliver further enhancements in 2014. However, the IRS also experienced some set-backs in 2013 and faces many other significant challenges to advancing ETA capabilities in the years ahead. The challenges highlighted in this report are daunting. In light of current budget constraints, the Board believes the IRS will benefit from developing a clear long term vision for electronic tax administration, and engaging its partners in achieving that vision.

Acknowledgements

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Council for Electronic Revenue Communication Advancement
Electronic Tax Administration Advisory Committee
IRS Wage and Investment Division
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Paul Cherecwich, Jr. is presently retired, having had a successful career as a tax attorney employed both in the business world and practitioner world. Employed by three Fortune 500 corporations, he retired in 2000 from Cordant Technologies, Inc. as Vice President of Tax and Tax Counsel. He subsequently joined the law firm of Miller & Chevalier, Chartered as "Of Counsel", from where he retired at the end of 2004. During his career he participated in several professional groups. As a result of his contributions, he was asked to serve leadership roles on several trade association tax committees. In addition, he was selected by his peers to be the 1997-1998 International President of The Tax Executives Institute (TEI), the preeminent association of corporate tax executives in North America. Mr. Cherecwich has served on the boards of several charitable organizations. He has also served on several government advisory groups, including the Massachusetts Governor's Management Task Force, the United States Trade Representative's Industry Advisory Committee on Customs, and the IRS Advisory Council, where he was selected to be the 2002 Chair. Mr. Cherecwich earned a B.E.E. from Rensselaer Polytechnic Institute, an M.B.A. from Northeastern University, a J.D. (*cum laude*) from Suffolk University Law School, and an LL.M. (taxation) from Boston University School of Law. He chairs the Oversight Board's Operations Support, Executive, and Risk Management Committees.

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