



*Repeated Efforts to Modernize Paper Tax
Return Processing Have Been Unsuccessful;
However, Actions Can Be Taken to
Increase Electronic Filing and
Reduce Processing Costs*

September 10, 2009

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 10, 2009

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs
(Audit # 200940010)

This report presents the results of our review to assess the Internal Revenue Service's (IRS) strategy to convert paper-filed individual income tax returns into an electronic format. This audit was included as part of our Fiscal Year 2009 Annual Audit Plan under the major management challenge of Modernization of the IRS.

Impact on the Taxpayer

In Calendar Year 2008, the IRS received 156.3 million individual income tax returns, of which 66.4 million (42.5 percent) were paper-filed. The IRS has devoted significant resources to identify ways it could modernize its method for processing paper tax returns but has had no success. Actions can be taken including mandating electronic filing (*e-filing*) for paid preparers and developing processes to convert paper returns into an electronic format which would significantly reduce paper filings, processing costs, and error rates, with the added benefit of faster tax refunds and more accurate tax returns for taxpayers.

Synopsis

The IRS continues to receive large numbers of paper-filed individual income tax returns despite a continued growth in *e-filing*. Processing of paper-filed tax returns costs the IRS approximately \$190.6 million. Error rates are considerably higher for paper-filed tax returns. Many errors are due to IRS employee keypunch errors when inputting information from the paper tax returns into



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

IRS computers. In contrast, *e-filed* tax returns are sent through a number of validations before the IRS accepts them. Unlike a paper tax return, an *e-filed* tax return is not accepted until the

Because the IRS has not been able to implement a modernized submission processing system to convert paper tax returns into an electronic format, it has to continue to use a labor intensive, costly, and error-prone system.

validity check confirms the tax return is free of errors. Once notified of an error, the taxpayer or preparer has to correct the tax return and resubmit it through *e-filing* or by paper. In some instances, rejected returns are not resubmitted.

Repeated efforts have been initiated to modernize paper tax return processing with no success. Significant resources have been expended on developing modernization concepts. Since at

least as far back as 1988, the IRS has attempted to develop a system to replace its current paper tax return processing. However, these efforts have resulted in little more than conceptual visions.

While the IRS has not been able to move beyond the conceptual stage for modernizing paper processing, there are actions that would reduce paper filings and/or convert paper tax returns into an electronic format. These options could result in a significant increase in *e-filing* as well as significant processing cost savings to the IRS. The options are:

- Mandate *e-filing* for paid preparers (this option would require a change in the law). The majority of paid preparers are already familiar with operating in an electronic environment. Most paid preparers who filed paper tax returns¹ actually used an electronic tax software preparation package and 70 percent also *e-filed* at least 1 tax return, which indicates a familiarity with the electronic preparation and *e-filing* process.
- Convert residual paper returns into an electronic format. Updating the Modernized Submission Processing concept to include pursuing successful processes followed by States that use scanning technology could provide the IRS with an option to convert paper-filed tax returns into an electronic format, thereby reducing processing costs associated with paper-filed tax returns.

Implementation of these 2 options could result in a 26.9 percent increase in *e-filing*, with cost savings of \$66.6 million annually (\$333 million over 5 years), and provide the ability to convert 13.2 million paper tax returns into an electronic format.

¹ For the purpose of this report, we defined paid preparers as those that included a preparer Social Security Number, Preparer Tax Identification Number, or Employer Identification Number and prepared six or more tax returns. It excluded returns prepared by volunteer preparers.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Recommendations

We recommended that the Commissioner, Wage and Investment Division, pursue implementing successful processes followed by States that use scanning technology (Optical Character Recognition and Two-Dimensional Bar Codes) to convert paper-filed tax returns prepared by individuals using a tax preparation software package into an electronic format.

Legislative Recommendation

Consider mandating *e-filing* for all paid preparers.

Response

IRS management agreed with the two recommendations. The Wage and Investment Division will pursue the implementation of processes that use scanning technology (Optical Character Recognition and Two-Dimensional Bar Codes). Two-Dimensional Bar Codes will be a project proposal for the 2012 Modernization Vision and Strategy planning cycle. In the meantime, a new proposal will be submitted to enhance legacy systems with Two-Dimensional Bar Code capabilities. The legislative recommendation is currently under consideration by the Department of the Treasury and included in the President's Fiscal Year 2010 budget request. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Table of Contents

Background	Page 1
Results of Review	Page 5
Repeated Efforts Have Been Initiated to Modernize Paper Submission Processing With No Success	Page 5
Actions Are Needed to Reduce Paper-Filed Tax Returns and/or Convert Paper Tax Returns to an Electronic Format	Page 7
<u>Recommendation 1:</u>	Page 12
<u>Recommendation 2:</u>	Page 17
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 18
Appendix II – Major Contributors to This Report	Page 19
Appendix III – Report Distribution List	Page 20
Appendix IV – Outcome Measure	Page 21
Appendix V – Management’s Response to the Draft Report	Page 22



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Abbreviations

<i>e-file(d); e-filing</i>	Electronically file(d); electronic filing
ETAAC	Electronic Tax Administration Advisory Committee
FY	Fiscal Year
IRS	Internal Revenue Service
2-D Barcode	Two-Dimensional Bar Code



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

Background

The Internal Revenue Service (IRS) continues to receive large numbers of paper-filed individual income tax returns despite a continued growth in electronic filing (*e-file*). In Calendar Year 2008, the IRS received 156.3 million individual income tax returns of which 66.4 million (42.5 percent) were paper-filed. As of May 1, 2009, the IRS had received 40.6 million paper-filed tax returns, representing 30.9 percent of the 131.6 million individual income tax returns received. The IRS recognizes that even though it is getting closer to meeting its 80 percent *e-file* goal,¹ paper-filed tax returns will continue to present a challenge in the foreseeable future. Figure 1 provides IRS projections on the volume of individual paper-filed tax returns for Calendar Years 2010 through 2015.

Paper-filed individual tax returns accounted for 42.5 percent of tax returns received in Calendar Year 2008. Processing of these returns cost the IRS approximately \$190.6 million.

Figure 1: Projected Filing Volumes of Individual Tax Returns (as of October 2008)

Year	Total Returns	Number of E-File Returns	E-File Percentage	Number of Paper-Filed Returns	Paper-Filed Percentage
2010	140,903,300	98,310,400	70%	42,592,900	30%
2011	141,565,500	103,357,600	73%	38,207,900	27%
2012	143,096,300	106,771,700	75%	36,324,600	25%
2013	144,218,200	109,552,500	76%	34,665,700	24%
2014	144,921,000	112,223,300	77%	32,697,700	23%
2015	145,599,200	114,486,800	79%	31,112,400	21%

Source: IRS' 2008 Calendar Year Return Projections for the United States and IRS Campuses² (Document 6186).

¹ The IRS Restructuring and Reform Act of 1998 required that paperless filing should be the preferred and most convenient means of filing Federal tax and information returns. It should be the goal of the IRS to have at least 80 percent of all returns filed electronically.

² The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

E-filing provides processing and error resolution savings

E-filed tax returns provide the IRS with significant processing cost savings and low error rates:

- IRS processing costs: \$0.35 for an *e-filed* tax return versus \$2.87 for a paper-filed tax return.³
- Error rates:⁴ historically, less than 2.5 percent for *e-filed* tax returns versus more than 25 percent for paper-filed returns.⁵

Error rates are considerably higher for paper-filed tax returns largely because of IRS employee keypunch errors when inputting information from the paper tax returns into IRS computers. In contrast, *e-filed* tax returns are sent through a number of validations which check for more than 600 possible errors before the IRS accepts the tax return. *E-filed* tax returns that do not pass the validation checks are rejected and sent back to the taxpayer or preparer for correction. For example, validity checks are performed on the taxpayer name, address, Social Security Number, and year of birth. Errors include incorrect Social Security Numbers of dependents, incorrect birthdates, numbers in an alphabetic field, and invalid zip codes. Unlike a paper tax return, an *e-filed* return is not accepted as filed until the validity checks confirm the tax return is free of these types of errors. Once notified of an error, the customer has to correct the tax return and resubmit it through *e-file* or by paper tax return. In some instances, rejected returns are not resubmitted.

Taxpayers benefit when e-filing

Taxpayer *e-file* benefits include:

- **Faster refunds.** With *e-file*, taxpayers receive refunds in one-half the time it takes to file a paper tax return and receive a refund check. Taxpayers who choose Direct Deposit can receive their refund in as few as 10 days.
- **More accurate returns.** In addition to the error checks built into return preparation software, additional checks are performed during acceptance processing of *e-file* returns. These additional checks reduce the chance of receiving an error letter from the IRS.
- **Electronic confirmations.** Taxpayers are notified electronically that their returns have been received.

³ Advancing *E-file* Study Phase 1 Report, dated August 14, 2008.

⁴ The error rate is the percentage of returns that are identified by the Error Resolution System with a transcription, math, or other error.

⁵ IRS' Miscellaneous Monitoring Reports.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

- **File now, pay later payment options.** Taxpayers can file early and pay later by scheduling an electronic funds withdrawal to be debited on or before April 15th. Taxpayers can also pay by credit or debit card when they *e-file* their returns.⁶
- **Convenient Federal/State *e-filing*.** Taxpayers in 37 states and the District of Columbia can *e-file* their Federal and State tax returns in 1 transmission to the IRS. The IRS forwards the State data to the appropriate State tax agency.

Taxpayers can also receive no-cost *e-filing* by using the IRS' Free File program. The Free File program is a free Federal online tax preparation and *e-filing* program for eligible taxpayers developed through a partnership between the IRS and the Free File Alliance, LLC, a group of private-sector tax preparation companies. The program enables eligible taxpayers to use commercial tax software for free. Taxpayers with adjusted gross incomes up to \$56,000 can use the standard Free File options in Calendar Year 2009—that is approximately 98 million United States taxpayers.

In addition, there is an option that opens up the Free File program to nearly everyone, even those with incomes exceeding \$56,000. This option is Free File Fillable Forms. These Fillable Forms allow taxpayers to fill out their tax forms and *e-file* them with the IRS at no cost. These forms are only available through the Free File program link on IRS.gov (the public IRS Internet web site). This option does not include the step-by-step question and probe process, but it does allow taxpayers to enter their tax data, perform basic math calculations, sign their tax returns electronically, print their returns for recordkeeping, and *e-file* their returns. This option may be right for those who are familiar with the tax law, know what forms they want to use, and do not need assistance.

The IRS initiated an Advancing E-File Study in an effort to meet the e-file goal set by Congress

The goal of the IRS' Advancing *E-file* Study is to help the IRS validate and launch future studies, research, and other activities to meet the goal of an 80 percent *e-file* rate set by Congress. Specifically, the IRS initiated a major effort to collect, synthesize, and analyze all substantial data on the IRS *e-file* program in one document called the *Advancing E-file Study Phase 1 Report*, dated August 14, 2008. The report includes the program's history, stakeholders, taxpayer and preparer behaviors, related programs and efforts, and options for expansion. The Phase 1 report does not include recommendations on selecting or implementing specific options for advancing *e-file*, but lays the foundation for doing so in future phases.

Phase 2 of the Advancing *E-file* Study is underway and was planned for completion in spring/summer 2009; however, it has been pushed back until the fall of 2009. Phase 2 will

⁶ For credit and debit card transactions, there is a fee charged by the service providers. Fees are based on the amount of the payment and may vary by service provider.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

include a cost/benefit analysis of the options to increase *e-file* based on original research of taxpayer and preparer motivators and analysis of the business and engineering/costing studies of those options.

This review was performed at the Wage and Investment Division Submission Processing function offices in Lanham, Maryland, and the Austin Submission Processing Site in Austin, Texas, during the period December 2008 through May 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

Results of Review

Repeated Efforts Have Been Initiated to Modernize Paper Submission Processing With No Success

The IRS has devoted significant resources to initiate studies to identify ways the IRS could modernize its method for processing paper tax returns. In order to process paper tax returns, information on the tax return must be entered by hand into a computer by an IRS employee. This manual process of inputting information into a computer system converts the information into an electronic format, which then can be processed electronically. The IRS has studied different ways to automate this labor-intensive and costly process.

The IRS process to receive and input paper-filed tax returns is extremely labor intensive, costly, and prone to errors.

However, none of these studies have moved beyond the concept stage, which leaves the IRS expending significant resources (\$190.6 million annually) to process paper-filed tax returns. Current processing methods require the IRS to employ more than 5,000 data transcribers during peak processing. For decades, the IRS has used an elaborate manual system to process its U. S. Individual Income Tax Return (Form 1040) series of paper tax returns. Paper returns are:

- Received and opened in a mailroom, then sorted and batched by return type.
- Coded and edited to prepare the returns for transcription by ensuring all tax forms are attached, completed, and signed. Special codes are also applied as needed to perform specific computations of tax liabilities, and then a Document Locator Number is added.
- Transcribed into IRS computers.
- Corrected for taxpayer and IRS errors.
- Filed for storage.

Without a modernized paper submission processing system that converts paper tax returns into an electronic format, the IRS will continue to have to use its labor-intensive, error-prone, and costly system to process paper-filed tax returns. In addition, the manual transcription of information from paper-filed tax returns into IRS computers has historically high error rates, which causes costly rework in order to ensure returns are correctly processed and cause no harm to taxpayers.



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

Significant resources have been expended developing modernization concepts

Since at least as far back as 1988, the IRS has attempted to develop a system to replace its current paper tax return processing. However, none of these efforts have resulted in more than conceptual visions. Figure 2 provides the progression of efforts conducted to modernize paper submission processing.

Figure 2: Efforts Initiated to Modernize Paper Submission Processing

1988	<i>Document Processing System</i> – Developed to replace the IRS’ labor-intensive, paper-based tax return processing system using imaging technology and Optical Character Recognition.	Cancelled due to cost overruns.
2003	<i>Submission Processing Visioning Taskforce</i> – Established to develop a 2–6 year overarching vision for the future submission processing organization, processes, and systems.	Concept was approved to pursue funding and then the concept was rolled into the next proposal.
2004	<i>Modernized Paper Pipeline Processing Proposal</i> – Proposal for a system capable of processing all IRS form types using the latest Optical Character Recognition, Intelligent Character Recognition, and Two-Dimensional Bar Code (2-D Barcode) recognition technology to capture information from the different submissions and convert that information into an electronic format.	Funding was pursued but not approved.
2007	<i>Modernized Submission Processing Proposal</i> – Current conceptual approach for an investment proposal to modernize paper submission processing.	Funding request was delayed.

Source: Treasury Inspector General for Tax Administration research and interviews with IRS officials.

Modernized Submission Processing is the IRS’ latest concept

The IRS has completed work on the Modernized Submission Processing concept, its latest effort for modernizing paper tax return processing. This concept provides for a system that will automate the extraction of paper tax return information. The IRS projects that the system would cost an estimated \$66.2 million in development costs. After the system is fully implemented, the recurring operation and maintenance costs are estimated to be \$10.7 million per year. The IRS



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

had planned to request funding for the concept in Fiscal Year (FY) 2010; however, no funding was ultimately requested.

The concept provides for a paper processing system that will use optical scanning, automated data extraction through Optical Character Recognition and 2-D Barcodes, modernized and legacy data export, and return-of-record image archive for the Form 1040 series of returns. The initial deployment was proposed for August 2011 at one of the three campuses that process paper-filed individual income tax returns with deployment to the remaining campuses in August 2012.⁷ The IRS anticipated that numerous benefits would be realized once fully implemented and estimated that \$67 million per year would be saved.

- \$30 million from eliminating the Full-Time Equivalents⁸ required to process paper returns. This estimate is based on the labor and overhead costs for the function used to input a paper tax return.
- \$16 million from eliminating the expense of maintaining the Service Center Recognition Image Processing System. The cost savings for this system is the annual maintenance costs. The Service Center Recognition Image Processing System will be retired once the new system is fully implemented.
- \$21 million from eliminating the expenses for the filing and storage of paper tax returns. Files and storage savings were based on savings from the contract with the National Archives and Records Administration and the cost of IRS files operations.

The Modernized Submission Processing Solution Concept⁹ has been completed and was previously ranked by IRS senior executives as one of the top new modernization priorities for the FY 2010 investment portfolio. However, no funding was ultimately requested for FY 2010, and it is no longer on the IRS' Enterprise Prioritization list for funding in FY 2010 or FY 2011.

Actions Are Needed to Reduce Paper-Filed Tax Returns and/or Convert Paper Tax Returns to an Electronic Format

While the IRS has not been able to move beyond the conceptual stage for modernizing paper submission processing, there are actions that would reduce paper filings and/or convert paper tax returns into an electronic format. These options can result in a significant increase in *e-filing* as well as significant processing cost savings to the IRS. The options are:

⁷ Processing of certain business returns was proposed for July 2013.

⁸ A measure of labor hours in which 1 Full-Time Equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2008, 1 Full-Time Equivalent is equal to 2,096 staff hours. For FY 2009, 1 Full-Time Equivalent is equal to 2,088 staff hours.

⁹ A Solution Concept is the first step toward the development of a modernization investment proposal and documents the project scope, assumptions, timeline, risks, and the technical solution envisioned.



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

- Mandate *e-filing* for paid preparers¹⁰ (this would require a change in current law).
- Convert residual paper returns into an electronic format.

Implementation of these options could result in a 26.9 percent increase in *e-filing* with processing cost savings of \$66.6 million annually as well as the ability to convert 13.2 million tax returns¹¹ into an electronic format.

Mandating e-file for paid preparers

A Federal mandate for paid preparers to *e-file* individual income tax returns would result in an increase of 26.9 percent¹² in *e-filed* tax returns and reduce IRS paper tax return processing costs by \$66.6 million annually.¹³ The majority of paid preparers are already familiar with operating in an electronic environment. Most paid preparers who filed paper tax returns actually used an electronic tax software preparation package and 70 percent also *e-filed* at least 1 tax return, which indicates a familiarity with the electronic preparation and *e-filing* process. However, while paid preparers are willing to *e-file* returns, some taxpayers are reluctant to do so, according to IRS management. Analysis of IRS return processing data for Processing Year 2008 showed that:

- 26.4 million (40.8 percent) of the 64.8 million paper-filed Forms 1040 were filed by 538,782 paid preparers; 21.6 million (81.5 percent)¹⁴ of these were prepared using an electronic tax software preparation package and then mailed to the IRS.
- 378,056 (70 percent) of the 538,782 paid preparers also *e-filed* at least 1 tax return and, of the remaining preparers who did not *e-file* at least 1 tax return, 141,967 prepared a tax return using computer preparation software, which indicates they are familiar with the electronic preparation and *e-filing* process.

¹⁰ For the purpose of this report, we defined a paid preparer as those who included a preparer Social Security Number, Preparer Tax Identification Number, or Employer Identification Number and prepared six or more tax returns. We excluded returns prepared by volunteer preparers.

¹¹ Prepared by taxpayers using tax preparation software then printed and mailed.

¹² Based on current IRS projections for Processing Year 2010.

¹³ Processing cost savings are based on a 26.4 million increase in *e-filing* by paid preparers and the \$2.52 difference in the cost of processing a paper return and an *e-filed* return.

¹⁴ Totals may not compute to those presented due to rounding.



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

Figure 3 illustrates the methods used by paid preparers for paper return submissions.

Figure 3: Methods Used by Paid Preparers to Prepare Paper Returns (Processing Year 2008)

Method Used by Paid Preparers to Prepare Paper Returns	Returns	Percent
Handwritten	4,882,074	18.5%
Computer	21,565,688	81.5%
Total	26,447,762	100.0%

Source: Treasury Inspector General for Tax Administration analysis of the IRS' Individual Return Transaction File¹⁵ for Processing Year 2008.

Federal law currently prohibits the IRS from mandating e-filing

Federal law currently prohibits the IRS from requiring *e-filing* of individual income tax returns. In order for a Federal mandate of individual *e-filing* to be implemented, the law would have to be changed. Advisory Groups and the Government Accountability Office have reported to Congress the benefits that could be achieved by mandating *e-filing*:

- The Electronic Tax Administration Advisory Committee (ETAAC) has advocated a Federal *e-file* mandate for several years. In its June 19, 2008, Annual Report to Congress,¹⁶ the ETAAC reported, “At this time, [the] ETAAC believes that all reasonable voluntary means have been exhausted with respect to encouraging preparers to *e-file* Individual Tax Returns, and it is time to take a stance by announcing an *e-file* mandate for tax return preparers.”
- The IRS Oversight Board agreed with the ETAAC’s recommendation in its *Electronic Filing 2008 Annual Report to Congress*.¹⁷ The Board supports the concept that Congress should lift the statutory prohibition on *e-filing* mandates for individual returns and give the IRS the discretion to implement such *e-file* mandates in the future as might be appropriate.
- The Government Accountability Office has also suggested an *e-file* mandate. Its 2006 Filing Season report¹⁸ suggested that Congress should mandate *e-filing* by paid tax preparers meeting criteria such as filing a certain number of tax returns. The Government Accountability Office stated, “With the slowing growth rate in electronic filing, [the] IRS

¹⁵ The Return Transaction File contains all edited, transcribed, and error-corrected data from the Form 1040 series and related forms for the current processing year and 2 prior years.

¹⁶ *Electronic Tax Administration Advisory Committee: Annual Report to Congress*, dated June 19, 2008.

¹⁷ *IRS Oversight Board: Electronic Filing 2008 Annual Report to Congress*, dated January 2009.

¹⁸ *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings* (GAO-07-27, dated November 2006).



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

is missing an opportunity to generate additional savings. Federal and [S]tate mandates for electronic filing have demonstrated success in increasing electronic filing; however, [the] IRS currently lacks the authority to mandate electronic filing for certain income tax returns such as individual returns filed by paid tax preparers. Using IRS estimates, savings from such a mandate could be on the order of \$60 million per year.”

It should also be noted that the President’s FY 2010 budget request for the IRS contains a legislative proposal to expand *e-filing* requirements for paid preparers. This proposal would allow regulations to require that tax return preparers who file more than 100 returns (or any other person who files more than 250 returns) *e-file* tax returns for individuals, estates, and trusts.

Many States are already mandating *e-filing* for paid preparers

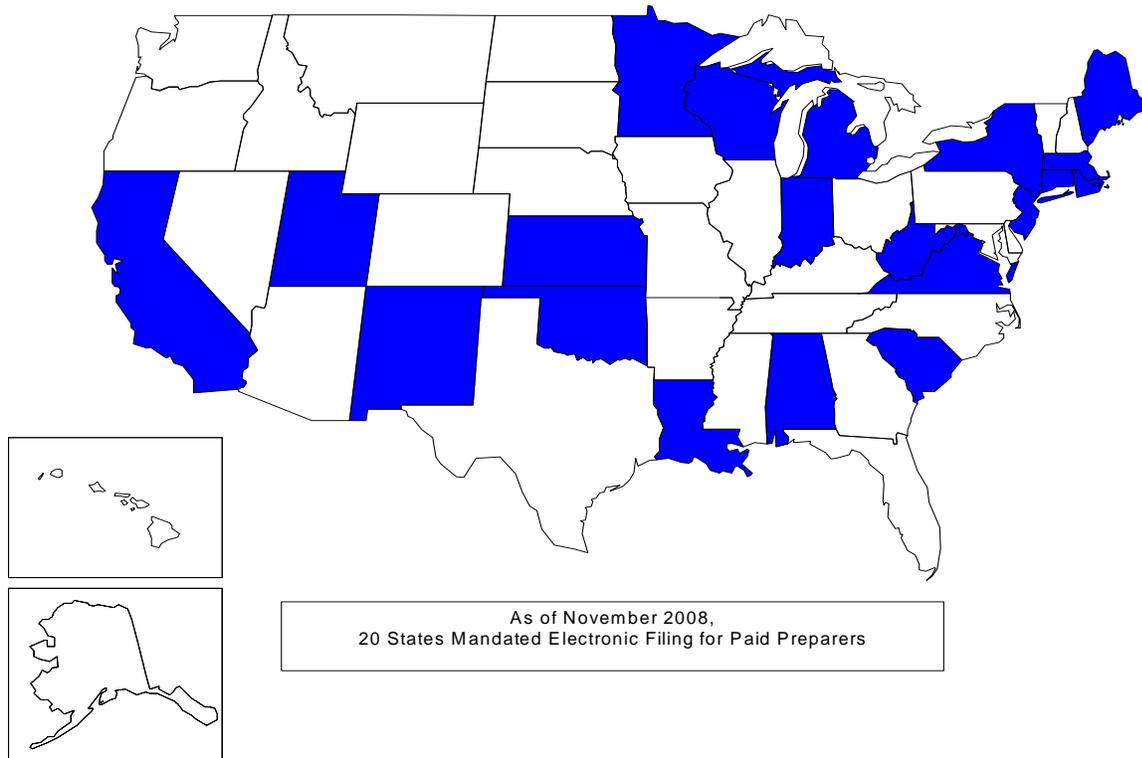
In recent years, a number of States have adopted requirements mandating that certain paid preparers must *e-file* all tax returns they prepare. As of November 2008, 20 (47 percent) of the 43 States that have a personal State income tax¹⁹ have adopted some type of mandate that paid preparers *e-file* State individual income tax returns. Some of these States have included volumes of tax returns prepared when determining which specific preparers have to *e-file*. For example, in 2004, the State of California mandated that tax preparers who prepared more than 100 California individual income tax returns during the previous year had to *e-file* all of their clients’ current year returns. Also, in 2008, the State of Kansas passed legislation that required paid preparers who prepare 50 or more returns per year to *e-file* not less than 90 percent of returns eligible for *e-filing*. Figure 4 shows the States that currently have an *e-file* mandate for paid preparers.

¹⁹ Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have a personal State income tax.



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

Figure 4: Map of States With E-file Mandates for Paid Preparers



Source: Federation of Tax Administrators.

Significant processing cost savings could be achieved as a result of a paid preparer mandate

A Federal mandate requiring paid preparers to *e-file* would provide significant processing cost savings to the IRS and would accelerate the time it will take for the IRS to meet its 80 percent *e-filing* goal. In addition, this would significantly reduce the volume of tax returns with keypunch errors that would require correction. Figure 5 shows the expected *e-filing* increase of an *e-file* mandate.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Figure 5: Projected E-Filing Increase From an E-file Mandate

Projected Return Filings	Current Projection 2010	Percentage	With Mandate 2010	Percentage
Total Individual Returns Forms 1040/A/EZ	140,903,300		140,903,300	
Total Paper Individual Returns	42,592,900	30%	16,145,138	11%
Total Electronic Individual Returns	98,310,400	70%	124,758,162	89%

Source: IRS' 2008 Calendar Year Return Projections for the United States and IRS Campuses (Document 6186) and Treasury Inspector General for Tax Administration analysis of the IRS' Individual Return Transaction File for Processing Year 2008.

Mandating *e-filing* for paid preparers²⁰ for individual income tax returns would result in a 26.9 percent increase²¹ in the number of *e-filed* tax returns and would reduce IRS paper tax return processing costs by \$66.6 million annually. Over 5 years, potential processing cost savings could total approximately \$333 million.

Legislative Recommendation

Recommendation 1: Consider mandating *e-filing* for all paid preparers.

Management's Response: The IRS agreed with this recommendation, which is currently under consideration by the Department of the Treasury and included in the President's FY 2010 budget request. The initiative will require *e-filing* by tax preparers who file more than 100 tax returns in a calendar year. The proposal would be effective for tax returns required to be filed after December 31, 2010. Since the Department of the Treasury and the Administration have already considered the subject, the IRS does not plan to take further action with regard to this recommendation.

Converting residual paper returns into an electronic format

Electronic tax preparation software companies currently provide tax software packages that enable State tax agencies to optically convert paper-filed tax returns into an electronic format

²⁰ The IRS requires paid preparers to sign the tax returns they prepare and to identify themselves using *either* their Social Security Numbers or Preparer Tax Identification Numbers. If the preparer is self-employed or a member of a firm, they are also to provide their Employer Identification Numbers. Our analysis identified returns that included a preparer Social Security Number, Preparer Tax Identification Number, or Employer Identification Number and excluded returns prepared by volunteer preparers. The analysis further limited paid preparers to those that prepared six or more returns. This criterion was based on preparer identification issues reported in our report entitled *Inadequate Data on Paid Preparers Impedes Effective Oversight* (Reference Number 2009-40-098, dated July 14, 2009).

²¹ Based on current IRS projections for Processing Year 2010.



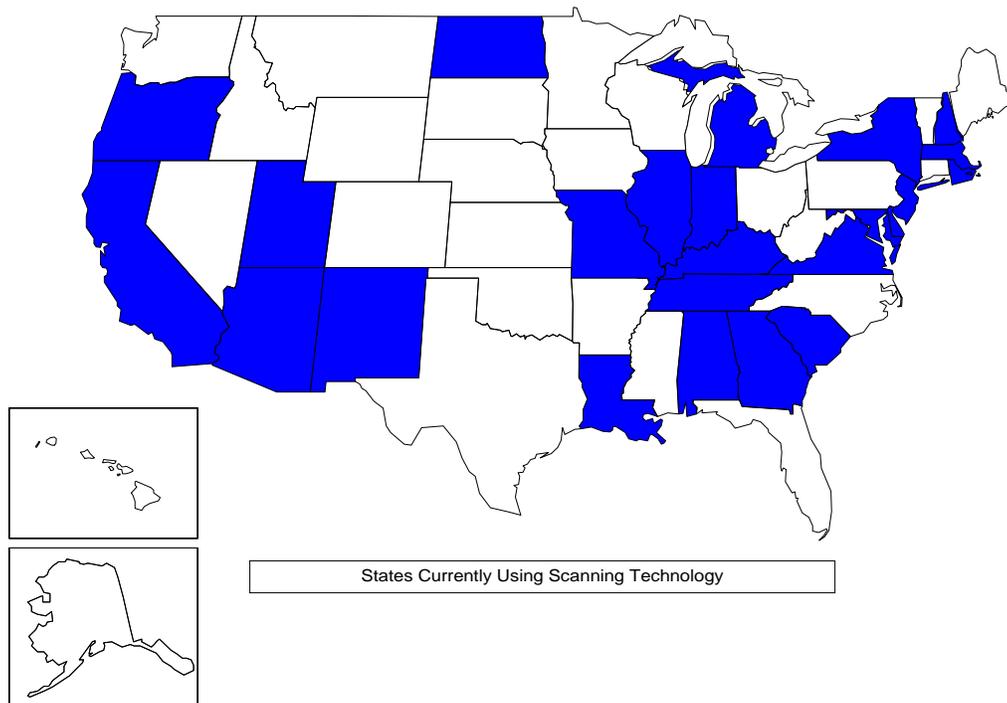
Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

using Optical Character Recognition and 2-D Barcodes. While mandating *e-filing* for paid preparers will significantly reduce the number of paper returns received by the IRS, it will not eliminate them. In Calendar Year 2008, taxpayers submitted 36.5 million paper returns of which 13.2 million, or 36.2 percent, were prepared using an electronic tax preparation software package. Yet these returns were mailed to the IRS as a paper tax return. The IRS will still need to develop a process to convert these residual paper returns into an electronic format.

Updating the Modernized Submission Processing concept to include pursuing successful processes followed by States that use scanning technology, including the use of Optical Character Recognition and 2-D Barcodes, could provide the IRS with an option to convert paper-filed tax returns into an electronic format, thereby reducing processing costs associated with paper-filed tax returns.

Representatives from the State of California told us that they partnered with tax software developers to provide a Scannable section called a “Scanband” on State personal income tax returns. Currently, 24 states are using scanning technology including scanbands and bar codes to improve the efficiency of tax return processing and in most of the States the bar code technology captures all data on a State individual income tax return. Figure 6 shows the States that currently use scanning technology.

Figure 6: Map of States Using Scanband and/or 2-D Barcodes



Source: Federation of Tax Administrators.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

The State of California Franchise Tax Board uses Optical Character Recognition to capture data and convert paper State personal income tax returns into an electronic format. The Franchise Tax Board uses high-speed scanners to take images of personal income tax returns and either captures data from scannable forms or uses the return image to hand input the data. The Franchise Tax Board's imaging system cost approximately \$12.8 million for nonrecurring development costs and a total of \$2.5 million in annual maintenance and operating costs. Last year, the Franchise Tax Board processed approximately 7 million paper personal income tax returns, of which 3.9 million (55.7 percent) used data captured from scannable forms. California State tax return preparers use tax preparation software that creates a scannable section on the face of the return called a "Scanband." The Scanband includes all the tax return information that is needed to process the return, such as name, address, income, and refund amount. The remaining pages of the return contain the same data that were included in the Scanband. Figure 7 shows the scannable version of a California Resident Income Tax Return.



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

Figure 7: California Resident Income Tax Return (Form 540) With Scanband

For Privacy Notice, get form FTB 1131.

California Resident Income Tax Return 2008 FORM 540 Cl Side 1

RAYMOND J TAXPAYER 10-05-06 P PRIORLASTNAME
 BONNIE A TAXPAYER 10-05-06 S PRIORLASTNAME
 BANK OF ANYTOWN
 123 MAIN ST APT 502
 ANYTOWN CA 95500-1111

01	2	37	0	408	0	RPE	0
06	0	38	0	409	0	PS	0
09	0	39	0	410	0	3800	0
10	0	40	0	411	0	3803	0
12	40000	41	0	412	15	SCHG1	1
14	20000	42	0	413	0	970A	1
16	4000	43	0	414	0	505 5805F	0
17	-10854	45	0	415	0	IDP12345678	0
18	25000	46	4000	62	0	EN 987654321	0
20	0	47	0	63	0	DESIGNEE	1
23	300	48	0	64	0		
25	0	49	0	66	975		
26	0	400	0	67	75		012345678
27	0	401	0	68	900		01234567890123456
28	0	402	10				1
31	0	403	0				012345678
32	0	404	0				01234567890123456
33	0	405	0				2
34	0	406	0				
36	5000	407	0			CHRISTOPHER R PREPARER JR PH 9165555121	

SCANBAND

1 Single 4 Head of household (with qualifying person). (see page 3)
 2 Married/RDP filing jointly. (see page 3) 5 Qualifying widow(er) with dependent child. Enter year spouse/RDP died.
 3 Married/RDP filing separately. Enter spouse's/RDP's SSN or ITIN above and full name here.
 If your California filing status is different from your federal filing status, check the box here
 6 If someone can claim you (or your spouse/RDP) as a dependent, check the box here (see page 9)
 7 Personal: If you checked 1, 3, or 4 above, enter 1 in the box. If you checked 2 or 5, enter 2 in the box. Whole dollars only
 If you checked the box on line 6, see page 9 7 X \$99 = \$
 8 Blind: If you (or your spouse/RDP) are visually impaired, enter 1; if both are visually impaired, enter 2. 8 X \$99 = \$
 9 Senior: If you (or your spouse/RDP) are 65 or older, enter 1; if both are 65 or older, enter 2. 9 X \$99 = \$
 10 Dependents: Enter name and relationship. Do not include yourself or your spouse/RDP.
 Total dependent exemptions... 10 X \$309 = \$
 11 Exemption amount. Add line 7 through line 10. Transfer this amount to line 21 11 \$

12 State wages from your Form (s) W-2, box 16 or CA Sch W-2 CG, line 3 12 40,000
 13 Enter federal adjusted gross income from Form 1040, line 37; Form 1040A, line 21; Form 1040EZ, line 4 13
 14 California adjustments--subtractions. Enter the amount from Schedule CA (540), line 37, column B 14 200,000
 15 Subtract line 14 from line 13. If less than zero, enter the result in parentheses (see page 11) 15
 16 California adjustments--additions. Enter the amount from Schedule CA (540), line 37, column C 16 4,000
 17 California adjusted gross income. Com line 15 and line 16 17 -10,854
 18 Enter the larger of your CA standard deduction OR your CA itemized deductions 18 25,000
 19 Subtract line 18 from line 17. This is your taxable income. If less than zero, enter -0- 19

20 Tax. Check box if from: Tax Table Tax Rate Schedule FTB 3800 FTB 3803 20
 21 Exemption credits. Enter the amount from line 11. If your federal AGI is more than \$163,187 (see page 13) 21
 22 Subtract line 21 from line 20. If less than zero, enter -0- 22
 23 Tax. (see page 13) Check box if from: Schedule G-1 Form FTB 5870A 23 300
 24 Add line 22 and line 23. Continue to Side 2 24

613 3101086

Source: California Franchise Tax Board Publication 1095D 2008.

In another example, the New York State Department of Taxation and Finance captures tax return data using 2-D Barcodes. This is a preferred option based on conversations we had with one large e-file provider because it is less confusing to the taxpayer since it looks like a regular tax return with a single cover sheet. A 2-D Barcode is a machine readable representation of information encoded in a pattern of two dimensions. Returns that are prepared on a computer



Repeated Efforts to Modernize Paper Tax Return Processing Have Been Unsuccessful; However, Actions Can Be Taken to Increase Electronic Filing and Reduce Processing Costs

and filed on paper have the data captured and printed in a 2-D Barcode capable of being read by either hand-held or high-speed scanners. As of June 2009, the State of New York processed 39 percent of its paper Tax Year 2008 returns using 2-D Barcodes. Figure 8 shows the cover sheet with 2-D Barcodes for the New York Resident Income Tax Return.

Figure 8: New York State Cover Sheet for Form IT-201 Resident Income Tax Return

For office use only New York State Department of Taxation and Finance
Cover Sheet for Form IT-201
Resident Income Tax Return
 New York State • New York City • Yonkers 2008 IT-201

This is the cover sheet of your return. For your return to be complete you must include this cover sheet with all four pages of Form IT-201 and all required attachments.

Taxpayer name and address	Software vendor code	
	1029	
Your social security number	Spouse's social security number	
111-11-1111	222-22-2222	
Your first name and middle initial	Your last name	
NELSON	TAXPAYER	
Spouse's first name and middle initial	Spouse's last name	
SPOUSE	TAXPAYER	
Mailing address (number and street or rural route)	Apt number	
STREET ADDR		
City, village or post office	State	ZIP code
CITY	IL	62794

Summary of return data

Federal adjusted gross income	25,243.
Total NYS adjusted gross income	25,150.
Total New York State tax withheld	
Total New York City tax withheld	
Total Yonkers tax withheld	
Amount to be refunded to you	1,353.
Amount you owe	

Staple check or money order here.

File this original e-scannable cover sheet with all four pages of your tax return.

Source: H&R Block.

These scanning technologies could be used in a rescaled version of the Modernized Submission Processing concept to provide the IRS with options to further reduce processing costs associated



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

with residual paper-filed tax returns subsequent to an *e-file* mandate. In addition, to further reduce implementation and equipment costs, the IRS should consider directing these taxpayers to submit returns to a single return processing site. Implementing a process to convert paper-filed tax returns that were prepared using a tax software package into an electronic format could result in further reductions in paper-filed tax return processing costs.

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 2: Pursue the implementation of successful processes followed by States that use scanning technology (Optical Character Recognition and 2-D Barcodes) to convert paper-filed tax returns prepared by individuals using a tax preparation software package into an electronic format.

Management's Response: The IRS agreed with this recommendation. The Wage and Investment Division will pursue the implementation of processes that use scanning technology (Optical Character Recognition and 2-D Barcodes). 2-D Barcodes will be a project proposal for the 2012 Modernization Vision and Strategy planning cycle. In the meantime, a new proposal will be submitted to enhance legacy systems with 2-D Barcode capabilities. Detailed requirements and timetables for that proposal are being developed, with a targeted implementation date of January 2011. It should be noted that there are budget and information systems prioritization constraints that may impact the IRS' ability to implement this recommendation.



*Repeated Efforts to Modernize Paper Tax Return Processing
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Increase Electronic Filing and Reduce Processing Costs*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of our review was to assess the IRS' strategy to convert paper-filed individual income tax returns into an electronic format. To accomplish our objective, we:

- I. Identified the process used to develop the strategy to convert paper-filed individual income tax returns into an electronic format.
- II. Identified the options the IRS considered and determined adequacy of testing of the various options, the accuracy of cost information included, and the method used to determine the potential benefits to be realized.
- III. Identified potential obstacles that could impact on the timely implementation of the strategy as well as IRS efforts to address the potential obstacles.
- IV. Identified processes used by State tax agencies to process paper-filed tax returns that could be used as a Best Practice.
- V. Determined the effect of an *e-file* mandate for paid preparers by analyzing 90,472,107 individual income tax return records¹ for Processing Year 2008 on the Individual Return Transaction File² and identified 26,447,762 paper individual income tax returns prepared by paid preparers.

¹ To assess the reliability of computer-processed data, programmers in the Treasury Inspector General for Tax Administration Office of Information Technology validated the extracted data, and we verified the appropriate documentation. In addition, run-to run balancing was performed and the data in the selected fields were analyzed to verify the validity of the data.

² The Return Transaction File contains all edited, transcribed, and error-corrected data from the U.S. Individual Income Tax Returns (Form 1040 series) and related forms for the current processing year and 2 prior years.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

Russell Martin, Director

Tina Parmer, Audit Manager

Steven Vandigriff, Lead Auditor

Karen Fulte, Senior Auditor



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Appendix III

Report Distribution List

Commissioner C
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Deputy Commissioner, Wage and Investment Division SE:W
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*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; return processing costs of \$66.6 million on 26,447,762 individual tax returns; \$333 million in return processing costs over 5 years (see page 7). It should be noted that realization of this outcome measure is contingent upon enactment of legislation.

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify from the IRS Individual Return Transaction File¹ a universe of 26,447,762 paper individual income tax returns filed by paid preparers in Processing Year 2008. Paid preparer returns were identified as those that included a preparer Social Security Number, Preparer Tax Identification Number, or Employer Identification Number. It excluded returns prepared by volunteer preparers, and we further limited paid preparers to those that prepared six or more returns. IRS return processing costs \$0.35 for an *e-filed* tax return versus \$2.87 for a paper-filed tax return. If the tax law is changed to mandate *e-file* for paid preparers, processing cost savings of \$333 million over 5 years could be put to better use.

¹ The Return Transaction File contains all edited, transcribed, and error-corrected data from the U.S. Individual Income Tax Returns (Form 1040 series) and related forms for the current processing year and 2 prior years.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
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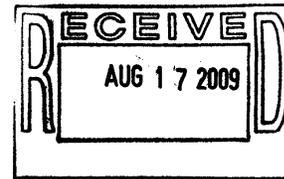
Appendix V

Management's Response to the Draft Report

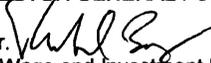


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

AUG 17 2009



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Repeated Efforts to Modernize Paper Tax
Return Processing Have Been Unsuccessful; However, Actions
Can Be Taken to Increase E-Filing and Reduce Processing
Costs (Audit #200940010)

I have reviewed the subject draft report and agree with your findings and recommendations. I also appreciate your acknowledgement of our efforts since 1988 to modernize paper returns processing. While your report focuses on systems modernization projects, we note that the IRS has achieved many efficiency and effectiveness gains in paper returns processing over these years. For example:

- Expansion of transshipment of work to maximize the use of all available resources.
- Service Center Recognition/Image Processing System (SCRIPS) 941 (Employer's Quarterly Federal Tax Return), 1096 (Annual Summary and Transmittal of U.S. Information Returns), 1099 (U.S. Information Return), Forms K-1 (Beneficiaries/Partners/Shareholders Share of Income, Credits and Deductions, etc.), and Federal Tax Deposit (FTD) coupons.
- Replacement of our data entry system to the Integrated Submission and Remittance Processing (ISRP) System for paper and remittance processing, as well as recent upgrades to the ISRP system.
- Implementation of Batch Block Tracking System (BBTS) in order to track work more efficiently.
- Improvement of mail opening systems with the Service Center Automated Mail Processing System (SCAMPS).
- Improvement of notice quality with Online Notice Review.
- Centralization of consolidated print sites made notice generation more efficient.
- Improvement of service to taxpayers through the Transcript Delivery System (TDS) and Income Verification Express Server (IVES).



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

2

- Improvement of quality through implementation of Embedded Quality (EQ), the Total Evaluation Performance (TEP) System, Computer Assisted Review of the Error Resolution System (CARE), and the Submission Processing Measures Analysis and Reporting Tool (SMART) Database to track performance.
- Partnered with other organizations to implement servicewide solutions for automation, such as the Account Management System (AMS) which allows for the electronic inventory control of entity transcripts and the Correspondence Imaging System (CIS) in the Files unit.
- Implementation of consolidation strategy which reduces the number of Submission Processing sites from 10 to 5. As part of this strategy, IRS recently implemented Remittance Strategy for Paper Check Conversion (RS-PCC) at all consolidated sites. This allows for the electronic transfer of payments at the point of receipt.
- The Customer Account Data Engine (CADE) posted a total of 39.8 million tax returns. This is a 30 percent increase from last year. For the first time, CADE posted a total of 7 million payments this year, with revenue in excess of 9.2 billion dollars. The CADE issued a total of 34.8 million refunds which is a 20 percent increase over last year, and processed and posted roughly 31 percent of all incoming returns filed this year, which is almost 10 percent better than last year.

Other noteworthy items are the fact that Submission Processing has been able to process special issues to execute tax laws such as the Economic Stimulus Payment and Recovery Rebate Credit, and administrative provisions such as the Telephone Excise Tax Refund. Submission Processing has also assisted other business units, operating divisions, and other government agencies during times of crisis, such as during Hurricane Katrina.

We agree with your legislative recommendation to consider mandating e-filing for all paid preparers. Electronic filing benefits both taxpayers and the IRS. This proposal is currently under consideration by the Department of Treasury and included in the President's Fiscal Year 2010 budget request for the IRS. We also agree with your recommendation to incrementally begin modernizing paper processing beginning with Two-Dimensional (2-D) bar coding. Implementation of this recommendation is contingent on IRS enterprise-wide information systems modernization priorities and funding.

Finally, we agree with the outcome measures reported in Appendix IV. Attached are our comments to your recommendations. If you have any questions, please call me at (404) 338-7060, or a member of your staff may contact Peter Stipek, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.

Attachment



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

Attachment

LEGISLATIVE RECOMMENDATION

RECOMMENDATION 1

Consider mandating *e-filing* for all paid preparers.

CORRECTIVE ACTION

We agree with this recommendation which is currently under consideration by the Department of Treasury and included in the President's Fiscal Year 2010 budget request. This initiative will require electronic filing by tax preparers who file more than 100 tax returns in a calendar year. The proposal would be effective for tax returns required to be filed after December 31, 2010. Since Treasury and the Administration have already considered the subject, we do not plan to take further action with regard to this recommendation.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 2

Pursue the implementation of successful processes followed by States that use scanning technology (optical character recognition and Two-Dimensional bar coding) to convert paper-filed tax returns prepared by individuals using a tax preparation software package into an electronic format.

CORRECTIVE ACTION

We agree with this recommendation. The Wage and Investment Division will pursue the implementation of processes that use scanning technology (optical character recognition and Two-Dimensional (2-D) bar coding). Two-Dimensional bar coding will be a project proposal for the 2012 Modernization Vision & Strategy planning cycle. In the meantime, a new proposal will be submitted to enhance legacy systems with 2-D barcode capabilities. Detailed requirements and timetables for that proposal are being developed with a targeted implementation date of January 2011. It should be noted that there are budget and information systems prioritization constraints that may impact our ability to implement this recommendation.



*Repeated Efforts to Modernize Paper Tax Return Processing
Have Been Unsuccessful; However, Actions Can Be Taken to
Increase Electronic Filing and Reduce Processing Costs*

2

IMPLEMENTATION DATE

January 15, 2011

RESPONSIBLE OFFICIAL

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

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal managerial control
system.