Electronic Tax Administration Advisory Committee

Annual Report to Congress

June 30, 2002

ETAAC Annual Report to Congress – 2002

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Executive Summary

Overview

The IRS Restructuring and Reform Act of 1998 (RRA 98) established the following goals for the IRS:

- Paperless filing should be the preferred and most convenient means of filing federal tax and information returns;
- The Internal Revenue Service should set goals to have at least 80 percent of all returns filed electronically by 2007 and all returns that are prepared on a computer filed electronically by 2003, and;
- The Internal Revenue Service should cooperate with the private sector to encourage competition to increase electronic filing (e-filing).

The IRS has made considerable progress toward achieving these goals, but much work remains to be done. Initial efforts focused on expanding the availability of electronic filing, particularly for individuals. While those were necessary first steps, we've since learned that offering electronic filing options doesn't, by itself, lead to their use. Over 99% of individual tax forms and schedules are able to be filed electronically, but just fewer than 35% (46.3 million) of all individual returns were e-filed this past year. Now that opportunity has been addressed, the key challenge to increasing individual e-filing is to stimulate demand by taxpayers and tax preparers. That, in turn, is dependent on continuing to increase the awareness and value of e-filing.

The challenge is different with business e-filing. Business e-filing initiatives to date have been limited, but well received. Business returns are generally more complex than individual returns, as are the filing, authentication and signature processes. Work is underway, as part of a comprehensive strategy, to develop and market additional opportunities for business e-filing that add value for businesses while improving IRS internal operations.

Third party tax practitioners are major players in the tax administration supply chain. They file 60% of all individual returns and at least 85% of all business returns, and are therefor critical to achieving the RRA 98 goals. The mass market tax preparers already file an average of 83% of individual tax returns electronically. The large accounting firms and the regional and local accounting and tax practices need to be the focus of future efforts to grow e-filing.

Individual e-Filing

Filing season 2001 was the first since the passage of RRA 98 to fall short of projections in the individual e-filing area. ETAAC is pleased to report that filing season 2002 results exceeded projections, netting a 6.5 million (16.3%) increase in e-filed returns over 2001, for a total of 46.3 million (34.9%) e-filed returns as of May 30, 2002. However, the trend is clearly toward lower annual growth rates in e-filing than was experienced in the early years of the program. At the

current rate of increase, the IRS will not achieve either 80% e-filing by 2007 or 100% e-filing of computer-prepared returns by 2003.

To improve the growth rate, the IRS will need to overcome barriers to adoption of e-filing that include a continued preference by taxpayers for paper filing, lack of awareness of e-filing and how to do it and concern about privacy, security and the role of third parties in the process. Some of these barriers can be addressed through education and marketing of the advantages of e-filing, such as faster refunds, electronic receipts that offer proof of filing, convenience, accuracy and reduced likelihood of receiving a notice from the IRS. Others need to be addressed through structural changes, such as modernizing the 1040 e-file system to provide more value to taxpayers and tax practitioners.

The segment of taxpayers and tax practitioners who prepare returns on computer but file them on paper offer the greatest potential for rapid conversion of a large number of taxpayers to e-filing. In particular, we recommend continued aggressive marketing and the early implementation of a broad range of e-services for practitioners as an incentive to e-file the estimated 30 million returns that this group prepares on computer but files on paper.

Increasing individual e-filing growth rates is also dependent on attracting self-preparers who use a computer but file on paper and balance-due taxpayers, who aren't lured by the promise of faster refunds. Changing the due date for e-filed returns is expected to appeal to this filing segment, and is projected to attract nearly 9 million new e-filers by 2007. Ensuring the privacy and security of e-filing is also essential to attracting these taxpayers.

The 30 million taxpayers who prepare their own returns by hand and file them on paper are the primary target audience for the EZ Tax Filing Initiative. EZ Tax Filing is aimed at offering free on-line filing to a subset of these taxpayers, through a consortium of private-sector providers. Successful penetration of this market segment depends on creating awareness of the EZ Tax Filing opportunity, delivering real value to customer, facilitating access to the Internet and making the products easy to use.

Modernization of the 1040 e-file platform is critical to ensuring that the IRS can meet future e-file performance commitments, provide faster acknowledgments and improve services to self-filers and practitioners. The existing 1040 family e-filing platform was built in the mid-1980's. While it served the IRS well in the early years of e-filing, it is not capable of supporting the future volumes and required functionality of e-filing, including online, interactive e-filing services.

Business e-Filing

Overall, business return e-filing levels are relatively low and e-filing is not yet available for many business return forms. However, early IRS business e-file initiatives generally have been well received, particularly where the e-file process added value and didn't increase administrative burden or cost. While progress in business e-filing growth lags the progress being made with individual returns, the IRS is moving aggressively to make up ground, and has adopted a strategic approach to business e-filing and e-services that includes the development of modern new business return e-filing systems that should promote more rapid growth in the future. A plan is in place to roll out additional business e-filing products over the next few years through the Expanded Business Products Initiative.

IRS development of e-filing capabilities for business returns focuses on products that capture the highest volume first. This prioritization is necessary to allocate limited resources to those initiatives with the greatest potential positive impact on e-filing. Compared to individual e-filing, business e-filing involves fewer but more complex returns that require more sophisticated e-filing systems and capabilities. Programs to date have focused on electronic transmission of payroll reports and related payments, fiduciary income tax returns (form 1041 and related K-1's) and partnership income tax returns (form 1065 and related K-1's).

ETAAC supports the development of a modern business e-file platform to support the expansion of business taxpayer e-filing, e-payment and e-services in the context of an overall strategy for improving services to business customers and their third-party representatives.

Tax Practitioners

Tax practitioners file nearly 60% of all individual tax returns and more than 85% of all business tax returns, so they are a primary key to the success of e-filing. Some segments of the professional tax preparation community, primarily mass-market preparers who file 83% of their returns electronically, have adopted e-filing as their principle way of doing business. However, there were more than 30 million returns computer-prepared by practitioners but submitted on paper rather than e-filed.

Two over-riding themes emerge from surveys of tax practitioners who don't e-file. First, efforts aimed at stimulating taxpayer demand for e-filing would encourage practitioner participation. Second, e-filing needs to be cost-effective for practitioners and to integrate well into their ongoing business processes. To address these themes, the IRS needs to continue to market e-filing aggressively to taxpayers who use paid preparers and to streamline the e-filing process as it relates to practitioners. Incentives and electronic services should be offered to offset the additional burdens and to add value for practitioners and taxpayers.

ETAAC encourages the IRS to quickly implement as wide a range of e-services as possible, making them available only to practitioners who e-file a significant quantity or proportion of eligible returns. If these services are made available exclusively to e-filers, and are provided in a timely fashion, they will provide a strong incentive for paper filers to convert.

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Section 1: Background

The National Commission on Restructuring the IRS issued a report in 1997 defining *A Vision for a New IRS*. In 1998, much of that vision was codified into law in the IRS Restructuring and Reform Act of 1998 (RRA 98). The Act established the following goals for the IRS:

- Paperless filing should be the preferred and most convenient means of filing federal tax and information returns;
- The Internal Revenue Service should set goals to have at least 80 percent of all returns filed electronically by 2007 and all returns that are prepared on a computer filed electronically by 2003, and;
- The Internal Revenue Service should cooperate with the private sector to encourage competition to increase electronic filing (e-filing).

The legislation further required that the IRS establish an advisory group, with an assignment to report to Congress annually on:

- The progress of the IRS in meeting RRA 98 goals;
- The status of the strategic plan to eliminate barriers, provide incentives, and use competitive market forces to increase electronic filing;
- The legislative changes necessary to assist the IRS in meeting those goals; and
- The effects on small businesses and the self-employed of electronically filing tax and information returns.

To fulfill this charge, the Electronic Tax Administration Advisory Committee (ETAAC) was created in 1998 by the IRS Electronic Tax Administration (ETA). Over the past few years, the IRS has made considerable progress toward achieving the goals identified above. The IRS Electronic Tax Administration Program is to be commended for bringing focus, energy and creativity to the effort. Electronic Tax Administration is also now considered an important component of the strategic plans of each of the IRS Operating Divisions.

Still, the IRS faces formidable challenges in meeting the aggressive goals set forth in RRA 98. When those goals were first articulated, opportunities for electronic filing and service delivery were more limited than they are today. Initial efforts focused on expanding the availability of electronic filing, particularly for individuals. This included creating electronic versions of all possible forms and schedules in the Form 1040 family, as well as offering free-style practitioner notes, electronic signatures, credit card payments and electronic funds withdrawal options. Additional electronic services identified as important benefits to the tax professional community, such as Electronic Account Resolution and Electronic Transcript Delivery, are being developed to provide practitioner incentives for E-filing.

While those were necessary first steps, we've since learned that offering electronic filing options doesn't, by itself, lead to their use. Over 99% of individual tax forms and schedules are able to be filed electronically, but less than 35% of all individual returns were e-filed this past year. In the individual income tax area, adoption, rather than opportunity, is the key issue.

Section 2: Progress Report–Filing Season 2002 Results for Individual e-Filing

Filing season 2001 was the first since the passage of RRA 98 to fall short of projections in the individual e-filing area. ETAAC is pleased to report that the filing season 2002 results exceeded projections, although not by enough to offset the slow growth of last year – and not at the same 20% or greater pace of the early years of e-filing. At the rate of increase experienced over the past two years, it appears the IRS will not achieve the goal of 80% e-filing by 2007 and will fall short of the goal to achieve 100% e-filing of computer-prepared returns by 2003. In 2002, only approximately 50% of computer-prepared returns were electronically filed. Attracting the first 46 million e-filers was relatively easy compared to what it will take to attract the next 66 million, required to meet the 80% goal by 2007.

As reflected in Table A below, filing season 2002 netted a 6.5 million increase in e-filed returns over 2001, for a total of 46.3 million e-filed returns as of May 30, 2002. This represents a 16.3% increase this year over last. To establish a base of understanding for this Report, it's important to examine the trends within each electronic filing segment:

- On-line filing grew by 38.8%
- Practitioner e-filing increased 14.3%
- Tele-file use decreased by 4.5%

Table A: 2002 Individual e-Filing Season Results					
Electronic Returns Entire Year	**2002 Projected Returns for thru 5/30**	**2002 Actuals thru 5/31**	**2001 Actuals Change**	**% Projected Change**	**% Actual Change**
On-Line	8.5M	9.3M	6.7M	26.9 %	38.8%
Practitioner	32.4M	32.8M	28.7M	12.9%	14.3%
Telefile	4.0M	4.2M	4.4M	-9.1%	- 4.5%
Totals	**44.9M**	**46.3M**	**39.8M**	**12.8%**	**16.3%**

Five Year Trends: Individual Returns

Table B illustrates this year's e-filing growth in the context of the five-year pattern of electronic filing. Unlike last year, actual results exceeded projections for individual e-filing. However, the trend is clearly toward lower annual growth rates in e-filing than was experienced in the early years of the program, for two primary reasons. First, as the base of total filers and e-filers grows, the number of new e-filers needed to sustain the same growth rate increases. Second, the filers most easily attracted to e-filing have now made the switch from paper filing – the more difficult target population remains to be converted.

Table B: Growth Trends in e-Filing

Year	Total Returns	On-Line Returns	Practitioner Returns	Telefile Returns	Total Elec.	% e-Filed	% Growth
2002	132.7	9.3	32.8	4.2	46.3	34.9%	16.3%
2001	130.3	6.8	28.9	4.4	40.2	30.8%	14.2%
2000	127.4	5.0	25	5.2	35.2	27.6%	20.1%
1999	124.9	2.4	21.1	5.7	29.3	23.4%	20.1%
1998	122.5	.9	17.6	5.9	24.4	20.0%	25.1%

Success Factors in the 2002 Individual Filing Season

Some of the key initiatives and accomplishments that contributed to the 2002 e-filing results include:

- **Marketing:**
  The IRS increased national and local marketing of e-filing with a targeted campaign aimed at two particular groups of taxpayers. The first group included taxpayers who use tax preparation software to prepare their own returns, but then mail a paper printout to the IRS. The second group included taxpayers who use tax preparers who print and mail returns rather than e-file. The targeted campaign seemed to help raise overall awareness of e-filing.

- **Improved Availability and Convenience**
  The IRS made 31 additional forms and schedules eligible for e-filing, thereby enabling 99% of all forms and schedules to be filed electronically. With the additional forms and the availability of the self-select PIN program, e-filing opportunity and convenience were enhanced.

- **State/Federal e-Filing**
  With a growing number of states implementing and expanding e-filing, the number of federal/state e-filed returns grew 27% over last year. The ability to simultaneously file both a federal and a state return adds significantly to the value of e-filing for taxpayers and tax practitioners, and will lead to continued growth of e-filing at the federal level.

- **Practitioner Personal Identification Number (PIN) Program**
  This program provided practitioners with a paper signature alternative – the self-selected PIN. It provided those who elected to participate in the program an easier way to file electronically, by not having to mail in the cumbersome paper signature Form 8453.

Section 3: Progress Report – Filing Season 2002 Results for Business e-Filing

Overall, business return e-filing levels are relatively low and e-filing is not yet available for many business return forms. However, the IRS business e-file initiatives that have been implemented generally have been well received, particularly where the e-file process added value and didn't increase administrative burden or cost. For example, the Form 1065 partnership return e-filing program is popular with many practitioners, growing at a rate of 16% per year.

While progress in business e-filing growth lags the progress being made with individual returns, the IRS is moving aggressively to make up ground, and has adopted a strategic approach to business e-filing and e-services that includes the development of modern new business return e-filing systems that should promote more rapid growth in the future. A plan is in place to roll out additional business e-filing products over the next few years through the Expanded Business Products Initiative.

Information Returns

Electronic filing of information returns, including Forms W-2, 1098, 1099, 5498 and W-2G, grew to 485 million returns in 2002 (380 million filed with the IRS and 105 million filed with the Social Security Administration) and is projected to grow to about 600 million returns by 2005. The Internal Revenue Code requires electronic or magnetic media filing when submitting 250 or more information returns. The Restructuring and Reform Act of 1998 extended the due date for Forms 1098, 1099, W-2, W-2G to March 31, if filing electronically.

Form 940 Employer's Annual Unemployment Return & Form 941 Quarterly Federal Employer's Tax Return

The 940 e-filing system is currently being redesigned to run on a modernized business e-filing platform, setting the stage for increased growth and improved efficiency in the future. For calendar year 2001, 5.5 million Form 940s were filed – 88.5% on paper forms and 11.5% on magnetic media. Of all Form 940 filings, 96% come from Small Business/Self Employed (SBSE) entities, 2% from Large & Medium Size Businesses (LMSB), and 2% from Tax Exempt and Government Entity (TEGE) filers.

Form 941 Quarterly Federal Employer's Tax Returns, reporting tax withholding and FICA tax information, are filed on a quarterly basis and can be filed on paper, on magnetic media, by Tele-File, online, or through e-file applications provided by software vendors. As with Form 940, a modernized Form 941 e-file application is under development for 2003. Of nearly 23 million returns filed in calendar year 2001, 84.4% were on paper, 6.4% were on magnetic media and 9.2% were e-filed (including Telefile and online filing). Of all Forms 941 filed, 85% came from SBSE filers, 5.6% from TEGE filers, and 1.3% from LMSB filers. The IRS projects Form 941 e-filing will grow to about 40% by 2007.

Form 1065 Partnership Returns

The 1065 e-filing program has turned out to be a very successful initiative, receiving positive reviews based on user surveys. There were more than 2.1 million returns filed in 2001, with most coming from SBSE taxpayers. The 1065 platform was the first true business e-file application to be developed; it includes 62 forms and schedules. For filing year 2001, less than 1% of partnership returns were e-filed, but these filings included nearly four million K1 attachments (approximately 19% of all K1's filed). The IRS projects that 12% of all 1065's will be e-filed by 2004.

Form 1120 Corporation Returns

Electronic filing is not yet available for corporation returns, but is under development for implementation in the 2004 filing year. In tax year 2001, 1.22 million Forms 1120 "C" corporation income tax returns were filed. SBSE taxpayers filed 96% of these returns, with 3.5% coming from large businesses. Paid preparers produced 89% of these returns. There were also more than 2 million Form 1120S Subchapter "S" corporation returns filed in 2001. Almost 100% of these returns came from small business taxpayers. Paid preparers produced 92% of these returns.

While the volume of 1120 returns processed each year is not large relative to information or individual returns, the information on the 1120 forms represents 65% of all business tax data submitted by taxpayers, making this a key strategic target for electronic filing.

Electronic Payments

More than 94% of all federal employment deposits are paid electronically. In FY2001, the IRS received over 64 million EFTPS payments from 3.6 million enrollees, of which almost 3 million are volunteers. Electronic payments now total approximately $1.6 trillion per year, reaching a peak in 2001 of $40 billion dollars and 1 million transactions on a single day.

The IRS implemented the Electronic Federal Tax Payment (EFTPS) in 1996. EFTPS is a tremendous success overall, with as many as six thousand new payers enrolling in EFTPS each week. The IRS added EFTPS Online last year, a new Internet-based program that has been very successful in moving a large percentage of tax deposits to direct electronic transfers, contributing to a 90% increase in direct debit dollars in the 2001 filing year.

Section 4: Assessment and Recommendations – Individual Taxpayers

At the close of filing season 2002, with 34.9% of all individual returns being filed electronically, the IRS is not yet halfway toward the 2007 80% goal. At the current rate of growth, only 50%-60% of returns will be e-filed by 2007. In the next five years, at least 66 million additional individual taxpayers must e-file for the IRS to achieve the 80% target. By next year (2003), an additional 40 million computer-prepared returns need to be e-filed to reach the goal of 100% e-filing of computer-prepared individual returns. The IRS is not likely to achieve either of these

goals, largely for reasons beyond its control. However, careful planning of where and how to focus the next efforts, and what those efforts should be, can potentially improve the outlook. The first step is to understand what keeps taxpayers from e-filing in greater numbers.

Barriers to Individual Taxpayer e-Filing

The IRS has conducted survey research to determine why individual taxpayers don't e-file, as summarized in Table C.

<table>
<tr><td colspan="2">Table C: Barriers to Individual Taxpayer e-Filing</td></tr>
<tr><td>E-file not perceived to be better, prefer paper filing</td><td>19%</td></tr>
<tr><td>Don't know enough about E-filing yet</td><td>17%</td></tr>
<tr><td>Concerned about privacy or security issues</td><td>16%</td></tr>
<tr><td>Heard about E-file, but don't know how to do it</td><td>15%</td></tr>
<tr><td>Concern about not getting a signed paper copy of the return</td><td>14%</td></tr>
<tr><td>Habit; used to filing on paper</td><td>13%</td></tr>
<tr><td>Perception that they are not "qualified" to E-file</td><td>12%</td></tr>
<tr><td>Lack of access to a computer or tax software</td><td>12%</td></tr>
<tr><td>Presence of "third party" businesses in the return filing process</td><td>12%</td></tr>
<tr><td>Concern about the cost of E-filing</td><td>9%</td></tr>
</table>

No predominant, easily correctable reason was identified, but the primary themes are:

- A continued preference for paper filing;
- Lack of awareness of e-filing and how to do it; and
- Concern about privacy, security and the role of third parties in the process.

IRS efforts to increase e-filing by individual taxpayers need to address these themes. However, to get the most out of those efforts, it's also important to understand individual taxpayer demographics and to develop a program of prioritized initiatives targeted at unique taxpayer segments.

Individual Taxpayer Segmentation

Success in attracting 66 million additional individual e-filers over the next five years, to reach the 80% e-filing goal, is dependent in large part on:

- Identifying the filing segments with the greatest potential for converting large volumes of return filings from paper to electronic format;
- Figuring out what would attract those taxpayers to electronic filing; and
- Targeting taxpayers whose behavior can likely be influenced by actions under IRS control.

Table D provides a segmented view of the individual taxpayer filing population. The primary conclusion we draw from this data is that the so-called "V-Coded" return segment – who prepare returns on computer but file them on paper – offers the greatest potential for rapid conversion of a large number of taxpayers to e-filing. Within this segment of more than 40 million returns, at least 31 million were filed by practitioners (see Section 6: Assessment and Recommendations – Tax Practitioners) and more than 9 million were self-prepared.

Table D: Personal Income Tax Return Segmentation for Filing Year 2001

Segment	Total Volume	Hand-Prepared Paper Return	V-Coded Returns***	e-Filed Returns
Self-prepared simple*	32.1M	20.2M	3.2M	8.7M
Self-prepared complex**	20.3M	9.3M	6.1M	4.9M
Paid-preparer simple	23.6M	2.4M	8.5M	12.7M
Paid-preparer complex	38.9M	3.1M	22.6M	13.2M
Unclassified	15.4M			0.7M
Total	130.3M	35.0M	40.4M	40.2M

* "Simple" returns include 1040A, 1040EZ and 1040 without attachments.
** "Complex" returns include all others.
*** "V-Coded" returns are prepared on a computer but filed on paper.

Individual Taxpayer Opportunity Areas

Target Filers Who Prepare Returns on Computer but File on Paper -- "V-Code" Returns

Because of the complexity of the US tax code, with over 1,395,000 words and 650 forms and schedules, many self preparers, and most paid preparers use computerized interactive tax software with integrated instructions, error trapping, and automatic calculation. The IRS estimates that as many as 70% of all individual tax returns are prepared using electronic tax software – a basic requirement for e-filing. Unfortunately, more than 40 million of these computer-prepared returns were printed and mailed to the IRS last year.

Recommendation: The IRS should continue to make the 40 million filers in this "V-Coded" return segment the primary focus of its efforts to increase e-filing, with a targeted marketing campaign to increase awareness of the availability and benefits of e-filing and a concerted effort to create valued incentives to overcome the barriers to e-filing.

Develop Programs to Attract Manual Self-Preparers to computerized preparation – "EZ Tax Filing"

Table D identifies a group of 30 million taxpayers who prepare their own returns by hand and file them on paper. These taxpayers are the primary target audience for the EZ Tax

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Filing Initiative, which is a key element of OMB's e-Government Initiative. EZ Tax Filing is aimed at offering free on-line filing to a subset of these 30 million taxpayers.

Through an ETAAC-sponsored joint effort of the IRS and tax software industry, Internet filing products will be offered by a consortium of voluntary software providers and marketed jointly with the IRS. EZ Tax Filing is expected to provide the following benefits:

- A significant number of taxpayers who are impeded from filing electronically by the costs of obtaining e-filing software or professional tax preparation services will be offered a free alternative;
- The IRS will receive more electronic returns while avoiding the cost of developing its own on-line product.
- The initiative preserves and strengthens government/industry cooperative relations which have led, in large part, to the e-filing gains achieved to date.

Successful penetration of this market segment depends on creating awareness of the EZ Tax Filing opportunity, delivering real value to customer, facilitating access to the Internet and making the products easy to use.

Demonstrating the value of EZ Tax Filing to these taxpayers will be challenging. Many in the target segment are comfortable with manual preparation and may be resistant to change. EZ Tax Filing will need to prove its value by saving time, adding convenience, improving accuracy and expediting refunds. An equally important aspect of the adoption process will be the "first-try" experience. If the product does not work well or is difficult to use, early experimenters will not easily return.

Lack of access to a computer and the Internet may be a roadblock for many in this group. The IRS will need to identify and encourage public access to computers and the Internet in such places as IRS and other government offices, community colleges, public schools, libraries and post offices. Additionally, tax preparation companies may realize significant client development benefits from providing free Internet access in their offices. For example, Peoples Income Tax, an IRS e-File Partner, has already volunteered to be a test marketing venue and, in selected offices where space permits, will provide walk-in access to Internet-connected computers to any taxpayers wishing to take advantage of the EZ Tax Filing opportunity.

Since many in this target group may be less computer literate, ease of use and customer assistance are also keys to success

Recommendation: ETAAC supports the EZ Tax Filing initiative and will continue to monitor its progress against the goals. In particular, ETAAC will be interested in monitoring:

- The extent and diversity of no-charge EZ Tax Filing offerings provided through the consortium;

- The diversity and percentage of the target population eligible for at least one offering;
- The extent of participation by the eligible population;
- Taxpayer perceptions of the quality and ease-of-use of the EZ Tax Filing products; and
- The rate of adoption over time.

Build a Modern Individual e-File Platform

The existing 1040 family e-filing platform was built in the mid-1980's. While it served the IRS well in the early years of e-filing, it is not capable of supporting the future volumes and required functionality of e-filing, including online, interactive e-filing services. Modernization of the platform should enable the IRS to meet future e-file performance commitments, provide faster acknowledgments and improve services to self-filers and practitioners.

Recommendation: We support early implementation of the IRS's strategic plan initiative to replace the current 1040 individual e-file platform. This initiative is critically important to achieving the long-term goals of 80% e-filing and improved efficiency of IRS internal processing.

Address Privacy and Security Concerns

Based on IRS survey research, the current "two-step" e-filing process, using private software companies or tax preparation service companies to prepare and then transmit the return to the IRS, is perceived by some taxpayers as less secure and private than mailing a paper return. In spite of statutory protections, taxpayers may be concerned that their return data will be used for marketing purposes, sold to other companies or intercepted in transit.

Recommendation: The IRS should publicize the laws currently in place to protect the privacy and confidentiality of taxpayer data when handled by either the IRS or third parties. The IRS should also consider developing the capacity to receive e-filed returns directly from taxpayers.

Change the Due Date for e-Filed Returns

The Administration has proposed changing the due date for e-filed returns to April 30th. The IRS estimates this proposal will increase e-filing by 3.7 million returns in the first year of implementation and approximately 8 million by the fifth year. Since e-filed balance-due returns would have to include an electronic payment to qualify for the later due date, e-payments would be expected to increase by approximately 3 million in year one and 6.5 million in year five as a result of this change.

The practitioner community has raised some concerns over the proposed due date change for e-filed returns. The perceived taxpayer advantage of additional filing and payment time translates into an extension of the filing season for practitioners and possibly more

people waiting until the final two weeks to file. States, while generally supportive, have expressed concerns about their ability to pass corresponding changes to statutes in time for a 2003 implementation. States and practitioners are both important partners in promoting e-filing; their support and cooperation is critical to success.

Recommendation: ETAAC welcomes any initiative to encourage e-filing, and will be looking to the IRS to bring forward a well conceived implementation of the change of due date for e-filed returns, if enacted. The implementation should provide relief from possible penalties where taxpayers or their preparers make a good faith effort to e-file, but are impeded by circumstances beyond their control.

Eliminate Tax Software Limitations That Impede E-Filing

Many e-file software programs are "automated" to the extent that they will not allow e-filing if the taxpayer manually changes an automatically calculated line amount. For example, the 2001 version of a popular software package did not allow e-filing if the taxable amount of a State tax refund was adjusted manually. Many tax software programs also do not cover all lines and data types that exist on IRS paper forms and schedules, and may not provide the proper place to input unusual forms of income, deductions or credits, such as items that taxpayers might receive on a Schedule K1.

There are other situations where returns cannot be e-filed, such as where the taxpayer had federal tax withheld on interest, dividends or Social Security payments. Some software developers have enabled their software to accept these types of information returns with withholding; others have not. The IRS is now taking the initiative to improve this situation by writing file specifications for all software development companies. For 2003, the IRS has developed specifications enabling e-filing for the 1099G, and will do so for other information returns in filing season 2004.

Recommendation: Encourage tax software developers to allow e-filing of a return even if the taxpayer or preparer alters a standard calculation amount or entry field limitation for line items, where the variation could be valid for some taxpayers. Software developers should also be encouraged to make sure that their software properly accepts all categories of income, deductions and credits, including those from "pass-through" entities, and to provide for electronic filing of information returns that include withholding.

Section 5: Assessment and Recommendations – Business Taxpayers

IRS development of e-filing capabilities for business returns has focused on products that capture the highest volume first. This prioritization is necessary to allocate limited resources to those initiatives with the greatest potential positive impact on e-filing. Compared to individual e-filing, business e-filing involves fewer but more complex returns that require more sophisticated e-filing systems and capabilities. Programs to date have focused on electronic transmission of payroll reports and related payments, fiduciary income tax returns (form 1041 and related K-1's) and partnership income tax returns (form 1065 and related K-1's).

ETAAC supports the expansion of business taxpayer e-filing, e-payment and e-services in the context of an overall strategy for improving services to business customers and their third-party representatives. Table E lists the business e-filing and e-service initiatives planned or in various stages of development at the IRS.

Table E: Planned Business e-Filing and e-Services Initiatives		
Program	**Time Framework**	**Description**
Form 8850 (Pre-screening notice and certification for the Work Opportunity and Welfare-to-work credits)	2002	A partnership has been formed with stakeholders to develop an electronic transmission for form 8850. Phase 1 (proof of concept) has been tested successfully.
New 1041	2003	A new e-file program is currently under development to receive form 1041 data electronically through EMS.
TIN Matching for Payers	2003	Develop the capability for payers of certain form 1099 income to match payee's name and taxpayer identification number with IRS records before filing.
1120/1120S with Payment	2004	A new e-file system is currently under development to receive and process electronic 1120/1120S returns.
990 Family	2004	Identify requirements and optimum alternate ways of filing electronically.
Foreign Address Partnerships

1065-B | 2004

Unknown | To enhance the current 1065 e-file Program, the IRS needs to accept Form 1065-B and partnership returns with a foreign address electronically. |
2290 with Payment	2004+	An integrated file and payment option will be offered, potentially built on the new 1120 e-filing platform.
7004 with Payment (extension form for 1120 return)	2004 +	Develop capability to receive extension requests electronically and transmit a payment record for the balance due amount of an electronic return.
Forms 5471 and 6166	2004+	Identify requirements and develop capability to receive both forms electronically
1065 with Payment	Unknown	The existing 1065 e-file program doesn't include an integrated payment component.

Business Taxpayer Opportunity Areas

Encourage e-Filing of Information Returns

Many information returns can be filed electronically using the Filing Information Returns Electronically (FIRE) system. FIRE is for filing Forms 1042-S, 1098, 1099, 5498, 8027, W-2G and QWF (Questionable Forms W-4). The FIRE system has been a major success for IRS electronic filing.

The Social Security Administration (SSA) receives and processes all Form W-2s and forwards tax information retrieved from the W-2 to the IRS. SSA offered an online Internet filing program and a PIN signature alternative program in 2001.

Recommendation: In partnership with the SSA, the IRS should continue to promote e-filing of Information Returns. Working in conjunction with software developers, the IRS should create free-standing downloadable software programs for the direct filing of all information returns. As the percentage of electronic filing increases, the extended due date for filing Forms 1098, 1099, W-2 and W-2G could be eliminated so income information is available to the IRS sooner in the filing season for matching against e-filed personal tax returns, thus reducing fraudulent refund claims while expediting legitimate refunds.

Implement New Business e-File Systems

Forms 940 and 941 – Employment tax return reporting has been identified by the Small Business Administration as a significant administrative burden. A new Employment Tax e-file System, scheduled for release in January 2003, will help alleviate this problem by allowing e-filing of Form 940 (Employer's Annual Unemployment Return) and Form 941(Quarterly Federal Employer's Tax Return) in a standard "XML format" (an emerging industry standard). The IRS has worked extensively with software developers, payroll providers and other government jurisdictions to develop standardized XML formats and transmission protocols.

Forms 1120 and 1120S – In conjunction with the new 940/941 platform, the IRS is developing a modern 1120/1120S (Corporation Tax Return) e-file application for implementation in 2004. Responding to concerns cited by practitioners regarding signing authority issues and other e-file technical problems, the 1120 e-file project has established close working relationships with the software developer, tax preparer and transmitter communities.

Recommendation: Developing a modern new business e-file platform is key to the future success of business e-filing. ETAAC strongly supports the continued development of the new 940/941 and 1120 e-filing systems. They will serve as a model for future business tax e-filing systems. Surveys of practitioner groups indicate a high interest in e-filing corporation returns, provided that the applications are complete and well tested, with signing authority issues defined, and other e-file technical problems resolved. Payroll reporting programs should be developed in coordination with the states to continue the move toward combined state and federal employment tax information reporting.

Promote e-Filing of Form 1065 Partnership Returns

To develop a better understanding of business e-file success factors, the IRS commissioned a satisfaction survey for the 1065 e-file program. They learned that, among a sample of Form 1065 e-file users, 90% were at least "satisfied" with the program and 63% were "very satisfied." Support was especially strong among the smaller firms that chose to use the program voluntarily. As a group, users found the program easier and more convenient than paper filing.

The IRS also learned from this survey that awareness, education and promotion of program advantages, combined with simplification of the registration process and provision of free filing software, would help the program to grow. Improved customer support was also cited as key to greater acceptance.

Recommendation: Participation in the Form 1065 e-file program can be further enhanced by promoting program advantages to businesses and practitioners. Business e-file program growth can also be driven by offering benefits to those who e-file, including e-services access, enhanced messaging systems for problem resolution, and preferred e-file technical support to quickly correct filing problems. Since most partnership returns are produced by professional tax software packages, the IRS should continue to work with these software developers to improve the convenience and lower the cost of e-filing.

The development of a free IRS direct electronic filing portal, using standard communications programs, would reduce the extra transmission management costs paid by software vendors. However, the business e-file platform needs to be modernized to support an electronic filing portal. ETAAC strongly supports the IRS' plans to develop a modernized business e-filing platform that will enable a broader range of e-services of interest to business taxpayers and practitioners, thereby increasing the value of e-filing and promoting its use.

Section 6: Assessment and Recommendations – Tax Practitioners

Tax practitioners file nearly 60% of all individual tax returns and more than 85% of all business tax returns, so they are a primary key to the success of e-filing. Some segments of the professional tax preparation community have adopted e-filing as their principle way of doing business. For example, the four largest national tax preparation firms filed an average of 83% of their returns electronically last year – a behavior that, if adopted by all filers, would put the IRS past its 80% e-filing goal. However, there were more than 30 million returns computer-prepared by practitioners but submitted on paper rather than e-filed. Most of those 30 million paper returns were filed by non-mass market practitioners who prepare returns using software, but often submit them on paper.

As a group, tax practitioners produce approximately 72% of all computer-prepared individual tax returns, but only 46% of them are e-filed. Understanding what impedes them from e-filing in greater numbers is the first step in determining how to attract more of them to the program.

Barriers to Practitioner e-Filing

The IRS has conducted survey research to determine why practitioners don't e-file, as summarized in Table F.

Table F: Barriers to Practitioner e-Filing	
Lack of interest or demand by clients; lack of perceived benefits	34%
E-filing software costs too much	24%
E-file adds to workload; takes too much time	24%
Cost of transmission via private companies is too high	16%
The paper signature form (no longer required) was burdensome	14%
E-filing is complex and requires additional learning	12%
E-filing shifts responsibility for filing from the taxpayer to the preparer	10%
Tax returns are too complicated or critical to e-file	9%
The high rejection rate adds extra responsibility and costs	9%
Preparers perceive they're doing the IRS's work for them	9%

Two over-riding themes emerge from this data. First, the survey results suggest that efforts identified in the previous two sections aimed at stimulating taxpayer interest in e-filing would encourage practitioner participation. However, it should also be noted that taxpayers view their practitioners as trusted advisors and are likely to follow their advice regarding e-filing. Therefore, it's important that practitioners themselves are convinced of the value. This leads to the second theme – e-filing needs to be cost-effective for practitioners and to integrate well into their ongoing business processes. These themes shape the opportunity areas presented below.

Tax Practitioner Opportunity Areas

Provide e-Services to Practitioners Who e-File

The IRS plans to begin implementing e-services for practitioners later this year, as an inducement to e-file. The aim of e-services is to provide practitioners who e-file with valuable tools to help them reduce costs and improve service to customers. IRS e-services is likely to prove the major incentive to practitioners to e-file their clients' returns. The initial package of e-services includes:

- Transcript delivery
- Taxpayer Identification Number (TIN) matching (online and bulk)
- Account resolution
- Disclosure authorization
- ERO registration
- Employee Identification Number (EIN) application

Rapid e-mail access to IRS staff to ask questions and resolve problems is also important to practitioners. The ERO's who participated in the beta test of a Secure Practitioner Messaging System praised it highly. The test program was eliminated at the end of the last filing season because of high costs per user for the very limited program. The IRS should provide a broader, less costly, secure e-mail messaging system for all qualified practitioners who e-file a high percentage of eligible returns.

The IRS website – the primary delivery channel for e-services – has undergone a major redesign this past year. Overall, the first release of the redesigned site was well received by the general population. While generally headed in the right direction, practitioners have commented that the next release should focus on improving the practitioner portal, including better organization, more precise search capability, and more complete tax code information.

Recommendation: ETAAC strongly supports these e-service initiatives and encourages the IRS to quickly implement as wide a range of e-services as possible, making them available only to practitioners who e-file a significant quantity or proportion of eligible returns. If these services are made available exclusively to e-filers, and are provided in a timely fashion, they will provide a strong incentive for paper filers to convert.

Reduce Practitioner e-Filing Costs and Administrative Burden

Converting from paper to electronic returns can be difficult and costly for practitioners. For example, as practitioners begin to adopt e-filing, they incur additional costs and administrative burdens in maintaining parallel paper and electronic systems, monitoring the e-filing process and correcting downstream errors and rejected electronic returns.

Many of the practitioners who have not been receptive to e-filing provide accounting services and prepare business returns as their primary lines of business. To encourage them to e-file, the IRS needs to continue to increase the number business tax forms and schedules eligible for e-filing. The IRS is developing an integrated strategy and comprehensive plan for the introduction of new e-filing opportunities and services for business taxpayers and their practitioners, including the development of a flexible new business e-filing system. Such an approach will help ensure that the rollout of new electronic business filing products addresses practitioner business process concerns.

Recommendation: The IRS should continue to streamline the e-filing process as it relates to practitioners, to help reduce the costs and administrative burden associated with offering e-filing to their customers. Incentives and services should be offered to offset these additional burdens and to add value for practitioners and taxpayers.

Another possible solution for reducing the extra administrative burden of e-filing is to provide an IRS portal that would accept a practitioner-prepared return, at no cost, directly from the taxpayer. The preparer could submit the return to the taxpayer electronically, who would then be responsible for reviewing and submitting the return to the IRS.

Improve Process Training and E-Filing Problem Assistance

Many preparers have successfully converted their return preparation and client interaction processes to make e-filing more efficient than paper return filing while also increasing the perceived benefit to their clients.

Recommendation: More emphasis should be placed on helping to identify the best business practices of successful ERO preparers, and communicating these practices to new EROs. The IRS should provide additional resources for IRS e-file support during tax season to answer e-filing questions, with the aim of ensuring the process works as well as it can for first-time electronic filers.

Eliminate the Extra Data Entry Required to E-File

Return preparation of an e-filed return requires additional input for W-2's and 1099R's, beyond what's required for paper returns. For example, with electronic filing, employer name and address and EIN are required on all these documents, whereas with a paper return, if there is no withholding on a 1099R, none of this information is required.

Recommendation: The IRS should validate the need for additional W2 and 1099 information on e-filed returns over and above that required for paper filing and try to limit data entry to essential information only. In the interest of promoting the efficiency of e-filing, the IRS should work with software developers to determine the feasibility and potential benefit of including 2D barcodes on W2's and 1099's to enable practitioners to scan the information.

Streamline Federal/State e-Filing

ETAAC recognizes that a number of states have made great strides in their own e-filing programs and the benefits have been tangible, in the form of reduced administrative burden and greater compliance. Some states can only receive a state return in conjunction with the related federal return. However, only the home state return can be e-filed with the federal return. If the taxpayer is required to file more than one state return, the preparer has the option of either re-entering the additional state information into a stand-alone state e-file system (if available) or filing a paper return. Most choose the paper option.

Recommendation: The benefits of e-filing could be enhanced further with increased co-operation between the IRS and state revenue departments in designing integrated multi-state filing programs. This would require a mechanism to file more than one state return with the federal return, and to attach an electronic file copy of the federal return to multiple state returns. Section 6103 of the Internal Revenue Code may require some change to accomplish this goal. The IRS has indicated they will be able to accept and forward separate state-only returns for the 2003 filing period.

Section 7: Assessment and Recommendations – General

The following are additional opportunities to increase e-filing and improve electronic services.

General Opportunity Areas

Electronic Taxpayer Education And Assistance

The IRS Internet web site has the potential to be an easily accessible and cost effective source of taxpayer education, tax code reference, and filing assistance. As part of a planned redesign of the site, initial changes in 2002 incorporated some improved presentation and information, particularly for the general public and business taxpayers, but additional improvements are needed and planned to increase the value of the site to self-preparers and tax practitioners.

Recommendation: Priority should be given to continued improvement of the IRS web site as a key strategic element of the taxpayer education and communication functions of each of the opperating divisions. The site should include an improved search capability by topic, code section, or form line number, and should operate against a complete data base of the Internal Revenue Code and IRS publications, instructions, regulations, and rulings.

Allow Attachment of Additional Information When E-Filing

While the IRS 1040 e-filing program allows for the attachment of "free form" explanatory information, some third party software for tax preparation and e-filing does not accommodate it. Some IRS forms currently ask that the taxpayer provide additional information about certain line items. Many self preparers and practitioners also add additional, non-required, explanatory information to paper returns with the perception that they reduce the chance of an examination if the return is reviewed for audit. The inability to attach this kind of information when e-filing may be a significant barrier to converting self preparers and paid preparers.

Recommendation: The IRS should encourage all software developers to include the capability to attach "free form" notes. The IRS should eventually, with the development of its new e-filing platforms, provide the ability to attach pre-formatted word processing documents in commonly used file formats such as PDF, Excel and Word.

Address Re-Use of Tax Software That Doesn't Allow Additional E-filing

A comparison of IRS data regarding the number of computer-generated self prepared returns being filed with the number of tax software packages sold each year suggests that individual "packaged" tax software programs are being used to prepare multiple returns. This may result from the software being copied and given to others, or from non-professional preparers using the software to prepare multiple returns for friends or other

family members. This presents two potential barriers to e-filing. The first is that most commercial packages provide only one instance of e-filing at no charge. Second, to reduce the potential for fraudulent filing of multiple returns, many consumer software packages, through agreement with the IRS, limit the number of returns that can be e-filed through the vendor's communication network.

Recommendation: Vendors of packaged tax software should be encouraged to include an option to e-file additional returns, up to a limit acceptable to the IRS, for a reasonable additional e-filing charge.

Increase e-Filing By IRS-Assisted Volunteer Groups

The IRS currently provides computerized tax form software, at government expense, to over 18,000 volunteer tax assistance sites, the military services, other government employees, and IRS "walk-in" taxpayer assistance offices.   Even though the software provides the ability to e-file returns, many of these returns are filed on computer-printed or handwritten paper forms.

Recommendation: While there may be some valid reasons why these volunteer groups e-file in such low numbers (e.g., lack of access to telecommunication lines, inexperience of volunteers, etc.), they file a relatively large number of returns and are provided by the IRS with the opportunity to e-file at no cost, so their participation in e-filing should be strongly encouraged and actively assisted by the IRS.

Addressing the Residual Paper Returns

Even with a highly successful migration to electronic filing, there will likely remain a significant number of paper tax returns for the foreseeable future.

Recommendation: The IRS should continue to assess the reasons for paper filing and develop strategies to promote e-filing as the preferred filing method. Recognizing that a significant number of returns will continue to be filed on paper, the IRS should assess the feasibility and costs – to the IRS and the software development industry – of requiring software developers to include a two dimensional (2D) barcode printing facility in their tax software.

ETAAC recognizes that there may be significant costs and potential diversion of limited IRS and software developer resources in implementing a 2D barcode system and that those efforts need to be secondary to efforts aimed at increasing true electronic filing. Congress has made it clear that paperless filing is the paramount goal. A key element of the 2D barcode analysis must be whether the introduction of the technology would increase or diminish future e-file growth.

Another potential use of 2D barcoding is to facilitate the data entry of information returns by both the IRS and by tax practitioners. This use would provide significant value to tax practitioners and may help encourage them to e-file. The IRS should work with software developers to assess the costs,\ feasibility and required incentives to encourage them to include 2D barcode capability in their information return software packages.

Appendix A

ETAAC Members – 2001/2002

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