Electronic Tax Administration Advisory Committee

Annual Report to Congress

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ETAAC ANNUAL REPORT TO CONGRESS, 2005

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EXECUTIVE SUMMARY

The Electronic Tax Administration Advisory Committee (ETAAC) is charged with reporting annually to the Congress, as outlined in the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98). The ETAAC analysis of the IRS E-File programs and recommendations for reaching the stated goal of RRA 98 follows.

The ETAAC Vision

The 2005 report defines a vision for electronic tax administration. As noted in previous reports, the ETAAC sees electronic tax administration playing a critical role in a modernized IRS as the mechanism transforming the IRS and serving its stakeholders.

The electronic filing goals established in RRA 98 may represent a meaningful metric to evaluate IRS progress toward achieving this transformation. The underlying objective, however, continues to be improving service to taxpayers by providing them with the electronic means of conveniently interacting with the IRS. Because we feel so strongly about this objective, we are devoting less time in our report to an evaluation *by the numbers* (for the details of the filing season see the Appendix exhibits). Increased levels of participation in e-filing will make it easier for IRS to administer the tax system. The IRS continues to make progress toward the 80 percent e-filing goal (by 2007) established in the RRA 1998. In 2005, the IRS received more than half of all individual returns electronically. Although this is encouraging, it is unlikely IRS will reach the 2007 target. We do not consider the IRS Strategic Plan (FY 2005–2009) to go far enough to encourage accelerated growth of e-filing. The ETAAC believes more dramatic steps will be required.

IRS Challenges

In using electronic tax administration to transform itself, the IRS must overcome several critical challenges:

- continuing to develop strategic planning processes, including accelerated progress of the Modernized E-File (1040 MeF) platform for individual returns;
- encouraging all professional tax preparers to become Electronic Return Originators (EROs);
- convincing tax preparers that filing and communicating with the IRS electronically is preferable to other methods;
- expanding e-service options and making these services available to all practitioners;
- increasing electronic filing among self-preparers;

- increasing electronic interactions between the IRS and businesses, including filings, payments, and communications; and
- continuing to form strategic alliances with businesses, federal government agencies, states, and other organizations to promote the growth of electronic tax administration and measure the impact of mandates.

The ETAAC has developed a vision of what meeting these critical challenges will look like, has evaluated the IRS' progress in meeting its electronic tax administration strategic goals, and has identified what the IRS must do to achieve this vision.

VISION DESCRIPTION FROM THE EYES OF THE INDIVIDUAL TAXPAYER

Imagine that you are sitting at your personal computer or with your professional paid preparer in an office environment, connected to the Internet, using commercially available software provided online. The software provides links to your prior years' tax return data, to the most current reference information needed to prepare your return, and to a secure login allowing access to an electronic tax administration website maintained by either a private sector financial services or government entity. You (or your preparer) log on to this website and click the "Get IRS Data" option, which presents all of your tax return information as reported to the IRS by third parties.

You or your preparer request that all relevant tax data—including but not limited to Form W-2, 1099, and 1040ES data—be downloaded to your computer and imported into the correct forms and lines in the tax preparation software.

Finally, you enter additional deductions, credits, and other information to complete your return. When all of this information has been entered, you run an automated final review process that checks your return for accuracy and completeness.

During this process, your refund or your balance due is visible and updated in real-time. After you and your preparer are satisfied that the Form 1040 is complete and accurate, the next step—which is an option—is to transfer all relevant information to the pertinent state tax return. You or your preparer then complete items on the state return that have not been supplied from the 1040. Again, the refund or balance due on the state return is visible and up-to-date at all times.

Once both returns are completed, you and your preparer sign and file the returns electronically. You elect to have your refund direct deposited the next day in your bank account, special debit card if you don't have a bank account, or other available financial product. If you have a balance due, you schedule payment on the payment due date of the respective returns.

Finally, if you pay quarterly estimated tax payments, you have the option of scheduling the payments to be made directly from your bank account, or other financial product, on the appropriate due dates. When the payments have been made, the Treasury Department website automatically generates an email to you thanking you for your payment.

At any time, you or your preparer can go to an IRS Electronic Tax Administration (ETA) website and view all of your current or prior-year tax information. Current and prior year tax information can be provided—via a secure server connection, and with written authorization from you—to third parties as needed to support your personal financial transactions.

Although this narrative focuses on the vision through the eyes of the individual taxpayer, the same scenario applies to all stakeholders. It is imperative that the designers and implementers of the tax eco-system thoroughly understand each stakeholder's vision of the desired ideal future state.

Major Issues for Stakeholders

Multiple stakeholders make up the tax eco-system, and only when their needs are met will an orderly efficient tax system exist. We have identified the top three issues common to all stakeholders that must be addressed before beginning to build a system to meet those needs.

First, there must be easy, secure access to the system for all stakeholders. Many taxpayers do not have access to either a computer or the Internet. Even internally, within the IRS, not everyone is connected and not everyone has access to the system. The access must be uniquely designed around the needs of each stakeholder, yet share a common base structure. Stakeholders must be assured the data is secure and that access is limited to those authorized to view the information.

Second, the Internal Revenue Service and each state jurisdiction must work alongside software providers working with the taxpayers to provide a seamlessly integrated experience for each taxpayer to file, pay, store, and retrieve tax information. Although there are several coordinated efforts underway between the federal and state jurisdictions, much more integration is needed with respect to data or processes and procedures to make preparing, filing, and paying taxes easy for taxpayers.

Last, all transactions associated with filing, paying, storing, and retrieving data—including communication with various federal and state agencies—must be electronic. Laws and regulations governing required documents and processes were designed in a paper environment and must be modified to meet the requirements of an electronic tax eco-system. Paper transactions must be optional and the exception, not the primary means of interaction within the tax eco-system.

Along with these three common issues are the unique needs and requirements unique to individual stakeholders. We have attempted to identify those stakeholders from whom extensive input is critical, and have created the following list. Further investigation may uncover additional stakeholders.

Stakeholders

- IRS personnel who interact with customers
- IRS personnel who interact with back office procedures and infrastructure
- individual taxpayers
- paid preparers and EROs
- payroll service providers (94X family)
- issuers of information returns
- business taxpayers
- state and local revenue departments
- U.S. government agencies
- software developers
- audit and planning professionals
- Treasury/Congress
- academic community
- estate/trust fiduciaries
- not-for-profit entities

The experience of the individual described and the ideal experience of the other stakeholders may seem fanciful. With the proper planning and resource allocation, however, this vision does not have to be either distant or purely theoretical. The information required to make most of this a reality is available now. A completed new master file system and modernized e-filing protocol can provide much of the internal backbone required. The critical step now is for the IRS to fully develop a plan for the future state from the perspective of the system stakeholders and begin working on overcoming the legislative and interagency hurdles that will otherwise halt this process and return little additional value to taxpayers.

EXPEDITE MODERNIZED E-FILE BY MOVING FUNDS TO EARLIER FISCAL YEAR

In an effort to expedite the implementation of 1040 Modernized e-File (MeF) for Individual Returns, the ETAAC recommends moving FY 2010 funds to FY 2008. There are many compelling cost-effective reasons to reallocating funds to an earlier fiscal year.

Issues and Challenges

Despite improvements in equipment and procedures, basic protocols and procedures in the structure of electronic filing have not significantly changed since their inception in 1986. Although e-filing has developed and worked well since 1986, future growth will be constrained as long as the current operating systems—which have reached maximum capacity—remain in place. At the same time, much more aggressive sales approaches must be undertaken in the effort to persuade those not yet convinced that e-filing is, indeed, a good business and personal decision. To continue growth in e-filing, structural changes in operating systems are essential now. Congress should not hesitate to allocate adequate funding to begin implementing 1040 MeF. Congress should also request from the IRS the business case justification for implementing 1040 MeF ahead of 1065 or any other return types.

The goal is to have all tax returns filed electronically. All attachments to the 1040 should be included in this electronic filing capability, eliminating the current requirement to file a paper supplement to the electronic record. More complex 1040s have either attachments or so many occurrences of some forms or schedules that e-filing is not at present possible.

❖ **1040 MeF eliminates these barriers.**

1040 MeF addresses the needs of providing acknowledgments in minutes rather than hours and error messages in plain, easily understood language. Improving the acknowledgment process will appeal to tax practitioners who have not yet embraced e-filing.

Most tax practitioners prepare and file individual returns, but not business returns. In those cases in which the practitioners prepare both types of returns, statistics show the individual return is, in sheer numbers, by far the overwhelming leader. For these reasons, ETAAC is recommending that MeF be reprogrammed to fully support e-filing capability for 1040 returns.

To facilitate this reprogramming, ETAAC recommends reallocating sufficient funds from FY 2010 to FY 2008.

As the past five to ten years have made clear, the U.S. population is rapidly embracing the use of computers and growing more and more technically sophisticated. The IRS must in turn expedite implementation of 1040 MeF to this demanding public. ETAAC is resolute in the idea that, in a heightened awareness of an e-world, e-filing will be the accepted norm for filing a tax return. As younger adults enter the workforce, they will understandably expect most of their daily routines to revolve around their computers.

The ETAAC is fully aware that implementing MeF as promptly as possible will directly affect the needs of stakeholders within the income tax preparation industry. Below are the identified stakeholders and the effect of 1040 MeF on them.

Internal Revenue Service

- By a significant margin, the 1040 family of returns is the most numerous of all income tax returns filed.
- Manually prepared tax returns are inherently error prone. ETAAC sees MeF as the obvious solution to such errors. Electronically prepared returns have far fewer errors then manually prepared returns. MeF will increase the number of electronically prepared returns and hence decrease errors. This will result in significant cost savings to stakeholders.
- The ETAAC envisions that preparers of individual income tax returns will begin to demand continued improvement in government services. This demand should act as a catalyst to motivate Congress to allocate funding sooner than FY 2010.
- The more promptly 1040 MeF is implemented, the sooner the IRS will benefit as its staff and scarce resources are reallocated from inefficient manual processing to compliance and taxpayer service functions.
- A fully integrated system is already considered more efficient, accurate, and fair, and should provide better overall filing compliance and less fraud.
- The ability to provide faster refunds to a larger segment of the public should have a positive effect on the national economy.

Practitioners

- Income tax practitioners prepare more individual income tax returns than business returns. 1040 MeF should motivate income tax practitioners to e-filing all tax returns.
- 1040 MeF will also allow tax practitioners to better serve their clients with faster acknowledgements and more informative error messages. ETAAC sees this as a dramatic improvement in e-filing satisfaction.
- Implementation of 1040 MeF will address security issues. Currently, manually filed income tax returns are exposed to multiple security breaches, including identity theft and lost returns.

- Broad-based application of 1040 MeF should help to eliminate current cost disparities among practitioners. ETAAC sees a greater acceptance of e-filing when all practitioners are faced with the same rules and procedures.

Software Developers

- Software developers must now maintain two sets of return filing structures. This is both expensive and inefficient and will continue until 1040 returns are converted to MeF.
- As 1040s become part of MeF, customer service should dramatically improve. Potentially faster response times and more inclusive product offerings should prove popular with customers.
- Maintaining two sets of filing structures complicates security issues. 1040 MeF would eliminate these issues.

Individual Taxpayers

- ETAAC envisions, once 1040 MeF is fully implemented, that more taxpayers will participate in e-filing their tax returns.
- The number of individual taxpayers filing their returns electronically will increase exponentially as they see more efficient, secure, and faster processing with e-filing.
- If e-filing is standard practice no matter the tax circumstance, taxpayers will demand the service from practitioners. If the value proposition can be neutralized for tax practitioners and better established for taxpayers, there will be an increase in demand for e-filing.

Conclusions

The ETAAC recommends implementing 1040 MeF immediately to maximize its use by a larger segment of population eager to solve their problems electronically.

Every effort must also be made to standardize e-filing requirements on a 1040 MeF platform as soon as possible. Separate federal and state-local procedures, processes, and rules confuse the individual taxpayer and create significant resistance to e-filing among tax practitioners. Shifting allocated budget dollars from FY 2010 to FY2008 should take place without further delay. This will prevent potential splintering of e-filing standards and methodologies if states set their own standards before the federal government does.

The IRS should undertake a publicity campaign to require tax practitioners to file taxpayer returns electronically. ETAAC recognizes that such a stipulation may initially increase costs to the practitioner—that is, new operating systems, appreciably more line time, and increased memory requirements. Encouraging practitioners to use third-party transmitters may help offset any potential increase in costs, as well as sharing best practices from practitioners who have already undergone the transformation to e-filing.

Tax practitioners play a significant role in educating individual taxpayers. Because of this, the ETAAC realizes that accelerated implementation of MeF means that more communication and training for both practitioners and the public will be necessary. The ETAAC maintains, however, that the IRS does not need to be the sole provider of that communication and training. If provided with the appropriate knowledge and materials, tax practitioners can assume the role of educating the individual taxpayers—thus creating a symbiotic relationship among taxpayers, practitioners, and the IRS.

E-TAX HURDLES

Until now, the IRS has focused on individual returns. The ETAAC believes, however, that the IRS would do better to identify and surmount specific barriers to e-filing by return type. Analyzing the returns by type will allow for necessary shifts in focus and will accelerate progress toward the congressionally mandated 80-percent goal. For example, manual signatures are required on the new modernized E-File platform for the Form 1120, which uses XML, while the ability to attach a signature document to the 1040 is already available.

E-File

❖ **E-File must be faster, easier, and more accurate than paper filing. The first experience needs to be positive.**

The biggest barrier now is the problem in maintaining both a legacy and an XML system. This means higher costs to both government and outside stakeholders. Developing and maintaining dual software, training, and support staff resources is a costly overhead. Converting to one platform—XML—as soon as possible is critical to reducing costs, learning curve, and paper burden. XML allows attachments, signatures, and universal acceptance of returns.

- Electronic return filing, processing, and acceptance must appear to taxpayers as completed when they transmit the return electronically as it is when they stamp an envelope and send by postal mail.
- Current restrictions preventing amended and prior year returns from being filed electronically continue to promote paper filing.

E-Pay

❖ **E-Pay must be faster, easier, and more foolproof than paying by paper check. The first experience needs to be positive.**

- Electronic payments should be considered as paid in a timely fashion when transmitted, just as checks and paper returns sent by postal mail are considered paid when postmarked. This is not currently the case.
- The Electronic Federal Tax Payment System (EFTPS) sign-up needs to be instantaneous. Having to wait 14 days for a PIN is unacceptable because it drives away potential users at a time when they need help the most. Many people using EFTPS to pay a balance due for the past year, or making an estimated payment, attempt to do so at the last minute. That is, the taxpayer often tries to use EFTPS for the first time on April 15 and thus has a negative first experience. Shared secrets (for example, date of birth, adjusted gross income, and the like) could resolve this and allow payment during the initial sign-up session.
- The IRS should also study methods of accepting withheld tax levy payments electronically.
- The EFTPS system should be available 24/7 with minimal down time. Notice on when the system will be unavailable should be routine.

E-Services

❖ **E-services must be faster, easier, and more efficient than paper, telephone, or fax-based communications. The first experience needs to be positive.**

At present, practitioners can telephone or fax faster than they can file e-services. The system must be user-friendly and, once moved to e-services, remain there.

- When a taxpayer applies for e-services, the pin is sent by postal mail.
- In some circumstances when e-services would be beneficial and convenient, they are not an option. For example, when tax practitioners try to obtain transcripts of tax return information for nonfilers, they encounter significant delays and other problems.

IRS should open e-services to all tax professionals with the authority to obtain taxpayer information for their clients. We applaud the IRS for lowering the threshold of e-filed returns to five or more returns. Allowing all authorized practitioners to use e-services will demonstrate the benefits of operating in an e-world and in turn assist in the increase or adoption of e-filing.

Federal, State, and Local Governments

It is important that multiple tax systems appear as a single transparent system to the taxpayer and practitioner. Each layer of tax government should be able to extract their specific data from the same file and place. Transparency is also critical for taxpayers when dealing with the government.

Free File

We applaud the extraordinary work of the IRS in establishing the model of public-private partnership in the Free File program. Potentially millions of taxpayers will enjoy the very best industry has to offer in tax preparation and e-filing products free of any charges. The ETAAC strongly recommends that both the Free File program and stakeholder-IRS relations as an alternative to a government-only model be continued. We believe this is a better use of resources than spending taxpayer dollars to build systems or services that compete with the private sector. As we prepare this report, the IRS and participants in the Free File program are in contract discussions regarding the 2006 and future filing seasons. The ETAAC anticipates that these discussions will conclude in the decision that free tax preparation and e-filing continue to be available to taxpayers.

MANDATES

In our 2004 Annual Report, we recommended that e-filing by paid practitioners be mandated. We understand that such a movement toward a federal e-file mandate must proceed with caution but believe it to be the proper solution. Many states are implementing e-file mandates. Practitioners, transmitters, and software developers face a complex set of rules and procedures as each state enacts unique mandate requirements. Although problematic for industry, the results in these states clearly demonstrate the positive impact a mandate can have on both the expansion of e-filing and taxpayer satisfaction with tax administration. The ETAAC believes the IRS should carefully study the experiences of these states to determine critical lessons learned. These include the importance of:

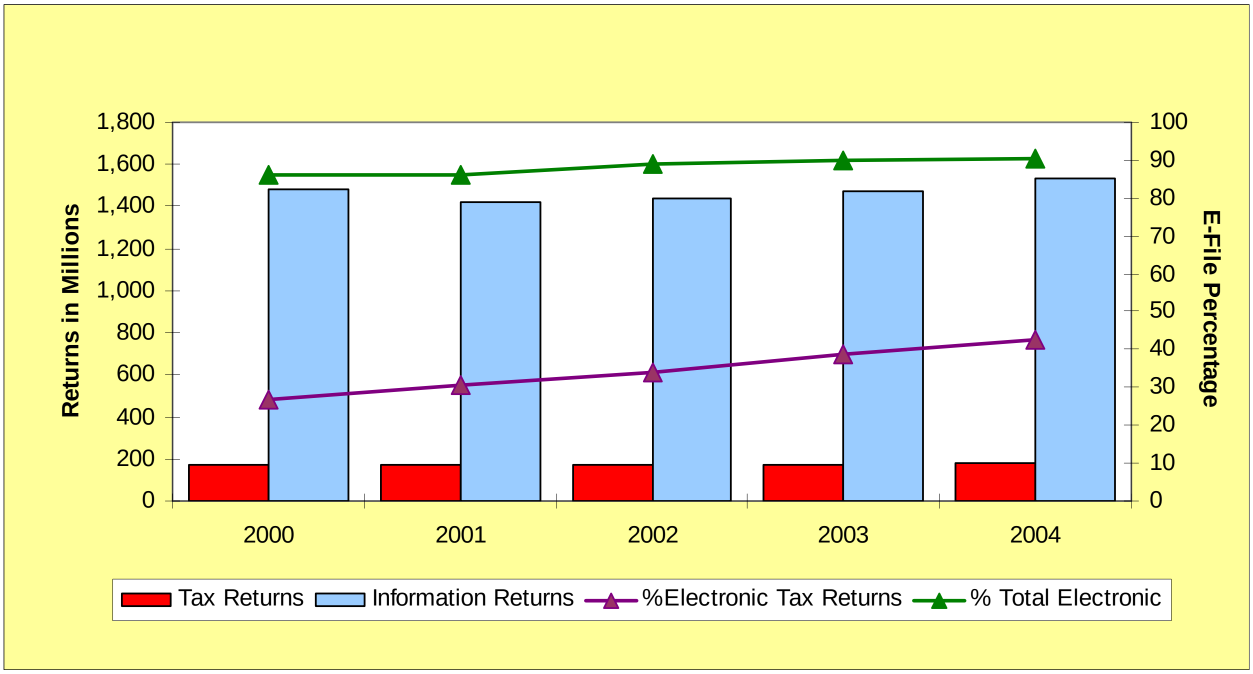
- defining a clearly defined business plan to achieve goals,
- phasing in mandates (that increase over time) to test system and operational capacity,
- establishing operational excellence to resolve problems before issuing mandates,
- implementing pre-release testing for users filing multiple types of returns,
- allowing a safe-harbor for practitioners not capable of converting to e-filing without a significant cost burden,

- understanding the lead time needed before software vendors and practitioners can comply with a mandate to e-file, and
- training both IRS employees and practitioners.

A white paper—which will be issued by Federation of Tax Administration (FTA)—will provide guidelines for states to follow when issuing mandates, including adequate lead time [18 months] for software developers and practitioners, necessary notices, availability of forms for e-filing, and paper filing certain state forms that cannot be filed electronically. A dialogue on common use of these guidelines should be opened between all fifty states. Because there will be no way to enforce the guidelines, the states should be encouraged to adopt best practices and the IRS should set the standards for e-file mandates. The ETAAC believes that the IRS should lead this initiative. We believe the IRS's policy should focus on simplicity and establish a compelling reason to e-file. This will help establish buy-in from both practitioners and individuals. There are many issues to be considered if a federal e-file mandate is established: timelines, technical specifications, state and local tax issues, penalties, impacts on both small and large businesses and software developers, and more. The ETAAC believes it is essential to the success of any future program that comprehensive discussions with all stakeholders be held to ensure the needs of all concerned are identified and resolved.

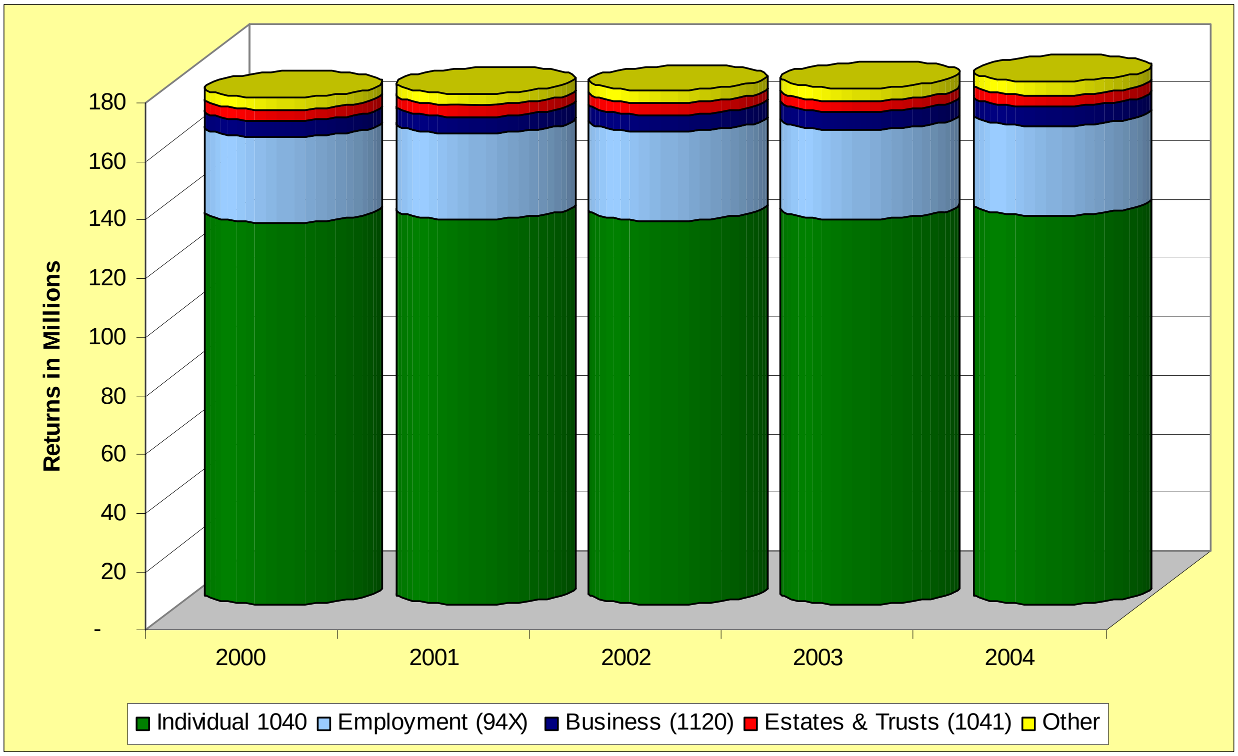
APPENDIX

Exhibit 1. Overall E-File Results



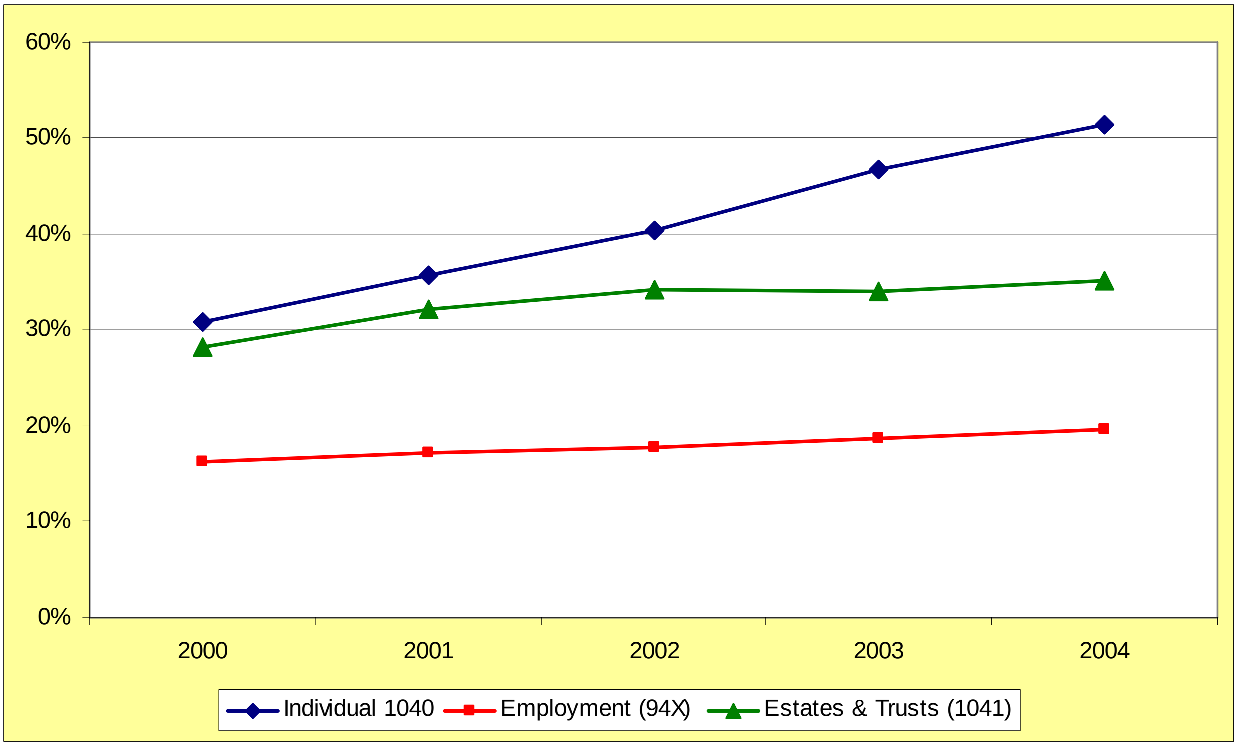
The percentage of tax returns filed electronically is significantly below the 80-percent target and will not reach that goal by 2007. Only information returns (Forms W-2 and Forms 1099) have met the 80-percent target.

Exhibit 2. Volume of Tax Returns



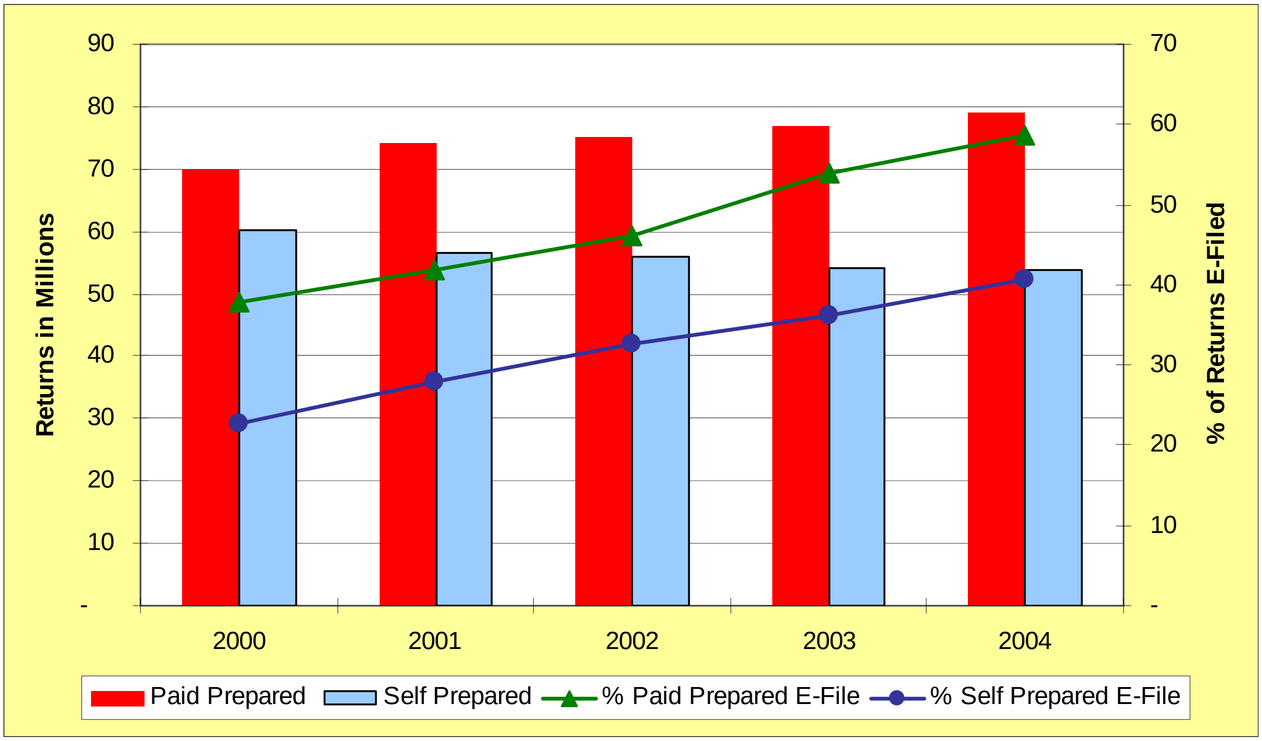
The majority of emphasis on e-file of tax returns belongs with individual returns and employment returns.

Exhibit 3. Percentage of Returns E-Filed



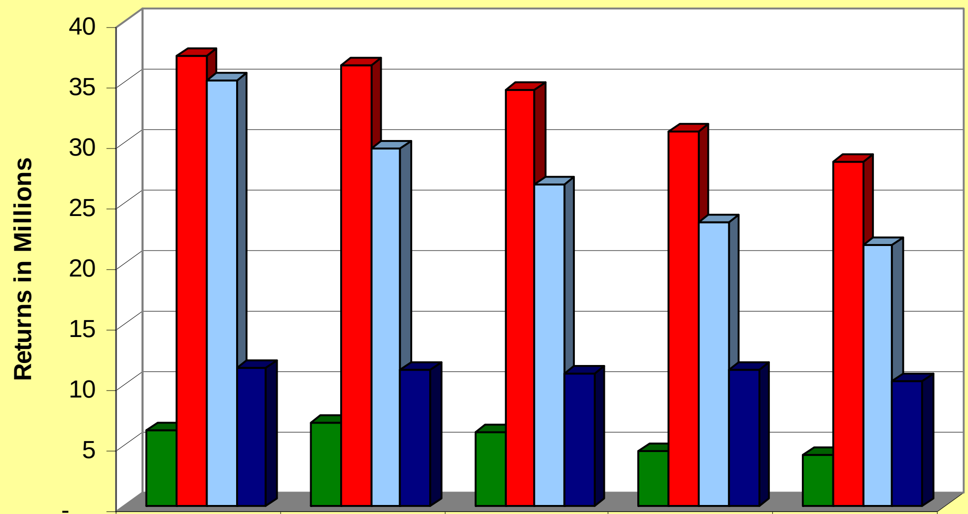
Of the three return types for which e-file was historically available, the adoption trend for e-file, though rising, is not enough to meet the goals of RRA 98.

Exhibit 4. Paid versus Self-Prepared Returns



The paid preparers e-file at a significantly higher rate than self preparers. However, to achieve the stated goals of RRA 98 even beyond 2007 the paid preparer adoption of e-file will have to be closer to 100 percent.

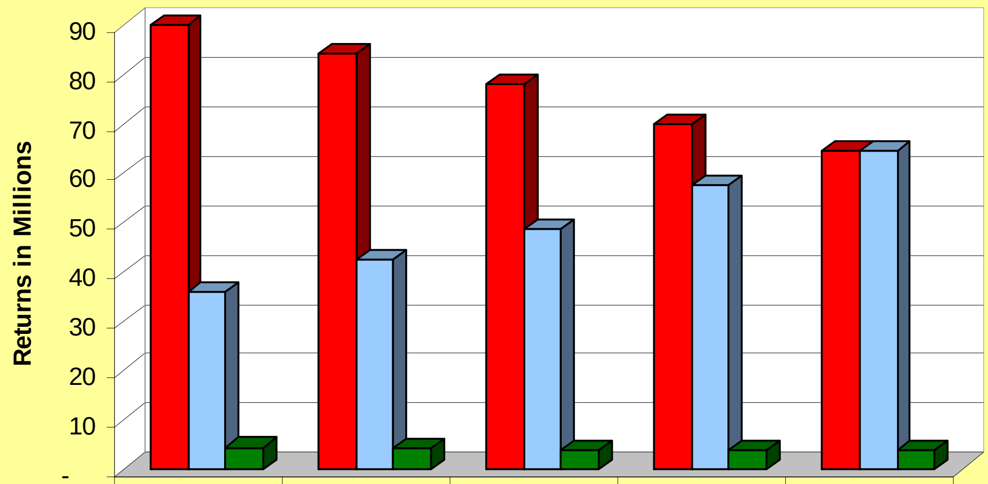
Exhibit 5. Paper Return Methods



	2000	2001	2002	2003	2004
Paid Pencil	6.2	6.9	6.1	4.5	4.2
Paid Computer	37.2	36.4	34.4	30.9	28.5
Self Pencil	35.1	29.5	26.6	23.4	21.6
Self Computer	11.4	11.3	10.9	11.2	10.3

The vast majority of paid preparers filing paper returns are already on computerized systems. This should make the conversion to e-file more straightforward and the adoption to e-file more obtainable. The conversion of self prepared is more problematic as the majority of those preparers do not use computer software for return preparation.

Exhibit 6. Individual Return Methods



	2000	2001	2002	2003	2004
Paper Returns	89.9	84.1	78.0	70.0	64.5
E-File	35.8	42.6	48.8	57.4	64.3
Telefile	4.5	4.2	4.1	3.8	3.9

The trend for filing methods of individual returns shows a continued decline in the use of Telefile making this method of filing increasingly costly.

Exhibit 7. Electronic Tax Administration Advisory Committee Member Listing

Lou Steven Blundell
Term: 11/1/2002 – 10/31/2005
Retired Vice President Acquisitions & Innovation, Intuit

David H. Boucher
Term: 09/16/2003 – 09/15/2006
President
Decision Modeling, Inc.

Alan W. Daniel
Term: 11/01/2002 - 10/31/2005
Franchisee
H&R Block

Nora Daly
Term: 12/1/2004 – 11/30/2007
Senior Legislative Analyst
Oracle Corporation

Grace Ann Dieterich
Term: 09/16/2003 – 09/15/2006
Senior Vice President, Technology
Jackson Hewitt, Inc.

Mary Jane Egr-Edson
Term: 09/16/2003 – 09/15/2006
State Tax Commissioner
Nebraska Department of Revenue

Edward B. Feinstein
Term: 11/01/2002 - 10/31/2005
ETAAC Chairperson
Retired Vice President Field Operations & Development
H&R Block

Sharon-Kay Flynn
Term: 11/01/2002 – 10/31/2005
Enrolled Agent
Cabot Financial

James Gottfried
Term: 12/1/2004 – 11/30/2007
Partner
Ernst & Young, LLP

Larry L. Gray
Term: 09/16/2003 – 09/15/2006
Owner
Alferman Gray & Company, LLC

Leonard B. Holt, Jr.
Term: 09/16/2003 – 09/15/2006
Vice President, Operations
Universal Tax Systems, Inc.

Emily L. Lindsay
Term: 11/01/2002 - 10/31/2005
Vice President, Corporate Accounting Services
Marriott International Inc.

Linda Lueck
Term: 12/1/2004 – 11/30/2007
Owner
Lueck Accounting Service

Frank J. Real
Term: 11/1/2002 - 10/31/2005
Chief Financial Officer
Aria Systems, LLC