

**Opportunities Exist to Transition Taxpayers
From Submitting Computer-Prepared Tax
Returns on Paper to E-Filing**

March 2004

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

March 31, 2004

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT
DEPUTY COMMISSIONER FOR OPERATIONS SUPPORT

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Opportunities Exist to Transition Taxpayers
From Submitting Computer-Prepared Tax Returns on Paper to
E-Filing (Audit # 200340044)

This report presents the results of our review of the Internal Revenue Service's (IRS) efforts to reduce the volume of tax returns prepared using computer software packages but submitted to the IRS on paper¹ instead of being electronically filed (*e-filed*).²

The IRS is the largest processor of information in the world. For Tax Year (TY) 2001, 63 percent of all individual tax returns it processed were filed on paper. However, it is the policy of the Congress that paperless filing (electronic filing) be the preferred and most convenient means of filing tax returns. The Congress included provisions in the IRS Restructuring and Reform Act of 1998 (RRA 98)³ to address paperless tax return filing and set goals for the IRS. For example, the RRA 98 requires the IRS to have at least 80 percent of all tax returns *e-filed* by the year 2007 and, to the extent practicable, ensure that all tax returns prepared electronically after 2001 are *e-filed*. The Congress also established a provision to promote and encourage the benefits and use of electronic tax administration programs, as they become available, through mass communications and other means. Since the passage of the RRA 98, the IRS' *e-file* marketing budget has increased from \$273,000 to approximately \$22 million in 2002.

¹ For the purposes of this report, we will refer to individual taxpayer tax returns prepared using a computer software tax package and submitted to the IRS on paper as "computer-prepared paper tax returns."

² *E-file* is a way to file a tax return electronically to the IRS using an authorized IRS *e-file* provider or personal computer.

³ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

Since the enactment of the RRA 98, the IRS has made a significant effort to make *e-filing* easier and continues to identify opportunities and create incentives for taxpayers to *e-file*. These efforts have resulted in taxpayers being able to electronically sign their tax returns, *e-file* their state tax returns with their Federal tax returns, pay their taxes using a credit card, *e-file* 99 percent of all tax forms, and *e-file* at no cost.⁴ Furthermore, in an attempt to encourage paid preparers to submit tax returns electronically, the IRS offers specific support services and is in the process of providing incentives exclusive to *e-file* providers.⁵ These incentives will include the ability to apply to become an *e-file* provider online, interact with the IRS by email, and obtain client transcripts online.

The IRS has made significant progress in attracting taxpayers to *e-file*. Taxpayers participating in *e-file* have increased from 24.6 million for TY 1997 to 46.8 million for TY 2001.⁶ However, the current rate of *e-file* growth is slowing and will not enable the IRS to meet its *e-file* goal of 80 percent by 2007.⁷ Therefore, it is essential that the IRS focus on taxpayers and paid preparers that have not *e-filed*, particularly those that continue to file computer-prepared paper tax returns.

As the IRS strives to increase *e-filing* by transitioning individual taxpayers and preparers from mailing their computer-prepared tax returns, the IRS needs to address the following issues to help ensure its success:

- The IRS does not currently identify all tax returns that are computer-prepared and submitted on paper.
- The IRS does not currently have a process to measure the effectiveness of all aspects of its marketing and outreach activities.
- The current marketing strategy does not include individuals that use computer software packages to self-prepare their tax returns and submit them on paper.

E-filing provides significant benefits to both taxpayers and the IRS. Over 46.7 million taxpayers that submitted TY 2001 computer-prepared paper tax returns did not receive the benefits associated with *e-filing*, including faster refunds, more accurately processed tax returns, and quick acknowledgement that the IRS received their tax returns. In addition, the IRS estimates the processing of an *e-filed* tax return compared to that of a paper tax return results in cost savings of approximately \$2.30⁸ per tax return.

We recommended the Deputy Commissioner for Services and Enforcement ensure the IRS (1) identifies all computer-prepared paper returns submitted on paper, (2) develops a process to measure *e-file* outreach and marketing activities, and (3) develops a

⁴ This no cost *e-filing* option is the result of the IRS entering into an agreement with tax preparation software companies and is available for taxpayers that meet certain requirements.

⁵ *E-file* providers may be electronic return originators, transmitters, software developers, tax practitioners, and states.

⁶ TY 2001 data are the most complete information available from the IRS.

⁷ *Tax Administration: IRS' 2003 Filing Season Performance Showed Improvements* (GAO-04-84, dated October 2003).

⁸ Cost savings relate to the costs saved to process a tax return and do not include Information Technology and Customer Service costs, as the IRS is still in the process of computing these costs.

marketing strategy to transition individual taxpayers that self-prepare computer-prepared paper returns to *e-filing*.

Management's Response: IRS management agreed with our recommendations and has initiated corrective actions. Specifically, the IRS will require tax examiners to v-code⁹ all computer-generated U.S. Individual Income Tax Return (Form 1040) series paper tax returns, has developed an *e-file* Outreach Strategy and a standard measurement system using several data sources to evaluate the results of marketing efforts, and will include the specific targeting of v-coded return filers in marketing efforts. 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 R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

⁹ IRS employees identify and code computer-prepared paper tax returns with a "V." This process is referred to as v-coding.

**Opportunities Exist to Transition Taxpayers From Submitting
Computer-Prepared Tax Returns on Paper to E-Filing**

Table of Contents

| | |
|---|---------|
| Background | Page 1 |
| Significant Effort Has Been Made to Increase Participation in E-File..... | Page 3 |
| Computer-Prepared Paper Tax Returns Continue to Be the Largest Opportunity for Meeting E-File Goals..... | Page 5 |
| <u>Recommendations 1 through 3:</u> | Page 11 |
| Appendix I – Detailed Objective, Scope, and Methodology | Page 13 |
| Appendix II – Major Contributors to This Report..... | Page 14 |
| Appendix III – Report Distribution List | Page 15 |
| Appendix IV – Outcome Measures | Page 16 |
| Appendix V – Management’s Response to the Draft Report | Page 17 |

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

Background

The Internal Revenue Service (IRS) is the largest processor of information in the world. For Tax Year (TY) 2001, approximately 80 million (63 percent) of the 126 million individual tax returns that it processed were filed on paper.¹ However, it is the policy of the Congress that paperless filing (electronic filing, or *e-filing*) be the preferred and most convenient means of filing tax returns. The Congress included provisions in the IRS Restructuring and Reform Act of 1998 (RRA 98)² to address paperless tax return filing and set goals for the IRS. For example, the RRA 98 requires the IRS to have at least 80 percent of all tax returns *e-filed* by the year 2007 and, to the extent practicable, ensure that all tax returns prepared electronically after 2001 are *e-filed*.

The Congress also established a provision to promote and encourage the benefits and use of electronic tax administration programs, as they become available, through mass communications and other means. Since the passage of the RRA 98, the IRS' *e-file* marketing budget has increased from \$273,000 to approximately \$22 million in 2002.

When filing their tax returns, individual taxpayers have the option to either *e-file* or submit their tax returns on paper to the IRS. *E-filed* tax returns and paper filed tax returns can be prepared either by the taxpayer (self-prepared) or by someone other than the taxpayer (paid preparer).

When taxpayers submit their tax returns on paper, the IRS classifies the tax returns into two categories:

Hand-prepared tax returns – Tax returns that are handwritten.

¹ TY 2001 data were the most complete information available from the IRS at the time of our analysis.

² Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

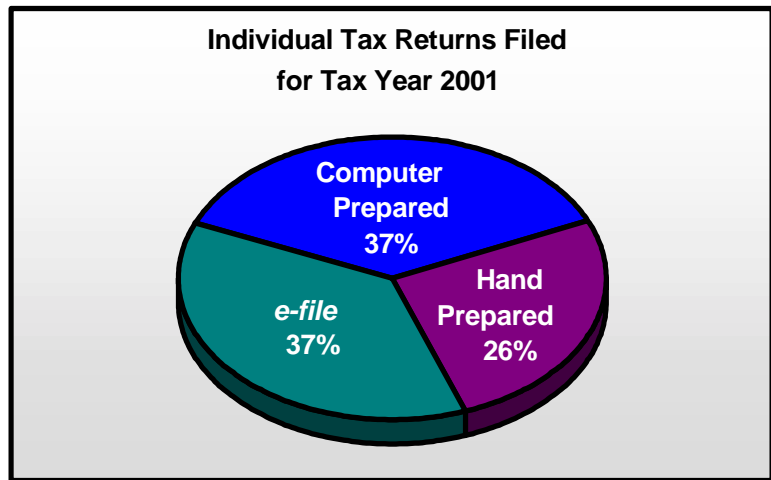
Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

Computer-prepared paper tax returns³ – Tax returns prepared using a computer software tax package but submitted to the IRS on paper rather than being *e-filed*.

IRS employees identify and code computer-prepared paper tax returns with a “V.” This process is referred to as v-coding. Although the IRS uniquely codes the computer-prepared paper tax returns, it processes them in the same manner in which it processes hand-prepared tax returns. The processing of paper tax returns requires IRS employees to manually input tax return information into IRS computers.

Chart 1 shows the percentage of *e-file* tax returns, computer-prepared paper tax returns, and hand-prepared tax returns for TY 2001.

Chart 1



Source: Treasury Inspector General for Tax Administration (TIGTA) Data Center Warehouse.

This review was performed at the IRS National Headquarters and the Office of Electronic Tax Administration in Washington, D.C.; the Wage and Investment (W&I) Division Headquarters in Atlanta, Georgia; and the Small Business/Self-Employed (SB/SE) Division Headquarters in

³ For the purposes of this report, we will refer to individual taxpayer tax returns prepared using a computer software tax package and submitted to the IRS on paper as “computer-prepared paper tax returns.”

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

Significant Effort Has Been Made to Increase Participation in E-File

New Carrollton, Maryland. We conducted our audit during the period February through November 2003.

The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS recognizes the need to promote the benefits of *e-file* and encourages taxpayers and paid preparers to *e-file*. Since the enactment of the RRA 98, the IRS has made a significant effort to make *e-filing* easier and continues to identify opportunities and create incentives for taxpayers to *e-file*. For example:

- **Taxpayers can now sign their tax returns using an electronic signature.** For TY 2001, 24.7 million taxpayers signed their electronically filed tax returns using a Personal Identification Number in lieu of a written signature.
- **Taxpayers can *e-file* their Federal and state tax returns together.** The IRS has formed a partnership with 37 states so taxpayers living in these states have this option. For TY 2001, 19.3 million taxpayers filed both their Federal and state tax returns with a single electronic transmission.
- **Taxpayers can pay their taxes using a credit card.** In TY 2002, over 768,000 payments were made electronically by credit card or electronic withdrawal from a checking or savings account.
- **Taxpayers can now file 99 percent of all tax forms electronically.**

In addition, the IRS has identified that the cost associated with *e-filing* is the largest barrier to an individual taxpayer's willingness to *e-file*. To address the cost issue, the IRS entered into an agreement with a number of tax preparation software companies to provide no-cost *e-filing* to individual taxpayers that meet certain requirements. For TY 2002, 119 million of the estimated 127 million individual taxpayers met the requirements to *e-file* a tax return at no cost.

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

The IRS Advisory Council⁴ reports that paid preparers file nearly 60 percent of all individual tax returns. In addition, segments of the preparer community have adopted *e-filing* as their principal way of doing business.⁵ However, the Council reported that, while paid preparers produce 72 percent of all computer-prepared tax returns, only 46 percent of these paid preparers *e-file*. If all paid preparers *e-filed*, it would put the IRS past its goal of having 80 percent of all tax returns *e-filed* by the year 2007.

In an attempt to encourage paid preparers to submit tax returns electronically, the IRS plans to provide incentives exclusive to *e-file* providers (preparers that *e-file* tax returns). For those preparers that are *e-file* providers, the IRS offers specific support services including:

- Quick Alerts – a messaging system that disseminates (within seconds, by email or telephone) information regarding the *e-file* Program.
- An *e-file* Toll-Free Assistance Helpdesk that addresses *e-file* questions and concerns.
- An *e-file* web page on the IRS Internet.
- On-line business tools, including an online application for a preparer tax identification number and the ability to verify the accuracy of taxpayer identification numbers.

In addition, the IRS is in the process of releasing a series of “E-Services” for third parties⁶ that participate in the *e-file* Program. E-Services will provide the ability to apply to become an authorized *e-file* provider online, electronically receive account transcripts for clients, and communicate by email with the IRS.

The IRS’ *e-file* improvements, promotions, and incentives have resulted in the steady growth of the *e-file* Program. Chart 2 shows the increase of *e-filed* tax returns.

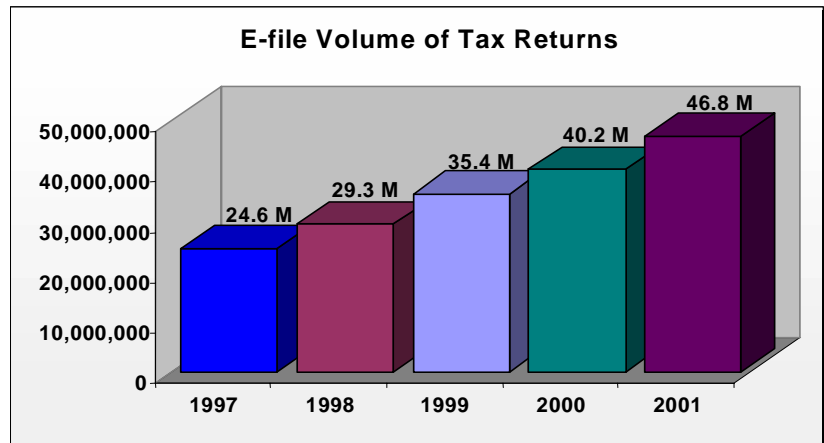
⁴ The IRS Advisory Council provides an organized public forum for IRS officials and representatives of the public to discuss relevant tax administration issues, including *e-filing*.

⁵ *IRS Advisory Council Small Business & Self-Employed Subgroup Report*, dated November 6, 2003.

⁶ Third parties may be electronic return originators, transmitters, software developers, tax practitioners, payers, and states.

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

Chart 2⁷



Source: IRS Electronic Tax Administration.

Computer-Prepared Paper Tax Returns Continue to Be the Largest Opportunity for Meeting E-File Goals

As shown in Chart 2, the IRS has made significant progress in attracting taxpayers to *e-file*. The General Accounting Office (GAO)⁸ recently reported that the current rate of growth of *e-filing* is slowing and will not allow the IRS to achieve its long-term *e-file* goal of 80 percent by 2007, despite a number of initiatives implemented over the years to reduce barriers and encourage more *e-filing*.

Provisions included in the RRA 98 directed the IRS, to the extent practicable, to ensure that all tax returns prepared electronically after 2001 are *e-filed*. Therefore, it is essential that the IRS focus its efforts on those taxpayers and paid preparers that have not *e-filed*, particularly those that continue to file computer-prepared paper tax returns.

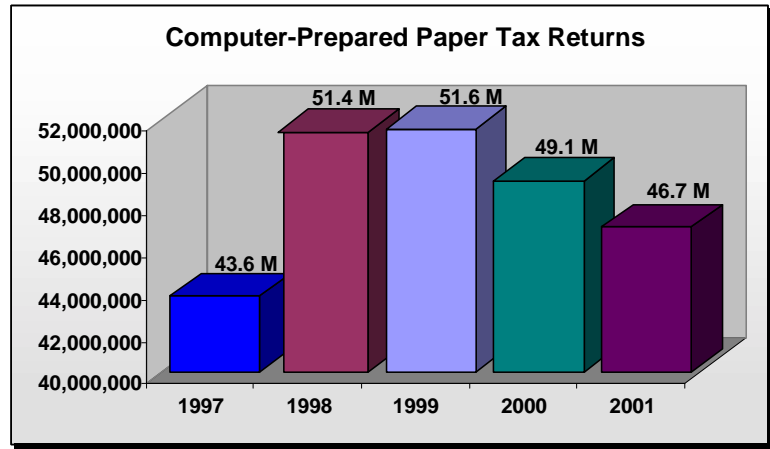
The IRS recognizes taxpayers and paid preparers that file computer-prepared paper tax returns provide an opportunity for furthering its *e-file* goals and plans to aggressively address this issue. Chart 3 shows that, although the number of computer-prepared paper tax returns is decreasing, 46.7 million were filed for TY 2001.

⁷ These data were provided by the IRS. We did not validate the accuracy and reliability of these data.

⁸ *Tax Administration: IRS' 2003 Filing Season Performance Showed Improvements* (GAO-04-84, dated October 2003).

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

Chart 3⁹



Sources: *Electronic Tax Administration for TYs 1997 to 2000*; *TIGTA Data Center Warehouse for TY 2001*.

As the IRS strives to increase *e-filing* by transitioning individual taxpayers and paid preparers from submitting computer-prepared paper tax returns to *e-filing*, the following issues need to be addressed to help ensure success.

The IRS does not currently identify all tax returns that are computer-prepared and submitted on paper

Currently, the IRS identifies computer-prepared paper tax returns submitted using U.S. Individual Income Tax Return (Form 1040) and U.S. Individual Income Tax Return (Form 1040A). Guidelines require that IRS employees processing paper tax returns identify and v-code only computer-prepared Forms 1040 and 1040A tax returns. The IRS identifies those tax returns so it can suppress future mailings of IRS tax packages. The IRS decided that, if individuals purchase IRS-approved tax preparation software packages to prepare their tax returns, sending the tax packages would not be cost-effective for the IRS or necessary for the taxpayers to prepare and file their tax returns in the future.

IRS guidelines do not include the requirement to identify and v-code computer-prepared paper tax returns filed using

⁹ We did not validate the accuracy of the data for TYs 1997 through 2000.

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ). However, IRS employees are not consistently following the guidelines. For example, our review of TY 2001 data files identified approximately 217,000 Form 1040EZ tax returns that had been v-coded, even though IRS employees are not required to v-code these tax returns.

Currently there are 66 IRS-approved electronic tax preparation software packages that taxpayers and paid preparers can use to prepare a Form 1040EZ tax return, which may then be submitted to the IRS as a computer-prepared paper tax return. During TY 2001, a total of 10.7 million Form 1040EZ tax returns were submitted on paper to the IRS. Because the IRS does not require the Form 1040EZ to be v-coded, there is no way to identify the volume that are computer-prepared paper tax returns.

Although the IRS' original intent of identifying and v-coding tax returns was to reduce mailing and postage costs, the IRS is now using the information to develop and target its marketing and outreach strategies in an effort to reduce this population. Therefore, it is essential that all Form 1040 series tax returns be identified. Inconsistent identification may result in underestimating the volume of individual taxpayers that file computer-prepared tax returns and may eliminate some taxpayers from being included in the IRS' marketing and outreach efforts.

The IRS does not currently have a process to measure the effectiveness of all aspects of its marketing and outreach activities

The IRS is currently in the process of finalizing plans for its Fiscal Year (FY) 2004 marketing and outreach strategy, which will focus on paid preparers that submit computer-prepared tax returns. For TY 2001, paid preparers filed 33.9 million (73 percent) of the 46.7 million computer-prepared paper tax returns. Although plans are being developed, the IRS has not developed a process to timely and consistently measure the effectiveness of its marketing and outreach activities.

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

For FY 2004, the IRS plans to undertake aggressive marketing and outreach campaigns coordinated by its W&I Division Office of Stakeholder Partnerships, Education, and Communication (SPEC) and SB/SE Division Office of Taxpayer Education and Communication (TEC). These offices educate and inform taxpayers and paid preparers about their tax obligations by developing educational products and services focused on customer needs and by providing top-quality pre-filing services to help taxpayers understand and comply with the tax laws.

The SPEC and TEC offices have developed a joint strategy that outlines the steps that will be taken to identify each organization's targeted audience. The goal is to ensure the organizations do not duplicate efforts (each organization visiting the same preparer). The targeted audience for each organization is as follows:

- The SPEC office will focus its outreach and marketing efforts on paid preparers that file primarily individual tax returns. These preparers are usually authorized *e-file* providers. The goal of the SPEC office's outreach and marketing is to increase the number of tax returns these preparers *e-file*. The SPEC office plans include field visits, telephone contacts, seminars, and mailings.
- The TEC office will focus its outreach and marketing efforts on paid preparers that file primarily business tax returns and are not always authorized *e-file* providers. The goal of TEC office's outreach and marketing is to get these preparers to become authorized *e-file* providers. The TEC office plans include field visits and seminars.

Although both offices are committed to a joint strategy, they have yet to implement a process to consistently capture the results of each office's outreach efforts. In addition, despite having outreach efforts since FY 2002, the SPEC office has yet to develop a standard measurement process to measure the effectiveness of its outreach efforts. The SPEC office has progressed in its efforts to develop a standard measurement process. It is analyzing and evaluating its previous measurement efforts to identify those steps to be included in a standard measurement process. The SPEC

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

office met with its Research function in December 2003 to discuss how to design such a measurement process.

The TEC office has coordinated with its Research function since the inception of its outreach efforts to develop a process to measure the effectiveness of its outreach and marketing activities. However, because of delays in getting the necessary data to perform this measurement, it is still attempting to measure the effectiveness of its outreach efforts performed in FYs 2002 and 2003.

Each office will have to address its inability to timely measure the effectiveness of its efforts resulting primarily from delays in obtaining the necessary data needed for this measurement analysis. For example, the FY 2004 strategy calls for the SPEC and TEC offices to conduct their outreach efforts between June and December 2004. However, delays in obtaining the necessary data timely will result in the inability to completely measure the effectiveness of the outreach efforts until February 2006 (approximately 20 months after the marketing strategy is initiated).

Without a timely and consistent method to measure its *e-file* outreach and marketing efforts, the IRS may not have the ability to effectively adjust its strategy or make informed business decisions on the impact that one or more of its marketing and outreach efforts may be having on transitioning taxpayers from computer-prepared paper tax returns to *e-file*.

The current marketing strategy does not include individuals that use computer software packages to self-prepare their tax returns and submit them on paper

The FY 2004 marketing and outreach strategy planned by the SPEC and TEC offices primarily targets computer-prepared paper tax returns submitted by paid preparers. However, of the 46.7 million computer-prepared paper tax returns submitted for TY 2001, a total of 12.8 million (27 percent) were self-prepared (taxpayers used computer software packages to prepare their own tax returns and submit them on paper to the IRS). The IRS has the ability to identify these taxpayers, but the SPEC and TEC

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

offices do not have plans to aggressively market to these taxpayers.

Without an aggressive marketing strategy by the IRS, individuals that self-prepare might not understand the numerous benefits of *e-file* and might continue to mail their computer-prepared paper tax returns. These taxpayers present further opportunities for the IRS to increase *e-file*.

After we discussed our results with IRS management, they agreed taxpayers that self-prepare computer-prepared paper tax returns should be included in marketing and outreach efforts. Specifically, management agreed to evaluate the possibility of direct mailing to these individuals, especially to inform them of the IRS' partnership with the electronic tax preparation software industry that could result in *e-filing* at no cost. Management indicated that they plan to implement the direct mail recommendation in their 2004 marketing strategy.

The effect of transitioning individual taxpayers from computer-prepared paper tax returns to e-file

E-filing provides significant benefits to both taxpayers and the IRS. For example:

- The approximately 46.7 million taxpayers that use computer software packages to prepare tax returns yet submit them on paper are not receiving the benefits associated with *e-file*, including faster refunds, more accurately processed tax returns,¹⁰ and quick acknowledgement that the IRS received the tax returns.
- The IRS estimates the processing of an *e-filed* tax return compared to that of a paper tax return results in processing cost savings of approximately \$2.30¹¹ per tax return. If the approximately 46.7 million taxpayers that submit computer-prepared paper tax returns elected to *e-file* these tax returns, the potential processing cost

¹⁰ Errors are made on 5 percent of tax returns when IRS employees manually input information from the tax return to the IRS' computer system.

¹¹ Cost savings relate to the costs saved to process a tax return and do not include Information Technology and Customer Service costs, as the IRS is still in the process of computing these costs.

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

savings would have exceeded \$107 million for TY 2001 and could be \$537 million over 5 years. (See Appendix IV for more details.)

Recommendations

The Deputy Commissioner for Services and Enforcement should ensure the IRS:

1. Accurately and consistently identifies all tax returns that are computer-prepared and submitted on paper.

Management's Response: The IRS will revise Internal Revenue Manual 3.11.3, Returns and Document Analysis, for the 2005 Filing Season¹² to instruct tax examiners to v-code all computer-generated Form 1040 series paper tax returns. This revision will be effective in January 2005.

2. Develops a standard measurement process to consistently and timely measure *e-file* outreach and marketing activities.

Management's Response: For FYs 2004 and beyond, the W&I Division SPEC and SB/SE Division TEC offices have segmented the preparer database primarily along individual and business filing components. Each organization developed complementary marketing strategies that target their respective preparer segments. For FY 2004, the SPEC office developed an *e-file* Outreach Strategy and a standard measurement system. In addition, the SPEC and TEC offices will use several data sources to evaluate results of marketing efforts. The SPEC and TEC offices will continue to work with the W&I and SB/SE Divisions' Research functions to determine the feasibility of combining research projects and standardizing the measurement process.

3. Develops a direct marketing strategy focusing on transitioning individual taxpayers that self-prepare computer-prepared paper tax returns to e-filing.

Management's Response: The IRS will include the specific targeting of v-coded return filers through the Statement of Work and contract with its vendor as part of the overall

¹² The period from January through mid-April when most individual income tax returns are filed.

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

FY 2005 advertising effort. The IRS will send *Isn't it time you e-filed?* (Publication 8160E) to targeted individuals. It will also survey selected recipients on the perceived effectiveness of this Publication and monitor the actual *e-file* rate of individual recipients as opposed to other individuals who did not receive the Publication.

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the Internal Revenue Service's (IRS) efforts to reduce the volume of tax returns prepared using computer software packages but submitted to the IRS on paper instead of being electronically filed (*e-filed*). To accomplish this objective, we:

- I. Determined what efforts the IRS has taken to identify the volume and characteristics of taxpayers that prepare their tax returns using computer software but submit the tax returns to the IRS on paper (referred to as computer-prepared paper tax returns).
 - A. Determined if the IRS accurately identifies all computer-prepared paper tax returns.
 - B. Obtained and reviewed IRS statistics on computer-prepared paper tax returns.
 - C. Performed a walk-through of the Code and Edit function to determine how the IRS codes computer-prepared paper tax returns.
 - D. Obtained an extract from the Treasury Inspector General for Tax Administration Data Center Warehouse to determine whether volumes of computer-prepared paper tax returns are consistently coded and identify limitations to the IRS' ability to identify computer-prepared paper tax returns.
 - E. Determined if the IRS accurately or completely captured computer-prepared paper tax returns.
 - F. Determined the impact to both the taxpayer and the IRS.
- II. Determined what IRS strategies and efforts have been taken to reduce the volume of computer-prepared paper tax returns.
 - A. Determined if the IRS has a documented strategic plan outlining initiatives to be taken to reduce computer-prepared paper tax returns.
 - B. Discussed strategies planned or completed with appropriate IRS management.
 - C. Determined whether the IRS used information provided by research projects to design initiatives to reduce the volume of computer-prepared paper tax returns.
 - D. Determined whether the IRS has undertaken sufficient efforts to reduce the volume of computer-prepared paper tax returns.
 - E. Computed the impact on both the taxpayer and the IRS relating to taxpayer burden and IRS cost savings.

Major Contributors to This Report

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**Opportunities Exist to Transition Taxpayers From Submitting
Computer-Prepared Tax Returns on Paper to E-Filing**

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Acting Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Chief Communications and Liaison CL
Deputy Chief, Information Technology Services OS:CIO:I
Director, Communications, Wage and Investment Division SE:W:C
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division
SE:W:CAR
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division
SE:S:T
Director, Communications and Liaison, Small Business/Self-Employed Division SE:S:MS:CL
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Division SE:W:CAR:SPEC
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Chief Counsel CC
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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison:
 Chief, Customer Liaison, Small Business/Self-Employed Division SE:S:COM
 GAO/TIGTA Liaison, Wage and Investment Division SE:W:S:PA

Outcome Measures

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

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 46.7 million taxpayers that filed computer-prepared paper tax returns for Tax Year (TY) 2001 did not receive the benefits of electronic filing (*e-filing*) for TY 2001¹ (see page 5).

Methodology Used to Measure the Reported Benefit:

The Internal Revenue Service (IRS) provided us the volume of v-coded² tax returns for TYs 1997 through 2000. Through the Treasury Inspector General for Tax Administration Data Center Warehouse, we retrieved the volume of tax returns filed for TY 2001.

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; \$537 million for 46.7 million computer-prepared paper tax returns, projected for each of 5 years (see page 5).

Methodology Used to Measure the Reported Benefit:

The IRS provided the cost of \$2.86 to process a paper tax return and \$.56 to process an *e-filed* tax return. We calculated the difference in cost ($\$2.86 - \$.56 = \$2.30$).³ We multiplied the 46.7 million tax returns by the difference in cost to get the total cost savings (46.7 million multiplied by $\$2.30 = \107.4 million multiplied by 5 years).

¹ TY 2001 data are the most complete information available from the IRS.

² When the IRS processes computer-prepared paper tax returns, IRS employees identify and code them to distinguish them from the hand-prepared tax returns. This is referred to as v-coding.

³ Cost savings relate to the costs saved to process a tax return and do not include Information Technology and Customer Service costs, as the IRS is still in the process of computing these costs.

Opportunities Exist to Transition Taxpayers From Submitting
Computer-Prepared Tax Returns on Paper to E-Filing

Appendix V

Management's Response to the Draft Report

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DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
MAR 22 2004

March 22, 2004

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

John M. Dalrymple
John M. Dalrymple
Deputy Commissioner for Operations Support

SUBJECT:

Management Response to Draft Audit Report -
Opportunities Exist to Transition Taxpayers From
Submitting Computer-Prepared Tax Returns on Paper
to E-Filing (Audit # 200340044)

In the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Congress established the policy that paperless filing should be the preferred and most convenient means of filing Federal tax and information returns. Since the enactment of RRA 98, the IRS has made a significant effort to make e-filing easier and continues to identify opportunities and create incentives for taxpayers to e-file. These efforts have resulted in taxpayers being able to electronically file 99 percent of all forms and schedules, electronically sign their tax return, e-file their state return with their Federal tax return, pay their taxes using a credit card, and under certain criteria e-file at no cost.

While our initial efforts concentrated on expanding the availability of electronic filing for individuals, we are redirecting our focus to tax returns prepared using computer software packages but submitted on paper. For Fiscal Year (FY) 2004 and beyond, we have developed complimentary marketing strategies for our individual and business filing components and identified several data sources to evaluate our marketing efforts.

In addition, we recently launched a new computer platform for receiving and processing electronic returns and also deployed a suite of web-based products that allow tax professionals and payers to transact electronically with the IRS. These products are the first in a series of services that will be offered to reduce barriers to electronic filing.

We concur with TIGTA's measurable benefits of electronic tax administration. Attached is our response to your specific recommendations.

If there are any questions, please call me at (202) 622-6860, or JoAnn Bass, Acting Director, Electronic Tax Administration Division at (202) 622-7990.

Attachment

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

Attachment

Management Response to Draft Audit Report – Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing (Audit # 200340044)

IDENTITY OF RECOMMENDATION #1:

The Deputy Commissioner for Services and Enforcement should ensure that the IRS accurately and consistently identifies all tax returns that are computer-prepared and submitted on paper.

CORRECTIVE ACTION #1:

We agree with the recommendation. The Director, Wage and Investment (W&I) Submission Processing will revise Internal Revenue Manual (IRM) 3.11.3, Returns and Document Analysis, for the 2005 filing season to instruct the tax examiners to edit a Returns Processing Code (RPC) "V" on all computer-generated Form 1040 series paper tax returns. This revision will be effective in January 2005.

IMPLEMENTATION DATE:

January 15, 2005

RESPONSIBLE OFFICIAL(S):

Director, Submission Processing, W&I Division

CORRECTIVE ACTION MONITORING PLAN #1:

The Submission Processing Division will use established managerial controls to monitor and ensure the corrective action is implemented.

IDENTITY OF RECOMMENDATION #2:

The Deputy Commissioner for Services and Enforcement should ensure that the IRS develops a standard measurement process to consistently and timely measure e-file outreach and marketing activities.

CORRECTIVE ACTION #2:

We agree with this recommendation and have already taken the following corrective actions.

For FY 2004 and beyond, the W&I Stakeholder Partnerships, Education and Communication (SPEC) and Small Business and Self-Employed (SB/SE) Taxpayer Education and Communication (TEC) Divisions, have segmented the preparer database primarily along individual and business filing components. Each organization developed complimentary marketing strategies that target their respective preparer segments.

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

2

For FY 2004, the W&I SPEC developed an e-file Outreach Strategy and a standard measurement system that will gauge:

- The volume and percent change in v-coded returns prepared by targeted Electronic Return Originators (ERO) and non-EROs.
- The percent change in reject rates for targeted EROs.
- The change in behavior of firms targeted for various outreach/marketing techniques.
- The volume and percent change in e-file returns prepared by volunteer return sites.

In addition, SPEC and TEC will use several data sources to evaluate results of marketing efforts. The Electronic Tax Administration (ETA) Marketing Database will be used to determine the differences in the number and percent of paper, e-filed and v-coded returns filed by firms receiving an outreach message, compared to control groups and to the e-file population at large. The data will be available 5 months after the January through June 2004 outreach effort is completed and 10 months after the full year outreach (January through December) effort is completed.

The Distribution Channel Management (DCM) Reporting Activity System will be used to obtain indicators of the relative effectiveness of its outreach more frequently (in May, August, and November). The DCM database will also be the source of data used to analyze differences in several reject codes for which targeted outreach is planned. SPEC will use a third set of sources (the Report of Verification of IMF Returns and the Non-Profits Organization Summary Report) to determine the change in e-file returns prepared by our volunteer return sites.

SPEC and TEC will continue to work with the W&I and SB/SE Research groups to determine the feasibility of combining research projects and standardizing the measurement process.

IMPLEMENTATION DATE:

Completed – January 1, 2004

RESPONSIBLE OFFICIAL(S):

Director, Stakeholders Partnerships, Education and Communication, W&I Division

Director, Taxpayer Education and Communication, SB/SE Division

Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing

3

CORRECTIVE ACTION MONITORING PLAN #2:

Not Applicable.

IDENTITY OF RECOMMENDATION #3:

The Deputy Commissioner for Services and Enforcement should ensure that the IRS develops a direct marketing strategy focusing on transitioning individual taxpayers that self-prepare computer-prepared paper tax returns to e-filing.

CORRECTIVE ACTION #3:

The Director, Wage and Investment Communications and Liaison will employ the following two strategies to target the "v-coded" return filer:

1. Include a specific targeting of v-coded return filers through the Statement of Work and contract with our vendor as part of our overall FY 2005 advertising effort.
2. Direct mail Publication 8160E, Isn't it Time You e-filed? to targeted individuals, survey selected recipients on the perceived effectiveness of this mailout, and monitor the actual e-file rate of individual recipients as opposed to other individuals who did not receive the mailout.

IMPLEMENTATION DATE:

July 15, 2005

RESPONSIBLE OFFICIAL(S):

Director, Communications and Liaison, W&I Division

CORRECTIVE ACTION MONITORING PLAN #3:

The Communications and Liaison Division will incorporate monitoring in their Operation Reviews.