

GAO

Report to the Committee on Finance,
U.S. Senate

February 2009

TAX ADMINISTRATION

Many Taxpayers Rely on Tax Software and IRS Needs to Assess Associated Risks



GAO
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Highlights

Highlights of [GAO-09-297](#), a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

Individual taxpayers used commercial tax software to prepare over 39 million tax returns in 2007, making it critical to the tax administration system. The majority were then filed electronically, resulting in fewer errors and reduced processing costs compared to paper returns.

GAO was asked to assess what is known about how pricing of tax software influences electronic filing, the extent to which the Internal Revenue Service (IRS) provides oversight of the software industry, and the risks to tax administration from using tax software. To do so, GAO analyzed software prices, met with IRS and software company officials, examined IRS policies, and reviewed what is known about the accuracy, security, and reliability of tax software.

What GAO Recommends

GAO's recommendations include that IRS require a software package identifier, ensure taxpayer surveys ask specifically about the effects of 2009 price changes, implement a plan to monitor compliance with recommended security standards in 2010, and determine whether using tax software creates any security or compliance risks.

In response, the IRS Deputy Commissioner agreed with all of GAO's recommendations and outlined the actions that IRS would take.

To view the full product, including the scope and methodology, click on [GAO-09-297](#). For more information, contact James White, (202) 512-9110, whitej@gao.gov.

TAX ADMINISTRATION

Many Taxpayers Rely on Tax Software and IRS Needs to Assess Associated Risks

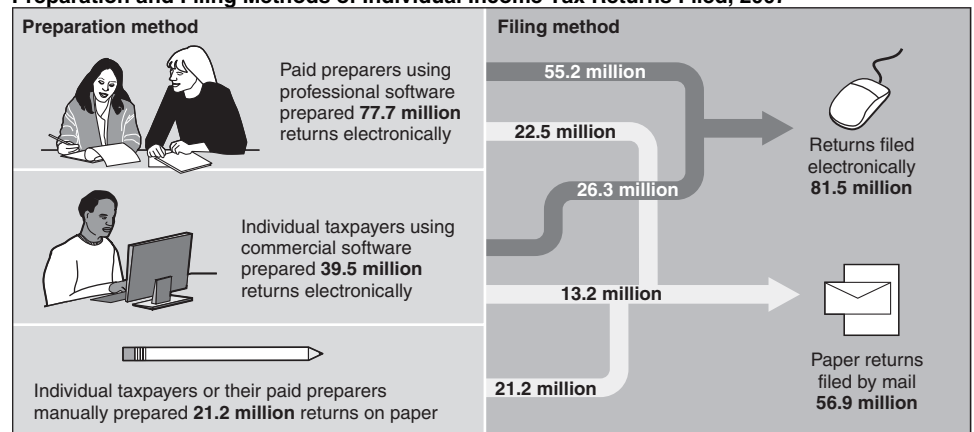
What GAO Found

IRS has little information about how the pricing of tax software affects taxpayers' willingness to file tax returns electronically. In 2009, the two largest tax software companies eliminated separate fees to file federal tax returns electronically when using software purchased from retail locations or downloaded from a Web site. As a result, IRS has an opportunity to study whether this and other changes are effective in increasing electronic filing. Additionally, IRS would benefit from being able to identify which software package the taxpayer used to better target research and efforts to increase software use and electronic filing.

IRS provides some oversight of the tax software industry but does not fully monitor compliance with established security and privacy standards. Further, IRS has not developed a plan to monitor compliance with new standards, which are optional in 2009 but may be mandatory in 2010. Without appropriate monitoring, IRS has limited assurance that the standards are being implemented or complied with.

IRS has not conducted an assessment to determine whether taxpayers' use of tax software poses any risks to tax administration. Risks include that IRS may be missing opportunities to systemically identify areas to improve software guidance and enhance information security. IRS officials said the likely benefits of an assessment would not warrant the costs but have not determined either the benefits or costs of such an assessment. Moreover, IRS has also said that it is in the agency's best interest to ensure that taxpayers can rely on commercial software to make electronic filing accurate, easy, and efficient. Further, if even small improvements in the accuracy of tax returns could be made by clarifying the guidance in tax software, the effect on revenue could be substantial. Without a risk assessment, IRS does not know whether its existing oversight of the tax software industry is sufficient or needs to be expanded.

Preparation and Filing Methods of Individual Income Tax Returns Filed, 2007



Source: GAO analysis of IRS data.

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Abbreviations

ADP	Automatic Data Processing
CAPTCHA	Completely Automated Public Turing Test To Tell Computers and Humans Apart
CCH	Commerce Clearinghouse
CERCA	Council for Electronic Revenue Communication Advancement
CRA	Canadian Revenue Agency
EITC	Earned Income Tax Credit
ERO	Electronic Return Originator
ETA	Electronic Tax Administration
ETAAC	Electronic Tax Administration and Advisory Committee
FFA	Free File Alliance, LLC
FTA	Federation of Tax Administrators
FTC	Federal Trade Commission
GAO	Government Accountability Office
GLB	Gramm-Leach-Bliley Act
ISP	Intermediate Service Providers
IRC	Internal Revenue Code
IRS	Internal Revenue Service
MOU	Memorandum of Understanding
NACTP	National Association of Computerized Tax Processors
NAM	National Account Manager
NTA	National Taxpayer Advocate
OMB	Office of Management and Budget
PATS	Participants Acceptance Testing System
PCI	Payment Card Industry
SEC	Securities and Exchange Commission
SSL	Secure Socket Layer
TIGTA	Treasury Inspector General for Tax Administration

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United States Government Accountability Office
Washington, DC 20548

February 25, 2009

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

In 2007, over 39 million income tax returns were prepared by individuals using commercial tax software such as TurboTax, TaxCut, or TaxAct, and more than 66 percent of those returns were then filed electronically. This volume makes commercial tax preparation software a critical part of the tax administration system.

Both taxpayers and the Internal Revenue Service (IRS) benefit from commercial tax software. Taxpayers use tax software as an alternative to hiring a paid preparer or manually preparing tax returns on their own. Taxpayers rely on tax software to answer tax law questions, prepare tax returns that are accurate, and, in many cases, file those returns electronically. Taxpayers also expect tax software to ensure the security and privacy of their tax information. Tax software that does not help taxpayers prepare accurate returns or that cannot be trusted to file electronically in a secure and timely manner could contribute to taxpayer noncompliance, the need for costly IRS enforcement actions, and taxpayers reverting to error-prone paper filing. It is in IRS's best interest to ensure that taxpayers can rely on commercial software to make electronic filing easy and efficient.

In recent reports, we have assessed the quality of services provided by paid tax return preparers because of the important role they play in the tax administration system and recommended that IRS do more to monitor the accuracy of returns prepared by paid preparers.¹ However, less is known about the quality of tax software, why some taxpayers decide to use it, and

¹GAO, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model For National Regulation*, [GAO-08-781](#) (Washington, D.C.: Aug. 15, 2008); *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, [GAO-06-563T](#) (Washington, D.C.: Apr. 4, 2006); and *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS Is a Challenge*, [GAO-04-70](#) (Washington, D.C.: Oct. 31, 2003).

its impact on electronic filing. Because of this lack of information, and your interest in making tax administration more effective, you asked us to study the use and quality of individual tax software.

As requested, our objectives were to assess (1) what is known about how pricing strategies affect the use of tax software and electronic filing; (2) the extent to which IRS provides oversight of the tax software industry to help ensure tax returns are accurate, taxpayer information is secure, and electronic filing systems are reliable; and (3) what is known about the risks of the reliance on commercial tax software used by individuals.

To meet our objectives, we:

- analyzed prices for the top three tax software companies for both online and retail/downloaded products for filing seasons 2008 and 2009 and reviewed studies examining the effects of varying pricing structures;²
- obtained and analyzed internal revenue manuals, industry standards, and government guidance and compared them to IRS's current procedures;
- determined IRS's legal authority to regulate the accuracy and security of commercial tax software;
- obtained and analyzed IRS security testing reports, certifications, new security requirements, and data on unauthorized disclosures of taxpayer information;
- reviewed Office of Management and Budget (OMB), GAO, and industry best practices for assessing risks;
- documented the availability of IRS risk assessments and of IRS and selected tax software companies' contingency plans and lessons learned documentation;
- reviewed results from a limited number of others' tests of how accurately and consistently tax software applied tax laws; and
- reviewed the effects of electronic filing disruptions in the United States, Canada, and Great Britain.³

²We limited our data analysis to the top three software companies because they account for 88 percent of all returns filed electronically by individuals and accepted by IRS. Because we limited our data analysis to these companies, we were unable to provide pricing information for all tax software products from which taxpayers may choose.

³We selected these countries based on examples that IRS provided on electronic filing disruptions.

Additionally, for all objectives, we reviewed pertinent reports and interviewed officials from IRS, the Treasury Inspector General for Tax Administration (TIGTA), the Electronic Tax Administration and Advisory Committee, and the IRS Oversight Board. We also interviewed officials from industry advisory councils and select tax software companies, and visited a major tax software company's data center. Our review focused on tax software designed for individuals who prepare their own returns, not software used by paid preparers, certified public accountants, attorneys, or other tax preparers.⁴

We conducted this performance audit from April 2008 through February 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. See appendix I for more details on our scope and methodology.

Background

While a large number of tax software companies offer return preparation and electronic filing services, three companies provide the tax software used by the majority of individuals who prepare and file their returns electronically (see app. II).⁵ One company's product—Intuit's TurboTax—represented over half of the returns filed electronically by individual taxpayers. These and other tax software companies generally offer several versions of retail, online, and downloadable software packages that

⁴Paid tax return preparers include enrolled agents, who are approved by IRS once they pass an examination on tax matters or demonstrate specific expertise based on past IRS employment experience; and unenrolled preparers, who include self-employed individuals and people employed by commercial tax preparation chains. Other paid preparers include those individuals who hold professional certifications such as certified public accountants and attorneys.

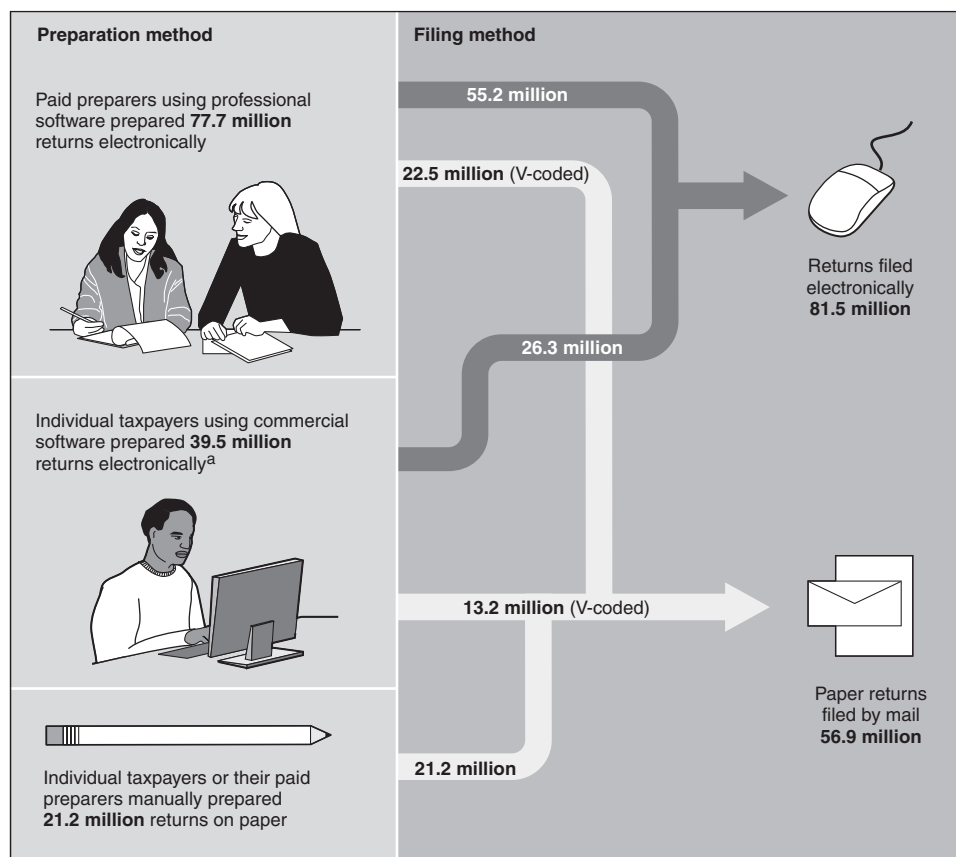
⁵Intuit is a multibillion dollar company with about \$3 billion in annual net revenue. A significant portion of the company's revenue is from its tax software segment for consumers as well as small businesses. Along with TurboTax, Intuit also offers two professional tax preparer software packages, Lacerte and ProSeries. H&R Block, Inc. provides income tax return preparation and related services and products via a nationwide network of approximately 13,000 company-owned and franchised offices and through the online and retail versions of TaxCut. H&R Block, Inc. generated annual revenues of \$4.4 billion in fiscal year 2008. TaxAct is made by 2nd Story Software, a privately held development and marketing company specializing in tax preparation software and Web-based service; thus, revenue information is not publicly available.

taxpayers can use to prepare federal and state tax returns.⁶ They generally charge less for versions that are designed to handle simple tax returns and charge more for versions that can prepare more complicated returns such as those dealing with business expenses. In 2008, the three companies also employed two basic pricing strategies. One strategy was to charge separate, incremental fees for federal return preparation, state return preparation, and electronic filing. For example, in 2008, one company charged about \$40 for federal return preparation, with incremental fees of about \$20 for electronic filing. The other pricing strategy used was to bundle several services together—typically return preparation and electronic filing—and charge one price for the bundle.

Tax software is one of the three major methods that taxpayers use to prepare their returns. As figure 1 illustrates, over 39 million (or 28 percent) of the approximately 138 million individual income tax returns filed in 2007 were prepared by individuals using tax software. Over 77 million individuals used a paid preparer to prepare returns electronically in 2007, and 71 percent of those returns were also submitted electronically to IRS. The remaining 21 million returns were manually prepared by individuals or their paid preparers. After preparation, taxpayers can either electronically file their return or mail a paper copy to IRS. Figure 1 shows that millions of taxpayers who had a return prepared electronically (either by using tax software or a paid preparer) filed paper copies. Such returns are called “v-coded” because IRS codes such returns with a “v” to process and track them separately from other paper-filed returns.

⁶Taxpayers can purchase tax software at retail locations, online, or via a downloadable program. “Retail” indicates packaged tax software products purchased at a retail store. “Online” indicates tax software programs that individuals use directly on a tax software company’s Web site when preparing and filing their return. “Downloadable” indicates a tax software program primarily available on a tax software company’s Web site that individuals can purchase and then download directly to their computer to use later in preparing and filing their return.

Figure 1: Preparation and Filing Methods of Individual Income Tax Returns Filed, 2007



Source: GAO analysis of IRS data.

Note: Sums may not add due to rounding. These are the most current, complete data available from IRS.

^aThis figure includes about 4 million returns filed through the Free File Alliance.

Many of the companies that sell tax software also have partnered with IRS to provide free electronic preparation and filing to eligible taxpayers. Those taxpayers have the option of filing their returns for free using products from the Free File Alliance, LLC (FFA)—a consortium of tax preparation companies that provides online electronic preparation and

filing to eligible taxpayers at no charge.⁷ Figure 1 includes the approximately 4 million FFA returns filed in 2007 by individuals using commercial software.

To help improve paper processing, about half of the state revenue agencies use a bar coding technology to convert data on paper returns to electronic data. Bar coding is less expensive and more accurate than processing paper returns because it eliminates manual transcription but is still more expensive and less efficient than electronic filing.⁸ IRS does not use this technology for processing individuals tax returns.

Returns filed electronically have significant advantages for IRS and taxpayers compared to paper-filed returns as discussed below and further detailed in appendix III.

- IRS estimates that processing an electronically filed return costs the agency \$0.35 per return while processing a paper return costs \$2.87 per return.⁹ Using IRS's current cost estimates based on fiscal year 2005 return data, we estimate IRS would have saved approximately \$143 million if the 56.9 million paper returns in 2007 had been filed electronically.
- Electronically filed returns also have higher accuracy rates than paper-filed returns because tax software eliminates transcription and other errors.
- IRS processes electronically filed returns in less than half the time it takes to process paper returns, facilitating faster refunds.¹⁰

⁷In 2002, IRS entered into an agreement with the Free File Alliance, LLC (FFA). As part of the agreement, IRS agreed not to compete with FFA members who would provide free, online tax return preparation and filing services to taxpayers on FFA's Web site. In 2005, IRS agreed that FFA products annually would cover 70 percent of taxpayers based on adjusted gross income. For 2009, the 70 percent equates to taxpayers with an adjusted gross income of \$56,000 or less with the exception of one new FFA product that will be available for free to all taxpayers. Individual companies may limit their offering to specific states and impose other eligibility requirements. FFA companies can only charge for preparing and filing state returns and cannot sell any other services.

⁸Bar coding is another form of filing returns whereby a return is printed with a two-dimensional bar code that can be scanned into a tax agency's system.

⁹IRS's cost data are limited to labor costs and do not include overhead such as rent, storage, or equipment costs.

¹⁰IRS estimates that it takes between 7-20 days to process paper returns, compared to 2-3 days for electronically filed returns.

-
- We have previously reported that electronically filed returns have the potential to improve IRS's enforcement programs.¹¹ IRS does not use all tax return information in its automated compliance checking programs because IRS policy is to post the same information from electronic and paper returns, and the cost of transcription prevents IRS from transcribing paper returns in full. IRS officials previously estimated in 2007 that having all tax return information available electronically would result in a \$175 million increase in tax revenue annually from at least one of its compliance programs.¹²

IRS recently issued the results of the first phase of its Advancing E-file study, which examines tax filing behavior and characteristics and contains potential options to increase electronic filing.¹³

We have previously reported that IRS's ability to achieve efficiencies depends on its continuing ability to increase electronic filing. We recently suggested that Congress mandate that paid tax return preparers use electronic filing and that IRS require software companies to include bar codes on individual paper returns.¹⁴ IRS agreed to study the latter option.

IRS has responsibility for enforcing tax laws in the Internal Revenue Code (IRC). In addition, IRC section 6011 provides specific authority for IRS to prescribe forms and regulations for tax returns, including the information required on those returns and whether they must be filed electronically.¹⁵ The IRC imposes civil and criminal penalties on paid tax return preparers, which include tax software companies, for unauthorized disclosure or use

¹¹GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated*, [GAO-08-38](#) (Washington, D.C.: Nov. 15, 2007).

¹²IRS officials said that if all data from tax returns were transcribed and posted, the Automated Underreporter Program—one of its main enforcement programs—could eliminate human screeners who currently review return information that has not been transcribed or posted. IRS estimated that if the screeners could be reallocated to performing audits, they could bring in an additional \$175 million annually.

¹³Advancing E-file Study, Phase 1, MITRE Corporation (Sept. 30, 2008).

¹⁴[GAO-08-38](#); GAO, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings*, [GAO-07-27](#) (Washington, D.C.: Nov. 15, 2006).

¹⁵Under section 6011(e), IRS generally cannot require electronic filing except in the case of persons required to file at least 250 returns during the calendar year.

IRS Has Little Information about How Tax Software Pricing Strategies Affect Taxpayers' Willingness to Use Software and File Electronically

of a taxpayer's personal and tax-related information.¹⁶ In addition to tax law penalties, the providers of services for preparing and filing tax returns are subject to the privacy and safeguarding rules created under the Gramm-Leach-Bliley Act (see app. IV).¹⁷

For the 2009 tax filing season, the two largest tax software companies that previously charged separate electronic filing fees for federal returns in some of their retail and downloadable products have eliminated those electronic filing fees. Moreover, the three largest companies will bundle federal tax preparation with electronic filing for all of their products (see app. II). However, for some products, the companies will still charge separate, incremental fees for other services such as state return preparation, state electronic filing, and return review by a tax professional. According to industry representatives, IRS officials suggested they eliminate separate federal filing fees to encourage electronic filing. However, the effect of these changes on electronic filing will not begin to be known until the end of the present tax filing period and will be difficult to determine. On one hand, taxpayers who buy a tax software package that includes a bundle of services may be encouraged to use software and file electronically because there is no longer a separate charge for doing so. On the other hand, if the cost of such a package is significantly higher, it may discourage taxpayers' use of tax software since they may not be able to purchase a less expensive package that does not include electronic filing.

The two largest tax software companies that eliminated federal electronic filing fees also made some other pricing changes for preparing and electronically filing both federal and state tax returns in 2009 including:

- online tax packages are generally priced lower than in 2008;
- online tax packages are generally priced lower than retail/downloadable packages; and
- most retail/downloadable packages remained essentially the same in price when compared to 2008.

¹⁶26 U.S.C. §§ 6713 & 7216.

¹⁷Pub. L. No. 106-102, Title V, 113 Stat. 1338, 1436 (Nov. 12, 1999). Responsibility for ensuring compliance with the privacy and safeguarding rules under the Gramm-Leach-Bliley Act falls on the Federal Trade Commission, not IRS. 15 U.S.C. § 6805(a)(7).

For the third largest tax software company, its package prices for both online and retail/downloadable products remained the same in 2009 as in 2008 because the preparation and electronic filing fees remained the same in both years. See appendix II for more details.

Another change in 2009 is that IRS and FFA have agreed to provide a fillable version of federal tax forms. These fillable tax forms, which taxpayers can complete online and file electronically, will provide a basic calculator function but will not provide the question-and-answer format similar to commercial tax software. The forms will be accessible for free to all taxpayers via IRS's Web site and are in addition to FFA's current free products for eligible taxpayers described in the background of this report.

As part of the upcoming second phase of its Advancing E-file study, IRS plans further surveys to obtain taxpayers' views on electronic filing.¹⁸ However, it does not plan to include questions, for example, about the effect of 2009 pricing changes on taxpayers' willingness to file electronically. Currently, IRS has little such information. For example, IRS and the Oversight Board surveys to date have not addressed how a separate charge for electronic filing affects taxpayers' willingness to file electronically.¹⁹

With the 2009 changes, however, IRS has an opportunity to directly measure the effect of eliminating separate fees to file federal tax returns electronically, making changes to software pricing overall, and making electronic tax forms available so that all taxpayers can complete and file for free online. We recognize that such a direct study would not be simple to conduct because, for example, it may be difficult to isolate the effect of multiple price changes and factors other than price, such as accuracy and security, which also affect taxpayers' willingness to file electronically. Further, prior year data are limited. However, even limited information

¹⁸The second phase of the study, expected to be completed during the summer of 2009, will estimate the effect of implementing each option on electronic filing including how much each option might cost.

¹⁹IRS's annual Taxpayer Satisfaction Studies and its 2006 Oversight Board's Customer Service and Channel Preference Survey examined individuals' satisfaction with electronic filing products and explored reasons why some taxpayers do not electronically file. Russell Research, *Findings from the 2006 Taxpayer Satisfaction Study for 1040 e-file*. A special report prepared at the request of the Internal Revenue Service (July 2006); IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report* (November 2006).

about how taxpayers' electronic filing behavior changes after price changes would give IRS an empirical basis for supporting the continued elimination of separate fees for electronic filing and other pricing changes as well as complementing surveys of taxpayers' views.

Ideally, to study the effect of pricing on electronic filing rates, IRS would need to know the software package and version used by each taxpayer in order to know the approximate price paid.²⁰ Currently, IRS requires a software identification number on electronically filed returns, which does not identify the specific software package or version used to prepare those returns. IRS does not require any type of software identification number on v-coded returns (returns prepared using software but filed on paper).²¹ Having a more complete software identification number would not only allow IRS to better target its research but also its enforcement activities and efforts to increase use of tax software and electronic filing.²² Officials from one software company told us that such a change could be easily made by their company at a relatively low cost.

IRS Oversight of the Tax Software Industry Is Not Comprehensive or Systematic

In its Advancing E-file study, IRS reported that one of the most important factors influencing taxpayers' use of tax software is its ability to accurately apply tax laws. IRS requires tax software to pass its Participants Acceptance Testing System (PATS), which includes verifying that computations are correct, tax rate schedules are updated, and returns transmitted electronically are compatible with IRS systems. However, PATS does not go further in testing to determine, for example, whether the guidance tax software provides is sufficient in helping taxpayers prepare accurate tax returns.

²⁰IRS would have to approximate the price paid since actual prices may have been affected by company promotions, discounts, and/or rebates, which would not be reflected at the time.

²¹We have previously recommended that IRS develop a plan to require an identification number for paid preparers to identify and track their performance for enforcement and research purposes. See GAO, *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, [GAO-08-567](#) (Washington, D.C.: Mar. 13, 2008).

²²For research purposes, IRS could pull a sample of returns and transcribe the identifiers for those returns instead of transcribing the identifiers from all returns, which could prove costly for IRS.

IRS developed a National Account Manager (NAM) position in 2000 to serve as the main communication channel between the tax software industry and IRS. NAMs communicate in regularly scheduled conference calls with tax software companies about issues of mutual interest including tax law changes, updates to IRS forms and publications, and the upcoming tax filing season. Software companies also contact the NAMs when they encounter technical issues such as a disruption to electronic filing. IRS also works with tax software industry groups and advisory councils, such as the Council for Electronic Revenue Communication Advancement, on annual updates to tax laws and procedures (see app. V).

IRS monitors acceptance rates for electronically transmitted returns, including the reasons for rejected returns, throughout the tax filing season and provides a “report card” to software companies at the end of each filing season.²³ Rejected returns are sent back to the taxpayer for correction and resubmission. IRS’s monitoring efforts allow the agency and software companies to identify and resolve problems with electronically filed returns.

For example, in 2008, IRS asked tax software companies to hold returns with the Alternative Minimum Tax until IRS was able to process them. Through its monitoring efforts, IRS officials identified companies that were transmitting those types of returns which IRS then rejected. IRS sent notices to these companies, which reduced the number of rejected returns.

IRS has worked with the tax software industry on an ad hoc basis to clarify the guidance provided by tax software. For example, for 2009:

- IRS is working with software companies to ensure their packages make users enter a “yes” or “no” response to questions about having a foreign bank account and signature authority. Prior to this change, some companies’ software defaulted to a “no” response.

Another example involving commercial software used by paid preparers rather than individual taxpayers shows that IRS can work with the software companies to influence and improve guidance:

²³IRS will not accept electronically filed returns unless they pass a computerized validation check that tests for obvious errors, such as name and Social Security number mismatches or missing or incomplete supplementary schedules.

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- IRS's Earned Income Tax Credit (EITC) office worked with a group of tax software developers to ensure software used by paid preparers eliminated default answers where taxpayers' answers are critical to return EITC accuracy, and incorporated a "note" capability in the tax software enabling the preparer to record additional inquiries and taxpayer responses.²⁴

IRS officials, however, acknowledged that these efforts were not the result of a comprehensive and systematic approach to improving the guidance provided by software. IRS does not have plans to review tax software to see if the guidance it provides to taxpayers is sufficient in helping them prepare accurate returns, in part because IRS relies on the extensive scenario and other testing done by the industry as discussed in the next section. As a result, IRS does not know if it is missing opportunities to improve tax software guidance to better ensure compliance. As an example of such an opportunity, we recently recommended that IRS expand outreach efforts to external stakeholders, including software providers, as part of an effort to reduce common types of misreporting related to rental real estate.²⁵ IRS agreed with these and most of the recommendations in that report and outlined the actions it plans to take to address those recommendations.

Security and Privacy of Taxpayer Information

IRS has provided limited oversight of the software industry's efforts to ensure that taxpayer information is secure. Taxpayers who file their returns on their home computers using online, retail, or downloadable tax software products are sending their returns to authorized electronic filing providers. IRS does not have the capability to receive electronic returns directly from individual taxpayers. Only IRS-authorized electronic filing providers, including Electronic Return Originators (ERO) and software

²⁴IRS/Earned Income Tax Credit (EITC) Software Developers Working Group Report, *Potential Software Enhancements to Improve the Accuracy of Tax Returns Claiming Earned Income Tax Credit and Help Paid Preparers Meet Their EITC Due Diligence Requirements* (July 31, 2008).

²⁵GAO, *Tax Gap: Actions that Could Improve Rental Real Estate Report Compliance*, [GAO-08-956](#) (Washington, D.C.: Aug. 28, 2008). That report noted that half of all individual taxpayers who had rental real estate misreported their income for tax year 2001, resulting in an estimated \$12.4 billion of net misreported income.

companies, among others, can transmit tax returns electronically to IRS.²⁶ According to TIGTA, EROs were responsible for the majority of electronically filed tax returns accepted by IRS in 2007.²⁷ IRS regulates authorized electronic filing providers by conducting suitability checks of applicants during the application screening process, including checks of the applicants' criminal backgrounds, credit histories, and tax compliance.²⁸ Once approved, authorized electronic filing providers are subject to IRS monitoring visits, which are conducted to ensure that the providers are meeting requirements such as ensuring security systems are in place to prevent unauthorized access to taxpayer data. However, in 2007, TIGTA identified deficiencies in IRS's monitoring program. For example, IRS did not suspend electronic filing providers who were in violation of program requirements even though they had been issued notifications of suspension.²⁹ In response, IRS added a new control procedure, effective January 30, 2008, to better track suspension cases.

IRS has also established security and privacy requirements that apply to FFA members. For example, according to IRS officials, FFA members must adhere to the Payment Card Industry (PCI) standards and third-party security and privacy certifications, and use PCI-approved companies to

²⁶Other IRS authorized electronic filing providers include (1) Intermediate Service Providers (ISP) who receive tax information from Electronic Return Originators (ERO) or from taxpayers who file electronically, process the tax information, and either forward the information to a transmitter or send the information back to the EROs or taxpayers; and (2) transmitters who connect with IRS computers and transmit tax return data to IRS. EROs and ISPs may also apply to be transmitters and transmit return data themselves or they may contract with accepted third-party transmitters who will transmit the data for them.

²⁷Treasury Inspector General for Tax Administration (TIGTA), *Better Screening and Monitoring of E-File Providers is Needed to Minimize the Risk of Unscrupulous Providers Participating in the E-File Program*, Reference Number 2007-40-176 (Washington, D.C.: Sept. 19, 2007).

²⁸IRS Publication 3112 *IRS e-file Application and Participation* and IRS Revenue Procedure 2007-40 provide guidance for authorized electronic filers.

²⁹TIGTA identified violations during the 2006 filing season including misleading advertisements, questionable signatures on tax returns, and/or preparation of tax returns based on the last pay stub received rather than an employer-issued wage and income statement as required.

conduct penetration and vulnerability testing.³⁰ IRS has a Memorandum of Understanding (MOU) with FFA requiring members to provide IRS with documentation demonstrating compliance with security standards. However, IRS does not fully monitor compliance with existing FFA security and privacy requirements. Although IRS receives FFA security reports, it does not actively review or validate those reports unless a problem, such as a security incident, is reported.

For 2009, IRS is suggesting that all authorized electronic filing providers that participate in online filing adhere to new security and privacy standards, the majority of which are similar to existing FFA requirements; however, IRS is not requiring compliance with those standards (see app. VI). These standards are optional in 2009 because IRS finalized them late in 2008. IRS has no plans to determine if tax software companies that are authorized electronic filing providers participating in online filing are adhering to advisory security and privacy standards for the 2009 filing season. Because the new standards would apply to a relatively few number of companies and include the three largest, the costs to collect information on adherence to the standards would be low. For the 2010 filing season, IRS may make those standards mandatory. Also, IRS is considering expanding these standards to include software companies that offer retail and downloadable products but has not yet established a time frame for doing so. IRS officials stated they are considering developing a plan to monitor compliance with these security and privacy standards for 2010. Without appropriate monitoring, IRS has limited assurance that the standards have been adequately implemented or software companies are complying with the standards. As a result, IRS does not know whether the confidentiality and integrity of the taxpayers' data are at an increased risk of being inadequately protected against fraud and identity theft.

³⁰Payment Card Industry standards are security standards that include requirements for policies, procedures, network architecture, software design, and other critical protective measures. These comprehensive standards are intended to help organizations proactively protect customer account data. Penetration testing is security testing in which assessors mimic real-world attacks to identify methods for circumventing the security features of an application, system, or network. A vulnerability assessment is a formal description and evaluation of the vulnerabilities in an information system. While we mention these examples, there are other security and privacy requirements in the agreement with FFA including compliance with applicable Department of Treasury/IRS rules and limiting the use of identifying information.

Reliability of Electronic Filing

Tax software companies have been reliable providers of electronic filing services, with one recent exception which did not have a significant effect on tax administration. In 2007, customers of some of Intuit's products experienced a disruption in their ability to file electronically on tax day.³¹ For approximately 13 hours, taxpayers could not reliably file their returns electronically through Intuit to IRS. According to IRS, about 171,000 tax returns were affected. IRS accommodated affected taxpayers by extending the tax filing deadline and not applying late filing penalties. IRS reported that the disruption did not delay processing of tax returns, payments to the government, or refunds to taxpayers because IRS already had a processing backlog of millions of returns at that time. Intuit agreed to pay any other penalties that customers incurred and also refunded any electronic filing fees charged during the disruption.

IRS's MOU with FFA requires the latter's members to maintain a continual level of service throughout the filing season. For example, members are not permitted to schedule any planned blackouts of service during that time. However, IRS does not monitor compliance with this requirement and does not have a similar requirement for non-FFA tax software companies. Additionally, while IRS's PATS testing reviews tax software to ensure that returns transmitted electronically are compatible with IRS systems before the start of the filing season, it does not do so throughout the filing season. All industry representatives we spoke with believed that testing throughout the filing season was important because of the potential effect of late tax law changes.

IRS Has Not Assessed the Risks to Tax Administration of the Use of Commercial Tax Software by Individuals

Despite devoting some resources to oversight of the tax software industry, IRS has not conducted an assessment to understand whether reliance on commercial tax software poses any significant risks to tax administration. Broadly defined, risk assessment involves (1) identifying future, potentially negative outcomes and (2) estimating the likelihood they will occur. In IRS's case, those outcomes include the possibility of security breaches, disruptions in electronic filing, and missed opportunities to identify and correct compliance problems. While the likelihood of these outcomes occurring may be low, IRS does not know whether this is the case.

³¹Intuit has been operating and providing electronic filing services for over 10 years.

OMB's and our guidance suggest that agencies conduct risk assessments to identify risks that could impede the efficient and effective achievement of their goals and allow managers to identify the most significant areas in which to place or enhance internal controls.³² Moreover, by increasing awareness of risks, these assessments can generate support for the policies and controls that are adopted in order to help ensure that these policies and controls operate as intended. Further, federal law requires agencies to implement an information security program that includes periodic assessments of risk.³³

According to IRS officials, the agency has not conducted a risk assessment because it does not believe the benefits warrant the cost of such an assessment. IRS and software industry officials we spoke with believe it is in the industry's financial interest to ensure that taxpayers can rely on tax software. In their annual filing reports, both Intuit and H&R Block identified financial losses and harm to their reputation as potential risks of system failures or interruptions.³⁴ For example, Intuit reported one of the many risks to its company is that the interruption or failure of its information and communication systems could cause customers to revert to paper filings, resulting in reduced company revenues. In addition, according to IRS officials and tax software industry representatives, the industry has not yet experienced a significant problem with tax software or electronic filing. IRS and tax software industry officials further stated that the industry is better suited to conduct extensive scenario and security testing because of the significant cost of conducting such testing. Software industry officials reported spending tens of millions of dollars each year on testing to ensure accuracy. Further, they reported employing hundreds of tax analysts to review and simplify IRS instructions, publications, and forms; monitor proposed changes to tax legislation; and consult with IRS and state revenue agencies to ensure accurate interpretations of tax laws. Intuit officials reported complying with

³²The Office of Management and Budget (OMB), *Revisions to OMB Circular A-123, Management's Responsibility for Internal Control* (Washington, D.C.: 2004); GAO, *Internal Control Management and Evaluation Tool*, [GAO-01-1008G](#) (Washington, D.C.: August 2001); and *Standards for Internal Control in the Federal Government*, [GAO/AMD-00-21.3.1](#) (Washington, D.C.: November 1999).

³³Federal Information Security Management Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002).

³⁴For H&R Block, Inc. see Form 10-K, United States Securities and Exchange Commission (SEC), (Apr. 30, 2008) and for Intuit, Inc. see Form 10-K, United States SEC, (July 31, 2008).

recognized international security standards.³⁵ Intuit officials also reported undergoing a biennial third-party security assessment, as well as proactively conducting ongoing security application assessments and vulnerability and penetration testing. Industry representatives noted the current public-private partnership between IRS and the software industry provides reliable coverage for electronic filing through redundancy in the market, unlike other countries that offer only a government-sponsored Internet filing option.

While the above may be true and financial and other incentives may exist, IRS's position is not based on an actual, systemic assessment that identifies potential negative outcomes and the likelihood of their occurrence. Further, there are several reasons to believe that the benefits of assessing the risks associated with reliance on commercial tax software are significant.

As already noted, IRS has said that it is in the agency's best interest to ensure that taxpayers can rely on commercial tax software to make electronic filing accurate, easy, and efficient. Continued growth in electronic filing depends on increasing use by individual taxpayers and maintaining their confidence in the accuracy as well as the security and privacy of their tax information, and the reliability of electronic filing. However, IRS does not know whether there are security and privacy risks because it has not monitored existing requirements. While tax software companies have not reported significant security breaches involving taxpayer data either residing on their databases or during electronic transmission to IRS in recent years, cases of lost or stolen data at other taxing authorities illustrate the potential negative outcomes of such a breach. For example, in 2007, Oregon's Department of Revenue experienced a breach in which electronic files containing confidential taxpayer information may have been compromised by an ex-employee downloading a contaminated file.

While tax administration has not been significantly affected by disruptions to electronic filing, as noted previously, on tax day 2007, about 171,000

³⁵International Organization for Standardization/International Electrotechnical Commission (ISO/IEC) 27002, *Information Technology — Security Techniques — Code of Practice for Information Security Management*, establishes guidelines and general principles for initiating, implementing, maintaining, and improving information security management in an organization, and includes best practices of control objectives and controls for information security management.

Examples of Electronic Filing System Disruptions in Other Countries:

While the tax and electronic filing systems in the United States are not directly analogous to other countries' systems, at least two countries have experienced disruptions. For example, the Canadian Revenue Agency (CRA) experienced an electronic filing disruption in March 2007 that lasted for 9 days. CRA was unable to process returns filed on paper or electronically during that time. Additionally, on January 31, 2008, the United Kingdom's electronic tax filing service experienced a system disruption. Taxpayers were given an extra 24 hours to file returns. Although IRS has multiple filing options and has not experienced similar disruptions large enough to significantly affect returns processing, it does not know the potential for such disruptions or the likelihood of their occurrence. If the U.S. tax system was to experience a similarly large disruption, IRS may not be able to process returns in a timely fashion.

Source: GAO.

Intuit customers experienced a 13-hour disruption. During this time, Intuit customers could not reliably file their returns electronically with Intuit, and ultimately to IRS, but this disruption did not significantly affect tax administration. Additionally, Canada and Great Britain recently experienced disruptions with their electronic filing systems (see text box).³⁶

If enhancements to tax software could produce even small improvements in voluntary compliance by taxpayers, the additional dollars of tax revenue could be substantial. Tens of billions of the \$290 billion dollar net tax gap (after IRS's collection efforts) are associated with sole proprietors and individual owners of rental real estate.³⁷ We have made several recent recommendations intended to improve the compliance of these taxpayers by enhancing the clarity of tax software which, as we noted, IRS plans to address in most cases.³⁸ However, IRS has not conducted research on the correlation between tax software and compliance—such as whether and how tax software packages influence compliance. Such research could be enhanced even more by the use of a single software identification number, which would allow IRS to identify the specific software package used by a taxpayer. Although limited testing of hypothetical scenarios by TIGTA and the National Taxpayer Advocate led them to identify possible software weaknesses that might affect compliance, this testing was based on a nonstatistical sample of scenarios and software packages.³⁹ Because there are millions of potential scenarios and each one is different, it is not possible to generalize from the nonstatistical samples and reach conclusions about the overall effect of tax software on compliance. Furthermore, hypothetical scenarios do not provide evidence about how

³⁶For more specifics on the Canadian example, refer to <http://www.cra-arc.gc.ca/nwsrm/rlss/2007/m03/nr070306-eng.html> and for the Great Britain example, see <http://www.hmrc.gov.uk/online/sa.htm>.

³⁷The tax gap is the difference between the taxes that taxpayers pay voluntarily and on time and the amounts they should pay under the law. IRS periodically measures taxpayer compliance and the tax gap that results from misreporting. IRS most recently estimated the gross tax gap at around \$345 billion for tax year 2001, before IRS's collection efforts.

³⁸GAO-08-956.

³⁹TIGTA, *Opportunities Exist to Improve Tax Software Packages*, Reference Number 2005-40-025 (Washington, D.C.: Jan. 12, 2005) and *The Internal Revenue Service Provides Helpful Tax Law Assistance but Still Has Problems with Tax Return Preparation Assistance*, Reference Number 2007-40-164 (Washington, D.C.: Aug. 24, 2007). Testimony of Nina Olsen, National Taxpayer Advocate, before the Committee on Finance, United States Senate on *Tax Return Preparation Options for Taxpayers* (Apr. 4, 2006).

taxpayers actually use the software or whether taxpayers are actually complying with tax laws.

IRS is already devoting resources to oversight of the tax software industry, as described in the previous section. IRS does conduct some testing, has developed the NAM position to communicate with the software industry, and tracks some performance. Also, according to IRS officials, in 2010 IRS plans to devote additional resources to implement new security and privacy requirements and monitor compliance.

While significant problems have not occurred to date, without performing a risk assessment—the first step in risk management and mitigation—IRS does not know the potential magnitude or nature of problems or their likelihood of occurring. As a result, IRS does not have an informed basis for making resource allocation decisions, taking steps to mitigate any significant risks, or avoiding costly risk mitigation in areas where the risks are low.

Conclusions

Commercial tax software—which is used by tens of millions of taxpayers—is a critical part of the tax administration system and a potential tool for increasing electronic filing. However, IRS does not identify which software packages taxpayers use or have information on the correlation between particular packages and compliance. Further, IRS does not know whether changes to software pricing would be an effective strategy for increasing electronic filing. Nor does IRS have assurance that tax software companies are adequately protecting and securing taxpayer data, another possible influence on taxpayers' willingness to file electronically.

Despite its role in influencing electronic filing and the accuracy of tax returns, IRS has not conducted a risk assessment of taxpayers' reliance on tax software. Such an assessment could be done alone or as part of a broader study that would include paid preparers. Without a risk assessment, IRS does not know whether its existing investment in oversight of the tax software industry is too great, about right, or needs to be expanded.

Recommendations for Executive Action

To help increase electronic filing and allow IRS to better target its efforts, we recommend that the Commissioner of Internal Revenue direct the appropriate officials to take the following six actions:

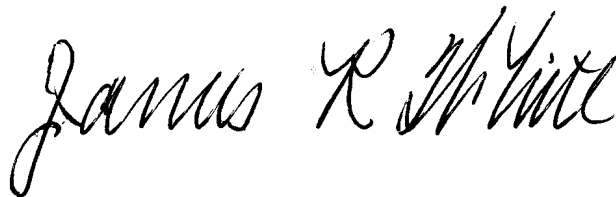
-
1. require tax software companies, as soon as practical, to include a software identification number that specifically identifies the software package used to prepare tax returns, which can be used in IRS research efforts;
 2. ensure that, as part of the second phase of IRS's Advancing E-file Study, surveys ask taxpayers the effect of tax software pricing changes and the opportunity to file for free using online tax forms on IRS's Web site on their decision to either file or not file tax returns electronically;
 3. to the extent possible, study the effect of the 2009 pricing changes and the opportunity to file for free using online tax forms on IRS's Web site on taxpayers' use of tax software and electronic filing rates;
 4. determine if tax software companies that are authorized to participate in online filing are adhering to advisory security and privacy standards for the 2009 filing season;
 5. develop and implement a plan for effectively monitoring compliance with recommended security and privacy standards for the 2010 filing season; and
 6. assess the extent to which the reliance on tax software creates significant risks to tax administration, particularly in the areas of tax return accuracy, the security and privacy of taxpayer information, and the reliability of electronic filing.

Agency Comments

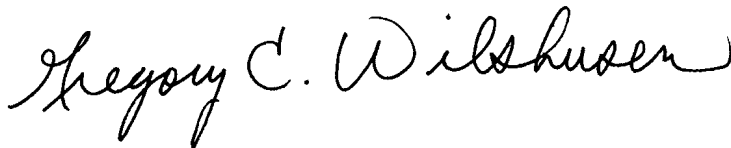
The Deputy Commissioner of Internal Revenue provided written comments in a February 19, 2009 letter in which she agreed with all our recommendations and outlined IRS's actions to address those recommendations (see app. VII). With respect to requiring tax software companies to identify the software package used, IRS plans to require an identification number on paper tax returns created using software. Related to ensuring that Advancing E-file surveys ask taxpayers about the effect of tax software pricing changes, IRS reported those surveys had already been finalized. In its place, IRS will be analyzing monetary disincentives associated with taxpayers' choice of filing method and plans to study the effect of the pricing changes on taxpayer electronic filing decisions. With respect to ensuring authorized electronic filing providers adhere to the advisory security and privacy standards for the 2009 filing season, IRS reported it plans to sample and observe online providers' Web sites to determine compliance. If IRS decides to make the standards mandatory, the agency will develop a monitoring and enforcement plan. Finally, to assess risks related to the reliance on tax software, IRS plans to summarize whether and the extent to which the agency is authorized to be involved in aspects of the software industry, including what additional authority it would need to impose changes and sanctions.

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

For further information regarding this report, please contact James R. White, Director, Strategic Issues, at (202) 512-9110 or whitej@gao.gov or Gregory C. Wilshusen, Director, Information Security Issues, at (202) 512-6244 or wilshuseng@gao.gov. Contacts for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Individuals making key contributions to this report can be found in appendix VIII.



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Appendix I: Scope and Methodology

To determine what is known about how pricing strategies affect the use of tax software and electronic filing, we obtained and analyzed the prices for the top three tax software companies for both online and retail or downloaded products for filing seasons 2008 and 2009. These costs did not include any rebates or promotional prices. We limited our data analysis to the top three software companies because they account for 88 percent of all returns filed electronically by individuals and accepted by the Internal Revenue Service (IRS). We also reviewed literature concerning the economics of information goods, including software pricing.

Further, we obtained and analyzed findings from IRS's Taxpayer Satisfaction Studies and reviewed the IRS Oversight Board's November 2006 Taxpayer Customer Service and Channel Preference Survey to determine why federal taxpayers do not file returns electronically.

To determine the extent to which IRS provides oversight of the tax software industry to help ensure tax returns are accurate, we reviewed and summarized IRS's legal authority to regulate the accuracy and security of commercial tax software. We also obtained and analyzed internal revenue manuals, industry standards, and government guidance and compared them to IRS's current procedures. We reviewed the Free File Alliance, LLC (FFA) Memorandum of Agreement (MOU) outlining IRS and FFA's agreements to provide free income tax software to individuals.

To determine the extent to which IRS provides oversight of the tax software industry to help ensure that taxpayer information is secure, we interviewed IRS and FFA officials. In addition, we obtained and analyzed IRS's new electronic filing security and privacy standards, comparing them to industry standards. We also reviewed the FFA MOU to assess the extent to which security and privacy requirements were already in place for FFA members.

To determine the extent to which IRS helps ensure electronic filing systems are reliable, we reviewed IRS requirements for electronic return originators, the FFA MOU, and documents and literature describing a significant disruption in electronic filing at Intuit. We also reviewed documents and interviewed Intuit officials to determine the extent of the disruption and corroborated the information they provided during interviews with IRS officials to determine the effect the disruption had on taxpayers and the agency.

To determine what is known about the risks of the reliance on commercial tax software used by individuals, we reviewed Office of Management and

Budget (OMB) and GAO guidance, including the criteria for assessing risk at an agency as well as industry best practices for risk assessments and internal controls; and interviewed IRS officials to determine what risk assessments IRS had in place. We also reviewed selected tax software companies' filing statements with the Securities and Exchange Commission to determine if they identified any risks. We also interviewed IRS and software industry officials to determine what steps they took to identify and address risks.

We reviewed the Treasury Inspector General for Tax Administration's (TIGTA) and National Taxpayer Advocate's (NTA) reports detailing their respective tests of how accurately and consistently tax software applied tax laws. Because the various tax software tests we reviewed were limited to a subset of tax software packages and used a nonstatistical sample of tax scenarios, their results were not generalizable to all types of taxpayers, tax filing situations, tax laws, or the entire tax software industry. We also reviewed literature on the effect of significant electronic filing disruptions in tax software systems in selected other countries. We selected Canada and Great Britain because these were the examples that IRS provided on electronic filing disruptions in other countries.

For background purposes, we also used IRS data to compare the cost of processing returns, and obtained and analyzed math error authority data, reject errors, and processing times across the different tax return filing methods.¹

Additionally, for all objectives, we reviewed reports and interviewed officials including those from IRS, NTA, TIGTA, FFA, the Electronic Tax Administration and Advisory Committee, the Federation of Tax Administrators and the IRS Oversight Board. We also interviewed officials from select industry groups such as the Council for Electronic Revenue Communication Advancement, the National Association of Computerized Tax Processors, and selected tax software companies. We visited a major tax software provider's data center. Our work was done primarily at IRS Headquarters in Washington, D.C. and its division offices in New Carrollton, Maryland, and Atlanta, Georgia.

We conducted this performance audit from April 2008 through February 2009 in accordance with generally accepted government auditing

¹We reported 2007 data, which are the most current and complete data available from IRS.

standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Tax Software Markets and 2008 and 2009 Pricing of Tax Software for Return Preparation and Electronic Filing

While a large number of companies offered tax preparation services in 2008, the top three tax software companies electronically filed 88 percent of returns prepared by individual taxpayers (as opposed to the returns prepared and electronically filed by paid preparers). Each of the companies outside the top three held less than 3 percent of the tax software market as measured by the number of electronically filed returns.¹ However, tax software companies also compete with the paid preparer industry as well as manual preparation.

Based on a review of pricing literature for software companies, tax software companies, like other software and information technology companies, have low marginal costs and high fixed costs for product development.² In such markets, if the price charged to taxpayers is equal to the marginal cost, companies will not be able to cover their average cost of production and cannot stay in business. Therefore, companies in these markets will attempt to recover more of their fixed costs through various forms of price discrimination. Price discrimination can take the form of developing different versions of the product to match the needs of different types of consumers, who are then charged different prices according to their willingness to pay.

The literature also suggests that companies in these markets may offer products that consist of several services bundled together—sometimes charging separate prices for each service or charging a single price for different combinations (bundles) of services. The bundling strategy is thought to potentially increase a company's revenue by attracting consumers who may value particular elements of the bundled product. Tax software companies bundle some or all of the following services or features: federal tax preparation, state tax preparation, electronic filing for federal and state returns, help services and technical support, return printing services, storage of information from prior returns, links to outside providers of relevant information (W-2s), and built-in accuracy checks.

¹GAO did not conduct a market definition analysis of the tax software industry or review the industry from an antitrust perspective in this report.

²Marginal costs are the costs due solely to selling an additional software package—for example, the cost of downloading software and recording the sale. Fixed costs do not change as the number of users change—for example, the cost of updating tax software for the new tax year.

Some tax software companies offer only online services to taxpayers, while others offer the option of downloading the program to a home computer or purchasing software from a retail location. The pricing structure may vary depending on whether a taxpayer prepares a return online or purchases a retail or downloadable program (see tables 1 and 2). In 2008, the largest companies offering online preparation products for federal returns usually bundled electronic filing with federal return preparation. However, if the program was downloaded or purchased at a retail location, electronic filing often involved a separate charge.

For the 2009 tax filing season, the two largest tax software companies that previously charged separate electronic filing fees for federal returns for some of their products have eliminated those electronic filing fees. The three largest companies will bundle federal tax preparation with electronic filing for all of their products. For some products, the companies will still charge separate, incremental fees for other services such as preparation and electronic filing for state returns, as well as return review. The two largest tax software companies that eliminated federal electronic filing fees also made some other pricing changes for preparing and electronically filing both a federal and state tax return in 2009 including:

- online tax packages are generally priced lower than 2008;
- online tax packages are generally priced lower than retail/downloadable packages; and
- most retail/downloadable packages remained essentially the same in price when compared to 2008.

For the third largest tax software company, its package prices for both online and retail/downloadable products remained the same in 2009 as in 2008 because the preparation and electronic filing fees remained the same in both years.

**Appendix II: Tax Software Markets and 2008
and 2009 Pricing of Tax Software for Return
Preparation and Electronic Filing**

Table 1: Comparison of 2008 and 2009 Prices of Top Three Retail/Downloadable Tax Software Packages for Return Preparation and Filing^a

	Federal				State				Total package price ^b	
	Preparation		Electronic filing		Preparation		Electronic filing			
TurboTax	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Basic	\$19.95	\$29.95	\$17.95	\$0	\$34.95	\$39.95	\$17.95	\$19.95	\$90.80	\$89.85
Deluxe	44.95	59.95	17.95	0	0	0	17.95	19.95	80.85	79.90
Premier	74.95	89.95	17.95	0	0	0	17.95	19.95	110.85	109.90
Home & Business	89.95	99.95	17.95	0	0	0	17.95	19.95	125.85	119.90
Business	99.95	109.95	17.95	0	49.95	49.95	17.95	0	185.80	159.90
TaxCut										
Basic Federal + E-file	N/A	19.95	N/A	0	N/A	29.95	N/A	19.95	N/A	69.85
Premium Federal + E-file	N/A	34.95	N/A	0	N/A	29.95	N/A	19.95	N/A	84.85
Premium Federal + State	39.95	N/A	19.95	N/A	N/A	N/A	19.95	N/A	59.90	N/A
Premium Federal + State + E-file	69.95	49.95	0	0	0	0	0	19.95	69.95	69.90
Home & Business + E-file	89.95	79.95	0	0	0	0	0	19.95	89.95	99.90
TaxAct										
Standard	0	0	0	0	13.95	13.95	7.95	7.95	21.90	21.90
Deluxe	12.95	12.95	0	0	13.95	13.95	7.95	7.95	34.85	34.85
Ultimate	19.95	19.95	0	0	0	0	7.95	7.95	27.90	27.90
Home & Business	N/A	44.95	N/A	0	N/A	0	N/A	7.95	N/A	52.90

Source: GAO.

N/A means not applicable because those packages were not offered at the time or this feature was not available with this package.

^a2008 prices refer to products used to prepare and file 2007 tax returns and 2009 prices refer to products used to prepare and file 2008 tax returns.

^bThe total package price includes charges for preparing and filing one federal and one state return only.

**Appendix II: Tax Software Markets and 2008
and 2009 Pricing of Tax Software for Return
Preparation and Electronic Filing**

Table 2: Comparison of 2008 and 2009 Prices of Top Three Online Tax Software Packages for Return Preparation and Electronic Filing^a

	Federal				State				Total package price ^b	
	Preparation		Electronic filing		Preparation		Electronic filing			
TurboTax	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Free Edition	\$0	\$0	\$0	\$0	\$30.95	\$25.95	\$0	\$0	\$30.95	\$25.95
Basic	29.95	14.95	0	0	34.95	34.95	0	0	64.90	49.90
Deluxe	49.95	29.95	0	0	34.95	34.95	0	0	84.90	64.90
Premier	74.95	49.95	0	0	34.95	34.95	0	0	109.90	84.90
Home & Business	99.95	74.95	0	0	34.95	34.95	0	0	134.90	109.90
TaxCut										
Free Edition	N/A	0	N/A	0	N/A	29.95	N/A	0	N/A	29.95
Basic + E-file	14.95	14.95	0	0	29.95	29.95	0	0	44.90	44.90
Premium + E-file	19.95	39.95	0	0	29.95	29.95	0	0	49.90	69.90
Premium + State + E-file	44.95	N/A	0	N/A	0	N/A	0	N/A	44.95	N/A
Signature	99.95	79.95	0	0	29.95	29.95	0	0	129.90	109.90
TaxAct										
Standard	0	0	0	0	13.95	13.95	0	0	13.95	13.95
Deluxe	9.95	9.95	0	0	7.00	7.00	0	0	16.95	16.95
Ultimate	16.95	16.95	0	0	0	0	0	0	16.95	16.95

Source: GAO.

N/A means not applicable because those packages were not offered at the time or this feature was not available with this package.

^a2008 prices refer to products used to prepare and file 2007 tax returns and 2009 prices refer to products used to prepare and file 2008 tax returns.

^bThe total package price includes charges for preparing and filing one federal and one state return only.

The effect of these pricing changes on electronic filing will not begin to be known until the end of the present tax filing period and will be difficult to determine. On one hand, taxpayers who buy a tax software package that includes a bundle of services may be encouraged to use software and file electronically because there is no longer a separate charge for doing so. On the other hand, if the cost of such a package is significantly higher, it may discourage taxpayers' use of tax software since they may not be able to purchase a less expensive package that does not include electronic filing.

Appendix III: Advantages and Disadvantages of Alternative Tax Preparation and Filing Methods

Taxpayers can experience many advantages and disadvantages based on the various methods for preparing and filing federal tax returns. Taxpayers preparing and filing their returns electronically may receive advantages such as reduced time spent on preparing the return and receiving faster refunds. On the other hand, taxpayers who prepare their returns manually may experience disadvantages such as increased transcription errors and slower refunds. Table 3 shows details of the advantages and disadvantages of the different preparation and filing methods.

Table 3: Advantages and Disadvantages of Alternative Tax Preparation and Filing Methods

Tax preparation and filing method	Advantages	Disadvantages
Preparation by hand/filing by mail	• No preparation costs • Low cost of submission (postage) • No third party involvement with tax return preparation or submission • No computer access needed	• Must rely on own knowledge; or forms, instructions, and taxpayer services provided by IRS • 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 software or paid preparer/filing by mail (v-coders)	• 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	• Cost of tax 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 software or paid preparer/file via an electronic filing company	• Reduced time/tax liability due to software or preparer tax planning capability • Easier preparation of other required income tax returns (if applicable) • Faster refunds • Fewer errors due to not needing to process paper • Less incidence of lost documentation • Math and omission error checks	• Computer and Internet access required for software users • Cost for tax software/tax preparer • Third party may have access to tax return data during preparation and/or submission

Source: GAO analysis.

Appendix IV: Laws Applicable to Tax Service Companies

In the Internal Revenue Service Restructuring and Reform Act of 1998, Congress instructed the agency to establish a goal of having 80 percent of all individual income tax returns filed electronically by 2007.¹ While the Internal Revenue Service (IRS) has no legal authority to generally oversee the operations of tax software companies, IRS does have the authority to prescribe the forms and regulations for the making of returns, including the information contained therein and whether forms must be filed electronically.² Accordingly, IRS has an interest in ensuring that tax software providers comply with tax laws and security and privacy laws so that taxpayers have confidence in these services and file their tax returns electronically.

Under section 6103 of the Internal Revenue Code (IRC), IRS is responsible for safeguarding taxpayer data while in IRS's control. Section 6103 nondisclosure requirements only apply to IRS and not to private entities that prepare and send tax data to IRS. However, private entities are subject to safeguarding and privacy rules with regard to taxpayer information and can be penalized for improper use and disclosure.

The Gramm-Leach-Bliley (GLB) Act requires financial institutions to protect consumers' personal financial information held by these institutions—including return preparers, data processors, transmitters, affiliates, service providers, and others who are paid to provide services involving preparation and filing of tax returns.³ For companies in the tax business, the GLB Act delegated rulemaking and enforcement authority to the Federal Trade Commission (FTC).⁴ Complying with the GLB Act generally means complying with FTC's Financial Privacy and Safeguards Rules. The Financial Privacy Rule requires financial institutions to give their customers privacy notices that explain the financial institution's information collection and sharing practices; the Safeguards Rule requires

¹Pub. L. No. 105-206, § 2001, 112 Stat. 685, 723, (July 22, 1998). The IRS Oversight Board, in its 2007 annual report to Congress on electronic filing (dated February 2008), approved extending the 80 percent electronic filing participation goal to 2012 because it was apparent that IRS could not meet the goal in 2007.

²26 U.S.C. § 6011. Under section 6011(e), IRS generally cannot require electronic filing except in the case of persons required to file at least 250 returns during the calendar year.

³Pub. L. No. 106-102, Title V, 113 Stat. 1338, 1436 (Nov. 12, 1999).

⁴15 U.S.C. § 6805(a)(7).

financial institutions to have a security plan to protect the confidentiality and integrity of personal consumer information.⁵

Additionally, paid tax return preparers are subject to both civil and criminal penalties for unauthorized disclosure or use of a taxpayer's confidential information. Tax return preparers include persons who develop tax software that is used to prepare or file a tax return, as well as any authorized IRS electronic filing provider.⁶ Tax return preparers who knowingly or recklessly disclose or use tax return information for a purpose other than preparing a tax return are guilty of a misdemeanor with a maximum penalty of up to 1 year's imprisonment or a fine of not more than \$1,000, or both.⁷ Any unauthorized disclosure or use by a tax return preparer not acting in bad faith still subjects that preparer to a civil penalty of \$250 for each disclosure, not to exceed \$10,000 for the year.⁸ A summary of the federal laws protecting taxpayer information are listed in table 4.

⁵16 C.F.R. Parts 313 & 314.

⁶26 C.F.R. § 301.7216-1(b)(2)(i)(B).

⁷26 U.S.C. § 7216.

⁸26 U.S.C. § 6713.

Table 4: Federal Laws Protecting Taxpayer Information

Law	Law's applicability	Summary
IRC § 6103	Officers and employees of the United States, or officers or employees of any state and local agencies receiving information from IRS for state or local law enforcement or social welfare purposes, and other persons lawfully receiving taxpayer information from IRS.	Prohibits the disclosure of tax returns and return information by IRS employees except in specifically enumerated circumstances. Where disclosure is permitted, section 6103 generally imposes strict safeguarding requirements and requires IRS to monitor and enforce compliance with those requirements.
Gramm-Leach-Bliley Act: The Safeguards Rule (16 C.F.R. Part 314)	Return preparers, data processors, transmitters, affiliates, service providers, and others who are paid to provide services involving preparation and filing of tax returns.	Entities must ensure the security and confidentiality of taxpayer records and information. Entities must develop, implement, and maintain a written information security program that contains administrative, physical, and technical safeguards that are appropriate.
Gramm-Leach-Bliley Act: The Privacy Rule (16 C.F.R. Part 313)	Return preparers, data processors, transmitters, affiliates, service providers, and others who are paid to provide services involving preparation and filing of tax returns.	Entities must give their customers privacy notices that explain the entities' information collection and sharing practices. Customers have the right to limit some sharing of their information. Entities that receive customer information from another entity may be limited in their ability to use that information.
IRC § 7216	Persons engaged in the business of preparing or assisting in the preparation of tax returns; or providing auxiliary services in connection with the preparation of tax returns, including a person who develops software that is used to prepare or file a tax return and any authorized IRS electronic filing provider; any persons compensated for preparing, or assisting in preparing, a tax return for any other person; or individuals who, as part of their duties of employment, perform services that assist in the preparation of, or assist in providing auxiliary services in connection with the preparation of, a tax return.	Imposes criminal penalties on any persons engaged in the business of preparing or providing services in connection with the preparation of tax returns who knowingly or recklessly make unauthorized disclosures or use of information furnished to them in connection with the preparation of a tax return. Those in violation are guilty of a misdemeanor with a maximum penalty of up to 1 year's imprisonment or a fine of not more than \$1,000, or both.
IRC § 6713	Persons engaged in the business of preparing or providing services in connection with the preparation of tax returns or any person who prepares any tax return for any other person for compensation.	Imposes monetary penalties of up to \$250 for each disclosure, not to exceed \$10,000 for the year, on the unauthorized disclosures or uses of taxpayer information by any person engaged in the business of preparing or providing services in connection with the preparation of tax returns.

Source: GAO.

Appendix V: Tax Software Industry Groups and Advisory Councils

In an effort to provide more effective tax administration, Internal Revenue Service (IRS) disseminates information and obtains technical perspectives and advice through industry and advisory councils. As shown in table 5, membership in many of these groups, with whom we consulted, is balanced to include representatives from tax practitioners and preparers, transmitters of electronic returns, tax software developers, large and small businesses, employers and payroll service providers, individual taxpayers, financial industry, academic, trusts and estates, tax exempt organizations, and state and local governments.

Table 5: Descriptions of Industry Groups and Advisory Councils

Name	Type of group or council	Description board members/major players
Council for Electronic Revenue Communication Advancement (CERCA)	Industry	A nonprofit trade association representing a broad cross-section of the electronic tax filing, IRS systems modernization, and state electronic revenue communities. CERCA works with IRS Electronic Tax Administration officials to provide stakeholder input into IRS decision making. The following companies are on CERCA's board: Automatic Data Processing (ADP) Commerce Clearinghouse (CCH) Chase Tax Related Products Computer Sciences Corporation Drake Software FileYourTaxes.com H&R Block IBM Intuit Jackson Hewitt Republic Bank & Trust River City Bank Santa Barbara Bank & Trust

**Appendix V: Tax Software Industry Groups
and Advisory Councils**

Name	Type of group or council	Description board members/major players
Electronic Tax Administration and Advisory Committee (ETAAC)	Advisory Committee	Supports the goal that paperless filing should be the preferred and most convenient method of filing tax and information returns. ETAAC members convey the public's perception of IRS electronic tax administration activities; offer observations about current or proposed policies, programs, and procedures; and suggest improvements. ETAAC members provide an annual report to Congress on IRS's progress in meeting the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) goals for electronic filing of tax returns. The following companies are on ETAAC: ADP Bank of America Balance Consulting, LLC Burdick Paving California's Franchise Tax Board Drake Software H&R Block Howard Hughes Medical Institute Intuit Marshall & Associates New York State's Taxation & Finance World Bank
Federation of Tax Administrators (FTA)	Advisory Committee	The FTA was organized to improve the quality of state tax administration by providing services to state tax authorities and administrators. These services include research and information exchange, training, and intergovernmental and interstate coordination. The federation also represents the interests of state tax administrators before federal policymakers where appropriate and includes representatives from the 50 states, the District of Columbia, Puerto Rico, and New York City.

**Appendix V: Tax Software Industry Groups
and Advisory Councils**

Name	Type of group or council	Description board members/major players
Free File Alliance, LLC (FFA)	Industry	The FFA is a free federal tax preparation and electronic filing program for eligible taxpayers developed through a public-private partnership between IRS and FFA, a group of private sector tax software companies. These companies are: 1040Now 123 Easy Tax Filing, LLC 2nd Story Software #1 Discount Tax Return Average1040.com CCH Tax & Accounting EFILE Tax Returns, Inc. ezTaxReturn Fileyourtaxes.com FreeTaxReturns.com H&R Block Intuit iSecure Tax Corporation Liberty Tax Online-taxes, Inc. Smokey Software, Inc./ CitizenTax Tax Centers of America/Online Tax Pros, Inc. Taxhawk, Inc. TaxSimple TaxSlayer
IRS Oversight Board	Advisory Committee	Created by RRA 98 and charged to oversee IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to IRS so that it may move forward in a cogent, focused direction. IRS Oversight Board provides an annual report to Congress. The Oversight Board is an independent body with nine members including the Secretary of Treasury and the Commissioner of Internal Revenue, along with seven others who are appointed by the President of the United States and confirmed by the Senate for 5-year terms. Currently there are two vacancies and board members are from: American University Council on Competitiveness Retired Corporate Tax Counsel Enterprise Rent-A-Car University of Montana School of Law

**Appendix V: Tax Software Industry Groups
and Advisory Councils**

Name	Type of group or council	Description board members/major players
National Association of Computerized Tax Processors (NACTP)	Industry	A nonprofit association that represents tax processing software and hardware developers, electronic filing processors, tax form publishers, and tax processing service bureaus. The association promotes standards in tax processing and works closely with IRS and state governments to promote efficient and effective tax filing. Board members are from: CCH Creative Solutions Drake Software H&R Block H&R Block Digital Tax Solutions Nelco Orrtax Software Universal Tax

Source: GAO.

^aAs of December 2008, Average1040.com discontinued their membership with FFA.

Appendix VI: Proposed Security and Privacy Requirements

For 2009, the Internal Revenue Service (IRS) has developed six new optional security and privacy standards which are intended to better protect taxpayer information collected, processed, and stored by online authorized electronic filing transmitters, as shown in table 6. These new standards are based on industry best practices and are intended to supplement the Gramm-Leach-Bliley Act and the implementing rules and regulations promulgated by the Federal Trade Commission.

Table 6: Proposed Security and Privacy Requirements for Authorized Electronic Filing Transmitters

1.	Providers must possess current and valid Secure Socket Layer (SSL) certificates that use strong validation and specific SSL versions and types of encryption. ^a
2.	External network vulnerability scan run by an independent certified third-party vendor weekly in accordance with the Payment Card Industry Data Security Standards.
3.	Information privacy and safeguard policies will be written consistent with the applicable government and industry guidelines and include “we maintain physical, electronic and procedural safeguards that comply with applicable law and deferral standards.” This compliance shall be certified by a privacy seal vendor acceptable to IRS.
4.	Web site-challenge-response test (e.g., Completely Automated Public Turing Test To Tell Computers and Humans Apart [CAPTCHA]) shall be implemented. ^b
5.	Public domain name shall be registered with a U.S. registrar accredited by Internet Corporation for Assigned Names and Numbers and must be locked and not private. ^c
6.	Security incidents must be reported to IRS as soon as possible via encrypted e-mails but not later than 1 hour after confirmation of the incident. If the provider’s Web site is the proximate cause of the incident, the provider shall cease collecting taxpayer information immediately via the compromised Web site.

Source: GAO analysis of IRS data.

^aA Secure Socket Layer (SSL) certificate establishes a private communication channel enabling encryption of the data during transmission. Encryption scrambles the data, essentially creating an envelope for message privacy. Each SSL Certificate consists of a public key and a private key. The public key is used to encrypt information and the private key is used to decipher it. When a Web browser points to a secured domain, a SSL handshake authenticates the server (Web site) and the client (Web browser). An encryption method is established with a unique session key and secure transmission can begin.

^bThe Completely Automated Public Turing Test To Tell Computers and Humans Apart, named after computer scientist Alan Turing, is a set of tests designed to differentiate a human from a computer prior to being allowed to submit Web content. It is used to reduce malicious automated Web submissions.

^cLocking a domain name provides protection from unauthorized third parties who might try to misdirect name servers or transfer the domain without permission. According to the National Institute of Standards and Technology, allowing private entries to exist in an external domain name server only serves to provide a target list for a remote attacker.

Appendix VII: Comments from the Department of Treasury



DEPUTY COMMISSIONER

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

February 19, 2009

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 am writing in response to the draft Government Accountability Office (GAO) audit report entitled *TAX ADMINISTRATION: Many Taxpayers Rely on Tax Software and IRS Needs to Assess Associated Risks* (GAO-09-297). I reviewed the report and think it accurately captures the challenge we face in establishing the appropriate role for the IRS in relationship to the tax software industry. The report accurately reflects the difficulty in assessing the quality of tax software, why some taxpayers decide to use tax software and the impact on electronic filing. Our approach to tax software is evolving and your report provides helpful insights and recommendations with which we generally agree.

The Wage and Investment Division, Electronic Tax Administration (ETA) manages high level relationships that have been identified as important to the continued growth and success of electronic filing. One of the relationships ETA manages is with the software developers' community. The IRS meets annually with developers to exchange ideas and information regarding issues pertaining to electronic tax administration, preparation and transmission. We also conduct annual pre-filing season conferences with the software community to ensure they have information necessary for smooth filing season implementation.

As noted in your report, commercial tax software is a critical part of the tax administration system, used by tens of millions of taxpayers, and a potential tool for increasing electronic filing. Also stated in your report, the IRS is devoting resources to oversight of the software industry, does conduct some testing, has developed a National Account Manager position to communicate with the software industry, and tracks performance. Starting this year, we will begin to implement new security and privacy requirements and monitor compliance.

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Responses to your specific recommendations are enclosed. If you have any questions, or would like to discuss this response in more detail, please contact David R. Williams, Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division, at (202) 622-7990.

Sincerely,



Linda E. Stiff

Enclosure

Enclosure

Recommendation

Require tax software companies, as soon as practical, to include a software identification number that specifically identifies the software package used to prepare tax returns, which can be used in IRS research efforts.

Comment

Procedures are currently in place for the Individual Electronic Filing program to require that a Software Identification Number be present on all e-file returns. If not present, the return will reject with Error Reject code 0493. Software identification numbers consist of eight digits, with the first two representing the tax year. The number is assigned to all tax packages during Participants Acceptance Testing System (PATS) testing to identify the different versions of software products. We will add requirements to Publication 1167 (General Rules and Specifications for Substitute Forms and Schedules) to require paper substitute forms created by e-file software to include the Software Identification Number. We will request this change for the 2010 filing season by the end of the current fiscal year.

Recommendation

Ensure that, as part of the second phase of IRS's Advancing E-file Study, surveys ask taxpayers the effect of tax software pricing changes and the opportunity to file for free using online tax forms on IRS's Web site on their decision to either file or not file tax returns electronically.

Comment

We agree with this recommendation and are currently seeking to better understand factors that affect taxpayers' behavior towards electronic filing, including pricing. Because of the elimination of separate e-Filing fees for many tax software users as well as the availability of a fillable forms utility on IRS.gov, we hope to learn a great deal about taxpayer behavior and preferences. However, the Advancing E-file Study taxpayer survey has already been finalized and is in progress. Also, it is too early to survey taxpayers regarding tax software pricing changes and the opportunity to file for free using online tax forms since these changes only went into effect on January 16th of this year. We also agree with you that this recommendation is difficult to implement because it is challenging to isolate the specific factors that cause a taxpayer to eventually choose to e-file. As part of the Advancing E-file Study Phase 2, we are working with the MITRE Corporation in trying to address this challenge by conducting conjoint analysis of factors driving taxpayers' e-file decisions and the analysis will include monetary disincentive associated with filing method as a choice factor. This analysis should be completed by September 30, 2009.

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Recommendation

To the extent possible, study the effect of the 2009 pricing changes and the opportunity to file for free using online tax forms on IRS's Web site on taxpayers' use of tax software and electronic filing rates.

Comment

We agree with the recommendation and will study the impact of cost on migration between filing methods. The study will be completed by December 31, 2009.

Recommendation

Determine if tax software companies that are authorized electronic filing providers which participate in online filing are adhering to advisory security and privacy standards for the 2009 filing season.

Comment

We agree with the recommendation. As we evaluate whether to make these advisory standards official policy, we will determine the impact of the advisory standards on provider behavior and incorporate those findings in our decision-making. Throughout the 2009 filing season we will sample and observe online providers websites to determine if they have adopted the advisory rules.

Recommendation

Develop and implement a plan for effectively monitoring compliance with recommended security and privacy standards for the 2010 filing season.

Comment

We agree with the recommendation. As stated in our comments to the prior recommendation above, we will monitor and assess self-compliance with the security advisories we issued in 2008, seek public comment on making these standards mandatory, and based on all findings, if we decide to make these advisory standards official policy, we will publish the new rules, develop a monitoring and enforcement plan, and identify resources to carry out monitoring and enforcement activities. A decision on making the advisory mandatory will be made by September 30, 2009.

Recommendation

Assess the extent to which the reliance on tax software creates significant risks to tax administration, focusing on tax return accuracy, the security and privacy of taxpayer information, and the reliability of electronic filing.

Comment

We agree with the recommendation in principle, but we also agree with you that this is very difficult to accomplish. Implementing a quality assurance function to test all tax

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software for accuracy is a very expensive and significant task, and it will be important to determine the scope and boundaries of what is tested. Software is subject to user errors that are difficult to eliminate altogether. Testing software on a large scale does not take into account how software may be abused by a taxpayer. As such, we need to determine the scope of what can be effectively tested, including computer code with glitches, validating compliance with any security rules in place, identifying and investigating, and monitoring reliability of transmissions. However, testing and certifying accuracy will pose a significant challenge because of the many scenarios that are present due to a complex tax code. Therefore, IRS's current approach of identifying cases of non-compliance by actual groups of users is effective because it does not deal with hypothetical cases and identifies both real weaknesses in software and user behavior. The Government Accountability Office (GAO) cited successful examples of this approach in the report entitled *IRS/Earned Income Tax Credit (EITC) Software Developers Working Group Report, Potential Software Enhancements to Improve the Accuracy of Tax Returns Claiming Earned Income Tax Credit and Help Paid Preparers Meet Their EITC Due Diligence Requirements* (July 31, 2008), involving EITC issues and foreign bank accounts. However, it may be possible to do more and we will look into ways of identifying additional areas of non-compliance in real settings to assess the extent to which reliance on tax software may contribute to such non-compliance.

Our plans for implementing and monitoring security and privacy standards are set out in our response to the two recommendations immediately above.

With regard to reliability, the extensive redundancy provided by many providers and the long history and experience of continuous service suggests that investing resources in assessing this factor is not warranted at this time.

By February 2010, we will consult with Chief Counsel and develop a document summarizing whether and to what extent IRS is authorized to involve itself in the software industry's development of tax preparation software, what actions IRS could take to drive software companies to make changes and under what circumstances, what sanctions IRS could impose on software companies that refuse to make requested changes, and what additional authority IRS would need to do all of the above. Based on this information IRS will determine its subsequent course of action.

Appendix VIII: GAO Contacts and Staff Acknowledgments

GAO Contacts

James R. White, (202) 512-9110, whitej@gao.gov
Gregory C. Wilshusen, (202) 512-6244, wilshuseng@gao.gov

Acknowledgments

In addition to the contacts named above, Joanna Stamatziades, Assistant Director; Amy Bowser; Debra Conner; Vanessa Dillard; Michele Fejfar; Jyoti Gupta; Jeffrey Knott; Ed Nannenhorn; Madhav Panwar; Joseph Price; and Robyn Trotter made key contributions to this report.

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