



*Eliminating TeleFile Increased the Cost and
Burden of Filing a Tax Return for Many
Taxpayers*

July 20, 2007

Reference Number: 2007-40-116

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Phone Number | 202-927-7037

Email Address | Bonnie.Heald@tigta.treas.gov

Web Site | <http://www.tigta.gov>



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 20, 2007

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers
(Audit # 200640017)

This report presents the results of our review of the Internal Revenue Service (IRS) TeleFile Program. The overall objective of the review was to determine the impact of the elimination of the TeleFile Program on individual taxpayers and the IRS electronic filing program. This audit was conducted in response to a request from the Senate Finance Committee staff to evaluate the impact of eliminating the TeleFile Program and was included as part of the coverage of the Wage and Investment Division in the Treasury Inspector General for Tax Administration's Fiscal Year 2007 Annual Audit Plan.

Impact on the Taxpayer

The TeleFile Program allowed an average of 4.4 million taxpayers to annually file their individual income tax returns for free using the keypads on their telephones. In August 2005, the IRS discontinued the TeleFile Program, citing increasing costs and declining participation, and ended one of two free electronic filing methods provided to taxpayers. Discontinuance of the TeleFile Program increased the cost and burden of filing a tax return for many individual taxpayers. Of the approximately 2 million individual taxpayers who filed their tax returns through TeleFile in 2005¹ and would have remained eligible to file their income tax returns for free had the TeleFile Program continued, we estimate more than 541,000 taxpayers paid \$23.6 million to file their tax returns in 2006. In addition, almost 966,000 taxpayers reverted to filing paper tax returns, thus losing the benefits of faster refunds that electronic filing provides.

¹ All dates are calendar year unless otherwise noted.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

These figures do not include those taxpayers who would have become eligible to use TeleFile for the first time in 2006 but had to choose other methods to file their income tax returns.

Synopsis

By eliminating the TeleFile Program, the IRS took away the simplest method for taxpayers to file their tax returns. Furthermore, this action removed one of only two free electronic filing methods at a time when the IRS was focusing on increasing the number of electronically filed tax returns. There are many factors, such as advances in technology or changing taxpayer preferences, that may have led to the eventual elimination of the TeleFile Program. However, we believe the IRS' decision to discontinue the TeleFile Program before adequate alternative free filing methods were developed was premature and created unnecessary taxpayer burden.

We analyzed a statistical sample of 400 taxpayers who used the TeleFile Program in 2005 to determine how they were affected by the elimination of the Program. Approximately 68 percent (273 of 400) of the taxpayers in our sample would have continued to be eligible for the TeleFile Program had it continued unchanged. Based on our sample results, approximately 2 million taxpayers who had previously used TeleFile would have been eligible for the Program in 2006. Our estimate does not include taxpayers who would have been new to the Program. We further evaluated our sample to determine how former TeleFile users filed their tax returns in 2006.

Of those taxpayers who would have remained eligible to use TeleFile, 29 percent (80 of 273) of the taxpayers in our sample incurred a cost to file their tax returns in 2006. These costs included either the purchase of tax preparation software packages and related fees to file their returns online from their homes or fees paid to tax professionals to prepare and file their tax returns. We estimate more than 541,000 taxpayers who would have remained eligible for TeleFile paid approximately \$23.6 million to file their tax returns in 2006.

Another impact of eliminating TeleFile was that 48 percent (965,905 taxpayers) of the approximately 2 million former TeleFile users reverted to filing a paper tax return. This negatively affects IRS efforts to increase electronic filing and increases taxpayers' wait time for refunds because paper returns take longer to process and increase the risk of errors.

The free filing alternatives the IRS provided in its notification to affected taxpayers were not comparable to TeleFile. Many contained filing or income restrictions, required access to computers and the Internet, or were overly burdensome when compared to the TeleFile Program.

The IRS cited a number of reasons for its decision to end the TeleFile Program, including increased processing costs and decreased taxpayer participation. The IRS expected to save between \$17 million and \$23 million by retiring the TeleFile Program and implementing program enhancements and reengineering processes in its Submission Processing function. However, we determined the information the IRS used to support its decision contained errors and was incomplete. For example, errors in the methodology and data the IRS used to compute



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

and compare the cost-per-return for each of its three processing methods (paper, electronic, and TeleFile) may have overstated the differences among the processing methods. We have indications that, if corrected, the differences among the processing methods may not have justified eliminating the TeleFile Program when the IRS did. Whatever the actual cost savings gained by discontinuing the TeleFile Program were, the result, in effect, was the shifting of costs from the IRS to taxpayers because former TeleFile users paid almost \$24 million to file their tax returns in 2006.

The concerns we identified are not unique to the IRS' decision regarding the TeleFile Program. The Treasury Inspector General for Tax Administration has advised the IRS on multiple occasions that it needs to improve the quality for and timing of data used to make decisions. While the IRS must continue to become as efficient as possible, it is imperative that decisions regarding its customer service and return processing programs include an accurate and timely evaluation of the costs and benefits of those programs, as well as the impact and burden on taxpayers.

Recommendations

We did not include recommendations because our concerns regarding the use of inaccurate and incomplete data to support program decisions have been previously reported to the IRS.

Response

The IRS believes it acted appropriately in choosing to end the TeleFile Program when it did and elimination of the Program is unlikely to have any long-term, negative consequences to achievement of its electronic filing goals. Management also stated the fact that many former TeleFile users who qualified but chose not to use the IRS Free File Program did not necessarily mean eliminating the TeleFile Program increased taxpayer burden. Management's complete response to the draft report is included as Appendix VIII.

Office of Audit Comment

We disagree with the IRS' opinion that eliminating the TeleFile Program did not increase taxpayer burden. Former TeleFile users must now choose among the remaining return preparation and filing methods. Many taxpayers are either ineligible for or unable to conveniently access one or more of the free options, and they now incur costs for return preparation and filing. The alternative of reverting to filing paper tax returns increases the time it takes to receive refunds and increases the IRS' cost of processing tax returns.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Copies of this report are also being sent to the IRS managers affected by the report findings. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Table of Contents

BackgroundPage 1

Results of ReviewPage 4

 Eliminating TeleFile Increased the Cost and Burden of Filing
 Tax Returns for Many Former TeleFile Users.....Page 4

 The Elimination of TeleFile and New Eligibility Restrictions on
 the Free File Program Limited the Growth of Electronic FilingPage 9

 Information Used to Support the Decision to Eliminate TeleFile Was
 Incomplete and InaccuratePage 11

Appendices

 Appendix I – Detailed Objective, Scope, and MethodologyPage 19

 Appendix II – Major Contributors to This ReportPage 22

 Appendix III – Report Distribution ListPage 23

 Appendix IV – Computation of Estimates – Former TeleFile Users
 Who Paid to File a Tax ReturnPage 24

 Appendix V – TeleFile Eligibility RequirementsPage 28

 Appendix VI – Tax Laws Affecting TeleFile Eligibility 1997-2002Page 30

 Appendix VII – Timeline of Events Affecting the TeleFile ProgramPage 32

 Appendix VIII – Management’s Response to the Draft ReportPage 41



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Abbreviations

ETA	Electronic Tax Administration
ETAAC	Electronic Tax Administration Advisory Committee
FY	Fiscal Year
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

Background

The TeleFile Program allowed taxpayers meeting certain criteria to file their tax returns using the keypads on their telephones. The Program was the only electronic filing method offered by the Internal Revenue Service (IRS) that did not require third-party involvement. The IRS launched the TeleFile Program in 1992¹ as a pilot and made the Program available nationwide in 1996.

Prior to 1997, only single filers using the Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ) could file their tax returns using the telephone. By 2005, taxpayers could file the following forms through the TeleFile Program:

- Form 1040EZ – both single and joint filing statuses with no dependents.
- Certain State individual tax returns.
- Application for Automatic Extension of Time To File U.S. Individual Income Tax Return (Form 4868).
- Employer’s Quarterly Federal Tax Return (Form 941).

For taxpayers to use TeleFile, they must have first received a TeleFile tax package in the mail and then met the qualification requirements found in the Package. See Appendix V for the specific requirements to use TeleFile. The TeleFile Program allowed an average of 4.4 million² taxpayers to file simple tax returns on their telephones annually. The “paperless” TeleFile Program no longer required taxpayers to mail their Wage and Tax Statements (Form W-2) or signature documents to the IRS.

An average of 4.4 million taxpayers annually used the TeleFile Program.

The Program was promoted as the most convenient, quickest, and simplest way to file a Federal tax return. It was free and was the only completely paperless direct-filing method the IRS offered. TeleFile returns, along with other electronically filed returns, were also more accurate than returns filed on paper. The TeleFile Program had a satisfaction rate of over 90 percent, the highest of all the filing options in 2004. The initial success of the TeleFile Program led Congress to mandate that “the IRS should continue to offer and improve its TeleFile Program and make available a comparable program on the Internet.”³

¹ All years in this report are calendar years unless otherwise noted.

² The average number of tax returns accepted by the TeleFile Program annually from 1996 to 2005.

³ H.R. Conf. Rep. No. 105-599 at 235 (1998).



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

In March 2003, the Treasury Inspector General for Tax Administration (TIGTA) reported that opportunities existed for the IRS to expand its TeleFile Program and provide more taxpayers with the option of filing via telephone.⁴ We recommended the Director, Electronic Tax Administration (ETA), develop a strategy outlining steps to be taken to offer the TeleFile Program to those taxpayers who file a Form 1040EZ and are currently ineligible to use the TeleFile system.

However, the IRS was reluctant to expand the TeleFile Program. Its reluctance was based primarily on management's assertion that the processing costs for TeleFile tax returns significantly exceeded the processing costs for paper and other electronically filed tax returns. Management also stated the use of a telephone to file tax returns was considered obsolete because of the widespread use of computers and the Internet.

In April 2005, the IRS Commissioner testified before Congress that the IRS expected to save somewhere between \$17 million and \$23 million by retiring the TeleFile Program, implementing program enhancements in the processing of employment tax returns, and reengineering processes in its Submission Processing function. In August 2005, the IRS discontinued its TeleFile Program citing the following reasons for its decision:

- Increasing costs to maintain the system.
- Discontinued State telefile programs.
- Declining use for most forms.
- Growth of other electronic filing options.

Figure 1 presents a general timeline of events relative to the elimination of the TeleFile Program. A detailed timeline is included in Appendix VII.

Figure 1: TeleFile Timeline

1996	2001	2003/2004	2004	2004	2005
TeleFile is implemented	IRS considers ending TeleFile	IRS evaluates cost and usage	IRS studies free filing alternatives	IRS decides to end TeleFile	TeleFile ends

Source: Analysis of multiple IRS cost and taxpayer satisfaction data reports.

The decision to discontinue the TeleFile Program followed a recommendation made by the Electronic Tax Administration Advisory Committee (ETAAC), which consists of members selected by the IRS to represent a broad spectrum of the private sector including tax preparers, tax software developers, payroll companies, financial institutions, small businesses, State

⁴ *Opportunities Exist to Expand the TeleFile Program* (Reference Number 2003-40-092, dated March 2003).



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Governments, and taxpayers. In its 2004 annual report to Congress, the ETAAC recommended the IRS eliminate the TeleFile option and redirect the funds to the Modernized *e-File* Project.⁵ The ETAAC relied on data provided by the IRS when making its recommendation to eliminate the TeleFile Program. Once the Program was eliminated, taxpayers who had used it would have to find another method to file.

This review was performed at the IRS National Headquarters in Washington, D.C., in the ETA and Submission Processing functions during the period May 2006 through February 2007. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁵ A modernized web-based system that allows electronic filing of corporate and tax-exempt returns with plans to allow individual returns in the future.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

Results of Review

By eliminating the TeleFile Program, the IRS took away the simplest method for taxpayers to file their tax returns. Furthermore, this action removed one of only two free electronic filing methods at a time when the IRS was focusing on increasing the number of electronically filed tax returns. There are many factors, such as advances in technology or changing taxpayer preferences, that may have led to the eventual elimination of the TeleFile Program. However, we believe the IRS' decision to discontinue the TeleFile Program before adequate alternative free filing methods were developed was premature and created unnecessary taxpayer burden.

Eliminating TeleFile Increased the Cost and Burden of Filing Tax Returns for Many Former TeleFile Users

The IRS considered eliminating the TeleFile Program in February 2001. Between February 2001 and August 2005, the IRS continued to gather cost data and information about taxpayers' satisfaction with the TeleFile Program. It also identified the tax return filing alternatives available to TeleFile users. Notwithstanding, when the IRS made the decision to eliminate the TeleFile Program, it does not appear it adequately factored in the burden and increased costs many taxpayers would experience if the Program was discontinued before comparable free electronic return filing alternatives were available.

Taxpayers who had previously filed for free paid to file their 2006 returns

Discontinuing the TeleFile Program ended a free and simple electronic filing method for millions of taxpayers. We selected a statistical sample of 400 taxpayers who had used the TeleFile Program in 2005 and filed a tax return in 2006 to determine how these taxpayers filed their returns after the TeleFile Program was discontinued. Approximately 68 percent (273) of the 400 taxpayers in our sample would have been eligible to continue to use TeleFile in 2006 if the Program had continued unchanged. Based on our sample, we estimate approximately 2 million taxpayers who had previously used TeleFile would have continued to be eligible for the Program in 2006. Our estimate does not include those taxpayers who would have been able to use the Program for the first time.

Taxpayers have a choice when selecting a return filing method. Some taxpayers would have chosen to leave the TeleFile Program on their own. However, an IRS study of TeleFile users indicated taxpayers who chose to use the Program were extremely loyal and repeat users.⁶ Based on this information, we attempted to quantify the impact of the IRS' decision to eliminate

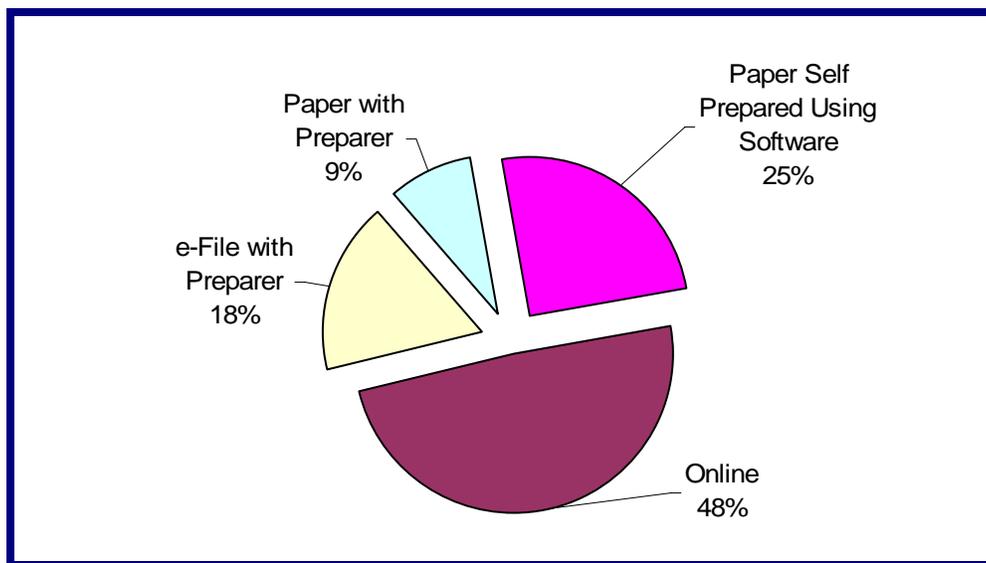
⁶ CHAID [Chi-Squared Automated Interactive Detector] Analysis – ETA Telefile, November 2000.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

TeleFile on the Program's users. We found that 29 percent (80 of 273) of the taxpayers in our sample who would have remained eligible for the Program incurred a cost to file their tax returns in 2006. Figure 2 shows the tax filing methods used by those taxpayers in our sample who incurred costs, either by purchasing tax preparation software or paying a tax practitioner to prepare and file their tax returns.

Figure 2: Tax Filing Methods Used by Taxpayers Who Paid to File Their Tax Returns



Source: TIGTA review of a sample of taxpayers who had used the TeleFile Program in 2005 and filed tax returns in 2006. e-File = electronic filing.

Taxpayers who filed their returns online had to obtain a tax preparation software package or use a software vendor's web-based package. The average cost of these packages was estimated at \$18.96,⁷ with an additional cost of approximately \$15 to electronically file a tax return. If taxpayers used a tax professional, it could cost an estimated \$81 to have their returns prepared. Based on our statistical sample, we estimate more than 541,500 taxpayers who would have remained eligible for

In 2006, more than 541,500 taxpayers who would have remained eligible to use TeleFile for free spent an estimated \$23.6 million to file their tax returns.

⁷ The average cost was determined by taking the average price of Turbo Tax's Basic and Tax Cut's Premium Federal software packages at five different retail outlets in Kansas City, Missouri.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

TeleFile incurred some cost to file their returns in 2006.⁸ We estimate the cost incurred by these taxpayers totaled approximately \$23.6 million. See Appendix IV for details.

A significant number of former TeleFile users reverted to filing paper tax returns

The IRS was aware that a significant number of TeleFile users would likely switch to paper filing before it decided to eliminate the TeleFile Program. A 2003 IRS study⁹ estimated 48 percent of taxpayers using TeleFile would revert to filing a paper return if TeleFile was no longer available. The IRS was concerned about taxpayers who had used TeleFile in the past but who do not have their own Internet access. The United States Department of Commerce reported from its October 2003 population survey that only 30.7 percent of households with incomes less than \$25,000 had Internet access¹⁰ (our analysis of the 2005 TeleFile tax returns showed 67.7 percent of TeleFile users had total income less than \$25,000). The IRS was concerned a significant number of these taxpayers would file a paper tax return.

Our analysis indicates the IRS' concern was accurate. Approximately 48 percent (965,905) of the 2 million taxpayers who would have been eligible for TeleFile, had it continued, reverted to filing paper tax returns. This significant reverting to use of paper returns negatively affects the IRS' efforts to increase electronic filing. Processing a paper tax return also takes longer than processing an electronic return, meaning taxpayers may have had to wait longer for their refunds. Figure 3 shows the methods used by former TeleFile users to file their tax returns in 2006.

Approximately 48 percent of former TeleFile users filed a paper return in 2006.

⁸ Because some tax preparation software packages allow the preparation of more than one tax return, it is possible some taxpayers borrowed a software package and did not incur any personal cost. Many tax software companies also offer free return preparation services directly on their Internet web sites. Recognizing this, our projections are based on the assumption that 90 percent of the taxpayers who filed their tax returns online paid for the software and a filing fee.

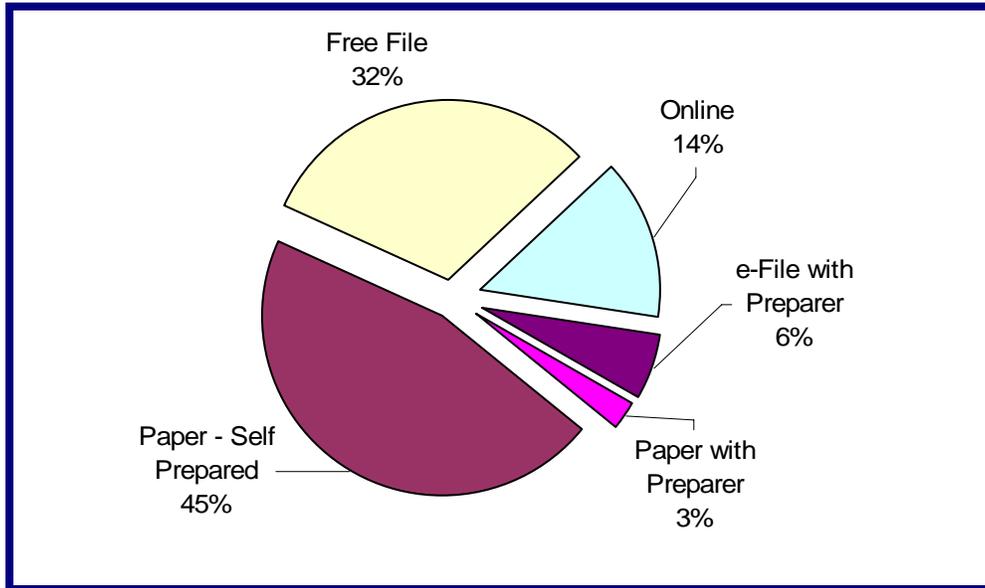
⁹ TeleFile Survey Report, Research Project 1-03-08-2-107N, November 2003.

¹⁰ *Computer and Internet Use in the United States: 2003*, United States Department of Commerce, Economics and Statistics Administration - Census Bureau, October 2005.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

Figure 3: Methods Used to File Subsequent Year Tax Returns



Source: TIGTA review of a sample of 400 taxpayers who had used the TeleFile Program in 2005 and filed tax returns in 2006. e-File = electronic filing.

Increased filing of paper returns affects the IRS as well as taxpayers. Paper tax returns increase the IRS' return processing costs because they require manual handling and data input and are more costly to process than electronic returns. Also, because paper returns are more likely to contain errors, the number of taxpayers who reverted to filing paper tax returns appears to explain the correlating increase in error volumes on paper Forms 1040EZ during the 2006 Filing Season. The number of errors on paper Forms 1040EZ increased by 76,295 (from 315,413 as of September 23, 2005, to 391,708 as of September 29, 2006). Errors on tax returns increase the burden on taxpayers, who have to respond to error notices, and the IRS, which has to resolve the errors.

The TeleFile Program was discontinued before comparable free alternatives were available

According to the IRS, free filing alternatives were available to all TeleFile users prior to the end of the Program. It stated that former TeleFile users could file their tax returns for free at an IRS Taxpayer Assistance Center, through a volunteer program, or by using the IRS Free File Program.¹¹ However, not all eligible TeleFile users qualified for free assistance, and there were other limitations. Of the approximately 2 million taxpayers who would have continued to be

¹¹ The Free File Program guarantees access to free electronic tax preparation and filing services for 70 percent of individual taxpayers. In 2006, this limit equated to an Adjusted Gross Income of \$50,000 or less. The limit was raised to \$52,000 in 2007.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

eligible for TeleFile, we estimate almost 12 percent (234,159) would not have qualified to use 1 of the other free filing services at the Taxpayer Assistance Centers or through a volunteer program.

Former TeleFile users would encounter the following restrictions or conditions if they tried to obtain free assistance from these programs:

IRS Taxpayer Assistance Centers

- Eligibility limit – taxpayers with income of more than \$39,000 are not eligible for return preparation assistance (TeleFile eligibility limits were significantly higher—taxpayers with incomes up to \$107,950 if filing as Single or \$115,900 if filing as Married Filing Jointly were eligible).
- Some States only have a few Taxpayer Assistance Centers to serve the entire State.
- Some Centers are open only during normal business hours from 8:30am to 4:30pm.
- Some Centers are not fully staffed or are not open full time.
- Eight percent (33 of 401) of the Centers do not offer return preparation.
- Taxpayers must make an appointment for assistance with their tax returns. Appointments can be made in person or by calling the local number. Taxpayers may have to come back at a later date to have their returns prepared and filed.

Volunteer Income Tax Assistance sites

- Eligibility limit – taxpayers with income of more than \$39,000 are not eligible for return preparation assistance.
- Some sites require the taxpayer to make an appointment.
- Almost 23 percent (1,060 of approximately 4,600) of the sites do not offer electronic filing as an option.

We estimate a significant portion (96.3 percent) of taxpayers who would have remained eligible for the TeleFile Program qualified for the IRS Free File Program.¹² However, taxpayers must have access to the Internet to be able to use Free File. According to a 2003 IRS study, 25 percent of TeleFile users do not have access to the Internet. In addition, the Free File Program may be difficult to use for taxpayers who are not computer proficient. To reduce the effect of limited Internet access, the IRS indicated taxpayers could use the Free File Program from a public library. However, conditions at a public library may not be conducive to filing a tax return.

¹² Taxpayers are eligible for the Free File Program if their 2006 Adjusted Gross Income is under \$50,000 (this limit can fluctuate from year to year).



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

- Computer use is restricted based on time and availability.
- Workspace is limited, and there are privacy concerns at both the computer terminals and the printer areas.
- Some libraries prohibit downloading of computer files and/or software. We identified at least one Free File Program consortium member that required users to have access to specific software, such as graphics players, to properly use its product. In this instance, the user was given the option to download the item needed for free.
- There are fewer available public libraries than the IRS indicated (16,549 versus 116,618). There are other libraries available in locations such as schools. However, access to these additional libraries is limited to specific segments of the population, and it is likely the conditions in those libraries do not differ significantly from conditions in public libraries.

The difficulties taxpayers encounter in obtaining free electronic filing assistance could be the reason so many former TeleFile users reverted to filing paper returns. This directly affects the IRS' efforts to reach its electronic filing goal.

The IRS began modernizing its electronic filing system in 2002 through its Modernized *e-File* Project. The Project's goal is to replace the current filing technology with a modernized, Internet-based electronic filing platform for any IRS form. The IRS' first focus was to improve the electronic filing capabilities for business and information returns.

The IRS plans to begin developing the capability to process individual returns in 2007. The filing of individual returns through the Modernized *e-File* Project is not scheduled to begin until 2009. The IRS indicated the TeleFile Program did not fit into its Modernized *e-File* Project. However, the individual tax returns would not have been affected by the Modernized *e-File* Project until at least 4 years after the TeleFile Program was discontinued. The Modernized *e-File* Project also will not eliminate the need for third-party involvement in return filing. This means most taxpayers who file electronically will still incur some cost to do so. In contrast with the IRS, which did not provide comparable free electronic filing alternatives, almost one-half of the States that eliminated their telefile programs (10 of 21 States) offered a direct Internet filing option as a free electronic filing alternative.

The Elimination of TeleFile and New Eligibility Restrictions on the Free File Program Limited the Growth of Electronic Filing

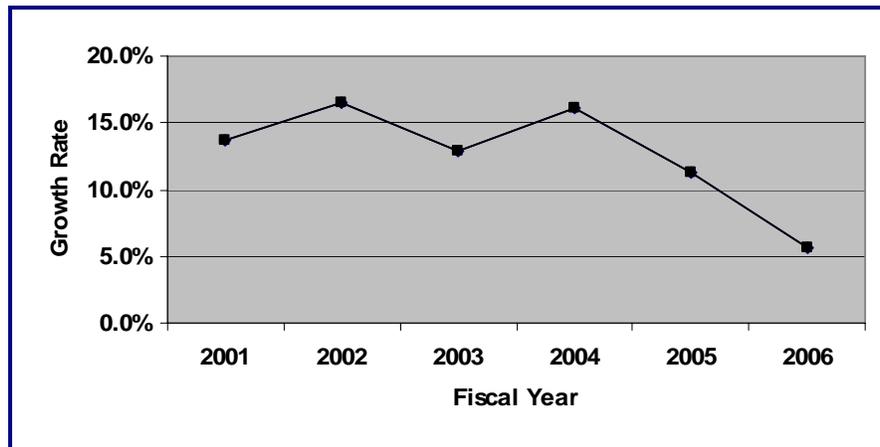
Congress established a goal for the IRS to have 80 percent of all Federal tax and information documents filed electronically by 2007. The TeleFile Program was a paperless filing option provided to taxpayers that allowed them to file their tax returns with the IRS electronically using a telephone. Therefore, continuance of the Program would have been consistent with the IRS' efforts to promote electronic filing.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

While the number of all returns filed electronically has increased each year, the rate of increase slowed significantly in Fiscal Year (FY) 2006. The 6.39 percent growth in electronic filing in FY 2006 is the lowest of any previous year. Electronic filing grew by 16 percent in FY 2004, 11 percent in FY 2005, and just over 6 percent in FY 2006.

Figure 4: Growth Rate of Electronically Filed Returns



Source: IRS Taxpayer Usage Studies and Reports of Individual Income Tax Returns Received and Processed.

The growth rate of electronic filing was expected to slow as the percentage of electronically filed returns increased. However, elimination of the TeleFile Program has also been a factor in the reduced rate of growth. TeleFile represented almost 5 percent of all electronic returns filed in 2005, the last year for the telephone filing system.

We analyzed the growth in electronic filing to evaluate the extent to which the elimination of the TeleFile Program affected the IRS' electronic filing program. The volume of Forms 1040EZ filed electronically in 2006 decreased by approximately 17 percent, while the volume of paper Forms 1040EZ increased by almost the same amount. This was caused in part by the significant number of TeleFile users that chose to file their 2006 tax returns on paper.

An IRS study indicated that the elimination of the TeleFile Program would reduce electronic filing by 2 percent at the most. However, those estimates relied on the expansion of the IRS Free File Program. Unfortunately, the Free File Program decreased significantly in 2006. The IRS renegotiated the Free File Agreement in October 2005, making fewer taxpayers eligible for the Program. With the exception of Free File, every other electronic filing method increased in 2006. The growth in these other methods likely contributed to overcoming both the elimination of TeleFile and the unexpected decrease in Free File.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

Information Used to Support the Decision to Eliminate TeleFile Was Incomplete and Inaccurate

The IRS cited a number of reasons for its decision to end the TeleFile Program. The primary reason given was the cost of the Program. The IRS also indicated declining participation, a reduction in the number of State telefile programs, and the emergence of other electronic filing methods played a role in its decision. However, we determined the information the IRS used to support its decision contained errors and was incomplete. In addition, it appears the IRS did not fully consider data relevant to the benefits the TeleFile Program could provide to taxpayers as well as the IRS. Whatever the actual cost savings gained by discontinuing the TeleFile Program were, the result, in effect, was the shifting of costs from the IRS to taxpayers because former TeleFile users paid almost \$24 million to file their tax returns in 2006.

Cost studies were inaccurate and incomplete

The IRS began gathering data about the cost of the TeleFile Program as early as 1996. It based the decision to eliminate the TeleFile Program on cost studies conducted between 2003 and 2004. The first cost study, conducted by Booz Allen Hamilton in March 2000, indicated TeleFile returns were more costly to process than returns filed on paper or electronically. The IRS updated the cost estimates in this study sometime in 2003 or 2004.¹³ An additional cost study, conducted in 2003, also supported the conclusion that TeleFile was the most expensive return processing method. However, the cost estimates in these studies were incomplete and contained critical errors that affected their accuracy.

We evaluated the methodology used to conduct the 2003 cost study and to update the cost estimates in the 2000 Booz Allen Hamilton study and identified errors in the way the IRS computed the cost estimates for the individual filing methods. For example:

- **Outdated information was used in the cost comparison** – In its 2003 cost study, the IRS used information technology costs from FY 2003 but used labor and other processing costs from FY 2000. To accurately compute an overall cost figure for each filing method, the IRS should have compiled all the costing data for the same period. Because processing of paper returns is labor intensive and labor-related costs tend to increase each year, using the lower FY 2000 labor costs understated the amount needed to process paper returns and may have overstated the cost to process TeleFile and electronic returns. We identified similar errors in the IRS' updated Booz Allen Hamilton cost estimates.
- **Fixed costs were incorrectly classified as “variable costs”** – In its 2003 study, the IRS incorrectly categorized TeleFile telecommunication costs as “variable” costs. A variable cost is one that changes based on volume, such as the number of returns processed. The

¹³ Based on the information provided by the IRS, it is unclear exactly when the updated cost estimates were computed.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

cost of the TeleFile telecommunication contracts was fixed, meaning the IRS would pay the same amount for the telecommunication services regardless of how many taxpayers participated in the Program. Misclassifying this cost implied that increasing the number of taxpayers who used the Program would increase the cost of the Program. In fact, it would have decreased the cost-per-return to process TeleFile tax returns, making the TeleFile Program more cost efficient.

We could not properly recompute the cost estimates because the necessary data were not available and the IRS did not maintain sufficient documentation of how it computed the estimates. However, we believe the net effect of these errors was an overstatement of the cost differences in the three processing methods. For example, the TeleFile cost-per-return computed in the 2003 study was \$4.48. The cost-per-return would have fallen to \$3.71 if the IRS had used FY 2002 instead of FY 2000 costs, reducing the difference between processing paper and TeleFile returns to only \$.05. Because the data necessary to correct all the errors were not available, we do not know what the true difference among the filing methods would have been. Correcting the errors may not necessarily show that processing returns using TeleFile was more cost efficient than the other filing methods, but it would likely reduce the difference among the three filing options to a point where those cost differences no longer justified eliminating the TeleFile Program when the IRS did.

The IRS collected annual operating cost data in addition to the cost-per-return studies. It used these data to support its assertion that the cost of the TeleFile Program was increasing annually. However, the IRS evaluated how the operating costs changed between only 2 years, FYs 2004 and 2005 rather than trending operating costs over a period of time. Because the TeleFile Program had been in place since 1996, it is not clear why only 2 years of data were used to support the assertion that TeleFile costs were continually increasing.

In addition, the operating cost estimates were not computed consistently from one year to the next. For example, the IRS included annual security certification costs totaling \$75,000 in its FY 2004 estimate but not in its FY 2005 estimate. The FY 2005 estimate included contractor costs for testing totaling \$1,193,000 that were not part of the FY 2004 estimate. The IRS was also unable to provide us with the source of the data it used to compute the annual operating costs, so we were unable to determine why some costs were included in one year or the other but not both.

The errors in the cost studies affected more than just the IRS' estimates for each filing method. The 2003 cost study estimated 10 million returns would have to be filed through TeleFile for the IRS to break even.¹⁴ The break-even point for this purpose is the volume of returns that would have to be processed through TeleFile that would make the cost-per-return for TeleFile the same as that for paper. However, when we corrected the estimate, the break-even point for all TeleFile forms, including Forms 941 and 4868, fell from 10 million to 5.4 million returns. It is possible

¹⁴ The break-even point is the point at which cost and benefit or income are even.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

that, given the convenience and cost savings to taxpayers, participation in the Program may have been close enough to the break-even point to justify continuing the Program a few more years until viable alternative return filing methods were available.

The IRS also could not provide documentation to show how it arrived at the estimated \$5 million in annual cost savings it hoped to realize as a result of eliminating the TeleFile Program.

Without this documentation, we could not determine whether all applicable factors were properly considered when computing the estimate. For example, the IRS stated it had considered the cost it would incur to mail paper Form 1040EZ tax packages once the TeleFile Program ended. The IRS provided us with the actual cost incurred to mail Form 1040EZ tax packages in 2006.

However, this information would not have been available when the IRS made its decision to end the TeleFile Program. The IRS could not provide us with the estimate of mailing costs it used to make its decision nor the method used to compute that figure.

The errors in the estimates are attributable in part to the IRS' lack of a standard method for determining cost. The IRS has a process to track costs associated with the processing of a tax return, such as the cost of labor. However, it does not have a method to consistently track information technology costs such as telecommunications, software, and maintenance costs.

The IRS also did not adequately consider all relevant data when making its decision. The IRS had gathered data about taxpayers' satisfaction with the TeleFile Program since the Program's inception. Taxpayers continually rated the TeleFile Program very high. In 2004, more than 90 percent of TeleFile users indicated they were very satisfied with the Program. This was the highest satisfaction rating among all of the electronic filing options. However, we did not find any indication that the IRS factored in taxpayers' satisfaction with the Program when making its decision. When asked for the basis for its decision, the IRS continually emphasized the cost of the Program and the related decline in participation.

A number of studies also indicated that expanding the TeleFile Program would be beneficial to the IRS. A February 2001 study recommended the IRS either expand TeleFile or discontinue it. A second study in November 2001 estimated the number of eligible taxpayers could increase by more than 3 million if the IRS allowed first-time filers to use the TeleFile Program. In 2005, approximately 3.3 million individual returns were filed using the TeleFile Program. The IRS could have increased the number of returns filed in 2005 by as much as 1.3 million returns by making TeleFile tax packages available to first-time filers, assuming the number of first-time filers remained relatively constant from year to year.¹⁵ This action would have brought the number of returns filed in 2005 to approximately 4.6 million returns or within 1 million returns of the Program's break-even point.

¹⁵ The estimated increase of 3 million in eligible taxpayers multiplied by the actual participation rate of 41.7 percent in 2005 equals about 1.3 million. This estimate is most likely understated because the number of new filers could increase annually.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

Later in 2001, we recommended the IRS reverse actions it had taken to reduce the number of TeleFile tax packages it mailed and conduct targeted surveys of nonusers to determine why taxpayers were not using the Program. In March 2003, we issued another report that recommended the IRS expand the TeleFile Program.

The IRS was reluctant to expand the TeleFile Program based on its estimates that the costs to process TeleFile returns significantly exceeding the costs for processing paper and electronically filed returns. The IRS also considered the use of a telephone to file tax returns obsolete because of the widespread use of computers and the Internet.

Most State telefile programs were discontinued after the IRS decision

The IRS indicated that discontinued State telefile programs were another reason for eliminating its TeleFile Program at the Federal level. We performed research and made site visits to four States¹⁶ to learn more about their telefile programs. We found a total of 31 States¹⁷ had a telefile program and only 9 States (29 percent) had eliminated their programs prior to the IRS' decision. Once the IRS had decided to eliminate the TeleFile Program, another 12 States discontinued their programs. Of those, 10 attributed their decision to the IRS' elimination of the Federal Program, including 8 States that were part of the Federal-State TeleFile Program.¹⁸

All of the States that discontinued their telefile programs offer other free electronic filing options through their own Internet filing programs or through the State free file alliances. According to the Federation of Tax Administrators,¹⁹ the elimination of the Federal TeleFile Program had a pronounced effect on the State telefile programs, suggesting that taxpayers did not differentiate well between Federal and State telefile programs. Ten States still offered telefile as an option for 2006; telefile returns accounted for approximately 10 percent of the returns electronically filed in these States in 2005. However, the participation level in many of these States had dropped by 40 percent or more as of March 17, 2006, compared to the normal 10 percent to 20 percent decline over the last several years.²⁰ One of the 10 States decided to no longer offer a telefile program after 2006.

¹⁶ California, Kansas, Missouri, and Pennsylvania.

¹⁷ The term "States" for this report includes the District of Columbia.

¹⁸ The Federal-State TeleFile Program allows eligible taxpayers in participating States to file their State income tax returns in the same telephone calls as their Federal returns using the IRS TeleFile system.

¹⁹ The Federation of Tax Administrators is an association of State tax administration agencies actively involved with promoting electronic filing at the State level.

²⁰ Statement of the Federation of Tax Administrators before the Committee on Finance, United States Senate, "Preparing Your Taxes, How Costly Is It?" (April 4, 2006).



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

The use of incomplete or inaccurate data to support decisions to reduce services to taxpayers is not unique to the TeleFile Program

The concerns identified in our review are not unique to the IRS' decision regarding the TeleFile Program. The TIGTA has advised the IRS that it needs to improve the quality for and timing of data used to make decisions for other taxpayer services as well. Most recently, we raised concerns with the IRS' plans to close Taxpayer Assistance Centers and reduce its toll-free telephone hours of operation.

When the IRS announced its plan to close 68 of the 400 Taxpayer Assistance Centers nationwide, the TIGTA performed a review of the Taxpayer Assistance Center Closure Model used by the IRS to identify which Taxpayer Assistance Centers to close.²¹ We reported that, although the structure of the Model was sound, not all data used were accurate or the most current available, and some of the data were based on estimates and projections instead of actual data currently available.

The TIGTA also reviewed the IRS' plans to reduce the toll-free telephone hours of operation and the projected savings as a result of that reduction.²² We reported that, while the IRS used the most current data available at the time the original analysis was performed, savings expected from reducing the toll-free telephone hours of operation should have been recalculated when updated data became available. In addition, support for some of the data used was not adequate or could not be found. Using the most current, complete data available significantly reduced the potential savings as compared to the initial IRS projections.

While the IRS must continue to become as efficient as possible, it is imperative that decisions regarding its customer service and return processing programs include an accurate and timely evaluation of the costs and the benefits of those programs. Using incomplete or inaccurate data to support program changes can result in significant burden to taxpayers and can undermine the IRS' efforts to effectively fulfill its mission.

IRS actions restricted TeleFile eligibility and affected participation

The IRS also cited decreasing participation in the TeleFile Program as a reason for eliminating it. From 1998 to 2005, the number of taxpayers who used TeleFile declined by nearly 45 percent, from approximately 6 million to approximately 3.3 million.

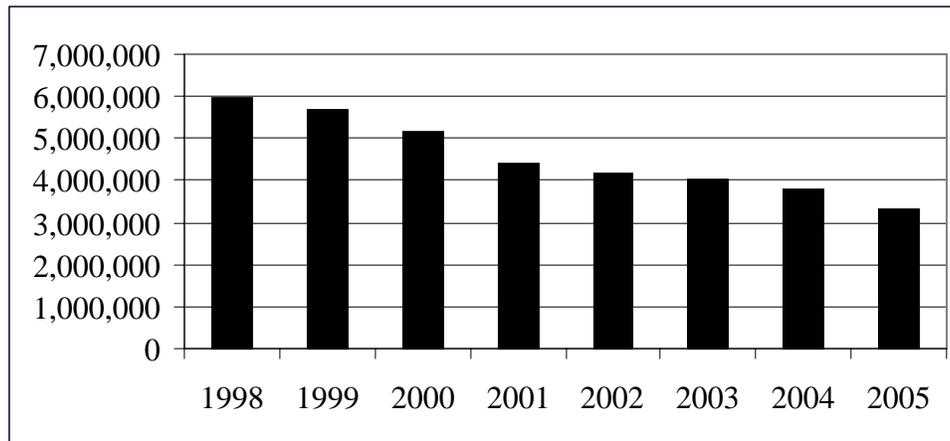
²¹ *The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data* (Reference Number 2006-40-061, dated March 2006).

²² *The Savings Used to Recommend Reducing Toll-Free Telephone Hours of Operation Are Not As Significant As Projected* (Reference Number 2006-40-169, dated September 21, 2006).



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

Figure 5: Number of Taxpayers Who Used TeleFile



Source: IRS Taxpayer Usage Studies.

IRS officials stated TeleFile usage was declining because the Program had become outdated as more and more taxpayers were turning to the Internet to file their tax returns. Some of the decline in TeleFile usage can be attributed to the advent of the Internet and other electronic filing alternatives such as Free File. However, IRS actions to reduce costs by reducing the number of TeleFile tax packages it mailed out also played a significant role in the declining participation.

Taxpayers had to meet two sets of requirements to be eligible for the TeleFile Program: they had to qualify to receive a TeleFile tax package and they had to meet the requirements for using the TeleFile Program that were listed in the tax package. The IRS annually evaluated the TeleFile Program in an effort to make the Program more efficient by reducing Program costs.

Specifically, it attempted to ensure it was sending TeleFile tax packages only to those eligible taxpayers who were using or were likely to use the Program. Such changes helped the IRS reduce its Program costs by reducing the number of TeleFile tax packages it mailed. As a result of this evaluation, the requirements for a taxpayer to qualify to receive a TeleFile tax package changed annually. However, changes to these requirements in 2001 and 2002 had a detrimental impact on the TeleFile Program.

In 2001, the IRS stopped mailing TeleFile tax packages to taxpayers who had used a practitioner in the previous year, thus reducing the number of taxpayers eligible to use the Program. The IRS estimated this initiative reduced the number of eligible taxpayers by more than 6.6 million and resulted in a decline in Program participation of approximately 330,000 returns that year. In 2002, the IRS stopped mailing TeleFile tax packages to taxpayers who were eligible for TeleFile but had not used it the prior 2 years. The IRS estimated this initiative reduced the number of eligible taxpayers by more than 3 million and caused participation to decline by approximately 360,000 returns that year. In 2004, the IRS reversed its decision to stop mailing TeleFile tax packages to taxpayers who qualified for the Program but had not used it the prior 2 years. However, the reversal was too late for participation in the Program to rebound.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

We evaluated the TeleFile Program’s participation rate²³ over time to determine if the decline in use was the result of fewer taxpayers being eligible to use the Program or fewer taxpayers choosing to use the Program. Although the number of returns filed using the Program declined annually, we found the percentage of eligible taxpayers who chose to use TeleFile remained relatively constant from 1998 to 2000. The participation rate increased in 2001 and 2002 then declined from 2003 to 2005.

Figure 6: TeleFile Participation (in millions)²⁴

	1998	1999	2000	2001	2002	2003	2004	2005
Number of TeleFile tax packages mailed	24.5	26.6	21.5	17.8	15.5	16.4	15.9	15.1
Taxpayers eligible to use TeleFile	14.6	13.8	12.6	9.3	7.7	8.5	8.2	7.9
Number of returns filed using TeleFile	6.0	5.7	5.2	4.4	4.2	4.0	3.8	3.3
Percentage of eligible taxpayers who used TeleFile	40.8%	41.2%	40.8%	47.5%	54.6%	47.4%	45.9%	41.7%

Source: IRS Wage and Investment Division Research Studies, the ETA function’s weekly e-File Reports, and the 10-Year History Individual Tax Packages Quantities Produced Report. e-File = electronic filing.

The constant and increasing participation rate from 1998 to 2002 suggests the decline in the number of returns filed using the Program during this time was primarily the result of the IRS’ actions to reduce the number of taxpayers who were eligible to TeleFile. The increase in the participation rate was not enough to offset the decrease in eligible taxpayers.

The decline in the participation rate from 2003 to 2005 suggests some of the decline in TeleFile use during this period was caused by fewer eligible taxpayers choosing to use TeleFile. It is likely that some of the decline is the result of an increase in use of other electronic filing methods such as Free File, which began in 2003. Despite the decrease, the participation rate for TeleFile was greater in its last year (2005) than it was in 1998, the year in which the greatest number of returns were filed using the Program. In 2005, nearly 42 percent of all taxpayers eligible for the Program took advantage of it. Although use was declining, the participation rate of TeleFile was still greater than that of other IRS programs such as Free File, which had a participation rate of a little over 4 percent in 2006.

Several tax laws implemented between 1997 and 2002 also negatively affected the number of taxpayers eligible to use the TeleFile Program. These laws created new deductions and credits

²³ The participation rate is the percentage of taxpayers who participate in a program. The rate is computed by dividing total participants by total eligible taxpayers.

²⁴ The percentages cannot be recomputed based on the numbers presented in the table due to rounding.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

that could not be claimed on Form 1040EZ. For instance, taxpayers who wanted to take advantage of new tax credits (e.g., the education credits) or new deductions (e.g., the student loan interest deduction) could not claim these on Form 1040EZ. As a result, taxpayers who wanted to claim these credits or deductions were no longer eligible to use the TeleFile Program. Appendix VI provides a description of the specific legislation and related credits and deductions. According to IRS research, approximately 500,000 taxpayers who received a TeleFile tax package in 1999 were not eligible for the Program because they claimed the education credits or student loan interest deduction that became available that year. These tax law changes combined with the IRS' attempts to reduce costs significantly reduced the number of taxpayers who were eligible to use the TeleFile Program.

Because the concerns we identified regarding the use of inaccurate and incomplete data to support program decisions have been previously reported to the IRS, we did not make recommendations in this report.

Management's Response: The IRS believes it acted appropriately in choosing to end the TeleFile Program when it did and elimination of the Program is unlikely to have any long-term, negative consequences to achievement of its electronic filing goals. Management also stated the fact that many former TeleFile users who qualified but chose not to use the IRS Free File Program did not necessarily mean eliminating the TeleFile Program increased taxpayer burden.

Office of Audit Comment: We disagree with the IRS' opinion that eliminating the TeleFile Program did not increase taxpayer burden. Former TeleFile users must now choose among the remaining return preparation and filing methods. Many taxpayers are either ineligible for or unable to conveniently access one or more of the free options, and they now incur costs for return preparation and filing. The alternative of reverting to filing paper tax returns increases the time it takes to receive refunds and increases the IRS' cost of processing tax returns.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine the impact of the elimination of the TeleFile Program on electronic filing. The TeleFile Program could accept Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ), Application for Automatic Extension of Time To File U.S. Individual Income Tax Return (Form 4868), and Employer's Quarterly Federal Tax Returns (Form 941). We limited the scope of our review to the impact on the Form 1040EZ.

We verified the reliability of computer processed data by comparing the data to information contained on the IRS Integrated Data Retrieval System.¹

To accomplish our objective, we:

- I. Determined the basis of the IRS' decision to eliminate the TeleFile Program.
 - A. Interviewed IRS management to determine the process used to make the decision to eliminate the Program.
 - B. Obtained copies of the information/data the IRS used in making the decision to eliminate the TeleFile Program and reviewed the data to determine whether the data supports the IRS' decision.
 - C. Met with the National Taxpayer Advocate to discuss any concerns regarding the elimination of the Program.
 - D. Identified any additional data that should have been considered in the decision to eliminate the Program.
 - E. Evaluated the validity of the reasons the IRS gave for eliminating the Program.
 - F. Compared the IRS' cost estimates for processing paper, electronic, and TeleFile returns and evaluated the costing method to determine the IRS' ability to accurately compare the costs of processing the various methods of filing a tax return.
 - G. Selected a judgmental sample of 4 of the 31 State Departments of Revenue that have or have had a telefile program in the past to determine their experiences with the telefile program. We used a judgmental sample to ensure we selected States with diverse telefile programs. We interviewed officials from the California Franchise Tax

¹ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

- Board, Kansas Department of Revenue, Missouri Department of Revenue, and Pennsylvania Department of Revenue.
- H. Visited three public libraries of varying size and location in the Kansas City Metropolitan Area to determine what taxpayers would have to do to file their tax returns from a public library.
- II. Evaluated the IRS' efforts to reduce the burden on taxpayers and other IRS programs as a result of eliminating the TeleFile Program.
- A. Assessed the effect the elimination of the TeleFile Program had on taxpayers.
1. Reviewed a sample of 400 taxpayers who had filed their Calendar Year² 2005 tax returns using TeleFile to determine how former TeleFile users filed their tax returns for 2006 and how many taxpayers went from no-cost returns to incurring costs to file their returns.
- To obtain the sample, we extracted 2006 tax return data for all taxpayers who used TeleFile to file their Tax Year (TY) 2004 tax returns. When we completed our data validations, we had a population of 3,059,189 records. Because the purpose of reviewing a sample of returns was to determine how the 2005 TeleFile users filed in 2006, we wanted to remove from our population the taxpayers that would have been unable to use TeleFile in 2006, if the Program had continued. We used the eligibility requirements in the 2005 TeleFile tax package and the 2005 criteria to eliminate from the population taxpayers that would have been ineligible to use TeleFile. Based on the tax return data extracted, we ended with a population of 2,926,984 records by eliminating 132,205 records that would not have been eligible to use TeleFile in 2006, if it had continued.
- The data extracted alone were not sufficient to determine if a taxpayer met all the requirements to be eligible to use TeleFile. Therefore, we used data found on the Integrated Data Retrieval System to determine if each of the 400 taxpayers sampled would have met the remaining eligibility requirements that could not be validated using the extracted data.
- We used a 95 percent confidence level, ± 5 percent precision level, and 49.08 percent expected error rate to determine our sample size. The sample was selected using a random number generator.
2. Interviewed IRS personnel and researched the IRS web site to determine how the IRS publicized the elimination of the TeleFile Program and other available alternatives for filing a tax return to minimize the number of taxpayers filing paper returns in 2006.

² All dates in Appendix I are calendar year unless otherwise noted.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

- B. Reviewed IRS Error Resolution System reports for Forms 1040EZ and compared the volumes of Form 1040EZ paper and electronic returns filed for 2005 and 2006 to assess the affect the elimination of the TeleFile Program had on other IRS programs.
 - C. Captured the demographics of the TeleFile Program and Form 1040EZ filers for 2005 using taxpayer data obtained from the Individual Return Transaction File located on the TIGTA Data Center Warehouse.
- III. Evaluated participation in the TeleFile Program during the 1996 through 2005 Filing Seasons.
- A. Determined the history of the TeleFile Program and created a timeline outlining the major events.
 - B. Gathered the volume of returns filed using the TeleFile Program in the 1996 through 2005 Filing Seasons, along with the volume of Forms 1040EZ filed on paper and electronically during the same period.
 - C. Reviewed TeleFile tax packages and TeleFile tax package mail-out criteria obtained from the IRS to determine the eligibility requirements for the TeleFile Program in the 1996 through 2005 Filing Seasons.
 - D. Determined the number of taxpayers eligible for the TeleFile Program in the 1998 through 2005 Filing Seasons using research studies obtained from the IRS and ETA web sites. We were unable to determine the number of taxpayers eligible for the TeleFile Program for the 1996 and 1997 Filing Seasons because estimates for these years were not available.
 - E. Obtained the volume of TeleFile tax packages mailed for the 1996 through 2005 Filing Seasons from the IRS. In addition, we determined the parameters used to identify the taxpayers who received the TeleFile tax packages for the 2000 through 2005 Filing Seasons from the mail-out criteria provided by the IRS. We were unable to determine the parameters used for the 1996 through 1999 Filing Seasons because the IRS was unable to provide the mail-out criteria used for these years.
 - F. Determined the participation level in the TeleFile Program for the 1998 through 2005 Filing Seasons.
 - G. Interviewed IRS personnel, reviewed data obtained from the IRS, and researched the IRS web site to determine how well the IRS marketed and promoted the TeleFile Program.
 - H. Interviewed IRS personnel to determine the steps the IRS took to assess why participation in the TeleFile Program was decreasing and the actions the IRS took to increase the use of TeleFile.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Scott A. Macfarlane, Director
Deann L. Baiza, Audit Manager
Karen C. Fulte, Lead Auditor
John L. Hawkins, Senior Auditor
John B. Mansfield, Senior Auditor
Sandra L. Hinton, Auditor
Ryan C. Powderly, Intern



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Electronic Tax Administration, Wage and Investment Division SE:W:ETA
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix IV

Computation of Estimates – Former TeleFile Users Who Paid to File a Tax Return

This appendix presents detailed information on the methodology used to estimate the number of former TeleFile Program users who paid to file their Calendar Year¹ 2006 tax returns. It also includes the methodology used to estimate the cost incurred by these taxpayers. The computations in this appendix may not be able to be replicated due to rounding.

Number of Taxpayers Who Paid to File

We estimate 541,492 taxpayers went from filing for free to paying to file their tax returns.

Methodology used to compute the estimate

We extracted TY 2005 tax return data for all taxpayers who used the TeleFile Program to file their 2005 tax returns. When we completed our data validations, we had a population of 3,059,189 records. We used the IRS' criteria for mailing the 2005 TeleFile tax packages and the eligibility requirements in the 2005 TeleFile tax package itself to eliminate taxpayers from the population. Based on the tax return data extracted, we ended with a population of 2,926,984 records by eliminating 132,205 records that would not have been eligible to use TeleFile in 2006, if the Program had continued.

The data extracted alone were not sufficient to determine if a taxpayer would have met all the requirements to be eligible to use TeleFile. Therefore, to estimate the number of taxpayers who would have been eligible to use TeleFile in 2006 if the Program had continued and determine how these taxpayers filed their 2006 tax returns, we analyzed a sample of our population. We used an attribute sampling method to select a statistical sample of 400 taxpayers from our population so we could achieve a ± 5 percent precision level at a confidence of 95 percent regardless of the error rate.

We determined in 80 (20 percent) of the 400 cases the taxpayer would have been eligible to use TeleFile and incurred some cost to file their 2006 returns. These 80 taxpayers used the following tax filing methods:

- Twenty-one used a tax practitioner to prepare and file their tax returns.
- Thirty-nine purchased tax preparation software and filed online.

¹ All dates in Appendix IV are calendar year unless otherwise noted.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

- Twenty purchased tax preparation software, printed the tax returns, and filed paper tax returns.²

Using the attribute sampling formula for each tax filing method, we are 95 percent confident the number of taxpayers who would have been eligible to use TeleFile in 2006 and incurred some cost to file their tax return is 541,492 ($\pm 204,734$) and the actual number of taxpayers ranges from 336,758 to 746,226.

Cost Incurred by Taxpayers Who Paid to File

We estimate the 541,492 taxpayers who paid to file their 2006 tax returns incurred costs totaling \$23,641,854.

Methodology used to compute the estimate

Using the same statistical sample previously described, we estimate the 541,492 taxpayers who would have been eligible to use the TeleFile Program and incurred a cost paid \$23,641,854 ($\pm \$9,072,701$) to file their 2006 tax returns.

There are three ways in which a taxpayer could have paid to file his or her 2006 tax return. The taxpayer could have filed using a paid preparer, filed online using software, or used software to prepare a paper return. To estimate the cost that taxpayers incurred to file their 2006 tax returns, we first estimated the number of taxpayers who would have been eligible to use TeleFile and filed tax returns using each of the three methods. Next, we determined the total cost that taxpayers incurred to file using each of the three methods. We then added the three costs together to arrive at our total cost estimate.

Computation of estimate for amount paid by taxpayers who used a paid preparer

We estimate taxpayers who would have been eligible to use TeleFile in 2006 spent \$12,447,027 ($\pm \$5,188,131$) to file their 2006 tax returns using a paid preparer.

Using the same statistical sample described previously, we determined 21 (5.25 percent) of the 400 records would have been eligible to use TeleFile and used a paid preparer to file their tax returns. Using the attribute sampling formula, we are 95 percent confident the number of taxpayers who would have been eligible to use TeleFile in 2006 and used a paid preparer to file their tax returns is 153,667 ($\pm 64,051$) and the actual number of taxpayers ranges from 89,616 to 217,718.

² Because some tax preparation software packages allow the preparation of more than one tax return, it is possible these taxpayers borrowed a software package and did not incur any personal cost. Many tax software companies also offer free return preparation services directly on their Internet web sites. Therefore, not all taxpayers who filed their returns online may have incurred a cost. Recognizing this, our projections are based on the assumption that 90 percent of the taxpayers who filed their tax returns online paid for the software and a filing fee.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

To estimate the cost that these taxpayers incurred, we multiplied our estimate and variance by the IRS' estimated average expense that taxpayers incurred to have an Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ) prepared by a paid professional for 2006. The 2006 Form 1040EZ instructions indicate taxpayers on average incurred a cost of \$81 to have a Form 1040EZ prepared by a paid professional. By taking the estimated number of taxpayers who would have been eligible to use TeleFile but filed using a paid preparer and multiplying it by \$81, we are 95 percent confident the expected cost incurred by taxpayers who would have been eligible to use TeleFile but used a paid preparer is \$12,447,027 (\pm \$5,188,131) and the expected cost incurred ranges from \$7,258,896 to \$17,635,158.

Computation of estimate for amount paid by taxpayers who used software and filed electronically

We estimate taxpayers who would have been eligible to use TeleFile in 2006 spent \$8,697,530 (\pm \$2,755,786) to electronically file their returns using tax preparation software. To determine the amount taxpayers paid, we first estimated the number of taxpayers who would have been eligible to use TeleFile and used tax software to file their return electronically.

Using the same statistical sample previously described, we determined 39 (9.75 percent) of the 400 records would have been eligible to use TeleFile and used tax software to electronically file their tax returns. Using the attribute sampling formula, we are 95 percent confident the number of taxpayers who would have been eligible to TeleFile their 2006 tax return and paid to electronically file their tax returns using software is 256,111 (\pm 81,148) and the actual number of taxpayers ranges from 174,963 to 337,259.

To estimate the cost that these taxpayers incurred, we multiplied our estimate and variance by the amount it costs taxpayers to use software to electronically file a return. It costs taxpayers on average \$18.96 to use tax preparation software. This estimate was determined by taking the average price of TurboTax's Basic software package and TaxCut's Premium Federal software package at five different retail outlets in Kansas City, Missouri. We then determined taxpayers also incur a cost of \$15 to electronically file their returns. This estimate was determined by taking the smaller of the fees charged by TaxCut and TurboTax to file a return electronically. When added together, these 2 estimates gave us an estimated total cost of \$33.96. By taking the estimated number of taxpayers who would have been eligible to use TeleFile but filed electronically using tax preparation software and multiplying it by \$33.96, we are 95 percent confident the expected cost incurred by these taxpayers is \$8,697,530 (\pm \$2,755,786) and the expected cost incurred ranges from \$5,941,743 to \$11,453,316.

Computation of estimate for amount paid by taxpayers who used software and filed on paper

We estimate taxpayers who would have been eligible to use the TeleFile Program in 2006 spent \$2,497,297 (\pm \$1,128,784) to prepare their returns using tax preparation software and file paper



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

returns. To determine the amount taxpayers paid, we first estimated the number of taxpayers who would have been eligible to use TeleFile and used software to prepare paper returns.

Using the same statistical sample previously described, we determined 20 (5 percent) of the 400 records would have been eligible to use TeleFile and used a tax software to prepare their paper returns. Using the attribute sampling formula, we are 95 percent confident the number of taxpayers who would have been eligible to use TeleFile in 2006 and paid to use tax software to prepare their paper returns is 131,714 ($\pm 59,535$) and the actual number of taxpayers ranges from 72,179 to 191,249.

To estimate the cost that these taxpayers incurred, we multiplied our estimate and variance by the cost of using tax software. As mentioned previously, the average cost of using tax software was \$18.96. By multiplying this cost by our estimate and variance for the number of taxpayers who used software to prepare a paper return, we are 95 percent confident the expected cost incurred by these taxpayers is \$2,497,297 ($\pm \$1,128,784$). Therefore, we are 95 percent confident the expected cost incurred by taxpayers who used tax software to file a paper return ranges from \$1,368,514 to \$3,626,081.

Combining the estimates for all 3 samples, we are 95 percent confident taxpayers who would have been eligible to use TeleFile incurred a total cost of \$23,641,854 ($\pm 9,072,701$) and the expected cost incurred ranges from \$14,569,153 to \$32,714,555.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix V

TeleFile Eligibility Requirements

There were two broad criteria that a taxpayer must have met to be eligible for TeleFile: receipt and qualification. A taxpayer must first have received a TeleFile tax package and then must have met the qualification requirements found in that package.

Criteria Used to Identify Taxpayers Who Received a TeleFile Tax Package:

To receive a TeleFile tax package in 2005, a taxpayer's previous year tax return must have met the requirements of an Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ) and the taxpayer could not have met any of the following eliminating criteria:

1. Used a preparer and did not live in a State that participates in the Fed/State Program.
2. Requested not to receive a TeleFile tax package.
3. Involved in an open criminal investigation.
4. Is a prisoner.
5. Is a foreign filer.
6. Is a nonresident alien.
7. Claimed foreign income on the previous year's tax return.
8. Previous year's tax return had a Puerto Rico or American Possession State code.
9. Previous year's tax return had a Puerto Rico or International filing district office code and the State code was not a military State.
10. Previous year's tax return had a filing status other than Single or Married Filing Jointly.
11. Filed as Married Filing Jointly the previous year with an invalid secondary Social Security Number.
12. Filed as Married Filing Jointly the previous year and the secondary Social Security Number was absent.
13. Has a temporary Social Security Number assigned by the IRS.
14. Date present in date of death field from the NAP DM-1, the IRS database of all validly issued Social Security Numbers and their related name controls.
15. Presence of "deceased" or "dec'd" on either the first or second name line of a taxpayer's previous year tax return.
16. Account contains certain transaction codes for the current year including penalty codes, estimated tax declarations, estimated taxes, or overpayment credits from prior tax periods.
17. Account contains codes indicating a miscellaneous change of entity or the issuance of a tax delinquent account due to noncompliance conditions.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

18. Value other than zero in the Earned Income Tax Credit Recertification Eligibility Indicator indicating the taxpayer is not eligible to receive the Earned Income Tax Credit because it was denied during an audit.
19. Month, day, or year of birth is zero.
20. Year of birth does not begin with 19 or 20.
21. Year of birth is prior to 1940.
22. Taxpayer was born January 1, 1940.

Requirements in TeleFile Tax Package:

Taxpayers who received a TeleFile tax package must have met the following requirements to qualify to use the TeleFile Program to file their TY 2004 tax returns (filed in 2005):

1. Are eligible to file a Form 1040EZ by meeting the following requirements:
 - a. Filing status is Single or Married Filing Jointly (the filing status of taxpayers who were nonresident aliens at any time in 2004 must be Married Filing Jointly).
 - b. Do not claim any dependents.
 - c. Do not claim any adjustments to income.
 - d. Do not claim any tax credits other than the Earned Income Tax Credit.
 - e. The taxpayer and spouse (if filing a joint return) were under age 65 on January 1, 2005, and not blind at the end of 2004.
 - f. Taxable income is less than \$100,000.
 - g. Had income from only the following sources: wages, salaries, tips, taxable scholarship or fellowship grants, unemployment compensation, or Alaska Permanent Fund dividends and taxable interest of \$1,500 or less.
 - h. Did not receive any advance earned income credit payments.
 - i. Do not owe any household employment taxes on wages paid to a household employee.
2. Name(s) must be correct on the TeleFile tax package (taxpayers can still use TeleFile if the address on the package is not correct as long as they have any refund directly deposited).
3. Filing status must be the same as last year.
4. All wages, salaries, tips, and taxable scholarship or fellowship grants are shown on Wage and Tax Statements (Form W-2).
5. Do not elect to include nontaxable combat pay in earned income for purposes of the Earned Income Tax Credit.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix VI

Tax Laws Affecting TeleFile Eligibility 1997-2002

Several tax laws implemented between 1998 and 2003 created new deductions and credits that could not be claimed on an Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ). As a result, taxpayers who wanted to claim these credits or deductions were no longer eligible to use the TeleFile Program.

- **Health Insurance Portability and Accountability Act of 1996¹** – This Act allowed taxpayers to establish tax-exempt medical savings accounts, excluded from income accelerated death benefits under life insurance contracts paid to chronically ill or terminally ill individuals, allowed taxpayers to deduct all or part of long-term care insurance premiums as a medical expense, and excluded benefits received from a long-term care insurance policy from taxable income. However, Form 1040EZ was not updated to account for these tax law changes; therefore, taxpayers who established a medical savings account, received accelerated death benefits, or received benefits from a long-term care insurance policy were no longer able to file using a Form 1040EZ or TeleFile.
- **The Small Business Job Protection Act of 1996²** – This Act reduced the number of taxpayers eligible to use the TeleFile Program by allowing taxpayers to exclude up to \$5,000 of qualified adoption expense under an employer’s adoption assistance program or claim up to a \$5,000 tax credit for adoption expenses incurred when they filed their tax returns in 1998. The Form 1040EZ was not updated to allow taxpayers to claim this exclusion; therefore, taxpayers claiming the exclusion were not eligible to use the TeleFile Program.
- **Taxpayer Relief Act of 1997³** – This Act created the student loan interest deduction and education credits. Beginning in 1999, taxpayers were allowed to deduct some of the interest they paid on qualified student loans and receive a credit for certain higher education expenses paid. Taxpayers wanting to claim the deduction or credit were required to file a U.S. Individual Income Tax Return (Form 1040 or 1040A); therefore, they were no longer eligible to use the TeleFile Program.

¹ Pub. L. No. 104-191, 110 Stat. 1936 (codified as amended in scattered sections of 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.).

² Pub. L. No. 104-188, 110 Stat. 1755 (codified as amended in scattered sections of 19 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.).

³ Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

- **Economic Growth and Tax Relief Reconciliation Act of 2001⁴** – This Act allowed taxpayers to deduct, as an adjustment to income, up to \$3,000 of qualified tuition and related expenses paid for higher education for themselves, their spouse, or their dependent. Taxpayers could also take a credit of up to \$1,000 (up to \$2,000 if filing jointly) for eligible contributions to a qualified retirement plan, an eligible deferred compensation plan, or an Individual Retirement Arrangement. However, taxpayers wanting to claim the deduction or credit were required to file a Form 1040 or Form 1040A; therefore, they were no longer eligible to use the TeleFile Program.
- **Trade Act of 2002⁵** – This Act allowed a Health Insurance Credit for Eligible Recipients. This is a credit for health insurance costs of individuals receiving a trade readjustment allowance or a benefit from the Pension Benefit Guaranty Corporation. Beginning in TY 2002, taxpayers could claim this credit but only by filing a Form 1040.
- **Job Creation and Worker Assistance Act of 2002⁶** – This Act allowed taxpayers who were educators to deduct up to \$250 of expenses they incurred for certain materials for use in the classroom. The taxpayer had to use Form 1040 or Form 1040A to do so.

⁴ Pub. L. No. 107-16, 115 Stat. 38 (2001).

⁵ Pub. L. No. 107-210, 116 Stat. 933 (codified as amended in scattered sections of 19 U.S.C., 26 U.S.C., and 42 U.S.C.).

⁶ Pub. L. No. 107-147, 116 Stat. 21 (codified in scattered sections of 26 U.S.C., 29 U.S.C., and 42 U.S.C.).



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix VII

Timeline of Events Affecting the TeleFile Program

Calendar Year 1986
Tax Systems Modernization began.
Calendar Year 1992
Filing from home began with the U.S. Individual Income Tax Return (Form 1040) TeleFile research test, which processed 125,983 TeleFile returns from the State of Ohio.
Calendar Year 1993
Approximately 150,000 people filed during the second year of the test in Ohio.
Calendar Year 1994
The TeleFile Program began operating as a regular filing alternative and was expanded to Florida, Indiana, Kentucky, Michigan, South Carolina, and West Virginia. Approximately 500,000 people filed.
Calendar Year 1995
The TeleFile Program was further expanded to Colorado and parts of California and Texas. Approximately 680,000 people filed.
The TeleFile Program began to offer Spanish voice prompts.
Calendar Year 1996
The TeleFile Program became available nationally to single Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ) filers.
The TeleFile Program went “paperless.” Taxpayers no longer had to mail their Wage and Tax Statements (Form W-2) or signature documents to the IRS. Instead of the signature document, taxpayers used a Personal Identification Number that was provided by the IRS.
Approximately 23.92 million TeleFile tax packages were mailed out.
Approximately 2.84 million returns were filed using TeleFile, exceeding the IRS’ projection of 2.5 million returns.
The participation rate was 12 percent (2.84 million of 23.92 million).



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Calendar Year 1997
The TeleFile Program was expanded to include married taxpayers filing jointly on Form 1040EZ.
Direct deposit for TeleFile was established.
The IRS stopped including a Form 1040EZ in the tax package sent to taxpayers who appeared eligible to file using TeleFile.
The initial cost study indicated the cost of processing TeleFile returns was less than that to process paper returns (\$.85 vs. \$1.40).
Customer service surveys and focus groups revealed that 88 percent of users considered TeleFile faster than filing a paper return. Analysis also indicated that when using TeleFile, taxpayers spent an average of 125 fewer minutes to complete all the tasks related to filing a tax return.
Approximately 26.46 million TeleFile tax packages were mailed out.
TeleFile usage increased 65 percent to approximately 4.69 million returns.
The participation rate was 18 percent (4.69 million of 26.46 million).
Calendar Year 1998
TeleFile was expanded to include Employer's Quarterly Federal Tax Return (Form 941).
The IRS began updating the address information in its records through use of the United States Postal Service's National Change of Address File to allow some taxpayers who moved after they had filed the prior year to be eligible to use TeleFile. The IRS estimated it increased the number of packages mailed out by 2.5 million and the number of returns filed using TeleFile by 500,000 in 1998.
In the Conference Report to the IRS Restructuring and Reform Act of 1998, ¹ Congress stated, "the conferees also intend that the IRS should continue to offer and improve its TeleFile Program and make available a comparable program on the Internet."

¹ Pub. L. No 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

May - IRS Public Service Announcement study found that only 20 percent of the taxpayers interviewed stated they were aware of TeleFile on an Unaided basis, and only 9 percent stated they recalled IRS mailings on the subject of TeleFile. Accordingly, the study reported there was still room for growth with respect to awareness of the TeleFile Program.
Approximately 24.47 million TeleFile tax packages were mailed out.
TeleFile usage increased 27 percent to approximately 5.96 million TY 1997 tax returns.
The participation rate was 24 percent (5.96 million of 24.47 million).
Calendar Year 1999
In an attempt to further increase the use of TeleFile, the IRS conducted a joint Federal and State TeleFile test in Indiana and Kentucky, known as the Fed/State Program. After completing the Federal portion of TeleFile, taxpayers participating in the Program were given the option to file their State tax returns. The IRS decided to implement the Program in response to the results of a survey of TeleFile nonusers in 1997. In responding to the survey, 44 percent of the nonusers stated they might be encouraged to use TeleFile if they could also use it to file their State returns.
The Government Accountability Office reported that, in response to a survey, 72 percent of TeleFile nonusers indicated they would be encouraged to use the system if they were able to determine their Federal tax before calling TeleFile. The IRS opposed the idea because it would require including the tax table in the TeleFile tax package—a step that would increase the size of the package by several pages (at an estimated cost of about \$1.4 million).
Tax law changes were enacted that enabled certain taxpayers to take a student loan interest deduction or an education credit. Persons claiming such a deduction or credit were no longer eligible to use TeleFile.
Approximately 26.59 million TeleFile tax packages were mailed out.
TeleFile usage declined 5 percent to approximately 5.67 million TY 1998 tax returns. The number of Forms 1040EZ filed declined by 7.8 percent. The ETAAC believed possible explanations for the decline included a shift to computer filings and the effect of new tax credits (education) this year. The ETAAC recommended the IRS analyze the causes of the decrease and factor them into future projections.
The participation rate was 21 percent (5.67 million of 26.59 million).
Calendar Year 2000
Direct debit for the TeleFile Program was established.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

March - Booz Allen Hamilton study indicated the TeleFile Program had the highest cost per return.
May - The ETA reported the following results of a 1996 cost study: <ul style="list-style-type: none">▪ Paper – \$3.51.▪ Electronic – \$4.63.▪ TeleFile – \$5.11 including investment cost, \$3.58 excluding investment cost.
May - IRS Communications Tracking Study reported that TeleFile appeared to be on a decline from both a communications as well as usage perspective. It recommended the TeleFile Program would need more communications support in the future to maintain usage.
June - After a second year of declining participation, the ETAAC recommended the IRS determine the future direction of the Program.
October - “The 2000 Wave Of ETA Taxpayer & Preparer e-file [electronic filing] Satisfaction Research” reported taxpayers were less likely to use TeleFile in 2000 than 1999 and TeleFile had the lowest repeat usage rate of all the electronic filing options.
November - Chi-Squared Automated Interactive Deductor Analysis by the ETA reported taxpayers who chose to use TeleFile were extremely loyal as repeat users. While this characteristic was also true of electronic filers in general, it was especially significant for predicting behavior with regard to TeleFile.
Approximately 21.55 million TeleFile tax packages were mailed out.
TeleFile usage declined 8.9 percent to approximately 5.16 million TY 1999 tax returns.
The participation rate was 24 percent (5.16 million of 21.55 million).
Calendar Year 2001
The TeleFile Program was expanded to include Application for Automatic Extension of Time To File U.S. Individual Income Tax Returns (Form 4868).
Starting with TY 2000, TeleFile tax packages were no longer mailed to taxpayers who had used a practitioner the previous year or had requested they receive a regular tax package instead of the TeleFile tax package.
A computer programming error created incorrect addresses for some taxpayers who had moved into an apartment in 2000. Affected taxpayers were told they should use TeleFile only if they expected a refund and would have the refund directly deposited into their bank accounts.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

Incorrect customer numbers were printed on about 192,000 TeleFile tax packages by an IRS contractor. The contractor sent notices with corrected numbers to affected taxpayers to enable the affected taxpayers to file via telephone.

February - IRS research study for TY 1999 found:

- TeleFile had the lowest retention rate.
- Moving was the number one reason (44 percent of taxpayers) why taxpayers who received a TeleFile tax package were ineligible to file.
- Online filing was not the cause of the decrease in TeleFile.

The study recommended the IRS either eliminate moving as a criterion for TeleFile eligibility or consider discontinuing TeleFile.

March - IRS study indicated the main reason taxpayers chose to TeleFile was the simplicity of filing via the telephone.

May - "Presentation Of Findings From The 2001 Wave Of ETA Attitudinal Tracking Research" cited TeleFile as the best alternative to move simple return taxpayers away from filing on paper.

August - Focus group study found:

- Many taxpayers did not recognize TeleFile as a way to file electronically.
- Taxpayers generally preferred a new 8-page design (vs. the old 12-page version).
- Taxpayers responded negatively to the idea of using a self-selected Personal Identification Number or having to pay to use TeleFile.
- Taxpayers responded that the worst thing about TeleFile was not getting a TeleFile tax package when you wanted to use it.

June - "2001 Wave Of ETA Taxpayer & Preparer e-file [electronic filing] Satisfaction Research" reported that TeleFile had the highest satisfaction rate, but it also had the lowest retention rate.

June - The ETAAC recommended the TeleFile Program be phased out and TeleFile taxpayers be encouraged to file using low- or no-cost private online tax preparation and electronic filing services, tax practitioners, existing IRS walk-in sites, or volunteer tax preparation services.

September - The IRS Oversight Board cautioned restraint on the ETAAC recommendation to phase out the TeleFile Program. The Board believed that, while the number of taxpayers who used TeleFile was declining, most likely in favor of Internet-based electronic filing, taxpayers who qualified for TeleFile needed only a telephone to use the system. Thus, for some segment of taxpayers, it might be the only channel of electronic filing available to them. To ensure the availability of one channel of electronic filing for qualifying taxpayers without computers, the Oversight Board recommended retention of the TeleFile Program.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

<p>September - In June 2000, the IRS approved two separate nonmodernization electronic filing projects. One project was for corporate forms; the other was for tax-exempt organization forms. As the projects progressed, the IRS decided to combine them to eliminate duplication of effort and oversight and bring the combined project into the larger IRS modernization effort. The project was renamed the Modernized <i>e-File</i> Project and was initiated on September 1, 2002.</p>
<p>October - A TIGTA report was issued on TeleFile – the IRS decided to discontinue mailing out TeleFile tax packages for taxpayers who had used a paid preparer the previous year (starting with TY 2000) and for taxpayers who had received the TeleFile tax package in the 2 previous years but had not used TeleFile (starting with TY 2001). The TIGTA recommended the ETA reverse this decision but the IRS disagreed, stating it was not cost effective. The TIGTA also recommended the IRS identify TeleFile-eligible taxpayers not using TeleFile, conduct a targeted survey to determine the main barriers that prevented eligible taxpayers from using TeleFile, and use the information for specific outreach efforts. The IRS responded that the targeted surveys it conducted were supported by analysis performed by the Research function and this analysis was a major component in determining the scheduled improvements to the TeleFile Program for the 2002 Filing Season.</p>
<p>November - A Research function study recommended providing taxpayers with an electronic means of changing their address, the self-select Personal Identification Number option for TeleFile, and TeleFile instructions within the Form 1040EZ instruction booklet.</p>
<p>Approximately 17.78 million TeleFile tax packages were mailed out.</p>
<p>TeleFile usage declined 14.4 percent to approximately 4.42 million TY 2000 tax returns.</p>
<p>The participation rate was 25 percent (4.42 million of 17.78 million).</p>
<p>Calendar Year 2002</p>
<p>Starting with TY 2001, TeleFile tax packages were no longer mailed to taxpayers who had received a TeleFile tax package the prior 2 years and did not use TeleFile.</p>
<p>April - The study “2002 Wave Of e-file [electronic filing] Taxpayer & Preparer Satisfaction Research” reported that taxpayers wanted the IRS to expand the qualifications of TeleFile to allow more individuals to qualify.</p>
<p>April - The study “2002 Wave Of e-file [electronic filing] Taxpayer Attitudinal Tracking Research” reported that awareness of the TeleFile Program was declining, but usage consideration for TeleFile had not changed. The study also found the TeleFile Program had the lowest usage consideration rate.</p>
<p>Approximately 15.54 million TeleFile tax packages were mailed out.</p>



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

TeleFile usage declined 5.5 percent to approximately 4.18 million TY 2001 tax returns.
The participation rate was 27 percent (4.18 million of 15.54 million).
Calendar Year 2003
March - A TIGTA report cited returns filed using TeleFile as the least costly type of return to process. The report cited costs of \$2.84, \$3.00, and \$3.92 for TeleFile, electronic, and paper returns, respectively.
March - A TIGTA report recommended the Director, ETA, develop a strategy to offer TeleFile to those taxpayers who file a Form 1040EZ and are currently ineligible to use TeleFile. IRS management agreed and planned to establish a task force to look at opportunities for expanding the TeleFile Program to include taxpayers who move and first-time filers.
In response to the TIGTA report, the IRS performed a new cost study. The study indicated returns filed using TeleFile, at \$4.48, are the most costly to process, compared to paper and electronic costs of \$4.25 and \$3.35, respectively.
The ETAAC reported that to allow taxpayers who moved to be eligible to use TeleFile the IRS had taken two actions: <ol style="list-style-type: none">1. The vendor that prints and mails the TeleFile tax packages used the National Change of Address File service provided by the United States Postal Service to update addresses just prior to mailing.2. Beginning with TY 2002 tax returns, taxpayers who moved after receiving their TeleFile tax packages were eligible to use the TeleFile system if they had their refunds directly deposited in their savings or checking accounts.
July - "The 2003 Wave Of e-file [electronic filing] Taxpayer & Preparer Satisfaction Research" reported that TeleFile has a satisfaction rate of 90 percent, the highest of all electronic filing methods.
November - A Research project reported the Submission Processing Visioning Task Force was considering discontinuing the TeleFile Program by 2008 because of the high cost for the relatively small number of users. The ETA needed more information before a decision was made. The Research project also reported that: <ul style="list-style-type: none">▪ 48 percent of TeleFile users would file paper returns.▪ 52 percent would file electronically (32 percent would use Free File).▪ 86 percent would consider Free File if they could not use TeleFile.▪ 71 percent were not aware they could have used Free File.▪ 85 percent file their "own" tax returns.▪ Previous research showed TeleFile users may revert to paper (55 percent) in the short term but would go to electronic filing at a higher rate than the general population.



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

November - The IRS Oversight Board reported that TeleFile would continue to provide valuable access to an electronic medium for taxpayers with simple tax returns. Although the IRS may find that it can in the long term phase out the TeleFile Program, the near term picture suggested the IRS should continue to seek out ways to expand taxpayer eligibility to participate in the TeleFile Program. The TeleFile Program leaves open a convenient mode of filing for a significant portion of the population that does not necessarily have electronic access to the IRS.

Approximately 16.42 million TeleFile tax packages were mailed out.

TeleFile usage declined 3.6 percent to approximately 4.03 million TY 2002 tax returns.

The participation rate was 25 percent (4.03 million of 16.42 million).

Calendar Year 2004

Maximum allowable taxable interest was increased from \$400 to \$1,500 for the TeleFile Program.

Although the TeleFile Program continued to be used by fewer taxpayers each year, the IRS Oversight Board continued to believe the Program provided valuable access to an electronic medium for taxpayers with simple tax returns. However, the Board recognized that IRS budget cuts for FY 2005 placed pressure on the IRS to reduce services that did not deliver as much value to taxpayers as other programs that compete for the same cost dollars. In evaluating whether TeleFile should continue, the Board expected that the IRS would include an assessment of taxpayers' needs and any effect on electronic filing goals established by Congress in the evaluation process.

May - The ETA presented a sunset proposal to the Services, Support, and Modernization Committee. The Committee decided 2006 was too soon to discontinue TeleFile, but the ETA should begin to target 2007.

May - The ETA reported an operational cost for the TeleFile Program of \$8.6 million in FY 2004 and an estimated operational cost of \$11.6 million in FY 2005.

June 30 - The ETAAC recommended to Congress that the TeleFile Program be eliminated immediately and funds redirected to help pay for the Modernized *e-File* Project because the number of Forms 1040EZ filed using TeleFile had been decreasing every year since 1999 and TeleFile is the most expensive mode of processing a return (on a cost-per-return basis).



Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers

<p>July - The 2004 electronic filing Taxpayer Satisfaction Study reported:</p> <ul style="list-style-type: none"> ▪ TeleFile had the highest satisfaction rate of all electronic filing methods (90 percent). ▪ 37 percent of TeleFile users would file on paper if the Program was eliminated. ▪ The top two reasons for reverting to use of paper were electronic methods were not as easy/convenient and unfamiliarity with electronic methods.
<p>September - IRS research indicated free alternatives existed for all Form 1040EZ TeleFile users.</p>
<p>September - The ETA created an action plan for eliminating TeleFile in 2007.</p>
<p>November - The Services, Support, and Modernization Committee met to decide whether TeleFile should be shut down in 2006 or 2007; it voted seven to one to shut down TeleFile in February 2006.</p>
<p>Approximately 15.93 million TeleFile tax packages were mailed out.</p>
<p>TeleFile usage declined 6.4 percent to 3.77 million TY 2003 tax returns.</p>
<p>The participation rate was 24 percent (3.77 million of 15.93 million).</p>
<p>Calendar Year 2005</p>
<p>The total income limitation was increased from \$57,800 (\$50,000 taxable income) to \$107,950 (\$100,000 taxable income) for single filers and \$64,050 (\$50,000 taxable income) to \$115,900 (\$100,000 taxable income) for married filing jointly filers.</p>
<p>January 4 - Communication plan for TeleFile sunset in February 2006 was developed.</p>
<p>January 10 - The ETA presented the communication plan for TeleFile shutdown in February 2006 to the Services, Support, and Modernization Committee.</p>
<p>Approximately 15.05 million TeleFile tax packages were mailed out.</p>
<p>TeleFile usage declined 12.6 percent to 3.29 million TY 2004 tax returns.</p>
<p>The participation rate was 22 percent (3.29 million of 15.05 million).</p>
<p>August 16 – The IRS discontinued the TeleFile Program.</p>
<p>Calendar Year 2007</p>
<p>The IRS is scheduled to start development and implementation of the Form 1040 on the Modernized <i>e-File</i> platform, which is expected to take 2 years.</p>



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

Appendix VIII

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

June 22, 2007

RECEIVED
JUN 22 2007

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard J. Morgante *Richard J. Morgante*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: Eliminating TeleFile Increased the Cost and
Burden of Filing a Tax Return for Many Taxpayers
(Audit # 200640017)

Thank you for the opportunity to respond to your report on the IRS TeleFile program. In brief, while we may disagree on timing, it appears both the IRS and TIGTA agree that the Telefile should ultimately be shut down. We acknowledge the fact that data limitations made it difficult to recreate some of our analysis; however, we believe the IRS acted appropriately in choosing to end the program when it did. The following narrative covers some of the main topics of the report.

First, we believe there were good reasons for eliminating TeleFile. As the report notes, TeleFile usage had been on a steady decline since 1998. By 2003, it had fallen by 45 percent to 3.3 million. Our projections indicated that this trend would continue. In addition, as you point out, the program was operating far below a breakeven level.

Our experience this filing season reinforces the conclusion to eliminate TeleFile. For 2007, IRS e-file is up approximately 8.7 percent – a trend that suggests eliminating TeleFile was unlikely to have had any long-term, negative consequences for our e-file goals.

The report suggests that one of the reasons TeleFile participation was declining was that the IRS had cut back on mailings to potentially eligible filers. In fact, the IRS did limit TeleFile mailings. We did this based on research and analysis that enabled us to identify groups of taxpayers who were unlikely to use TeleFile and to stop mailings to these groups. This strategy allowed us to focus our limited resources on mailing to those taxpayers most likely to respond.



*Eliminating TeleFile Increased the Cost and Burden of Filing a
Tax Return for Many Taxpayers*

2

It is also important to point out that the link between TeleFile mailings and TeleFile usage is not clear. For example, in 2001, despite an increase in the number of packages sent, TeleFile usage actually declined.

In our experience, the reasons taxpayers chose a particular means to prepare and file their tax returns are quite complicated and sometimes difficult to predict. That is why one of the factors we considered as we thought about TeleFile was what alternatives were available to those taxpayers who would have used the service.

As you note, 97 percent of TeleFile users were eligible for the IRS Free File program. The fact that many of these taxpayers ultimately made the choice to pay for tax preparation services does not necessarily mean that eliminating TeleFile increased taxpayer burden. It does, however, raise questions about how taxpayers decide among tax preparation and filing options – questions that warrant further research as the IRS continues our efforts to improve taxpayer service.

Thank you for the opportunity to comment on this report. If you have any questions, please contact me at (404) 338-7060, or members of your staff may contact David Williams, Director, Electronic Tax Administration, at (202) 622-7990.