TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

A Service-Wide Strategy Is Needed to Increase Business Tax Return Electronic Filing

September 24, 2014

Reference Number: 2014-40-084

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A SERVICE-WIDE STRATEGY IS NEEDED TO INCREASE BUSINESS TAX RETURN ELECTRONIC FILING

Highlights

Final Report issued on September 24, 2014

Highlights of Reference Number: 2014-40-084 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

IMPACT ON TAXPAYERS

Electronic filing (e-filing) benefits both taxpayers and the IRS. For taxpayers, benefits include faster refunds, electronic confirmation of receipt of their tax return, and secure and confidential submission of sensitive return information. For the IRS, benefits include a significant reduction of submission processing costs and the receipt of a more accurate tax return, which reduces taxpayer burden and avoids additional processing costs.

WHY TIGTA DID THE AUDIT

This audit was initiated because the Restructuring and Reform Act of 1998 (RRA 98) required e-filing as the preferred and most convenient method of filing Federal tax and information returns. The Act also established a goal that the IRS has at least 80 percent of all tax returns, individual and business, e-filed. Our review assessed the effectiveness of the IRS's efforts to increase the number of business tax returns and information returns e-filed.

WHAT TIGTA FOUND

While e-filing of business tax returns continues to increase, the e-filing rate still lags behind that of individual tax returns. Since RRA 98 went into effect, the IRS has focused most of its efforts on increasing the e-filing rate of individual tax returns. These efforts have resulted in considerable growth in the e-filing of individual tax returns, which was at an 81 percent rate in Processing Year 2012 compared to a 41 percent rate for business tax returns in Tax Year 2012.

Employment tax returns provide the most significant opportunity for growth in business e-filing. For Tax Year 2012, more than 21.1 million (71 percent) employment tax returns were paper-filed. A burdensome electronic signature process has been cited by stakeholders as one of the barriers to e-filing employment tax returns.

Processes have not been established to consistently ensure compliance with e-filing requirements and assessment of penalties. Also, establishing a requirement for paid preparers to e-file business returns corresponding to the individual return requirement of 11 or more returns filed would result in an increase of e-filed business returns. Our review of Tax Year 2012 business tax returns found the IRS could increase its e-filing rate by 23.8 percent and reduce paper return processing costs by more than $17 million.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop a business tax return e-filing Service-wide strategy, continue to expand the types of business tax returns that can be e-filed, and evaluate providing business filers with the option of Free Fillable Forms. The IRS should develop a less burdensome electronic signature process for employment tax returns, evaluate the feasibility of using the Electronic Federal Tax Payment System® to e-file employment tax returns, and develop processes and procedures to consistently identify business filers that are not compliant with the e-filing requirements and assess penalties. Also, the IRS should work with Treasury and consider revising current requirements and/or creating new requirements for the e-filing of business tax returns that would increase the overall e-filing rate.

IRS officials agreed with five recommendations and disagreed with three recommendations. TIGTA believes it is important to consistently identify all businesses not meeting the e-filing requirements as outlined in the law and take the necessary actions to ensure future compliance.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 24, 2014

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – A Service-Wide Strategy Is Needed to Increase Business Tax Return Electronic Filing (Audit # 201340023)

This report presents the results of our review to assess the effectiveness of the Internal Revenue Service's efforts to increase the number of business tax returns and information returns electronically submitted. This audit is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenges of Modernization and Achieving Program Efficiencies and Cost Savings.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).

Table of Contents

Abbreviations

e-file(d)	Electronically file(d)
e-filing	Electronic filing
EFTPS	Electronic Federal Tax Payment System®
IRS	Internal Revenue Service
MeF	Modernized e-File
RRA 98	Restructuring and Reform Act of 1998

Background

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)[1] required that electronic filing (e-filing) be the preferred and most convenient method of filing Federal tax and information returns.[2] The Act also established a goal that the IRS have at least 80 percent of all tax returns, individual and business, electronically filed (e-filed) by Calendar Year 2007. RRA 98 also provided a requirement for annual reporting on the IRS's progress toward meeting the 80 percent e-filing goal. Pursuant to RRA 98, the IRS receives two annual reports from the Electronic Tax Administration Advisory Committee and IRS Oversight Board that provide input on the development and progress of electronic tax administration. A third committee, the IRS Advisory Council,[3] also provides annual input and feedback to the IRS on electronic tax administration matters. Although each of these advisory groups can recommend ways to improve electronic tax administration, they cannot require the IRS to implement the changes. Figure 1 provides a description of the advisory groups as well as the specific focus area of each group.

Figure 1: Advisory Groups Providing E-Filing Input to IRS

Advisory Group Name	Responsibilities
Electronic Tax Administration Advisory Committee	Provides input to the IRS on the development and implementation of the IRS strategic plan for electronic tax administration. This group reports to Congress on areas concerning: 1) the IRS's progress in meeting the 80 percent e-filing goal; 2) the status of the IRS's strategic plan for electronic tax administration; 3) the legislative changes that would assist the IRS in meeting the 80 percent goal; and 4) the effect on small businesses and the self-employed of e-filing tax and information returns.
IRS Oversight Board	Provides oversight of the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the Internal Revenue laws and provides experience, independence, and stability to the IRS so that it may move forward in a focused direction. This group reports to Congress on the IRS's efforts to advance electronic tax administration and meet the 80 percent goal established by RRA 98.

[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[2] An information return is a tax document used to report certain types of payments made by financial institutions and others who make payments as part of their trade or business as required by Internal Revenue Code regulations.
[3] This committee was formed by the Federal Advisory Committee Act of 1972; Pub. L. No. 92-463.

Advisory Group Name	Responsibilities
IRS Advisory Council	Consists of four subgroups (*i.e.*, Large Business and International; Office of Professional Responsibility; Small Business/Self-Employed; and Wage and Investment) that focus on broad policy matters by reviewing existing tax policy and recommending policies with respect to emerging tax administration issues. In 2012, the IRS requested that the Wage and Investment subgroup provide recommendations to increase e-filing of business tax returns. The group made seven recommendations, with the majority of recommendations focused on employment tax returns.

Source: Advisory groups' annual reports to Congress.

The strategic importance of e-filing is derived, in part, from its benefits to both taxpayers and the IRS. For taxpayers, the benefits include faster refunds, electronic confirmation of receipt of their tax return, and secure and confidential submission of sensitive return information. For the IRS, e-filing results in significant reduction of submission processing costs and the receipt of a more accurate tax return, which reduces taxpayer burden and avoids additional processing costs. Figure 2 shows the paper-filed error rates compared to e-filed error rates associated with major business tax return types.

Figure 2: Comparison of Paper-Filed and E-Filed Error Rates for Most Frequently Filed Tax Return Types

Tax Form[4]	Error Rate of Paper-Filed Returns	Error Rate of E-Filed Returns
Form 941	14.55%	0.13%
Form 990	20.69%	1.98%
Form 1065	19.10%	0.50%
Form 1120	15.82%	3.68%

Source: IRS Document 6746 (2012).

The error rate refers to the percentage of tax returns with errors that need correction by the IRS's Error Resolution function. Error rates are considerably higher for paper-filed tax returns largely because of IRS employee keypunch errors (*i.e.*, employees incorrectly enter information from the paper tax return into IRS computers). In contrast, e-filed tax returns are sent through a number of validations to check for possible errors before the IRS accepts the tax return. For example, e-filed Forms 1120 are subjected to more than 400 validation checks, which include checking the

[4] See Appendix VII for a glossary of business tax returns.

business name, address, Employer Identification Number, tax year, return type, and math calculations.

E-filed tax returns that do not pass the validation checks are rejected and sent back to the taxpayer and/or preparer for correction. Types of errors include not attaching the proper forms or schedules, using an incorrect Employer Identification Number, and using invalid ZIP codes. Unlike a paper tax return, an e-filed return is not accepted as filed until the validity checks confirm that the tax return is free of these types of errors. Once notified of an error, the taxpayer or preparer has to correct the tax return and resubmit it through e-filing or by paper tax return. In some instances, rejected returns are not resubmitted.

This review was performed with information obtained from the IRS Submission Processing Site in Covington, Kentucky, during the period July 2013 through May 2014. We conducted this 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 about our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

A Service-Wide Strategy Is Needed to Focus Efforts on Increasing Electronic Filing of Business Tax Returns

While e-filing of business tax returns continues to increase, the overall rate still lags significantly behind that of individual tax return e-filing. For example, in Processing Year[5] 2012, individual taxpayers e-filed 118.9 million (81 percent) tax returns; whereas in Tax Year[6] 2012, business taxpayers[7] e-filed 18.5 million (41 percent) tax returns. For business-filed information returns, a total of 1.95 billion (97 percent) were e-filed for this same period. Figure 3 provides an overview of e-filed versus paper for individual, business, and information returns.

Figure 3: Tax Return Filing Volumes and Rates[8]

Type of Return	Number E-Filed	Number Paper-Filed	Total	E-Filing Rate
Individual Tax Returns	118.9 million	27.7 million	146.6 million	81%
Business Tax Returns[9]	18.5 million	26.9 million	45.5 million[10]	41%
Information Returns	1.95 billion	69.3 million	2.0 billion	97%

Source: The IRS's 2013 Update of Publication 6186, Calendar Year Return Projections for the United States and IRS Campuses 2013–2020, and the Treasury Inspector General for Tax Administration's analysis of the Business Return Transaction File and Information Returns Master File.

Contributing to the growth in business tax return e-filing is the IRS's continued efforts to offer more types of business tax returns that can be e-filed through the Modernized e-File (MeF) processing system.[11] The MeF system provides a single method for electronically filing business and individual tax returns, forms, and schedules via the Internet. The system provides real-time processing of tax returns and extensions that improves error detection, provides more detailed

[5] The calendar year in which the tax return or document is processed by the IRS.
[6] 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.
[7] This includes business income tax returns, tax-exempt returns, and estate and gift tax returns.
[8] Individual Tax Returns analysis based on Processing Year 2012 data. Business Tax Returns and Information Returns analysis based on Tax Year 2012 data. All data have been rounded.
[9] Appendices VI and VII list the specific business tax returns included in this analysis.
[10] Total number of business tax returns does not calculate due to rounding.
[11] The MeF system is a web-based system that allows electronic filing of corporate, individual, partnership, exempt organization and excise tax returns through the Internet.

error code descriptions, and expedites tax return receipt acknowledgements to taxpayers. In Processing Year 2014, the IRS expanded the MeF system to include the various employment tax returns (*i.e.*, the Forms 94x family) and Form 1041, *U.S. Income Tax Return for Estates and Trusts*. This is an important milestone in the IRS's efforts to increase the overall e-filing rate of business tax returns by providing a much more flexible and modern application that provides better service to taxpayers and preparers. Figure 4 depicts the significant growth in business tax returns received through the MeF system in Processing Years 2010 through 2013.

Figure 4: Business Tax Returns Processed Through the MeF System for Processing Years 2010–2013 (in thousands)

Type of Business Tax Return[12]	Processing Year			
	2010	2011	2012	2013
Corporations – Forms 1120, 1120-S, 1120-F	2,255	3,161	3,864	4,300
Excise Tax – Forms 2290, 720, 8849	56	118	195	234
Tax-Exempt – Forms 990, 990-EZ, 990-N, 990-PF, 1120-POL	604	603	728	798
Partnerships – Forms 1065, 1065-B	1,271	1,799	2,255	2,552

Source: IRS MeF Business Master File return data, Processing Years 2010–2013.

The MeF system does not allow the processing of all business tax return types. The current MeF system accepts 141 types of business returns. Our analysis of Tax Year 2012 business returns found that 19 types of business tax returns could not be e-filed through the MeF system, totaling more than 1.1 million paper-filed returns.[13] IRS management noted that due to the focus on implementing the new forms and capabilities associated with the Affordable Care Act,[14] they will need to revisit the timelines for expanding business tax returns offered on the MeF system.

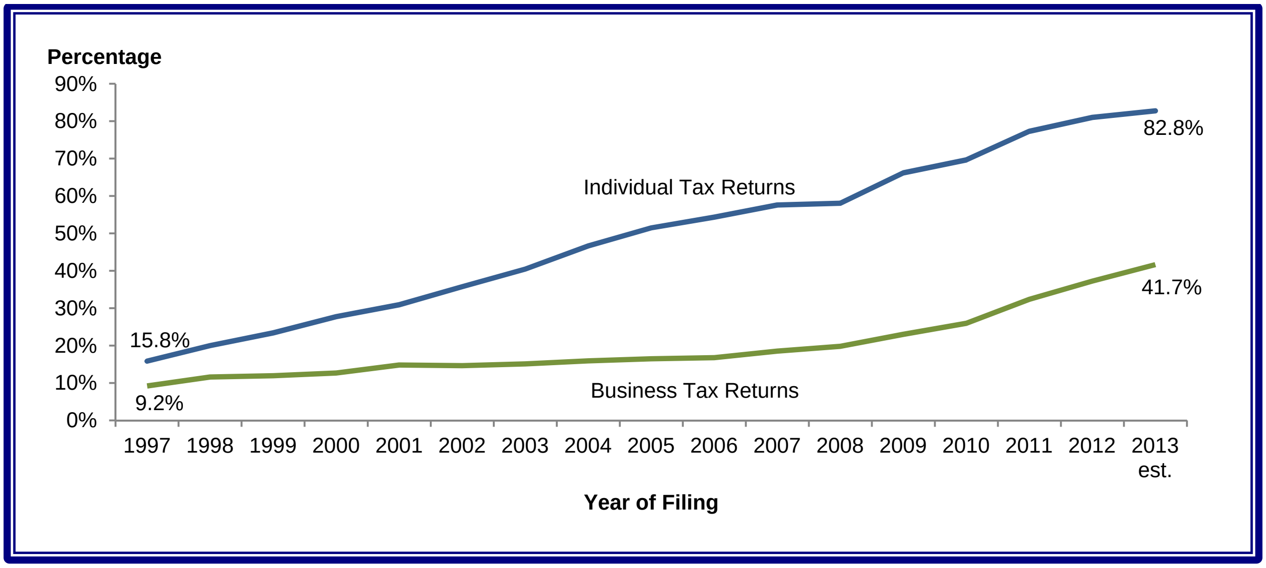
Extensive efforts used to increase individual e-filing have not been initiated for business e-filing

Although the IRS has taken steps to expand e-filing options for businesses, a Service-wide strategy similar to what the IRS developed for individual e-filing is needed. Since RRA 98 went into effect, the IRS has focused most of its efforts on increasing the e-filing rate of individual tax returns. These efforts have resulted in considerable growth in the e-filing of individual tax returns when compared to business tax returns. In Processing Year 1997, the year before

[12] See Appendix VII for the proper names of tax returns used in Figure 4.
[13] See Appendix VI.
[14] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 and Pub. L. No. 111-152, 124 Stat. 1029. (See Affordable Care Act, *infra*).

RRA 98, there was a small gap between the e-filing rate for individual and business returns. However, as time progressed and the IRS introduced free-filing options and the paid preparer mandate for individual returns, the e-filing rate for individual returns continued to increase. It was not until Processing Year 2008 that the e-filing rate for businesses started showing improvement, with particularly stronger growth trends beginning in Processing Year 2010. IRS management acknowledges that continued action is needed to achieve further increases in the overall e-filing rate for business returns. Figure 5 provides a comparison of the e-filing rates for individual and business tax returns for Processing Years 1997 through 2013.

Figure 5: E-Filing Rates of Major Tax Returns Processing Years 1997 to 2013



Source: The IRS's 2013 Publication 6186 and the IRS Oversight Board's analysis of IRS Publication 6186.

In August 2013, the IRS received approval to centralize the development of a business e-file strategy in the Wage and Investment Division. IRS management also advised us that they hired two analysts at the end of February 2014 whose responsibilities include developing a coordinated and focused approach to business e-filing. The staff is currently working on gathering information (*e.g.*, former studies) and data on business e-filing and drafting a charter to outline the purpose, scope, goals, *etc*., for this new group. However, unlike the consolidated and coordinated effort the IRS put forth to increase individual e-filing, much of the responsibility to increase e-filing of business returns has been placed within each business unit, resulting in a disjointed approach. Figure 6 provides a timeline of major activities the IRS has taken to increase e-filing of individual tax returns versus business tax returns.

Figure 6: Timeline of Major E-filing Events

Calendar Year	Individual Tax Returns	Business Tax Returns
1997	The Electronic Tax Administration organization was established within the Wage and Investment Division to oversee responsibilities for electronic tax administration of individual tax returns.	
1998	Congress establishes a goal of an 80 percent e-filing rate for all Federal tax and information returns.	
2000	Leading electronic tax return preparation companies begin offering free e-filing.	
2001		E-filing becomes mandatory for Partnerships (Forms 1065/1065-B) with more than 100 partners (I.R.C §6011-3).
2003	The IRS partners with the Free File Alliance[15] to provide free electronic filing for at least 60 percent of all taxpayers who file an individual tax return.	
2004		The MeF system begins accepting limited corporate tax returns and tax-exempt returns, including Forms 1120, 1120-S, and 990.
2005		E-filing becomes mandatory for Form 2290 with 25 or more vehicles reported in a taxable period (I.R.C. §4481).
2006		Additional corporate tax returns added to the MeF system, and e-filing becomes mandatory for corporations, Forms 1120 series (I.R.C. §6011-5), and exempt organizations, Forms 990/990-PF (I.R.C. §6033-4) with assets of $50 million or more and 250 returns filed annually.
2007		Partnership returns (Forms 1065/1065-B) added to the MeF system. E-filing thresholds for corporations and exempt organizations lowered to assets of $10 million or more and 250 returns filed annually (Treasury Decision 9363).
2008	Phase I Advancing E-Filing Study performed and report released to help the IRS validate and launch future studies, research, and other activities in a continued effort to meet the goal of an 80 percent e-filing rate for individual returns set by Congress.	

[15] The Free-File Alliance is a group of industry-leading private-sector tax preparation companies that have agreed to provide free commercial online tax preparation and electronic filing.

Calendar Year	Individual Tax Returns	Business Tax Returns
2009	Congress enacts legislation that requires tax return preparers who file 100 or more individual tax returns to e-file in 2011. Beginning in 2012, the requirement changes to 11 or more. Free Fillable Forms[16] became available as part of the Free File Alliance program.	
2010	Phase II Advancing E-Filing Study performed and report released that included a cost/benefit analysis of the options to increase e-filing based on original research of taxpayer and preparer motivators and analysis of the business and engineering/costing studies of those options. First phase of Form 1040, *U.S. Individual Income Tax Return*, available on the MeF system.	
2011	Start of preparer e-filing requirement – 100 or more returns.	
2012	Full implementation of preparer e-filing requirement – 11 or more returns. Full implementation of Form 1040 returns on the MeF system. IRS achieves 81 percent individual e-filing rate.	Business tax returns are e-filed at 41 percent rate.

Source: Treasury Inspector General for Tax Administration's analysis of the IRS e-filing documentation. I.R.C. = Internal Revenue Code.

Currently, the IRS offers Free Fillable Forms only to individual filers. When we asked IRS management why this same service is not being offered to businesses, IRS management stated that some businesses find it easier to submit the forms via mail. IRS management stated that offering this filing option could increase the business e-filing rates.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Develop a Service-wide strategy that outlines specific efforts the IRS will initiate to advance the e-filing rate of business tax returns.

> **Management's Response:** The IRS agreed with this recommendation. In February 2014, the IRS formed a team to develop a Service-wide strategy for increasing the volume of electronic returns filed by business taxpayers. In addition to developing a communications outreach plan to promote e-filing for business returns during the

[16] Fillable forms are online versions of paper forms designed for filers comfortable with preparing their own tax returns. This option allows filers to prepare, print, and e-file a free Federal tax return.

2015 Filing Season, the IRS will evaluate e-file participation rates for business returns during the 2014 Filing Season. Based on the results of its review, achievable goals will be identified and an action plan will be developed to document the strategy for achieving those goals.

Recommendation 2: Continue to expand the type of business tax returns that can be e-filed through the MeF system.

> **Management's Response:** The IRS agreed with this recommendation. The goal of the IRS is to use the MeF system as the sole portal for receiving electronic returns. Accordingly, the IRS has a long-term strategy for expanding the MeF system capabilities through the controlled expansion of income tax forms that may be accepted by the system. The strategy is reviewed and revised on an annual basis to adjust for legislative or other environmental changes that may affect the timeline for adding new forms. The IRS does not foresee the need for additional corrective action beyond the process already in place.

Recommendation 3: Evaluate the feasibility of providing business filers with the option of Free Fillable Forms.

> **Management's Response:** The IRS agreed with this recommendation. The IRS will discuss with its industry partners in the Free File Program the desire to provide business filers with a Free Fillable Forms option.

Employment Tax Returns Provide the Most Significant Opportunity for Growth in Business Electronic Filing

Advisory groups have continually urged the IRS to focus on increasing e-filing of employment tax returns because they comprise the second largest population of returns after individual returns. For example, our review of Tax Year 2012 business tax returns identified that 29.7 million (65 percent) of 45.5 million business returns filed were employment tax returns.[17] More than 21.1 million (71 percent) of the employment tax returns were paper-filed. The e-filing rate of these tax returns has increased only slightly from 22.8 percent for Processing Year 2009 to 27.7 percent in Processing Year 2012.

All tax returns submitted to the IRS, including an e-filed return, must be signed by an authorized signer of the entity type (*e.g.*, corporation), the Electronic Return Originator[18] (if applicable), and the paid preparer (if applicable). If an e-filed return is filed without the required signature, the return will be rejected. For example, for employment tax returns, the MeF system requires taxpayers and return preparers to use one of two signature methods for signing e-filed returns.

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[17] Our analysis of employment tax returns included Forms 940, Forms 941, and Forms 944.
[18] The authorized IRS e-file provider that originates the electronic submission of a return to the IRS.

The two available options are the Practitioner Personal Identification Number method using Form 8879, *IRS e-file Signature Authorization*, or the scanned Form 8453-EMP, *Employment Tax Declaration for an IRS e-file Return*.

Previous research on employment tax filers compiled by the Electronic Tax Administration Advisory Committee[19] revealed that the employment tax return filing community is highly fragmented, with many that submit only a few such returns each year and see little economic incentive to e-file. In addition, the 2013 IRS Oversight Board Annual Report to Congress stated that feedback received from industry stakeholders identified the need for a less burdensome electronic signature process for businesses submitting employment tax returns via the MeF system.

The MeF system currently requires businesses electronically filing their own employment tax returns to print Form 8453-EMP, sign the form, scan the form into a Portable Document Format (PDF),[20] and attach the form to their return. IRS management is aware of the burden that the Form 8453-EMP electronic signature process causes businesses when e-filing these tax returns using the MeF system and is working to address this issue. Although the IRS added Form 941 filing to the MeF system, significant increases in the e-filing rate for these tax returns may not result until a less burdensome electronic signature process is established. It is incumbent on the IRS to develop strategies, products, and services to address these barriers and attract more employment tax filers to e-file. If it does not reduce the high volumes of paper-filed employment tax returns, the IRS will not achieve the 80 percent e-filing goal. For example, if the IRS increased the e-filing rate on all business tax returns with the ability to e-file to 100 percent while maintaining the e-filing rate on employment tax returns at its current rate, the overall business return e-filing rate would increase only to 52.4 percent. Therefore, increasing the e-filing rate of employment tax returns is critical to the IRS's strategy and success in achieving the 80 percent e-filing goal for business returns. IRS management indicated that a long-term e-filing strategy needs to be developed that will include identifying barriers to e-filing and improve the overall customer experience, such as potentially making improvements to the electronic signature process for all business return types.

The Electronic Federal Tax Payment System® could provide an alternative option to increase employment tax e-filing

The Electronic Federal Tax Payment System[21] (EFTPS) provides the capability to e-file tax returns with the IRS. Beginning in November 2009, Federal agencies had the ability to e-file

[19] The Electronic Tax Administration Advisory Committee, *Electronic Tax Administration Advisory Committee Annual Report to Congress*, IRS Publication 3415, June 2011.
[20] A PDF is a file that will look the same on the screen and in print, regardless of the kind of computer or printer someone is using and regardless of what software package was used to create it.
[21] A free service for making electronic tax deposits, available online or by phone, provided by the U.S. Department of the Treasury. It is quick, secure, and 99.9 percent accurate.

their Form 941 using the EFTPS. At that time, 185 Federal agencies were enrolled to use the EFTPS. The IRS provided an e-filing signature Personal Identification Number, as the method to sign the return, to Federal agencies that used the EFTPS to e-file employment tax returns. Federal agencies would access the EFTPS and create a new tax return filing by selecting the tax form and tax period to be e-filed. Once the employment tax information was input as required, the Federal agency would sign the tax return using the provided Personal Identification Number and submit the tax return. In response, the IRS would send a confirmation that the employment tax return had been accepted.

IRS management noted that the ability of Federal agencies to e-file was discontinued in January 2011. However, IRS management indicated they did not know the exact reasons for discontinuing this option through the EFTPS. The IRS should explore expanding the use of the EFTPS to all business filers as an alternative option that may increase the e-filing of employment tax returns. Generally, each employer must file five employment tax returns with the IRS each year, four quarterly and one annual. Additionally, employers are required to deposit Federal payroll taxes monthly or semiweekly if their tax liability for the quarter is $2,500 or more.

The IRS noted that it would need to determine the additional costs involved before consideration could be given to expanding the e-filing of employment tax returns using the EFTPS to all businesses. It should be noted that more than 95 percent of employment tax dollars are collected through the EFTPS each year. Providing the ability to e-file at the same time using the same system may provide a type of one-stop service from which business filers would benefit. This could result in significant processing cost savings to the IRS when compared to what is currently expended to process paper-filed Forms 941.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 4: Develop a less burdensome electronic signature process for businesses e-filing employment tax returns using the MeF system.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS is developing an e-signature strategy aligned with a robust e-authentication process to identify and authenticate the return signer. A work group has been formed to develop strategies, plans, and recommendations for identifying proofing and authentication. The work group will coordinate activities related to e-authentication and e-signature within the IRS to implement this process.

Recommendation 5: Evaluate the feasibility of providing business taxpayers with the option of using the EFTPS to e-file employment tax returns. This evaluation should include a cost/benefit analysis.

Management's Response: The IRS disagreed with this recommendation. The MeF system has been established as the system for receiving employment tax returns electronically and yields savings for the IRS by eliminating the need to program and support multiple systems. The MeF system provides taxpayers with the ability to remit tax payments when submitting their returns.

Office of Audit Comment: Although the IRS added Form 941 filing to the MeF system, it has not resulted in a significant increase in the e-filing rate for these tax returns. In addition, while the MeF system can accept payments to satisfy a balance due return, it cannot accept quarterly employment tax deposits. The EFTPS is the system used to make the tax deposits. Moreover, the EFTPS has been used in the past to facilitate the e-filing of employment tax returns for Federal agencies. As such, we believe the IRS should consider the use of the EFTPS as a as an alternative option to facilitate the e-filing of employment tax returns for businesses.

Processes Have Not Been Established to Consistently Ensure Compliance With Electronic Filing Requirements and the Assessment of Penalties

The IRS has established a systemic process to identify partnerships and tax-exempt organizations[22] that are not compliant with e-filing requirements. However, no such process has been established to identify corporate or Heavy Highway Vehicle Use Tax filers that are not in compliance with e-filing requirements. Our review of Tax Year 2012 returns identified 1,023 corporate taxpayers[23] that filed a paper tax return but were required by law to e-file. IRS management indicated it has yet to implement a process to identify corporations that do not comply because it is not cost effective. Notwithstanding management's explanation, it should be able to accomplish this in a cost-effective manner because a similar process is already in place to identify noncompliant tax-exempt filers that have the same e-filing requirements as corporations.

In addition, we identified 1,134 Heavy Highway Vehicle Use Tax filers that did not e-file as required. The IRS indicated that even though e-filing is required by law for Heavy Highway Vehicle Use Tax filers reporting 25 or more vehicles, they may still file paper tax returns without penalty because there is no penalty authority associated with the Heavy Highway Vehicle Use Tax e-filing requirement. Figure 7 summarizes the current business tax returns e-filing requirements, associated penalites, and effective dates.

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[22] Noncompliant partnerships are assessed a systemic penalty and noncompliant tax-exempt organizations are sent a notice that informs the taxpayer of their noncompliance and the penalties that could be assessed.

[23] This information is a projection based on a statistically valid sample of 133 corporate returns with assets greater than $10 million that did not e-file and had no e-file requirement waiver placed on the account from a population of 10,878. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 291 and 1,756 corporations and $5,686,840 and $9,785,501.

Figure 7: Business E-Filing Requirements and Associated Penalties

Tax Form	E-Filing Required When	Penalty That Can Be Assessed for Noncompliance	Effective Date of Law
Partnerships Forms 1065/1065-B	More than 100 partners.	$100 per partner more than 100, not to exceed $1.5 million.	12/31/00
Heavy Highway Vehicle Tax Form 2290	Reporting 25 or more vehicles in any taxable period.	None.	7/1/05
Corporations Forms 1120/1120-S	Assets of $10 million or more and 250 returns, including information returns[24] filed annually.	5 percent of balance due per month the tax return is not filed, not to exceed 25 percent of balance due.	12/31/06
Tax-Exempt Organizations Forms 990/990-PF	Assets of $10 million or more and 250 returns filed annually.	$20 per day the return is not filed, not to exceed $10,000 or 5 percent of gross receipts for returns with gross receipts of $1 million or less. $100 per day the return is not filed, not to exceed $50,000 or 5 percent of gross receipts for returns with gross receipts of more than $1 million.	12/31/06

Source: Treasury Inspector General for Tax Administration analysis of the Internal Revenue Code.

Finally, we found that the IRS is inconsistent in its application of penalties for filers that are not compliant with the e-filing requirements. For example, of the three e-filing requirements that include a penalty provision for noncompliance, the IRS has developed procedures to assess penalties only for noncompliant partnership filers. Our review of Tax Year 2012 partnership returns found that the IRS systemically assessed penalties totaling $16.8 million for 127 partnerships that were not in compliance with the e-filing requirement. However, no penalties were assessed on 98[25] noncompliant corporate filers and 358 tax-exempt filers. Specifically, we found that the IRS could have assessed:

[24] For example, Forms W-2, *Wage and Tax Statement*, and Forms 1099-MISC, *Miscellaneous Income.*
[25] Only balance due corporate tax returns are subject to the penalty under I.R.C. §6651.

- A minimum of more than $7.7 million[26] in penalties on 98 noncompliant corporate filers.[27]
- A minimum of $34,440[28] in penalties on 358 noncompliant tax-exempt organizations.

When we brought this to IRS management's attention, they stated that in the early stages of the e-filing program, a decision was made not to penalize noncompliant corporations and tax-exempt organizations. However, IRS management could not elaborate on the reason for this decision because those employees who made the decision have since retired from the IRS. IRS management also cited attrition and other staffing limitations as contributing to why the penalties are not being assessed.

Recommendations

The Deputy Commissioner for Services and Enforcement should:

Recommendation 6: Develop processes and procedures to consistently identify business filers that are not compliant with e-filing requirements (both current and any new e-filing requirements) and take actions necessary to ensure future compliance.

> ***Management's Response:*** The IRS disagreed with this recommendation. The development of processes and procedures that would consistently identify business filers that are not compliant with e-filing requirements would require a substantial expenditure of funds to upgrade and program its automated return processing systems. With limited budgetary resources and other competing initiatives that have higher priority, the IRS does not intend to pursue this action.
>
> ***Office of Audit Comment:*** Not taking the recommended corrective action not only leads to higher processing costs, but also results in the inconsistent treatment of business filers, since the IRS is ensuring compliance with mandates for some business filers and not for others.

Recommendation 7: Develop processes and procedures to consistently assess penalties when applicable against business filers that are not compliant with e-filing requirements.

---

[26] To be conservative, we reported on the minimum penalties allowed to be assessed. The maximum penalties totaled nearly $38.7 million.
[27] This information is a projection based on a statistically valid sample of 133 corporate returns with assets greater than $10 million that did not file e-file and no e-file requirement waiver placed on the account from a population of 10,878. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 291 and 1,756 corporations and $5,686,840 and $9,785,501.
[28] To be conservative, we reported on the minimum penalties allowed to be assessed. The maximum penalties totaled more than $17.2 million.

Management's Response: The IRS disagreed with this recommendation. The development of processes and procedures that would consistently assess applicable penalties against business filers that are not compliant with e-filing requirements would require a substantial expenditure of funds to upgrade and program its automated systems. Based on a relatively small number of affected taxpayers, the limited potential penalties to be assessed, and the demands of higher priorities competing for limited resources, the IRS does not agree to implement a corrective action for this recommendation. When appropriate, noncompliance can be addressed on an individual basis by its Compliance functions.

Office of Audit Comment: As we noted above, the lack of consistent application of penalties not only ultimately leads to higher processing costs in the future, but also results in the inconsistent treatment of business filers, since the IRS is ensuring compliance with mandates for some business filers and not for others.

Revising Existing Business Electronic Filing Requirements and/or Creating New Requirements Could Increase Volumes

Current e-filing requirements do not require a significant enough population of business filers to assist the IRS in achieving e-filing goals. Our analysis of Tax Year 2012 business tax returns identified that more than 26.9 million returns were paper-filed, resulting in the IRS incurring nearly $36.4 million in additional processing costs. Figure 8 summarizes the annual e-filing processing cost savings that additional e-filing requirements could achieve. The actual processing cost savings would depend on the specifics of any revision or new e-filing requirement.

Figure 8: Processing Cost Savings That Can Be Achieved Through Expanded E-Filing of Business Tax Returns

Type of Filer	Tax Year 2012 E-File	Paper	Cost Savings Per Return	Total Cost Savings
Corporations	4,193,309	1,861,811	$3.21	$5,976,413
Exempt Organizations	773,988	306,340	$4.05	$1,240,677
Partnerships	2,532,579	1,033,670	$3.67	$3,793,569
Fiduciary	2,275,373	829,418	$2.60	$2,156,487
Employment Taxes	8,557,723	21,101,538	$1.04[29]	$21,953,968
Excise Taxes	197,025	663,732	$1.89[30]	$1,256,649
Tax Return Types Unable to Be E-Filed Using MeF	0	1,140,637	N/A	N/A
Total Business Tax Returns	**18,529,997**	**26,937,146**		**$36,377,763**

Source: Treasury Inspector General for Tax Administration analysis of the Business Return Transaction File as of December 31, 2013.

A mandate similar to the requirement for paid preparers to e-file individual tax returns could reduce business tax return processing costs by $17 million annually

A Federal mandate was enacted on January 1, 2012, requiring paid preparers who file 11 or more individual returns to e-file. A similar requirement for paid preparers who file business returns would result in an increase of e-filed business returns. Our review of Tax Year 2012 business tax returns found that the IRS could increase its e-filing rate by 23.8 percent and reduce IRS paper return processing costs by more than $17 million annually if this same e-filing requirement applied to paid preparers filing business tax returns.

Federal law currently prohibits the IRS from creating requirements for businesses to e-file. Legislation would be needed in order for an e-filing requirement to be implemented. Advisory

[29] The e-file cost savings differs per return type for employment tax returns. We calculated an average cost per return of $1.0404 and rounded to the nearest cent. The total cost savings will not calculate due to rounding.
[30] The e-file cost savings differs per return type for excise tax returns. We calculated an average cost per return of $1.8933 and rounded to the nearest cent. The total cost savings will not calculate due to rounding.

groups have reported to Congress the benefits that could be achieved by expanding the current requirements for e-filing business tax returns. For example:

- The IRS Oversight Board, in its 2010 Annual Report to Congress, stated that new and more innovative strategies are needed to move the rates of e-filing participation for the employment tax return series. The Board found merit in the idea of potential e-filing requirements for employment tax returns.
- The IRS Advisory Committee, in its 2012 report, stated that focusing on employment tax returns would have the biggest impact on the overall business returns population. As such, they recommended that the IRS pursue a requirement for e-filing employment tax returns through the MeF system.

Legislative Recommendation

Recommendation 8: The Deputy Commissioner for Services and Enforcement should work with the Department of the Treasury Office of Tax Policy to consider a legislative proposal to revise current requirements and/or create new requirements for e-filing of business tax returns that would increase the overall e-filing rate.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will identify and consider options for increasing the overall e-filing rate as part of the development of its business e-file strategy, including working with the Department of the Treasury Office of Tax Policy in drafting legislative proposals to promote e-filing and increase the overall e-filing rate.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the effectiveness of the IRS's efforts to increase the number of business tax returns and information returns electronically submitted. To accomplish our objective, we:

I. Assessed the IRS's efforts to meet the 80 percent e-filing goal established in the IRS Strategic Plan for all major business tax returns and information returns.

   A. Reviewed IRS policies and procedures and interviewed IRS management and:

      1. Determined the effectiveness of a strategy, if any, for meeting the 80 percent e-filing goal and/or increasing e-filing of business tax returns and information returns.

      2. Determined the effectiveness of initiatives, if any, to modernize the paper filing of business tax returns and information returns into an electronic format.

      3. Determined the effectiveness of IRS promotion, if any, including incentives to encourage businesses to electronically file business tax returns and information returns.

      4. Determined the effectiveness of a centralized office, if any, for administering electronic tax administration for business tax returns and information returns.

   B. Identified all Tax Year[1] 2012 business tax returns and information returns processed through December 31, 2013, that have been electronically and paper-filed. We calculated the potential cost savings if all business tax returns could be e-filed.

   C. Identified the e-filing rate of paid tax preparers who submit business tax returns and identified effective procedures that would increase the e-filing rate for high-volume preparers. Also, we identified paid tax preparers who submitted 11 or more business tax returns and calculated the increase in the e-filing rate and processing cost savings if the IRS adopted an e-filing requirement that mirrors the individual returns requirement for paid preparers.

      1. From our computer extract, identified 10,557,552 paper-filed business tax returns filed by tax prepares for Tax Year 2012.

[1] 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.

2. Multiplied the number of tax returns above by the processing cost saving for each type of return to compute the total cost savings if the requirement were implemented.

D. Identified the business tax returns and information returns that do not have the ability to be e-filed and determined the effect on tax administration.

E. Reviewed five years of annual reports on electronic tax administration by the Electronic Tax Administration Advisory Committee, the IRS Advisory Council, and the IRS Oversight Board and determined whether the IRS is implementing the corrective actions to the recommendations for business tax returns and information returns.

F. Reviewed IRS policies and procedures and interviewed IRS management and:

1. Determined how the EFTPS is used and its current functionality.

2. Determined whether the EFTPS has ever been used for processing employment tax returns.

G. Reviewed IRS policies and procedures and interviewed IRS management and:

1. Determined the requirements for submitting electronic signatures on employment tax returns through the MeF system.

2. Determined whether the IRS is aware that the IRS Oversight Board has concerns regarding the electronic signature process of filing employment tax returns through the new MeF system.

3. Determined whether the IRS feels the current MeF system processes have eliminated the burdensome signature processes of the old legacy system.

II. Assessed IRS processes and procedures to ensure that taxpayers comply with e-filing requirements including the assessing of penalties for noncompliance.

A. Reviewed IRS policies and procedures and interviewed IRS management and:

1. Identified the requirements for businesses to electronically file tax returns and information returns.

2. Identified the penalties allowed to be assessed to businesses not in compliance with the e-filing requirements.

3. Assessed the effectiveness of legislation that allowed the IRS to apply requirements that businesses to e-file and penalties allowed to be assessed for noncompliance.

B. Identified all Tax Year 2012 business tax returns required to be e-filed and determined if they were compliant with the requirements. For the corporate returns, we identified 10,878 taxpayers with assets greater than $10 million that did not file their corporate returns electronically and had no e-filing requirement waiver on their account. We selected a statistically valid sample of 133 of these returns to determine how many met the e-filing requirement (assets greater than $10 million and filed 250 or more returns). A statistical sample was taken because we wanted to estimate the number of returns from the population that met the corporate e-filing requirement. The computation of our sample size and projections were done by our contract statistician using a two-sided 95 percent confidence interval. The standard error rate for minimum and maximum penalties were $96 and $481, respectively. The precision rate for minimum and maximum penalties were $188 and $942, respectively. The standard error rate and precision rate for the Stratum 1 population (no balance due) was 3.37 percent and 6.60 percent, respectively. The standard error rate and precision rate for the Stratums 2 and 3 populations (balance due) were 4.14 percent and 8.11 percent, respectively. For tax-exempt returns, we identified 358 taxpayers with assets greater than $10 million that did not file their tax-exempt returns electronically, had no e-filing requirement waiver on their account, and had a 250 return requirement indicator placed on their account. For Heavy Highway Vehicle Use Tax filers, we identified 1,134 taxpayers reporting 25 or more vehicles who did not file their returns electronically.

C. Determined whether the IRS is effectively assessing the penalties allowed for businesses not compliant with e-filing requirements.

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 that the following internal controls were relevant to our audit objective: policies and procedures to meet the 80 percent e-filing goal for business tax returns, and processes and procedures to ensure that taxpayers comply with business e-filing requirements and the IRS enforces penalties for noncompliance. We evaluated the controls by reviewing the IRS's Internal Revenue Manuals used by various business operating divisions, interviewing IRS management, reviewing Internal Revenue Codes and Treasury Regulations applicable to e-filing requirements and penalties for noncompliance, and evaluating applicable documentation and management information reports.

Data validation methodology

During this review, we relied on data stored at the Treasury Inspector General for Tax Administration's Data Center Warehouse and performed analysis of data extracted from the Business Return Transaction File for Processing Years 2012 and 2013 and from the Business Master File[2] for Processing Year 2013. To assess the reliability of computer-processed data, programmers within the Treasury Inspector General for Tax Administration's Data Center Warehouse validated the data files we extracted while we ensured that each data extract contained the specific data elements we requested and that the data elements were accurate. For example, we reviewed judgmental samples of the data extracts and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System.[3] As a result of our testing, we determined the data used in our review were reliable.

[2] The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
[3] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Large Business and International Division SE:LB
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Tax Exempt and Government Entities Division SE:T
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Large Business and International Division SE:LB
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
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Audit Liaisons:
    Commissioner, Small Business/Self-Employed Division SE:S
    Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
Assistant Secretary of the Treasury for Tax Policy

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $7,770,610 of minimum penalties ($38,853,050 over five years)[1] the IRS was allowed to assess but did not on 456 noncompliant corporations and tax-exempt organizations subject to the e-filing requirement in Tax Year[2] 2012 (see page 12).

Methodology Used to Measure the Reported Benefit:

We identified the following in our analysis of Tax Year 2012 business tax returns:

- 1,023 corporations were noncompliant with the e-filing requirement and 98 of these had a balance due return and were allowed to be assessed minimum penalties totaling $7,736,170[3] and maximum penalties totaling $38,680,852. However, the IRS did not enforce these penalties. The criteria used to identify noncompliant corporations were $10 million or more in total assets and no e-filing requirement waiver placed on the account. After identifying these 10,878 corporations, we calculated minimum penalties as 5 percent of the balance due and maximum penalties as 25 percent of the balance due. We then took a statistically valid sample of 133 returns to determine whether the corporation met the 250 return requirement and projected our results. This information is a projection based on a statistically valid sample of 133 corporate returns from a population of 10,878 with assets greater than $10 million that did not e-file and had no e-filing requirement waiver placed on the account. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 291 and 1,756 corporations and $5,686,840 and $9,785,501.

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[1] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.
[2] 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.
[3] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between $5,686,840 and $9,785,501.

- 358 tax-exempt organizations were noncompliant with the e-filing requirement and all 358 were allowed to be assessed minimum penalties totaling $34,440 and maximum penalties totaling $17,214,374. However, the IRS did not enforce these penalties. The criteria used to identify noncompliant tax-exempt organizations was $10 million or more in total assets, no e-filing requirement waiver placed on the account, and the 250 return requirement indicator placed on the account. After identifying noncompliant tax-exempt organizations, we calculated minimum penalties as $20 per return (for returns with gross receipts of $1 million or less) or $100 per return (for returns with gross receipts more than $1 million), and maximum penalties as the lesser of $10,000 or 5 percent of gross receipts (for returns with gross receipts of $1 million or less) or the lesser of $50,000 or 5 percent of gross receipts (for returns with gross receipts more than $1 million).

We then took the minimum penalties of $7,736,170 allowed to be assessed to noncompliant corporations and minimum penalties of $34,440 allowed to be assessed to noncompliant tax-exempt organizations to arrive at our outcome measure of $7,770,610.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; return processing cost savings of $17,040,997 ($85,204,985 over five years)[4] if the IRS enforced e-filing requirements on paid preparers filing 11 or more business tax returns. It should be noted that realization of this outcome measure is contingent upon enactment of legislation (see page 15).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify from the IRS Business Return Transaction File a population of 20,670,928[5] business tax returns that were filed by 425,109 paid preparers. From the population of 20,670,928, we then identified 19,949,641 business tax returns were filed by 152,871 paid preparers that submitted 11 or more returns of which 10,557,552 returns were paper-filed in Tax Year 2012. From the 10,557,552 business tax returns that were paper-filed by paid preparers that submitted 11 or more returns, we then calculated IRS return processing cost savings for each type of business return. For example, we identified 6,195,700 Forms 941 were paper-filed by paid preparers that submitted 11 or more returns. We calculated IRS return processing cost savings as $1.10 per Form 941 ($0.29 for an e-filed Form 941 versus $1.39 for a paper-filed Form 941), totaling $6,815,270 in processing cost savings. If the tax law is changed to require e-filing for paid preparers filing 11 or more business tax returns, processing cost savings of more than $85 million over five years could be put to better use.

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[4] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.
[5] These business tax returns included only those returns that had the ability to be e-filed.

Appendix V

Electronic Filing Requirements and Penalties for Noncompliance

<u>Form 1120 – Corporations</u>

Internal Revenue Code Section 6011-5, *Required use of magnetic media for corporate income tax returns*, states:

(a) Corporate income tax returns required on magnetic media

(1) A corporation required to file a corporate income tax return on Form 1120, "U.S. Corporation Income Tax Return," under § 1.6012-2 of this chapter must file its corporate income tax return on magnetic media if the corporation is required by the Internal Revenue Code or regulations to file at least 250 returns during the calendar year.

(b) Waiver

The Commissioner may grant waivers of the requirements of this section in cases of undue hardship.

(c) Failure to file

If a corporation fails to file a corporate income tax return on magnetic media when required to do so by this section, the corporation is deemed to have failed to file the return. (See section 6651 for the addition to tax for failure to file a return).

Internal Revenue Code Section 6651, *Failure to file tax return or to pay tax*, states:

(a) Addition to the tax

In case of failure—

(1) to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

In the case of a failure to file a return of tax imposed by chapter 1 within 60 days of the date prescribed for filing of such return (determined with regard to any extensions of *time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, the addition to tax under paragraph (1) shall not be less than the lesser of $135 or 100 percent of the amount required to be shown as tax on such return.*

(b) Penalty imposed on net amount due

For purposes of—

(1) subsection (a)(1), the amount of tax required to be shown on the return shall be reduced by the amount of any part of the tax which is paid on or before the date prescribed for payment of the tax and by the amount of any credit against the tax which may be claimed on the return.

<u>Form 990/990-PF – Tax-Exempt Organizations</u>

Internal Revenue Code Section 6033-4, *Required use of magnetic media for returns by organizations required to file returns under section 6033*, states:

(a) Returns by organizations required to file returns under section 6033 on magnetic media.

An organization required to file a return under section 6033 on Form 990, "Return of Organization Exempt from Income Tax," or Form 990-PF, "Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation," must file its Form 990 or 990-PF on magnetic media if the organization is required by the Internal Revenue Code or regulations to file at least 250 returns during the calendar year ending with or within its taxable year.

(b) Waiver.

The Commissioner may grant waivers of the requirements of this section in cases of undue hardship.

(c) Failure to file.

If an organization required to file a return under section 6033 fails to file an information return on magnetic media when required to do so by this section, the organization is deemed to have failed to file the return. (See section 6652 for the addition to tax for failure to file a return.)

Internal Revenue Code Section 6652, *Failure to file certain information returns, registration statements, etc.*, states:

(c) Returns by exempt organizations and by certain trusts

(1) Annual returns under section 6033(a)(1) or 6012(a)(6)

(A) Penalty on organization

In the case of—

(i) failure to file a return required under section 6033 (a)(1) (relating to returns by exempt organizations) or section 6012 (a)(6) (relating to returns by political organizations) on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), or

(ii) failure to include any of the information required to be shown on a return filed under section 6033 (a)(1) or section 6012 (a)(6) or to show the correct information,

There shall be paid by the exempt organization $20 for each day during which such failure continues. The maximum penalty under this subparagraph on failures with respect to any 1 return shall not exceed the lesser of $10,000 or 5 percent of the gross receipts of the organization for the year. In the case of an organization having gross receipts exceeding $1,000,000 for any year, with respect to the return required under section 6033 (a)(1) or section 6012 (a)(6) for such year, the first sentence of this subparagraph shall be applied by substituting "$100" for "$20" and, in lieu of applying the second sentence of this subparagraph, the maximum penalty under this subparagraph shall not exceed $50,000.

Treasury Decision 9363 (December 2007) – Corporations and Tax-Exempt Organizations

Background

On January 12, 2005, the IRS published a notice of proposed rulemaking (by cross reference to temporary regulations) and a notice of public hearing, (REG-130671-04, 2005-1 C.B. 694) (70 FR 2075). The proposed regulations require certain large corporations, including S corporations, to file their corporate income tax returns electronically. The proposed regulations also require certain large exempt organizations, nonexempt charitable trusts, and exempt and nonexempt private foundations to electronically file those returns required to be filed under Section 6033. A public hearing was held on March 16, 2005. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision.

Summary of Contents and Explanation of Revisions

Returns Covered.

The proposed regulations required electronic filing of Forms 1120 and 1120S, *U.S. Income Tax Return for an S Corporation*, by corporations required to file at least 250 returns during the calendar year, required to file corporate income tax returns, and that had total assets of $50 million or more as shown on Schedule L of their Form 1120 or 1120S for taxable years ending on or after December 31, 2005. The proposed regulations also required electronic filing of Forms 1120 and 1120S by corporations required to file at least 250 returns during the calendar year, required to file corporate income tax returns, and that had total assets of $10 million or more as shown on Schedule L of their Form 1120 or 1120S for taxable years ending on or after December 31, 2006. The proposed regulations also required electronic filing of Form 990, *Return of Organization Exempt From Income Tax*, by organizations required to file at least 250 returns during the calendar year, required to file Form 990 and that had, for a taxable year ending on or after December 31, 2005, total assets as of the end of the taxable year of $100 million or more or that, for a taxable year ending on or after December 31, 2006, had total assets as of the end of the taxable year of $10 million or more. The proposed regulations also required electronic filing of Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*, regardless of total assets, by organizations required to file at least 250 returns during the calendar year that were required to file Form 990-PF for taxable years ending on or after December 31, 2006.

Form 1065/1065-B – Partnerships

Internal Revenue Code Section 6011-3, *Required use of magnetic media for partnership returns*, states:

(a) Partnership returns required on magnetic media.

> *If a partnership with more than 100 partners is required to file a partnership return pursuant to § 1.6031(a)-1 of this chapter, the information required by the applicable forms and schedules must be filed on magnetic media, except as otherwise provided in paragraph (b) of this section.*

(b) Waiver.

> *The Commissioner may waive the requirements of this section if hardship is shown in a request for waiver filed in accordance with this paragraph (b). A determination of hardship will be based upon all of the facts and circumstances. One factor in determining hardship will be the reasonableness of the incremental cost to the partnership of complying with the magnetic media filing requirements. Other factors, such as equipment breakdowns or destruction of magnetic media filing equipment, also may be considered.*

(c) Failure to file.

> *If a partnership fails to file a partnership return on magnetic media in the manner required and when required to do so by this section, the partnership will be deemed to have failed to file the return in the manner prescribed for purposes of the information return penalty under section 6721.*

(d) Meaning of terms.

> *(4) Partnership return. The term partnership return means a form in Series 1065 (including Form 1065, U.S. Partnership Return of Income, and Form 1065-B, U.S. Return of Income for Electing Large Partnerships), along with the corresponding Schedules K-1 and all other related forms and schedules that are required to be attached to the Series 1065 form.*
>
> *(5) Partnerships with more than 100 partners. A partnership has more than 100 partners if, over the course of the partnership's taxable year, the partnership had more than 100 partners, regardless of whether a partner was a partner for the entire year or whether the partnership had over 100 partners on any particular day in the year. For purposes of this paragraph (d)(5), however, only those persons having a direct interest in*

the partnership must be considered partners for purposes of determining the number of partners during the partnership's taxable year.

Internal Revenue Code Section 6721, *Failure to file correct information returns*, states:

(a) Imposition of penalty

(1) In general
In the case of a failure described in paragraph (2) by any person with respect to an information return, such person shall pay a penalty of $100 for each return with respect to which such a failure occurs, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $1,500,000.

(2) Failures subject to penalty
For purposes of paragraph (1), the failures described in this paragraph are—
(A) any failure to file an information return with the Secretary on or before the required filing date, and
(B) any failure to include all of the information required to be shown on the return or the inclusion of incorrect information.

Form 2290, *Heavy Highway Vehicle Tax Return* - (Excise Taxes)

Internal Revenue Code Section 4481, *Imposition of Tax*, states:

(e) Electronic filing
Any taxpayer who files a return under this section with respect to 25 or more vehicles for any taxable period shall file such return electronically.

Appendix VI

Tax Year 2012 Business Tax Returns Unable to Be Processed Using the Modernized E-File System
(and volumes)

Tax Form Number	Tax Form Name	E-File	Paper
Form 709	*United States Gift (and Generation-Skipping Transfer) Tax Return*	0	351,131
Form 943	*Employer's Annual Federal Tax Return for Agricultural Employees*[1]	0	196,157
Form 990-T	*Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))*	0	150,584
Form 5227	*Split-Interest Trust Information Return*	0	111,320
Form 945	*Annual Return of Withheld Federal Income Tax*	0	75,331
Form 1042	*Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*	0	38,967
Form 1066	*U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return*	0	36,959
Form 706	*United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 2013)*	0	31,724
Form 8804	*Annual Return for Partnership Withholding Tax (Section 1446)*	0	31,571
Form 8752	*Required Payment or Refund Under Section 7519*	0	30,891
Form 730	*Monthly Tax Return for Wagers*	0	29,248
Form 3520	*Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*	0	27,431
Form 1041-A	*U.S. Information Return Trust Accumulation of Charitable Amounts*	0	9,737
Form 1120-C	*U.S. Income Tax Return for Cooperative Associations*	0	8,476
Form 11-C	*Occupational Tax and Registration Return for Wagering*	0	4,673
Form 8038	*Information Return for Tax-Exempt Private Activity Bond Issues*	0	3,153
Form 4720	*Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*	0	1,837
Form 706-GS(T)	*Generation Skipping Transfer Tax Return for Terminations*	0	769
Form 706-GS(D)	*Generation-Skipping Transfer Tax Return for Distributions*	0	678
Total Returns		**0**	**1,140,637**

[1] Forms 943and 945 were added to the MeF system in Processing Year 2014.

Appendix VII

Tax Year 2012 Business Tax Returns Processed Using the Modernized E-File System (and volumes)

Tax Form Number	Tax Form Name	E-File	Paper
Form 720	*Quarterly Federal Excise Tax Return*	291	121,090
Form 940	*Employer's Annual Federal Unemployment Tax Return*	1,668,055	3,888,034
Form 941	*Employer's QUARTERLY Federal Tax Return*	6,881,174	17,107,228
Form 944	*Employer's ANNUAL Federal Tax Return*	8,494	106,276
Form 990	*Return of Organization Exempt From Income Tax*	168,775	112,253
Form 990-EZ	*Short Form Return of Organization Exempt from Income Tax*	88,608	130,787
Form 990-N	*Electronic Notice (e-Postcard) for Tax Exempt Organizations not Required To File Form 990 or 990-EZ.*	477,957	22
Form 990-PF	*Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*	38,648	63,278
Form 1041	*U.S. Income Tax Return for Estates and Trusts*	2,275,373	829,418
Form 1065	*U.S. Return of Partnership Income*	2,532,516	1,033,625
Form 1065-B	*U.S. Return of Income for Electing Large Partnerships*	63	45
Form 1120	*U.S. Corporation Income Tax Return*	1,049,595	631,047
Form 1120-F	*U.S. Income Tax Return of a Foreign Corporation*	10,550	20,872
Form 1120-POL[1]	*U.S. Income Tax Return for Certain Political Organizations*	*N/A*	*N/A*
Form 1120-S	*U.S. Income Tax Return for an S Corporation*	3,133,164	1,209,892
Form 2290	*Heavy Highway Vehicle Use Tax Return*	196,734	542,642
Form 8849[2]	*Claim for Refund of Excise Taxes*	*N/A*	*N/A*
Total Returns		**18,529,997**	**25,796,509**

[1] Not available on TIGTA's Data Center Warehouse, Business Return Transaction File, Tax Year 2012 as of December 31, 2013.
[2] Not available on TIGTA's Data Center Warehouse, Business Return Transaction File, Tax Year 2012 as of December 31, 2013.

Appendix VIII

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

AUG 29 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Debra Holland Debra Holland
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – A Service-Wide Strategy is Needed to Increase Business Tax Return Electronic Filing (Audit # 201340023)

We appreciate the opportunity to review the subject draft report and provide comments. Both the IRS and the taxpaying public have realized significant benefits and cost savings associated with the adoption of electronic filing for individual income tax returns, and we recognize additional gains are possible with the increased adoption of electronic filing for business tax returns. By leveraging relationships with outside stakeholders, including the IRS Oversight Board, the Electronic Tax Administration Advisory Committee, the IRS Advisory Council, and industry partners, the IRS continues to build on past gains to reach our overall goal of an 80 percent e-file participation rate for all returns.

The IRS has recently initiated a work group that is identifying opportunities for the IRS to increase the business e-file rate. Initial actions planned for the near term are the development of a communications outreach strategy to promote e-file options available to business taxpayers. The development of a longer-term strategy will include identifying potential solutions for Service-wide taxpayer authentication services, to improve the taxpayer experience associated with e-signature services and identity verification, and identification of solutions to remove the challenges taxpayers face in electronically filing business returns.

One of the challenges to be addressed in boosting the e-file rate for business returns is ensuring the process is cost-effective for taxpayers and less burdensome than filing paper returns. There may be some reluctance among small business taxpayers who prepare their own employment tax returns to incur expenses for obtaining software and paying fees to an authorized e-file provider to transmit the return to the IRS. Expanding the option of *Free File Fillable Forms* to business taxpayers would address both

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concerns, for employment and other business tax returns; however, it is important to note that the *Free File Fillable Forms* program is a service provided by Free File Alliance – Free File, Inc., a nonprofit organization comprised of industry-leading tax software companies that have partnered with the IRS to help millions of Americans prepare and e-file their federal tax returns for free. Expanding the service to include business tax returns is a desirable goal, and will be discussed with the coalition; however, the feasibility of expanding the program must recognize and consider the needs and concerns of the coalition partners.

We do not agree that the Electronic Federal Tax Payment System (EFTPS) is a viable option for receiving employment tax returns electronically. The EFTPS was used for one year by federal agencies filing Form 941, *Employer's Quarterly Federal Tax Return*. Its use was discontinued in 2011 due to problems encountered in timely updating the programming for each quarter and systemic limitations that did not support the automatic computation of calculated fields or the population of information that had already been entered elsewhere. The IRS is moving toward using the Modernized e-File platform as the sole intake point for electronic returns and, in this time of limited budgetary resources, operating the EFTPS as another e-file platform would not be an efficient use of resources.

We acknowledge the Treasury Inspector General for Tax Administration's point regarding the use of penalties, and the exploration of decreased thresholds or new requirements for mandatory e-filing. We will develop the business e-file strategy with the objective of increasing the participation rate by improving and promoting the benefits associated with electronic filing. This will include working with the Department of the Treasury Office of Tax Policy in developing a proposal that will assist in the promotion of electronic filing of business returns

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Ivy McChesney, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.

Attachment

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1
Develop a Service-wide strategy that outlines specific efforts the IRS will initiate to advance the e-filing rate of business tax returns.

CORRECTIVE ACTION
In February 2014, the IRS formed a team to develop a Service-wide strategy for increasing the volume of electronic returns filed by business taxpayers. In addition to developing a communications outreach plan to promote e-filing for business returns during the 2015 Filing Season, we will evaluate e-file participation rates for business returns during the 2014 Filing Season. Based on the results of our review, achievable goals will be identified and an action plan will be developed to document the strategy for achieving those goals.

IMPLEMENTATION DATE
January 15, 2016

RESPONSIBLE OFFICIAL
Director, 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.

RECOMMENDATION 2
Continue to expand the type of business tax returns that can be e-filed through the MeF system.

CORRECTIVE ACTION
The goal of the IRS is to use the Modernized e-File (MeF) platform as the sole portal for receiving electronic returns. Accordingly, we have a long-term strategy for expanding the MeF capabilities through the controlled expansion of income tax forms that may be accepted by the system. The strategy is reviewed and revised on an annual basis to adjust for legislative or other environmental changes that may affect the timeline for adding new forms. We agree with the recommendation, but do not foresee the need for additional corrective action beyond the process already in place.

IMPLEMENTATION DATE
Implemented

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RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 3
Evaluate the feasibility of providing business filers with the option of Free Fillable Forms.

CORRECTIVE ACTION
We will discuss with our industry partners in the Free File Program the desire to provide business filers with a Free File Fillable Forms option.

IMPLEMENTATION DATE
January 15, 2016

RESPONSIBLE OFFICIAL
Director, 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.

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 4
Develop a less burdensome electronic signature process for businesses e-filing employment tax returns using the MeF system.

CORRECTIVE ACTION
The IRS is developing an e-signature strategy aligned with a robust e-authentication process to identify and authenticate the return signer. A work group has been formed to develop strategies, plans, and recommendations for identity proofing and authentication. The work group will coordinate activities related to e-authentication and e-signature within the IRS to implement this process.

IMPLEMENTATION DATE
January 15, 2017

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RESPONSIBLE OFFICIAL
Director, 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.

RECOMMENDATION 5
Evaluate the feasibility of providing business taxpayers with the option of using the EFTPS to e-file employment tax returns. This evaluation should include a cost/benefit analysis.

CORRECTIVE ACTION
We disagree with this recommendation. The MeF platform has been established as the system for receiving employment tax returns electronically, and yields savings for the IRS by eliminating the need to program and support multiple systems. The MeF system provides taxpayers with the ability to remit tax payments when submitting their returns.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

Recommendations

The Deputy Commissioner for Services and Enforcement should:

RECOMMENDATION 6
Develop processes and procedures to consistently identify business filers that are not compliant with e-filing requirements (both current and any new e-filing requirements) and take actions necessary to ensure future compliance.

CORRECTIVE ACTION
The development of processes and procedures that would consistently identify business filers that are not compliant with e-filing requirements would require a substantial expenditure of funds to upgrade and program our automated return processing systems. With limited budgetary resources and other competing initiatives that have higher priority, we do not intend to pursue this action.

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IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 7
Develop processes and procedures to consistently assess penalties when applicable against business filers that are not compliant with e-filing requirements.

CORRECTIVE ACTION
The development of processes and procedures that would consistently assess applicable penalties against business filers that are not compliant with e-filing requirements would require a substantial expenditure of funds to upgrade and program our automated return processing systems. Based on a relatively small number of affected taxpayers, the limited potential penalties to be assessed, and the demands of higher priorities competing for limited resources, we do not agree to implement a corrective action for this recommendation. When appropriate, non-compliance can be addressed on an individual basis by our Compliance functions.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

Legislative Recommendation

RECOMMENDATION 8
The Deputy Commissioner for Services and Enforcement should work with the Department of the Treasury Office of Tax Policy to consider a legislative proposal to revise current requirements and/or create new requirements for e-filing of business tax returns that would increase the overall e-filing rate.

CORRECTIVE ACTION
The IRS will identify and consider options for increasing the overall e-filing rate as part of the development of our business e-file strategy, including working with the

Department of the Treasury Office of Tax Policy in drafting legislative proposals to promote electronic filing and increase the overall e-filing rate.

IMPLEMENTATION DATE
October 15, 2015

RESPONSIBLE OFFICIAL
Director, 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.