Legislative Recommendation #5

Require the IRS to Work With Tax Software Companies to Incorporate Scanning Technology for Individual Income Tax Returns Filed on Paper

PRESENT LAW

Present law does not address the treatment of individual income tax returns prepared electronically but mailed and filed on paper.

REASONS FOR CHANGE

In recent years, about 90 percent of individual income tax returns have been submitted electronically. While this percentage is relatively high, more than 15 million individual income tax returns are still submitted on paper.[1] When the IRS cannot capture the data from a tax return electronically, IRS employees must enter the data from paper-filed returns manually. The manual transcription of millions of lines of return data is expensive, produces transcription errors, and delays return processing and the payment of tax refunds. Because of the impact of the COVID-19 pandemic on IRS operations, backlogs in the processing of paper returns have often exceeded six months, delaying refunds for, and in some cases inflicting financial hardships on, millions of taxpayers.

Technology is available that would allow the IRS to scan paper returns prepared with tax return preparation software and capture the data quickly and efficiently. To enable the IRS to utilize one form of scanning technology, known as "2-D barcoding," tax return preparation software would generate and imprint a horizontal or vertical barcode containing all return information on the return. The IRS, upon receiving the paper return, would scan the barcode, capture the data, decode it, and process the return as if it had been transmitted electronically. Many states have been using 2-D barcoding for paper-based income tax returns for more than a decade. The IRS itself has partnered with the software industry to enable Schedules K-1 to be filed with a 2-D bar code.

In addition, the IRS has adopted another type of scanning technology, known as "optical character recognition" (OCR), to process certain forms filed on paper. With OCR technology, the IRS scans the paper-filed return (without a barcode), captures the data, stores the tax form images and data in an electronic format, and processes the return as if it had been e-filed.[2] A major advantage of OCR technology is that it is not limited to digitizing returns prepared with software. It can scan all paper tax returns, including handwritten returns, preventing the need for manual data entry.[3]

While scanning technology is not considered e-file and still involves the submission of a paper return, it produces significant advantages over traditional paper filing, including (i) faster processing of tax returns and therefore delivery of refunds, (ii) more accurate recording of tax return information, and (iii) cost savings due to the reduction in training, recruiting, and staffing for manual data transcription. Despite these benefits, the IRS does not have updated scanning technology for many paper-filed returns, including individual income tax returns. The IRS has indicated an interest in adding 2-D barcodes on all IRS forms and outgoing

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1   IRS, Filing Season Statistics Report, Week Ending October 23, 2021.

2   See Internal Revenue Manual (IRM) 3.41.274, General Instructions for Processing via SCRIPS (Nov. 5, 2019); IRM 3.41.275.1, Program Scope and Objectives (Nov. 14, 2017).

3   In the case of handwritten returns, there will be some scanning errors. For example, a scanner might read a sloppily written "1" as a "7" or vice versa. However, similar errors are made when IRS employees transcribe returns, along with others, so OCR scanning should still be more accurate while reducing processing times.

correspondence due to the industry-proven efficiencies associated with extracting machine-readable data from paper returns and correspondence. It is exploring both 2-D barcode and OCR technology with the software industry as part of a pilot program.[4] However, widescale expansion of these two technologies will require additional multiyear funding.

RECOMMENDATION

- Provide the IRS with dedicated multiyear funding to purchase and implement scanning technology in order to improve the speed and accuracy of paper returns and correspondence processing.[5]

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4   U.S. Department of the Treasury, Pilot IRS Informational Posting (Apr. 2, 2021), https://sam.gov/opp/5eb4fcfbdfd342bd94c0af400dbcca38/view?index=opp&naics=541&page=9; Department of the Treasury, Pilot IRS: EDCMO Digitalization Technology Pilot OCR Awards (July 26, 2021), https://sam.gov/opp/3d9a450e51df4bc9b3f75ddc12b9a578/view.

5   For legislative language that would impose a requirement for 2-D barcode, or scannable code, technology, see Taxpayer First Act of 2018, S. 3246, 115th Cong. § 2104 (2018), https://www.congress.gov/bill/115th-congress/senate-bill/3246.