IRS Oversight Board

Electronic Filing 2010 Annual Report to Congress

January 2011

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Executive Summary

Electronic tax administration (ETA) is the foundation for a modernized Internal Revenue Service (IRS) that provides secure, convenient, timely, and accurate services to taxpayers, and to the tax professionals and IRS employees who serve them. The electronic filing of tax returns, known as e-file, is part of the broader range of tax-related technology applications embedded in the concept of ETA, in which the vast majority of taxpayer interactions with the tax administration system are handled electronically. This ETA vision is also in keeping with the E-Government Act of 2002 and is embedded in key IRS long-term planning endeavors, including the *IRS Strategic Plan 2009-2013.*

Having secure and easy-to-use systems for the electronic filing of major tax returns is a critical component of the ETA vision. The IRS Restructuring and Reform Act of 1998 (RRA 98) established a goal that 80 percent of returns be filed electronically by the year 2007. It also required that the IRS Oversight Board submit an annual report to Congress addressing the progress the IRS is making in meeting that goal, and placed a similar reporting responsibility on the Electronic Tax Administration Advisory Committee (ETAAC).

When RRA 98 was enacted, only 20 percent of individual income tax returns were filed electronically. By 2007, that number had grown to nearly 58 percent; and it is now at approximately 70 percent. Although the IRS did not meet the challenging goal of an 80 percent e-file rate by 2007 called for in RRA 98, the IRS, its partners in the tax administration community, and taxpayers have made steady progress toward that goal and the broader ETA vision. In the view of the Board, this progress has been significant and is due in no small measure to the 80 percent e-file goal set in RRA 98.

The IRS recommitted itself in early 2007 to the 80 percent e-file goal. That reframed goal was expanded in scope and now calls for an overall 80 percent e-file participation rate for all major individual, business and exempt organization tax returns by filing year 2012. Explicitly including major business and exempt organization tax returns within the context of the 80 percent e-file goal increases the challenge of the effort because the corresponding e-file rates for these returns are substantially lower than for individual income tax returns.

However, reaching a combined 80 percent e-file participation rate by 2012 for all major tax returns now seems unlikely. The filing experience for most of 2010 indicates that the overall e-file rate for major tax returns now stands at approximately 59 percent, which leaves the IRS over 20 percentage points below the target goal with only two more years remaining. In addition, the Board's analysis of the underlying historical trend in e-file growth, plus estimates of the impact of the new federal e-file mandate for return preparers, indicate that while the mandate may push the e-file rate for individual income tax returns over 80 percent by 2012, the corresponding rate for all major tax returns combined will likely be no higher than the low 70 percent range.

Nevertheless, even if attaining the 80 percent e-file rate for all major tax returns by 2012 proves to be impossible, the Board is confident that tax administration will eventually cross that important threshold. Between 1998 and 2010, the total number of major individual, business, and exempt organization tax returns filed electronically grew from less than 30 million to approximately 110 million. Meanwhile, the corresponding number of major tax returns filed on paper has dropped from around 135 million to just under 77 million. It is apparent that federal tax returns filed on paper are steadily becoming a thing of the past. The Board encourages the IRS, its partners in the tax administration community, and policymakers to remain committed to attaining the 80 percent e-file target, and open to further actions that might help achieve that goal and the broader vision of a modern electronic tax administration system.

It is important to note that progress in electronic tax administration is multidimensional and goes beyond just the growth in e-file. It includes the deployment of many helpful self-assistance tools on the IRS website, as well as progress in moving the IRS closer to a daily tax account processing capability for all individual filers through a revamped Customer Account Data Engine (CADE) effort. It also includes the deployment of the Modernized e-File (MeF) platforms for most of the major business and exempt organization returns, and the roll-out of the first phase of the Form 1040 MeF application. The CADE and MeF projects are major parts of the IRS' Business Systems Modernization (BSM) program and reflect the technological infrastructure for a modern ETA environment. All these advancements in electronic tax administration provide valuable assistance to taxpayers and tax professionals today, and lay the foundation for even greater improvements in customer service, burden reduction, and voluntary compliance in the future.

Of course, this progress is not solely attributable to the IRS. It could not have been achieved without the active cooperation and initiative of the tax administration community, which includes return preparers, tax software developers, and many other tax-related service providers in the private sector. This successful and commendable partnership between the IRS and private industry to advance electronic tax administration is in keeping with the spirit of RRA 98, which explicitly encouraged such cooperation. Also tremendously important to the advancement of e-file and the ETA vision has been the continued support and interest of policymakers.

The IRS still has a way to go in achieving the full ETA vision and serious challenges remain. These challenges include funding, managing, and successfully delivering the remaining components of the IRS' BSM program. Successful resolution of security and other related matters is also needed to build a more expansive and robust set of ETA applications on the Internet. While progress is being made in these areas, the pace must accelerate so as to move the IRS technology infrastructure more fully into the modern age.

However, the Board believes that the progress being made will eventually deliver the ETA vision inspired by RRA 98, including an 80 percent e-file rate, providing the IRS, its tax partners in the private sector, and policymakers in Congress and the Administration remain actively committed to that vision and open to new ideas.

The Board highlights in this report several key considerations to help advance e-file and the larger ETA vision. For example, the Board emphasizes the importance of the IRS and industry focusing attention on the large volume of employment tax returns filed on paper, particularly the quarterly Form 941 returns. In terms of the pursuit of the broader ETA vision, the Board recommends greater attention and strategic thought as to how all the data on tax returns might be captured electronically and put to use in new and innovative ways to improve service to taxpayers and overall voluntary compliance. The Board also comments on some of the thoughtful recommendations recently put forth by the ETAAC, which also seek to increase e-file participation and further the broader ETA objectives.

Introduction

Scope of Report

Under the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998[1] (RRA 98), the IRS Oversight Board is required to submit this annual report to Congress on the IRS' progress in meeting the goal that calls for 80 percent of returns to be filed electronically. The 80 percent electric filing (e-file) goal was originally set as part of RRA 98, which challenged the IRS to achieve that target level by the year 2007.

At the time RRA 98 was enacted, only 20 percent of individual income tax returns were filed electronically. By filing year 2007, that number had grown to about 57.5 percent and, as of 2010, now stands at approximately 70 percent. As the Board has noted in prior reports to Congress, although the IRS did not achieve the challenging 80 percent electronic filing goal called for in RRA 98, the IRS, its private sector partners in the tax administration community, and taxpayers have nevertheless made significant progress in advancing electronic tax administration since the passage of that landmark legislation. The Board further believes that the progress achieved is a direct result of the 80 percent goal articulated by RRA 98 and the continued attention policymakers devote to assessing how well the IRS is advancing toward that plainly stated target.

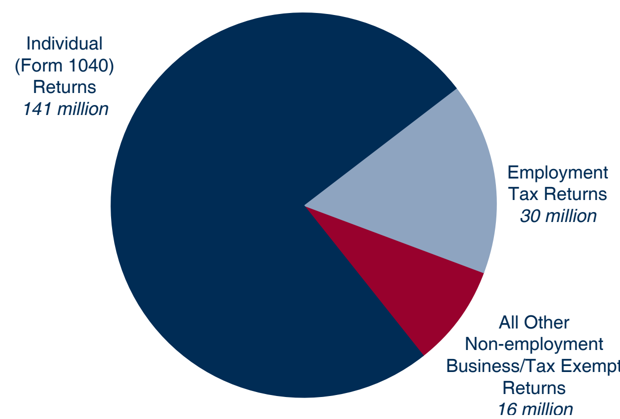
The noteworthy progress in ETA since the passage of RRA 98 is multidimensional. It includes substantially increasing e-file participation from a small minority of filers to a clear majority, as well as providing many highly useful self-assistance applications on the IRS website, IRS.gov. It also includes building key parts of the technological infrastructure for a more modern ETA environment, such as the various Modernized e-File (MeF) applications that allow the electronic filing of most of the business, tax exempt and individual tax returns through the Internet.

In early 2007, the Board approved a new long term goal that recommitted the agency to the 80 percent e-file target. The new goal calls for a combined e-file rate of 80 percent for all major tax returns filed by individuals, businesses, and tax exempt organizations by the year 2012. As shown in Figure 1, approximately 141 million individual income tax

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

returns are estimated to be filed in total during 2010, and they comprise around three-quarters of all major tax returns.[2] The next largest group of return filings is the nearly 30 million business employment tax returns, such as Form 941 (*Employer's Quarterly Federal Tax Return*) and Form 940 (*Employer's Annual Federal Unemployment Tax Return*), which comprise about 16 percent of all major tax returns. The remaining share of major return filings (around 9 percent) reflect the various other business and tax exempt return series such as Form 1120 (*U.S. Corporation Income Tax Return*), Form 1065 (*U.S. Return of Partnership Income*), Form 1041 (*U.S Income Tax Return for Estates and Trusts*), Form 720 (*Quarterly Federal Excise Tax Return*), and Form 990 (*Return of Organization Exempt from Income Tax*). Explicitly including major business and exempt organization tax returns within the context of the 80 percent e-file goal increases the challenge of the effort because the corresponding e-file rates for these returns are substantially lower than for individual income tax returns.

Figure 1. Number of Major Tax Returns Filed by Return Type Estimated 2010 (in millions)



Source: IRS

This report provides the Board's latest assessment of the IRS' progress toward the 2012 e-file goal of 80 percent for all major tax returns. It also highlights major developments in electronic tax administration during 2010, along with key considerations and challenges to reaching the 80 percent e-file goal. As it has in the past, the Board also uses this report to

[2] The major tax return form types considered for purposes of the 2012 e-file goal are those in which the filers account for income, expenses, and/or tax liabilities. In general, these consists 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.

provide additional comment on important e-file related recommendations put forth by the experts on the Electronic Tax Administration Advisory Committee (ETAAC) in its 2010 report to Congress.[3]

The Strategic Importance of Electronic Tax Administration and e-File

It is important to note that electronic filing of tax returns is only part of a broader range of tax-related technology applications embedded in the concept of electronic tax administration. Electronic tax administration 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.

Such a comprehensive vision of ETA 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.[4] The ETA vision is further embedded in key IRS long-term planning initiatives, including the *Taxpayer Assistance Blueprint*, the IRS *Information Technology (IT) Modernization Vision and Strategy*, and the *IRS Strategic Plan 2009-2013.*

For example, a key objective articulated in the IRS strategic plan is “to build and deploy advanced information technology systems, processes, and tools to improve IRS efficiency and productivity.” Associated strategies in the IRS strategic plan to achieve that objective include: (a) deliver modernized systems designed to store and manage taxpayer data, strengthen enforcement efforts, and meet service expectations of taxpayers and tax practitioners; and (b) expand online tools and services.[5] Thus, ETA is a central part of the IRS’ strategic thinking and remains the means by which IRS can evolve into a truly modern

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[3] Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2010, Publication 3415 (Revised 6-2010). As with the IRS Oversight Board, RRA 98 placed a similar responsibility on ETAAC to report to Congress on IRS’ progress toward the 80 percent e-file goal. The ETAAC members are chosen for their particular expertise in the electronic exchange of tax administration information and they assist the IRS in devising strategies to advance electronic filing and the broader ETA vision.

[4] 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.

[5] Internal Revenue Service, *IRS Strategic Plan 2009-2013*, Publication 3744 (4-2009).

organization that can deliver world-class quality service in a much more efficient manner.

Achievement of the ETA vision, in turn, is only possible if a highly successfully e-file environment exists. Thus, the focus provided by the 80 percent e-file goal by 2012 remains a valuable reference point by which to gauge IRS success. It can also help inform the decisions of tax administrators, tax professionals, and policymakers, whose concerted actions are the key to whether the goal is achieved.

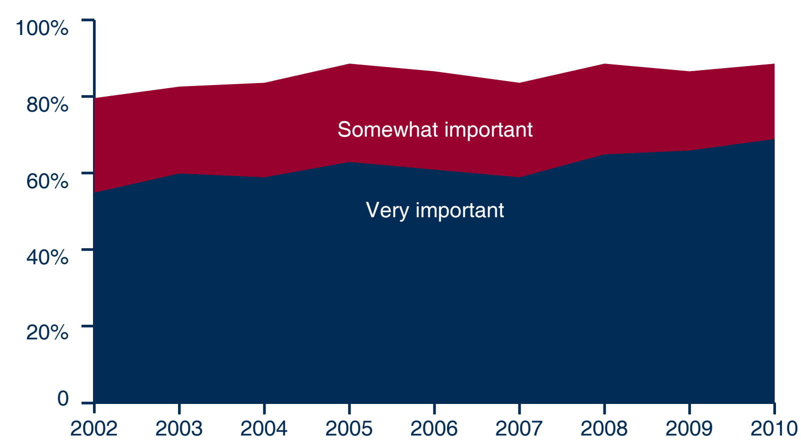
Taxpayer Views on e-File and Electronic Tax Administration

Taxpayers recognize that e-file is important to tax administration. As shown in Figure 2, the Board's annual taxpayer attitude survey regularly reveals that well over 80 percent of the general public believe it is "very important" or "somewhat important" that the IRS provides opportunities for electronic filing. Further, the share of the public saying it is very important has generally grown over the years, going from 55 percent in 2002, to 69 percent in 2010.

In addition, as shown in Figure 3, 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. In 2009, the latest year for which data are available, the American Customer Satisfaction Index (ACSI) score for individual e-filers was 79 compared to only 55 for paper filers.

Satisfaction with electronic filing also is not limited to individual return filers. It extends to business return filers. For example, a survey of e-filers of corporation income tax returns (i.e., Forms 1120 and 1120S) in

Figure 2. Percent of Public Who Say It Is Important That the IRS Provides Opportunities for Electronic Filing

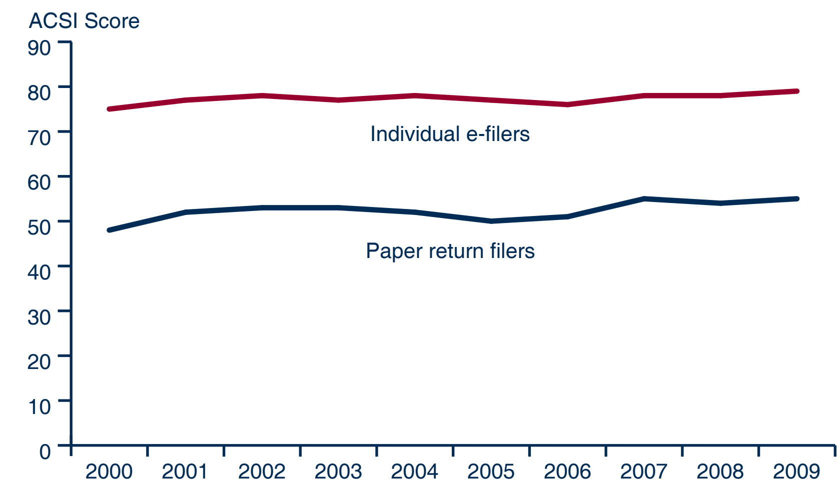


Source: IRS Oversight Board Taxpayer Attitude Survey

May 2009 revealed that 92 percent said that they were very satisfied with their e-filing experience (with another six percent somewhat satisfied).[6]

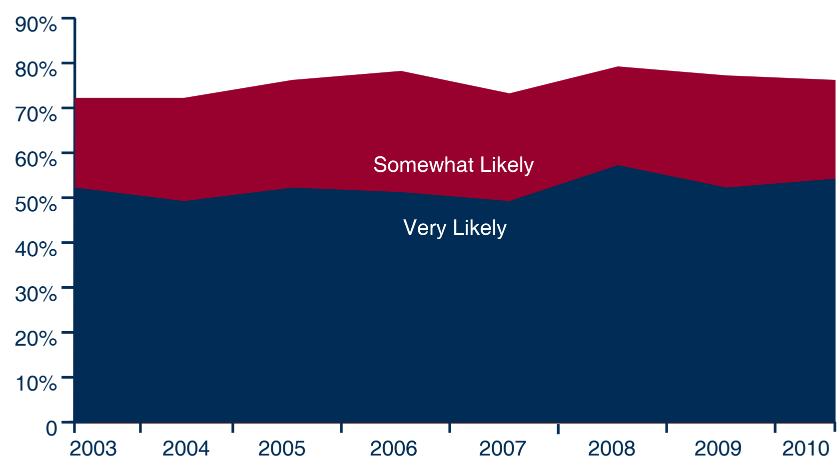
It is also interesting to note that even though a majority of individual taxpayers use a paid return preparer to complete their income tax return, around three-quarters of the general public regularly say they would be likely to use the IRS website. This includes 54 percent who say they are "very likely" to use IRS.gov, based on the Board's 2010 survey (see Figure 4).

Figure 3. ACSI Scores 2000-2009



Source: www.theacsi.org

Figure 4. Percent of Public Who Say They Would Be Likely to Use the IRS Website



Source: IRS Oversight Board Taxpayer Attitude Survey

[6] Internal Revenue Service, *Findings From the 2009 Form 1120 e-file Customer Satisfaction Study*, Publication 4417 (Rev. 07-2009).

Notable Developments in Electronic Tax Administration During 2010

The IRS and its partners in the tax administration community have developed and introduced many new and useful electronic tax products and services over the years. The Board has noted a number of these major ETA advancements in its prior reports to Congress.[7] Still, designing and delivering new technological applications that serve taxpayers better will be a never-ending process. Highlighted below are some of the major developments during 2010 that have impacted the electronic tax interactions of individuals and businesses, or will in the very near future.

First Phase of Form 1040 Modernized e-File Implemented

During the 2010 filing season, the IRS implemented the first phase of its modernized e-file (MeF) application for processing individual tax returns. While the IRS has had MeF platforms in place for years to process various types of business and exempt organization tax returns, this was its initial effort in tackling individual income tax returns. The MeF application implemented for the 2010 filing season was capable of handling the basic Form 1040 return, and over 20 of its more common forms and schedules, along with the Form 4868 (*Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*).

The IRS will continue this phased-in approach to Form 1040 MeF for 2011, continuing to accommodate only part of the individual return population. The IRS expects to have the complete Form 1040 MeF system in place to handle all individual tax returns by the 2012 filing season, at which point it can replace the old legacy e-file system, which has been in use for decades. The Board will closely monitor the IRS' progress in this regard.

The MeF platforms for business, tax exempt, and individual returns are a key component of the ETA vision. The MeF applications are web-based systems that greatly facilitate e-file by using flexible, industry standard technology for identifying, storing and transmitting data. As the Treasury Inspector General for Tax Administration (TIGTA) noted, when complete, the MeF system will provide a single method for filing

[7] For example, see the IRS Oversight Board, *Electronic Filing 2007 Annual Report to Congress*, February 2008, pp. 20-21, for a summary of the major electronic tax administration products and services introduced from 1989 to 2007.

all IRS tax returns, information returns, and schedules via the Internet. It will also provide real-time processing of tax returns and extensions that will improve error detection, standardize business rules, and expedite IRS acknowledgments of receipt of returns. In addition, the MeF system will provide the IRS with the capability to accept return attachments in portable document format (PDF), which will provide additional benefits to tax administration, including an increased ability to accommodate legislation and form changes enacted late in the year.[8] The development and deployment of MeF applications are a major part of the IRS' Business Systems Modernization (BSM) effort and reflect the technological foundation for electronic filing in the modern age.

Returns Claiming First-Time Homebuyer Credit Not Eligible for e-File

Because of the documentation requirements for claiming the First-Time Homebuyer Credit on their tax year 2009 returns, particularly to attach a copy of the settlement statement, these taxpayers were required to file a paper return during the 2010 filing season. Partial year 2010 filing experience through mid-summer indicates that at least 1.8 million taxpayers claimed this credit. While some of these taxpayers would likely have filed a paper return in 2010 regardless, the requirement to file on paper if claiming the First-Time Homebuyer Credit reduced the volume of e-file returns that otherwise would have been filed in 2010.

New IRS.gov Applications: Federal Student Aid Datashare; Electronic Filing PIN Help; Did I Receive a 2009 Economic Recovery Payment?

The IRS implemented more applications in 2010 on its Internet website, IRS.gov, to better serve taxpayers. For example, TIGTA reports that the IRS successfully developed and deployed the Federal Student Aid Datashare application in January 2010. More than 260,000 taxpayers used this new Internet-based tool to automatically transfer their tax return information to their student aid application while completing the Free Application for Federal Student Aid (FAFSA) on the Department of Education web site.[9]

In addition, the IRS implemented the Electronic Filing PIN Help application on its web site for the 2010 filing season. This application provides taxpayers with a personal identification number (PIN) to e-file in those instances when they cannot locate their prior year adjusted gross income or the prior year's PIN. Taxpayers need such a PIN to "sign" an individual tax return they intend to submit electronically.

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[8] Treasury Inspector General for Tax Administration, *Interim Results of the 2010 Filing Season*, Reference Number 2010-41-047, March 31, 2010.

[9] Treasury Inspector General for Tax Administration, *The Federal Student Aid Datashare Application Was Successfully Deployed, But Improvements in Systems Development Disciplines Are Needed*, Reference Number 2010-20-099, September 3, 2010.

The IRS also implemented a new web application (Did I Receive a 2009 Economic Recovery Payment?) and a new 800-number in March 2010 in response to a commonly occurring taxpayer error that had led to the initial rejection of electronically filed returns from more than one million taxpayers. Both the new web application and the new toll-free automated telephone line enabled taxpayers to determine whether they had received an Economic Recovery Payment. The cause of the frequently occurring error, which affected mostly new retirees and seniors with part-time jobs, was confusion involving the interaction of two economic stimulus provisions.[10]

Online PTIN Application Implemented as Part of the New Preparer Regulation

In early 2010, the IRS announced proposed new registration, testing and continuing professional education requirements for all paid tax return preparers. While the bulk of the newly proposed regulations primarily affect tax return preparers not already subject to oversight, some impact all paid preparers. The most immediate of these is the requirement that all paid return preparers who prepare all or substantially all of a return get a newly-reconstituted Preparer Tax Identification Number (PTIN), which must then be provided on all tax returns filed after December 31, 2010. Preparers who already have a PTIN may retain their old number, but are still required to submit a PTIN application under the new regulatory system.

Given the size of the paid return preparer population, which some IRS data suggest could approach one million, the IRS has implemented an online application to handle the logistics of registration. The new online application enables return preparers to fill out the necessary application, pay a fee, and receive their PTIN all in the same session.[11] The PTIN online application system went live in September 2010.

IRS Announces that e-File Mandate for Preparers Will Be Phased in Starting in 2011

Congress enacted legislation in late 2009 that establishes an e-file mandate for those preparers who file more than ten income tax returns for individuals, estates or trusts. The law is effective for returns filed in calendar year 2011 (i.e., tax year 2010).[12] The IRS has since announced that this e-file mandate will be phased in over two years. Starting in January 2011, the mandate will apply to those preparers who anticipate filing 100 or more returns; the full mandate will then begin in January 2012 and apply to preparers expecting to submit 11 or more returns.

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[10] Ashlea Ebeling, Forbes, *Tax Time: After Rejecting 1.7 Million Returns*, *IRS Offers Help*, March 8, 2010.

[11] Tax Notes Today, *Preparers May Keep Old PTIN and Get Relief from E-file Mandate*, *Official Says*, May 24, 2010.

[12] Public Law 111-92, *111th Congress, Worker, Homeownership, and Business Assistance Act of 2009*, November 6, 2009.

The Board has supported an e-file mandate and has continuously monitored the IRS' e-file performance for several years. The e-file mandate has long been a recommendation of several major stakeholders, including the ETAAC, TIGTA, and the Government Accountability Office (GAO). In addition, at least 20 states have already implemented some type of e-file mandate for preparers of their state tax returns to achieve return processing cost savings and reduce the volume of tax returns submitted with errors.[13] The Board also believes that the IRS plan to phase-in the mandate over two years reflects a sensible approach that should make the transition easier for the affected preparers. The Board further notes that feedback it received during discussions with return preparers at 2010 IRS Nationwide Tax Forums, indicated that it is likely that few professional preparers will find the mandate problematic because the vast majority of them are already committed users of e-file.

There is no doubt that this new e-file mandate will have a significant positive effect on the e-file rate for individual returns. It should also boost the e-file rate for the income tax returns for estates and trusts (Forms 1041) processed by the IRS as business returns. However, it will not, by itself, enable the IRS to achieve its long term goal of an 80 percent e-file rate for all major tax returns. A later section of this report takes a closer look at the remaining volume of paper returns submitted by return preparers and the approximate impact of this new e-file mandate on the overall e-file rate.

IRS Announces Cessation of Debt Indicator on e-Filed Returns Effective in 2011

In August 2010, the IRS announced that starting with the 2011 filing season, it would no longer provide the debt indicator, which is used to facilitate refund anticipation loans (RALs).[14] The debt indicator is currently provided by the IRS when it acknowledges receipt of an electronically filed individual return. The indicator essentially advises a lending institution whether the tax refund of an applicant for a RAL will be offset to satisfy a government debt.

The IRS explained that part of the reason for discontinuing the debt indicator is that the IRS can process a tax return and deliver a refund in ten days if taxpayers e-file with direct deposit. Also, in a related move, the U.S. Department of the Treasury announced in September 2010, a new pilot program that will allow some low-to-moderate income taxpayers to have their tax refunds directly deposited into a new,

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[13] Treasury Inspector General for Tax Administration, *Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs*, Reference Number: 2009-40-130, September 10, 2009.

[14] Internal Revenue Service, *IRS Removes Debt Indicator for 2011 Filing Season*, IRS Press Release IR-2010-89, August 5, 2010.

low-cost bank account. These unique accounts are intended to serve Americans without bank accounts and provide them a tool to help avoid using high-interest payday and refund anticipation loans. The pilot will be launched during the 2011 tax return filing season.[15]

The Board has noted in the past that one straightforward approach to reducing the number of RALs is to process tax accounts on a daily basis. The IRS expects to achieve a daily account processing capability for all individual returns, along with a modern relational database structure for its central taxpayer account system by 2012 through a revised strategy for its Customer Account Data Engine (CADE) project referred to as "CADE 2."[16] Daily account processing for all individual returns, in turn, will enable the IRS to issue taxpayer refunds even more quickly than the current ten-day cycle for e-file.

The degree to which faster refunds could reduce the demand for RALs can be found in a survey of individual taxpayers sponsored by the IRS' Wage and Investment (W&I) Division. Of the respondents to the 2009 W&I *Market Segment Survey* who indicated they had taken out a RAL during the most recent filing season, only 16 percent stated they still would have taken out that refund anticipation loan even if they could have received their refund in about three days.

IRS Debuts Webinar for Return Preparers

In June 2010, the IRS debuted its latest Internet-based educational program for tax professionals, the webinar *IRS Live*. The hour-long program featured IRS and industry experts and focused on key aspects of the new requirements for paid return preparers such as PTINs, competency testing, and preparer compliance verification checks. Tax professionals were able to watch the live program for free and submit questions by e-mail during the session. In addition, those who registered online in advance via IRS.gov and viewed the webinar were eligible to receive continuing professional education (CPE) credit.[17]

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[15] Darrell A. Hughes, Dow Jones, *US Treasury to Offer Low-Cost Bank Account for Tax Returns*, September 2, 2010.

[16] Tax Notes Today, *IRS Reveals First Details of Revamped Modernization Program*, October 15, 2009.

[17] Internal Revenue Service, *IRS Presents IRS Live–New Requirements for Tax Return Preparers–Learn the Who, What, When and How*, IRS Press Release IR-2010-070, June 1, 2010.

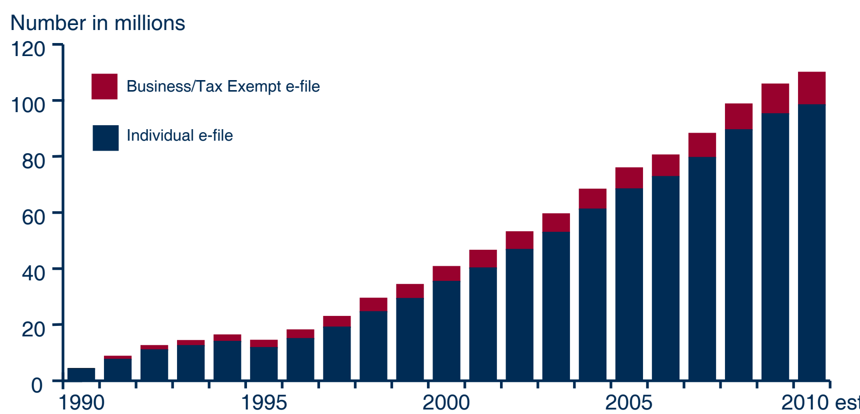
2010 e-File Results and Longer Term Trends in Electronic Filing

e-File Continues to Grow in 2010 but at a Somewhat Slower Pace and Remains Below 80 Percent Goal

The e-file experience through early fall of 2010 indicates another year of growth, both in terms of the number and percentage of returns filed electronically. The number of all major individual, business and tax exempt returns filed electronically in 2010 is estimated to be approximately 110 million; about four million higher than in 2009—or around a four percent increase. While this growth reflects continued progress, it is the smallest increase in the volume of e-file returns since 1996 and may be attributed, at least in part, to the fallout from the recent recession, which is estimated to contribute to a net reduction of over three million in the total number of major tax returns filed in 2010 compared to 2009.

From a longer term perspective, the total annual number of major tax returns filed electronically has grown more than 80 million since the passage of RRA 98, from 29.4 million in 1998 to approximately 110 million in 2010. As illustrated in Figure 5, this growth since RRA 98 has occurred every year and has been driven particularly by the electronic filing of individual tax returns, which have increased from 24.6 million in 1998 to over 98 million for 2010. Business and tax exempt returns have also grown over this same period, from 4.8 million to nearly 12 million.

Figure 5. Number of Electronically Filed Returns: Individual and Business/Tax Exempt

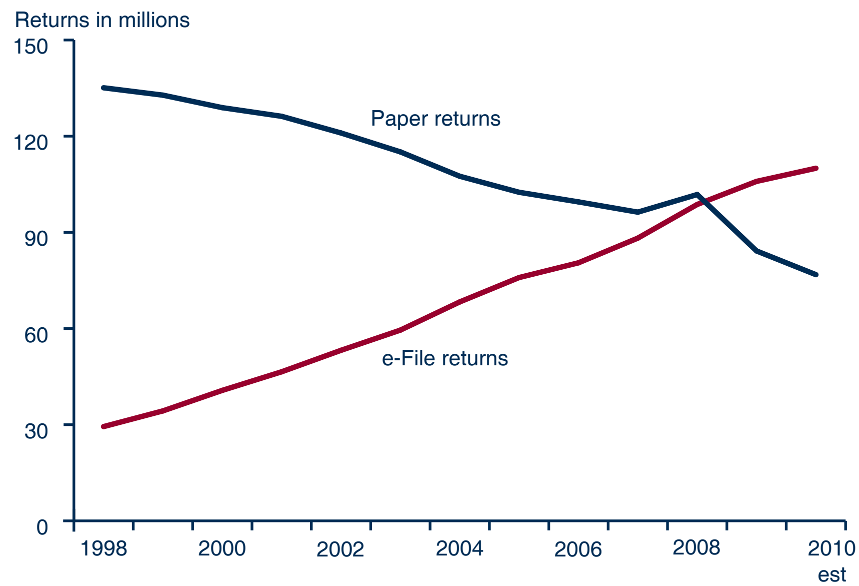


Source: IRS with IRS Oversight Board 2010 Estimate

In terms of the percentage of returns filed electronically, available filing experience indicates the e-file rate for all major tax returns in 2010 will be approximately 59 percent. This reflects about a net three percentage point increase in the e-file rate compared to 2009, which is slightly below the average net annual increase of 3.5 percentage points experienced over the prior decade.

While the growth in e-file has appeared to slow somewhat in 2010, the overall progress in electronic filing since the passage of RRA 98 is significant, as is further illustrated by the trends presented in Figure 6. In 1998, the total number of all major tax returns filed on paper was around 135 million, which vastly outnumbered the corresponding volume of e-file returns by a margin of more than 4-to-1. In 2010, over 30 million more major tax returns will be e-filed than submitted on paper, i.e., approximately 110 million e-file returns versus about 77 million on paper.

Figure 6. Number of Major Tax Returns: e-Filed versus Paper



Source: IRS with IRS Oversight Board 2010 Estimate

Note: Return counts for 2008 reflect impact of the one-time only returns filed to claim the economic stimulus payments.

However, despite continued progress in the number and percentage of returns filed electronically, the IRS still remains more than 20 percentage points below the goal of an 80 percent e-file rate for all major tax returns, based on the available 2010 filing experience. Also, while the impact of the e-file mandate for preparers of individual returns starting next year will boost the e-file rate significantly, particularly for individual returns, it is not expected to achieve the IRS' long term 80 percent goal by itself. The remainder of this section takes a more detailed look at the trends in electronic filing by return type. Discussion of the potential impact of the e-file mandate follows in the later section on key considerations in reaching the 80 percent goal.

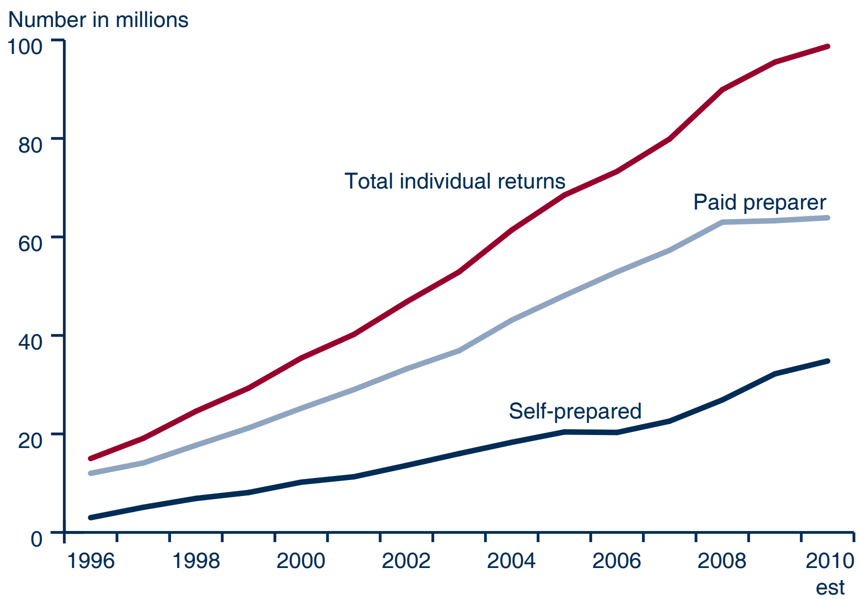
Number of Individual e-File Returns—Total Grows More Slowly in 2010

Total individual tax returns filed electronically continued to grow in 2010. As indicated in Figure 7, the IRS will receive over 98 million individual e-file returns during filing year 2010. This reflects growth of over three million returns compared to 2009—about a 3.4 percent increase. However, this is the smallest annual increase in individual e-file returns since the mid-1990s and likely reflects, at least in part, the impact of the recent recession. In particular, the IRS projects the total number of individual income tax returns to drop over two million in 2010, compared to 2009, and attributes that decline to the lagged effect of the economic downturn.[18] Thus, the Board credits both the IRS and the tax administration community for continuing to promote e-file and increase the population of individual taxpayers using the electronic filing medium in 2010, despite the decline in total filers.

Number of Individual e-File Returns by Preparation Method—Most of the 2010 Growth Reflects Self-Prepared Online Filing

Similar to the experience in 2009, the annual increase in total individual electronic filing in 2010 is driven almost entirely by the growth in returns submitted online (over the Internet) by those who self-prepared their returns using tax preparation software. In contrast, the number of e-file

Figure 7. Number of Individual e-File Returns by Preparation Method



Source: IRS with IRS Oversight Board 2010 Estimate

[18] Internal Revenue Service, Office of Research, Analysis and Statistics, *Fiscal Year Return Projections for the United States: 2010-2017*, IRS Document 6292 (Rev. 9-2010).

returns in 2010 submitted through paid tax preparers grew very little. These divergent trends in 2009 and 2010 for self-prepared online filed returns versus e-file returns from paid preparers are also depicted in Figure 7.

Self-prepared returns submitted online grew to just under 35 million in 2010, up about 2.7 million from 2009—or around eight percent. The results presented in Figure 7 illustrate how the number of individual electronic returns submitted through paid preparers (i.e., practitioner e-file) in 2010 has experienced little growth for the second year in a row. Based on the available filing data, the volume of practitioner e-file returns is expected to grow about 600,000 in 2010, to approximately 64 million, or about a one percent increase. Prior to 2009, however, practitioner e-file grew eight percent or more every year for the prior decade.

One possible explanation for the increase in online filed returns in 2010 is the residual, second-year impact of the decision of industry leaders to embed a free federal return e-file option into their retail tax preparation software products. However, there is also some evidence that the relatively strong growth in online filing and the contrasting weak growth for practitioner e-file are a consequence of the economy. In particular, there are signs that a share of taxpayers who might normally have used paid return preparers in 2009 and 2010 (and thus would have added to the practitioner e-file volume/growth) instead opted to prepare their own returns using retail tax preparation software—presumably to save money during difficult economic times. For example, one newspaper reported on how two major tax-preparation companies both showed declines in their business during the early part of the 2010 filing season, while the largest provider of retail tax software saw a substantial rise in its sales.[19]

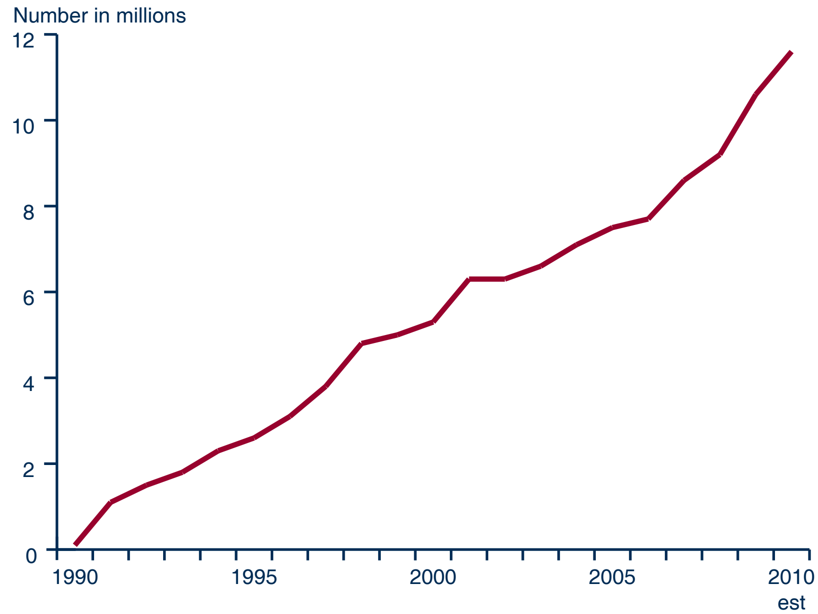
Also, it is clear that the growth in 2010 in online filing is not attributable to the subset of online filed returns submitted for free via the Free File Alliance links on the IRS website. Available 2010 filing data through late summer indicate that the number of Free File returns will be around 2.9 million, about 70,000 fewer than in 2009. However, several private companies offer free federal return preparation and electronic filing online directly from their own company website for certain types of individual returns. Such free e-file offerings are outside the Free File program, but would contribute to the total volume of returns filed online.

[19] Sandra Block, USA Today, *More Taxpayers Are Preparing Their Taxes on Their Own*, April 14, 2010.

Number of Business and Tax Exempt e-File Returns—Both Grow in 2010 But Less Than in 2009

The number of major business and tax exempt returns filed electronically also grew in 2010. As depicted in Figure 8, the combined number of business and tax exempt e-file returns is estimated to reach approximately 11.6 million in 2010. This reflects growth of around one million returns, or about nine percent, compared to 2009. This increase is slightly above the 6.8 percent annual average for the years 1999 to 2008. However, it is roughly half that of the 15.7 percent increase recorded in 2009.

Figure 8. Number of Business/Tax Exempt e-File Returns



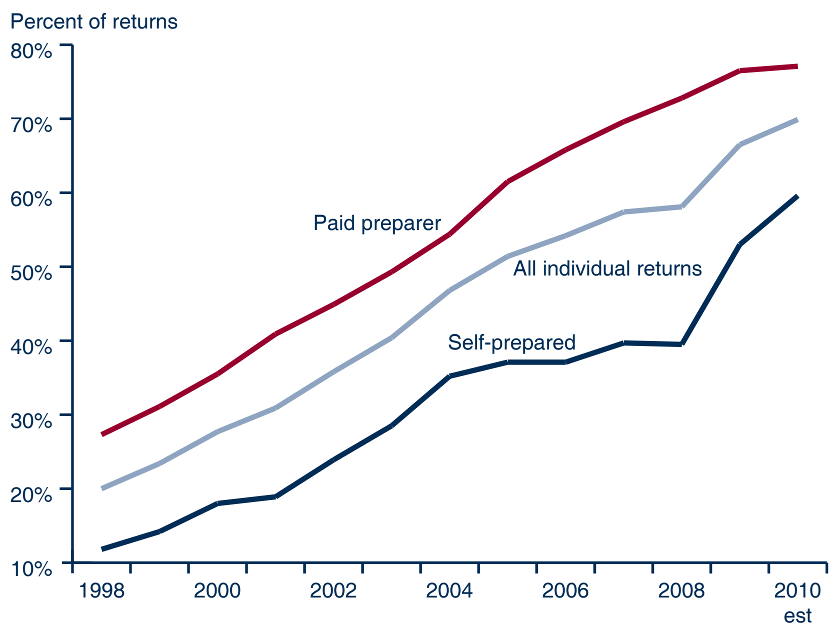
Source: IRS with IRS Oversight Board 2010 Estimate

In total, there are vastly more business returns than tax exempt returns —roughly 44 million for the former and only 1.3 million for the latter. Consequently, there are also far more business e-file returns than tax exempt e-file returns. The e-file volume for both return series grew in 2010. In particular, electronically filed business returns are expected to grow to about 11 million returns in 2010, up about 800,000 returns from 2009. Meanwhile, tax exempt e-file returns are expected to grow to about 540,000, up about 200,000 from 2009. The overall pace at which business and tax exempt e-file returns have been growing over the years is too slow to help IRS achieve its overall goal of 80 percent e-file by 2012—as analyses later in this report reveal.

Percent of Individual Returns Filed Electronically—e-File Rates in 2010 Grow for Self-Prepared Returns But Stall for Paid Preparer Returns

Figure 9 presents a long-term view of the percentage of total individual returns filed electronically. It also contains the trends in individual e-file rates broken out by filings submitted on-line by taxpayers who self-prepare their returns versus those filed through paid preparers. The results for 2010 in Figure 9 reveal noticeable growth in the percentage of returns filed electronically for individual returns in total and for self-prepared returns. However, based on estimates developed by the Board from partial year data, it appears that the e-file rate for paid preparer returns in 2010 will change only a little from 2009. If so, it will mark an unprecedented departure from the previous historical pattern of steadily increasing e-file participation among paid preparer individual returns.

Figure 9. Percent of Individual Returns Filed Electronically by Preparation Method



Source: IRS with IRS Oversight Board 2010 Estimate

As indicated in Figure 9, the e-file rate for all individual returns grew from about 66.5 percent in 2009 to approximately 70 percent in 2010. The percentage of self-prepared returns filed electronically increased from around 53 percent in 2009 to a little under 60 percent in 2010. The growth in the e-file rate for individuals who self-prepare their returns has been particularly strong for the past two years, and most likely reflects the beneficial impact of the decision by industry leaders to embed a free federal e-file option into the major retail tax preparation software products starting in 2009. The strong increase in the e-file rate for self-prepared returns since 2009 is encouraging given that the rate had appeared to reach a plateau (in the high-30 percent range) over the prior five-year period with hardly any upward movement.

In contrast to self-prepared returns, the e-file rate among individual filings submitted through paid preparers appears to have largely stalled in 2010, nudging up from 76.5 percent in 2009 to around 77 percent in 2010. Such a result for 2010 reflects a sharp break from the prior historical trend in which the e-file rate for individual returns submitted by paid preparers increased an average of 4.5 net percentage points annually, since the passage of RRA 98. One factor that may have contributed to the apparent stall in the growth of the e-file rate for paid preparers is the First-Time Homebuyer Credit.

As previously noted in the earlier section of this report on ETA developments in 2010, taxpayers claiming the First-Time Homebuyer Credit on this year's return were not able to e-file, and instead had to submit their returns and supporting documentation on paper. This credit affected the returns of at least 1.8 million taxpayers. However, some and perhaps even most of these individuals claiming the credit also used paid preparers; had these filers been able to submit their returns electronically, a more appreciable increase in the e-file rate for paid preparer returns in 2010 may have occurred. Also, while an end to the historical upward trend in the e-file rate for paid preparer returns would certainly be of concern to the Board, in terms of its impact on the 80 percent e-file goal, it is less of an issue now in light of the e-file mandate on individual return preparers.

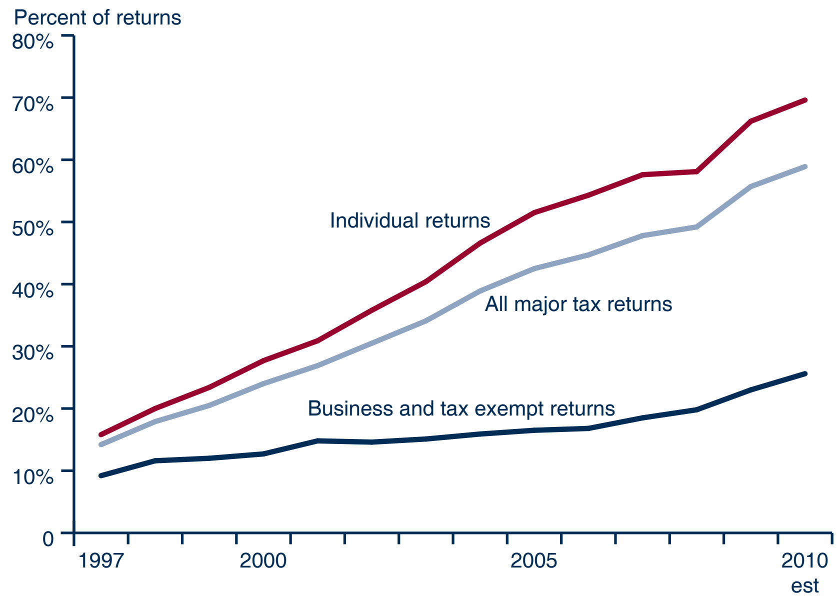
Percent of Business and Tax Exempt Returns Filed Electronically—e-File Rate Grows in 2010, as Does the Rate for All Major Returns Combined

Figure 10 presents a comparison of the trends in the long term e-file participation rates through 2010 for all individual returns, for all business and tax exempt returns, and for all major tax returns combined. The results through 2010 for these three trend lines point toward continued progress in increasing the share of all returns filed electronically.

As indicated in Figure 10, the e-file rate for business and tax exempt returns grew from 23 percent in 2009 to a little over 25.6 percent in 2010. This is a net increase of about 2.6 percentage points in the e-file rate for business and tax exempt returns in 2010, which is higher than the respective average increase recorded over the prior decade (i.e., 1.1 percentage points per year). However, as is also apparent in Figure 10, participation in e-file is much lower for business and tax exempt returns than for individual returns, which makes it far more difficult for the IRS to achieve its e-file goal.

Because individual tax returns comprise roughly 75 percent of all major tax returns and because the percentage of returns filed electronically by individuals is substantially higher than for businesses and tax exempt entities, the e-file rate for the combined total of all major tax returns in 2010 is approximately 59 percent. This reflects an increase from the corresponding e-file rate of 55.7 percent for 2009.

Figure 10. Percent of Major Tax Returns Filed Electronically



Source: IRS with IRS Oversight Board 2010 Estimates

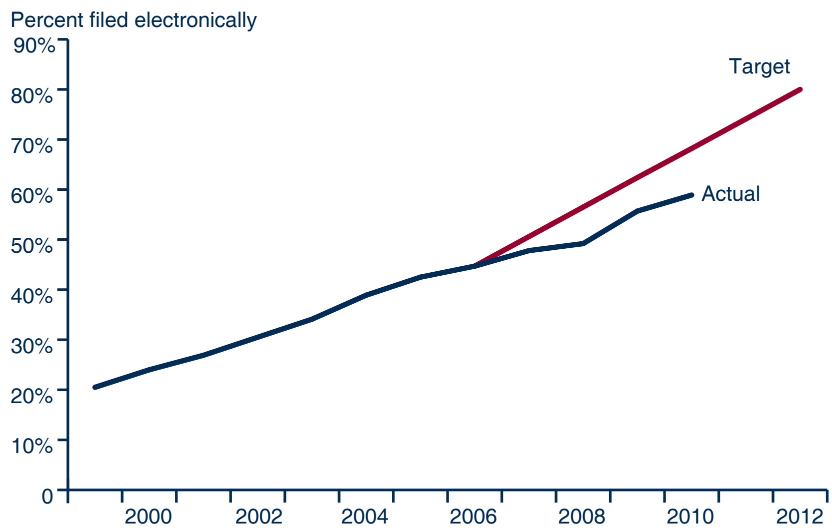
Assessing Progress on the 80 Percent e-File Goal

Overall e-File Rate Continues to Grow but Will Not Reach 80 Percent Goal by 2012 at Current Pace

Looking back to when RRA 98 was enacted, the e-file rate for individual returns has grown from 20 percent in 1998 to about 70 percent in 2010. For business and tax exempt returns, the respective e-file rate has gone from 11.6 percent to about 26 percent. The corresponding e-file rate for all major tax returns combined has gone from just under 18 percent to around 59 percent.

The Board views these increases in the shares of returns filed electronically to be clear signs of progress, and attributes that success in large part to the challenging 80 percent e-file goal specified in RRA 98 and to the continued interest of policymakers in monitoring how well the IRS is doing in advancing toward that goal. Nevertheless, with only 59 percent of all major tax returns filed electronically in 2010, the IRS faces a tremendous challenge in its efforts to reach the goal of an 80 percent e-file rate by 2012—now only two short years away. The extent of that challenge is illustrated in Figure 11.

Figure 11. e-File Rate for All Major Tax Returns Combined: Actual vs. Target



Source: IRS and IRS Oversight Board Analysis

The Board has been tracking the progress of the IRS since the agency recommitted itself to the 80 percent e-file goal based on all major tax returns back in early 2007. Its trend analysis is presented in Figure 11 and indicates that if the current trend continues, IRS will fall short of the 2012 e-file goal.

Using 2012 as the target for reaching the 80 percent e-file level and 2006 as the base point for measuring progress, Figure 11 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 recommitting the agency to the 80 percent goal.

The results in Figure 11 indicate that the actual 2010 e-file participation rate for all major returns combined is around nine percentage points below the targeted level, i.e., a target of about 68 percent versus an actual of around 59 percent. Figure 11 also indicates that the gap between the target value and the actual e-file experience is growing. Furthermore, extrapolating the e-file rate for all major tax returns, based on the underlying rate of growth experienced over the 1997 to 2010 period (but excluding the impact of the preparer e-file mandate), indicates that the value will only reach an overall e-file rate of around 66 percent by the year 2012—14 net percentage points below the 80 percent goal by the target year.

Of course, the federal e-file mandate for individual return preparers is an unprecedented development that is not reflected in the extrapolation of the underling historical trend and will help to close a substantial portion of that 14 point gap. Still, available data indicates that the mandate alone will not be enough to attain the e-file goal by 2012 for all major tax returns, based on the Board's estimates. The mandate may enable the IRS to pass the 80 percent e-file threshold in 2012 relative to individual tax returns—the *de facto* goal originally called for in RRA 98. The estimated impact of the e-file mandate is discussed in the next section of the report, along with other key considerations and challenges in attaining the e-file goal and the broader ETA vision.

Key Considerations and Challenges to Attaining the Electronic Tax Administration Vision

e-File Mandate for Individual Return Paid Preparers Will Substantially Raise the e-File Rate, but Not Enough to Reach 80 Percent Goal

As mentioned earlier, the IRS has announced that it will phase in the e-file mandate on individual return preparers. It will start in January 2011 with those preparers filing more than 100 returns and then extend the mandate in full in January 2012 to all preparers submitting 11 or more returns. Available data indicate that around 19 million individual returns and nearly two million Form 1041 estate and trust income tax returns will be submitted on paper during 2010 with a paid preparer signature. However, in estimating the likely impact of the e-file mandate on the longer term e-file rate for 2012, several other key considerations must also be kept in mind.

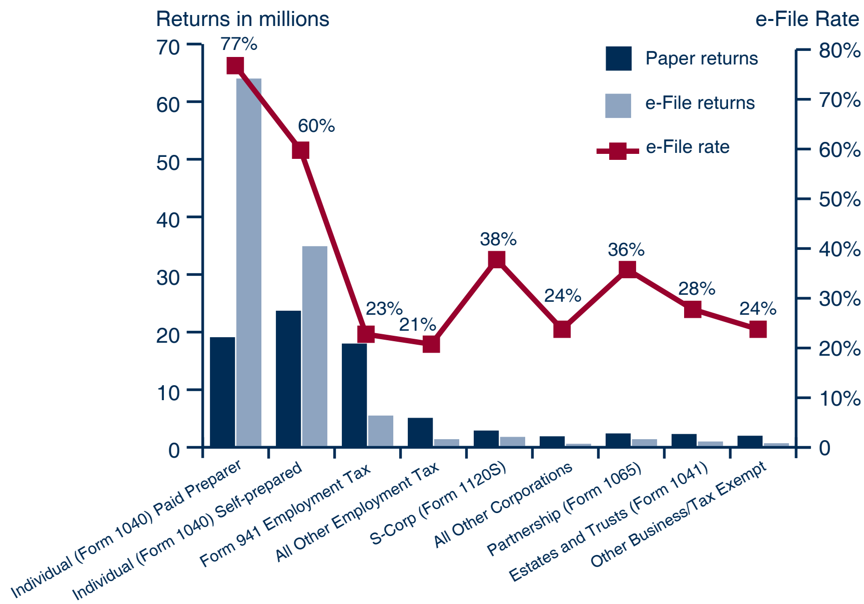
First, for various reasons, not all of the 19 million individual returns and two million business Form 1041 returns in question can be expected to switch to e-file in the future despite the mandate. For example, the mandate exempts preparers submitting ten or fewer returns a year and there will likely be some IRS waivers from the mandates as well. Second, in terms of the mandate's impact on the longer term e-file rate, it is reasonable to assume that based on historical trends, some of these returns with preparer signatures currently filed on paper would have switched to e-file in the future anyway, even in the absence of the mandate. Thus, the net effect of the mandate will likely be less by 2012 than the affected paper volumes estimated above from the 2010 filing counts.

Considering these factors and other available data, the Board estimates that the e-file mandate for individual return preparers will likely bump the 2012 overall e-file rate higher—in the range of five-to-eight net percentage points. An increase in the overall e-file rate of this magnitude by 2012 is substantial, and would likely even push electronic filing participation above the 80 percent mark for individual income tax returns. This attests to the overall value of the e-file mandate on individual return preparers in advancing a key aspect of the ETA vision. However, even using the higher end of the Board's estimates of the mandate's impact, the overall e-file rate for all major tax returns will likely be no higher than the low mid-70s in 2012, and thus still below the 80 percent goal—based on existing trends and likely impact of the new preparer e-file mandate.

IRS Needs to Convert Approximately 39 Million Paper Returns to e-File to Reach Goal

Based on estimated 2010 return filings, the IRS needs to convert to e-file approximately 39 million of the remaining 76 million tax returns still filed on paper by individuals, businesses, and tax exempt organizations to reach the 80 percent goal. In attempting to push the e-file rate over the 80 percent mark, the IRS and its partners need to consider carefully which types of tax returns comprise the bulk of the remaining paper and their relative e-file rates. Figure 12 summarizes the major tax return groupings by form type, along with their corresponding volume of e-file returns, paper returns, and e-file rates.

Figure 12. Number of Paper vs. e-File Returns by Major Return Type and Respective e-File Rates - Estimated Filings in 2010



Source: IRS Oversight Board estimate based on partial year IRS data

Return Categories with the Largest Paper Volumes Include Self-Prepared Individual Returns and Employment Tax Returns

As Figure 12 indicates, four major types of tax returns comprise roughly 85 percent of the remaining paper tax filings:

- individual returns filed through paid preparers (approximately 19 million);
- self-prepared individual returns (approximately 24 million);
- Form 941 employment tax returns (approximately 18 million); and
- all other employment tax returns such as Forms 940, 944 and 943 (approximately five million).

Given the high concentration of paper returns in these four particular return areas, part of a sensible strategy for attaining the e-file goal is to devote specific attention to initiatives that will increase electronic filing in these four segments. The enacted federal e-file mandate for preparers of individual returns should provide an effective strategy to significantly increase the volumes of e-file returns from one of these four segments. Consequently, the key remaining challenge facing the IRS and its partners in the tax administration community is to identify the additional strategies that can significantly increase the e-file participation rates among those individuals who self-prepare their returns and among employers filing the employment tax returns, particularly the quarterly Form 941.

Further Efforts Needed That Target Self-Prepared Individual Returns Filed on Paper

As shown in Figure 12, the Board estimates that about 60 percent of individuals self preparing their returns in 2010 elected to e-file. This means approximately 40 percent of individuals who self-prepare their returns remain unconvinced as to the benefits of electronic filing. One opportunity within this pool of paper return filers consists of those who submit what the IRS labels “V-coded” returns. V-coded returns are those filed on paper despite being computer generated from tax preparation software. The Board estimates that at least six million of the roughly 24 million self-prepared individual returns filed on paper are V-coded returns. Given that the major retail tax preparation software packages for individuals now include a free federal e-file option, the IRS and its tax partners must do more to get the remaining V-code self-preparers to take advantage of the free e-file option already embedded within their tax software.

The Importance of Getting More Employers to e-File Their Forms 941 and Other Employment Tax Returns

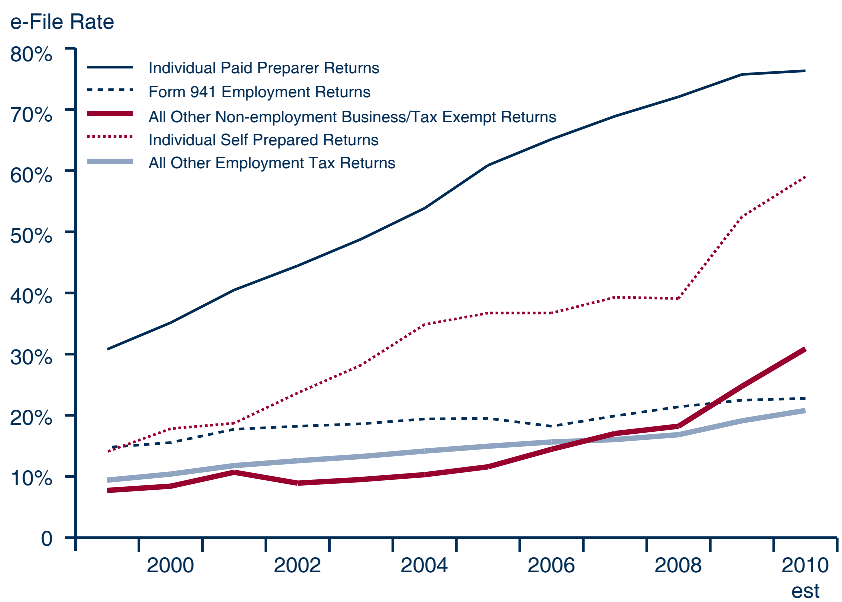
As Figure 12 also reveals, far smaller shares of business and tax exempt returns are currently filed electronically, compared to either paid preparer or self-prepared individual returns. In addition, because employers file such a large number of paper Form 941 returns, increasing e-file among this segment of returns is particularly crucial to achieving the 80 percent goal. In general, Form 941 employment tax returns are filed quarterly by employers, both for-profit businesses and not-for-profit organizations, to report their liabilities for Social Security and Medicare taxes, and for federal incomes taxes withheld from employees wages, where the total of those liabilities exceeds $1,000 per year.

The data in Figure 12 indicate that only 23 percent of Forms 941 are currently e-filed, with an even lower e-file rate for all other employment tax returns. Clearly, more needs to be done to increase the share of these employment returns filed electronically if the 80 percent e-file goal is to be attained. It is also important to note that given that Form 941 is usually filed quarterly, success in converting one employer from paper to e-file typically translates into four electronic Form 941 returns.

The Board recognizes that the IRS and its tax partners have made various attempts over the years to increase the e-file volumes of Form 941 and other employment returns. For example, the IRS once offered employers a free e-file option based on touch-tone telephone technology (i.e., the Form 941 TeleFile program). The IRS also made Forms 941 and 940 their first e-file applications to be built on the more flexible, industry-standard "XML" software. Meanwhile, payroll service companies and tax preparation software businesses have and continue to offer an array of services to meet the payroll needs of employers, including options for e-filing Forms 941 and other employment tax returns and information documents. In fact, large payroll service companies have a long-established partnership with the IRS in which the employment related return data of their clients is transmitted electronically.

Still, despite all these efforts, only slight progress has been made over the past decade to increase e-file participation among employment tax returns. As shown in Figure 13, while the other major groupings of return types have shown noticeable progress in raising their respective electronic filing rates since the passage of RRA 98, the level of e-file participation among the Form 941 return filers and for the other employment tax returns has grown only modestly during that same period. For example, while the e-file rate for individual self-prepared returns was nearly the same as for Forms 941 in 1999 at about 15 percent, the former has since grown to nearly 60 percent in 2010, while the latter has grown to only around 23 percent. Similarly, as a result of increasing the e-file rates among corporation, partnership and exempt organization tax returns, the e-file rate for all non-employment business and tax exempt returns, which was far below the rate for Form 941 in 1999 at less than eight percent, has since risen to an estimated 31 percent in 2010.

Figure 13. e-File Rates for Individual, Form 941, Other Employment, and All Other Returns - 1999-2010



Source: IRS with IRS Oversight Board 2010 Estimate

Many Filers of Employment Tax Returns May Reflect a Unique Segment Little Influenced by Traditional e-File Marketing Efforts

The limited success to date in moving filers of employment tax returns to e-file may be due in part to a substantial share of these filers reflecting a unique subset of the tax community that is perhaps not readily influenced by traditional IRS and industry e-file marketing strategies targeting tax professionals. In particular, while there is no doubt that some payroll service companies and paid return preparers submit Forms 941 and other employment tax returns on behalf of their business clients, many employers apparently rely on their administrative staff who handle payroll to prepare and file their employment tax returns.

For example, in commenting on the newly proposed IRS regulations for paid return preparers that would lead to a requirement that preparers of payroll (employment) returns be required to pass an IRS competency test covering individual tax return matters, the National Society of Accountants stated that, "staff bookkeepers typically prepare these [employment] returns and in almost all instances they are merely transcribing data that has been captured by other accounting processes of the business."[20] Indeed, the IRS subsequently recognized a distinction between simple payroll return preparation and retail tax return preparation in its implementation of the IRS' return preparer regulations. According to the IRS, an employee of a company that prepares its own payroll returns is acting as an employer, and the payroll staff generally will not be required under the proposed rules to apply for a PTIN, nor be subject to the associated competency testing and continuing professional education.[21]

New Strategies Are Needed to Increase e-File Participation Among Employment Returns

Slow growth in the e-file rates in the employment tax area may have occurred because many of these returns are submitted by payroll professionals within the companies, or the business owners themselves, who are not part of the typical community of tax professionals to whom e-file and supporting tax preparation software are regularly marketed and the benefits of electronic filing espoused. The Board encourages the IRS to develop a more definitive profile of those submitting the bulk of the paper employment tax returns and whether better marketing by IRS and/or industry could help increase their e-file participation. It is also clear that new and more innovative strategies are needed to move the rates of e-file participation of Form 941 and the other employment series return types to the higher levels that are crucial to attaining the 80 percent e-file goal. The Board strongly encourages the IRS to systemically explore such new options.

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[20] BNA Daily Tax Report, *Tax Preparers: Tax Preparers Protest New Fees Proposed by IRS to Obtain Tax Identification Numbers*, August 24, 2010.

[21] BNA Daily Tax Report, *Tax Practice: Many Payroll Professionals Will Not Need PTINs under Proposed Rules*, Official Says, September 9, 2010.

For example, the Board finds merit in the ideas of a direct Form 941 e-file portal and potential e-file mandates for employment tax returns. The Board notes that similar practices are already in place for related employment tax matters. In terms of a direct e-file portal, the Social Security Administration (SSA) operates its W-2 Online application on its website, which allows employers to e-file their Forms W-2 directly with SSA. The data on wages and tax withholding reported on an individual basis using Forms W-2 are essentially the same as the amounts being reported to the IRS in aggregate on Form 941.

The SSA application also performs various computational checks during the process and is a very useful Internet tool for small businesses, particularly those with relatively few employees and who fall below the threshold for mandatory electronic filing of Forms W-2.[22]

It is also worth noting that near the peak of its usage in 2002, over 850,000 employment tax returns were filed directly with the IRS via its since-discontinued Form 941-TeleFile application, which was based on touch-tone telephone technology.[23] Indeed, while RRA 98 encouraged a robust and competitive private sector environment that would increase e-file, Congress also made clear their intent that the IRS should continue to improve its TeleFile program by making a comparable program available on the Internet.[24] While the industry-supported Free File program has provided a comparable Internet replacement for the Form 1040-TeleFile program, none has yet been provided for the former Form 941-TeleFile application.

In terms of e-file mandates for employment tax matters, larger employers (with 250 or more employees) are already required to file their Forms W-2 electronically. In addition, in August 2010, the IRS proposed regulations that would require all federal tax deposits to be made electronically.[25] The bulk of such tax deposits are submitted by employers and reflect employee tax withholdings associated with the Forms 941. Thus, given existing requirements to submit tax deposits and Forms W-2 electronically, it may not be an unreasonable burden to extend electronic tax administration requirements a bit further to include the filing of employment tax returns by certain employers, particularly if there were a direct e-file portal.

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[22] Social Security Administration, *Payroll Pointers for Filers of Forms W-2/W-3,* as published in the *IRS Nationwide Tax Forum 2010 Seminar Handbook*, IRS Publication 1811 (Rev. 05-2010).

[23] Internal Revenue Service, Research, Analysis, and Statistics, *Calendar Year Return Projections of the United States and IRS Centers*, Document 6186 (Rev. 11-2003).

[24] *Internal Revenue Service Restructuring and Reform Act of 1998*, Conference Report to Accompany H.R. 2676, June 24, 1998.

[25] BNA Daily Tax Report, *Tax Administration: IRS Proposes Rules to Require All Deposits of Federal Taxes Be Made Electronically*, August 20, 2010.

An 80 Percent e-File Rate: When, Not If

With the 2012 filing season only two years away, and considering the likely impact of the e-file mandate for individual return paid preparers, it is doubtful that the IRS can achieve the 80 percent e-file goal for all major returns by the target year in the absence of some other major initiatives by the IRS or industry. The comparatively low e-file rates among the business and tax exempt return areas, plus the sizeable volume of paper filings still submitted by those who self-prepare their individual returns, present major obstacles for the IRS to achieve the e-file goal by 2012.

Nevertheless, the Board encourages the IRS, its partners in the tax community, and policymakers to continue to strive for that desired overall target of 80 percent e-file, and to vigorously pursue other innovations that might yet help achieve that goal. As indicated by the likely impact of the e-file mandate for individual return preparers, and the actual impact of the decision by industry a few years back to embed a free federal e-file option into retail tax preparation software, certain actions can in fact lead to substantial increases in e-file in a very short timeframe. Advancement toward the 80 percent e-file rate for all major tax returns must remain an urgent priority of all stakeholders in tax administration.

Even if attaining the overall 80 percent e-file goal by 2012 proves to be impossible, the Board has no doubt that tax administration will eventually cross that threshold in the not too distant future. As a result, the Board further encourages the IRS, policymakers, and other stakeholders in tax administration to expand their consideration of ideas to include not only those designed to achieve the e-file goal but also to those that focus on the attainment of the more comprehensive ETA vision. That vision entails an environment where virtually all tax administration data are in electronic format, stored in modern relational databases, and available in near-real time to taxpayers, their authorized preparers, and the IRS in an appropriately tailored and secure fashion. Such an ETA environment, in turn, opens up a tremendous range of opportunities for the IRS and tax professionals to serve America's taxpayers in a world class fashion and to advance voluntary compliance to unprecedented levels.

2D Bar Coding: a Supplement Strategy to e-File

A supplemental option to e-file that leverages the pool of V-coded returns, both those submitted by self-preparers and those from paid preparers, which the IRS should also explore more thoroughly is 2-dimensional (2D) bar coding. While not fully electronic filing, 2D bar coding entails printing of a computer-readable symbol on V-coded paper individual and business returns that allows all the information encoded on the tax form(s) to be automatically extracted via electronic scanning. In fact, the GAO has previously recommended that the IRS determine the actions needed to require tax software vendors to include bar codes on printed federal paper tax returns and further noted that such bar coding produces some of the efficiencies of e-file. These efficiencies include enabling the IRS to electronically capture all the information on a tax return, avoiding the labor-intensive IRS transcription process, and eliminating the associated IRS transcription errors that burden taxpayers.[26]

Bar coding on V-coded tax returns is a well-established practice. As noted in a 2008 IRS report exploring ideas to advance electronic filing, at least 32 states and three countries use 2D bar coding in the processing of their tax returns.[27] In addition, the IRS already makes use of 2D bar coding and scanning in the processing of certain Schedule K-1 forms it receives. With the growing reliance on tax software by individuals and businesses preparing their own tax returns, and the near universal use of such software by professional return preparers, the Board believes that it is time for the IRS to position itself to take advantage of this more modern technology in the processing of tax returns to advance a data-centric ETA vision.

Nevertheless, the Board also notes that 2D bar coding lacks some of the major benefits to taxpayers and the IRS that occurs with true electronic filing. Thus, bar coding must be pursued as a secondary strategy behind the preferred option of persuading more taxpayers to e-file. For example, bar coding still requires some IRS processing of paper such as receiving and opening mail, separating the bar coded paper returns from the others, and funneling the applicable paper forms successfully through the scanners. Further, the time associated with mailing the bar coded returns, along with the subsequent IRS processing, precludes receipt acknowledgement of returns, speedy upfront error detection, and rapid refund delivery (where applicable) that is provided to taxpayers when they e-file.

Need for a Strategic ETA View Regarding Increased Data in Electronic Form

The Board emphasizes the need to substantially increase the e-file rate, particularly among businesses filing employment tax returns, because it is crucial to the IRS to achieve the strategic 80 percent electronic filing goal. However, as it has emphasized in its previous reports on e-file, the Board also believes that e-file mandates and other ETA requirements placed on employers, tax software manufacturers, and other businesses need to be considered in a more strategic fashion.

Part of that strategic approach would be to avoid the piecemeal approach of the past, which has led to a patchwork of mandates in the business returns area with often limited effectiveness. For example, while mandates have been in place for a number of years relative to

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[26] The United States Government Accountability Office, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated*, GAO-08-38, November 2007.

[27] Internal Revenue Service, *Advancing E-file Study Phase 1 Report*, September 30, 2008.

partnership Form 1065, corporation Forms 1120 and 1120S, excise tax Form 2290, and exempt organization Form 990 returns, none have contributed to a noticeable impact on the respective e-file rates—as is indicated by the results in Figure 12. Indeed, IRS data indicate that only around half of large corporations with more than $10 million in assets, and only about a third of the returns from similarly large partnerships, will be electronically filed in 2010—despite e-file mandates targeted specifically at such large business entities.

Equally important to a more strategic view of electronic filing and 2D bar coding in the context of the ETA vision, is to carefully consider how the increased volume of data in electronic form would be leveraged to improve service and tax compliance. For example, it is possible to envision a much more effective and less burdensome IRS compliance program in the future, if significantly more “flow through entity” information on gains and losses reported on partnership (Form 1065) and S-Corporation (Form 1120S) returns were received electronically and capable of being matched in a more sophisticated manner via full data capture on individuals returns. The GAO has often made a similar point; for example, recommending in a 2007 report that the IRS analyze the cost and benefits of having all individual return information available for use in IRS enforcement programs.[28] Thus, while the Board is encouraging the IRS and its tax partners to devote attention to individual and employment tax returns in pursuit of achieving the 80 percent e-file goal by 2012, and to explore 2D bar coding as a supplemental strategy to e-file for full data capture, the Board also emphasizes that attention must be given to how data in electronic form will be used in pursuit of better tax administration.

Need to Move Beyond Weekly Master File Processing

Despite steady progress in raising the electronic filing rate and other e-file advancements since the passage of RRA 98, such as the information and services provided on the IRS website and the many MeF applications implemented in the business and tax exempt return areas[29], the federal tax administration environment of today falls short of the full ETA vision. Major challenges must still be overcome to achieve the vision in which the vast majority of tax interactions are handled electronically. For example, the IRS remains handicapped in achieving its ETA vision in part because it must continue to rely upon its old master file systems. These systems limit more effective uses of tax

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[28] The U.S. Government Accountability Office, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated*, GAO-08-38, November 2007.

[29] The IRS has deployed Modernized e-File (MeF) systems for the following business and tax exempt return areas: corporation (Forms 1120, 1120-F, and 1120S); exempt organization (Forms 1120-POL, 990, 990-EZ, 990-N, and 990-PF); partnership (Forms 1065 and 1065B); excise (Forms 2290, 720, and 8849); and extensions of time to file (Forms 7004 and 8868).

administration data because they do not use more modern “relational” database structures and because they provide only weekly account processing capabilities.

The new strategy the IRS is pursuing under its CADE 2 project promises to provide a quicker route to daily taxpayer account processing for all individuals and the ability to store and retrieve data in a relational format than was the case with the prior incremental approach. The Board strongly supports the CADE 2 initiative and believes it will provide the basis for many new and innovative tax administration programs that better serve taxpayers and enhance voluntary compliance. It encourages policymakers to fund this and other BSM initiatives at the levels necessary to achieve their success.

However, even in the best scenario, the current individual master file system with its weekly processing cycle will remain the norm at least through January 2012. Furthermore, plans for CADE 2 have yet to address the implementation of a daily processing capability for the business master file, although lessons learned from the current effort will no doubt be applied when the IRS moves to tackle that challenge. Ultimately, the full ETA vision cannot be attained until the IRS has moved beyond the constraints of its current weekly master file processing routines and the antiquated database storage formats associated with them.

Need to Successfully Implement the Modernized e-File Platform for Form 1040

Compared to the decades-old legacy e-file technology for individual returns, the new Form 1040 MeF platform promises to provide a much more flexible system that will help achieve the ETA vision. The new Form 1040 MeF system will enable the IRS to receive and process returns in an Internet format, provide real-time processing of e-file acknowledgements, and streamline error detection. The Form 1040 MeF application will also give taxpayers the capability to attach PDF documents, accommodate year-round processing, and for the first time, enable the electronic filing of amended individual income tax returns. The eventual delivery of an e-file capability for amended individual returns is particularly promising because the Board has long heard many complaints from practitioners that the IRS has continued to burden taxpayers with erroneous balance due notices and other demands for payments while the amended returns that would resolve the issues sit unprocessed at IRS campus facilities handling paper returns.

The Form 1040 MeF application should help induce even greater e-file participation and provide better service to individual taxpayers when it is fully in place and functioning. However, in its review of the new application, TIGTA found that some returns were erroneously rejected by the new MeF system or were rejected without providing accurate explanation. TIGTA also reported that due to the low volume of Form 1040 returns received through the MeF system (only around 750,000 returns out of an IRS anticipated volume of over nine million), the IRS was not able to use its 2010 experience to assess its capability to handle large volumes of tax returns using the MeF platform.[30]

The TIGTA report contained a number of recommendations to address the problems they uncovered and the IRS agreed with TIGTA's advice. The Board expects the IRS to carry through on those recommendations and take all other actions needed to ensure the eventual delivery of a smoothly operating Form 1040 MeF system—given its criticality to the long-term viability of e-file and the ETA vision.

Need for an Efficient Yet Secure ETA Environment

Providing an efficient, yet secure electronic environment that meets the varying needs of external IRS customers and internal IRS staff is a very difficult challenge. For example, self-assistance applications that have complicated security protocols are less likely to be used by taxpayers. Yet, the dangers of identity theft, unauthorized access of taxpayer information, and malicious cyber-attacks on IRS computer systems are very real and pose continual threats to achieving the ETA vision.

The Board expects the IRS to continue to keep security utmost in mind as it moves ahead with delivery of key components of a modern electronic tax administration system, and to meet all applicable standards for federal agencies. The Board also expects the IRS to leverage both internal and external experts to ensure IRS electronic systems follow best practices when it comes to electronic security, including the advice and recommendations of such knowledgeable stakeholders as the GAO, TIGTA and ETAAC.

For example, relative to web-based IRS services that would enable taxpayers to access their individual records and take certain actions on their IRS accounts, TIGTA has emphasized that the IRS needs to develop and deploy a strategy for an enterprise-wide electronic authentication solution so projects that require secure online access can be deployed more expeditiously and with requisite security.[31] In addition, recommendations from the most recent report to Congress by ETAAC, which will be discussed in more detail later in this report, also include advice focused on security, e-authentication, and e-signature.

The Board maintains an interest in the area of online security because the ability of taxpayers to review their tax account electronically was a capability explicitly called for in RRA 98. The Board remains convinced

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[30] Treasury Inspector General for Tax Administration, *System Errors and Lower Than Expected Tax Return Volumes Affected the Implementation of the Modernized E-File System for Individual Tax Return Processing*, Report Reference Number 2010-40-111, September 8, 2010.

[31] Treasury Inspector General for Tax Administration, *Changing Strategies Led to the Termination of the My IRS Account Project*, Report Number: 2009-20-102, August 12, 2009.

that the ability of taxpayers and their authorized tax professionals to research and resolve account issues in a secure, online environment is a foundational part of a modern ETA system. The Board encourages the IRS to keep initiatives in this regard a top priority.

Meeting the Challenges

The challenges the IRS and the tax administration community face in achieving the broad vision for electronic tax administration remain significant. Indeed, the latest e-file results for 2010 and other relevant data indicate that it is unlikely that the IRS will be able to meet its long term goal of 80 percent e-file for all major tax returns by the year 2012. Also, the pace at which some of the major enabling technologies for the ETA vision are being delivered, such as the Form 1040 MeF system, the replacement of the master files, and the ability for taxpayers to review their personal tax account information electronically, are slower than many stakeholders and the Board would like.

Nevertheless, progress continues to be made each year in efforts to advance e-file and move closer to the ETA vision. This is evidenced by the steady annual rise in e-file participation and by the yearly deployment of new and innovative electronic applications. Thus, while the Board would view a failure to achieve the 80 percent e-file goal by 2012 as a disappointment, it also believes that it should not be used as an excuse to give up on the ETA vision. In fact, the Board believes that the progress being made will eventually deliver the ETA vision inspired by RRA 98, including an 80 percent e-file rate, provided the IRS, its tax partners in the private sector, and policymakers in Congress and the Administration remain actively committed to the vision of a modern tax administration system and are willing to explore additional ideas that could help deliver that vision. Among these additional ideas are those put forth by the ETAAC in its 2010 Report to Congress, which the Board comments on in the following section.

Comments on Key Recommendations from the Electronic Tax Administration Advisory Committee

The 2010 ETAAC report to Congress offers several recommendations to further increase e-file participation and advance the ETA vision. The Board finds merit in many of these suggestions and commends ETAAC members for their thoughtful advice and suggestions. As for particular ETAAC recommendations, the Board offers the following comments.

Fund and Complete the Pillars of Business Systems Modernization

The ETAAC report states that Congress should fund, and IRS should successfully complete, the mission-critical pillars of BSM, including CADE, MeF, and the Accounts Management Services (AMS) projects, before beginning any new significant information technology projects. The Board agrees that CADE, MeF, and AMS must remain top information technology (IT) priorities at the IRS, and that Congress and the IRS must devote the resources and attention needed to bring these critical BSM projects to fruition.

For years, the Board has emphasized in its various reports to Congress that the continued underfunding of the IRS BSM program scales back IRS technological improvements to the lowest possible levels and thus limits BSM projects to only modest progress at best. As indicated earlier in this report, the BSM efforts on CADE, MeF and AMS are foundational components that are critical to achieving the full ETA vision because they are at the heart of a modern system that can receive, process, store, and use tax data in a rapid, electronic fashion. The Board also recommends that the IRS articulate more definitively the end states for its MeF and AMS projects, as it has done as part of its CADE 2 effort.

Solve the Challenges of Security, e-Authentication, and e-Signatures; Pursue a Rigorous Process for Determining Priorities for Online Service Offerings

The ETAAC notes that the IRS must solve three challenges that are key to enabling an expanded ETA system: security, e-authentication, and e-signatures. The report also recommends that the IRS Internet strategy include a rigorous process that ensures any online service will meet real taxpayer needs, will be used by the taxpayer, and is aligned with the IRS' strategic priorities. The ETAAC report provides more detailed suggestions in pursuit of these broad recommendations such as IRS coordination and agreement with state revenue departments on common authentication standards, having a single and consistent set of information required to access IRS online applications, and use of a thorough evaluation process for proposed online services so that those selected for development yield the highest return on investment for taxpayers.

The Board finds these ETAAC recommendations quite sensible and encourages IRS to consider them very carefully. Resolving the matters of system security, e-authentication, e-signature, and project priorities are fundamental to providing more meaningful online services to taxpayers and tax professionals, which is a core component of the ETA vision.

Implement Preparer Oversight and Preparer e-File Mandate in a Communicative Rather Than Enforcement Fashion; Seek New Partnerships with Industry to Increase Collaborative Innovation

The ETAAC report contains a series of recommendations that are focused on certain relationships between the IRS and key industry partners. Relative to the new IRS initiative to regulate all paid return preparers and the new statutory e-file mandate for preparers, the ETAAC essentially advises the IRS to avoid using a stern enforcement approach, and instead pursue a “change management” path that seeks to educate the preparer community and help them through the transition in a communicative and supportive manner. For example, in citing the experience of state governments that have implemented e-file mandates, the ETAAC report emphasizes that in the early years of the requirement, most states emphasized compliance primarily through practitioner and taxpayer education programs and not through any sanctions.

Among the more detailed suggestions from the ETAAC are recommendations for multi-year phased-in approaches for the new requirements on return preparers and the e-file mandate; ideas on how to implement the new return preparer regulations in a manner that does not adversely affect having an adequate supply of qualified e-file providers; and suggestions for “opt-out” and “waiver” provisions relative to the e-file mandate in certain circumstances. Also stressed in the ETAAC report was the need for multi-channeled and targeted IRS communications strategies designed to educate members of the tax preparer community and taxpayers in the general public.

The Board is in general agreement with the ETAAC recommendations on preparer regulation and the e-file mandate and encourages the IRS to give consideration to the specific suggestions put forth in the ETAAC report. Given that roughly three-quarters of paid preparer returns are currently being e-filed, it is apparent that a large portion of the preparer community already supports electronic filing. Thus, it seems sensible to the Board, in keeping with ETAAC recommendations, that the IRS’ initial implementation of the preparer e-file mandate should rely primarily upon outreach designed to convince the remaining pool of preparers still filing on paper that e-file is now the expected norm within their profession.

Further, the Board strongly supports the IRS initiative to bring all paid return preparers into a regulatory regime and agrees with ETAAC that the IRS must implement this oversight in a measured and multi-year fashion that is not too stern initially, and which improves the quality of service to taxpayers and does not detract from it. However, as the Board also noted in its *2009 Annual Report to Congress*, for the IRS preparer regulations to successfully improve taxpayer compliance, several elements are required. First, taxpayers must do their part by ensuring that preparers sign the returns they complete, and by reporting non-compliant preparers. Second, the IRS needs to determine the measures it will use to evaluate the effectiveness of its new regulations. Lastly, the IRS will need to enforce the new provisions in a systematic manner, once the key components of registration, testing, and continuing education requirements are in place.

Beyond the preparer regulation and e-file mandate matters, the ETAAC also recommends a new and collaborative partnership between the IRS and the tax preparation industry that would foster more innovative service to taxpayers. As key steps in building that new partnership for innovation, the ETAAC highlights the need for the IRS to set clearly defined outcomes for electronic tax administration, as well as specify the respective roles and responsibilities of the IRS and the tax administration community. The ETAAC also suggests that IRS reintroduce the “Request for Agreement” (RFA) program that existed in the late 1990s, which ETAAC describes as a non-monetary program where the IRS sought and received ideas from private companies to increase electronic filing, and could cooperate with companies to implement their pilot proposals.

The Board finds efforts to foster further collaborative innovation between the IRS and industry in pursuit of the ETA vision very appealing and urges careful consideration of the ETAAC suggestions in this area. The Board recognizes that the success in substantially raising the e-file rate over the past decade is attributable in large part to the innovation and initiative of private industry and its successful relationship with the IRS. Accordingly, ideas to reinvigorate that relationship, so as to create new and better electronic services to taxpayers, are clearly in the best interest of tax administration. Indeed, RRA 98 itself explicitly encouraged IRS cooperation with the private industry so as to foster robust private sector competition in the interest of advancing electronic tax administration and service to taxpayers.[32]

[32] P.L. 105-206, 105th Congress: *Internal Revenue Service Restructuring and Reform Act of 1998*, Title II, Section 2001.

IRS Must Evaluate Its Readiness and Invest in the Resources to Handle Increased Volumes of Electronically Filed Information Reports

The ETAAC report makes note of recent law changes such as the Patient Protection and Affordable Care Act that will significantly increase both the volume of electronically filed information returns and the number of entities submitting those documents to the IRS. The ETAAC also cites proposals from some stakeholders calling for an acceleration of when various information documents are to be submitted to the IRS. In light of these developments, ETAAC questions whether the IRS' Filing Information Returns Electronically (FIRE) system, which is used by the IRS to receive electronic information documents from financial institutions and others, will be able to handle the increased demand. It also expresses concerns about the increased burden on multiple stakeholders in the business community associated with the enacted and proposed expansions in information reporting.

As a result, the ETAAC recommends that the IRS carefully evaluate whether its systems and processes for receiving information documents will be able to handle this increased demand. It further recommends that the IRS invest in the resources and systems required to handle the increased volumes certain to arise from enacted legislation, but then move cautiously beyond that point so as to avoid situations where the actual benefits of expanded or accelerated information reporting are outweighed by the costs in term of burden on businesses and the receipt of less accurate information from expedited submissions.

The Board largely agrees with the ETAAC comments in these areas. The Board recognizes that modern computer systems that can receive and quickly process large volumes of information returns electronically are vital components of an effective tax administration system. Thus, the IRS must thoughtfully plan and invest to ensure its resources and technology are up to the task embedded in the tax laws. However, the Board also believes that the IRS must not only plan for its ability to receive and store the increased information return volumes, but also give thoughtful consideration to how it will use that data in an effective manner, given the more complex nature of what is to be reported in many instances.

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 is an extremely critical component of that ETA vision in which the vast majority of tax-related interactions are handled electronically.

While the IRS may achieve an 80 percent e-file rate for individual income tax returns in 2012, once the full effect of the preparer e-file mandate is in place, it now seems unlikely that the IRS will achieve its broader long term goal of an 80 percent e-file rate for all major tax returns by that year in the absence of a major new initiative. However, the Board does expect the IRS to be near the 80 percent e-file rate for all major tax returns by 2012, and to eventually cross that symbolically important threshold not long thereafter.

However, to make that happen the Board encourages the IRS, its partners in the tax administration community, and policymakers to continue to pursue actions to advance electronic filing—including particular focus on increasing e-file among employment tax returns. The Board further emphasizes that the ultimate goal of electronic tax administration is not just to receive more information electronically but to leverage that data in a modern and strategic fashion to improve service to taxpayers and overall voluntary compliance.

IRS Oversight Board

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