
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***While Use of the Modernized e-File System
for Individual Tax Returns Has Increased,
the Legacy e-File System Is Still
Needed As a Backup***

September 19, 2012

Reference Number: 2012-40-116

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.

Redaction Legend: 2(f) = Risk Circumvention of Agency Regulation or Statute

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HIGHLIGHTS

WHILE USE OF THE MODERNIZED E-FILE SYSTEM FOR INDIVIDUAL TAX RETURNS HAS INCREASED, THE LEGACY E-FILE SYSTEM IS STILL NEEDED AS A BACKUP

Highlights

Final Report issued on September 19, 2012

Highlights of Reference Number: 2012-40-116 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The IRS implemented the final phase of the transition from its existing electronic filing (e-file) platform, referred to as the Legacy e-File system, to the Modernized e-File (MeF) system during the 2012 Filing Season. 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 will replace the Legacy e-File system as the primary e-filing platform during the 2013 Filing Season.

WHY TIGTA DID THE AUDIT

This audit was initiated because the IRS plans to fully replace the Legacy e-File system with the MeF system after the 2012 Filing Season. The objective of this review was to evaluate the continued implementation of the MeF system to determine whether individual income tax returns will be accurately and timely processed and whether sufficient progress is being made to replace the Legacy e-File system.

WHAT TIGTA FOUND

The MeF system has not shown that it can consistently process large volumes of tax returns for an extended period of time. Although the IRS significantly increased the volume of tax returns processed through the MeF system during the 2012 Filing Season, the volume of tax returns received was less than anticipated due to performance issues and programming errors.

Issues identified during pre-implementation testing are not always addressed prior to the filing season. In addition, processes used to validate and monitor the MeF system, including system business rules designed to validate basic requirements on a tax return, do not ensure the accuracy of processing individual tax forms and schedules. As a result, the IRS continues to have limited assurance that the MeF system is accurately and effectively processing individual tax returns.

Finally, transmitters reported additional burdens due to the restrictions placed on the use of the Legacy e-File system and were generally not satisfied with the performance of the MeF system.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop a comprehensive testing plan that ensures tax returns are accurately processed through the MeF system before it permanently retires the Legacy e-File system. The testing plan should include a review of all tax forms, schedules, and business rules applicable to individual tax returns processed through the MeF system and ensure that all programming issues identified during pre-implementation testing are addressed prior to the start of the filing season.

In their response to the report, IRS management agreed to enhance their testing procedures based on lessons learned. The IRS needs to take the steps necessary to ensure all conditions identified during its testing activities are addressed prior to the 2013 Filing Season.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 19, 2012

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM:

Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – While Use of the Modernized e-File System for Individual Tax Returns Has Increased, the Legacy e-File System Is Still Needed As a Backup (Audit # 201240012)

This report presents the results of our review to evaluate the continued implementation of Modernized e-File system to determine whether individual income tax returns will be accurately and timely processed and whether sufficient progress has been made to replace the Legacy e-File system for individual tax returns for the 2013 Filing Season. This audit is included in our Fiscal Year 2012 Annual Audit Plan and addresses the major management challenges of Modernization and Implementing Major Tax Law Changes.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services), at (770) 617-6434.



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Abbreviations

e-file(d); e-filing	Electronically file(d); electronic filing
IRS	Internal Revenue Service
MeF	Modernized e-File
PDF	Portable Document Format
TIGTA	Treasury Inspector General for Tax Administration
XML	Extensible Markup Language



***While Use of the Modernized e-File System
for Individual Tax Returns Has Increased, the
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Background

The Modernized e-File (MeF) system is a modernized, Internet-based electronic filing (e-file) platform that is replacing the current Internal Revenue Service (IRS) e-filing system (referred to as the Legacy e-File system). Tax returns and attachments submitted through the MeF system use extensible markup language (XML), which is a different format than is used in the Legacy e-File system.¹ Once fully implemented, the MeF system will provide a single method for filing all business and individual tax returns, forms, and schedules via the Internet. The MeF system provides real-time processing of tax returns that improves error detection, standardizes business rules, and expedites acknowledgments. The MeF system also allows for attachments in Portable Document Format (PDF).² Figure 1 provides a comparison of key differences between the MeF and Legacy e-File systems.

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

Condition	MeF System	Legacy e-File System
Data Format	XML.	American Standard Code for Information Interchange.
Attachments	Accepted in PDF.	No attachments accepted.
Transmissions	Transaction-based system – processed upon receipt.	Batch return system with batches processed three times daily to process transmissions.
Acknowledgements	Acknowledgments returned in real-time.	Acknowledgments returned within two calendar days of receipt.
Tax Return Errors	Business rules for each error condition.	Error reject codes that may address multiple conditions.
Processing Year	Year-round processing.	No e-filed tax returns after October 15.
Prior Year Returns	Prior year tax returns accepted.	Prior year tax returns are not accepted via e-file.

Source: IRS MeF and Legacy e-File systems documentation.

² The PDF is a file format for representing documents in a manner that is independent of the original application software, hardware, and operating system used to create those documents.



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MeF system Release 7.0 includes 129 additional tax forms and schedules

The IRS implemented MeF system processing for individual tax returns in three phases. The IRS implemented the first phase (Release 6.1) during the 2010 Filing Season³ and the second phase (Release 6.2) during the 2011 Filing Season. The IRS implemented the third phase (Release 7.0) during the 2012 Filing Season. The current Legacy e-File system is scheduled to be retired at the end of the 2012 Filing Season (October 2012).

Below is a general description of the functionality included in each implementation phase of the MeF system.

MeF System Release 6.1 – This phase of MeF system implementation included Form 1040, *U.S. Individual Income Tax Return*; Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*; and 21 forms and schedules related to Form 1040 for Tax Year⁴ 2009.

MeF System Release 6.2 – Release 6.2 did not provide for the filing of any additional tax forms or schedules. The primary difference between Release 6.1 and 6.2 was the ability for individual taxpayers to file prior year tax returns. Beginning in the 2011 Filing Season, individual taxpayers were able to file both their Tax Years 2009 and 2010 tax returns using the MeF system. IRS management informed us that the focus of Release 6.2 was system stability, performance, and tuning.

MeF System Release 7.0 – This final release includes 129 individual tax forms for Tax Year 2011 and prior year processing support for the original forms deployed in Release 6.1 for Tax Years 2009 and 2010. IRS management informed us that Release 7.0 also contained additional system performance improvements. Appendix V details the specific tax forms and schedules that were added to the MeF system for the 2012 Filing Season.

Individual tax returns processed through the MeF system must pass validation rules to be accepted for processing

The MeF system uses three levels of validation. Once a tax return has passed all three levels of validation, it will enter the IRS's tax return pipeline processing. While this is a different approach to validating tax returns than the one currently employed by the Legacy e-File system, all of the Legacy e-File system's error reject codes are included in the three levels of MeF system validation. The three levels of validation include:

Level 1 – Schema Validation – A MeF system tax return is divided into a series of different data structures. Schemas provide the basic definitions for the data elements within each data

³ The period from January through mid-April when most individual income tax returns are filed. However, individuals may continue to file tax returns through October if they apply for an extension of time to file.

⁴ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



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structure and the interrelationships among the data elements (what is required, field length, data type, allowable field values, *etc.*). The MeF system verifies the accuracy of the data format in the tax return by validating each tax return against the individual schemas. If an error is found during the schema validation, the tax return is rejected.

Level 2 – National Account Profile⁵ Checks – The taxpayer, spouse, and dependent name controls and Social Security Numbers contained on the 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. As with schema validations, a tax return is rejected if it fails one or more of the National Account Profile validations.

Level 3 – Business Rule Check – The IRS established criteria or business rules that each tax return must pass before it can be processed electronically. The business 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 will be rejected if one or more of the business rules are not met.

Prior Treasury Inspector General for Tax Administration (TIGTA) reviews raised concerns with the implementation of the MeF system

The TIGTA conducted four reviews of the development and implementation of the MeF system for individual tax return processing between August 2009 and September 2011.⁶ These reviews raised the following concerns with the management of MeF system development as well as the ability of the system to accurately process tax returns.

- System Integration Testing of MeF Release 6.0 did not include testing of all system application requirements. Still other requirements failed testing, and no indication was provided to show the errors identified were corrected before implementation.
- Controls were not adequate to manage all of the system requirements, security weaknesses, issues, and action items.
- Processes used to test and monitor the system did not ensure business rules designed to validate basic requirements on a tax return were working as intended.
- Lower than expected tax return volumes prevented the IRS from assessing the ability of the system to process large volumes of tax returns.

⁵ 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.

⁶ See Appendix VI for a list of these reports.



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- Key functionality to attach scanned documents to individual tax returns was not being promoted or used.

This review was performed at the Wage and Investment Division Office of Submission Processing in Atlanta, Georgia, and the Information Technology organization's Office of Applications Development in New Carrollton, Maryland, during the period January through June 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those 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

The Modernized e-File System Has Not Consistently Processed Large Volumes of Tax Returns for an Extended Period of Time

The IRS has significantly increased the number of tax returns processed through the MeF system since it first began processing individual tax returns in Processing Year⁷ 2010. As of April 17, 2012, the MeF system had processed 72.4 million individual tax returns, significantly more than the 8.7 million tax returns processed by the system during a comparable period last year. However, the number of tax returns processed through the MeF system during the 2010 through 2012 Filing Seasons⁸ does not equate to the number of e-filed tax returns the IRS anticipates receiving during the 2013 Filing Season.

On May 1, 2012, the IRS announced that the MeF system will be the only e-filing platform for the 2013 Filing Season. IRS management advised us that the IRS will maintain the Legacy e-File system only as a backup for Federal tax returns. However, the IRS has yet to decide the individual tax forms and schedules that the Legacy e-File system will accept. IRS management noted the high costs of maintaining dual processing systems for both the IRS and tax return transmitters as the main reason for its decision. The IRS estimates that maintaining and operating the Legacy e-File system will cost the IRS more than \$7 million for Fiscal Year 2012. Nevertheless, performance problems during the 2012 Filing Season and continued concerns about the accuracy of tax return processing could risk the success of the IRS's e-File Program and the IRS's ability to successfully complete the processing of individual tax returns during the 2013 Filing Season.

Volumes of tax returns processed through the MeF system have been significantly lower than expectations and goals

In November 2011, the IRS announced that all transmitters that transmitted one million or more individual tax returns during the 2011 Filing Season must use the MeF system to e-file tax returns during the 2012 Filing Season. The IRS believed limiting the use of the Legacy e-File system was necessary to be able to fully evaluate the success of the MeF system.

The IRS's decision to limit the use of the Legacy e-File system resulted in 72.4 million individual tax returns being processed through the MeF system through April 17, 2012, a 732.2 percent increase over the same period last year. Although the IRS significantly increased

⁷ The calendar year in which the tax return or document is processed by the IRS.

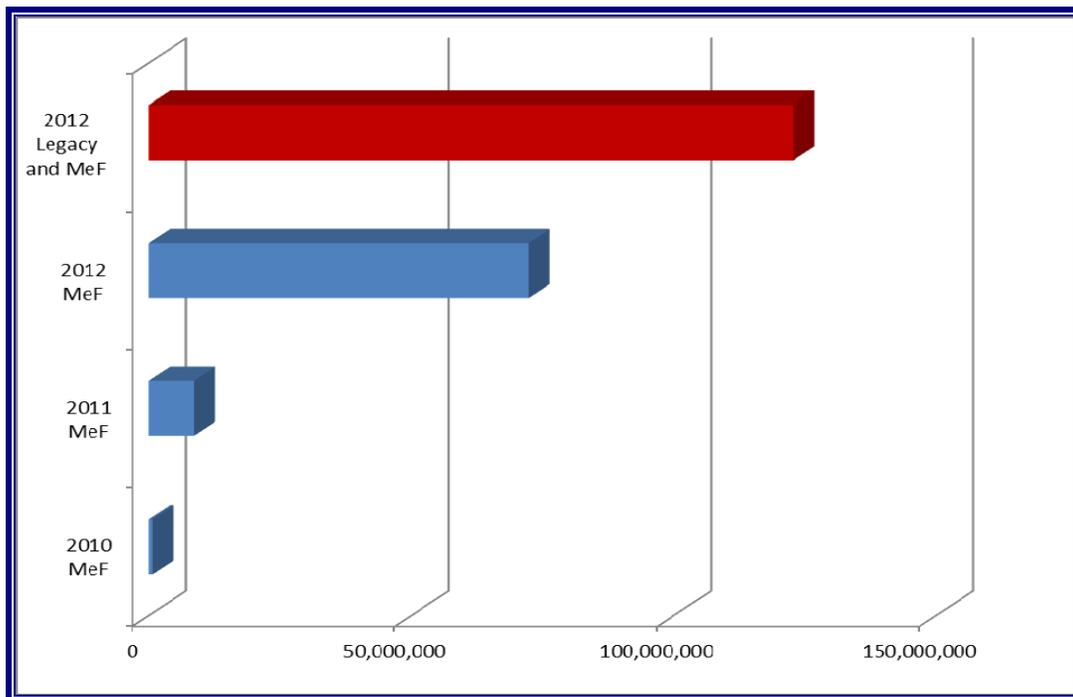
⁸ As of April 17, 2012.



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the volume of tax returns processed through the MeF system during the 2012 Filing Season, IRS management stated that the volume of tax returns received by the MeF system was still less than anticipated. Figure 2 provides the number of tax returns processed through the MeF system during the 2010 through 2012 Filing Seasons compared to the total number of e-filed tax returns processed through both the Legacy e-File and MeF systems through April 17, 2012, for the 2012 Filing Season.

***Figure 2: Comparison of Tax Returns Processed Through
the MeF System During the 2010–2012⁹ Filing Seasons
Compared to All Tax Returns e-Filed During the 2012 Filing Season***



Source: TIGTA analyses of filing season return volumes during the 2010–2012 Filing Seasons.

Performance issues and programming errors reduced the number of tax returns processed through the MeF system

On at least two different occasions, the IRS had to suspend MeF system processing to correct system performance issues. This resulted in delays in processing individual tax returns.

⁹ During the 2010 and 2011 Filing Seasons, MeF processing of individual tax returns only supported the Form 1040, Form 4868, and 21 forms and schedules related to Form 1040.



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MeF system performance issues interrupted tax return transmissions on the first day of the 2012 Filing Season

The IRS successfully opened the MeF system at 9:00 a.m. Eastern Standard Time on January 17, 2012, for individual tax returns and extensions. However, the MeF system was taken offline for 18 hours shortly after the IRS began processing individual tax returns to correct performance issues that were delaying the transmission of tax return acknowledgements.¹⁰ Taxpayers and transmitters were unable to e-file their tax returns during this time. As a result, the IRS received almost 1.4 million fewer e-filed tax returns on January 17, 2012, when compared to the same day during the previous filing season.

Prior to shutting down the MeF system to correct the performance issues, acknowledgements were taking approximately three hours to generate. According to the IRS, transmission acknowledgements are to be returned in real-time with a delay of no more than two hours during peak processing periods. IRS management stated that discontinuing some MeF system background processes not related to the processing of tax returns and repairing some of the data tables in the MeF database returned MeF processing to acceptable levels. The IRS was able to reopen the MeF system to accept tax return transmissions at noon on January 18, 2012.

IRS management noted that the performance issues experienced on January 17, 2012, might have been caused by the large volume of tax returns received by the MeF system during the first day of processing. According to the IRS, the volume of returns received by the MeF system during the first day of processing was one of the largest the IRS had ever received to date.

Programming issues delayed the transmission of accepted tax return data to downstream processing systems

In late January 2012, MeF system programming problems resulted in the creation of incomplete and/or duplicate output files containing accepted tax return data that other IRS systems need to continue with the processing of the tax returns. This caused delays in sending the output files to downstream processing systems. The IRS estimated that the programming problem delayed the processing of approximately 7.8 million individual tax returns. The majority of these tax returns were processed through the MeF system from February 2 through 11, 2012. The IRS stated that the programming problems were corrected and all delayed tax returns were sent to other downstream processes by February 18, 2012.

The IRS encouraged transmitters to use the Legacy e-File system instead of the MeF system after errors in MeF system programming were identified in February. The IRS issued a QuickAlert¹¹

¹⁰ Taxpayers who e-file their tax return receive an electronic notification from the IRS called an acknowledgement when the tax return has been either rejected or accepted for processing.

¹¹ QuickAlerts is a free online service that sends e-file messages, within seconds, to all “subscribers.” These messages provide up-to-date information on events that affect e-file Transmitters, software developers, and Authorized IRS e-File Providers.



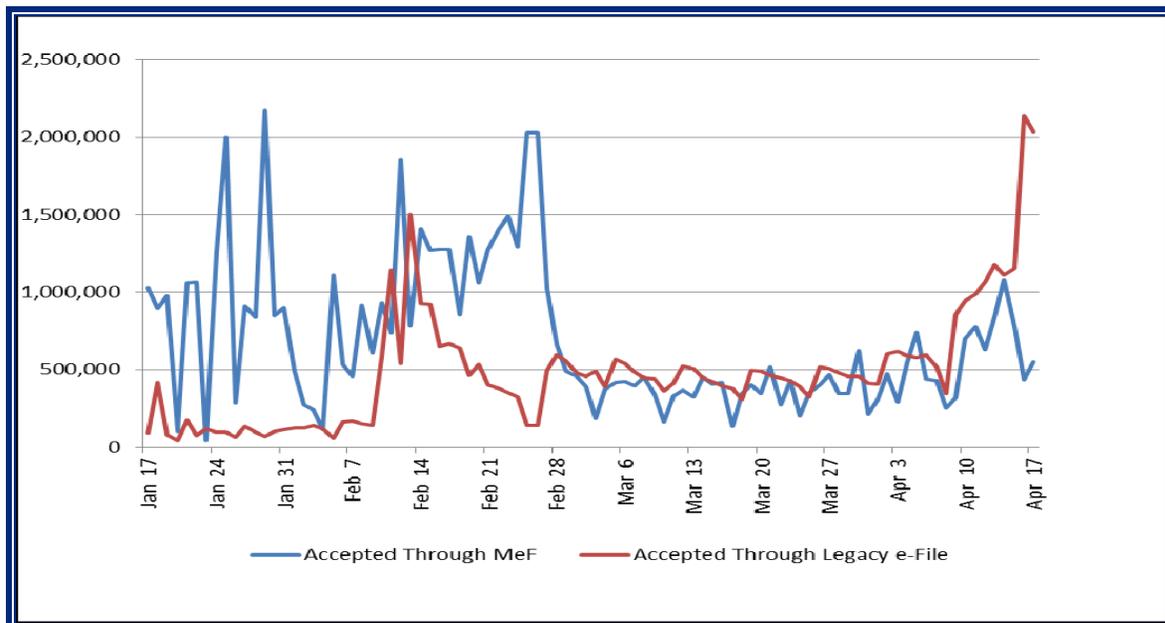
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on February 10, 2012, informing transmitters that the restrictions on the Legacy e-File system were temporarily lifted and encouraged them to use the Legacy e-File system until further notice. The IRS stated that the processing issues were resolved. However, the IRS encouraged the use of the Legacy e-File system until further notice to ensure future processing ran smoothly and to provide adequate time to complete processing of the affected returns. The IRS did not reinstate the restrictions on the use of the Legacy e-File system during the filing season. IRS management informed us that they intentionally left the decision of which system to use up to the individual transmitters.

The volume of tax returns submitted through the MeF system was affected significantly after the IRS encouraged transmitters to use the Legacy e-File system to e-file tax returns. Prior to the IRS's alert, approximately 84.3 percent of e-filed individual tax returns were processed through the MeF system. As of April 17, 2012, the percentage of accepted e-filed individual tax returns processed through the MeF system decreased to 59.6 percent.

The number of tax returns accepted daily through the Legacy e-File system surpassed the MeF system as the primary e-filing platform after the IRS identified the processing issues in February 2012. Figure 3 below provides a comparison of tax returns accepted daily through the MeF system and the Legacy e-File system from January 17 through April 17, 2012.

***Figure 3: Comparison of Individual Tax Returns Accepted Daily
Through the MeF and Legacy e-File Systems
From January 17–April 17, 2012***



Source: TIGTA analyses of filing season tax return volumes through April 17, 2012.



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Each year more individuals file their tax return electronically. Electronic filing provides increased tax return accuracy and reduces IRS processing costs. However, the IRS must ensure that the e-file platform is stable and capable of processing large numbers of tax returns continually throughout the tax return filing season. Disruptions to tax return processing can significantly increase costs to the IRS, increase taxpayer burden, increase the risk of allowing taxpayers erroneous tax benefits, and erode taxpayers' confidence in the IRS's ability to timely and accurately process tax returns. It is imperative that the IRS ensure that the MeF system can timely and accurately process the anticipated number of individual tax returns it expects to receive in a single filing season before it discontinues the use of the Legacy e-File system.

Testing and Validation of the Modernized e-File System Do Not Ensure Tax Returns Are Accurately and Effectively Processed

The IRS conducts pre-implementation system testing before the filing season to assess whether the MeF system is ready for implementation. A post-implementation review of tax returns that are processed through the MeF system is performed during the filing season to spot check that tax returns are being processed accurately by the system. Neither of these reviews prevented significant programming issues that affected the 2012 Filing Season. This resulted in processing delays for almost eight million tax returns. In addition, we identified business rules that were either accepting or rejecting tax returns in error.

Issues identified during the pre-implementation testing process are not always addressed prior to the filing season

Pre-implementation testing of the MeF system was designed to ensure MeF software changes are tested and comply with system requirements, the MeF system performs within established performance requirements, and the MeF system properly interfaces with other IRS systems. Prior TIGTA audits¹² identified concerns with the IRS's pre-implementation testing of the MeF system. For example:

- Processes were not in place to ensure identified errors were corrected before the beginning of the filing season.
- MeF system release requirements were not tested or working as intended prior to the beginning of the filing season.

Testing during the current audit identified similar issues. Additionally, analyses of the pre-implementation testing documentation found that one or more of the IRS's pre-implementation tests had identified concerns with MeF system performance, but there was no indication that these concerns were addressed before the 2012 Filing Season.

¹² See Appendix VI for a list of these reports.



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Deficiencies in the pre-implementation testing resulted in MeF system programming errors that delayed the processing of tax returns accepted through the MeF system. Tax returns accepted through the MeF system from January 17 through March 12, 2012, took twice as long to process as tax returns processed through the Legacy e-File system. Processing times averaged 5.9 days through the MeF system compared to 2.3 days through the Legacy e-File system.

IRS management advised us that pre-implementation performance testing simulated the processing of a large number of individual tax returns during an eight-hour period. Management noted that test results indicated the MeF system would meet expected performance goals. However, they acknowledged that they did not have the capability to test the levels of sustained input volumes in the test environment and the testing environment does not mimic the MeF system production environment.

MeF system programming problems identified in January 2012 affected the accuracy of tax return information available to taxpayers

Taxpayers were not able to obtain the status of their tax refunds because programming problems delayed the tax refund information from being loaded into the Internet tool “Where’s My Refund.” The status of a tax refund should be available in the “Where’s My Refund” tool within 72 hours after a tax return is e-filed. Transmitters indicated that delays in the information being available caused significant taxpayer anxiety as taxpayers were concerned that their tax returns had not been successfully transmitted and that they might not receive their refunds.

Additionally, the results of a limited survey of transmitters showed that the delay in refund information on “Where’s My Refund” also created a significant burden on them. Five of the 10 transmitters that responded to our survey reported problems with “Where’s My Refund” or with the IRS providing inaccurate information to taxpayers during the 2012 Filing Season. Transmitters indicated the problems with the “Where’s My Refund” tool caused them to receive higher than normal call volumes and complaints from taxpayers concerned about the status of their tax returns.

MeF system processing issues delayed the availability of accurate and consistent tax return information on IRS systems

Tax return information processed by the MeF system is stored on several databases that are used by IRS employees to access taxpayer accounts. IRS employees use tax return information to update taxpayers’ accounts or when responding to taxpayer inquiries. Information on one of the databases was not updated timely for tax returns accepted by the MeF system during the 2012 Filing Season.

We notified the IRS of this concern on February 14, 2012. At that time, the IRS attributed the inaccurate information to the programming issues that delayed the transmission of accepted tax return data to downstream processing systems early in the filing season. Since then, the IRS has begun conducting further research to identify the root causes of the issues identified.



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Post-implementation validation and monitoring of the MeF system is not sufficient to ensure that tax returns are accurately processed

Approximately 15,294 e-filed tax returns processed through the MeF system during the 2012 Filing Season were accepted in error. These tax returns resulted in taxpayers possibly receiving approximately \$4.8 million in benefits to which they were not entitled.¹³

Processes used to validate and monitor the MeF system, including system business rules designed to validate basic requirements on a tax return, do not ensure the accuracy of processing of individual tax forms and schedules. Ineffective or insufficient monitoring of tax return processing increases the risk that individual tax returns processed through the MeF system will be erroneously accepted or rejected. This risk might increase if the MeF system is the only e-file platform the IRS uses for the 2013 Filing Season.

In our Fiscal Year 2011 audit report,¹⁴ we recommended that the IRS develop a comprehensive testing plan to ensure that a representative sample of all tax forms, schedules, and business rules applicable to individual tax returns transmitted through the MeF system (rejected and accepted) throughout the filing season are reviewed and all business rules applicable to those tax returns are verified. IRS management disagreed with our recommendation, stating that the MeF system is developed under its standard systems development approach, which included extensive validation prior to its release.

However, earlier processes are not in place to ensure errors identified during pre-implementation testing are corrected before the MeF system begins accepting tax returns. Pre-implementation testing also does not ensure that all MeF system validation rules are tested prior to accepting tax returns for processing. As a result, extensive post-implementation review is necessary to ensure that specific business rules, tax forms, and schedules are being processed correctly through the MeF system.

A limited review of tax returns significantly restricted the IRS's ability to determine if the MeF system is accurately processing individual tax returns

The IRS's plan to validate and monitor the MeF system during the filing season was too limited to provide assurance that the MeF system was processing tax returns accurately. One specific objective of the testing was to ensure that individual tax return submissions received by the MeF system were accurately processed by conducting a review of randomly selected submissions.

¹³ See Appendix IV for details. The 15,294 is the sum of 5,870 tax returns that received a benefit for an exemption claimed for a Social Security Number that was previously used on another tax return and ****2(f)*****
*****2(f)*****
*****2(f)*****.

¹⁴ TIGTA, Ref. No. 2011-40-131, *Low Participation and Tax Return Volumes Continue to Hinder the Transition of Individual Income Tax Returns to the Modernized e-File System* (Sept. 2011).



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However, the implementation of the IRS's review plans was limited by available resources and did not ensure that all business rules were included in the sample tested.

For the 2012 Filing Season, the IRS developed a two-phase plan to test the processing of individual tax returns once Release 7.0 was implemented.

- The first phase of testing consisted of a controlled launch that occurred a week before the MeF system was officially deployed. During the controlled launch, the IRS requested that a select group of transmitters transmit low volumes of tax returns through the MeF production system to confirm that the transmitters could successfully transmit tax returns. As part of the controlled launch, the IRS also analyzed trends in error rates and manually reviewed a small sample of the tax returns that were received to determine if the MeF system business rules were accurately applied.
- The second phase of testing, the Post Production Review, began with the start of the 2012 Filing Season and was to be conducted intermittently until error fallout rates reached acceptable levels. The testing plan consisted of an initial review to be performed during the first two weeks of the filing season and the option of two subsequent follow-up review sessions scheduled at approximately six week intervals. The initial review focused on identifying areas with potential for erroneous processing with the goal of enabling the IRS to more effectively monitor production processing and identify, evaluate, and correct processing issues early in the filing season to minimize taxpayer burden.

The IRS's reliance on manual reviews to perform its tax return validation restricts the number of tax returns and business rules that the IRS is able to review. For example, the IRS only reviewed 0.123 percent (2,250 of 1,832,180) of the rejected tax return submissions and 0.004 percent (426 of 10,879,851) of the accepted tax returns received during the testing period. Given the limited number of tax returns reviewed, the IRS could not be assured that significant errors did not exist.

The MeF system individual tax return Post Production Review plan did not include an adequate review of new tax forms and schedules

The IRS did not take additional steps to ensure that it reviewed a sufficient number of new tax forms and schedules. The IRS only reviewed the new forms and schedules if they were included in one of the tax returns that the IRS randomly selected for review.

MeF Release 7.0 included the addition of 129 individual tax forms and schedules not previously accepted by the MeF system. The IRS did not review 88 (68.2 percent) of the 129 new forms and schedules added to MeF Release 7.0 during the initial phase of its Post Production Review. The Post Production Review documentation indicated that not all of the new forms and schedules could be reviewed because they had not been received at the time the review was conducted. We agree the IRS can only review those forms and schedules filed through the MeF system as of a given date. However, 51 (58 percent) of the 88 forms and schedules the IRS did not review



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during the initial phase of the Post Production Review had been filed through the MeF system at the time of its initial review. As a result, the IRS has only limited assurance that a majority of the new forms and schedules are being accurately processed by the MeF system.

The MeF system incorrectly accepted tax returns into the system for processing

The MeF system validates the accuracy of tax returns by ensuring that all tax returns meet business rules designed to ensure the tax return is accurate. As of April 17, 2012, 63.7 million tax returns were accepted and 8.6 million tax returns were rejected, with a cumulative reject rate of 11.9 percent. However, tax returns with inaccurate information were incorrectly accepted for processing into the MeF system.

- Tax returns were accepted even though the tax return claimed an exemption for a Taxpayer Identification Number that was previously claimed on another tax return. An individual can only be used once in each tax year for the purposes of claiming an exemption. The tax returns were incorrectly accepted due to programming errors in the MeF business rules that reject tax returns with multiple Taxpayer Identification Number uses. We informed the IRS of the issue on February 1, 2012, and the IRS corrected the business rules. Before the corrections were implemented, the MeF system incorrectly accepted 5,870 tax returns claiming exemptions for Taxpayer Identification Numbers that were already used, which incorrectly reduced the tax liabilities on these tax returns by approximately \$3.1 million.
- Taxpayers are allowed to claim a higher standard deduction amount on their tax return if the taxpayer or the taxpayer's spouse is age 65 or older.¹⁵ *****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)***** . We estimate the IRS could allow approximately \$8.7 million in erroneous benefits over the next five years. We informed the IRS of our concerns on February 28, 2012. The IRS responded that it did not have the authority to reject these tax returns. *****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)***** .

¹⁵ The standard deduction increases by \$1,400 for taxpayers filing single or head of household. The standard deduction increases by \$1,150 for each primary or spouse taxpayer age 65 or older when the filing status is married filing jointly or married filing separately.



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Transmitter inquiries are used to validate the accuracy of tax returns in the MeF system

The IRS created an electronic mailbox for the 2012 Filing Season that allowed transmitters and States to submit questions and concerns about the MeF system. Submissions to the mailbox indicated transmitters experienced issues with business rules causing tax returns to be incorrectly rejected. As of February 29, 2012, transmitters had questioned and the IRS had confirmed 184 issues with the MeF system, including 38 business rules that were incorrectly rejecting tax returns. The IRS indicated that the issues with these business rules had either been resolved or were being resolved.

While feedback from transmitters is an effective way of identifying business rules that are incorrectly rejecting tax returns, it incorrectly places the burden of ensuring the MeF system is accurately processing tax returns on transmitters. In addition, accuracy issues experienced by the transmitters create burden on the transmitters and taxpayers. Relying on transmitters to identify MeF system errors can also reduce transmitter confidence in the MeF system.

Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should develop a comprehensive testing plan to incorporate the pre-implementation test results into the post-implementation quality review. The comprehensive testing plan should ensure that all programming issues are addressed prior to the start of the filing season. In addition, all tax forms, schedules, and business rules applicable to individual tax returns through the MeF system (rejected and accepted) should be reviewed to ensure tax returns are accurately processed through the MeF system before the IRS permanently retires the Legacy e-File system.

Management's Response: The IRS will enhance its test procedures based on lessons learned, but the IRS will do so in a way that conforms to IRS enterprise standards. The MeF system was developed under the guidance of Internal Revenue Manual 2.16.1, *Enterprise Life Cycle–Enterprise Life Guidance*. The Enterprise Life Cycle is the approach used by the IRS to manage initiatives and implement changes in business information systems. It provides a comprehensive project management structure for systems development that includes extensive planning, risk analysis, development, testing, milestone reviews, and certification processes. Testing activities include System Acceptability Tests, System Integration Tests, Government Acceptance Tests, and Final Integration Tests. Prior to deployment into the production environment, MeF Release 7 used in the 2012 Filing Season was cleared by the Submission Processing Executive Steering Committee as having met and passed all milestone objectives and requirements.

Office of Audit Comment: The IRS needs to take the steps necessary to ensure all conditions identified during its testing activities are addressed prior to the 2013 Filing Season. Further, the IRS should develop a comprehensive plan that incorporates the results of the IRS's pre-filing season testing with its efforts to monitor the performance of



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the MeF system and the accuracy of tax returns processed through the MeF system throughout the 2013 Filing Season. The MeF system will be the primary e-filing platform during the 2013 Filing Season. As such, any issues that may occur with the MeF system could negatively impact taxpayers and significantly impact the IRS’s ability to timely and accurately process individual tax returns.

Management and Performance of the Modernized e-File System Negatively Affected Transmitters During the 2012 Filing Season

The IRS’s restriction on the use of the Legacy e-File system successfully increased participation in the MeF system during the 2012 Filing Season. However, transmitters reported additional burdens preparing for the 2012 Filing Season, such as increased costs caused by the late notice of the requirement to use MeF. In addition, transmitters were generally not satisfied with the performance of the MeF system during the 2012 Filing Season.

The IRS’s efforts to increase participation in the MeF system negatively affected transmitters

In November 2011, the IRS announced that all transmitters that e-filed one million or more individual tax returns during the 2011 Filing Season would be required to use the MeF system to process their e-filed tax returns during the 2012 Filing Season. In addition, the IRS limited the daily use of the Legacy e-File system to three one-hour windows a day. The IRS stated that the Legacy e-File system volume limitation was necessary to ensure the ultimate success of the MeF system.

During the 2012 Filing Season, the number of transmitters supporting the MeF system increased by 185 percent. State participation increased by 40 percent when compared to the previous filing season. Figure 4 provides a comparison of the number of transmitters and States participating in the MeF system during the 2011 and 2012 Filing Seasons for individual tax returns.

Figure 4: Comparison of MeF System Transmitters Through April 17, 2012

Number of Transmitters	2011 ¹⁶	2012	% Change
Total Transmitters	45	92	104%
Transmitters Participating in the MeF System			
Transmitters	20	57	185%
States	25	35	40%

Source: TIGTA analysis of 2012 MeF system transmitter statistics through April 17, 2012.

¹⁶ Data for the 2011 Filing Season are through April 18, 2011.



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We surveyed 13 transmitters that were required to use the MeF system as their primary e-filing platform during the 2012 Filing Season to obtain feedback on the impact of 1) the IRS's mandate to use the MeF system and 2) restrictions on the use of the Legacy e-File system on their e-file operations. Ten transmitters responded. These transmitters processed approximately 57.6 million (77.8 percent) of all individual tax returns through the MeF system through April 17, 2012. Of the 10 respondents, seven transmitters reported that the IRS mandate to use the MeF system during the 2012 Filing Season negatively affected their businesses. For example:

- Five transmitters indicated that the mandate was burdensome due to the late notice, which caused them to either incur unplanned costs or expedite their implementation plans or forced them to redirect development resources that impaired research and development in new products.
- Three transmitters indicated that the mandate created issues with State tax returns because a number of States did not accept tax returns through the MeF system.
- Two transmitters thought that the mandate put the system at risk because the late notice did not allow proper time for testing the MeF system or that the restrictions on the use of the Legacy e-File system were misguided because the IRS removed the contingency if issues existed with the MeF system.

The performance of the MeF system did not meet transmitters' expectations

The MeF system performance issues during the 2012 Filing Season create uncertainty about the MeF system's ability to successfully process all e-filed tax returns in the future. The IRS originally planned to retire the Legacy e-File system after the 2012 Filing Season, but later decided to maintain the Legacy e-File system as a failover for the 2013 Filing Season. Transmitters are faced with a similar decision and must either incur additional costs to maintain the ability to submit tax returns through the Legacy e-File system or risk that they may not be able to e-file tax returns if the MeF system encounters serious issues.

Our surveys of the transmitters indicate that they generally had concerns with the performance of the MeF system during the 2012 Filing Season. Only three (30 percent) of the 10 transmitters who responded to our survey rated the system as "Successful" or "Very Successful."¹⁷ The transmitters were primarily concerned with the processing delays and other technical issues with the MeF system that negatively affected their ability to process tax returns and serve their customers.

In addition, transmitters are not confident that the MeF system will be able to completely replace the Legacy e-File system during the 2013 Filing Season. Of the 10 transmitters that responded,

¹⁷ TIGTA survey questions asked transmitters to rate the MeF system based on their experience during the 2012 Filing Season. Ratings included: Very Successful, Successful, Moderately Successful, and Failure.



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four expressed concerns with the IRS's initial plan to discontinue the use of the Legacy e-File system because of the 2012 Filing Season issues. Two transmitters indicated that they would rather use the Legacy e-File system until the MeF system issues were corrected.

Transmitters' lack of confidence in the MeF system and the IRS's inability to ensure that the system can accurately and effectively process individual tax returns raise significant concerns about the IRS's decision to not use the Legacy e-File system to process tax returns during the 2013 Filing Season. To avoid any disruptions to the processing of tax returns, the IRS must ensure that the MeF system can timely and accurately process the number of individual tax returns it expects to receive in a single filing season before it discontinues the use of the Legacy e-File system.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the continued implementation of the MeF system to determine whether individual income tax returns will be accurately and timely processed and whether sufficient progress has been made to replace the Legacy e-File system for individual tax returns for the 2013 Filing Season.¹ To accomplish this objective, we:

- I. Determined whether the IRS made sufficient progress to replace the Legacy e-File system for individual tax returns for the 2013 Filing Season.
 - A. Obtained documentation needed to determine whether the MeF system provides the same processing capabilities as the Legacy e-File system.
 - B. Surveyed 34 State taxing authorities and 13 approved MeF system transmitters regarding individual tax returns transmitted through the MeF system during the 2012 Filing Season and additional concerns with the MeF system processing season.
- II. Determined whether the IRS is correctly accepting and rejecting individual tax returns and related forms and schedules through MeF Release 7.0 during Processing Year² 2012.
 - A. Determined whether the IRS adequately evaluated the MeF system prior to the 2012 Filing Season.
 1. Obtained and analyzed IRS validation plans and results referred to as “Post Production Validation” conducted in January 2012.
 2. Obtained statistics on volumes of tax returns accepted and rejected by the MeF system and analyzed the volumes of tax returns reviewed during the IRS validation period.
 - B. Determined whether the MeF system properly accepted and rejected tax returns during the 2012 Filing Season.
 1. Obtained IRS statistics on volumes of electronic tax returns transmitted through the MeF system during the 2012 Filing Season and compared the reject rates to the 2011 Filing Season.

¹ The period from January through mid-April when most individual income tax returns are filed. However, individuals may continue to file tax returns through October if they apply for an extension of time to file.

² The calendar year in which the tax return or document is processed by the IRS.



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2. Obtained rejected individual tax return data from the MeF system. We utilized these data to determine whether the MeF system was correctly rejecting individual tax returns. We validated the reliability of the data by comparing it with the Employee User Portal data.³
 3. Obtained the MeF system individual income tax return data that were accepted and processed from the weekly IRS Individual Return Transaction File⁴ for all accepted and processed tax returns. We utilized these data to determine whether the accepted tax forms and schedules were correctly processed. We validated the reliability of the IRS's Individual Return Transaction File computer-processed data by comparing the data with the IRS's Integrated Data Retrieval System⁵ and Employee User Portal data.
- C. Determined whether the MeF system properly accounted for all tax returns received into the system during the 2012 Filing Season.

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: the controls in place to ensure 1) all of the error reject codes included in the Legacy e-File system were included in the MeF system, 2) tax returns were properly accepted or rejected by the MeF system, and 3) tax returns were properly accounted for in the MeF system. We tested these controls by reviewing and analyzing relevant documents and data and conducting a survey of State taxing authorities and approved MeF system transmitters.

³ IRS computer system used to review tax return information transmitted through the MeF system.

⁴ The Individual Return Transaction File contains all edited, transcribed, and error-corrected data from the Form 1040 (*U.S. Individual Income Tax Return*) series and related forms and schedules for the current processing year and two prior years.

⁵ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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Appendix II

Major Contributors to This Report

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Steven Vandigriff, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W
Director, Business Modernization Office, Wage and Investment Division SE:W:BMO
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division
SE:W:CAR
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division
SE:W:RICS
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Field Assistance, Wage and Investment Division SE:W:CAR:FA
Director, Joint Operations Center, Wage and Investment Division SE:W:CAS:JOC
Director, Stakeholder Partnership, Education, and Communications, Wage and Investment
Division SE:W:CAR:SPEC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
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: Chief, Program Evaluation and Improvement, Wage and Investment Division
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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

Revenue Protection – Potential; \$3,051,428 tax effect for exemptions allowed in error for Taxpayer Identification Numbers previously claimed on another tax return as a result of issues with the MeF business rules that prevent multiple Taxpayer Identification Number uses (see page 9).

Methodology Used to Measure the Reported Benefit:

We identified 5,870 Tax Year 2011 tax returns on the IRS Individual Return Transaction File¹ that were processed by the MeF system in Processing Year² 2012 and claimed an exemption for a Taxpayer Identification Number that was previously claimed as an exemption on another tax return for the same tax year.³ The Internal Revenue Code states that an individual can only be used once in each tax year for the purposes of claiming an exemption. The tax returns were incorrectly accepted due to issues with the programming of the MeF business rules that reject tax returns with multiple Taxpayer Identification Number uses.

To determine the tax effect of the improper exemptions, we first computed the amount of the exemptions claimed using a Taxpayer Identification Number that was previously claimed on another tax return and then computed the amount of the improper exemptions that was used to offset taxable income on each of the tax returns. We then computed the tax effect of the improper exemptions on each tax return. We multiplied the amount of the improper exemption by the marginal tax rate for each tax return that was determined using the IRS's tax rate schedules for Tax Year 2011. Using this methodology, we estimate the total tax effect of the exemptions claimed for Taxpayer Identification Numbers that were previously claimed on another tax return was \$3,051,428.

¹ The Individual Return Transaction File contains all edited, transcribed, and error-corrected data from the Form 1040 (*U.S. Individual Income Tax Return*) series and related forms and schedules for the current processing year and two prior years.

² The calendar year in which the tax return or document is processed by the IRS.

³ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



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Type and Value of Outcome Measure:

Revenue Protection – Potential; \$1,748,127 (\$8,740,635 over five years) tax effect for additional standard deductions allowed in error (see page 9).

Methodology Used to Measure the Reported Benefit:

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*****2(f)*****
*****2(f)*****
on the IRS National Account Profile.⁴ *****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****.

To determine the tax effect of the improper additional standard deductions, we first computed the amount of the improper standard deduction that was used to offset taxable income on each of the tax returns. We then computed the tax effect of the improper additional standard deductions on each tax return. We multiplied the amount of the improper standard deduction by the marginal tax rate for each tax return that was determined using the IRS’s tax rate schedules for Tax Year 2011. *****2(f)*****
*****2(f)*****. We estimate the tax effect of these improper additional standard deductions over the next five years will total \$8,740,635.

⁴ 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.



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Appendix V

***Individual Tax Return Forms and Schedules
Added for Processing in the
Modernized e-File System Release 7.0***

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

Form 1040EZ – Income Tax Return for Single and Joint Filers With No Dependents

Form 1040 Schedule C-EZ – Net Profit From Business (Sole Proprietorship)

Form 1040 Schedule F – Profit or Loss From Farming

Form 1040 Schedule H – Household Employment Taxes

Form 1040 Schedule J – Income Averaging for Farmers and Fishermen

Form 1040 SS (PR) – U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)

Form 1116 – Foreign Tax Credit (Individual, Estate, or Trust)

Form 1310 – Statement of Person Claiming Refund Due a Deceased Taxpayer

Form 2106-EZ – Unreimbursed Employee Business Expenses

Form 2120 – Multiple Support Declaration

Form 2210-F – Underpayment of Estimated Tax by Farmers and Fishermen

Form 2350 – Application for Extension of Time to File U.S. Income Tax Return

Form 2439 – Notice to Shareholder of Undistributed Long-Term Capital Gains

Form 2555 – Foreign Earned Income

Form 2555-EZ – Foreign Earned Income Exclusion

Form 3468 – Investment Credit

Form 3800 – General Business Credit



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Form 3903 – Moving Expenses

Form 4136 – Credit for Federal Tax Paid on Fuels

Form 4137 – Social Security and Medicare Tax on Unreported Tip Income

Form 4255 – Recapture of Investment Credit

Form 4563 – Exclusion of Income for Bona Fide Residents of American Samoa

Form 4684 – Casualties and Thefts

Form 4797 – Sales of Business Property

Form 4835 – Farm Rental Income and Expenses

Form 4952 – Investment Interest Expense Deduction

Form 4970 – Tax on Accumulation Distribution of Trusts

Form 4972 – Tax on Lump-Sum Distributions

Form 5074 – Allocation of Individual Income Tax to Guam or the Commonwealth of the Northern Mariana Islands (CNMI)

Form 5329 – Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

Form 5405 – First-Time Homebuyer Credit and Repayment of the Credit

Form 5471 – Information Return of U.S. Persons With Respect to Certain Foreign Corporations

Form 5471 (Schedule J) – Accumulated Earnings and Profits (E&P) of Controlled Foreign Corporation

Form 5471 (Schedule M) – Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons

Form 5471 (Schedule O) – Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of Its Stock

Form 56 – Notice Concerning Fiduciary Relationship

Form 5695 – Residential Energy Credits

Form 5713 – International Boycott Report



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- Form 5713 (Schedule A)** – International Boycott Factor (Section 999(c)(1))
- Form 5713 (Schedule B)** – Specifically Attributable Taxes and Income (Section 999(c)(2))
- Form 5713 (Schedule C)** – Tax Effect of the International Boycott Provisions
- Form 5884** – Work Opportunity Credit
- Form 5884-A** – Credits for Affected Midwestern Disaster Area Employees
- Form 5884-B** – New Hire Retention Credit
- Form 6198** – At-Risk Limitations
- Form 6251** – Alternative Minimum Tax – Individuals
- Form 6252** – Installment Sale Income
- Form 6478** – Alcohol and Cellulosic Biofuel Fuels Credit
- Form 6765** – Credit for Increasing Research Activities
- Form 6781** – Gains and Losses From Section 1256 Contracts and Straddles
- Form 8082** – Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)
- Form 8275** – Disclosure Statement
- Form 8275-R** – Regulation Disclosure Statement
- Form 8379** – Injured Spouse Allocation
- Form 8396** – Mortgage Interest Credit
- Form 8582** – Passive Activity Loss Limitations
- Form 8582-CR** – Passive Activity Credit Limitations
- Form 8586** – Low-Income Housing Credit
- Form 8594** – Asset Acquisition Statement Under Section 1060
- Form 8606** – Nondeductible IRAs
- Form 8609-A** – Annual Statement for Low-Income Housing Credit
- Form 8611** – Recapture of Low-Income Housing Credit



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- Form 8615** – Tax for Certain Children Who Have Investment Income of More Than \$1,900
- Form 8621** – Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
- Form 8689** – Allocation of Individual Income Tax to the U.S. Virgin Islands
- Form 8697** – Interest Computation Under the Look-Back Method for Completed Long-Term Contracts
- Form 8801** – Credit for Prior Year Minimum Tax – Individuals, Estates, and Trusts
- Form 8814** – Parent’s Election to Report Child’s Interest and Dividends
- Form 8815** – Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- Form 8820** – Orphan Drug Credit
- Form 8824** – Like-Kind Exchanges
- Form 8826** – Disabled Access Credit
- Form 8828** – Recapture of Federal Mortgage Subsidy
- Form 8833** – Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)
- Form 8834** – Qualified Plug-in Electric and Electric Vehicle Credit
- Form 8835** – Renewable Electricity, Refined Coal, and Indian Coal Production Credit
- Form 8844** – Empowerment Zone and Renewal Community Employment Credit
- Form 8845** – Indian Employment Credit
- Form 8846** – Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips
- Form 8853** – Archer MSAs and Long-Term Care Insurance Contracts
- Form 8859** – District of Columbia First-Time Homebuyer Credit
- Form 8862** – Information to Claim Earned Income Credit After Disallowance
- Form 8864** – Biodiesel and Renewable Diesel Fuels Credit
- Form 8865** – Return of U.S. Persons With Respect to Certain Foreign Partnerships



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Form 8865 (Schedule K-1) – Partner’s Share of Income, Deductions, Credits, *etc.*

Form 8865 (Schedule O) – Transfer of Property to a Foreign Partnership (under section 6038B)

Form 8865 (Schedule P) – Acquisitions, Dispositions, and Changes of Interests in a Foreign Partnership

Form 8866 – Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method

Form 8867 – Paid Preparer’s Earned Income Credit Checklist

Form 8873 – Extraterritorial Income Exclusion

Form 8874 – New Markets Credit

Form 8881 – Credit for Small Employer Pension Plan Startup Costs

Form 8882 – Credit for Employer-Provided Child Care Facilities and Services

Form 8885 – Health Coverage Tax Credit

Form 8886 – Reportable Transaction Disclosure Statement

Form 8889 – Health Savings Accounts (HSAs)

Form 8891 – U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans

Form 8896 – Low Sulfur Diesel Fuel Production Credit

Form 8900 – Qualified Railroad Track Maintenance Credit

Form 8903 – Domestic Production Activities Deduction

Form 8906 – Distilled Spirits Credit

Form 8907 – Nonconventional Source Fuel Credit

Form 8908 – Energy Efficient Home Credit

Form 8909 – Energy Efficient Appliance Credit

Form 8910 – Alternative Motor Vehicle Credit

Form 8911 – Alternative Fuel Vehicle Refueling Property Credit



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Form 8912 – Credit to Holders of Tax Credit Bonds

Form 8917 – Tuition and Fees Deduction

Form 8919 – Uncollected Social Security and Medicare Tax on Wages

Form 8925 – Report of Employer-Owned Life Insurance Contracts

Form 8930 – Qualified Disaster Recovery Assistance Retirement Plan Distributions and Repayments

Form 8931 – Agricultural Chemicals Security Credit

Form 8932 – Credit for Employer Differential Wage Payments

Form 8933 – Carbon Dioxide Sequestration Credit

Form 8936 – Qualified Plug-in Electric Drive Motor Vehicle Credit

Form 8938 (PDF) – Statement of Foreign Financial Assets

Form 8941 – Credit for Small Employer Health Insurance Premiums

Form 8949 – Sales and Other Dispositions of Capital Assets

Form 9465 – Installment Agreement Request

Form 970 – Tax Benefits for Education

Form 982 – Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

Form T (Timber) – Forest Activities Schedule

W-2AS – American Samoa Wage and Tax Statement (Info Copy Only)

W-2CM – Commonwealth of the Northern Mariana Island Wage and Tax Statement (Info Copy Only)

W-2G – Certain Gambling Winnings

W-2GU – Guam Wage and Tax Statement (Info Copy Only)

W-2VI – U.S. Virgin Islands Wage and Tax Statement (Info Copy Only)

499R-2/W-2PR – Record of Puerto Rico Withholding



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Appendix VI

***Treasury Inspector General for Tax Administration
Audit Reports on the Modernized e-File System***

TIGTA, Ref. No. 2010-20-041, *Modernized e-File Will Enhance Processing of Electronically Filed Individual Income Tax Returns, but System Development and Security Need Improvement* (May 2010).

TIGTA, Ref. No. 2010-40-111, *System Errors and Lower Than Expected Tax Return Volumes Affected the Implementation of the Modernized e-File System for Individual Tax Return Processing* (Sept. 2010).

TIGTA, Ref. No. 2011-20-088, *The Modernized e-File Release 6.2 Included Enhancements, but Improvements Are Needed for Tracking Performance Issues and Security Weaknesses* (Sept. 2011).

TIGTA, Ref. No. 2011-40-131, *Low Participation and Tax Return Volumes Continue to Hinder the Transition of Individual Income Tax Returns to the Modernized e-File System* (Sept. 2011).



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Appendix VII

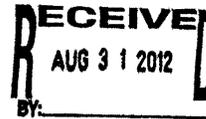
Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

August 31, 2012



MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi *Peggy Bogadi*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – While Use of the Modernized e-File System
for Individual Tax Returns Has Increased, the Legacy e-File
System Is Still Needed as a Backup (Audit # 201240012)

We have reviewed your subject draft audit report concerning the Modernized e-File (MeF) Program. As stated below, we took significant steps during the 2012 Filing Season to ensure MeF performed properly, and we will be deploying additional measures to ensure MeF continues to perform as the primary e-File platform for the upcoming filing season.

It should be noted that, up to April 17, 2012, the IRS processed 72.4 million individual income tax returns through MeF, up from 8.7 million returns in the prior year period. This is a significant achievement, and is the result of several years of focus and careful management of a large, complex, multi-year technology deployment. Any deployment of technology at this scale will involve issues. When those issues have arisen, we have moved quickly to resolve them. Further, we have incorporated the lessons learned into our planning for the 2013 filing season. We are actively managing risks, while also recognizing that it would not be a prudent use of taxpayer dollars to maintain two systems indefinitely. We will maintain the legacy system for 2013, but on a limited, exception-only basis.

We strongly disagree with the conclusions "the MeF system has not shown it can consistently process large volumes of tax returns for an extended period of time", and "the IRS continues to have limited assurances that the MeF system is accurately and effectively processing individual tax returns." While we did experience some delays in processing returns during the 2012 filing season, the overall time frame for refund delivery was consistent with prior years.



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The MeF system clearly demonstrated the capacity to process returns during the prior filing season. Return volume is one of two measures that need to be factored to assess the ability of MeF to process large volumes for extended periods of time. The second more critical measure, not mentioned in your report, is the transaction processing rate (i.e. the number of transactions per second that MeF can process).

- Return Volume: the statistics for the 2012 Filing Season (FS) showing 60 percent MeF and 40 percent Legacy are distorted by a few anomalies, which overstate the numbers. Most of the legacy volume came from preventive measures that the IRS took with a few of the largest volume transmitters while the MeF-related issues were being diagnosed and resolved in the early part of the filing season. Notwithstanding the preventive measures, as of April 17, 2012, MeF experienced a 732.2 percent increase in returns being processed compared to the same period last year. This significant volume increase enabled the IRS to demonstrate the system can perform at the required transaction processing rate.
- Transaction Processing Rate: the data for transactions per second show MeF timely processed all tax returns during the 2012 FS after the February processing issue was resolved. For example, during the 4 p.m. hour on April 17, 2012, MeF received over 265,000 tax returns at more than 73 returns per second. At the same time, acknowledgements were also being returned at a rate of over 73 per second, signifying no processing backlog. At these processing rates, acknowledgements were made available to the transmitters well within the established timeframes communicated to the external community.

Taking these two measures into consideration, we believe MeF has shown it can process large volumes of data for extended periods of time. With the additional performance improvements being made in preparation for the 2013 FS, we are highly confident that MeF can handle the full return volume.

As with any large-scale deployment, deployment issues are to be expected, and when they arose the IRS took quick action to address them. The draft report does not thoroughly describe the quality control process used to test application functionality. We disagree that our processes have "limited assurances that the MeF system is accurately and effectively processing individual tax returns."

Prior to deployment in the production environment, MeF underwent extensive testing as part of the software development process. We followed the industry agreed practice that quality control is most important during the design and development process. The Post Production Review covered in your report is not a required practice of the Enterprise Life-Cycle (ELC). This after-the-fact verification once a system is in use is a necessary element of an overall process, but is substantially less critical than the upfront testing and quality control that is performed in accordance with the ELC. It is for this reason that during the 2012 FS, the IRS adapted its phased approach to the Post Production



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Review verification and decided not to execute the last optional phase once the system was up and running smoothly.

The survey conclusions drawn from the responses of 10 transmitters are not indicative of the consensus of all transmitters. Despite the early challenges in the filing season, the overall data shows that MeF performed extremely well. The IRS values the partnership we have with the industry (e.g., tax software developers, states, and tax professionals). Over the course of the three-year deployment of the 1040 MeF program, we have demonstrated commitment, flexibility and willingness to work with our industry partners to reduce burden overall. The requirement to use MeF during 2012 FS and limited Legacy e-File availability, were reasonable and measured steps to take to ensure the necessary larger volumes were processed through MeF.

The IRS is systematically applying lessons learned from the 2012 FS, and making key operational and performance enhancements to the MeF system. In anticipation of significant volume growth, we are substantially enhancing our performance testing and engineering capabilities to ensure solid performance throughout the 2013 FS.

Our specific comments to your recommendation are attached. If you have any questions, please contact me, or a member of your staff may contact Peter J. Stipek, Director, Customer Account Services, Wage and Investment Division at (404) 338-8910.

Attachment



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Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should develop a comprehensive testing plan to incorporate the pre-implementation test results into the post-implementation quality review. The comprehensive testing plan should ensure that all programming issues are addressed prior to the start of the filing season. In addition, all tax forms, schedules, and business rules applicable to individual tax returns through the MeF system (rejected and accepted) should be reviewed to ensure tax returns are accurately processed through the MeF system before the IRS permanently retires the Legacy e-File system.

CORRECTIVE ACTION

We will enhance our test procedures based on our lessons learned, but we will do so in a way that conforms to IRS enterprise standards. The Modernized e-File (MeF) system was developed under the guidance of Internal Revenue Manual 2.16.1, *Enterprise Life Cycle (ELC) - Enterprise Life Guidance*. The ELC is the approach used by the IRS to manage initiatives and implement changes in business information systems. It provides a comprehensive project management structure for systems development that includes extensive planning, risk analysis, development, testing, milestone reviews, and certification processes. Testing activities include System Acceptability Tests, System Integration Tests, Government Acceptance Tests, and Final Integration Tests. Prior to deployment into the production environment, MeF Release 7, used in the 2012 Filing Season, was cleared by the Submission Processing Executive Steering Committee as having met and passed all milestone objectives and requirements.

IMPLEMENTATION DATE

January 15, 2014

RESPONSIBLE OFFICIAL

Director, e-Channel Support, Submission Processing, Customer Account Services,
Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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