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TAXPAYER SERVICE

State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits





Highlights of [GAO-07-570](#), a report to the Committee on Finance, U.S. Senate

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Why GAO Did This Study

Some states and countries allow taxpayers to prepare and file tax returns on their Internet Web sites at no charge, an option not available to federal taxpayers. Such a service might mitigate the concerns taxpayers have about current electronic filing options, which require filing through a third party and may involve fees. Increased electronic filing would reduce IRS's paper processing costs, reduce transcription errors, and speed up refunds.

However, the idea is controversial. IRS already has a Free File program which offers free return preparation and filing by private companies for some people via IRS's Web site. Some are opposed to IRS competing with tax preparation software companies.

GAO was asked to (1) describe IRS's options for on-line preparation and filing (I-file) based on states' experiences; (2) determine the benefits and costs of I-file based on the experiences of the states; and (3) describe the potential for IRS to realize cost savings from I-file. GAO profiled 7 states and the District of Columbia, 2 foreign countries and 3 federal agencies to describe I-file options and determine their benefits and costs.

Commenting on a draft of this report, the IRS Commissioner said he appreciated our observations on the states' experiences.

www.gao.gov/cgi-bin/getrpt?GAO-07-570.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jim White at (202) 512-9110 or whitej@gao.gov.

What GAO Found

The options available to IRS for implementing I-file system vary in technology, features, and eligibility. The states profiled all employed an interactive format on their Web sites for tax return preparation. The systems varied in whether they included features such as the ability to save and return. Systems also varied in eligibility, i.e. limiting income or residency.

For the systems profiled, both reported benefits and costs were relatively modest and it is unclear whether benefits were greater than costs. I-file systems may generate benefits by increasing electronic filing and reducing filing fees for taxpayers. California and Pennsylvania estimated savings of \$1.00 per return and \$3.47 respectively per return converted from paper. However, the benefits were limited by low usage. I-file usage rates were less than 6 percent. Available data on I-file costs, while limited, shows costs are a very small percentage of state tax agencies' budgets. For example, California reported spending \$700,000 to develop and operate CalFile from 2003 to 2005—less than 0.1 percent of the tax agency's annual budget. States kept I-file costs relatively modest by restricting eligibility and features. Several states used contractors to develop and operate their I-file system as well as provide the computer hardware. Low usage also contributed to modest costs. For example, some states said low usage meant they could use existing computer equipment.

IRS's potential to realize net cost savings from an I-file system depends on the costs of developing the system and the number of taxpayers converted from paper to electronic filing. IRS's costs could be higher than the states'. First, the federal tax system is more complex. Second, unlike states which already had Web sites with Internet transaction capabilities, IRS would have to significantly upgrade its Web site and incur new security costs. Finally, developing an I-file system would further stretch IRS's capability to manage systems development, a GAO high risk area since 1995. Converting paper filers to electronic filing generates savings of \$2.36 per return, according to IRS estimates. However, the number of paper filers who would convert is uncertain. The 13 million individual taxpayers who prepared their returns on a computer but then printed and mailed them to IRS are one target for conversion to I-file.

I-file System 2006 Usage Rates for 7 State Agencies and the District of Columbia

	I-file users	Total filers	Percentage of total filers
California	111,436	14.6 million	0.76
District of Columbia	9,285	.3 million	3.19
Indiana	83,422	3.0 million	2.74
Kansas	50,999	1.4 million	3.59
Maryland	115,678	2.8 million	4.17
Pennsylvania	300,552	5.6 million	5.32
South Carolina	29,241	2.0 million	1.43
Utah	25,267	1.0 million	2.51

Source: State tax agencies.

Note: Usage rates are based on the total number of filers, not the number of eligible I-file users.

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Abbreviations

ETA	Electronic Tax Administration
ERO	Electronic Return Originator(s)
IRS	Internal Revenue Service
IT	Information Technology
HTML	Hyper Text Mark-up Language
MeF	Modernized e-File
MITS	Modernization and Information Technology Services
PDF	Portable Document Format
USDA	United States Department of Agriculture

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United States Government Accountability Office
Washington, DC 20548

April 5, 2007

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Minority Member
Committee on Finance
United States Senate

In 2006, about 72 million of the 130 million individual federal tax returns were filed electronically. The other 58 million were filed on paper. Paper returns cost more for the Internal Revenue Service (IRS) to process and have disadvantages for taxpayers as well. IRS must transcribe paper returns to its computerized databases, a process that is labor intensive, slows down refunds, and inevitably introduces errors. By 2006, the growth of electronic filing had allowed IRS to close two paper processing centers and eliminate 1,600 staff years, resulting in a savings of tens of millions of dollars.

Of the 58 million paper returns, 42 million (about 72 percent) were prepared electronically on computers but then printed and mailed to IRS rather than being filed electronically. Taxpayers cite security concerns and electronic filing fees as some of the reasons for not filing electronically. IRS does not have the capability to receive electronic returns directly from taxpayers. Taxpayers filing electronically must do so through third-party transmitters, such as paid preparers and tax preparation software companies, who route the tax returns to the IRS and may charge for the service.

Some states and other countries allow taxpayers to prepare and file returns directly on tax agency Internet Web sites (what we will call I-file), an option not available to federal taxpayers. In 2006, 20 states and the District of Columbia offered this service to taxpayers; three states had discontinued an I-file service; 9 had no state income tax;¹ and 18 states do not offer an I-file service. A return preparation and filing option on IRS's Web site could reduce cost for taxpayers and mitigate any concerns about

¹Tennessee and New Hampshire levy individual income taxes on certain interest and dividend income only. Both states offer an I-file service for this tax.

the security of third-party transmitters. However, the idea is controversial. Some see it as unnecessary because of IRS's Free File program, which allows taxpayers below an income ceiling to access free tax preparation software provided by private sector companies and then file their returns electronically at no charge. Others are concerned about the impact IRS direct Internet filing would have on the tax preparation software industry.

Because of your interest in information on whether IRS should provide tax preparation software and electronic filing on its Web site, you asked us to describe various I-file options and what is known about their use. Our objectives were to: (1) describe the options available to IRS for developing an I-file service based on states' experiences, (2) determine the benefits and costs associated with a range of I-file options based on the experiences of selected states, countries, and federal agencies, and (3) describe the potential for IRS to realize cost savings from providing an I-file service.

Our review is based on data analysis, interviews, and examinations of agencies' Internet Web sites. We developed in-depth profiles of seven states and the District of Columbia² tax agencies to illustrate the range of Internet filing systems, types of features, and level of usage. We used the following criteria to select these agencies: (1) number of I-file users, (2) year I-file system was implemented, (3) whether the I-file system was developed by a contractor or in-house, and (4) types of features offered. We collected information in less depth for two foreign tax agencies and three federal agencies with I-file systems.

To collect this information we developed a data collection instrument and conducted structured interviews with agency officials about usage rates, system features, eligibility requirements, benefits to agencies and taxpayers, and system costs. We also interviewed officials from two of the three states that discontinued an I-file service. We saw consistency in the types of benefits state tax agencies reported. Based on previous GAO work and discussions with state agency and IRS officials, we understand that electronic filing reduces the number of processing staff needed, for example, and generates dollar savings. We determined that state estimates of savings per return are sufficiently reliable as a general indicator, but not necessarily as a precise indicator, of savings.

²For the purposes of this report, we refer to the District of Columbia's Office of Tax and Revenue as a state tax agency.

We summarized tax agency costs on a total cost basis and per return basis. No state could give us complete cost information; however, the data gathered covered large elements of total costs such as development and operating costs. When available we reviewed state documents such as feasibility studies, post-implementation evaluations, and contracts with companies that developed or operated some of the systems. Based on the consistency of the reporting from the eight states, we determined that the data were reliable for estimating the rough magnitude of total costs. We compared the types of system development and operations costs states incurred with the types of costs IRS would likely face in developing and operating an I-file system. Appendix III provides a more detailed scope and methodology. We performed our work from May 2006 through March 2007 in accordance with generally accepted government auditing standards.

Results in Brief

The options available to IRS for implementing an I-file system vary in technology, features, and eligibility. Two main technologies are used to collect data from taxpayers: PDF fillable form technology often looks like the paper version of a form and Web page technology is interactive and prompts the user to respond to preformatted questions. Optional features allow users to create an account, perform calculations, access help information, and view prior years' information. The eight state tax agencies we profiled all used Web page technology, but varied in whether they offered all these features. States also varied by taxpayer eligibility. Some states restricted taxpayer eligibility, for example, by placing limits on income, types of deductions, types of tax forms, or residency.

For the eight states we profiled, both I-file benefits and costs were relatively modest and it is unclear whether benefits were greater than costs. State I-file systems generated benefits by increasing e-filing and reducing paper filing and reducing filing fees for taxpayers, according to officials in the eight states profiled. California estimated a savings of \$1.00 per return converted from paper to e-filing, while Pennsylvania officials estimated that they saved \$3.47 per return. However, the overall benefits were limited by low usage. In the eight states profiled, I-file usage rates ranged from less than 1 percent to just over 5 percent of taxpayers. Some state officials said low usage was partly due to a lack of marketing. Another factor may have been convenience. Taxpayers could only prepare their state returns on the I-file systems and had to use other preparation methods for their federal returns. The cost data available from the states profiled, while incomplete, implies that agency costs were relatively

modest. For example, California spent just over \$700,000 to develop and operate CalFile, its version of an I-file system, from 2003 to 2005 — less than one-tenth percent of the tax agency's annual budget. Restrictions on taxpayer eligibility and system features helped keep costs modest as did the use of contractors. Several states used contractors and spread the costs of systems development over multiple services, not just tax services. Some had systems that operated on the contractor's computer hardware. Low usage also contributed to modest costs since several states did not need to purchase additional computer hardware to support their I-file systems. Whether benefits from I-file were greater than the costs is unclear in states profiled for two reasons — state agencies had incomplete data and reported modest benefits and costs. In 2004, California, for example, estimated that 67,000 users converted from paper to I-file for a savings of \$67,000 in processing costs. California estimated it spent \$256,000 developing and operating I-file in 2004.

IRS's potential to realize net cost savings from an I-file system depends on the costs of developing the system and the number of taxpayers converted from paper to electronic filing. IRS's costs to provide a new I-file service could be higher than states' for a number of reasons. First, the federal tax system is more complex. Second, IRS's existing Web site cannot be used for transactions such as filing a tax return. Unlike some of the states we profiled which had transactional Web sites before developing their I-file systems, IRS would need to develop a transactional Web site for I-file, which would require additional security and other features. Third, the states profiled built their systems using existing capacity while IRS would likely have to purchase additional computer hardware. And finally, developing an I-file system could further stretch IRS's capability to manage systems development, an area we have designated high risk since 1995. IRS could achieve a net cost savings if the costs saved by reduced paper processing were greater than the costs incurred from developing and operating an I-file system. The key to IRS achieving a net cost savings depends on the number of individuals converted from paper to electronic filing and the savings per return (estimated to be \$2.36 by IRS). However, the accuracy of IRS's cost estimates may be problematic given inadequacies in its financial accounting system. Further, it is uncertain how many of the 58 million paper tax returns filed in 2006 would be converted to I-file. Over 13 million taxpayers self-prepare their returns on a computer but then print and mail them to IRS. These taxpayers are an attractive target for I-file because they already have access to a computer and may be more willing to try I-file. However, IRS's Free File program,

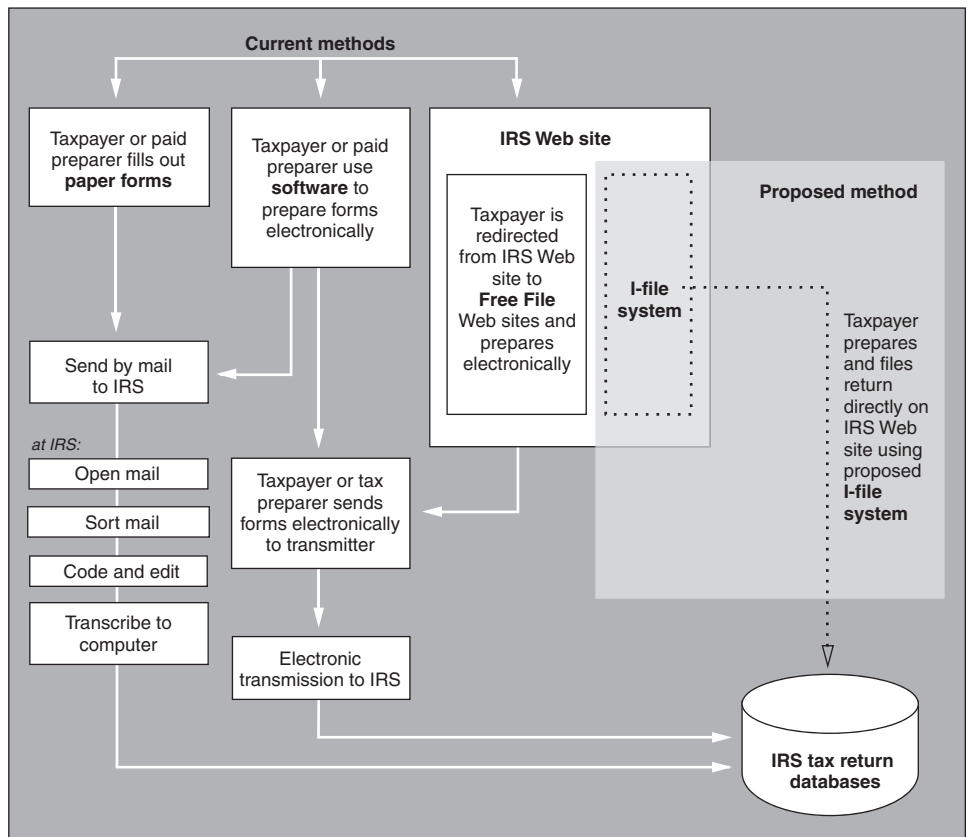
designed to attract similar taxpayers, only had 4 million users (about 3 percent of total taxpayers and 4 percent of eligible taxpayers) in 2006.

In written comments on a draft of this report, the Commissioner of Internal Revenue said he appreciated our observations on the states' experiences and summarized the facts in the report. He then reached the conclusion that the facts support IRS's current strategy for growing electronic filing.

Background

Individual federal taxpayers have several options for preparing and filing their returns as shown in figure 1.

Figure 1: Preparation and Filing Methods for Individual Federal Taxpayers or Their Paid Preparers



Source: GAO analysis of IRS information.

Using the traditional method, taxpayers or their preparers prepare paper returns and then file the returns by mailing them to one of IRS's submission processing centers. At the submission processing centers, paper returns are opened and sorted, checked for completeness, numbered with an identifying code, manually transcribed into IRS's computerized databases, and checked for accuracy. Transcribing paper returns inevitably introduces errors that then must be resolved by IRS and taxpayers. IRS devoted 2,798 staff years to paper processing in 2006. About 58 million taxpayers submitted their returns on paper in 2006.

For a number of years, some taxpayers or preparers have used tax preparation software to prepare returns electronically. However, after returns have been electronically prepared taxpayers cannot transmit them directly to IRS in order to electronically file them. Instead, only paid tax preparers and tax preparation software companies that IRS has designated as electronic return originators (ERO) can transmit tax returns electronically to IRS. These companies may charge taxpayers for the services they provide, including electronic filing. Taxpayers who prepare their returns on their home computer and then use the electronic filing option are actually sending their returns electronically to an ERO. The EROs typically bundle returns from many taxpayers and then electronically forwards them to IRS. IRS conducts suitability checks of applicants who are applying to become EROs. These checks may include checking the applicants' criminal background, credit history, and tax compliance. In 2006, approximately 72 million returns were submitted electronically. As shown in figure 1, electronic filing eliminates a number of steps necessary for processing paper returns.

In 2002, IRS entered into an agreement with the Free File Alliance, a consortium of tax preparation companies, to provide on-line electronic preparation and filing to eligible taxpayers at no charge. Taxpayers can access Free File on IRS's Web site, which provides links to the Web sites of the Free File Alliance companies.³ Taxpayers prepare their returns using free software on the companies' Web sites and then electronically file their returns from the Web sites. In 2005, eligibility was restricted to taxpayers with incomes of \$50,000⁴ or less. The number of tax returns filed

³The Free File Alliance had 17 members in 2002 and 20 members in 2007.

⁴The Free File Program income requirement was raised to \$52,000 for 2007. IRS estimates 70 percent of taxpayers qualify for Free File.

through Free File for filing season 2006 was about 4 million. As part of the Free File agreement, IRS agreed not to compete with the Alliance members by providing free, on-line tax return preparation and filing services to taxpayers on its Web site.

Some taxpayers electronically prepare their returns but they choose to print and mail the tax return to IRS. These taxpayers are known as “v-coders” because IRS codes these returns with a “v” for processing purposes and to track separately from other paper filers. As shown in table 1, out of the 58.3 million paper returns submitted last year, approximately 42 million were v-coded returns. V-coders are an attractive target for conversion to e-filing because these taxpayers already have access to computers and electronically prepare their returns, both prerequisites for electronic filing.

Table 1: Individual Returns by Filing Methods, 2006 Filing Season

Numbers in millions (percentage)	
Total individual tax returns	130.2 (100%)
Returns filed via paper	58.3 (45%)
Self-prepared returns	28.3 (22%)
V-coders	13.6 (10%)
Returns by paid preparers	30.0 (23%)
V-coders	28.8 (22%)
Returns filed electronically	71.9 (55%)
Self-prepared returns	21.2 (16%)
Free filed	4.0 (3%)
Returns by paid preparers	50.8 (39%)

Source: GAO analysis of IRS data as of August 2006.

Note: All percentages are based on the total number of returns. Numbers may not sum to totals because of rounding.

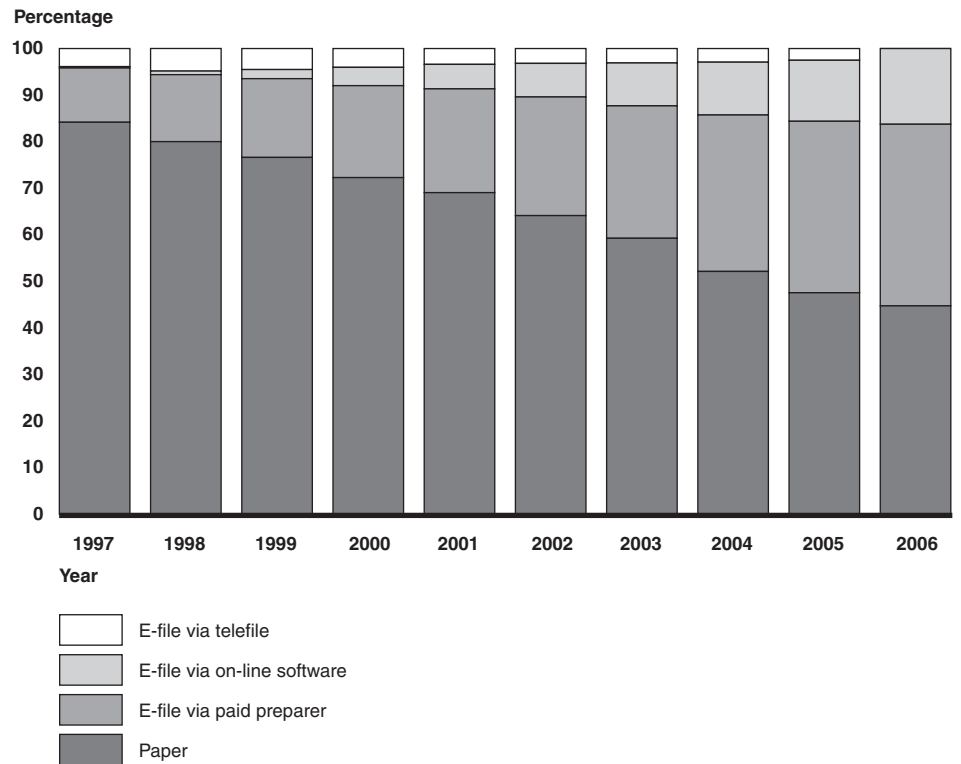
Until 2005, federal taxpayers had the option to Telefile. Telefile allowed taxpayers with simple returns to file electronically via telephone. This service was discontinued in 2005 because of declining usage and relatively high costs.

Very generally, I-file is a Web site application that allows users to prepare and submit information to an agency electronically. Since the late 1990s, almost half of the states have offered an I-file service to taxpayers. Currently, 20 states and the District of Columbia currently offer this

service to taxpayers. Three states have discontinued an I-file service for taxpayers. In addition, several foreign tax agencies offer I-file services. Also, some federal agencies offer nontax I-file services that, for example, allow users to apply for benefits on-line. Individuals applying for federal student aid, agricultural grants and loans, and veterans' benefits may choose to use the agencies' Web sites to prepare and submit applications rather than using paper to prepare forms and the mail to submit forms. For example, since 1997, the Department of Education has offered individuals an I-file service for preparing and submitting the Free Application for Federal Student Aid.

Figure 2 shows the growth of federal electronic filing since 1997. According to IRS officials, it is getting harder to convert taxpayers to electronic tax return filing since those who might convert most readily have already done so.

Figure 2: Percentage of Individual IRS Returns by Preparation and Filing Method, Calendar Years 1997-2006



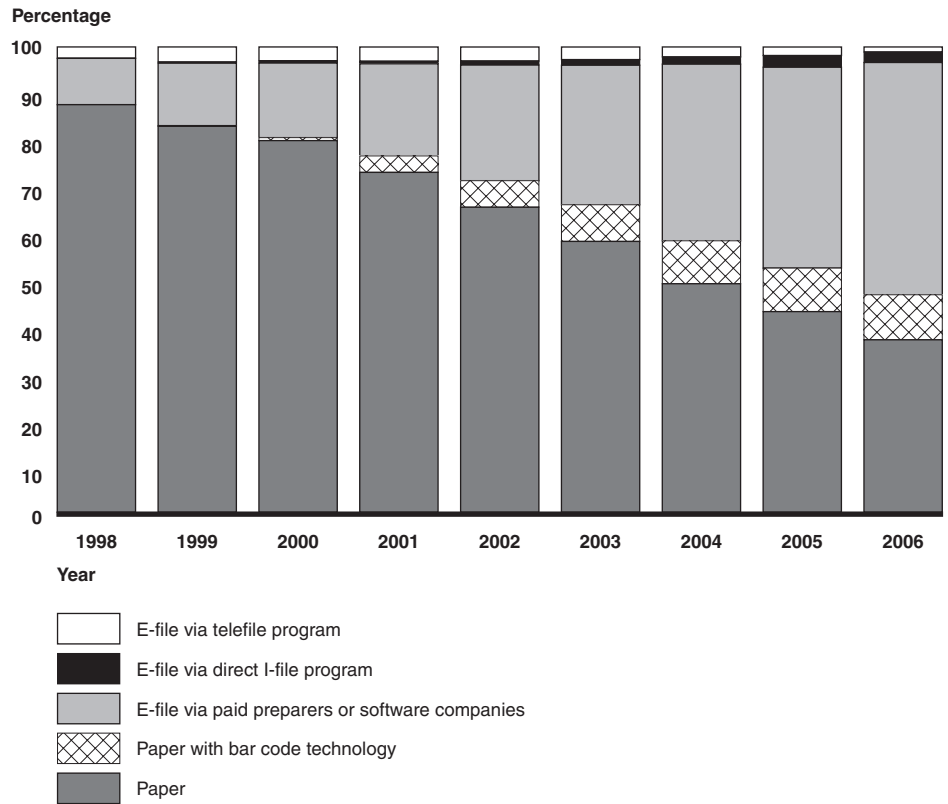
Source: GAO analysis of IRS data.

Note: Figure includes some rounded totals for paper returns.

Electronic filing has also grown at the state level, as shown in figure 3. Several states imposed electronic filing mandates on tax preparers who meet certain criteria, such as filing 100 state tax returns or more, which contributed to increased electronic filing. Moreover, state taxing authorities are using technologies such as I-file and 2-D barcode⁵ to enable more efficient processing of returns.

⁵The 2-D barcode technology uses software to prepare the tax return, but when the return is printed, a horizontal and vertical bar code containing the information (for example, name, social security number) is imprinted on the paper. The taxing authority then scans the return, captures the data, decodes the data, and processes the return as if it had been sent electronically if the 2-D barcode contains all the pertinent information on the return.

Figure 3: Percentage of State Tax Returns by Preparation and Filing Method for Individuals, Calendar Years 1998-2006



Source: GAO analysis of Federation of Tax Administrators data.

Within IRS, the Wage and Investment Division (W&I) and Modernization and Information Technology Services (MITS) have a role in electronic filing. W&I's Electronic Tax Administration (ETA) administers IRS's electronic filing programs and is responsible for receiving and processing tax returns electronically filed through EROs by taxpayers and preparers. MITS has the information technology (IT) and programming staff that develops and maintains IRS's electronic filing systems, including hardware and software.



IRS currently has a project underway, Modernized e-File (MeF), to replace its current electronic filing technology with a modernized, Internet-based electronic filing application. Successful implementation of the MeF system will give IRS increased capability to accept electronically filed returns

(including individual returns) from EROs. Neither the current e-filing technology nor MeF does allow direct electronic filing by individuals.

I-file Systems Use Two Main Technologies and Offer a Range of Features and Taxpayer Eligibility Requirements

I-file systems have a range of design options. Two main technologies used to collect data from taxpayers exist: PDF⁶ fillable form technology often looks like the paper version of a form and Web page technology is interactive and prompts the user to respond to preformatted questions. Figure 4 illustrates the variety of features available with either technology. Tax agencies that have I-file systems also established a variety of eligibility requirements for taxpayers.

Figure 4: Examples of I-file Systems and Features

	 PDF fillable form	 Web pages		
I-file features	USDA	California I-file	U.K. I-file	Maryland I-file
Login/create account	✓	✓	✓	✓
Perform calculations	✓	✓	✓	✓
Hyperlinks to other forms and publications	✓	✓	✓	✓
Ability to save and return to form	✓		✓	✓
Auto-populate some fields			✓	✓
Status checks	✓		✓	✓
View prior year information				✓

Sources: GAO analysis of USDA, State of California, Her Majesty's Revenue and Customs, and State of Maryland information; PhotoDisc (images).

PDF Fillable Forms

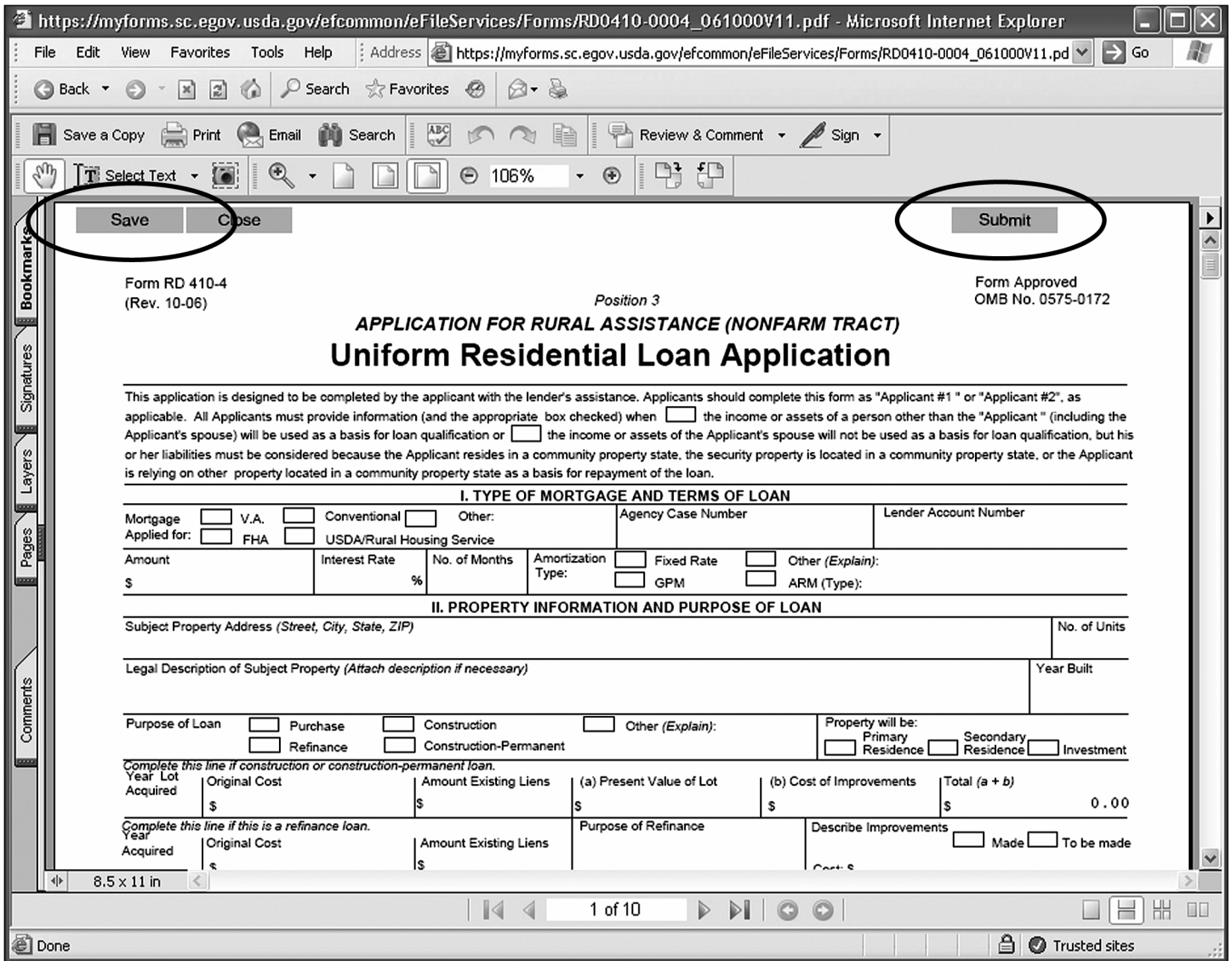
PDF fillable form technology can closely resemble or reproduce the paper version of the form. This is one technology often used when agencies want to show users the paper version of a form. The PDF fillable forms are accessed through the agencies' Web site, but users need additional

⁶A Portable Document Format (PDF) is an electronic document that must be read using a PDF reader application, such as Adobe Reader.

software (PDF readers are available for free on the Internet) to view and fill in the fields.

The U.S. Department of Agriculture (USDA) has offered PDF fillable forms with direct submission to support USDA's Rural Development eForms System since 2002. USDA initially offered 200–300 on-line forms but later expanded the system to about 1,500 eForms for the public and USDA employees to prepare and submit forms directly on USDA's Web site. Individuals may use the agency's Web site to apply for a number of programs such as agriculture conservation, crop disaster, rural water, and farm loans. Users of USDA's eForms can access the system with and without a user account. If a user creates an account with USDA, the user may save forms on USDA's Web space and electronically submit the forms to the agency via the agency Web site. With an account, users may also bundle several forms together for submission. Once the forms are submitted electronically, the user receives an instant confirmation code, which users may reference if any questions arise. Additionally, users may use the account to view the status of the forms, and resubmit any form that may need corrections. Figure 5 shows a USDA fillable form with save and submission features.

Figure 5: Computer Screen Picture/Image of USDA's eForms Showing Save and Submission Features



Source: USDA.

Without an account, users can search and download forms from the Web site, fill the forms in, and print the forms. However, users cannot submit forms electronically. USDA's eForms provide basic instructions, like the paper version, and more detailed instructions are provided in separate

PDF documents. After the user completes the form, it may be saved on a personal computer or printed and mailed to the agency.

IRS currently provides PDF fillable form versions of some tax return forms and schedules. These forms can be downloaded to a home computer, filled in, printed, and mailed back to IRS. They cannot be filed electronically with IRS and, therefore, are not an I-file option.

Web Pages That Allow Data Entry

Another technology uses Web pages (HMTL),⁷ an interactive, ease-of-use Web site feature, containing checkboxes, option lists, text boxes, and buttons that allow users to respond to preformatted questions. Web pages do not always resemble the paper version of the form but collect similar information. Because these Web pages can be viewed using a regular Web browser, users usually do not need additional software.

Similar to the PDF fillable forms, Web pages allow the agency to choose the features offered to the user. Some agencies offer fewer features to users. For example, both Utah's TaxExpress and California's CalFile systems allow users to log-in/create an account, perform calculations, link to other forms and publications, and submit directly to the agency. Other agencies have more sophisticated systems which offer more features. For example, United Kingdom's Self Assessment system allows users to save their partially completed forms and return to the system at a later time,⁸ edit the forms, and view any changes made.

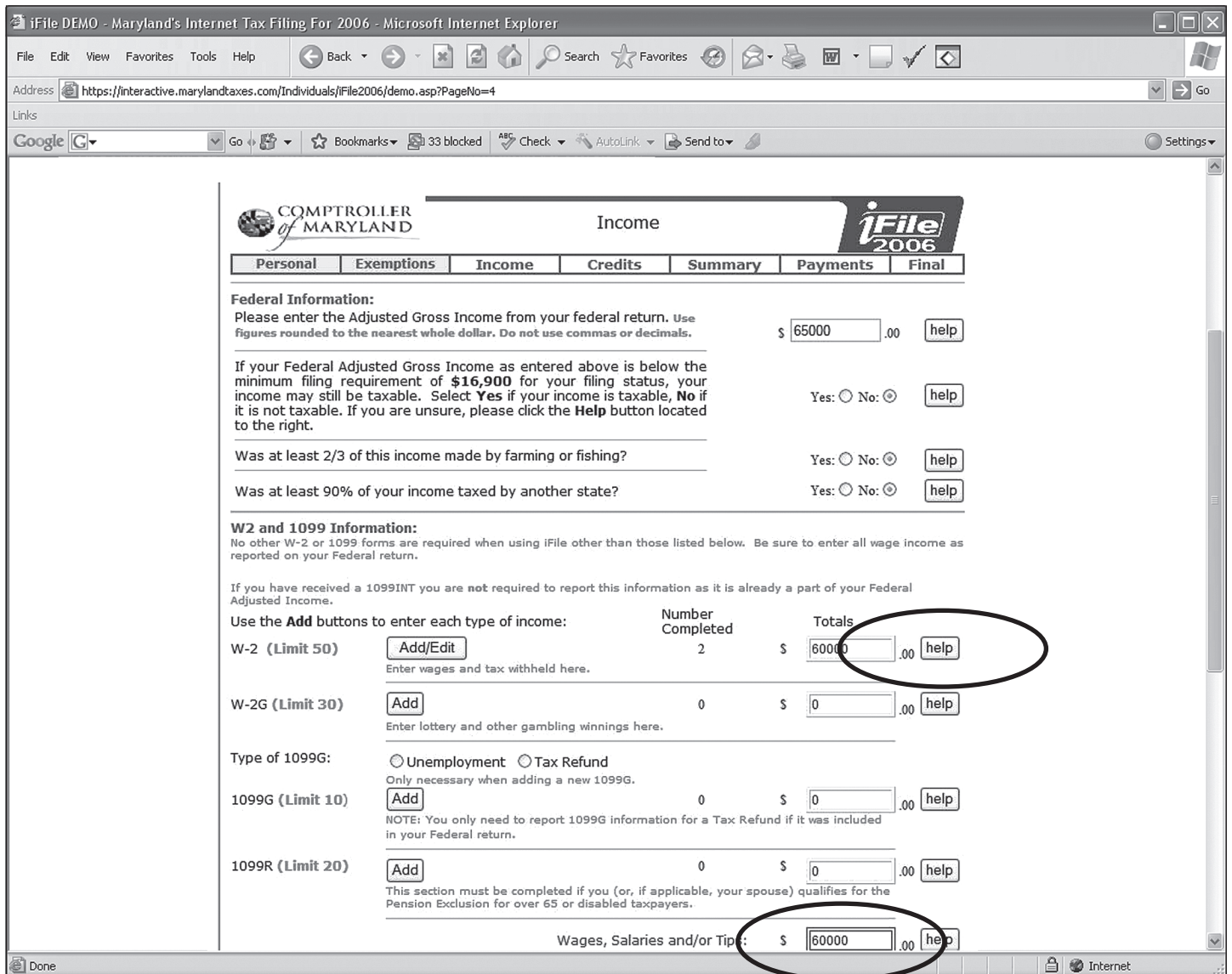
Another example of a more sophisticated system with multiple features is Maryland's I-file. Maryland offers features such as account access, calculations, and hyperlinks to other forms and publications. It also allows users to save work and return later and view prior years' returns. The Maryland system also prepopulates some of the taxpayer's biographic information⁹ and allows users to check the status of their current return. Figure 6 shows a computer screen picture/image of Web page technology with calculations and hyperlinks to help features from Maryland's I-file system.

⁷HTML (Hypertext Markup Language) is the software language used on the Internet's World Wide Web. HTML is used for creating World Wide Web pages.

⁸This is referred to as the save and return feature.

⁹The Maryland system prepopulates some tax information for state employees.

Figure 6: Computer Screen Picture/Image of Maryland's I-file System Showing Calculations and Hyperlinks



Source: State of Maryland.

Eight States We Profiled Offer I-file Systems with a Variety of Features and Taxpayer Eligibility Requirements

Table 2 describes the I-file systems we profiled in eight states. As mentioned, state tax agencies offered a range of features such as calculations and save and return. Some states restricted eligibility by income, residency requirements, or number of itemized deductions.

Table 2: Eight I-file Systems and System Name, Technology, Key Features, Eligibility Requirements, and Year Implemented

States	System name /technology	Key features	Eligibility requirements ^a	Year implemented
California	CalFile Web pages technology	<ul style="list-style-type: none"> Log-in/create account Perform calculations Hyperlinked to other forms and publications 	<ul style="list-style-type: none"> Limits on residency, amount of income, type of income, itemized deductions, type of credits, number of dependents, types of payments 	2003
DC	On-line Tax Filing Service Web pages technology	<ul style="list-style-type: none"> Log-in/create account Perform calculations Hyperlinked to other forms and publications Ability to save and return to form Auto populate some fields Status checks 	<ul style="list-style-type: none"> Must have filed a return the previous year 	2002
Indiana	I-file Web pages technology	<ul style="list-style-type: none"> Log-in/create account Perform calculations Hyperlinked to other forms and publications Ability to save and return to form Auto populate some fields 	<ul style="list-style-type: none"> Limits on type of form Must have not legally changed first or last names since the last filed return 	1998
Kansas	Webfile Web pages technology	<ul style="list-style-type: none"> Log-in/create account Perform calculations Hyperlinked to other forms and publications Ability to save and return to form Auto populate some fields Status checks 	<ul style="list-style-type: none"> Limits on income Open to nonresidents Must have filed a state return the previous year 	2001

Maryland	I-file Web pages technology	<ul style="list-style-type: none"> • Log-in/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto populate some fields • Status checks • View prior year's information 	<ul style="list-style-type: none"> • Limits on number and type of forms • Open to nonresidents 	2001
Pennsylvania	pa.direct.file Web pages technology	<ul style="list-style-type: none"> • Log-in/create account • Perform calculations • Hyperlinked to other forms and publications 	<ul style="list-style-type: none"> • Limits on type of income, type and number of forms, credits, and types of deductions 	2000
South Carolina	SCnetFile! Web pages technology	<ul style="list-style-type: none"> • Log-in/create account • Perform calculations • Hyperlinked to other forms and publications • Auto populates some fields 	<ul style="list-style-type: none"> • Limits on type of income, type of forms, and type of credits • Open to nonresidents 	1999
Utah	TaxExpress Web pages technology	<ul style="list-style-type: none"> • Log-in/create account • Perform calculations • Hyperlinked to other forms and publications • Status checks 	<ul style="list-style-type: none"> • Limits on income, type of deductions, and type of credits • Must have filed a state return the previous year 	2001

Source: GAO analysis of information from states.

^aEligibility requirements are for the 2006 tax year. Appendix I contains detailed information on state eligibility requirements.

Appendix I provides additional information about each state's I-file system such as the extent to which the state used contractors to develop and operate the system. Some systems do not operate on computer hardware owned by the states, but instead operate on hardware owned by contractors.

State Agencies' I-file Benefits and Costs Have Been Relatively Modest

Both the benefits states received from their I-file systems and costs of developing and operating them have been relatively modest. Based on the available information, it is unclear whether the benefits to the states were greater than their costs.

State I-file Systems Reduced Paper Filing, but the Magnitude of the Benefits Was Limited by Low Usage

According to officials in five of the eight states we profiled, state I-file systems generated benefits (before subtracting the costs of system development and operation) by increasing e-filing and reducing paper filing. However, the benefits were limited by the low usage. As shown in table 3, I-file users as a percentage of total filers ranged from less than 1 percent to just over 5 percent. Only three states gave us estimates of the number of taxpayers eligible to I-file. Pennsylvania had 20 percent of eligible taxpayers I-filing in 2006 while California and South Carolina both had less than 2 percent. While Pennsylvania had 20 percent of eligible taxpayers using I-file, GAO is interpreting this as a low usage rate since the state instituted the system in 2000.

Table 3: 2006 I-file System Usage Rates for Eight State Agencies

	I-file users	Eligible filers	Percentage of eligible filers	Total filers	Percentage of total filers
California	111,436	6.4 million	1.74	14.6 million	0.76
District of Columbia ^a	9,285	N/A	N/A	.3 million	3.19
Indiana	83,422	N/A	N/A	3.0 million	2.74
Kansas	50,999	N/A	N/A	1.4 million	3.59
Maryland	115,678	N/A	N/A	2.8 million	4.17
Pennsylvania	300,552	1.5 million	20.04	5.6 million	5.32
South Carolina	29,241	1.5 million	1.95	2.0 million	1.43
Utah	25,267	N/A	N/A	1.0 million	2.51

Source: GAO analysis of state tax agencies.

Note: N/A is not available

^aUsers and calculations based on 2005 data.

The benefits to state tax agencies included reducing the costs of processing paper returns plus related costs due to correcting math and transcription errors and contacting taxpayers about such errors. The magnitude of the benefits to tax agencies depends on the savings per return and the number of taxpayers converted from paper to electronic filing. Returns prepared and filed through I-file that would have otherwise been electronically filed do not generate significant benefits in the form of reduced costs for the tax agencies. Only returns converted from paper to electronic filing generate benefits in terms of cost savings for the tax agency.

Three of the tax agencies we profiled gave us estimates of how much converting a return from paper to electronic filing saved them in

processing costs. California estimated that each taxpayer converted from paper to e-filing saved the state about \$1.00 in processing costs per return. Pennsylvania officials reported it costs about \$4.72 to process paper returns, while electronically filed returns costs them only \$1.25—a cost savings of \$3.47 per return. One of the largest cost savings on a per return basis was reported by Kansas where agency officials reported saving \$11 per electronic return filed. These savings reflect operations in each state and may not indicate savings that other states or IRS might achieve.

State agency officials provided some information about savings beyond reduced processing costs but could not provide dollar estimates of the savings. Kansas officials said the state had less than a 1 percent math error rate for I-filed returns compared to a 17 percent rate for paper returns. California officials reported a decrease in math and transcription errors. The state agency reported that fewer contacts with taxpayers can benefit the agency and yield a savings from fewer notices. Maryland officials said they have less need to contact taxpayers who I-file.

The number of taxpayers converted from paper filing to electronic filing due to state I-file systems is relatively modest. In an evaluation conducted 3 years after CalFile was implemented, California estimated that as many as 67,000 I-filers were new e-filers in 2004. That number is less than 1 percent of eligible filers in California the same year. The other tax agencies we profiled could not document how many returns were converted from paper to electronic filing as a result of I-file, but the number has to be relatively small because the total number of I-file users is relatively small.

Low usage may be due to a number of reasons, including little marketing and the lack of integration with the federal tax system. Officials in five states said the amount budgeted for marketing was minimal. Pennsylvania reported allocating \$20,000 to \$40,000 for marketing during calendar years 2000 to 2002. The other tax agencies did not provide dollar amounts. Using different methods to prepare and file state and federal returns can be an inconvenience to taxpayers. Many tax preparation software packages offer the convenience of integrating federal and state tax return preparation. Much of the required data has to be entered only one time and is automatically transferred from the federal to the state tax return. Users of state I-file systems would have to prepare their federal tax return using one preparation method and then learn a second, to prepare their state return.

Foreign tax agencies with I-file systems and federal agencies with on-line application systems reported higher usage rates than the state agencies we profiled, as shown in table 4. Reasons differed for the higher usage rates among foreign tax agencies and federal agencies. French officials offered a financial incentive of 20 euros (approximately \$26) in 2005 to French taxpayers who filed tax returns on-line and paid taxes electronically. An official with France's General Tax Directorate said the rebate increased usage to such a degree the system was overloaded and officials needed to extend the filing deadline. One federal agency attributed high usage to the type of user the agency serves. An official with the Department of Education said usage of the on-line financial aid system was high, due in part, to the target population of students who are Internet-savvy.

Table 4: I-file System Usage Rates for Selected Foreign Tax Agencies and Federal Agencies

	I-file users		
	2006	Total filers	Percentage of total filers
United Kingdom	2 million	9 million	22.22
France	5.7 million	35 million	16.29
Department of Education	11.3 million	13.9 million	81.29
Department of Agriculture	4,398	N/A	N/A
Department of Veterans Affairs	144,220	N/A	N/A

Source: GAO analysis of foreign tax agencies and federal agencies information.

Note: N/A is not available.

In addition to the benefits to the tax agencies, state I-file systems also generated benefits for users. Taxpayers who convert from paper to electronic filing because of the availability of I-file received the benefits of electronic filing, such as faster refunds. Compared to paper filing, Utah's TaxExpress I-file system reduced return processing time to 4-5 days from 8-10 days and generated faster refunds. South Carolina's SCnetFile! users received direct deposit of refunds within 9-10 days, paper checks were processed within about 3 weeks, according to agency officials. Some taxpayers who convert from paper may benefit by not having to respond to notices for math errors, by having lower compliance burdens, and by preferring electronic confirmation that the tax agency received their return. A benefit to some taxpayers using I-file is saving on electronic filing fees. Taxpayers who were charged electronic filing fees and convert to I-file would save. Taxpayers, who electronically file for free, such as users of the Free File program, would not save on fees. Another benefit to

some taxpayers using state I-file systems is the security of not having to file through a third party such as an ERO. However, as was noted earlier and shown in appendix I, some state I-file systems are operated by contractors on the contractors' computer hardware.

Table 5 compares some of the advantages and disadvantages of the various methods of preparing and filing federal tax returns from a taxpayer's perspective.

Table 5: Advantages and Disadvantages to Taxpayers of Alternative Tax Preparation and Filing Methods

Tax preparation and filing method	Advantages	Disadvantages
Preparation by hand/filing by mail	<ul style="list-style-type: none"> • No preparation costs • Low cost of submission (postage) • No third party involvement with tax return preparation or submission • No computer access needed 	<ul style="list-style-type: none"> • Must rely on own knowledge; forms, instructions, and taxpayer services provided by tax agency • Slower refunds • Increased errors due to paper processing • Increased incidence of lost documentation • Other required income tax returns (if applicable) are an additional task
Preparation using tax preparation software or tax preparer/filing by mail (v-coders)	<ul style="list-style-type: none"> • Reduced time/tax liability due to software or preparer tax planning capability • Easier preparation of other required income tax returns (if applicable) • Low cost of submission (postage) • Third party may not access tax return data during submission • Math and omission error checks 	<ul style="list-style-type: none"> • Cost of software/preparer • Computer access required for software users • Slower refunds • Increased errors due to paper processing • Increased incidence of lost documentation • Third party may have access to tax return data during preparation
Preparation using tax preparation software or tax preparer/filing by ERO	<ul style="list-style-type: none"> • Reduced time/tax liability due to software/preparer's tax planning capability • Easier preparation of other required income tax returns (if applicable) • Faster refunds • Fewer errors due to paper processing • Less incidence of lost documentation • Math and omission error checks 	<ul style="list-style-type: none"> • Computer and Internet access required for software users • Cost for software/tax preparer • Third party may have access to tax return data during preparation and/or submission

Tax preparation and filing method	Advantages	Disadvantages
Preparation using Free File/ filing via Free File	<ul style="list-style-type: none"> • Reduced time/tax liability due to software/preparer's tax planning capability • Easier preparation of other required income tax returns (if applicable) • Faster refunds • Fewer errors due to paper processing • Less incidence of lost documentation • Math and omission error checks • No cost for filing fees 	<ul style="list-style-type: none"> • Not all taxpayers are eligible • Computer and Internet access required • Third party may have access to tax return data during preparation and submission
Preparation using direct Internet filing system/ filing directly on agency Web site	<ul style="list-style-type: none"> • Same as above • No third party involvement with tax return preparation or submission 	<ul style="list-style-type: none"> • Computer and Internet access required

Source: GAO analysis.

Available Information Indicates That I-file Costs Were Relatively Modest Because States Limited Features, Eligibility, and Capacity Needs

The cost data we were able to gather from the state tax and federal agencies we profiled, while incomplete, implies that costs were relatively modest. No state tax agency had complete, documented data on the costs of developing their I-file systems. In many cases, I-file costs were not tracked separately from department-wide activities. No state tax agency had available data on costs such as management planning and conceptualization or contractor oversight. However, some state tax agencies did have estimates for large portions of their I-file costs, such as systems development or operating costs, as shown in table 6.

As already noted, state tax agencies varied in the extent to which they used contractors or in-house staff to develop or operate I-file systems. Three states profiled—Indiana, Kansas, and Utah—used a contractor and relied almost wholly on the contractor to provide I-file services. The software and servers (computer hardware) are owned and operated by the contractors. Some taxpayer support for individuals, including technical help desk assistance, is provided by the contractor as well. Other states used a contractor to develop the system, but the state owned and operated the server. Some states, such as California and Maryland, primarily used in-house staff to develop and operate their systems. In these states, taxpayers prepared returns on state-owned servers.

Available data on total I-file costs show costs are a small percentage of state tax agencies' budgets. For example, California spent just over \$700,000 to develop and operate CalFile from 2003 to 2005—less than 0.1

percent of the tax agency's annual budget.¹⁰ Pennsylvania's pa.direct.file annual operating cost of \$125,000 is less than 0.1 percent of the Revenue Department's 2006 budget of \$176 million. For states that primarily used contractors, data on specific types of costs are not available because many types of costs are covered by the fee per return charged by contractors. We did not verify cost information provided by state agencies or contractors. While the state cost data are incomplete, the data are consistent with what we learned about development and operating costs at USDA and the Department of Veterans Affairs.

Table 6: Available Cost Information on Agencies I-file Systems

	Development	Operating	Marketing	Taxpayer support	Average cost per return
California (costs cover 2003 to 2005) ^a	\$511,797	\$205,384	N/A	N/A	\$2.30
Pennsylvania ^b	\$400,000	\$125,000	N/A	N/A	\$0.94
District of Columbia (costs are for individual and business I-file) ^c	\$1-\$2 million	\$480,000	N/A	N/A	N/A
Indiana ^d	Contractor's fee per return:	\$1.00			N/A
Kansas ^e	Contractor's fee per return:	\$1.00			N/A
Utah ^f	Contractor's fee per return:	\$0.75			N/A
South Carolina ^g	Data not tracked separately from departmentwide services				N/A
Maryland ^h	Data not tracked separately from departmentwide services				N/A
Department of Agriculture ⁱ	\$600,000	\$50,000	N/A	N/A	N/A
Department of Veterans Affairs ^j	\$358,500	\$40,000	N/A	N/A	N/A
Department of Education ^k	No available information				N/A
United Kingdom ^l	Data not tracked separately from departmentwide services				N/A
France ^m	Data not tracked separately from departmentwide services				N/A

Source: GAO analysis of state tax agencies, foreign tax authorities, and other federal agencies.

Note: N/A is not available.

^aCalifornia reported costs for years 2003-2005 for development and operating. Officials had a marketing budget of \$100,000 for all electronic filing in 2005, but did not have a specific marketing budget for CalFile. Additional costs to taxpayer support were not tracked. Cost per return is a GAO calculation based on state data.

^bPennsylvania reported a one time development cost and annual operating costs. For years 2000-2002, officials had marketing budget of \$20,000-\$40,000. Additional costs to taxpayer support were not tracked. Cost per return is a GAO calculation based on state data.

¹⁰California's Franchise Tax Board's Budget for 2004-2005 was \$466 million.

^cDistrict of Columbia reported a one time development cost and annual operating costs, but did not report an annual marketing budget. Additional costs to taxpayer support were not tracked.

^dIndiana officials reported a contractor's fee per return.

^eKansas officials reported a contractor's fee per return and a marketing budget of \$100,000 per year for 2006-2007. Additional costs to taxpayer support were not tracked.

^fUtah officials reported a contractor's fee per return and a one time Web site upgrade fee of \$30,000.

^gSouth Carolina officials were unable to track cost information separate from other department costs.

^hMaryland officials were unable to track cost information separate from other department costs.

ⁱDepartment of Agriculture had a marketing budget of \$100,000 in 2002 for the eForms application.

^jDepartment of Veterans Affairs reported a one time development cost and annual operating costs, but did not report an annual marketing budget. Additional costs to taxpayer support were not tracked.

^kDepartment of Education provided no cost information.

^lUnited Kingdom officials were unable to track cost information separate from other department costs.

^mFrance officials were unable to track cost information separate from other department costs.

The available data also show costs are relatively modest when calculated per tax return. Three states that relied heavily on a contractor were charged \$0.75 per return or \$1.00 per return to develop and operate I-file systems, as shown in table 6. Based on the data provided, we calculated Pennsylvania's I-file average costs per return as \$0.94 for 2000 to 2006, and California's average costs per return as \$2.30 for 2003 to 2005. These costs per return are relatively modest compared to what the states told us about their costs for processing paper returns. For example, Pennsylvania officials said it cost \$4.72 per return to process a paper return.

Several factors contributed to keeping I-file costs relatively modest. Six of the eight state agencies we profiled limited eligibility. Three states developed their system incrementally and increased eligibility over time. As shown in table 2, some states restricted eligibility by income, residency requirements, or number of itemized deductions. States also varied on the extent to which they offered system features, such as the ability to save a partially completed return and the extent to which certain information can be automatically filled in on the form using previous years' returns. By limiting eligibility and features, agencies can limit certain costs, such as software development and testing, that do not change as the number of users changes (fixed costs). Restricting the eligibility and features also has some effect on costs that do depend on the number of system users (variable costs), such as computer hardware and help desk assistance. Variable costs for purchases of hardware and telecommunications to support the system can also increase if system features become more sophisticated and if the system allows users to file more complex returns.

Appendix II has more information on types of variable and fixed costs agencies incurred in implementing an I-file system.

Another factor that contributed to modest costs was that contracts between states and contractors covered the development and operation of computer systems that provided multiple services, not just tax services. For example, a contractor's representative told us the contractor may not recoup all its costs for I-file with the fees charged per tax return. Instead, the costs may be recouped from other services provided to the state.

One other factor keeping costs modest was the limited number of anticipated users. As discussed previously, the number of users in all eight states we profiled was less than 6 percent of all taxpayers. Low usage also affects variable costs for purchases of system hardware and telecommunication services. Several states told us that they were able to mitigate additional capacity costs by building upon existing systems hardware. As reported in their feasibility report, California officials planned to build the CalFile system using the existing technical environment and noted that no additional software, hardware, or licenses would need to be procured. It was expected that all project expenditures would be for staff costs only. One contractor indicated that additional capacity was available to support increased usage, if needed, from other existing servers. Some states we profiled did not make significant changes to their current levels of taxpayer support because of the low usage rates. For instance, Maryland's taxpayer service group provided I-file training to the current staff but did not have any need to hire additional staff.

Whether States Realize Benefits Greater Than Costs from Their I-file Systems Is Unclear

In all states profiled, whether benefits are greater than costs is unclear for two reasons. As previously noted (1) data on benefits and costs was incomplete and (2) based on available data, both benefits and costs were modest.

Although incomplete, the available data combined with the decision by three states to discontinue their systems raise the possibility that in at least some states the benefits were less than costs. According to officials in two of the three states that discontinued their I-file systems, the benefits did not appear greater than costs and the system was not providing a good return on their investment. One agency official reported experiencing low usage and high costs. Officials with Iowa's Department of Revenue said the state had hoped to see major growth in electronic filing usage by introducing an I-file system, yet the system use peaked at 22,815 I-filed

returns in 2004. Iowa officials estimated the system was costing about \$7.00 per return. Like Iowa, Arkansas discontinued its I-file services. According to a state official, Arkansas's I-file system operated for 5 years beginning in tax year 2000 and processed a total of 5,149 returns. The highest usage was in 2005, with only 1,382 returns processed.

Another example of a state in which the benefits may be less than the costs, based on reported information, is California. A study of the CalFile system revealed California overestimated benefits, expecting 400,000 users in 2004 but getting 110,000. Further, the study highlighted that California underestimated costs with development costs expected to be \$304,538 but coming in at \$511,797. California officials estimated the agency saves approximately \$1.00 per return in processing costs by converting paper returns to electronic returns. In 2004, California estimated 67,000 filers converted to electronic filing, which would have saved the agency \$67,000. In the same year, California reported spending \$256,362 on CalFile for development and operating costs. Consequently, based on reported information, benefits appear less than costs. However, additional benefits could have been realized from decreased math errors, for example, but the amount of such benefits is not known. California officials told us that CalFile may still be beneficial to the state because it provided another method of filing.

Pennsylvania estimates show the benefits of its I-file system could exceed costs. Pennsylvania estimated \$3.47 per return in cost savings for processing and administrative costs associated with converting paper to electronic filing. Between tax year 1999 and 2005, a total of 1,362,867 taxpayers used the I-file system. Pennsylvania did not provide an estimate of the number of I-file users that converted from paper. However, if 28 percent of users converted from paper to e-filing, Pennsylvania would break even. If more than 28 percent converted, Pennsylvania could realize a net benefit.

Achieving a Net Cost Savings for IRS Depends on the Cost of Developing the System and the Number of Paper Filers Converted

Providing federal taxpayers with an I-file system would be a new service for which IRS would incur new costs. Whether the additional costs of the new program could be offset by reduced costs from processing fewer paper returns depends on a number of factors, such as the costs of developing and operating the system and number of taxpayers converted from paper to I-file.

Providing I-file Would Be a New Service with New Costs for IRS That Could Be Higher Than States' Costs

I-file would be a new service that IRS would provide for taxpayers. To develop the new service, IRS would have to (1) create or procure return preparation software for IRS's Web site and (2) extend direct e-filing to individuals, in which the return would be routed into the current stream of electronically filed returns coming in from EROs.

IRS's fixed costs for I-file could be higher than the fixed costs of the states we profiled for several reasons. Currently, IRS's Web site is mostly informational, meaning taxpayers can obtain information from IRS but they cannot submit information to IRS's tax return databases. The information that taxpayers can obtain includes instructions, downloadable forms, and refund status. Developing an I-file system would require IRS to develop a transactional Web site, where taxpayers could enter information that would be submitted to IRS's tax return databases. Transactional Web sites require more security and other features not necessary for an informational Web site.

Some of the states we profiled had transactional Web sites in place before they developed their I-file systems.¹¹ Those states included Kansas, California, Indiana, and Utah. To provide I-file, IRS would need to incur the costs of developing a transactional capability.

Other factors that could cause IRS's fixed costs to differ from the states' fixed costs include the relative complexity of the federal tax system, the

¹¹While state agencies incurred one-time costs for developing transactional Web sites, the costs were not a part of the agencies' decision to implement the state's I-file system.

types of taxpayers who are eligible, and the features of the I-file system, such as memory. The federal income tax system is more complex than states' tax systems, which generally piggyback on the federal return. For example, the federal Form 1040 for tax year 2006 contains 77 lines and can require up to 41 other forms, schedules, or worksheets to complete, while Maryland's Form 502 contains 52 lines (starting with federal adjusted gross income) and can require only 7 other forms, schedules, or worksheets to complete. IRS could limit fixed costs by limiting taxpayer eligibility the way some states did. Limiting eligibility to more simple forms, such as the federal Form 1040 EZ, would reduce the complexity of I-file software. Similarly, the features offered on an I-file system would affect the complexity of the software. Features such as save and return and auto-populating can require additional memory and potentially increase costs.

IRS's variable costs for an I-file system could also be higher than the states'. As previously noted, many of the states we profiled had low variable costs for computer hardware and taxpayer support because they were able to make use of existing capacity, either inside the tax agency or at other state agencies. Several states we profiled said that if their usage rates were significantly higher than current rates, they would incur additional costs to increase capacity. According to IRS officials, IRS does not have excess capacity that could be used to provide I-file services to taxpayers. As a consequence, IRS's variable costs per return for I-file services could be higher than the states'.

Net Cost Savings Depends on the Number of Paper Filers Converted

The number of paper filers who convert to electronic filing can have a significant impact on the overall cost savings IRS could achieve by operating I-file. IRS data show, each paper return that is processed cost an estimated \$2.65 per return in 2003, while each electronic return cost an estimated \$0.29, resulting in an estimated cost savings of \$2.36 per return processed electronically. However, we cannot independently verify this estimate and its basis is unclear because IRS's cost accounting system is not yet able to support preparation of such cost estimates.¹² Additionally, other costs may be reduced by electronic filing including costs associated with math errors. Math errors on paper returns may be due to taxpayer error or IRS transcription errors. Both can result in notices being sent to

¹²GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements*, [GAO-07-136](#) (Washington, D.C.: Nov. 9, 2006), and *Tax Administration: IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed*, [GAO-05-67](#) (Washington, D.C.: Nov. 15, 2006).

taxpayers and phone contacts with taxpayers. Both types of errors are reduced by electronic filing.

IRS could achieve a net cost savings if the costs saved by reduced paper processing were greater than the costs incurred from developing and operating an I-file system. The key to IRS achieving a net cost savings depends on the number of individuals converted from paper to electronic filing and the savings per return (estimated to be \$2.36 per return by IRS). I-file users who previously electronically filed do not generate such savings. In 2006, 58.3 million tax returns (45 percent of all tax returns) were filed on paper. Any savings from reduced paper processing would have to be netted against the cost of the I-file system to determine whether cost savings were realized.

The extent to which federal paper filers would convert to an I-file system is uncertain. According to respondents of an IRS Oversight Board survey,¹³ some taxpayers reported not feeling comfortable filing taxes electronically. These taxpayers reported not having confidence that the Internet is secure or that their privacy is protected. These taxpayers also cited other reasons including: the Internet was too complicated, or the taxpayer liked to use paper method or they didn't want to pay the electronic filing fee. An I-file system would address some of these taxpayer concerns but not all of them. For example, if taxpayers' security and privacy concerns are focused on third party transmitters, then an I-file system might mitigate the concerns.¹⁴ If the concerns are more general and apply to the Internet as a whole, then an I-file system (only accessible over the Internet) may not mitigate the concerns. Additionally, IRS's Free File service, which may be the existing service most similar to I-file had 4.0 million users (about 3 percent of total taxpayers and 4 percent of eligible taxpayers) in 2006. This usage rate is an indication of the challenge of converting some taxpayers to electronic filing.

The 13.6 million v-coders who self-prepared are an attractive target for an I-file program. Because v-coders prepare their return on a computer, they are presumably more comfortable with computers and may be more willing to try I-file than taxpayers who did not use a computer to prepare

¹³IRS Oversight Board Taxpayer Customer Service and Channel Preference Survey, November 2006.

¹⁴Of the eight states we profiled, five used contractors to operate and maintain their I-file systems. See appendix I for more details.

their returns. Because they file on paper, converting them to I-file results in reduced paper processing costs. V-coded returns prepared by paid preparers may be less susceptible to convert to I-file because these paid preparers have concerns about existing e-file options. Several of the states we profiled emphasized the importance of defining the target population when designing an I-file system. Whether such a narrowly defined population, as v-coders who self prepare, could be successfully targeted at the federal level is unclear.

In addition to the net savings that could be realized from I-file, another factor that should be considered is whether IRS has the systems management capability needed to develop such a program. For well over a decade, IRS has been involved in a multibillion dollar effort to modernize its information systems. While IRS has made noteworthy progress improving its systems management capability, it has had a history of cost increases and schedule delays that led us to designate systems modernization as a high-risk area in 1995.¹⁵ Those cost increases and schedule delays were due, at least in part, to deficiencies in various management controls and capabilities that have not yet been fully corrected. In 2003, we noted that IRS had made significant progress in establishing management controls and foundational systems architecture.¹⁶ However, systems modernization remained at risk because the scope and complexity of modernization activities was increasing. In 2005, we reported that balancing the scope and pace of modernization activities with IRS's ability to manage them remained a challenge.¹⁷ IRS has made further progress since 2005 addressing concerns about systems management. However, critical management controls and capabilities have still not yet been fully implemented or institutionalized. Before proceeding with I-file, IRS would need to consider the impact of the program on its existing portfolio of systems development projects and the impact of the program on its current modernization vision and strategy. This would entail IRS determining whether it has the management capabilities to take on this new project and what, if any, ongoing and planned programs would need to be deferred.

¹⁵GAO, *High-Risk Series: An Overview*, [GAO/HR-95-1](#) (Washington, D.C.: Feb. 1, 1995).

¹⁶GAO, *High-Risk Series: An Update*, [GAO-03-119](#) (Washington, D.C.: January 2003).

¹⁷GAO, *High-Risk Series: An Update*, [GAO-05-207](#) (Washington, D.C.: January 2005).

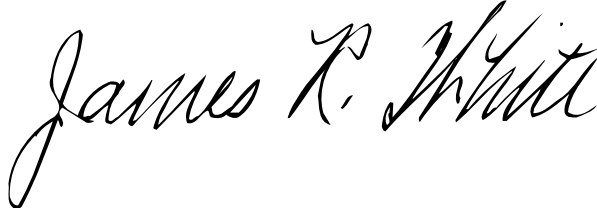
Agency Comments

In written comments on a draft of this report, the Commissioner of Internal Revenue said he appreciated our observations on the states' experiences with I-file systems. He summarized the facts presented in the report. He then went beyond our description of the facts to reach the conclusion that the facts support IRS's current strategy for growing electronic filing.

The full text of the Commissioner's comments is reprinted in appendix IV.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies to other appropriate congressional committees and the Commissioner of Internal Revenue. The report is available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.



James R. White
Director, Tax Issues
Strategic Issues Team

Appendix I: Individual Profiles

We profiled eight state tax agencies, two foreign tax agencies, and three federal agencies with I-file systems. The tables below (tables 7-19) contain information on the characteristics of individual agencies, taxpayer eligibility requirement for 2006, and the costs, benefits, and challenges associated with developing and operating I-file systems. Information on benefits and challenges was collected via structured interviews with open-ended questions. We are reporting information on eligibility found on agencies' Web sites.¹

Table 7: California

Name of system	CalFile
Type of system	Web pages
Year implemented	2003
Total taxpayer population (2006)	14,594,174
Number of 2006 eligible I-file users	6.4 million
Number and percent of 2006 I-file users based on total filers	111,436 (0.76 percent)
Number and percent of 2006 I-file users based on eligible filers	111,436 (1.74 percent)
System developed and operated	In-house developed and operated, and the server owned by the state
Major features	<ul style="list-style-type: none">• Login/create account• Perform calculations• Hyperlinked to other forms and publications

¹France's eligibility information was collected from the structured interview.

Appendix I: Individual Profiles

Name of system	CalFile
Eligibility criteria	<ul style="list-style-type: none">• Must be a California resident for the entire year• Taxpayer is filing an original tax return for 2006• Taxpayer can use any filing status that he/she qualify for• Claim up to 5 dependents• Taxpayer's federal adjusted growth income(AGI) can be up to \$150,743 (S & MFS), \$226,119 (HOH), and \$301,491 MFJ & qualifying widow(er)• Taxpayer's only income is from one or more of the following:<ul style="list-style-type: none">• Wages, salaries, and tips reported on Form W-2• Taxable scholarship and fellowship grants reported on Form W-2• Interest and dividends reported on Form 1099-INT or 1099-DIV• Unemployment compensation, paid family leave, and tax refund reported on Form 1099-G• Fully and partially taxable IRA distributions, pensions, and annuities reported on Form 1099-R• Tier 1 and tier 2 railroad retirement payments reported on Form RRB-1099 or RRB-1099-R

Appendix I: Individual Profiles

Name of system	CalFile
	<ul style="list-style-type: none"> • Social Security benefits reported on Form SSA-1099 • Gambling winnings reported on Form W-2G • Alimony • Taxpayer's only adjustments to income reported on their federal return (if any) are from one or more of the following: <ul style="list-style-type: none"> • Archer MSA deduction • IRA deduction • Moving expenses • Penalty on early withdrawal of savings • Alimony paid • Student loan interest deduction • Jury duty pay given to employer • Taxpayer's only adjustments to federal AGI (if any) are from one or more of the following: <ul style="list-style-type: none"> • California income tax refund • Nontaxable interest and ordinary dividends • Unemployment compensation and/or paid family leave • Social Security benefits • Fully and partially taxable IRA distributions, pensions, and annuities • Tier 1 and tier 2 railroad retirement payments • California Lottery winnings • Taxpayer can claim either the Standard deduction or Itemized deductions • Taxpayer's California payments made are from one or more of the following: <ul style="list-style-type: none"> • Withholding shown on Form(s) W-2, W-2G, and 1099-R • Estimated tax payments • Payments made with an extension voucher • Excess State Disability Insurance (SDI) or Voluntary Plan Disability Insurance (VPDI) • Refund from the previous year applied to 2006 estimated tax • Taxpayers' only exemptions and credits claimed are one or more of the following: <ul style="list-style-type: none"> • Personal exemption credit • Senior exemption credit • Blind exemption credit • Dependent exemption credit • Nonrefundable renter's credit • Child and dependent care expenses credit • Taxpayer can use CalFile if: <ul style="list-style-type: none"> • Will get a refund • Have no amount due • Owe an amount

Source: GAO analysis of California's information.

- Total costs were \$717,000 over 3 years. For years 2003-2005, one-time development costs were \$512,000 and ongoing costs for operations were \$205,000.
- Reported benefits to the agency:
 - Increase in e-filing
 - Fewer processing errors
 - Increase in taxpayers paying via e-pay
 - Faster payment processing
 - Cost savings per I-filed return
- Reported benefits to the taxpayers:
 - Direct submission to tax agency/no third party involvement
 - Faster refunds
- Reported challenges:
 - Tax preparation industry objections
 - Ensuring security of the system
 - Updates to system based on late tax law changes

Table 8: District of Columbia

Name of system	Online Tax Filing Service
Type of system	Web pages
Year implemented	2002
Total taxpayer population (2005)	291,181
Number of 2005 eligible I-file users	Number not available
Number and percent of 2005 I-file users based on 2005 total filers	9,285 (3.19%)
Number and percent of 2005 I-file users based on eligible filers	9,285; percentage cannot be calculated
System developed and operated	Contractor developed and operated and owner of server unknown ^a
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto-populate some fields • Status checks
Eligibility criteria	<ul style="list-style-type: none"> • Taxpayer must log on using their Social Security Number and the Federal AGI from the previous year's return • Taxpayer must have filed a tax return the previous year.

Source: GAO analysis of District of Columbia's information.

^aOfficials with the District of Columbia Office of Tax and Revenue declined several requests for follow-up interviews.

- Total costs for development of the system were approximately \$1 million to \$2 million with an annual maintenance fee of \$480,000 for individual and business users.
- Reported benefits to the agency:
 - Increase in e-filing
 - Reduced paper processing and reduced paper processing staff
- Reported benefits to the taxpayers:
 - Confirmation of return receipt
 - Ability to print a PDF copy of the return
 - Direct deposit for refund
- Reported challenge:
 - Attracting taxpayers to use the system

Table 9: Indiana

Name of system	I-file
Type of system	Web pages
Year implemented	1998
Total taxpayer population (2006)	3,039,782
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 I-file users based on 2006 total filers	83,422 (2.74%)
Number and percent of 2006 I-file users based on eligible filers	83,422; percentage cannot be calculated
System developed and operated	Contractor developed and operated, and the server owned by the contractor
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto-populate some fields
Eligibility criteria	<ul style="list-style-type: none"> • Taxpayer must have filed an individual return with the state of Indiana in the past. • This program will allow taxpayer to file IT-40, IT-40EZ, IT-40PNR, or IT-40RNR directly through the Internet. • Taxpayer first or last name must not have been legally changed since he/she last filed

Source: GAO analysis of Indiana's information.

- Total costs were not available. Contractors charged \$1 per return for developing and operating the system, along with some marketing and technical taxpayer support.
- Officials with the Indiana Department of Revenue declined several requests for interviews to discuss benefits and challenges associated with developing the I-file system.

Table 10: Kansas

Name of system	Webfile
Type of system	Web pages
Year implemented	2001
Total taxpayer population (2006)	1,420,149
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 I-file users based on 2006 total filers	50,999 (3.59%)
Number and percent of 2006 I-file users based on eligible filers	50,999; percentage cannot be calculated
System developed and operated	Contractor developed and operated, and the server owned by the contractor
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto-populate some fields • Status checks
Eligibility criteria	<ul style="list-style-type: none"> • All Kansas residents and nonresidents who filed a Kansas income tax return last year can use WebFile, even to itemize. • Taxpayer may file an amended Kansas Individual income tax return (K-40) using WebFile, but not an extension or a Homestead Refund Claim (K-40H). • Taxpayer may not use WebFile if their Kansas adjusted gross income is greater than \$9,999,999.

Source: GAO analysis of Kansas' information.

- Total costs were not available. Contractors charged \$1 per return for developing and operating the system, along with some marketing and technical taxpayer support. In 2006 and 2007, Kansas also received a marketing budget of \$100,000 for marketing of Webfile and electronic filing.
- Reported benefits to the agency:
 - Increase in electronically filed returns
 - Fewer paper returns
 - Fewer processing errors
 - Cost savings
- Reported benefit to the taxpayers:
 - Less incidence of lost documentation
- Reported challenge:
 - Authentication of taxpayers

Table 11: Maryland

Name of system	I-file
Type of system	Web pages
Year implemented	2001
Total taxpayer population (2006)	2,773,321
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 I-file users based on 2006 total filers	115,678 (4.17%)
Number and percent of 2006 I-file users based on eligible filers	115,678; percentage cannot be calculated
System developed and operated	In-house developed and operated, and the server owned by the state
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto-populate some fields • Status checks • View prior years' information
Eligibility criteria	<ul style="list-style-type: none"> • Maryland's Internet tax filing system allows online electronic filing of resident or nonresident personal income tax returns along with the most commonly associated schedules and forms. • Taxpayers are NOT eligible to use this system if: <ul style="list-style-type: none"> • Filing a Form 500CR. • Filing Form 515 for nonresident local tax. • Filing to amend a return that was previously filed on paper or another electronic source other than I-file. • Filing to amend a nonresident Form 505. • Filing married, separately or head of household and claiming spouse as a dependent taxpayer based on special conditions on the federal return. • Filing more than the number of forms allowed to I-file. <p>(W2 Limit 50, W2G Limit 30, 502CR Limit 10, 1099G Limit 10 1099R Limit 20)</p>

Source: GAO analysis of Maryland's information.

- Maryland did not track any of its costs separate from the operating budget for the Information Technology Division and Revenue Administration Division. They noted that most of their costs would be incurred in staff hours; however, none of their staff is specifically dedicated to the I-file system.
- Reported benefits to the agency:
 - Reduced paper processing staff
 - Less contact with taxpayers via telephone or notices
 - Fewer processing errors

- Reported benefits to taxpayers:
 - Faster refunds
 - Auto-population of W-2 information (state employees only)
 - Quicker preparation of return
- Reported challenges:
 - Compatibility of system with all user browsers
 - Addressing taxpayers concerns about the security of their information
 - Development and maintenance of the security platforms

Table 12: Pennsylvania

Name of system	pa.direct.file
Type of system	Web pages
Year implemented	2000
Total taxpayer population (2006)	5,644,575
Number of 2006 eligible I-file users	1.5 million
Number and percent of 2006 I-file users based on 2006 total filers	300,552 (5.32%)
Number and percent of 2006 I-file users based on eligible filers	300,552 (20.04%)
System developed and operated	Contractor developed and the server owned and operated by the state
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications
Eligibility criteria	<p>Taxpayer can report most types of income and claim the Tax Forgiveness credit – even if there are dependent children.</p> <p>However, pa.direct.file cannot process a return if the taxpayer:</p> <ul style="list-style-type: none"> • Operated a business or profession and (1) report a loss or (2) have expenses over \$2,500, which disqualify him/her from using PA Schedule C-EZ. • Report income from a partnership or PA S-corporation unless distributed by a trust or estate. • Earned income from an installment sale (PA Schedule D-1). • Had a taxable gain to report on the sale of property purchased before June 1, 1971 (PA Schedule D-71). • Sold property in which the gross sales price is equal to zero (PA Schedule D). • Claim an out-of-state tax credit using PA Schedule G. • Incurred unreimbursed business expenses from working within and outside of Pennsylvania as a nonresident or part-year resident. • Claim a tax credit for PA Job Creation, PA Research and Development, or a Keystone Opportunity Zone (KOZ), KOEZ, or KOIZ Tax Credit. • Participated in the Employment Incentive Program and claim credit on PA Schedule W.

Name of system	pa.direct.file
	<ul style="list-style-type: none"> • Are filing a return for a deceased person. • Derived income from farming. • Are filing for a taxable year other than 2006. • Amending a PA tax return if the original return was not filed on pa.direct.file. • Had expenses related to executor fees. • Had deductions for medical and health savings accounts. <p>pa.direct.file can handle returns with:</p> <ul style="list-style-type: none"> • Up to 20 Forms W-2 • Unreimbursed business expenses for up to 4 employers (PA Schedule UE's) • Interest income reported on up to 40 1099's (PA Schedule A) • Dividend income reported on up to 40 1099's (PA Schedule B) • Sales of property for up to 60 transactions (PA Schedule D) • PA Estimated Installment Payments for tax year 2005 • Tax Forgiveness credit claimed on PA Schedule SP • Income from rents, royalties, patents, or copyrights from up to 6 different sources (PA Schedule E) • Supplemental information reported on up to 4 Statement Schedules • Income from self-employment for each taxpayer — One PA Schedule C-EZ for each taxpayer • Up to 35 items from trusts or fiduciaries (PA Schedule J) • Gambling & lottery winnings (one PA Schedule T) • Miscellaneous income from up to 12 different sources reported (PA Schedule MC)

Source: GAO analysis of Pennsylvania's information.

- State officials estimated the system cost \$400,000 to develop, \$125,000 per year to operate, and \$40,000 in improvements for the system. Officials also received between \$20,000 – \$40,000 to market the system for the first few years.
- Reported benefits to the agency:
 - Reduced paper processing
 - Faster return processing
 - Improving customer service and satisfaction
- Reported benefits to the taxpayers:
 - Faster refunds
 - Confirmation of return receipt
 - Less incidence of lost documents
- Reported challenges:
 - Agreement among stakeholders
 - Designing a user friendly, intuitive system
 - Capacity needs during peak filing

Table 13: South Carolina

Name of system	SCnetFile!
Type of system	Web pages
Year implemented	1999
Total taxpayer population (2006)	2,043,552
Number of 2006 eligible I-file users	1.5 million
Number and percent of 2006 I-file users based on 2006 total filers	29,241 (1.43%)
Number and percent of 2006 I-file users based on eligible filers	29,241 (1.95%)
System developed and operated	Contractor developed, state operated, and the server owned by the state
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Auto-populate some fields
Eligibility criteria	<ul style="list-style-type: none"> • Selected taxpayers are able to file their 2006 South Carolina individual income tax returns directly with the Department of Revenue over the Internet utilizing SCnetFile!. SCnetFile! is available to select full-year/part-year or nonresidents filing either SC1040 or SC1040A (short form) South Carolina returns. • SCnetFile! allows taxpayers that file federal Schedules C, D, E, and F to participate. • Taxpayers cannot file by SCnetFile! if they have information on the following lines: <ul style="list-style-type: none"> • Line 7 - Lump Sum Distribution (SC4972) • Line 8 - Active Trade or Business Income (I-335) • Line 12 - Other Non-refundable Credits (SC1040TC)

Source: GAO analysis of South Carolina's information.

- Total costs were not documented; however, officials believed the development of the system cost several hundred thousand dollars, while maintenance of the system is expensed to the information technology department.
- South Carolina officials did not report any specific benefits for the agency or taxpayers.
- Reported challenges:
 - Attracting users to the system
 - Maintaining current users to the system

Table 14: Utah

Name of system	TaxExpress
Type of system	Web pages

Appendix I: Individual Profiles

Name of system	TaxExpress
Year implemented	2001
Total taxpayer population (2005)	1,004,919
Number of 2005 eligible I-file users	Number not available
Number and percent of 2005 I-file users based on 2005 total filers	25,267 (2.51%)
Number and percent of 2005 I-file users based on eligible filers	25,267; percentage cannot be calculated
System developed and operated	Contractor developed and operated, and the server owned by the contractor
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Status checks
Eligibility criteria	<p>TaxExpress is designed for the most frequent tax situations. Taxpayers can use TaxExpress if all the following statements are true:</p> <ul style="list-style-type: none"> • Federal AGI is \$100,000 or less; • Taxpayer was Utah resident for the entire year; • Taxpayer claim the federal standard deduction (not itemized deductions); • Taxpayer does not claim any Utah tax credits, such as At Home Parent credit; • Taxpayer does not claim other deductions from income. • Taxpayer is not filing an amended Utah return. • Taxpayer has 10 or fewer W-2 and/or 1099 forms showing Utah income and withholding. (If there is out-of-state withholding, taxpayer cannot use TaxExpress). • Taxpayer do not claim a credit for taxes paid to another state. • Taxpayer filed a 2005 Utah resident return. <p>TaxExpress may not be the best filing option if:</p> <ul style="list-style-type: none"> • Taxpayer (or spouse) was a nonresident or a part-year Utah resident. • Taxpayer (or spouse) are under age 65 and qualify for the Retirement Income Deduction. • Taxpayer need to claim an exemption for providing housing for persons displaced by Hurricane Katrina and filed IRS form 8914. <p>Using TaxExpress in these cases may cause taxpayer to have a higher tax liability.</p>

Source: GAO analysis of Utah's information.

- Total costs were not captured. Contractors charged the state of Utah \$0.75 per return to develop and operate the system along with some marketing and technical taxpayer support.
- Reported benefits to the agency:
 - Increase in electronically filed returns
 - Reduced paper processing
 - Reduced paper processing staff
- Reported benefits to the taxpayers:
 - Faster refunds

- Another electronic filing option
- Reported challenges:
 - Ensuring the stability of system during the first year roll-out
 - Authentication of taxpayers

Table 15: Department of Agriculture

Name of system	eForms
Type of system	PDF Fillable Forms
Year implemented	2002
Total population	Number not available
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 applicants based on total applicants	4,398; percentage cannot be calculated
Number and percent of 2006 applicants based on eligible applicants	4,398; percentage cannot be calculated
System developed and operated	In-house developed and operated, and the server owned by the agency
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Status checks
Federal benefit program	Allows Farm Service Agency (FSA), Natural Resources Conservation Service (NRCS), and Rural Development (RD) applicants to find forms and instructions and then complete and submit the forms to the agency

Name of system	eForms
Eligibility criteria	<ul style="list-style-type: none"> • Level 1 access: Limited access to USDA Web site portals and applications that have minimal security requirements. Note: Level 1 access is limited and does not allow applicant to conduct official electronic business transactions with the USDA via the Internet. • Must have user identification, password, profile, and valid email address. • Registering for an account with Level 1 access is easy. The applicant will create a brief customer profile, user identification, password, that he/she can remember and respond to the confirmation email within 7 days. Note: Applicant must have a valid email address to register for an account with Level 1 access. • Level 2 access: Access to all the portals and applications that are covered by an account with Level 2 access and also provides the ability to conduct official electronic business transactions with the USDA via the Internet. • Applicant must visit the nearest USDA Service Center in person and prove identity with a current state driver's license, state photo ID, U.S. Passport or U.S. military ID. Applicant's first and last names must be entered exactly as they appear on the government-issued photo ID that will be taken to the Service Center to prove applicant's identity. • Create a password that applicant will remember. The password must be a minimum of 4 characters and cannot exceed 10. • Applicant must respond to the confirmation email before going to the Service Center, or the Service Center employee will not be able to activate the account. <p>NOTE: Once the applicant presents their government issued photo ID at a local USDA Service Center and the account is activated, they will be required to update the password at their next login to meet Level 2 access password requirements.</p>

Source: GAO analysis of USDA's information.

- Total costs for development was \$600,000, with \$350,000 for a special license from Adobe, \$50,000 for maintenance and \$200,000 for forms technology, research, and piloting the initial system.
- Reported benefits to agency:
 - Higher than anticipated electronically filed applications
 - Transmission of forms internally (USDA employees only)
- Reported benefits to applicants:
 - None reported
- Reported challenge:
 - User authentication

Table 16: Department of Education

Name of system	Free Application for Federal Student Aid (FAFSA)
Type of system	Web pages
Year implemented	1997
Total population	13,852,805
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 applicants based on total applicants	11,308,161; (81.63%)
Number and percent of 2006 applicants based on eligible applicants	11,308,161; percentage cannot be calculated
System developed and operated	Contractor developed and operated and the server owned by the agency
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto-populate some fields • Status checks
Federal benefit program	Allows students to file financial aid applications online.
Eligibility criteria	<p>To be eligible to receive federal student aid, applicant must meet certain requirements. Taxpayer must:</p> <ul style="list-style-type: none"> • Be a U.S. citizen or eligible non-citizen • Have a valid Social Security Number (unless from the Republic of the Marshall Islands, the Federated States of Micronesia, or the Republic of Palau) • Comply with Selective Service registration, if required (see www.sss.gov for more information) • Have a high school diploma or a General Education Development (GED) Certificate or pass an approved ability-to-benefit (ATB) test • Be enrolled or accepted for enrollment as a regular student working toward a degree or certificate in an eligible program at a school that participates in the federal student aid programs • Applicant must not owe a refund on a federal grant or be in default on a federal student loan • Applicant must have financial need (except for unsubsidized Stafford Loans) • Applicant must not have certain drug convictions • Other requirements may apply. <p>Applicant must contact their school's financial aid office for more information.</p>

Source: GAO analysis of Department of Education's information.

- Total costs not reported.
- Reported benefit to agency:
 - High percentage of electronic applications
- Reported benefits to applicant:

- Helped users avoid errors
- Provided quicker application processing
- Reported challenges:
 - Stakeholder agreement
 - System stability and capacity during peak filing

Table 17: Department of Veterans Affairs

Name of system	Veterans Online Application (VONAPP)
Type of system	Web pages
Year implemented	2000
Total population	Number not available
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 applicants based on total applicants	144,220; percentage cannot be calculated
Number and percent of 2006 applicants based on eligible applicants	144,220; percentage cannot be calculated
System developed and operated	Contractor developed and operated and the server owned by the agency
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Auto populate some fields • Ability to save and return to form • View prior years' applications
Federal benefit program	Allows veterans to apply for benefits using the Internet
Eligibility criteria	<p>If applying for Compensation, Pension, or Vocational Rehabilitation: Applicant should use VONAPP if they are a U.S. military veteran who wants to apply for compensation, pension, or vocational rehabilitation benefits using the Internet.</p> <p><u>VA Compensation Benefits</u> Applicant may apply if:</p> <ul style="list-style-type: none"> • Injured while in the service, or • Permanently and totally disabled and applicant believes that it is because of military service, or • Seriously ill while in the service, and applicant believes they have continuing problems, or • Developed a mental or physical condition that they believe may be related to military service. <p><u>VA Disability Pension</u> Applicant may apply if:</p> <ul style="list-style-type: none"> • Permanently and totally disabled but not as a result of military service, and • Served on active duty during a wartime period, and • Income is limited.

Appendix I: Individual Profiles

Name of system	Veterans Online Application (VONAPP)
	<p data-bbox="591 464 948 491"><u>Vocational Rehabilitation Benefits</u></p> <p data-bbox="591 501 854 529">Applicant should apply if:</p> <ul data-bbox="591 537 1526 684" style="list-style-type: none"> <li data-bbox="591 537 1403 564">• Applicant is a veteran or a service member awaiting a disability discharge. <li data-bbox="591 573 1474 621">• Applicant has a VA combined service-connected disability rating of 10 percent or more. <li data-bbox="591 630 1526 684">• Applicant believes disability is due to military service and have an application pending for service connection or are filing one with a vocational rehabilitation claim. <p data-bbox="591 693 829 720"><u>VA Education Benefits</u></p> <p data-bbox="591 730 854 758">Applicant should apply if:</p> <ul data-bbox="591 766 1516 846" style="list-style-type: none"> <li data-bbox="591 766 1516 846">• They believe they are eligible for benefits based upon active-duty service or if currently a member of the Selected Reserve. There are many categories of eligibility. For specific details, see the help text in the VONAPP application.

Source: GAO analysis of Department of Veterans Affairs' information.

- Total costs of developing this system was \$355,000 with additional associated costs of about \$3,500. The annual maintenance contract is \$40,000.
- Reported benefits to agency:
 - None reported
- Reported benefit to applicants:
 - First time electronic application process
- Reported challenge:
 - Lack of electronic signature functionality requires extensive paper processing

Table 18: France

Name of system	TeleIR
Type of system	Web pages
Year implemented	2002
Total taxpayer population	35,000,000 ^a
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 I-file users based on total filers	5,700,000 (16.29%)
Number and percent of 2006 I-file users based on eligible filers	5,700,000; percentage cannot be calculated
System developed and operated	In-house developed and operated, and the server owned by France

Appendix I: Individual Profiles

Name of system	TeleIR
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto-populate some fields • View prior years' information
Eligibility criteria	<ul style="list-style-type: none"> • Open to residents and non-residents with previous filing history • No first time users • No income or deduction restrictions

Source: GAO analysis of France's information.

^aApproximate, according to agency.

- Total costs were not tracked separately from entire revenue system.
- Reported benefits to the agency:
 - Fewer processing errors
 - Fewer paper returns
- Reported benefits to the taxpayers:
 - Productive, modern system for filing taxes
 - Increase in quality of service
 - Real-time responses to questions
- Reported challenges:
 - Ensuring continued system performance

Table 19: United Kingdom

Name of system	Self Assessment Online
Type of system	Web pages
Year implemented	2000
Total taxpayer population	9,000,000 ^a
Number of 2006 eligible I-file users	Number not available
Number and percent of 2006 I-file users based on total filers	2,000,000 (22.22%)
Number and percent of 2006 I-file users based on eligible filers	2,000,000; percentage cannot be calculated
System developed and operated	Contractor developed and operated, and the server owned by the contractor
Major features	<ul style="list-style-type: none"> • Login/create account • Perform calculations • Hyperlinked to other forms and publications • Ability to save and return to form • Auto-populate some fields • Status checks

Name of system	Self Assessment Online
Eligibility criteria	<p>Taxpayers can only use Self Assessment Online to file a current year tax return.</p> <p>Self Assessment Online is available to:</p> <ul style="list-style-type: none"> • Individuals who receive a Self Assessment Tax Return (SA100) or Notice to complete a tax return. • Partnerships who receive a Self Assessment Tax Return (SA800) or Notice to complete a tax return. • Trusts who receive a Self Assessment Tax Return (SA900) or Notice to complete a tax return. • Agents on behalf of their clients (who are individuals, partnerships or trusts). • Individuals, Agents, or Trustees who wish to view their Self Assessment Statement of Account, Liabilities and Payments, and choose to receive notifications and reminders by email or text message.
	<p>Taxpayers can file Self Assessment Tax Returns (SA100, SA800 and SA900) and supplementary pages over the Internet.</p> <p>Taxpayers cannot use the service:</p> <ul style="list-style-type: none"> • To file Estate, Nonresident, Companies, or Self Administered Pension Schemes Returns. • If they have already filed a tax return for the current tax year. • To correct a return already filed • To file a previous year's return.

Source: GAO analysis of United Kingdom's information.

^aApproximate, according to agency.

- Total costs were not available.
- Reported benefits to the agency:
 - Reduced paper processing
 - Reduced paper postage, printing, and storage costs
 - Fewer processing errors
- Reported benefits to taxpayers:
 - Quicker and easier tax return preparation
 - Met expectations of having on-line services
- Reported challenges:
 - Capacity needs during peak filing times
 - Negotiating IT contracts

Appendix II: One-time, Ongoing, Variable, and Fixed Costs

The costs of developing and operating an I-file system can be characterized in several ways. Some types of costs are incurred one-time; other types of costs will recur consistently over time (ongoing). In addition, some costs can be considered to be variable in that they depend on the number of users of the system, while other types of costs can be considered to be fixed—independent of the number of users of the system. Table 20 shows the types of one-time/ongoing and fixed/variable costs that may be incurred to develop and operate an I-file system.

Table 20: Types of One-Time and Ongoing Costs Agencies Can Incur When Developing and Operating an I-file System

	One-time		Ongoing	
	Fixed	Variable	Fixed	Variable
Development	<ul style="list-style-type: none"> Initial system development (design, planning, construction, installation, project management, testing) Project oversight Facility modifications resulting from project 	<ul style="list-style-type: none"> Initial equipment purchases for hardware, bandwidth, and personal computers 	<ul style="list-style-type: none"> Updates to system based on tax law changes 	N/A
Operating	N/A	N/A	<ul style="list-style-type: none"> Facility overhead System oversight Software maintenance Licensing fees Hardware maintenance Ongoing system maintenance 	<ul style="list-style-type: none"> Expanded capacity purchases for hardware, bandwidth, etc. Internet/browser support Application support
Marketing	<ul style="list-style-type: none"> Development of logo or brand that is used over multiple years Marketing consultants 	N/A	<ul style="list-style-type: none"> Radio or television advertising 	<ul style="list-style-type: none"> Printed flyers, booklets, etc.
Taxpayer support	N/A	<ul style="list-style-type: none"> Training for staff for initial use of program 	N/A	<ul style="list-style-type: none"> IT help desk support Training for staff based on yearly updates Telecommunications

Source: GAO analysis.

Note: N/A is not applicable.

Appendix III: Objectives, Scope, and Methodology

To identify the options available to IRS for developing an I-file system, we conducted literature searches and examined Web sites for all states, 75 executive and independent branch agencies, and two studies listing foreign countries with e-filing services. We also interviewed representatives from the IRS Oversight Board,¹ Federation of Tax Administrators (FTA),² four government contractors (Adobe, EZGov, NIC Inc., and Pearson Government Solutions), and the Electronic Tax Administration Advisory Committee (ETAAC).

To identify the universe of states with I-file systems, we reviewed the Web sites of all 50 states and the District of Columbia. We found 20 states and the District of Columbia provided I-file services. Of the remaining 30 states, we found 3 discontinued their I-file program, 9 had no state income tax,³ and 18 relied on other technologies, such as 2-D barcode.

For data on I-file usage rates, we used data from FTA's annual state individual income tax filings reports for 1998-2006. FTA annually surveys states on their paper and electronic filing figures. We reviewed FTA's methodology for collecting the data but did not verify all the numbers reported by states to FTA. However, we corroborated some of FTA's data with our data on six of the eight states we profiled. We found one discrepancy with the state of Utah due to a definitional misunderstanding. We corrected the inaccuracy using the state's data. We used this data as background for reporting and determined that the data were sufficiently reliable for this report.

To determine the benefits and costs of I-file systems, we developed in-depth profiles of eight state tax agencies (California, District of Columbia, Indiana, Kansas, Maryland, Pennsylvania, South Carolina, and Utah) to illustrate the range of Internet filing systems, types of features, and level of

¹The IRS Oversight Board, created by the IRS Restructuring and Reform Act of 1998 (RRA 98), oversees the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws.

²The Federation of Tax Administrators (FTA) was organized in 1937 to improve the quality of state tax administration by providing services to state tax authorities and administrators. FTA serves the principal tax collection agencies of the 50 states, the District of Columbia, Puerto Rico, and New York City.

³Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not levy individual income taxes. Tennessee and New Hampshire levy individual income taxes on certain interest and dividend income and both states offer an I-file service for this tax.

usage. In less depth, we collected information about two foreign tax agencies and three federal agencies with I-file systems. We used the following criteria to select our eight state tax agencies to profile: (1) number of I-file users (based on data from the Federation of Tax Administrators), (2) year I-file system implemented, (3) contractor or in-house developed, and (4) types of features offered. We selected the states to have a range for each one of our criteria. We selected tax agencies in two foreign countries (United Kingdom and France) based primarily on their having a large volume of users. We selected three federal agencies (Department of Agriculture, Department of Education, and Department of Veterans Affairs) that allow individuals to prepare and submit forms on agencies' Web sites and have a range of features, users, and technologies.

We developed a data collection instrument and conducted structured interviews to collect information on agency benefits and costs associated with developing and operating I-file systems. We asked open-ended questions about usage rates, system features, eligibility requirements, benefits to agencies and taxpayers, and system costs. We interviewed state tax, foreign tax, and federal agency officials and contractors with the California Franchise Board, District of Columbia Office of Tax and Revenue, Indiana Department of Revenue, Kansas Department of Revenue, Comptroller of Maryland, Pennsylvania Department of Revenue, South Carolina Department of Revenue, Utah State Tax Commission, the United Kingdom Her Majesty's Revenue and Customs, and the France General Tax Directorate. We talked to contractors, program directors, program staff, IT staff for the Department of Agriculture's Rural Development office, the Department of Education, and the Department of Veterans Affairs' Office of Compensation and Pension Service. We analyzed and summarized our information and confirmed the accuracy of our analysis and summaries with the appropriate state tax, foreign tax, and federal agency officials.

We used widely accepted economic definitions of benefits and costs and corroborated these definitions with state officials, IRS officials, the IRS Oversight Board, ETAAC, and FTA.

To determine benefits, we asked for information on savings from reduced paper processing, reduced error rates, improvements in processing time and refund issuance, the number of I-file users, and the number of taxpayers converted from paper filing to I-file. When benefit information was not measured in dollars, we asked for other available quantitative measures, such as time saved. In cases where tangible measures of

benefits were not available, we asked for qualitative descriptions. We corroborated benefit information reported by the contractors, the IRS Oversight Board, and FTA with information provided by the states profiled. By profiling eight states, we saw consistency in the types of benefits reported. However, we did not verify the amount of cost savings reported by state agencies, but based on previous GAO work and discussions with state agency and IRS officials for this engagement, we understand that electronic filing reduces the number of processing staff needed, for example, and generates dollar savings. We determined that state estimates of savings per return are sufficiently reliable as a general indicator, but not necessarily as a precise indicator, of savings.

To determine costs, we summarized costs on a total cost basis and per return basis. We distinguished between fixed and variable costs and summarized the factors influencing each. We asked for information on development costs, operating costs, marketing costs, and taxpayer support (help desk) costs. No state could give us complete information on costs. For example, no state had information on planning costs, or where applicable, contract management costs. However, the cost information we were able to gather covered large elements of total costs, such as development and operating costs. In such cases, we asked for definitions of terms, dates covered, and other available information about the estimates. Seven of the eight state tax agencies could not provide supporting documentation. California was the one state with extensive documentation on its system's benefits and costs including a feasibility study, a post-implementation evaluation, and a project overview.

For states that relied on contractors, we asked state officials for information about contract costs. We corroborated information provided on contractor fees per return by interviewing contractors and reviewing contracts. We obtained copies of the contracts for Kansas, Indiana, and Utah from state agency Web sites and publicly available documents. The contracts documented the fee per tax return paid by those states to the contractor for I-file services.

Because the available state data were incomplete and not always documented, the total costs that we calculated can only be interpreted as rough orders of magnitude. Based on the consistency in what was reported from the eight states, we determined that the data were reliable for estimating the rough magnitude of total costs.

To determine the reliability of IRS's processing cost estimates for paper and electronic filing, we reviewed agency spreadsheets that support the estimates and interviewed knowledgeable officials. We spoke with IRS officials in the Electronic Tax Administration and W&I's Strategy and Finance about costs included in paper processing and electronic filing costs. These costs include pipeline processing costs, labor, oversight with management and supervision, and non-pipeline processing activities including quality assurance. Because of long standing limitations in IRS's cost accounting capability, cost data at this detailed level has not been audited.⁴ Based on prior reports about staff savings from electronic filing, we determined that IRS's estimate of savings per return is sufficiently reliable as a general indicator, but not necessarily as a precise indicator, of savings.

To describe the potential for IRS to realize cost savings from providing an I-file service, we compared the types of costs states incurred with the types of costs IRS would likely face in developing and operating an I-file system. We identified (1) the segments of the taxpayer population who may be potential I-file users, (2) the potential for net cost savings, and (3) the likelihood federal paper filers would convert to an I-file system. We reviewed the IRS Oversight Board's Taxpayer Customer Service and Channel Preference Survey, November 2006, to determine why federal taxpayers do not file returns electronically. Because of the low response rate to this survey, the survey results we report cannot be used to make inferences about the views of all U.S. taxpayers. Instead, the results we present should be interpreted as representing the 1,101 taxpayers who responded to the survey. GAO did not assess the extent to which these respondents over- or under-represent certain segments of the U.S. taxpayer population in terms of such characteristics as age, income, education level, race, or Hispanic origin. We reviewed agency documentation on cost savings associated with reduced paper processing. We reviewed prior GAO reports⁵ to determine management capacity for

⁴GAO-07-136.

⁵GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January 2007); *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005); *High-Risk Series: An Update*, GAO-03-119 (Washington, D.C.: January 2003); *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: February 1995); and *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2007 Expenditure Plan*, GAO-07-247 (Washington, D.C.: Feb. 15, 2007).

overseeing previous IT projects and IRS's history of management challenges.

We performed our work from May 2006 through March 2007 in accordance with generally accepted government auditing standards.

Appendix IV: Comments from the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

April 2, 2007

Mr. James R. White
Director, Tax Issues
U.S. Government Accountability Office
441 G. Street, N.W.
Washington, D.C. 20548

Dear Mr. White:

I have reviewed your draft report entitled "TAXPAYER SERVICES: State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits," in which you provided information regarding the experiences of selected states, federal agencies, and countries in developing internet filing systems (I-file).

Your report reflects that, despite some apparent savings and conversion of some taxpayers to electronic filing, the states you reviewed reported very low usage of their I-file systems. In some cases, the low usage experienced by the states significantly contributed to those states reporting that the costs to develop and operate their I-file systems were relatively low compared to their annual agency budgets. Many of the states you reviewed acknowledged that, because of the limited usage of their I-file systems, they were able to use existing equipment and other resources, rather than having to make expensive investments in additional hardware and infrastructure. Likewise, a number of the states whose experiences are included in your report were able to minimize development and operation costs by limiting the features their systems offer and by applying restrictive eligibility requirements to use them. As a result of the low usage their I-file systems experienced, your report notes that three states that developed I-file systems eventually discontinued them because of a combination of low usage and high costs.

I appreciate your acknowledgement that, even without the benefit of the experiences of the states you reviewed, when considering the potential associated with IRS developing an I-file system, one must consider many more factors than would likely have been faced by the states. For example, as you note, the federal tax system and federal tax returns are more complex than the states and IRS fixed and variable costs would be substantially higher than those incurred by the states. The scale of any such system implemented by IRS would inevitably require significant investments in hardware, software, and business process redesign, and such an effort would have to be prioritized in the context of all the other modernization projects IRS is in the process of delivering. Other critical issues that must be taken into account when considering

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development of an I-file system by IRS include taxpayer security and privacy, ongoing maintenance and continuous upgrades to keep pace with changes in the tax laws, and the impact of such an effort on IRS operations and IRS' portfolio of enterprise improvement projects.

All of these considerations, especially when viewed in conjunction with the experiences of the states, federal agencies, and countries included in your report, make a very compelling case for IRS' current strategy to develop, market and grow electronic filing. Under this strategy, which capitalizes on the competitive energy of the tax preparation software industry, IRS has created and sustained momentum toward achieving our electronic filing goals. Under this same strategy, by partnering with leading tax preparation software companies through such efforts as the Free File Alliance, taxpayers meeting certain income criteria, who otherwise might not be able to do so, can now electronically file their returns at no charge.

Once again, I appreciate your observations on the states' experiences with development of I-file systems, and if you have any questions, please contact me or Floyd Williams, Director, Legislative Affairs, at (202) 622-3720.

Sincerely,

Mark W. Everson For Mark W. Everson

Mark W. Everson

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

James R. White, (202) 512-9110 or whitej@gao.gov

Acknowledgments

In addition to the person named above, Signora J. May, Assistant Director; Michele Fejfar; Evan Gilman; Robyn Howard; Rich Hung; Veronica Mayhand; Donna Miller; Ed Nannenhorn; Cheryl Peterson; Gabriele Tonsil; and Tina L. Younger made key contributions to this report.

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