



*System Errors and Lower Than Expected  
Tax Return Volumes Affected the  
Implementation of the Modernized e-File  
System for Individual Tax Return Processing*

**September 8, 2010**

**Reference Number: 2010-40-111**

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.



## HIGHLIGHTS

### SYSTEM ERRORS AND LOWER THAN EXPECTED TAX RETURN VOLUMES AFFECTED THE IMPLEMENTATION OF THE MODERNIZED E-FILE SYSTEM FOR INDIVIDUAL TAX RETURN PROCESSING

## Highlights

Final Report issued on September 8, 2010

Highlights of Report Number: 2010-40-111 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

### IMPACT ON TAXPAYERS

The Internal Revenue Service (IRS) is in the process of replacing its existing electronic filing (*e-file*) platform, referred to as "the Legacy *e-File* system," with a modernized, Internet-based system, the Modernized *e-File* (MeF) system. The MeF system provides real-time processing of tax returns and extensions that will improve error detection, standardize business rules, and expedite acknowledgments. The MeF system also allows taxpayers to attach documents to their tax returns.

### WHY TIGTA DID THE AUDIT

This audit was initiated because the MeF system aims to increase *e-file* use through a system that is efficient and easy to access, use, and maintain. The overall objective of this review was to determine whether *e-filed* individual income tax returns transmitted through the MeF system are processed timely and accurately in a manner consistent with tax returns processed in the Legacy *e-File* system.

### WHAT TIGTA FOUND

Although the IRS has processed business tax returns through the MeF system since February 2004, the processing of individual tax returns presented a significant challenge. The migration of individual tax returns to the MeF system is a joint venture among the IRS, the tax return preparation industry, and the States. The IRS established a number of tools to share information and assist its stakeholders

during the development and implementation of MeF Release 6.1.

Our review identified that tax returns were erroneously rejected from the MeF system. Of the 29 MeF system business rules we reviewed, 19 (66 percent) appeared to either reject tax returns in error or reject tax returns without providing accurate explanation as to why the tax returns were rejected.

In addition, the IRS anticipated processing 9.3 million tax returns through its MeF system as of April 15, 2010. However, the IRS only received 752,320 tax returns (8.1 percent). Due to the low volume of tax returns received through the MeF system, the IRS was not able to assess its capability to handle large volumes of tax returns.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Wage and Investment Division:

- Establish processes to timely monitor the transmitting and processing of individual tax returns through the MeF system.
- Work with tax return transmitters and the States to identify and address issues that prevented them from using the MeF system and encourage them to use it during the 2011 Filing Season.

The IRS agreed with our recommendations. It employed several processes to validate the accuracy of individual tax return processing for the 2010 Filing Season. It also plans to use Business Objects for the 2011 Filing Season to identify trends that may indicate errors in the rejection or acceptance of tax returns and to ensure the explanations provided for rejected returns are correct. The IRS has also begun to work with tax return transmitters and the States to identify and address issues that prevented them from using the MeF system and encourage them to use it during the 2011 Filing Season. It plans to continue to leverage existing external venues for the MeF system to maximize its partnership, outreach, and customer service to external stakeholders. Finally, the IRS plans to identify and implement system performance enhancements.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 8, 2010

**MEMORANDUM FOR** COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

**SUBJECT:** Final Audit Report – System Errors and Lower Than Expected Tax Return Volumes Affected the Implementation of the Modernized e-File System for Individual Tax Return Processing (Audit # 200940047)

This report presents the results of our review to determine whether electronically filed (*e-filed*) individual income tax returns transmitted through the Modernized *e-File* (MeF) system are processed timely and accurately in a manner consistent with tax returns processed in the Legacy *e-File* system. This audit was included in the Treasury Inspector General for Tax Administration Fiscal Year 2009 Annual Audit Plan under the major management challenge of Implementing Tax Law Changes.

Management's complete response to the draft report is included as Appendix VII.

Copies of this report are being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



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## *Abbreviations*

<i>e-file or e-filed</i>	Electronic Filing or Electronically File(d)
IRS	Internal Revenue Service
MeF	Modernized <i>e-File</i>
PDF	Portable Document Format
SSN	Social Security Number
XML	Extensible Markup Language



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## *Background*

The Internal Revenue Service (IRS) is in the process of replacing its existing electronic filing (*e-file*) platform, referred to as “the Legacy *e-File* system,” with a new modernized, Internet-based system. The IRS refers to its modernized system as the Modernized *e-File* (MeF) system. With the MeF system, the IRS aims to increase *e-file* use through a system that is efficient and easy to access, use, and maintain.

The MeF system is being developed and implemented over multiple phases. When completed, it will provide a single method for filing all IRS tax returns, forms, and schedules via the Internet. The MeF system provides real-time processing of tax returns and extensions, which will improve error detection, standardize business rules,<sup>1</sup> and expedite acknowledgments. It also allows taxpayers to attach documents to their tax returns in a portable document format (PDF).

***The MeF system streamlines  
tax return filing processes  
and provides enhanced service to  
taxpayers, tax preparers, and  
electronic tax return transmitters.***

The IRS first introduced the MeF system in February 2004 for business taxpayers. Since that time, the IRS has expanded it to include excise and partnership tax returns with MeF Release 6.1, including U.S. Individual Income Tax Returns (Form 1040). On February 17, 2010, the MeF system began accepting transmissions of the Form 1040 and 22 related individual forms and schedules filed during the 2010 Filing Season<sup>2</sup> (see Appendix IV). The IRS estimated these forms and schedules could account for 72 million of the approximately 90 million individual tax returns *e-filed* during the 2009 Filing Season. Future releases of the MeF system will include full disaster recovery capability and the remaining Form 1040 related forms (approximately 120 forms).

The IRS plans to fully implement the MeF system in Processing Year 2012. This final release will include all individual tax returns for Tax Year 2011 and provide the capability to accept prior year individual tax returns for Tax Years 2009 and 2010. The current *e-file* system is scheduled to be retired at the end of the 2012 Filing Season (October 2012). IRS management stated that they will continue to evaluate the planned retirement of the current *e-file* system and will make adjustments to the date as necessary. The IRS estimates MeF Release 6.1 cost at \$78.7 million and a total cost of \$673 million to develop, operate, and maintain the MeF system through Fiscal Year 2020, which is the project’s planned completion date.

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<sup>1</sup> Specific criteria tax returns must meet before they are accepted for processing.

<sup>2</sup> The period from January 1 through April 15 when most individual income tax returns are filed.



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MeF system processing of individual tax returns will provide enhanced service to taxpayers, tax preparers, and electronic tax return transmitters. Figure 1 compares the planned functionality for the MeF system with that of the existing Legacy *e-File* system.

**Figure 1: Comparison of Legacy e-File and MeF Systems**

<b>Legacy e-File System</b>	<b>MeF System</b>
Utilizes different data formats for various types of tax return transmissions.	Consistent file format for tax forms and schedules (extensible markup language (XML)).
Does not accept tax return transmissions between mid-October and January each year.	Accepts tax return transmissions year-round.
Tax return transmissions are received in a batch return system with tax returns being extracted and processed at three points each day. Acknowledgement of tax return receipts provided within 2 days of receipt.	Tax return transmissions are received in a transaction-based system with tax returns processed when received. Acknowledgement of tax return receipts provided to the transmitters within a few minutes of their transmissions.
A single validation process with generic reject <sup>3</sup> messages	Multilevel validation process with detailed reject messages to provide more specific information on the reason a tax return was rejected.
Does not accept tax return supporting documentation.	Accepts tax return supporting documentation in PDF format.
Does not allow the filing of prior year tax returns during the current processing year.	Will allow the filing of prior year tax returns during the current processing year.
Does not allow the filing of an amended individual tax return.	Will allow the filing of an amended individual income tax return.

Source: IRS documentation of the functionality of the Legacy *e-File* and MeF systems.

<sup>3</sup> Tax returns submitted through *e-filing* must meet an established set of requirements before being accepted for processing. Tax returns that do not meet one or more of these requirements are rejected back to the taxpayer for correction.



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**The MeF System Uses a Multilevel Validation Process to Ensure Tax Returns Meet Filing Requirements**

Unlike the Legacy *e-File* system processing of *e-filed* tax returns, the MeF system uses three levels of validation. Once a tax return has passed all three levels of validation, it will enter the IRS' tax return processing stream. The three levels of validation include:

- **Level 1 – Schema Validation** – A MeF system tax return is divided into a series of different data structures. A schema defines the data elements within each data structure and the interrelationships among the data elements (i.e., what is required, field length, data type, allowable field values, etc.). The MeF system verifies that the data structure of each tax return transmission file meets the requirements defined in the individual schemas. If an error is found, the tax return is rejected and returned to the transmitter for correction.
- **Level 2 – National Account Profile<sup>4</sup> Checks** – The taxpayer, spouse, and dependent name controls<sup>5</sup> and Taxpayer Identification Numbers on a tax return must match the information on the National Account Profile before the IRS will accept the tax return for processing. The MeF system conducts the same basic verification as the Legacy *e-File* system. However, the MeF system verifies transmissions on a transaction basis, while the Legacy *e-File* system verifies transmissions using batch processing. As with schema validations, a tax return is rejected if it fails one or more of the National Account Profile checks. Examples of these checks include verifying that a Social Security Number (SSN) listed on the tax return is valid and that the name and SSN match IRS records.
- **Level 3 – Business Rule Checks** – The IRS established criteria or business rules each tax return must meet before it can be processed electronically. These rules are designed to validate basic requirements on a tax return, such as income limits for tax credits and deductions and the need to attach a specific schedule if certain conditions are present on the tax return. A tax return may be rejected if one or more of the business rules are not met.

This review was performed at the Wage and Investment Division Office of Electronic Tax Administration Headquarters in Washington, D.C.; the Customer Account Services Submission Processing function Headquarters in Atlanta, Georgia; and the Modernization and Information Technology Services organization Headquarters in New Carrollton, Maryland. Our testing was completed during the period November 2009 through May 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those

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<sup>4</sup> The National Account Profile is a compilation of selected entity data from the IRS Master Files, which are the databases that store various taxpayer information. The National Account Profile includes all valid and invalid taxpayer entity information.

<sup>5</sup> The name control is the first four significant letters of a taxpayer's last name that the IRS uses in connection with the taxpayer's SSN to identify the taxpayer, spouse, and dependents.



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standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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## *Results of Review*

### **System Errors and Lower Than Expected Tax Return Volumes Affected Implementation and the Ability to Evaluate System Performance**

Although the IRS has processed business tax returns through the MeF system since February 2004, processing individual tax returns through this system presented a significant challenge for the IRS. Adding individual income tax returns to the MeF system is a significant undertaking when compared with business tax returns.

***Individual tax return processing through the MeF system involves more complex programming and system requirements than business tax return processing.***

For example, processing individual tax returns requires:

- Developing formats and data structures as well as the attributes necessary for the various tax forms and schedules individuals may be required to file.
- Expanding the MeF system, including adding additional computer equipment, so that a much

higher volume of tax returns can be received and processed.

- Developing interfaces with 21 different IRS system applications.
- Establishing a new and much more extensive set of verifications or business rules to ensure that tax returns filed have a high probability of being accepted and processed without error. The IRS was also required to incorporate several important tax law changes for a number of the business rules.

As of April 15, 2010, the IRS successfully accepted 618,839 individual tax returns transmitted through the MeF system for processing.

#### **The IRS developed tools and processes to inform and engage stakeholders in the implementation of MeF system individual tax return processing**

The migration of individual tax returns to the MeF system is a joint venture among the IRS, the tax return preparation industry, and the various States. The IRS recognizes that successful implementation and migration to the MeF system for individual tax returns hinges on its stakeholders' ability to develop and upgrade their tax return preparation and transmission programs and processes. The IRS established a number of tools to share information and assist its stakeholders during the development and implementation of MeF Release 6.1 including:



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- Holding monthly Form 1040 MeF working group calls with participants from the States and tax return transmitters, preparers, and software developers to discuss their concerns, including what tax forms and schedules would be allowed, issues with business rules, and difficulties experienced with transmissions.
- Holding monthly Form 1040 MeF Executive Steering Council calls with a select group of cross-functional IRS and tax industry stakeholders to discuss common interests and concerns related to the design, development, and deployment for individual income tax return processing. The IRS began these calls in the fall of 2007, with the start of development of the MeF system for individual tax returns, and continued the calls throughout development and implementation of MeF Release 6.1.
- Establishing a MeF 1040 mailbox to allow external stakeholders such as tax return transmitters to submit technical and procedural questions via electronic mail to the IRS. The IRS received 303 emails to this mailbox between October 2009 and April 2010.
- Establishing various MeF system informational pages on IRS.gov to provide one source for information related to MeF. Available information includes the system's operational status, updates on recent issues affecting the MeF system, and details about certain business rules that are affecting tax return transmissions.
- Offering stakeholders the ability to receive automatic email alerts. These alerts may include updates about system issues, information on business rules for problems that have developed, and changes to publications and relevant data requirements and formats. The IRS issued 81 automatic email alerts related to the MeF system between October 2009 and April 2010.

Once the IRS began accepting individual tax returns through the MeF system, it continued to provide support to external stakeholders by holding daily/weekly conference calls to discuss immediate concerns or problems being experienced. In addition, the IRS established individual points of contact within the IRS to enable stakeholders to raise concerns and receive assistance during the last phase of testing and initial startup of tax return transmissions. Overall, comments received from tax return transmitters we surveyed were consistent in complimenting the IRS on sharing information, providing needed guidance, and responding to concerns.

***Tax return transmitters we surveyed complimented the IRS on sharing information, providing guidance when needed, and responding to their concerns.***

Although the IRS provided significant support to its stakeholders, our review showed that the IRS did not develop effective processes to identify errors once MeF system individual tax return processing began. In addition, the low volume of individual tax return transmissions via the MeF system makes it difficult to evaluate the success of the system. The MeF system is a critical component of the IRS' efforts to modernize its *e-file* program.



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The successful migration of individual tax returns to the MeF system becomes even more important as the number of taxpayers who *e-file* continues to grow. As of April 12, 2010, less than 1 percent of the almost 90 million *e-filed* individual tax returns were filed through the MeF system. Recent legislation will result in further increases in the number of tax returns that are *e-filed*. The Worker, Homeownership, and Business Assistance Act of 2009<sup>6</sup> mandated that all tax return preparers who prepare more than 10 individual tax returns annually must submit tax returns to the IRS electronically. As the IRS continues to expand MeF system processing of individual tax returns, the development of processes to identify system errors and increase participation will assist in achieving the IRS Restructuring and Reform Act of 1998<sup>7</sup> goal of receiving at least 80 percent of all tax returns in an electronic format.

**Effective processes were not developed to identify MeF system individual tax return errors**

Erroneously rejected tax returns and missing business rules hindered the success of MeF Release 6.1. Our review of 29<sup>8</sup> MeF system business rules identified that 19 (66 percent) of the 29 rules we analyzed as of April 21, 2010, appeared to reject tax returns in error or reject the tax returns without providing accurate explanations as to why they were rejected. The accuracy of the explanation provided is essential to the transmitter's/preparer's ability to correct the error condition. Tax returns were erroneously rejected from the MeF system because of incorrect system requirements and programming errors. Erroneous rejections could result in taxpayers not receiving tax credits and other tax benefits to which they are entitled. In addition, inaccurate and confusing explanations of why tax returns are rejected can cause taxpayers to make unnecessary changes to their tax returns. Appendix VI provides a summary of the errors we identified and reported to the IRS between February 17 and April 21, 2010.

In a separate review of MeF Release 6.1 system development activities,<sup>9</sup> we identified that the MeF System Development Project Team created plans to ensure required capabilities were developed by tracing release requirements between the Business System Requirements Report Final<sup>10</sup> and the System Integration and Test Plan.<sup>11</sup> However, while the System Integration Test results provided by the IRS show most application requirements were tested and passed,

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<sup>6</sup> Pub. L. No. 111-92, 123 Stat. 2984 (2009).

<sup>7</sup> 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.).

<sup>8</sup> We selected these business rules for review based on the volume and concerns identified prior to the IRS accepting tax returns through the MeF system on February 17, 2010.

<sup>9</sup> *Modernized e-File Will Enhance Processing of Electronically Filed Individual Tax Returns, but System Development and Security Need Improvement* (Reference Number 2010-20-041, issued May 26, 2010).

<sup>10</sup> This report presents the customer and system requirements, including system security requirements, authentication requirements for transmitters, and capability to handle peak tax return transmissions.

<sup>11</sup> This plan should ensure that the test's purpose is accomplished (the purpose of the test is to accept, integrate, and test system components received from development until the full system has been successfully built and all agreed-upon customer requirements are tested).



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supporting test documents provided to us after the audit's closing conference showed that many of the requirements were in fact not tested. Many more failed the tests and no indication was provided to show the defects were corrected. In spite of this conflicting information and the possibility that some requirements were not tested or working as intended, the IRS deployed MeF Release 6.1 on February 17, 2010.

In this review we also analyzed system documentation prior to the IRS accepting tax returns through the MeF system to determine if all of the applicable business rules included in the Legacy *e-File* system were programmed for the MeF system. Our analysis identified six business rules that were missing from the MeF system. These rules affected the Individual

***We identified six business rules that were not programmed into the MeF system. Incorrect business rules could result in taxpayers receiving credits and benefits to which they were not entitled.***

Retirement Account deduction, Additional Child Tax Credit, Education Credits, Earned Income Tax Credit, and capital gains and losses. These missing business rules could have resulted in taxpayers receiving tax credits and other benefits to which they were not entitled and not receiving those to which they were. We notified the IRS that these criteria were missing from the MeF system prior to it accepting tax return transmissions through the system. Appendix V

provides a summary of the conditions we identified and reported to the IRS. The IRS took action to correct two of the six conditions we identified and indicated that the remaining four conditions were covered by existing MeF system processes or business rules and did not require any additional action.

The IRS also identified and addressed 22 additional errors or concerns and has provided guidance to the stakeholder community to ensure the MeF system meets current and future taxpayer needs. Although the IRS had processes in place to monitor the implementation of the system, those processes did not provide adequate testing of the accuracy of the tax return reject process. The IRS did not have a comprehensive plan in place that would provide an adequate evaluation of all business rules being applied to tax returns submitted through the MeF system.

Adding individual tax return processing for the MeF system required the IRS to create new processes. Critical processes such as the accepting and rejecting of tax returns were newly created and required extensive, complex computer programming. The risk for error was extremely high and required a detailed plan to extensively test and monitor the system's implementation. However, the IRS did not have a well documented plan, and the steps it took to monitor the acceptance and rejection of tax returns did not provide a comprehensive review of these processes. For example, the IRS selected and reviewed a statistically valid sample of 30 of each of the tax forms and schedules filed through the MeF system beginning February 17, 2010. The IRS reviewed each of the sampled tax forms and schedules to determine if the system was correctly accepting or rejecting the tax returns based on the business rules pertaining to these forms and schedules. The samples did not ensure every business rule applicable to tax returns



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transmitted to the MeF system was evaluated. The IRS is aware that its statistical sampling process did not test all of the business rules that applied to individual tax returns transmitted through the system.

In addition, the IRS did not place enough emphasis on testing the tax return rejection process. The IRS' primary focus in its statistical testing was to ensure tax returns were properly accepted for processing; two-thirds of the samples for each tax form or schedule were accepted tax returns. Almost all of the conditions we identified related to the improper rejection of tax returns. As of April 15, 2010, 133,481 (18 percent) of the 752,320 tax returns transmitted to the MeF system were rejected.<sup>12</sup> These tax returns were rejected for 1 or more of 202 business rules in place on April 15, 2010.<sup>13</sup>

Further reducing the IRS' ability to receive timely input from tax return transmitters using the MeF system was that the IRS allowed them to subsequently transmit tax returns rejected by the MeF system through the Legacy *e-File* system. The IRS directed the transmitters to temporarily resubmit some rejected tax returns with specific conditions through the Legacy *e-File* system until errors in the MeF system could be corrected. Resubmitting tax returns through the Legacy *e-File* system in these instances allowed the IRS to timely accept and process affected tax returns and reduce the burden on the transmitters and the taxpayers. However, the IRS had no guidelines in place as to under what circumstances transmitters were to use the Legacy *e-File* system when a tax return was rejected. Allowing transmitters to use both *e-file* systems could result in the IRS not receiving real-time input from its stakeholders on potential concerns that may have resulted from the incorrect rejection of tax returns by the MeF system.

**Lower than expected tax return transmissions limit the IRS' ability to evaluate the performance of the MeF system**

The IRS anticipated processing 9.3 million tax returns through its MeF system by April 15, 2010. However, the IRS only received 752,320 tax returns (8 percent). Due to the low volume of tax returns received through the MeF system, the IRS was not able to assess the capability of the system to handle large volumes of tax returns. Recognizing the challenges in implementing the MeF system for individual tax returns, the IRS developed a *Volume Management Plan* to manage the volume of individual tax returns and forms received through the MeF system. The MeF Release 6.1 included a plan to effectively manage the potentially large volume of individual tax returns to be processed. This plan incorporated a careful approach by limiting the volume of forms for processing in Calendar Year 2010 so that the IRS and tax return transmitters had an opportunity to observe system behavior and responses. Figure 2 shows the volume of individual

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<sup>12</sup> A tax return may be submitted and rejected by the MeF system more than one time.

<sup>13</sup> A total of 419 business rules were programmed in the MeF system as of April 15, 2010. However, the tax returns transmitted as of April 15, 2010, only violated 202 of these rules. No tax return transmitted had conditions that violated one of the remaining 217 business rules.



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tax returns the IRS estimated MeF Release 6.1 would be able to process during the periods specified based on agreements with transmitters.

**Figure 2: MeF System Volumes for Individual Tax Returns<sup>14</sup>**

Date	Tax Return Volumes	
	Estimated	Actual
February 17–28, 2010	1.4 million	55,603
March 1–31, 2010	4.0 million	319,184
April 1–15, 2010	3.9 million	377,533

*Source: IRS estimated volume based upon adjusted Form 1040 volumes for Tax Year 2009 and actual volume per IRS E-File Reports of actual tax return receipts for the 2010 Filing Season.*

In addition, the Volume Management Plan expected 16 States and 33 tax return transmitters to participate. As of February 17, 2010, 10 States and 11 transmitters had met the requirements to participate in the MeF system. States and transmitters had to notify the IRS several months prior to the filing season that they would participate in the MeF system. Once approved by the IRS, the participant would have to successfully complete the IRS testing process that began on November 2, 2009. As of April 15, 2010, only 11 transmitters and 11 States participated in the MeF system.

***As of April 15, 2010, only  
11 States and 11 transmitters  
had participated, which  
contributed to lower than  
expected tax return volumes.***

IRS management indicated that the number of participants and the associated volume of tax return transmissions were low because participation in the MeF system was voluntary for the 2010 Filing Season. The IRS also indicated that budget cuts and the lagging economy may have impacted some States' ability to complete the development of their systems in time to participate this filing season. For some participants, using the MeF system requires modifying their current *e-file* system or developing a new system to conform to the XML format.

We surveyed six tax return transmitters with varying levels of participation in the MeF system to determine what factors influenced their participation.<sup>15</sup> We received responses from four of the six transmitters we surveyed. Three of the four transmitters who responded were not participating on February 17, 2010, and indicated that concerns with the stability of the MeF system influenced their decision on whether to participate in using the system.

<sup>14</sup> The estimated totals and actual volumes for the February, March, and April time periods do not include State income tax returns and Applications of Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868).

<sup>15</sup> We selected two tax return transmitters participating on February 17, 2010; two transmitters who began participating after February 17, 2010; and two transmitters who were not participating as of March 9, 2010.



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- Two transmitters chose not to participate until after April 15, 2010, because of concerns with the ability of the system to be continuously available to receive tax return transmissions and the need to complete internal system redesign.
- One transmitter began transmitting individual tax returns on February 18, 2010, but stopped using the system on April 11 because of concerns with the system's ability to be continually available to receive tax return transmissions. The concern was that unavailability of the system at this critical time (filing season) could significantly delay the successful filing and processing of the clients' tax returns.

When we discussed the lower than expected volumes with IRS management, they cautioned that their Volume Management Plan was intended to provide volume limits per tax return transmitter to maintain system performance and not to establish expected tax return receipts. IRS management agreed that they did not receive a sufficient individual tax return volume to effectively evaluate the performance of the MeF Release 6.1. They advised us that they will use the actual data collected to evaluate the MeF system's capabilities with the hopes it can remain on schedule with its plans to fully implement the MeF system for individual tax returns.

## ***Recommendations***

The Commissioner, Wage and Investment Division, should:

**Recommendation 1:** Establish processes to timely monitor the transmission and processing of individual tax returns as they are processed through the MeF system. These processes should include an analysis of available tax return processing data to identify trends that may indicate errors in the rejection or acceptance of tax returns. These processes should also include an analysis of the responses generated when a tax return is rejected to ensure the explanation provided is correct.

**Management's Response:** The IRS agreed with this recommendation. For the 2010 Filing Season, it employed several processes to validate the accuracy of individual tax return processing. For the 2011 Filing Season, the IRS plans to use Business Objects (an enterprise reporting and analysis tool) in addition to those processes used for the 2010 Filing Season to analyze available tax return data to identify trends that may indicate errors in the rejection or acceptance of tax returns and ensure the explanation provided for rejection of returns is correct.

**Recommendation 2:** Work with tax return transmitters and the States to identify and address concerns and conditions that prevented them from participating in the MeF system and encourage them to participate in it during the 2011 Filing Season.

**Management's Response:** The IRS agreed with this recommendation. It has begun working with tax return transmitters and States to identify and address concerns and conditions that prevented them from participating in the MeF system and encourage them



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to participate in the MeF system during the 2011 Filing Season. It also plans to continue to leverage existing external venues for the MeF system (i.e., 1040 MeF Executive Council, 1040 MeF Working Group, and Federation of Tax Administrators) in conjunction with MeF system products and services to maximize its partnership, outreach, and customer service to external stakeholders.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to determine whether *e-filed* individual income tax returns transmitted to the MeF system are processed timely and accurately in a manner consistent with tax returns processed by the Legacy *e-File* system. To accomplish this objective, we:

- I. Determined whether the IRS properly planned for the deployment of the MeF system for individual income tax returns.
- II. Determined whether the MeF system correctly rejected and accepted individual income tax returns during processing and whether the IRS ensured that accepted tax returns were processed timely and recorded accurately when compared with similar tax returns accepted under the Legacy *e-File* system during the 2010 Filing Season.<sup>1</sup>
  - A. Obtained the MeF system documentation needed to allow us, with the assistance of the Treasury Inspector General for Tax Administration Information Technology function and the IRS, to obtain and analyze individual income tax returns processed by the MeF system during the 2010 Filing Season.
  - B. Obtained IRS test results from three separate IRS tests, referred to as “Hub Testing,” conducted in January and February 2010.
  - C. Obtained data extracts of rejected individual income tax returns and the associated business rule<sup>2</sup> reasons for those rejections at the earliest points possible in the MeF system process. We analyzed this data and judgmentally selected 195 tax returns from a population of 3,311 tax returns for which we reviewed the information stored on the IRS’ Integrated Data Retrieval System<sup>3</sup> to verify whether those returns were correctly rejected and proper explanations were provided to the taxpayers. We validated the reliability of our computer-processed data by comparing the data extracts with information from the IRS’ Integrated Data Retrieval System.
  - D. Obtained IRS statistics on volumes of rejected electronic tax returns for both the Legacy *e-File* and MeF systems and compared the volumes by business rule (MeF system) to the associated error reject code (Legacy *e-File* system). For any significant variance, we performed further analysis using data from the IRS’

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<sup>1</sup> The period from January 1 through April 15 when most individual income tax returns are filed.

<sup>2</sup> Specific criteria tax returns must meet before they are accepted for processing.

<sup>3</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer’s account records.



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Integrated Data Retrieval System and the IRS' Return Request and Display System<sup>4</sup> to determine if the rejection process was properly functioning to ensure against returns being incorrectly accepted for processing.

- E. Obtained the MeF system individual income tax return data that were accepted and processed from the weekly IRS Individual Return Transaction File<sup>5</sup> for all accepted and processed tax returns for the period February 17 through April 15, 2010. We utilized this data to determine that the MeF system was accepting only those tax forms and schedules prescribed for this filing season, that the accepted tax forms and schedules were correctly processed, and that IRS corrective actions to the issues we identified prior to the filing season (see Appendix V) were effective. In completing our analysis, we also reviewed judgmental samples of 100 tax returns from a population of 1,515 tax returns that met certain criteria. We validated the reliability of the IRS' Individual Return Transaction File computer-processed data by comparison with the IRS' Integrated Data Retrieval System and Return Request and Display System.

**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: 1) the controls in place to ensure all of the error reject codes included in the Legacy *e-File* system were included in the MeF system and 2) controls in place to ensure tax returns were properly accepted or rejected by the MeF system.

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<sup>4</sup> The IRS' Return Request and Display System displays specific tax return and status information for tax returns processed through the MeF tax system.

<sup>5</sup> The Return Transaction File contains all edited, transcribed, and error-corrected data from the Form 1040 series and related forms for the current processing year and 2 prior years.



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**Appendix II**

*Major Contributors to This Report*

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

Russell P. Martin, Director

Deann L. Baiza, Audit Manager

John L. Hawkins, Lead Auditor

Sharon A. Buford, Senior Auditor

Bonnie G. Shanks, Senior Auditor

Linna K. Hung, Auditor



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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Operations Support OS  
Deputy Commissioner for Services and Enforcement SE  
Chief Technology Officer OS:CTO  
Commissioner, Wage and Investment Division SE:W  
Deputy Commissioner of Operations SE:W  
Deputy Commissioner of Services SE:W  
Associate Chief Information Officer, Applications Development OS:CTO:AD  
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division  
SE:W:ETARC  
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PRA:PEI  
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 Liaisons:  
    Supervisor, Modern Information Tech Services OS:CTO  
    Chief, Program Evaluation and Improvement, Wage and Investment Division  
    SE:W:S:PRA:PEI



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## **Appendix IV**

### *Individual Tax Return Forms and Schedules Included for Processing in Modernized e-File Release 6.1 Deployment*

**Form 1040** – U.S. Individual Income Tax Return

**Schedule A** – Itemized Deductions

**Schedule B** – Interest and Ordinary Dividends

**Schedule C** – Profit or Loss From Business

**Schedule D** – Capital Gains and Losses

**Schedule E** – Supplemental Income and Loss

**Schedule EIC** – Earned Income Credit

**Schedule M** – Making Work Pay and Government Retiree Credits

**Schedule R** – Credit for the Elderly or the Disabled

**Schedule SE** – Self-Employment Tax

**Form 1099-R** – Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

**Form 2106** – Employee Business Expenses

**Form 2210** – Underpayment of Estimated Tax by Individuals, Estates and Trusts

**Form 2441** – Child and Dependent Care Expenses

**Form 4562** – Depreciation and Amortization

**Form 4868** – Application of Automatic Extension of Time to File U.S. Individual Income Tax Return

**Form 8283** – Noncash Charitable Contributions

**Form 8812** – Additional Child Tax Credit

**Form 8829** – Expenses for Business Use of Your Home

**Form 8863** – Education Credits (American Opportunity, Hope, and Lifetime Learning Credits)



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**Form 8880** – Credit for Qualified Retirement Savings Contributions

**Form 8888** – Direct Deposit of Refund to More Than One Account

**Form W-2** – Wage and Tax Statement



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**Appendix V**

*Modernized e-File Business Rule<sup>1</sup> Issues Identified  
During Pre-Processing Testing<sup>2</sup>*

Issue	Date IRS Notified	IRS Action Taken	Audit Comment
Making Work Pay Credit claims will incorrectly reject if only one spouse has an Individual Taxpayer Identification Number, but the other spouse has a valid SSN.	10/15/2009	<b>No Action Taken.</b> The IRS did not agree. It indicated that the current programming and business rules addressed our concern.	We do not agree that this issue was corrected. We identified the same issue occurring once the IRS began processing tax returns using the MeF system. See Appendix VI.
American Opportunity Credit rules contain the wrong maximum credit limits, Adjusted Gross Income limits, and qualifying child expense limits.	11/9/2009	<b>Action Taken.</b> The IRS had already identified the issues with two of the business rules we identified and agreed to the remaining issues. Revisions to the remaining rules in question were completed on 2/1/2010.	We agree that the actions taken will correct the issues.
The Earned Income Tax Credit rule for individuals with no qualifying children incorrectly states the age requirements to include taxpayers that are age 65.	11/9/2009	<b>Action Taken.</b> Changes were implemented in the 12/23/2009 release of the business rules.	We agree that the actions taken will correct the issue.
A rule is missing to deny an Individual Retirement Arrangement deduction for contributions made for age 70½ and older.	12/1/2009	<b>Action Taken.</b> The rule was planned but was scheduled for a later system release. It was added to Version 2009v4.0 of the MeF 1040 Business Rules released 12/8/2009.	We agree that the actions taken will correct the issue.

<sup>1</sup> Specific criteria tax returns must meet before they are accepted for processing.

<sup>2</sup> A number of the conditions we identified involve errors with more than one MeF system business rule.



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Issue	Date IRS Notified	IRS Action Taken	Audit Comment
The Child & Dependent Care Credit rule does not include the exception to the 2-income requirement when either the primary or secondary taxpayer has a date of death.	12/1/2009	<b>Action Taken.</b> Changes were scheduled but were not made before 2/17/2010. Interim procedures are to send these returns to Error Resolution. A new business rule was created and included in the 2/23/2010 updates to the business rules.	We agree that the actions taken will correct the issue.
The MeF system does not address the reporting requirements for taxable interest & dividends on Interest and Ordinary Dividends (Schedule B) for amounts less than \$1,500.	12/1/2009	<b>Action Taken.</b> Changes were scheduled but were not made before 2/17/2010. Interim procedures are to send these returns to Error Resolution. New business rules were added in the 2/23/2010 updates.	We agree that the actions taken will correct the issue.
A rule is missing to verify the amount of the Motor Vehicle Sales Tax Deduction on Itemized Deductions (Schedule A), line 7.	1/26/2010	<b>No Action Taken.</b> The IRS did not agree and indicated the MeF system does not need a separate rule since it is pulling the Schedule A, line 7, amounts directly from the worksheet.	We do not agree that the actions taken corrected the issue. We identified the same issue occurring once the IRS began processing MeF system tax returns. See Appendix VI.
A rule is missing to require the Additional Child Tax Credit Form (Form 8812) when the Additional Child Tax Credit is claimed.	1/26/2010	<b>No Action Taken.</b> The IRS responded that the MeF system has a corresponding business rule.	We agree that the IRS did not have to take additional actions.
A rule is missing to require the Education Credits (American Opportunity, Hope and Lifetime Learning Credits) (Form 8863) when education credits are claimed.	1/26/2010	<b>No Action Taken.</b> The IRS responded that the MeF system has a corresponding business rule.	We agree that the IRS did not have to take additional actions.



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Issue	Date IRS Notified	IRS Action Taken	Audit Comment
A rule is missing to require an amount on the U.S. Individual Income Tax Return (Form 1040), line 13 (capital gains and loss), if the Capital Gains and Losses (Schedule D) not required indicator is checked.	1/26/2010	<b>No Action Taken.</b> The IRS initially agreed a change was needed. On 4/23/2010, it corrected its initial response, indicating the condition is already addressed by a business rule.	We agree that the IRS did not have to take additional actions.
The MeF system does not include the variance for the check of total withholding on Form 1040, line 61, to the total withholding on all Wage and Tax Statements (Form W-2) and Information Reporting Documents (Form 1099).	1/26/2010	<b>Action Taken.</b> The applicable business rule was revised in the 2/1/2010 updates to the business rules.	We agree that the actions taken will correct the issue.
MeF system business rules do not reflect the increased Adjusted Gross Income limits for the Student Loan Deduction.	1/26/2010	<b>Action Taken.</b> The IRS changed the Adjusted Gross Income limits in the 2/1/2010 updates to the business rules.	We agree that the actions taken will correct the issue.
The MeF system does not require the taxpayer to provide both the name and SSN of a qualifying person when filing as a Head of Household.	1/26/2010	<b>Action Taken.</b> The applicable business rule was revised in the 2/1/2010 updates.	We agree that the action taken should have corrected the issue; however, it resurfaced again during the February 11, 2010, Hub Testing. We notified the IRS on 2/16/2010.
The MeF system does not include the exception for the Earned Income Tax Credit qualifying child age requirement when the qualifying child is permanently and totally disabled.	1/26/2010	<b>No Action Taken.</b> The IRS responded that the MeF system has already included this change in the implementation notes for these rules.	We agree that the IRS did not have to take additional action.



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Issue	Date IRS Notified	IRS Action Taken	Audit Comment
The MeF system incorrectly allows certain personal expenses claimed on Schedule A, line 28, Other Miscellaneous Deductions.	1/26/2010	<p><b>No Action Taken.</b></p> <p>The IRS responded that no additional business rule is needed and the disallowance of these personal expenses is being handled correctly.</p>	We agree that the IRS did not have to take additional action.
A rule is missing to require an Information to Claim Earned Income Credit After Disallowance (Form 8862) on claims filed by taxpayers who need to show that they have been recertified and are now eligible.	2/9/2010	<p><b>Action Taken.</b></p> <p>The IRS added a business rule in the 3/5/2010 updates. Interim procedures sent returns to Submission Processing Rejects.</p>	We agree that the actions taken will correct the issue.
The MeF system business rule is incorrectly applied to tax returns when a taxpayer filing as Head of Household provides the name and SSN of a qualifying child as required.	2/16/2010 Issued as an alert on 1/26/2010.	<p><b>Action Taken</b></p> <p>The issues reported on 1/26/2010 are continuing and IRS actions taken on 2/1/2010 are not functioning properly. The IRS had already identified this issue and implemented additional changes on 2/17/2010.</p>	We agree that the actions taken will correct the issue.



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**Appendix VI**

*Modernized e-File Business Rule<sup>1</sup> Issues Identified  
During Processing As of April 21, 2010<sup>2</sup>*

Issue	Date IRS Notified	IRS Action Taken	Audit Comment
Tax returns are rejecting in error when the Making Work Pay Credit is claimed and one spouse has an Individual Taxpayer Identification Number. Per the eligibility requirements, these taxpayers should receive the credit if one spouse has an Individual Taxpayer Identification Number as long as one spouse has an SSN.	2/17/2010  Issued as an alert in planning.	<b>Action Taken.</b>  The IRS had already identified this issue and updated the existing business rule on 2/15/2010. It created a new business rule on 2/15/2010. Programming changes were implemented on 2/17/2010.	We agree that the actions taken will correct the issue.
Tax returns are rejecting in error when a taxpayer with an Individual Taxpayer Identification Number files a tax return with a Wage and Tax Statement (Form W-2) that has an SSN. Generally, an employee's SSN on Form W-2 must match either the primary or the secondary taxpayer's SSN on the tax return. However, the Legacy <i>e-File</i> system provides an exception for a taxpayer who <i>e-files</i> with an Individual Taxpayer Identification Number even if the Form W-2 was issued with an SSN.	2/18/2010	<b>Action Taken</b>  The IRS had already identified this issue and implemented changes on 2/17/2010 prior to startup.	We agree that the IRS did not have to take additional actions.

<sup>1</sup> Specific criteria tax returns must meet before they are accepted for processing.

<sup>2</sup> A number of the conditions we identified involve errors with more than one MeF system business rule.



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Issue	Date IRS Notified	IRS Action Taken	Audit Comment
Tax returns are rejecting in error when the total withholding on the U.S. Individual Income Tax Form (Form 1040) is within \$5 of the total withholding on all Forms W-2 and Information Reporting Documents (Forms 1099) and a Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, Individual Retirement Accounts, Insurance Contracts, etc. (Form 1099-R) are present.	2/19/2010  Issued as an alert in planning.	<b>No Action Taken</b>  The IRS did not agree. It indicated that tax returns with this condition are being correctly rejected.	We agree that the IRS did not have to take additional actions.
Tax returns are rejecting in error when there are multiple dependents identified on the Child and Dependent Care Expenses (Form 2441) and the qualified expenses entered on Form 2441, line 2(c), were not child-specific.	2/24/2010	<b>Action Taken.</b>  Changes were implemented on 3/8/2010.	We agree that the actions taken will correct the issue.
Tax returns are rejecting in error when a taxpayer names the preparer as the third-party designee by inserting "Preparer" instead of the preparer's name on the Third-Party Designee name line.	2/25/2010	<b>Action Taken.</b>  The IRS had already identified the issue and implemented changes in 2/1/2010 updates to the business rules.	We agree that the IRS did not have to take additional actions.
The deduction amount from the New Motor Vehicle Sales Tax Deduction worksheet on Itemized Deductions (Schedule A) is not being captured by the MeF system.	2/26/2010  Issued as an alert in planning.	<b>Action Taken.</b>  Changes were implemented on 3/7/2010.	We agree that this issue has been addressed with an interim solution to reduce the burden on IRS' external partners during the filing season.



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Issue	Date IRS Notified	IRS Action Taken	Audit Comment
<p>Incorrect reject rules are generating when there is a dependent SSN/name control mismatch and the business rule that requires the dependent SSN and name control to match the <i>e-file</i> database generates. If the Earned Income Tax Credit was claimed, the business rule addressing a SSN/name control mismatch for a qualifying child also generates.</p>	3/2/2010	<p><b>Action Planned</b></p> <p>The IRS plans to make changes for Release 6.2 for Processing Year 2011. These changes are complex and, as such, are being deferred to a later release to mitigate the risk to this filing season. An interim plan will be implemented to mitigate the impact on taxpayers.</p>	<p>Although the IRS is taking interim steps to reduce the burden on taxpayers, we do not agree that the issue has been resolved. The issue will not be addressed until Release 6.2.</p>
<p>Tax returns are rejecting in error when the taxpayer correctly provided the prior year Adjusted Gross Income and/or Personal Identification Number as required for electronically filed returns.</p>	3/2/2010	<p><b>Action Planned</b></p> <p>The IRS plans to make changes for Release 6.2 for Processing Year 2011. These changes are complex and, as such, are being deferred to a later release to mitigate the risk to this filing season. An interim plan will be implemented to mitigate the impact on taxpayers.</p>	<p>Although the IRS is taking interim steps to reduce the burden on taxpayers, we do not agree that the issue has been resolved. The issue will not be addressed until Release 6.2.</p>
<p>Incorrect reject rules are generating when there is a primary SSN/name control mismatch and the business rule that requires the primary SSN and name control to match the <i>e-file</i> database generates.</p>	3/3/2010	<p><b>Action Planned</b></p> <p>The IRS plans to make changes for Release 6.2 for Processing Year 2011. These changes are complex and, as such, are being deferred to a later release to mitigate the risk to this filing season. An interim plan will be implemented to mitigate the impact on taxpayers.</p>	<p>Although the IRS is taking interim steps to reduce the burden on taxpayers, we do not agree that the issue has been resolved. The issue will not be addressed until Release 6.2.</p>



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Issue	Date IRS Notified	IRS Action Taken	Audit Comment
<p>Incorrect reject rules are generating when there is a secondary SSN/name control mismatch and the business rule that requires the secondary SSN and name control to match the <i>e-file</i> database generates.</p>	3/5/2010	<p><b>Action Planned</b></p> <p>The IRS plans to make changes for Release 6.2 for Processing Year 2011. These changes are complex and, as such, are being deferred to a later release to mitigate the risk to this filing season. An interim plan will be implemented to mitigate the impact on taxpayers.</p>	<p>Although the IRS is taking interim steps to reduce the burden on taxpayers, we do not agree that the issue has been resolved. The issue will not be addressed until Release 6.2.</p>
<p>Incorrect reject rules are generating when there is an employer name/Employer Identification Number mismatch on Form W-2 and the business rule that requires the Employer Identification Number to match the information in the <i>e-file</i> database generates. We also noted a similar condition could exist with payer name/Employer Identification Number mismatches on Form 1099-R and the business rule that requires the Employer Identification Number to match the <i>e-file</i> database.</p>	3/5/2010	<p><b>Action Planned</b></p> <p>The IRS plans to make changes for Release 6.2 for Processing Year 2011. These changes are complex and, as such, are being deferred to a later release to mitigate the risk to this filing season. An interim plan will be implemented to mitigate the impact on taxpayers.</p>	<p>Although the IRS is taking interim steps to reduce the burden on taxpayers, we do not agree that the issue has been resolved. The issue will not be addressed until Release 6.2.</p>
<p>Tax returns were incorrectly rejecting because the primary taxpayer's SSN had already been used to file a tax return this year when the primary SSN had not been previously used.</p>	3/5/2010	<p><b>Action Taken.</b></p> <p>Changes were made on 3/28/2010.</p>	<p>We agree that the actions taken will correct the issue.</p>



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Issue	Date IRS Notified	IRS Action Taken	Audit Comment
Incorrect reject rules are generating for the Making Work Pay Credit when there is a primary or secondary SSN/name control mismatch and the applicable business rules are correctly applied.	3/12/2010	<p><b>Action Planned</b></p> <p>The IRS plans to make changes for Release 6.2 for Processing Year 2011. These changes are complex and, as such, are being deferred to a later release to mitigate the risk to this filing season. An interim plan will be implemented to mitigate the impact on taxpayers.</p>	Although the IRS is taking interim steps to reduce the burden on taxpayers, we do not agree that the issue has been resolved. The issue will not be addressed until Release 6.2.
Tax return information from Interest and Ordinary Dividends (Schedule B) on accepted MeF system tax returns is not being correctly recorded on the IRS' Individual Return Transaction File. <sup>3</sup>	4/9/2010	<p><b>Action Planned</b></p> <p>The IRS agreed and is requesting that computer programming changes be made so that interest and dividend amounts are properly recorded on the Individual Return Transaction File.</p>	We agree that the actions, when taken, will correct the issue.
Tax returns are being rejected without any business rule explanations appearing on the IRS' Tax Return Database. <sup>4</sup>	4/21/2010	<p><b>Action Planned</b></p> <p>The IRS agreed and will be making changes during the week of May 10<sup>th</sup> to update a system table that provides the data to other IRS systems for several new business rules that have been added to the existing set of rules.</p>	We agree that these actions will correct the issue.

<sup>3</sup> The Return Transaction File contains all edited, transcribed, and error-corrected data from the Form 1040 series and related forms for the current processing year and 2 prior years.

<sup>4</sup> The IRS' Tax Return Database contains tax return source information for all electronically filed tax returns.



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**Appendix VII**

*Management's Response to Draft Report*

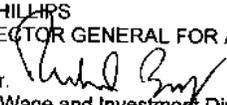


DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

RECEIVED  
AUG 13 2010  
BY: DAS

August 6, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr.   
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – System Errors and Lower Than Expected  
Tax Return Volumes Affected the Implementation of the  
Modernized e-File System for Individual Tax Return Processing  
(Audit # 200940047)

Thank you for the opportunity to comment on the draft audit report concerning the processing of Individual Tax Returns through the Modernized e-File (MeF) system.

Your report accurately describes:

- The strategic importance of MeF to increase e-file use through the benefits it offers compared to the Legacy e-File system;
- the significant undertaking and complexities of developing and deploying the individual tax return processing capabilities compared to business tax returns;
- the partnership and dependency with the tax return preparation/software industry and States to migrate to MeF; and
- the challenges the IRS faced in the first phase deployment of the 1040 MeF program.

The challenges and types of processing errors identified in your report were the kind of issues we anticipated. As your report notes, we created a number of tools and processes to share information and communicate system status and issues with the industry. Our top priority was to ensure that accepted returns were processed accurately in a manner consistent with Legacy e-File. Our analysis shows that they were.

Our second priority was to correct problems, or to establish communications and workarounds to address erroneous rejects. Using information identified during this audit, stakeholder engagement, and through our operations and maintenance function, we took all appropriate and necessary action to address issues as they were identified.



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We agree with the two recommendations and look forward to continued involvement by the Treasury Inspector General for Tax Administration in the next phase of the 1040 MeF deployment.

Our specific comments to your recommendations are attached. If you have any questions, please contact me, or a member of your staff may contact David Williams, Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division, at (202) 622-7990.

Attachment



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Attachment

The Commissioner, Wage and Investment Division, should:

**RECOMMENDATION 1**

Establish processes to timely monitor the transmission and processing of individual tax returns as they are processed through the MeF system. These processes should include an analysis of available tax return processing data to identify trends that may indicate errors in the rejection or acceptance of tax returns. These processes should also include an analysis of the responses generated when a tax return is rejected to ensure the explanation provided is correct.

**CORRECTIVE ACTION**

We agree with this recommendation to implement processes to timely monitor the processing of individual tax returns as they are processed through the Modernized e-File (MeF) system. For the 2010 Filing Season, we employed several processes to validate the accuracy of individual tax return processing. These processes included post-implementation systemic testing (a.k.a. Hub Testing); a manual review of selected production tax returns to identify any errors in rejected and accepted returns; and validation of downstream return processing, including the Error Resolution System, Code and Edit, payment processing and Master File posting.

For the 2011 Filing Season, in addition to the aforementioned processes, we will use Business Objects (an enterprise reporting and analysis tool) to analyze available return data to identify trends that may indicate errors in the rejection or acceptance of tax returns, and ensure the explanation provided is correct. These capabilities will enhance our ability to select an optimal sample size of production returns to review, and also enhance the effectiveness of the actual review of those returns, as well as overall monitoring as tax returns are processed.

**IMPLEMENTATION DATE**

February 15, 2011

**RESPONSIBLE OFFICIAL**

Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control system.

**RECOMMENDATION 2**

Work with tax return transmitters and the States to identify and address concerns and conditions that prevented them from participating in the MeF system and encourage them to participate in it during the 2011 Filing Season.



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**CORRECTIVE ACTION**

We agree with this recommendation. We have begun working with tax return transmitters and States to identify and address concerns and/or conditions that prevented them from participating in MeF and encourage them to participate in MeF during the 2011 Filing Season. We will continue to leverage existing external venues for MeF (i.e., 1040 MeF Executive Council, 1040 MeF Working Group, and Federation of Tax Administrators) in conjunction with MeF products and services to maximize our partnership, and outreach and customer service to external stakeholders. Efforts are underway to identify and implement system performance enhancements to ensure the MeF system can process the anticipated volume of individual tax returns for the 2011 Filing Season. Implementation of this recommendation will start August 15, 2010, and continue through the 2012 filing season with a target completion of April 15, 2012.

**IMPLEMENTATION DATE**

April 15, 2012

**RESPONSIBLE OFFICIAL**

Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control system.