

Failure to Expand Digitalization Technology Leaves Millions of Taxpayers Without Access to Electronic Filing and Wastes IRS Resources

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TAXPAYER RIGHTS IMPACTED¹

- *The Right to Quality Service*
- *The Right to a Fair and Just Tax System*

EXPLANATION OF THE PROBLEM

Electronic filing (e-filing) has many benefits for taxpayers and the IRS. The transmission of data is quick and accurate, the automated processing of an e-filed form eliminates the need for the costly manual transcription of millions of lines of data, and the increased accuracy of the data imported reduces the need to resolve transcription errors. Digitalizing data also gives the IRS more flexibility to allow employees to work remotely.

While most taxpayers prefer e-filing when it is available, some prefer to file paper returns or must file on paper because they do not have access to a computer or broadband internet. Therefore, even as the IRS expands its e-filing options, it must maintain options that allow taxpayers to choose their preferred method of filing.

The IRS's antiquated information technology (IT) systems and infrastructure present significant obstacles to expanding e-filing and digitizing paper returns. Taxpayers can e-file some returns and forms; however, more than 40 active forms still require paper filing. Some taxpayers who e-file experience processing delays because the IRS cannot digitally accept certain documents attached to an e-filed return, requiring the taxpayer to file them separately on paper.²

The IRS should expand its electronic filing capabilities to allow all taxpayers an e-filing option, regardless of the return or any associated schedules, documents, and attachments. It must also improve the processing of paper returns by expanding existing technology and implementing new technology to reduce processing delays. These actions reduce burden to taxpayers and the IRS and produce long-term cost savings.

¹ See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

² See Form 8453, U.S. Individual Income Tax Transmittal for an IRS e-file Return (2020).

ANALYSIS

Taxpayers who e-file their returns gain the benefit of faster processing of their return, digital confirmation of filing and receipt, and the flexibility to file from anywhere if they can access the internet. Taxpayers who file by mail must rely on the IRS's ability to process mail efficiently, transcribe their return information accurately, and process payments and refunds promptly. The forced shutdown of the IRS's mail processing campuses during the 2020 filing season exposed the inflexibility of these interdependent manual processes. Between mid-March and June 1, the IRS could not process paper returns due to the COVID-19 shutdown, and as of November 20, 2020, it estimated there was a backlog of individual returns of one million unopened paper returns and 6.8 million returns it had not fully processed.³ Whereas, the IRS continued processing e-filed returns during the shutdown.

The pandemic reinforced the importance of the IRS embracing digitalization technology to allow taxpayers to transmit documents to the IRS electronically. It must develop a program to accept all forms through electronic means and capture and process the information submitted, either manually, electronically, or via a combination of the two.

There are many reasons the IRS cannot electronically process forms, including complexity, inclusion of attachments, and the potential tax impact on related or joint filers; however, none are true barriers to expanding e-filing or digital imaging of paper returns. The operational challenges arising under the pandemic forced the IRS to reconsider its stance on electronic communication, such as accepting wet (*i.e.*, handwritten) signatures.⁴ The IRS temporarily deviated from the wet signature requirement for more than a dozen forms in response to the pandemic and permitted the use of electronic signatures. This allowed taxpayers and their representatives to fulfill their filing responsibilities without being in the same physical location or relying on the mail to transfer documents and allowed the IRS to conduct its business untethered to a physical location.

The pandemic reinforced the importance of the IRS embracing digitalization technology to allow taxpayers to transmit documents to the IRS electronically. It must develop a program to accept all forms through electronic means and capture and process the information submitted, either manually, electronically, or via a combination of the two. Figure 1.5.1 provides a list of active forms that taxpayers cannot e-file and the number of each filed during 2019.⁵

3 *Hearing with IRS Commissioner Charles Rettig: Hearing Before the H. Ways and Means, Subcomm. on Oversight*, 116th Cong. (Nov. 20, 2020) (statement of Charles Rettig, IRS Commissioner).

4 *See, e.g.*, Form 2848, Power of Attorney and Declaration of Representative (Feb. 2020).

5 Some forms listed in this table are submitted multiple times for the same purpose before the IRS processes them properly. E-filing would cut down on repeated submissions and the overall volume of mail and follow-up calls.

FIGURE 1.5.1, Processing Year (PY) 2019 Filings of Forms Ineligible for e-Filing⁶

Forms	PY 2019 Filings
Form 2848, Power of Attorney and Declaration of Representative	2,318,162
Form W-7, Application for IRS Individual Taxpayer Identification Number	1,526,880
Form 8821, Tax Information Authorization	873,426
Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Currently e-filing is not available for Foreign-owned U.S. Disregarded Entities)	286,100
Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund	219,745
Form 1065X, Amended Partnership Return	103,264
Form 8332, Release of Claim to Exemption for Child by Custodial Parent	96,311
Form 14039, Identity Theft Affidavit	59,250
Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons	55,891
Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts	55,235
Form SS-4, Application for Employer Identification Number (for foreign companies)	53,950
Form 1139, Corporation Application for Tentative Refund	39,191
Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)	38,206
Form 730, Monthly Tax Return for Wagers	23,889
Form 12153, Request for a Collection Due Process or Equivalent Hearing	23,278
Form 8038-G, Information Return for Tax-Exempt Governmental Bonds	22,000
Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies	18,331
Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return	16,515
Form 4768, Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes	15,182
Form 8275, Disclosure Statement	8,383
Form 8703, Annual Certification of a Residential Rental Project	6,226
Form 843, Claim for Refund and Request for Abatement	5,486
Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts	4,101
Form 3115, Application for Change in Accounting Method	3,267
Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues	2,695
Form 1120-L, U.S. Life Insurance Company Income Tax Return	513
Form 8854, Initial and Annual Expatriation Information Statement	312
Form 14039-B, Business Identity Theft Affidavit	232
Form 8328, Carryforward Election of Unused Private Activity Bond Volume Cap	225

6 Data compiled from the IRS Compliance Data Warehouse (CDW) Individual Returns Transaction File (IRTF), Business Returns Transaction File (BRTF), Individual Master File (IMF), Business Master File (BMF), Modernized Tax Return Data Base (MTRDB), Electronic Tax Administration Research and Analysis System (ETARAS), Entity Application Programs (EAP), and Centralized Authorization File (CAF) databases. There are other forms that must be filed on paper but which are not transcribed (or for which complete data is not readily available) including: Form 56, Notice Concerning Fiduciary Relationship; Form 211, Application for Award for Original Information; Form 1045, Application for Tentative Refund; Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer (when Part 1 Boxes A and B are present); Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax; Form 4506, Request for Copy of Tax Return; Form 5074, Allocation of Individual Income Tax to Guam or the Commonwealth of the Northern Mariana Islands (CNMI); Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests; Form 8802, Application for United States Residency Certification; Form 8809-I, Application for Extension of Time to File FATCA Form 8966; Form 8822, Change of Address; Form 8898, Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Possession; and Form 8918, Material Advisor Disclosure Statement.

The IRS does not have a comprehensive plan showing when the remaining forms will be available for e-filing and when taxpayers can digitally submit non-form attachments. Quite simply, the IRS needs to make long-term investments in technology that would enable all taxpayers to e-file all forms and supporting documents.⁷

Modernized e-File System

The IRS provides a detailed set of communication procedures, transmission formats, business rules, and validation procedures that dictate what information taxpayers can and cannot e-file through the Modernized e-File (MeF) System.⁸ When determining the rules on e-filing, the IRS consults with the private industry to understand the latest digitalization strategies and solutions available in the marketplace, including costs and benefits.⁹ Before the IRS can change the business rules for e-filing, it determines the impact to processing and balances the competing priorities of reducing taxpayer burden while minimizing administrative burdens and downstream risk beyond the IRS's ability to manage.

When a taxpayer submits an e-filed return, the IRS automatically matches information on the return against its own records to determine whether to accept or reject the return. This process shifts the burden to the taxpayer of identifying and correcting an error causing the return to reject.¹⁰ If the taxpayer cannot correct the problem, he or she must file a paper return. While an automated process allows the IRS expeditious return processing and issuance of refunds, it means fewer taxpayers can e-file successfully.¹¹

Processing Costs

The cost of processing paper returns is enormous. The IRS spent more than \$77 million processing nearly 17 million¹² paper Forms 1040 in fiscal year (FY) 2019. It spends about \$4.78 to process a paper return compared to \$0.18 for an electronically filed return.¹³ Each paper filing is labor-intensive, requiring more than a dozen manual touches to process.¹⁴ The IRS must handle and store all that paper, spending \$37 million a year to manage, ship, process, transfer, and retrieve paper records.¹⁵ E-filing alleviates many of these costs. Over 920,000 taxpayers used tax preparation software but were unsuccessful in e-filing their 2018 tax return before needing to mail a paper return to the IRS.¹⁶ If those taxpayers had been able to electronically transmit their returns, the IRS could have realized significant cost savings and the taxpayers could have benefited by receiving expedited refund payments and improved data entry accuracy.

7 IRS response to TAS information request (Oct. 29, 2020).

8 See, e.g., IRS Pub. 4164, Modernized e-File (MeF) Guide for Software Developers and Transmitters (Dec. 2019).

9 IRS response to TAS information request (Oct. 29, 2020).

10 For example, an e-filed return would not be accepted for processing if the taxpayer's identity could not be confirmed. In that instance, a taxpayer would need to file a paper return.

11 Over 920,000 taxpayers used tax preparation software for their 2018 tax return and attempted to e-file the return but were unable to and had to mail a paper return to the IRS. IRS CDW, IRTF Entity table.

12 Approximately 16.8 million individual income tax returns were filed in FY 2019. IRS, FY 2019 Data Book Tables 3 and 4 (June 2020) (difference between total individual income tax returns and electronically filed individual income tax returns filed in FY 2019).

13 The total pipeline and non-pipeline cost per return is \$4.78. The processing cost for an electronically filed return is \$0.18. IRS, Document 6746, Cost Estimate Reference FY 2019 (June 2020).

14 IRS Services and Enforcement PMO (S&E PMO) Digitalization Overview (Oct. 2019).

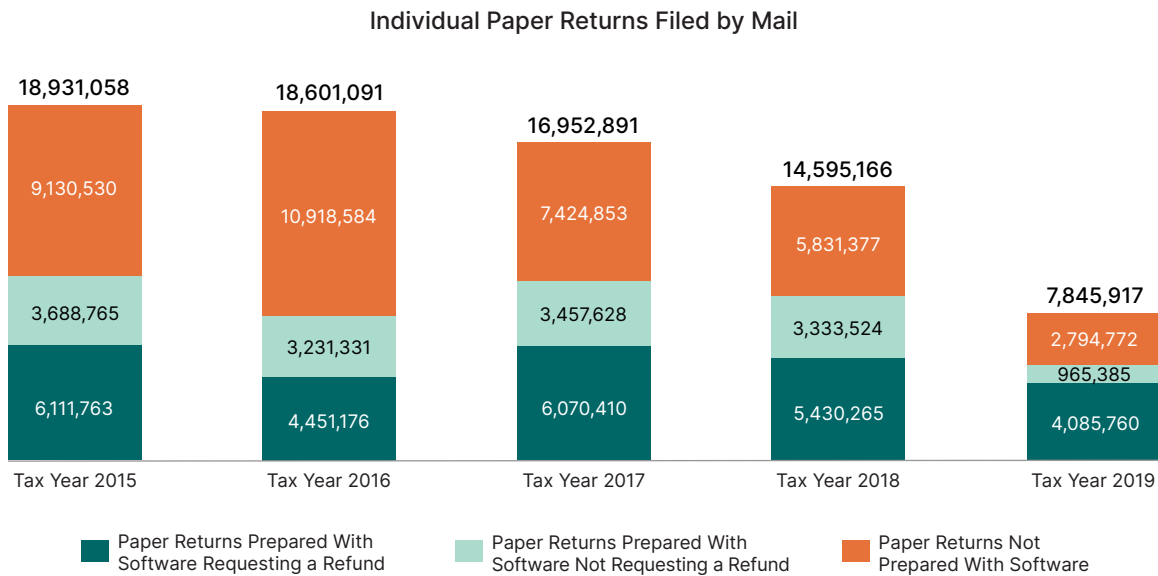
15 *Id.* A portion of this cost is attributable to the handling and storage of paper returns.

16 IRS CDW, IRTF Entity table.

Refund Delays

Although the number of taxpayers filing paper returns is steadily declining, millions of taxpayers continue to file paper returns by mail, as shown in Figure 1.5.2. More than half of taxpayers who file by mail prepare the return using tax software.¹⁷ Taxpayers filing by mail who were unable to e-file their return because of the IRS’s technological shortcomings experienced longer wait times to receive their refund.¹⁸ Taxpayers who e-filed their return claiming a refund generally received their refund via direct deposit within seven to 21 days or by paper check within 30 days.¹⁹

FIGURE 1.5.2²⁰



Transcription Errors

When processing paper returns, such as Form 1040, a submission processing employee manually enters the information from each line into IRS systems. Manual data entry inevitably leads to transcription errors, which then must be identified and corrected. For example, after the redesign of Form 1040 in 2018 to the “postcard” format,²¹ the IRS manually processed some returns without capturing all the data.²²

Since the IRS generally has no way of identifying transcription errors that are not systemic, taxpayers are in the difficult position of self-identifying any errors the IRS may make during the manual entry. It is not until

¹⁷ IRS CDW, IRTF Entity table, IRTF F1040 table.

¹⁸ Even with the excessive processing delays during the tax year 2019 filing season, 84 percent of taxpayers who prepared their return on software and filed by mail were seeking a refund.

¹⁹ IRS, Where’s My Refund?, <https://www.irs.gov/refunds> (last visited Dec. 21, 2020).

²⁰ IRS CDW, IRTF Entity table, IRTF F1040 table. The IRS continues to process 2019 returns. These numbers are as of November 17, 2020.

²¹ U.S. Dept. of Treasury, Treasury, IRS Announce Development of Postcard-Size Form 1040 for 2019 (June 29, 2018), <https://home.treasury.gov/news/press-releases/sm421>.

²² IRS response to TAS information request (Oct. 29, 2020).

the IRS sends a notification of additional tax due or other adjustment that the taxpayer learns of an issue. The taxpayer then has the daunting task of determining the cause of the error and correcting it.

The IRS reviews about two percent of manually transcribed returns to evaluate the accuracy of the processing.²³ However, that review is a measure of employee performance, not quality assurance. The average accuracy rate based on quality review held steady at about 80 percent during calendar year (CY) 2019 and the first nine months of CY 2020.²⁴ Any error rate related to manual transcription of paper returns is inherent to the transcription process — a process eliminated with electronic filing. Thus, more e-filed returns leads to fewer transcription errors.

Paper Processing Options

There are four campus facilities that process paper submissions. The IRS shifted processing between those locations based on resources to overcome the backlog of mail submissions caused by the pandemic.²⁵ The IRS plans to eliminate submission processing at two of those locations by 2025. As the IRS streamlines submission processing, it should ensure its paper processing campuses have the appropriate tools and technology to handle all individual paper filers and retain the flexibility to handle disruptions caused by disasters and unforeseen events.

Scanning Technology

The IRS engaged private industry and other government entities to explore the latest digitalization strategies and solutions²⁶ for processing forms that vary in type, length, and complexity. One such technology, Optical Character Recognition (OCR), incorporates a photoelectric machine that reads the information from a form and computer software that captures the data. OCR can be used on a digital file the taxpayer transmits or on a paper document the IRS scans into a digital format. The IRS should expand the use of OCR and similar technologies to automate processing and reduce the need for manual transcription, which would allow it to accept more forms and attachments electronically.

2-D Barcoding

Processing errors resulting from manual data transcription could be significantly reduced if the IRS worked with software providers to implement 2-D barcoding. 2-D barcoding adds a horizontal or vertical bar code containing the return information when printed. The IRS can record and capture the information reported on a return by scanning the barcode, eliminating the need for line-by-line data entry. The Government Accountability Office (GAO),²⁷ Treasury Inspector General for Tax Administration (TIGTA),²⁸ and the

23 IRS response to TAS information request (Oct. 29, 2020); IRS Submission Processing (SP) Filing Season Statistics Report, Report for Week Ending October 3, 2020.

24 IRS response to TAS information request (Oct. 29, 2020).

25 *Hearing with IRS Commissioner Charles Rettig: Hearing Before the H. Ways and Means, Subcomm. on Oversight*, 116th Cong. (Nov. 20, 2020) (statement of Charles Rettig, IRS Commissioner).

26 In July 2018, the Digitalization Working Group (DWG) issued a Request for Information (RFI), and shared information with both the Social Security Administration and U.S. Census Bureau to gain industry and peer insights on best practices for document imaging and digitalization technology and solutions.

27 GAO, GAO-18-544, *Tax Fraud and Compliance: IRS Could Further Leverage the Return Review Program to Strengthen Tax Enforcement* (July 2018).

28 TIGTA, Ref. No. 2007-40-105, *Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program* (June 28, 2007).

National Taxpayer Advocate²⁹ have urged the IRS to explore this technology, which it already uses on IRS Form K-1.³⁰ However, the 2-D barcoding the IRS uses is limited to fewer than 100 characters and would need to be upgraded to scan forms with significantly more characters, such as the Form 1040-series. Expanding 2-D barcoding would require upfront investment into new machines capable of reading barcodes but would lead to faster, more accurate processing of paper returns, with downstream cost savings for each return that an IRS employee does not need to manually transcribe.

CONCLUSION AND RECOMMENDATIONS

In the wake of the COVID-19 pandemic, the IRS has taken a fresh look at new — and not-so-new — technologies it has rejected in the past.³¹ The IRS should provide a means for taxpayers to file any form electronically. It should use existing technology to digitize information to allow taxpayers to send forms and returns that the IRS does not currently permit taxpayers to e-file.

And for taxpayers who choose or are required to paper file their return, the IRS should incorporate technology to reduce processing transcription errors. These practices would produce long-term cost savings and significantly reduce burden on both taxpayers and the IRS.

Preliminary Administrative Recommendations to the IRS

The National Taxpayer Advocate preliminarily recommends that the IRS:

1. Make and publish an e-file plan for the forms that taxpayers cannot e-file.
2. Reevaluate the MeF System to allow for e-filing of all forms, schedules, and attachments.
3. Expand the use of optical character recognition and 2-D barcoding to improve processing of paper filings and reduce processing transcription errors.
4. Make permanent all temporary changes to electronic or digital signature requirements the IRS implemented in response to the COVID-19 pandemic.

29 See National Taxpayer Advocate 2021 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Require the IRS to Work With Tax Software Companies to Incorporate Scanning Technology for Individual Income Tax Returns Prepared Electronically But Filed on Paper)*.

30 IRS, 2-D Bar Coding for Schedules K-1 is the Preferred Method, <https://www.irs.gov/e-file-providers/two-dimensional-bar-coding-for-schedules-k-1-is-the-preferred-method> (last visited Dec. 21, 2020).

31 See, e.g., IRS, IRS Operations During COVID-19: Mission-Critical Functions Continue, <https://www.irs.gov/newsroom/irs-operations-during-covid-19-mission-critical-functions-continue> (last visited Nov. 16, 2020).

IRS COMMENTS

We continuously strive to improve how we process returns, whether filed electronically or on paper. Electronic return filing continues to trend upward, and overall through September 30, 2020, individual electronically filed returns were up 9.1% and electronically filed business returns were up 5.7% from last year. For FY 2020, the IRS processed over 150 million individual and almost 30.7 million business electronically filed returns.

Free File also continues to outpace last year. As of November 21, 2020, total returns filed through the Free File program are up over 300%, due in part to returns filed through the Non-Filer application or via the many partners that offered a streamlined entry for non-filers to claim their Economic Impact Payment (EIP). All of the IRS partners in the Free File Initiative (FFI) stepped up to provide a variety of Non-Filer utilities, including products in Spanish and an online Non-Filers tool to enable taxpayers to file for the EIP. As of November 21, 2020, over 8 million citizens received their EIP thanks to the FFI's efforts.

When removing EIP from consideration, Free File still marked a 50% increase this year as more than 4.2 million taxpayers used one of the free online partner products. To continue expanding the program, the IRS also introduced a host of new web changes for the Free File pages on IRS.gov. These changes, which were released in September, were based on the findings and recommendations from last summer's independent review of the program along with findings from focus group research conducted in December 2018. The IRS is currently assessing other recommendations from external stakeholders and oversight agencies, including the Treasury Inspector General for Tax Administration, National Taxpayer Advocate, Internal Revenue Service Advisory Council (IRSAC), and Government Accountability Office, among others, to inform future improvements.

The IRS has also expanded electronic filing options to include an electronic version of amended Form 1040 returns. The ability to electronically file the Form 1040X, Amended U.S. Individual Income Tax Return, has been an important goal of the IRS, the tax software, and tax professional industry for many years. It is also an ongoing recommendation from the IRSAC and the Electronic Tax Administration Advisory Committee. The availability of an electronically filed Form 1040X is a great success for IRS modernization efforts, given the numerous challenges to adding this form to the e-file family due to the details needed on the form. As of November 21, 2020, over 144,000 electronically filed amended returns have been accepted from 18 industry partners. Electronically filing Form 1040X provides taxpayers with a quicker, easier way to submit amended returns, streamlines work for the IRS and the entire tax community, and minimizes errors normally associated with manually completing the form.

Given the many benefits of e-filing, digitalization and technologies such as 2-D barcoding and Optical Character Recognition, the IRS continues to support their implementation. However, the speed with which we can execute these improvements is sometimes limited by available resources.

TAXPAYER ADVOCATE SERVICE COMMENTS

As the IRS rightly points out, the number of taxpayers using electronic filing is growing. When the IRS offers new e-filing options, such as introducing the ability to electronically file Form 1040X, a large number of taxpayers are ready and waiting to use the new service. There is clearly a substantial demand for the service from taxpayers. The IRS also deserves praise for announcing the 2021 launch of online submission of Form 2848, Power of Attorney and Declaration of Representative, and Form 8821, Tax Information Authorization. Combined, the IRS received nearly 3.2 million of those two forms in 2019. Offering electronic filing of these forms provides better service to taxpayers and will reduce the IRS's paper processing workload.

The IRS cannot further expand e-filing options without the necessary resources from Congress, but nothing stands in the way of the IRS making an e-file plan for the forms that taxpayers cannot e-file and publishing it. Without a published schedule for upgrades, the IRS's plan for improving the e-file system seems to be "the squeaky wheel gets the grease," but that is not an effective long-term strategy. Instead of addressing forms one at a time, the IRS needs to establish a plan for all forms to be part of the MeF System and allow itself to be held accountable for meeting established goals.

The IRS supports more widespread implementation of e-filing, digitalization, and technologies such as 2-D barcoding and Optical Character Recognition, but points to lack of resources. Resource limitations are an ongoing issue for the IRS but should not stand in the way of having a plan ready for future upgrades as resources become available.

As the IRS extended the temporary deviation from the wet signature requirement on at least 20 forms³² and allows electronic signatures for an additional six months, it should consider allowing electronic signatures on a permanent basis.

RECOMMENDATIONS

Administrative Recommendations to the IRS

1. Make and publish an e-file plan for the forms that taxpayers cannot e-file.
2. Reevaluate the MeF System to allow for e-filing of all forms, schedules, and attachments.
3. Expand the use of optical character recognition and 2-D barcoding to improve processing of paper filings and reduce processing transcription errors.
4. Make permanent all temporary changes to electronic or digital signature requirements the IRS implemented in response to the COVID-19 pandemic.

32 See IRS, IRS Operations During COVID-19: Mission-Critical Functions Continue, <https://www.irs.gov/newsroom/irs-operations-during-covid-19-mission-critical-functions-continue>.