

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**Comments on (Temporary and Proposed) Regulations, REG-130671-04
Regarding Electronic Filing Requirements for Large Corporations and Exempt
Organizations**

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BACKGROUND

Proposed Implementation Schedule

On January 11, 2005, the IRS issued temporary and proposed regulations regarding requirements for electronically filing (1) income tax returns for large corporations and (2) annual information returns for certain exempt organizations, pursuant to sections 6011, 6033, and 6037 of the Internal Revenue Code.

Effective for taxable years ending on or after December 31, 2005, these regulations generally require (1) corporations with total assets of \$50 million or more to electronically file Forms 1120 and 1120S, and (2) tax exempt organizations with total assets of \$100 million or more to e-File Forms 990. Moreover, for taxable years ending on or after December 31, 2006, this electronic filing requirement will generally be expanded to include (1) the returns of corporations and exempt organizations with \$10 million or more in total assets; and (2) the Forms 990-PF for all private foundations and charitable trusts regardless of assets size. These electronic filing requirements only apply to entities that file at least 250 returns during a calendar year – including income tax, excise tax, information (e.g., Forms 1099 and W-2), and employment tax returns.

The AICPA supports the IRS's long-range goals for electronic tax administration in general, and electronic filing in particular. We also applaud the Service for its improvements over the last several years in the Form 1040 e-File program and for implementing the "Electronic Services" section on the IRS website, which includes a suite of web-based products for doing business with the IRS electronically.

We concur with Commissioner Mark W. Everson's January 11, 2005 comments that "electronic filing can improve both [the IRS's] service and enforcement missions." Moreover, we appreciate the administrative benefits e-filing offers, including faster tax processing, reduced cycle time, quicker identification of emerging audit trends, and the potential for more current resolution of taxpayer uncertainties.

The IRS introduced Modernized e-File in February 2004 for corporations and exempt organizations, the start of the voluntary e-File program for these entities. We acknowledge and commend the Service for actively reaching out to the AICPA and other stakeholders in 2003 to discuss the procedures and specifications of the voluntary e-File program the agency intended to implement for exempt organizations. In fact, during 2003 the AICPA reviewed the specifications for the exempt organizations voluntary e-File program and we made a number of suggestions for improvements in the program that were adopted by the Service. Unfortunately, the IRS did not actively seek input from stakeholders regarding the voluntary corporate e-File initiative prior to Service's January 2005 announcement of mandatory e-File.

However, our experience with the prior mandatory e-File program for large partnerships indicates that proper planning by and collaboration with the IRS is critical to successful implementation. Accordingly, we are very concerned that the approach being taken to date by the IRS in this sudden implementation of mandatory E-File for large corporations, large exempt organizations, private foundations, and charitable trusts does not provide adequate lead time for practitioners, the business community, exempt organizations, and software developers to prepare for what we view as dramatic change for taxpayers.

In particular, we are concerned that this implementation deadline coincides with another major corporate filing initiative – the new Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 million or more. This new schedule is effective for tax years ending on or after December 31, 2004. Since the IRS and the public are not cognizant of the full impacts or burdens that compliance with Schedule M-3 may place on taxpayers, we are worried that adding yet another compliance burden by implementing corporate e-filing in the same filing period will cause significant problems for taxpayers and the Service.

Furthermore, the risk management issues associated with the e-filing of corporate income tax returns by tax return preparers is staggering, and we do not believe the IRS has considered these issues. The IRS should work with the AICPA and other stakeholders to determine the reasonable cause standards to be applied for abatement of failure to file penalties when there has been a transmission or file error that causes the IRS's system to reject a return. In addition, the IRS must work with the preparer community to establish guidance as to the "timely" filing of rejected returns for purposes of making valid and timely elections on those returns before e-filing is mandatory.

The implementation of mandatory e-File will require significant process and technology changes by practitioners, the business community, exempt organizations, software developers and most importantly the affected taxpayers. Before these changes can occur, there must be substantial collaboration and coordination by the IRS with all impacted parties to insure that the new mandatory e-File program is successful and does not result in a considerable burden to taxpayers. While the IRS has done a commendable job in coordinating with stakeholders on the exempt organizations voluntary e-File program and possibly with software vendors on corporate e-File as well, taxpayers and practitioners (who prepare and file the vast majority of affected returns) have not been provided ample opportunity to share their concerns on corporate e-File. Given this failure, and for other reasons described below, we do not believe that the system will support taxpayers' needs at this time. Therefore, since the mandate will take effect in about ten months and no substantial planning, collaboration or testing has occurred thus far, we recommend that the IRS delay implementation of REG-130671-04 by at least one year so that these many issues can be resolved to ensure a smooth transition.

SPECIFIC COMMENTS

The Service's Previous Experience with a Mandatory E-file Program

As a result of the enactment of the Taxpayer Relief Act of 1997, the IRS and the practitioner community entered into an extended dialogue over several years regarding implementation of a

mandatory e-Filing requirement for large partnerships. Major difficulties centered around (1) an inability to file initially all, and then some returns electronically because of the difficulty software companies had with developing software to process certain required forms and schedules; and (2) a significant number of basic administrative and procedural issues.

It is our view that the IRS should expect, based on the experience with the large partnership e-File program, to encounter even more significant issues when implementing the new mandatory e-Filing program for large corporations and exempt organizations. Again, based on the lack of collaboration and planning that has taken place to date with the stakeholder community, we fear that the IRS does not appreciate the magnitude of the implementation issues that the agency and/or affected parties are likely to encounter as a result of this mandate.

We have received reports that the voluntary e-File program for exempt organizations, though involving a limited number of Forms 990, seems to be working satisfactorily. Nevertheless, even when taking into account the modest number of corporate tax returns that have been e-filed under the voluntary program, this is still nowhere close to the volume of returns that will be required to be filed electronically under the newly proposed mandate. More importantly, we are also concerned that few, if any, of the taxpayers who will be required to file electronically in 2006 have used the system, particularly with the result that it is untested with respect to the larger, more complex corporate returns that are mandated for electronic filing next year.

We must also stress the severe burdens that the mandatory e-File requirements for 2007 will have on smaller corporations and exempt organizations, small firm practitioners, and private foundations and charitable trusts. For example, even a simple C corporation with minimal real estate holdings could easily exceed the \$10 million total asset threshold involving 2006 tax year returns, thereby triggering the mandatory e-File requirements.

The current paper Form 990-PF requires private foundations to report (on attached schedules) all investments, such as (1) U.S. and state government obligations, (2) corporate stocks, (3) corporate bonds, (4) mortgage loans, and (5) capital gains and losses. Thus, a mandatory e-File program could readily prove very difficult for large numbers of private foundations without some type of accommodation for large schedules of securities and asset holdings (and transactions).

Announcement of the New E-File Program

During the last several years, the IRS has generally done an outstanding job in terms of seeking input from key stakeholders on the details and development of tax administration programs, prior to formal announcement of the program's start-up. During 2004, the AICPA and our members provided feedback on numerous draft IRS forms, examination reengineering proposals, training materials for the National Research Program (NRP) flow-through entity reporting compliance initiative, Schedule M-3, and other programs.

However, the IRS did not actively reach out and seek prior input from all key stakeholders in advance of the launch of the mandatory corporate e-File project. Instead, the IRS made its first public announcement of the new program on January 11, 2005; that is, the day the agency

publicly released the temporary and proposed implementing regulations. We urge the agency to try to minimize announcements of such significant new programs in this way in the future. Very often, when the IRS announces a new initiative without vetting the proposed program with stakeholders in advance, the program encounters significant problems, forcing the agency to suspend the program in mid-course.

Availability of Appropriate Technology and Software

As has been the case with other e-File mandates, it is expected that the IRS, practitioners, the business community, and software developers will experience technology related issues that will impact the success of this large-scale program. We have significant concerns that these technology issues have not been sufficiently explored, considered, or planned for.

Our members have reported that most of the major software vendors are currently offering e-filing of Form 990 for 2004 returns; and that (absent dramatic changes to this form) minimal modifications will need to be made to Form 990 under the new mandatory program. Nevertheless, particularly with respect to the mandatory corporate e-File program, we remain concerned that the IRS, software developers, tax practitioners and taxpayers are not ready for the launch of mandatory e-File beginning in 2006; which is only ten months from now.

It is our understanding based on discussions with tax software vendors that the e-File forms and program plans and requirements must be provided to the vendors no later than March or April 2005 in order to be ready for e-filing in January 2006. This is necessary to allow the software vendors to incorporate the forms and program plans into their applications in sufficient time to release their products for the 2006 filing season. Many taxpayers and practitioners will not accept software updates after the first product shipment, which for most vendors is in December. Seldom are updates taken after the first or second month of the year in order to mitigate various technology risks. IRS technology has to clearly take this into account as well.

There are also issues such as ensuring that the process to register as a transmitter and to test transmissions of returns is easy for taxpayers. Additionally, there are many issues regarding conversion of numerous accounting software systems into the approved electronic filing system that are quite challenging.

Security

Along with our concerns about software availability, our members also have concerns about what steps, if any, the IRS has taken to mitigate chances of a significant security breach. Corporate and exempt organization officers are likely to be very concerned about the risks associated with the implementation of a weak security system otherwise subject to attack by computer viruses or hackers attempting to steal sensitive financial data or tax return information. Before engaging in electronic filing, practitioners and taxpayers should be made comfortable with the security features of the e-File program.

We urge the IRS to initiate a dialogue with stakeholders about system security and encryption, including the extent to which the Service is employing knowledgeable security professionals to

resolve problems as the e-File program is rolled out. We further encourage the IRS to consider alternatives for filing such as on CD or DVD, thus mitigating taxpayers' concerns regarding internet security issues.

Development of a Consistent E-File Platform

The AICPA is supportive of the concept of moving corporations and exempt organizations to electronic filing, and we believe the best way to accomplish this is through the development of one nationwide e-File platform for both the IRS and state taxing authorities. A uniform platform would alleviate the multiple compliance burdens currently placed on taxpayers and practitioners, and reduce overall software development lead times and taxing authorities' administrative costs.

Hardship Waivers

The regulations' preamble states that the Service believes electronic filing will not impose significant burdens on taxpayers covered by the new regulations and therefore, the IRS will grant waivers for hardship from the electronic filing requirement only in "exceptional cases."

We appreciate that the IRS intends to issue guidance as to how a taxpayer may request a hardship waiver. Nevertheless, because the corporate and exempt organization e-File program is so new, the IRS should maintain a posture of flexibility on the issue of filing waivers and not attempt to establish a stated policy of only granting waivers in exceptional cases. We believe a posture of waiver flexibility is important based on our members' experiences with the large partnership e-File program, where a number of partnerships found it necessary to request waivers when software was not (under certain circumstances) available for processing an entire return electronically. In addition, we believe there might also be circumstances when an entity otherwise subject to the new e-file requirements should be eligible for an automatic hardship waiver as opposed to being required to file a formal waiver request.

We strongly recommend that final guidance on waivers include a clear definition of what constitutes justification for a waiver, examples, and a flexible standard on when a taxpayer would qualify for a waiver from the e-File requirement. Further, we encourage that this guidance be released publicly by March 31, 2005; or if not feasible, it should be released as early in the second quarter of 2005 as possible.

Defining "Timely" Filed Return

Under the regulations, organizations that "fail to file" an income tax return or information return "on magnetic media when required to do so" shall be "deemed to have failed to file the return," subject to civil penalty under IRC section 6651. However, section 6651 also provides for a reasonable cause exception.

The regulations' preamble states that "A return filed electronically is deemed to be filed on the date of the electronic postmark." While we strongly support the concept and use of an electronic

postmark with the new e-File program, we are concerned that the electronic postmark feature could become unworkable or meaningless should the IRS experience “capacity” problems with the mandatory e-File system. For example, it is not clear that the IRS will have the capacity to handle the electronic transmission of thousands of returns by large taxpayers at the same time on the last official day of the filing season. Under this example, there is a major question as to who bears the burden of failure if the transmission system overloads and breaks down. In other words, the IRS needs to find a way to accommodate the transmission of large numbers of tax returns without the system crashing.

The question as to who bears the burden of a transmission failure is a critical risk management issue whether we are talking about the business entity, the preparer, or the transmitter. In order to mitigate these risk management concerns, the IRS needs to clearly define what constitutes reasonable cause for purposes of penalty relief. For instance, given the sheer size of income tax returns for large corporations, there are clearly going to be instances when a taxpayer’s return transmission may fail due to legitimate circumstances, and guidance as to what will constitute reasonable cause in such circumstances should be set out.

Finally, it is critical that many business returns are deemed filed timely for purposes of making various elections that are required to be attached to those returns. Therefore, the IRS must provide clear and concise guidance as to when a return that is sent to the IRS electronically, but is rejected either because of transmission issues or IRS acceptance criteria, will be deemed “filed” for purposes of making timely elections.

Electronic Filing of Extensions

The IRS currently permits individual taxpayers to e-File Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. The ability to e-File Form 4868 is a positive and burden reduction opportunity for taxpayers.

The AICPA understands that the IRS is considering a number of burden reduction proposals in the area of extensions in general; and in particular, a proposal to create an automatic feature for extension requests through the removal of the signature and explanation requirements. This latter proposal is intended to encourage the e-filing of both Forms 4868 and 7004, Application for Automatic Extension of Time to File Corporate Income Tax Return. We believe a great deal of time and effort could be saved for taxpayers and practitioners by implementation of a consistent e-File extension program.

Conclusion

Based on the need for further planning and collaboration between the Service and stakeholders, we recommend that the IRS delay implementation of REG-130671-04 by at least one year so that the issues we raised above are resolved satisfactorily. During this transition period from a voluntary to a mandatory e-File program, we look forward to working with the Service to develop, test, and ultimately implement an effective program for taxpayers.

The AICPA would be pleased to discuss these comments with the IRS at any time. If you have any questions, please contact Thomas J. Purcell, III, Chair of the Tax Executive Committee, at (402) 280-2062 or tpurcell@creighton.edu; Mark VanDeveer, Chair of the IRS Practice and Procedures Committee, at (757) 422-4470 or markv12@juno.com; or Benson S. Goldstein, AICPA Technical Manager at (202) 434-9279 or bgoldstein@aicpa.org.