

**WRITTEN TESTIMONY OF
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BEFORE
SENATE COMMITTEE ON FINANCE
ON
RETURN PREPARATION OPTIONS FOR TAXPAYERS
APRIL 4, 2006**

Good morning Mr. Chairman, ranking Member Baucus and members of the Senate Committee on Finance. My name is Bert Dumars and I am the Director of Electronic Tax Administration (ETA) for the Internal Revenue Service. It is my pleasure to be with you this morning to discuss, from an electronic perspective, return preparation options for taxpayers.

However, before discussing the specifics of our electronic filing program and the Free File Alliance, I would like to briefly update you on the status of this filing season.

2006 Filing Season

We expect to process almost 135 million individual tax returns in 2006, and we anticipate a continued growth in the number of those that are e-filed. In the 2005 filing season, over 50 percent of all individual income tax returns were e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. The error rate for returns e-filed is significantly less than for paper returns. This includes taxpayer errors when they are preparing their return, as well as IRS data entry errors once the paper return is processed by the IRS. Reduced error rates increases IRS efficiency and saves taxpayers from unnecessary correspondence with IRS.

We have updated our web site, IRS.gov, to make it easier for taxpayers to get answers to many of their tax questions. The web site:

- Allows a taxpayer to determine whether he or she qualifies for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows 70 percent of taxpayers the option of filing their tax returns at no cost through the FreeFile program;
- Assists hurricane victims with information on many of the changes in the tax laws that are designed to help them along with a toll free number for victims to get their questions answered: and

- Allows a taxpayer, who is receiving a refund once a return is filed, to track its progress via the “Where’s My Refund?” feature on the site.

As of March 24, we have received over 73 million returns, a very slight decline over the same period as last year. However, we have seen an over two percent increase in the number of returns filed electronically. As of March 24, 50.3 million were filed electronically.

While returns filed through FreeFile are down nearly 21 percent, overall returns filed via home computers are up 17.2 percent.

Background on E-Filing

The IRS began the e-file program in 1986 as a pilot project in three cities: Cincinnati, Ohio, Phoenix, Ariz., and Raleigh-Durham, N.C. That year, there were 25,000 tax returns filed electronically. The e-file program expanded nationwide in 1990 and 4.2 million tax returns were filed. IRS e-file has undergone tremendous growth each year.

It received a major boost in 1998 with the enactment of the IRS Restructuring and Reform Act (RRA), which set forth the mandate that at least 80 percent of all tax and information returns be filed electronically by 2007. This ambitious goal set the stage for an aggressive campaign to expand significantly our electronic outreach to taxpayers. A robust ETA program will reduce time spent by taxpayers dealing with the IRS. It will reduce the number of phone calls we have to answer and because of these two factors we will free up our compliance employees to focus on real compliance issues, rather than just retrieving or correcting information.

We believe the internet has become our primary vehicle for delivering service information to taxpayers. Please note that I said primary and not exclusive. We recognize that we will likely always have a percentage of taxpayers that we need to serve through either direct personal service or over the telephone, but we hope to continually drive that number down, while at the same time improving the levels of service and taxpayer satisfaction. This will not only save us time and resources, but also will provide a valuable service to taxpayers. They can get answers to their questions at their home, at their convenience, rather than visiting a walk-in site.

Our e-Strategy for Growth outlines our plans to reduce taxpayer burden and continuously grow the e-file program. Key strategies include:

- Make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.
- Substantially increase taxpayer access to electronic filing, payment, and communication products and services.
- Aggressively protect transaction integrity and internal processing accuracy.
- Deliver the highest quality products and services as promised.

- Partner with states and other governmental entities to maximize opportunities to reduce burden for our common customer base.
- Encourage private sector innovation and competition.

To achieve these strategic goals, we will continue to develop and implement e-file marketing strategies, expand the use of electronic signatures, and enhance our web site services for practitioners, taxpayers and stakeholders. Ultimately, our goal is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

Thus far, we have achieved enormous success. Over 95 percent of information returns are filed electronically or through magnetic media. For Tax Year (TY) 2003, 51 percent of individual returns and 18 percent of business returns were filed electronically. While we will not meet the statutory goal of 80 percent by 2007, we are seeing steady growth. We continue to focus on increasing the number of individual taxpayers who e-file their tax return. In 2005 (Tax Year 2004), we received 52 percent of individual returns electronically, which represents an increase of 8.3 million over the previous year. We are making steady, sustainable progress in individual e-filing as the chart below illustrates:

Calendar Year	# of Electronic Returns
2005	68,476,000
2004	61,428,268
2003	52,869,010
2002	46,836,082
2001	40,206,823
2000	35,402,150
1999	29,329,540
1998	24,580,300
1997	19,135,670
1996	14,968,400

We have also made considerable progress in terms of e-filing corporate returns. Effective for the FY 2005 tax year, large corporate taxpayers (those with over \$50 million in assets) that file at least 250 returns of any kind annually must e-file.

E-file has been available to corporations on a voluntary basis since 2004. In 2005, more than 200,000 corporations voluntarily filed their corporate income tax returns electronically, including about 1,200 corporations with assets exceeding \$10 million. As of March 26, 2006 more than 240,000 corporations filed their corporate income tax returns electronically. Tax-exempt organizations with \$100 million in assets that file at least 250 information returns a year also are required to file electronically this year.

For tax years ending on or after Dec. 31, 2006, the electronic filing requirement will be expanded to include the tax year 2006 returns of corporations and tax-exempt

organizations with \$10 million or more in total assets who file 250 or more returns a year. In addition, private foundations and charitable trusts will be required to electronically file Form 990-PF, regardless of their asset size if they file 250 or more returns a year. As of March 26, 2006, the IRS has received more than 1,400 electronically filed information returns from tax exempt organizations.

I encourage Congress to pass the Administration's proposal to expand the Secretary's authority to require electronic filing from businesses and exempt organizations to help us continue to expand electronic filing.

Free File

Free File's roots can be found in the President's FY 2002 Management Agenda. It contained five Government-wide initiatives, one of which was to expand electronic government. The overarching goal was to "champion citizen-centered electronic government that will result in major improvements in the federal government's value to the citizen."

Subsequently, in November 2001, OMB's Quicksilver Task Force established 24 e-government initiatives as part of the President's Management Agenda. These initiatives were designed to improve government-to-government, government-to-business, and government-to-citizen electronic capabilities.

One initiative instructed the IRS to provide free online tax return preparation and filing services to taxpayers. In accordance with this OMB directive, the IRS began working in partnership with the tax software industry to develop a solution. Two principles guided its development: no one should be forced to pay extra to file his or her return and the IRS should not get into the software business.

The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. Rather than entering the tax software business, IRS' partnership with private industry: (1) provides taxpayers with high quality services by using the existing private sector expertise; (2) maximizes consumer choice; (3) promotes competition within the marketplace; and (4) meets these objectives at the least cost to taxpayers.

On October 30, 2002, the IRS and the Free File Alliance, LLC, signed an agreement that created a public-private partnership to provide free services to the majority of taxpayers. The Free File Alliance, LLC, is a private-sector consortium of tax preparation software companies. The original agreement was for three years with a series of two year renewal options. The primary candidates for Free File were those taxpayers who prepare their own taxes and still file paper returns.

While membership in the Alliance may change from time to time, all members must meet certain IRS standards. Specifically, we must approve each member's proprietary tax

preparation software. In addition, each member must obtain third party privacy and security certification. Finally, all Alliance members must adhere to all Federal laws regarding taxpayer privacy.

Each Free File Alliance member was allowed to set taxpayer eligibility requirements for its program. Generally, eligibility was based on such factors as age, adjusted gross income, state residency, eligibility to file a Form 1040EZ or for the Earned Income Tax Credit. But, as a whole, under the original agreement, the Alliance was required to provide free services to at least 60 percent or 78 million of the nation's individual taxpayers. In addition, all active armed forces, federal reservist and National Guard personnel were eligible to free file through a separate program operated by the military.

While the IRS did not support or endorse any Free File Alliance company or product offered, it did provide a listing of the Alliance members via the Free File web page, which is hosted on IRS.gov. Companies were allowed to offer ancillary services to taxpayers for a fee, but the taxpayer was under no obligation to purchase any of those services as a condition of getting their Federal tax return prepared free of charge.

The intent of the Free File program was to reduce the burden on individual taxpayers, make tax preparation easier and expand the benefits of electronic filing to a majority of Americans. In the 2003 filing season, 2.8 million taxpayers took advantage of Free File. This number rose to 3.4 million in 2004. In 2005, the number increased to over 5 million.

The 2005 number may be a bit of an aberration in that many of the companies in the Alliance opted to lift qualification restrictions on taxpayers thus allowing any taxpayer, regardless of income, to utilize Free File. This started as some companies sought a competitive advantage by expanding their base and ended with many of the companies' offering free return preparation services to anyone.

While this was good for taxpayers in general, it posed a serious threat to the survival of the Alliance and was a prime topic of discussion when the contract was up for renewal at the end of last year. Many of the companies could not continue in the Free File Alliance unless it returned to offering the free service to low and moderate income individuals. The loss of these companies would have jeopardized the continued existence of the Alliance.

Renewal of Free File

It is important to remember that IRS' philosophy in developing Free File is that it would be a partnership between the Service and private tax preparation software providers.

Tax preparation is not an inherently governmental activity. Long before electronic filing became available, taxpayers used private sector companies to prepare and file their tax returns. Taxpayers today have the option of using third-party preparers or purchasing commercially available software and preparing the return themselves. In some cases, it

may be to the taxpayer's advantage to use a third party, particularly in complex situations that are subject to interpretation.

In terms of electronic filing, our partnership with private industry gives taxpayers high quality services, maximizes consumer choices, and promotes competition within the marketplace.

As we prepared for negotiations to extend the Free File agreement in 2005, the IRS took the position that Free File should be available to as many taxpayers as possible. The Alliance position was that Free File should only be available to low and moderate income taxpayers.

As is the case in most negotiations, we compromised and agreed that Free File would be offered to 70 percent of taxpayers, or anyone with an AGI of \$50,000 or less in 2005. This covers approximately 93 million of the 133 million taxpayers expected to file. This is an improvement over our earlier agreement which only guaranteed coverage of 60 percent or availability to 78 million taxpayers. The active armed forces, federal reservist and National Guard personnel continue to be eligible to free file under their own program.

The 70 percent taxpayer coverage is a national number. In many states the coverage rate is much higher. In Iowa for example, 71 percent of the taxpayers are eligible for Free File. In Montana, 78 percent of the taxpayers can Free File. In more affluent areas, the number of taxpayers eligible will be lower dependent on AGI.

In 2006, three Free File Alliance members are offering state filing for free. Seven members are offering to file F4868, Extension of Time to File Individual return. As of the end of February, 653 extension forms had been filed. In addition, there are two companies offering free packages in Spanish.

While the number of taxpayers taking advantage of Free File in 2006 will likely be less than in 2005, we are unable at this time to fully explain the decline. Certainly the fact that it is not available to everyone is one factor, but there likely are other factors as well.

A year ago, the Free File program was benefited greatly by a major article on the front page of *USA Today*. Immediately following that article, there was a tremendous surge of positive publicity as well as a surge in Free File usage by taxpayers. We have not been the beneficiary of similar publicity this year and to the extent we have received coverage much of it has focused on the taxpayers that Free File does not cover.

Ancillary Services

One of the major concerns that many critics of the Free File program have had has been the ability of the Alliance members to use Free File to market other services to taxpayers. These include the filing of state tax refunds and the offering of refund anticipation loans (RALs). We make it clear to taxpayers that the IRS does not endorse any of these

products or services nor is the completion of their tax return at no cost conditioned on the purchase of any product or service.

We generally do not know what if any fee services taxpayers actually use from the Free File vendors. The one service that we do have data on is refund anticipation loans (RALs). RALs are designed to provide the taxpayer an immediate refund in the form of a consumer loan. Often the costs incurred with the RAL are disproportionate to the amount of the refund, especially considering that a taxpayer that files electronically will get the refund from the IRS in about two weeks. Unfortunately, it is often low income taxpayers, the ones that can least afford it, who choose RALs.

What we are seeing from our Free File data thus far in this regard is encouraging. Only 0.6 percent of the taxpayers utilizing Free File have utilized a RAL. In fact, half of the Free File vendors do not even offer refund anticipation loans.

This 0.6 percent RAL participation for Free File is the lowest of any of our electronic filing groups. Other online filers have a 0.8 percent participation rate. The rate for online returns done by paid tax preparers is the highest. Approximately 20 percent of the preparer returns submitted electronically include a RAL.

Conclusions

Mr. Chairman, in summary, I would like to emphasize the following points:

- We are making tremendous progress in electronic tax administration. Our web site is an award winning site that gives taxpayers access to virtually everything they need to get their questions answered, determine their eligibility for things like the earned income tax credit and even file their returns.
- Currently, total e-file volume is up by 1.3 million returns. Online filing shows an increase of 2 million over last year and practitioner e-file is ahead of last years count by 1.9 million.
- We are also making progress on e-filing of corporate and tax exempt returns as e-filing is mandated for the largest companies and the largest tax exempt groups.
- The Free File program serves the twin objectives of keeping the IRS out of the tax preparation business and offers 70 percent of all taxpayers the ability to have their returns done at no cost,
- The Free File program has the lowest rate of RALs of any online filing group. Only 0.6 percent of Free File filers have utilized a RAL.

Thank you Mr. Chairman and I will be happy to respond to any questions that you may have.

