

GAO

Report to the Subcommittee on  
Financial Services and General  
Government, Committee on  
Appropriations, U.S. Senate

October 2011

# E-FILING TAX RETURNS

## Penalty Authority and Digitizing More Paper Return Data Could Increase Benefits

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Highlights of [GAO-12-33](#), a report to the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. Senate

## Why GAO Did This Study

The Internal Revenue Service's (IRS) goal is to receive 80 percent of all major types of tax returns electronically by 2012. Legislation passed in November 2009 supports the 80 percent goal for individual income tax returns by requiring tax return preparers who file more than 10 individual returns per year to file them electronically, or e-file.

GAO was asked to review IRS's implementation of this e-file mandate. Specifically, GAO (1) described e-file rates and preparers' experiences implementing the mandate, (2) assessed IRS's plans to enforce the mandate, (3) assessed IRS's analysis of options for digitizing more data from paper returns, and (4) determined whether there are any tax forms IRS cannot accept electronically and assessed IRS's plans for adding them to the e-file system. To conduct these analyses, GAO reviewed IRS processing data and e-file planning documents, and interviewed IRS officials and 26 members of national preparer organizations.

## What GAO Recommends

Congress should consider amending the Internal Revenue Code (IRC) to provide IRS with penalty authority for preparer noncompliance with the mandate. GAO also recommends, among other things, that IRS conduct analyses on the costs and benefits of implementing bar coding and additional transcription and create a time line and list of forms to be added to the e-file system. IRS agreed with the recommendations.

View [GAO-12-33](#). For more information, contact James R. White, (202) 512-9110, [WhiteJ@gao.gov](mailto:WhiteJ@gao.gov).

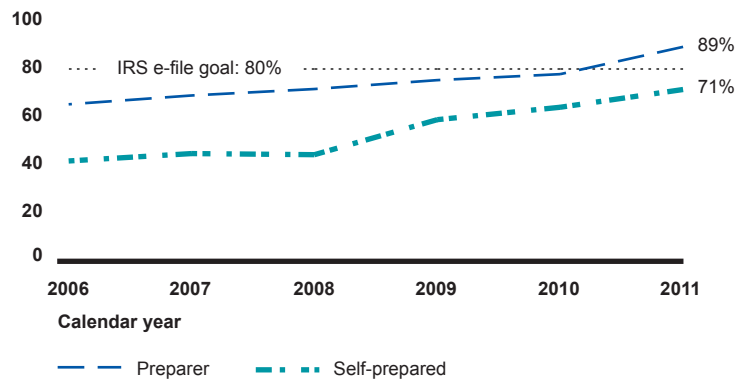
## E-FILING TAX RETURNS

### Penalty Authority and Digitizing More Paper Return Data Could Increase Benefits

## What GAO Found

In 2011, 79 percent of all individual tax returns were e-filed, a noticeable increase over prior years. Both preparer and self-prepared e-file rates increased, which IRS officials attributed to different factors. They said the e-file mandate was one key factor in the growth of preparer e-filing. Preparers GAO interviewed who were new to e-filing said they experienced increased costs and administrative burdens due to the mandate. Several preparers who had been e-filing prior to the mandate said they experienced some of these same problems when they first e-filed, but they now find that e-filing helps their business—for example, by reducing the time needed to file returns.

**E-file Rates for Preparers and Self-Prepared, Calendar Years 2006 to 2011**  
Percent



Source: IRS's Individual Return Transaction File data.

IRS's plans to identify preparers who are not complying with the mandate are not fully developed because IRS does not know the extent of noncompliance and it may be low. Nonetheless, officials stated some noncompliance likely exists and may increase in 2012 when the mandate applies to more preparers. Regardless of the extent, IRS does not have authority under the IRC to assess penalties on preparers who fail to comply. IRS may be able to impose sanctions under Department of Treasury regulations that govern practice before IRS. However, the process is costly and the penalties, which could include suspension of practice, may be harsher than needed.

IRS is considering pursuing two options to digitize more data—bar coding and additional transcription. IRS does not transcribe all lines from paper returns. IRS's policy is to post the same information from electronic and paper returns to its databases, so that similar paper and electronic returns have equal chances of being audited. IRS has not analyzed the costs and benefits of these options, which could support informed funding decisions.

Some forms cannot be e-filed, including two relatively high-volume forms for amended returns and nonresident aliens. IRS has not developed a complete list of forms that cannot currently be e-filed nor does it have a time line for adding them to the e-file system. Without adding forms such as these to the system, IRS will limit e-filing's growth potential.

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## Abbreviations

2-D	two-dimensional
E-file	electronically file
EFIN	Electronic Filing Identification Number
EMS	Electronic Management System
FTE	full-time equivalent
IIRAPHQ	Individual Income Received and Processed - Headquarters
IRC	Internal Revenue Code
IRS	Internal Revenue Service
MeF	Modernized e-File
OCR	optical character recognition
OPR	Office of Professional Responsibility
PDF	Portable Document Format
PTIN	Preparer Tax Identification Number

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United States Government Accountability Office  
Washington, DC 20548

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October 5, 2011

The Honorable Richard J. Durbin  
Chairman  
The Honorable Jerry Moran  
Ranking Member  
Subcommittee on Financial Services and General Government  
Committee on Appropriations  
United States Senate

The Honorable Susan Collins  
United States Senate

Electronically filed (e-filed) tax returns have many benefits for taxpayers such as improved convenience, higher accuracy rates, and faster refunds. According to the Internal Revenue Service (IRS), taxpayers who e-file can expect to get a refund within 3 weeks, while taxpayers who paper file should expect their refund within 6 to 8 weeks. E-filed returns also cost less to process—about \$3.50 less per return, according to IRS officials. IRS officials said that increased e-filing could make it possible to transcribe more data from paper returns, which could result in increased enforcement revenue and improved service to taxpayers. Nevertheless, tens of millions of individual tax returns are still filed on paper. If these remaining paper returns were e-filed, IRS could have saved about 85 percent of its processing costs during 2010, or about \$131 million.

To support increased e-filing, Congress passed the Worker, Homeownership, and Business Assistance Act of 2009, which requires tax return preparers who expect to file more than 10 federal income tax returns for individuals, estates, and trusts during a calendar year to e-file, starting on January 1, 2011 (i.e., for tax year 2010).<sup>1</sup>

Given the potential benefits for IRS, taxpayers, and preparers, you requested that we review IRS's implementation of this e-file mandate and IRS's plans and capacity to maximize its use of digital data. In March 2011, we issued an interim report that assessed IRS's initial implementation of the mandate and made recommendations to simplify

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<sup>1</sup>Pub. L. No.111-92, § 17, 123 Stat. 2984 (Nov. 6, 2009).

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the e-filing process for preparers and better inform the taxpayers of the benefits of e-filing, to which IRS agreed.<sup>2</sup> To complete your request, in this report we (1) describe e-file rates, IRS processing capacity, reasons why preparers did not e-file, and their experiences implementing the mandate; (2) assess IRS's plans to enforce the mandate and determine lessons learned; (3) assess IRS's analysis of options for digitizing more data from paper returns; and (4) determine whether there are any tax forms IRS cannot accept electronically and assess IRS's plans for adding them to the e-filing system.

To accomplish our objectives, we obtained and analyzed e-file data prior to and during IRS's 2011 filing season, examined preparer e-file and waiver applications, and interviewed 9 tax preparation software companies and 26 representatives from tax preparation firms to obtain their views about the mandate's implementation. Companies and preparers were identified through referrals from industry groups. We reviewed IRS compliance and enforcement plans and interviewed officials from IRS's Office of Professional Responsibility (OPR). We analyzed prior proposals to add a bar coding system to process paper returns as well as IRS's priority transcription list and calculated line-by-line transcription costs. Finally, we reviewed IRS's list of forms that can currently be e-filed and analyzed when remaining forms would be added to the e-file systems. For all objectives, we interviewed relevant IRS officials to collect information on IRS's mandate implementation efforts and future plans to increase e-filing.

We reviewed documents and interviewed IRS officials and determined that the data presented in our report were sufficiently reliable for our purposes. We conducted this performance audit from March to October 2011, 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. (See app. I for more information on our scope and methodology.)

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<sup>2</sup>GAO, *Electronic Tax Return Filing: Improvements Can Be Made Before Mandate Becomes Fully Implemented*, [GAO-11-344](#) (Washington, D.C.: Mar. 7, 2011).

## Background

The IRS Restructuring and Reform Act of 1998 established a goal of having 80 percent of individual returns filed electronically by 2007.<sup>3</sup> IRS worked to promote e-filing, and although rates increased steadily between 1998 and 2007, IRS did not meet the 80 percent goal. The IRS Oversight Board recommended extending the goal's time period to 2012 and expanding the scope of the goal to include all major individual, business, and exempt organization returns.<sup>4</sup> Table 1 shows e-filing rates by type of return for fiscal year 2010. Except for individual returns, those rates were far from the 80 percent goal.

**Table 1: E-filing Rates for Major Return Types Subject to the 80 Percent Goal, Fiscal Year 2010**

Returns in millions				
Type of return (form number) <sup>a</sup>	Total number of returns filed	Total number of returns e-filed	Percentage of returns e-filed <sup>b</sup>	Number of additional e-filed returns required to reach 80 percent goal <sup>c</sup>
Individual (1040)	141.2	98.3	69.6%	14.6
Employment (940/941)	29.8	6.9	23.3	16.9
Corporate (1120)	6.8	2.2	32.5	3.2
Partnership (1065)	3.5	1.3	36.1	1.5
Fiduciary (1041)	3.1	0.9	28.2	1.6
Tax exempt (990)	1.3	0.5	40.0	0.5
<b>Total<sup>d</sup></b>	<b>185.7</b>	<b>110.1</b>	<b>59.3%</b>	<b>38.4</b>

Source: GAO analysis of IRS Document 6292, Fiscal Year Return Projections for the United States 2011 through 2018 (revised June 2011).

<sup>a</sup>IRS's 2012 e-file goal also includes real estate mortgage investment conduits and excise tax returns. These returns are small in volume and not included in this chart.

<sup>b</sup>Percentages are based on non-rounded return counts.

<sup>c</sup>While the number of returns needed to reach the 80 percent goal may appear small in several cases (e.g., corporate returns), the percent needed is large. Numbers are based on non-rounded return counts.

<sup>d</sup>Numbers may not sum to totals due to rounding.

IRS is implementing the e-file mandate in two phases. In 2011, paid preparers who reasonably expect to file 100 or more individual, estate, or

<sup>3</sup>Pub. L. No. 105-206, title II, § 2001, 112 Stat. 685 (July 22, 1998).

<sup>4</sup>IRS Oversight Board, *Electronic Filing 2006: Annual Report to Congress*, Feb. 28, 2007. The IRS Oversight Board's responsibility is to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws.



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trust income tax returns are required to e-file. In 2012, the e-file requirement will apply to paid preparers who reasonably expect to file more than 10 individual, estate, or trust tax returns.<sup>5</sup> IRS decided to implement the mandate in two phases to give preparers time to make any necessary changes to their business practices and to help IRS prepare for the anticipated volume in e-file applications. (See app. II for possible business changes affecting preparers as a result of the mandate as well as a comparison of the paper filing and e-filing processes.)

In recent years, taxpayers have relied heavily on third party software companies and preparers to get tax information and prepare their tax returns. Figure 1 illustrates how taxpayers avoid direct interaction with IRS by working with third parties. In 2010, 91 percent of all tax returns were prepared using tax software—some by preparers and some by taxpayers.<sup>6</sup> Approximately 70 percent of all 2010 returns were e-filed while the remainder were printed and mailed in on paper (see more details of preparation and filing methods in app. III). Also, as reported in IRS's Return Preparer Review, many taxpayers often rely on third parties to assist them with their tax law questions.<sup>7</sup>

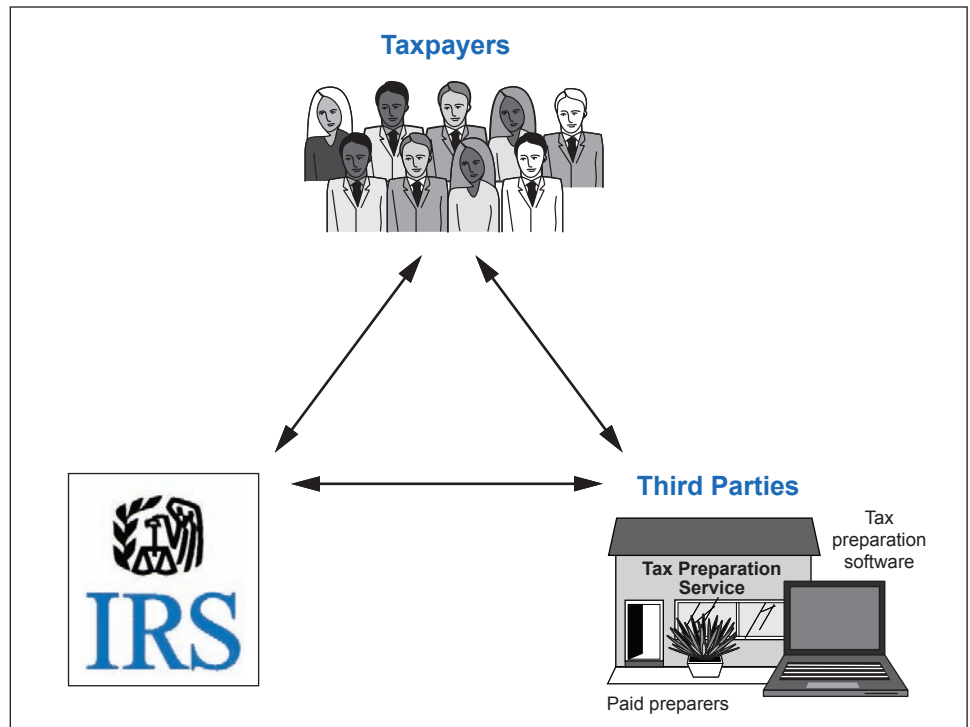
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<sup>5</sup>*Specified Tax Return Preparers Required to File Individual Income Tax Returns Using Magnetic Media (Final Regulations)*, 76 *Fed. Reg.* 17,521 (Mar. 30, 2011). The regulations specify that the determination of whether a preparer reasonably expects to file more than 10 returns is made by adding together all of the individual tax returns the preparer or the preparer's firm reasonably expects to prepare and file in the calendar year, except for returns subject to administrative exemptions and returns for which the taxpayer signs an opt-out statement.

<sup>6</sup>Calendar year data from Individual Return Transaction File.

<sup>7</sup>Department of the Treasury, Internal Revenue Service, *Return Preparer Review*, Publication 4832 (Rev 12-2009) (Washington, D.C.: December 2009).

**Figure 1: Key Parties in Providing Tax Information and Preparing Returns**



Source: GAO analysis of IRS information.

IRS accepts e-filed tax returns through two systems, the legacy Electronic Management System (EMS) and the new Modernized e-File (MeF) system. During filing season 2011, only certain forms were accepted through the MeF system, so not all tax returns could be processed with the new system. IRS plans to add all of the forms currently accepted in EMS to MeF and discontinue use of EMS in October 2012. IRS officials said that MeF provides several benefits; for example, MeF accepts or rejects individual tax returns faster than the EMS and provides better explanations for rejections.<sup>8</sup> MeF will also allow taxpayers to attach Portable Document Format (PDF) files to their tax returns, which will be

<sup>8</sup>We previously recommended that IRS provide paid preparers and software providers with clearer descriptions of why returns are rejected. See GAO, *Tax Administration: Opportunities Exist for IRS to Enhance Taxpayer Service and Enforcement for the 2010 Filing Season*, [GAO-09-1026](#) (Washington, D.C.: Sept. 23, 2009).

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useful in instances where taxpayers are required to submit additional documentation, such as settlement statements when claiming the First Time Homebuyer Credit. Another benefit is that MeF accepts prior year returns starting with tax year 2009. As we previously reported, IRS tested MeF during the 2010 filing season, but use was low.<sup>9</sup> Industry stakeholders, who are major users of the e-filing systems, said MeF was unstable (i.e., the system often had down time, time-outs, slow servers, and delayed acknowledgments). Use of MeF increased during the 2011 filing season and industry stakeholders reported improvements and positive experiences with the system. IRS officials said that plans to exclusively use MeF for the 2013 filing season are viable.

E-filed tax returns provide IRS with digital information. IRS transcribes select data from paper returns to convert it to a digital format. IRS's policy is to post the same information from electronic and paper returns to its databases. Only information posted to its databases is readily available for use in IRS's enforcement programs and audit selections, which means that similar paper and electronic returns have equal chances of being selected for audit.<sup>10</sup> In addition to e-filing or transcribing, IRS can potentially obtain digital tax data from two-dimensional (2-D) bar coding. A 2-D bar code is a black and white grid that encodes tax return data. Tax software would print bar codes on paper tax returns and high-speed scanners would scan them and import the data into IRS's systems. IRS released a study in December 2010 that found that using 2-D bar codes would provide significant flexibility and generate cost savings.<sup>11</sup> Paper returns that were prepared with pens or typewriters rather than software would still have to be transcribed.

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<sup>9</sup>GAO, *Tax Filing Season: IRS's Performance Improved in Some Key Areas, but Efficiency Gains Are Possible in Others*, [GAO-11-111](#) (Washington, D.C.: Dec. 16, 2010).

<sup>10</sup>Information not posted to IRS databases can be obtained from the original source documents (i.e., paper or e-filed return) when needed.

<sup>11</sup>The MITRE Corporation, *Advancing E-file Study Phase 2 Report: An Examination of Options to Increase Electronic Filing of Individual Returns*. A special report sponsored by the Internal Revenue Service. (Dec. 15, 2010.)

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## Individual E-filing Rate Approaches 80 Percent Goal After First Year of Mandate, but Some Taxpayers Still Choose to File on Paper

### 2011 E-filed Returns Have Surpassed Projections and Were Processed Smoothly

As of August 12, 2011, IRS processed 108 million returns electronically and 29 million returns on paper, for an e-filing rate of about 79 percent, according to IRS's weekly processing data.<sup>12</sup> IRS officials had estimated that the mandate would increase the individual e-filing rate to 75 percent in 2011 and 77 percent in 2012.

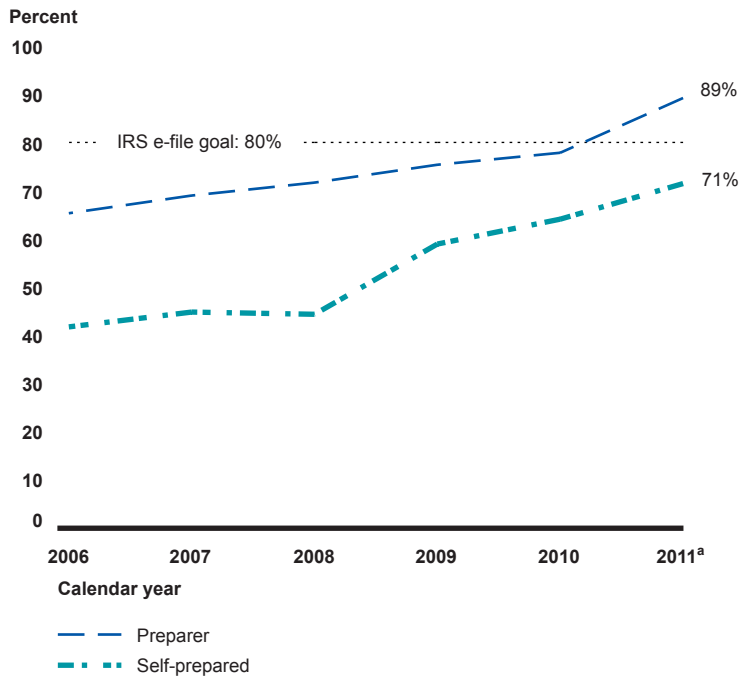
The e-file rate for preparers increased this year, to about 89 percent, which is an increase of about 11 percentage points over last year's rate, according to data as of July 2, 2011, from the Individual Return Transaction File.<sup>13</sup> Although the e-file mandate did not apply to individual taxpayers who self-prepared their returns using commercial tax software, their e-file rate also increased to about 71 percent or about 7 percentage points over last year's rate. (See fig. 2.) Based on IRS processing data and interviews with select software companies, IRS did not have any problems processing the 7.9 million additional returns e-filed in 2011.

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<sup>12</sup>Individual Income Received and Processed Headquarters (IIRAPHQ) Cumulative Individual Income Tax Return report for week ending Aug. 12, 2011.

<sup>13</sup>IRS officials stated that the Individual Return Transaction File, which provides data broken down by preparers vs. individual taxpayers, is updated after and less frequently than the IIRAPHQ report.

**Figure 2: E-file Rates for Returns Prepared by Preparers and Self-Prepared, Calendar Years 2006 to 2011**



Source: IRS's Individual Return Transaction File data.

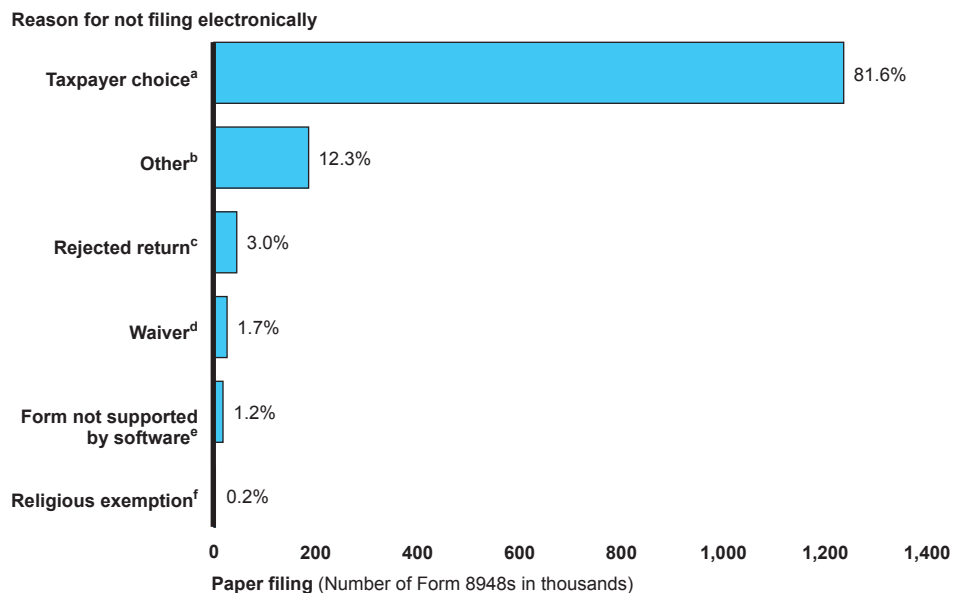
<sup>a</sup>Calendar year 2011 data are part-year data through July 2, 2011.

While IRS has not conducted an analysis to determine what factors influenced e-file growth, officials in the Return Preparer Office said that the mandate was one of the main contributors. According to IRS Forecasting Office officials, the increased e-file rate for self-prepared returns may have been due, in part, to IRS no longer mailing the paper forms and instructions to taxpayers, and to taxpayers becoming more comfortable with technology.

## Most Preparers Who Did Not E-file Cited Taxpayer's Choice as the Explanation

By far the most common reason preparers cited for not e-filing was that the taxpayer asked to file on paper, as shown in figure 3.<sup>14</sup> Preparers subject to the mandate who did not e-file a tax return were required to complete Form 8948, "Preparer Explanation for Not Filing Electronically," and submit it with the return.<sup>15</sup> IRS has not analyzed why taxpayers chose to file on paper, but it plans to do so in the future. Other reports about e-filing suggest some taxpayers have security concerns with e-filing.<sup>16</sup>

**Figure 3: Preparer Reasons for Paper Filing Based on 1.5 Million Form 8948s, "Preparer Explanation for Not Filing Electronically"**



Source: GAO analysis of IRS Preparer Explanation Form count data.

<sup>14</sup>Waivers were a less common reason but they are noteworthy as well, because they require a separate administrative process by IRS. Preparers could apply for hardship waivers, which IRS could grant for bankruptcy or economic hardship in cases where preparers are located in a declared disaster area, and for "other" reasons. As of June 21, 2011, IRS received and processed 938 preparer hardship waiver applications, 72 percent of which were approved.

<sup>15</sup>As of June 17, 2011, IRS received and processed 1.5 million Form 8948s.

<sup>16</sup>The MITRE Corporation, *Advancing E-file Study Phase 2 Report: An Examination of Options to Increase Electronic Filing of Individual Returns*. A special report sponsored by the Internal Revenue Service. (Dec. 15, 2010.)

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<sup>a</sup>The taxpayer requested that the return be filed on paper.

<sup>b</sup>Other can include various things, such as a foreign preparer without a Social Security number.

<sup>c</sup>The tax return was rejected by the e-file system and the error could not be resolved.

<sup>d</sup>The preparer obtained a hardship waiver from IRS for instances such as economic hardship.

<sup>e</sup>Some e-file software packages may not support lesser-used forms.

<sup>f</sup>A religious exemption is allowed for a preparer who is a member of a recognized religious group that is conscientiously opposed to filing electronically.

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## Preparers' Views about Implementing the Mandate Varied Based on Prior E-filing Experiences

The preparers we talked with who were new to e-filing said they experienced increased costs and administrative burdens as a result of the mandate. Other preparers, who previously e-filed returns, told us that the mandate had little effect on their practice. We interviewed 26 preparers who were members of national preparer groups. Their views are not representative of the entire population of preparers, but they provide some examples of preparer experiences.<sup>17</sup>

Five of the 26 preparers we interviewed had not previously e-filed, and they provided a variety of examples of how the mandate affected them. One preparer noted that her software provider charged an additional fee to e-file returns. Another preparer stated he hired an additional administrative employee to help manage requirements that were new to him when e-filing, such as Form 8879, "IRS e-file Signature Authorization." Several preparers told us that it took them several hours to make changes to rejected returns—a step that may not occur until months later, if at all, when filing a paper return. Another preparer who had not previously e-filed reported that she experienced a learning curve for e-filing, but after e-filing the first 10 or so returns, the process went more smoothly. Several preparers who had been e-filing prior to the mandate said they experienced some of these same problems when they first e-filed, but do not any longer.

Some preparers who previously e-filed said that e-filing helped their businesses and found that the mandate did not change their operations greatly from the previous years. These preparers liked the convenience of e-filing and told us that it reduced the time needed to file returns, ensured the receipt of returns at IRS, and did not cost them any additional money,

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<sup>17</sup>We interviewed members from three national groups: American Institute of Certified Public Accountants, National Association of Tax Professionals, and National Association of Enrolled Agents.

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but in fact saved them money. One preparer noted that he had e-filed some returns in previous years, but this year was the first time that almost all of his clients e-filed due to his encouragement because of the mandate. He said he saved money by placing PDF versions of his clients' returns on a secure network space for them to review before he e-filed the return with IRS, reducing printing costs.

Some preparers we interviewed relied heavily on software companies. One preparer noted that he attends tax law training conducted by his software company to get annual updates. Three of the preparers we interviewed noted that their software automatically generated the new forms needed to comply with the mandate (e.g., Form 8948), and two preparers said that they heard about the mandate through their software companies.

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## IRS Is Developing Plans to Deal with Noncompliant Preparers and Study Lessons Learned from E-file Mandate Implementation

### IRS Does Not Know the Extent of Preparer Noncompliance with the Mandate or Have the Authority to Issue Monetary Penalties

IRS officials believe there are potentially three types of preparers who may not comply with the e-file mandate: Preparers who

- are unaware of the mandate or do not fully understand the requirements;
- know about the mandate, sign the tax return, but intentionally choose not to e-file; or
- complete tax returns, but do not sign the returns or submit them electronically. IRS refers to these preparers as “ghost preparers.”

IRS has preliminary plans to identify each of these types of noncompliant preparers, but the plans are not yet fully developed. To identify preparers who may be unaware of or deliberately noncompliant with the mandate,



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IRS plans to review paper tax returns and identify ones that were completed by a preparer and appear eligible for e-filing but have no Form 8948, "Preparer Explanation for Not Filing Electronically."<sup>18</sup> To further identify preparers who are willfully noncompliant with the mandate, officials plan to review preparers' use of Form 8948, but have not yet determined how they will use this information to identify noncompliant preparers. Officials in IRS's Return Preparer Office also stated they plan to modify the existing e-file monitoring program—currently focused mostly on e-file security—to include compliance with the e-file mandate. However, officials have not yet developed the selection criteria to determine which preparers they will send notices to and visit, nor have they determined how compliance with the e-file mandate will fit into the scope of their visits. IRS has some plans regarding ghost preparers that were developed to enforce new regulations for preparers. Among other things, IRS plans to send letters to taxpayers who submitted returns without preparer signatures yet appear to have had assistance completing their returns.<sup>19</sup>

IRS officials said that one reason they have not completed their compliance plans is that they do not yet know the extent of noncompliance with the mandate. IRS officials said an extensive compliance strategy may not be needed unless noncompliance rates are high. They said that because this is the first year of the mandate's 2-year implementation period, there is not sufficient data to know whether noncompliance with the e-file mandate is high or will be high in the future. In fact, they suspect that noncompliance may be low, because e-file rates exceeded projections in the first year of the mandate. Nonetheless, they acknowledged that some noncompliance likely exists, and that there could be more next year when the mandate is fully effective and the threshold for the e-file requirement drops to more than 10 returns (down from 100 in 2011).

Regardless of the extent of noncompliance, IRS does not have authority under the Internal Revenue Code (IRC) to impose penalties on preparers

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<sup>18</sup>A return that appears eligible for e-filing could include a paper return with a preparer tax identification number (PTIN) but not a Form 8948, "Preparer Explanation for Not Filing Electronically." Starting in 2011, tax return preparers must obtain a PTIN, and use it to sign all returns they prepare, paper and electronic. 26 C.F.R. § 1.6109-2.

<sup>19</sup>IRS uses different methods to determine if taxpayers appear to have had assistance in preparing their returns. IRS safeguards such details of its compliance strategy.

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who fail to comply with the e-file mandate, but does have some authority to discipline preparers under the Department of Treasury's Circular No. 230.<sup>20</sup> Circular 230 governs the practice of practitioners, including tax return preparers, before IRS, and provides IRS with a limited ability to sanction preparers for failing to e-file.<sup>21</sup> IRS's Office of Professional Responsibility (OPR) administers and enforces Circular 230 standards. OPR officials said that they do not plan to frequently impose sanctions against preparers for noncompliance with the e-file mandate because the administrative process is resource-intensive and the sanctions may also be harsher than necessary. Prior to imposing sanctions, OPR must provide practitioners with notice and an opportunity for a hearing. Building a case against a preparer is time-consuming, often taking longer than a filing season. Sanctions can include censure, suspension from practice before IRS, or disbarment. IRS can also impose monetary sanctions under Circular 230, but officials said they likely would not because the agency does not have the authority to collect any unpaid amounts—such cases must be referred to the Department of Justice, adding to the time and costs of enforcement.

Because imposing monetary sanctions under Circular 230 is time-consuming and costly, IRS could benefit from separate penalty authority under the IRC. IRS already has authority under the IRC to impose penalties in other, similar circumstances.<sup>22</sup> For example, IRS may impose a \$50 penalty per return if a preparer neglects to sign a tax return or

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<sup>20</sup>IRS has the authority under the IRC to impose and collect penalties on paid preparers for certain misconduct in the preparation of tax returns. See, for example, 26 U.S.C. §§ 6694, 6695, 6701 and 6713. IRS currently cannot impose or collect penalties for a paid preparer's failure to e-file. Section 330 of title 31 of the United States Code allows the Secretary of the Treasury, delegated to OPR, to regulate the practice of representatives of persons before IRS. The regulations governing practice are in 31 C.F.R., part 10, which was published as *Circular 230*. Under *Circular 230*, OPR may initiate disciplinary proceedings against these practitioners for certain incompetent or disreputable conduct.

<sup>21</sup>Practice before IRS encompasses all matters connected with a presentation to IRS relating to taxpayer's rights, privileges, or liabilities under tax laws, including preparing documents or filing documents with IRS. Practitioners are attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and as of August 2, 2011, registered tax return preparers. 31 C.F.R. § 10.2(a). *Circular 230* includes failure to e-file in the definition of disreputable conduct for which a preparer can be sanctioned. 31 C.F.R. § 10.51(a)(16).

<sup>22</sup>IRS is authorized to assess penalties on paid preparers for a variety of reasons including failure to (a) furnish a copy of the return to taxpayer, (b) sign the return, (c) obtain and include a PTIN on the return, and (d) retain copy of the return. 26 U.S.C. § 6695.

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include a Preparer Tax Identification Number (PTIN) on a return.<sup>23</sup> According to IRS's penalty handbook, penalties exist to encourage voluntary compliance by supporting the standards of behavior required by the IRC.<sup>24</sup> Granting IRS the authority to penalize for failing to e-file would build upon IRS's existing penalty regime and provide a more commensurate sanction than those which can be imposed under Circular 230. Without such penalty authority, IRS may be limited in its ability to deter noncompliance and enforce the e-file mandate.

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### Analyzing and Documenting Lessons Learned Could Improve the Implementation of Any Future E-file Mandates

According to the Director of the Return Preparer Office, IRS intends to conduct a "lessons learned" review of steps taken to implement the e-file mandate, but does not have a plan or schedule for doing so. As discussed in our previous reports, lessons learned can be useful tools for an organization to identify areas of improvement or document things that worked well.<sup>25</sup> Areas of focus could include a review of staffing levels, timeliness of management decision making, and communication with the public. One lesson learned during the first year of the e-file mandate may be that additional staff helped IRS process e-file applications in a timely manner.<sup>26</sup> (See app. IV for more information on the e-file application process.)

Performing a lessons learned analysis on the e-file mandate for preparers could have future benefits because the fiscal year 2012 budget request for IRS included five legislative proposals for additional e-file mandates.<sup>27</sup> Without identifying and documenting lessons learned, the knowledge

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<sup>23</sup>Starting in 2011, tax return preparers must obtain a PTIN, and use it to sign all returns they prepare, paper and electronic. PTINs will allow IRS to identify preparers and help ensure they are in compliance with rules relating to tax return preparers. 26C.F.R. § 1.6109-2.

<sup>24</sup>Internal Revenue Manual 20.1.

<sup>25</sup>GAO, *Recovery Act: IRS Quickly Implemented Tax Provisions, but Reporting and Enforcement Improvements Are Needed*, [GAO-10-349](#) (Washington, D.C.: Feb. 10, 2010) and GAO, *Information Reporting: IRS Could Improve Cost Basis and Transaction Settlement Reporting Implementation*, [GAO-11-557](#) (Washington, D.C.: May 19, 2011).

<sup>26</sup>IRS added 41 full-time equivalents (FTE) to process the increased e-file applications in fiscal year 2011, which allowed IRS to process 89 percent of the applications within IRS's target time period of 45 days.

<sup>27</sup>As an example, IRS asked for regulatory authority to require that all information returns and Form 5500s, "Annual Return/Report of Employee Benefit Plan," be e-filed.

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could be lost for reasons such as staff turnover. The scope and depth of a lessons learned study should, of course, balance the costs of the study against the potential benefits.

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## The Benefits and Costs of Different Options for Digitizing Remaining Paper Returns Have Not Been Fully Analyzed

Paper returns limit the effectiveness of IRS's enforcement and service programs. To control costs, IRS does not transcribe all the information on paper tax returns into its computer databases. In addition, as previously noted, IRS has a policy of posting the same information from electronic and paper returns to its databases, so that similar paper and electronic returns have equal chances of being selected for audit. In part, IRS's intention with this policy is to avoid disincentives to e-filing. Consequently, if a line is not digitized from paper returns, it is not posted from electronic returns either, which limits the amount of information readily available for enforcement and service purposes. For example, taxpayers' telephone numbers are not digitized. When IRS wants to obtain a phone number from a paper tax return, the number must be retrieved from the originally filed return, which takes extra time.

Digitizing data can benefit taxpayers. In addition to faster refunds and improved convenience, IRS officials said that having more tax return information available electronically would improve audit selection, thus reducing burdensome audits for compliant taxpayers.<sup>28</sup> Additionally, digital information can help some taxpayers get larger refunds, or reduce their taxes due. For example, using automated error checking, IRS corrected 7.7 million returns from taxpayers claiming the Making Work Pay credit, about 60 percent of which were in the taxpayer's favor.<sup>29</sup> These automated corrections, which reduced taxes, may not have been possible without digitizing relevant data from paper returns.

According to IRS officials, digitizing and posting more comprehensive information from individual income tax returns could also facilitate enforcement efforts, expedite contacts for faster resolution, reduce handling costs, and increase compliance revenue. For example, in fiscal

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<sup>28</sup>See GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated*, [GAO-08-38](#) (Washington, D.C.: Nov. 15, 2007).

<sup>29</sup>The error corrections were made January 1 through September 30, 2010. See GAO, *Tax Refunds: Enhanced Prerefund Compliance Checks Could Yield Significant Benefits*, [GAO-11-691T](#) (Washington, D.C.: May 25, 2011).

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year 2010, IRS increased the amount of data it transcribed from Form 5405, "First-Time Home Buyer Credit." It used this additional information to conduct prerefund compliance checks to ensure that taxpayers do not claim the credit in multiple years. We calculated IRS's increased enforcement efforts prevented about \$95 million in erroneous refunds in fiscal year 2010.<sup>30</sup>

Options for digitizing more paper tax return data include optical character recognition (OCR), bar coding, and transcription.<sup>31</sup> An OCR system would read text directly from paper returns using optical scanners and recognition software and convert the text to digital data. IRS is not currently considering implementing OCR to obtain more digital data because of the high expense of the additional equipment needed.<sup>32</sup> Instead, IRS is pursuing what it considers to be a less costly bar coding system and transcribing more data from paper returns.

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## Bar Coding Could Be Operational In Several Years

Two-dimensional (2-D) bar coding technology would capture data on v-coded returns, which are those returns that are prepared using software but are printed and mailed to IRS. All of the information on a return can be coded in bar codes, and unlike transcription, bar codes transfer data with 100 percent accuracy (although poorly printed bar codes may be rejected by the scanners). On a limited basis, IRS already uses bar coding technology to digitize the Schedule K-1, "Partner's Share of Income, Deductions, Credits, etc." This system, implemented in the early 1990s, was used to digitize about 15 million Schedule K-1s in fiscal year 2010. IRS also recently started to use bar codes to mask Social Security numbers on communication letters to preparers.

IRS's Submission Processing officials told us that they have written a proposal for a bar coding system, and IRS may request funding for it in the near future. Officials believe bar coding will improve tax return processing and reduce costs. As we previously reported, bar coding could contribute to IRS's agency modernization goals and produce some of the

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<sup>30</sup>See [GAO-10-349](#) and [GAO-11-691T](#).

<sup>31</sup>Other options may be available or could be developed in the future.

<sup>32</sup>IRS officials did not provide us documentation showing that OCR is a more expensive option than bar coding or additional transcription. Our analysis only considered the options IRS officials say they are pursuing.

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same efficiencies as e-filing by replacing the labor-intensive transcription process and eliminating transcription errors.<sup>33</sup> However, returns that were prepared without software—for example, with a typewriter or pen—would still require manual transcription, and bar coded returns would require some paper processing such as receiving and opening mail. A cost-benefit analysis for bar coding could include costs for processing and transcribing remaining paper returns.

In our prior report, we recommended that IRS determine actions needed to require bar coding and related costs.<sup>34</sup> IRS's 2012 Revenue Proposals included a legislative proposal that would require all taxpayers who prepare their returns electronically but print and file them on paper to print the returns with a 2-D bar code.<sup>35</sup> As of September 1, 2011, there had been no action on this legislative proposal.

Officials also told us that even if a potential request is funded, it will be another 18 to 24 months before IRS could begin scanning individual paper returns using the technology. IRS has not yet produced a cost-benefit analysis or a return on investment study related to the bar coding initiative. Without a cost-benefit study, IRS management and Congress will lack key information useful for deciding whether to fund bar coding.

IRS officials told us that if IRS is able to implement bar coding, they plan to model the bar code system on systems that states have developed and standardized, working in collaboration with software companies. As of 2007, 24 states and the District of Columbia were using bar code scanning to process some or all of their tax returns.<sup>36</sup> State tax agencies reported that bar coding is quicker, more accurate, and less expensive than manual transcription of paper tax return data. A 2007 survey by the Federation of Tax Administrators asked the states that bar coded various state tax returns that year about savings they realized by bar coding instead of transcribing data manually. Eleven states provided answers

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<sup>33</sup>[GAO-08-38](#).

<sup>34</sup>*Ibid.*

<sup>35</sup>Due to the limitations under Section 6011(e)(1), a statutory change is necessary to require individuals, estates, and trusts to print their returns with a 2-D bar code.

<sup>36</sup>These data have not been updated since 2007.

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with quantitative cost information; each of them reported that bar coding cost less than manual transcription.

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### Transcribing More Lines of Data from Paper Returns May Have Net Benefits

Manual transcription of data is the primary method currently available to IRS to digitize data from paper returns. IRS has analyzed the cost of transcribing all remaining lines on individual paper tax forms, and estimates that it would require 1,714 full-time equivalent (FTE) staff, costing about \$71 million, for fiscal year 2012. However, IRS officials told us that IRS does not have funding at this time to transcribe all the remaining data lines from paper returns. According to IRS officials, IRS may increase the digital data available to its programs by transcribing selected lines, although the amount of transcription needed would be reduced if bar coding were implemented.

If the additional transcription is phased in, a cost-benefit analysis that prioritizes data on a line-by-line basis could be used to determine which lines would have the lowest costs and greatest benefits. IRS has not completed such an analysis. IRS has taken some steps, such as developing priority lists of additional lines to transcribe, but has not quantified the costs or benefits of transcribing each line. Also, these listings were developed in different business operating divisions and are not integrated across divisions, so there is no ranking of the agency's transcription priorities as a whole.

Ranking transcription priorities could have benefits because the cost of transcription varies by line. We used IRS data to develop calculations to illustrate the potential variability of transcription costs across different tax return lines that IRS included in its priority listing.<sup>37</sup> We estimated the costs of transcribing different lines from all paper tax returns submitted during a filing season, and found that costs varied from less than \$1,000 to more than \$500,000.

We illustrate the variability of transcription costs by presenting averages for all lines on selected forms. For example, if IRS were to transcribe an average line on Form 1040 Schedule C from all paper tax returns for a

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<sup>37</sup>These calculations are based on the cost per keystroke transcribed, the average number of keystrokes for the line, the e-file rate of the form or schedule that the line appears on, the number of taxpayers who submit the form or schedule that the line appears on, and the rate at which the line is filled in rather than left blank.

filing season, it would cost \$123,400. Costs for different lines on Schedule C would vary substantially around this average. Table 2 illustrates some of the average costs for lines on high-volume forms and schedules. (More details on our calculations are in app. V.)

**Table 2: Estimated Average Filing Season Transcription Cost Per Line on High Volume Forms and Schedules<sup>a</sup>**

Form/Schedule	Estimated average filing season transcription cost for line on form/schedule
Form 8863, "Education Credits"	\$217,800
Form 1040, "U.S. Individual Income Tax Return"	159,700
1040 Schedule C, "Profit or Loss From Business"	123,400
1040 Schedule E, "Supplemental Income and Loss"	50,400
Form 4562, "Depreciation and Amortization"	11,600
1040 Schedule D, "Capital Gains and Losses"	8,100

Source: IRS data.

<sup>a</sup>Based on lines listed by IRS as priorities for transcription. Averages do not include lines that are already transcribed. Averages are rounded. Costs for individual lines vary substantially around the averages. Cost information is based on IRS labor cost projections for 2012.

Because an increasing percentage of returns are e-filed, IRS could be at the tipping point where the service and compliance benefits of digitizing additional data from paper returns are greater than costs. Given today's tight budget environment, additional resources for transcription would likely have to be moved from other areas within IRS. In deciding on whether to transcribe more lines, IRS would have to balance the benefits of additional transcription against the value of the work foregone.



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## IRS Does Not Have a Complete List of Forms That Cannot Be Accepted Electronically Nor Does It Have a Time Line for Adding Them to the E-file System

Preparers and taxpayers wanting to e-file may not be able to because some forms have not been added to IRS's e-file systems. We identified two high-volume individual forms that currently cannot be e-filed and do not have a time line to be added to MeF.<sup>38</sup>

- Form 1040-X, "Amended U.S. Individual Income Tax Return." About 6.9 million taxpayers submitted a Form 1040-X in fiscal year 2010. Several tax preparers we spoke with said it was a burden not to be able to e-file this form. Electronic Tax Administration officials said eventually they would like to enable e-filing of the 1040-X, but they have not done so because the technology would need to be developed to check the amended data against what was originally filed.
- Form 1040-NR, "U.S. Nonresident Alien Income Tax Return." About 621,000 taxpayers submitted a Form 1040-NR in 2010. IRS officials said that Form 1040-NR was not included in the decision process when IRS decided on the sequence of adding forms to e-file, but it might be in the future.

Having a time line to add these high-volume or other forms to the e-file system could help IRS further achieve its e-filing goals, consistent with IRS's e-Strategy for Growth.<sup>39</sup> Without a time line, these high-volume or other forms may not be added to the e-file system.

One reason IRS does not have a complete time line is that it has not developed a complete list of forms that cannot currently be e-filed. IRS's Strategic Plan calls for using data and research across the organization to make informed decisions and allocate resources.<sup>40</sup> Adding forms to the e-file system requires one-time expenditures, but ultimately may have compliance benefits, save IRS money, and reduce the burden on preparers and taxpayers. Without a list of forms that are not currently e-filed, IRS would not be able analyze the costs and benefits of adding

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<sup>38</sup>Other forms exist that cannot be e-filed—for example, Form 1041-QFT, "U.S. Income Tax Return for Qualified Funeral Trusts" and Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons." These forms may be lower in volume, but having them available electronically may help with IRS's compliance efforts.

<sup>39</sup>IRS, *e-Strategy for Growth: Expanding e-Government for Taxpayers and Their Representatives*, Pub 3187 (Washington, D.C.: Rev. January 2005).

<sup>40</sup>IRS, "Strategic Plan 2009-2013," Pub. 3744 (Washington, D.C.: Rev. April. 2009). [www.irs.gov/pub/irs-pdf/p3744.pdf](http://www.irs.gov/pub/irs-pdf/p3744.pdf).

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different forms in order to prioritize which forms to add. Further, as with additional transcription, IRS would need to weigh the benefits of shifting resources to enable forms to be e-filed against the value of the work forgone.

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## Conclusions

E-filing provides important benefits to taxpayers, including faster refunds and more accurate returns. It provides a low-cost option for IRS to improve enforcement operations and services to taxpayers. This is especially important in an era of tight budgets when federal agencies will be expected to do more with less. The increased e-filing rates from the first year of the mandate are helping IRS do this.

IRS would benefit from having increased penalty authority to enforce the mandate and deter noncompliance. There are also several steps IRS could take to reduce costs, obtain more digital data, and facilitate further growth in e-filing. Documenting lessons learned from the current mandate might help with the implementation of future e-file mandates. Analysis of the costs and benefits of bar coding technology and additional transcription could better inform decisions about whether to digitize more data from paper returns. Similarly, developing a list and scheduling the addition of more forms to the e-file system could inform resource allocation decisions.

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## Matter for Congressional Consideration

Congress should consider amending the Internal Revenue Code to authorize IRS to assess penalties on preparers for failure to comply with section 6011(e)(3).

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## Recommendations for Executive Action

To help increase electronic filing and to better target IRS's efforts, we recommend that the Commissioner of Internal Revenue direct the appropriate officials to take the following five actions:

- develop a plan for and schedule to conduct a study that identifies and documents lessons learned from the implementation of the e-file mandate;
- determine whether and to what extent the benefits of bar-coding would outweigh the costs;
- determine the relative costs and benefits of transcribing different individual lines of tax return data;

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- develop and prioritize a list of forms that still need to be added to the Modernized e-File system; and
  - create a timetable to add additional forms to the Modernized e-File system, particularly for high-volume forms, such as the 1040-X and 1040-NR.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of Internal Revenue for his review and comment. The Deputy Commissioner for Services and Enforcement provided written comments, which are reprinted in appendix VI. IRS also provided us with technical comments, which we incorporated into the report as appropriate.

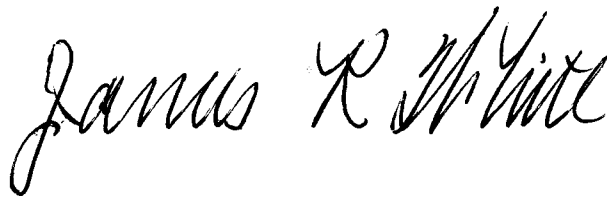
In response to our draft report, the Deputy Commissioner expressed appreciation to GAO for recognizing the noticeable increase in e-file participation this year and agreed with all five of our recommendations. However, the steps IRS outlined in its comments may not fully address two of our recommendations. Regarding our recommendation on the relative costs and benefits of transcribing different individual lines of tax return data, IRS stated that it has determined the relative costs of transcribing individual lines. To fully address this recommendation, however, IRS should also quantify the benefits of transcribing individual lines and compare them to the individual costs. This analysis could inform budget decisions by allowing IRS to compare the option of additional transcription against any work foregone. Regarding our recommendation to develop and prioritize a list of forms that still need to be added to MeF, IRS outlined the next three releases scheduled for MeF (through filing season 2014). While IRS has a list of forms it plans to transfer from EMS to MeF, there are still some forms that cannot be e-filed on either system. To fully address this recommendation, IRS should also develop a list of forms and schedules that cannot currently be e-filed. A complete list would enable IRS to analyze the costs and benefits of adding different forms to MeF as well as prioritizing which forms to add first.

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We plan to send copies of this report to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We are also sending copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. This report is also available at no charge on the GAO Web site at <http://www.gao.gov>.

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If you or your staffs have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9110 or [WhiteJ@gao.gov](mailto:WhiteJ@gao.gov). Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. Individuals making key contributions to this report can be found in appendix VII.

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, looping initial "J".

James R. White  
Director, Tax Issues  
Strategic Issues

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# Appendix I: Scope and Methodology

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To describe electronic filing (e-file) rates, the Internal Revenue Service's (IRS) processing capacity, reasons why preparers did not e-file, and their experiences implementing the mandate, we obtained and analyzed data from IRS's weekly processing reports and the Individual Return Transaction File from Submission Processing and the Return Preparer Office, respectively.<sup>1</sup> Data included numbers of returns that were completed by taxpayers and preparers as well as the filing method—e-filed, "v-coded," and paper filed. In addition, we obtained and analyzed data about Form 8948, "Preparer Explanation for Not Filing Electronically," and Form 8944, "Preparer e-file Hardship Waiver Request." To determine the reliability of IRS's data, we interviewed IRS officials who created the reports, reviewed related documentation, and reviewed the data for obvious errors. We found the data to be sufficiently reliable for our purposes. We interviewed Submission Processing officials and representatives from the National Association of Computerized Tax Processors about how well IRS processed additional e-filed returns this year. We also interviewed 9 tax software companies and 26 representatives from tax preparation firms to obtain their views about the mandate's implementation. We chose a nonrepresentative sample of preparers affiliated with national preparer groups: American Institute of Certified Public Accountants, National Association of Tax Professionals, and National Association of Enrolled Agents. Each group gathered 6 to 9 preparers for group interviews, and two of the groups identified 4 preparers whom we spoke with individually. Additionally, we spoke with one preparer who contacted us in response to our previous report on e-filing.

To assess IRS's plans to enforce the mandate and determine lessons learned, we reviewed the 2011 planning documents for the integrated preparer compliance strategy and E-file Monitoring Program. We also interviewed officials from the Return Preparer Office about their compliance and enforcement plans for ensuring preparers were following the mandate. We interviewed officials from the Chief Counsel's Office and the Office of Professional Responsibility to determine current options available to sanction preparers noncompliant with the e-file mandate. We also interviewed IRS officials from the Return Preparer Office about IRS

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<sup>1</sup>Weekly processing reports are from the Individual Income Received and Processed Headquarters (IIRAPHQ) Cumulative Individual Income Tax Return report.

plans for conducting a lessons learned study on the mandate's implementation.

To assess IRS's analysis of options for digitizing more data from paper returns, we reviewed IRS's 2008 proposal, Modernized Submission Processing: Solution Concept Briefing, to add a bar coding system to process paper returns and analyzed IRS's priority transcription list developed by IRS's Deputy Commissioner's Office for Service and Enforcement (Service and Enforcement). Using IRS data, such as staff cost per keystroke and volume of paper forms, we estimated costs to transcribe additional lines of data (see app. V). To determine the reliability of IRS's data, we interviewed IRS officials who developed the transcription priority listing, reviewed related documentation, and reviewed the data for obvious errors. We found these data to be sufficiently reliable for our purposes. We shared our calculations with IRS officials in Service and Enforcement who agreed with our approach. Also, we interviewed IRS officials from Submission Processing and Service and Enforcement about their plans to implement bar coding technology and transcribe additional lines of data and any analysis of the costs and benefits of implementing such methods.

To determine whether there are any tax forms IRS cannot accept electronically and assess IRS's plans for adding them to the e-filing system, we compared a list and time line of all tax forms that Submission Processing planned to add to the e-file system to a list of all existing IRS forms obtained from the Forms and Publications division. We also interviewed officials from the Wage and Investment division and the offices of Electronic Tax Administration and Submission Processing about their plans to add more forms to the e-file system.

For each objective, we also interviewed officials at IRS's office of Electronic Tax Administration and Return Preparer Office. Our work was done primarily at IRS Headquarters in Washington, D.C. and its division offices in New Carrollton, Maryland, and Atlanta, Georgia where the IRS officials who manage the e-file mandate implementation are located.

We conducted this performance audit from March 2011 to October 2011, 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Appendix II: Possible Changes Affecting Preparers as a Result of the E-file Mandate

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Tax return preparers who have never electronically filed (e-filed) a tax return may need to make some changes in their business practices as a result of the e-file mandate. Some preparers may need to purchase a tax software package to enable them to e-file. Most preparers will also need to apply to become an Authorized E-file Provider with the Internal Revenue Service (IRS), which allows them to submit electronic tax returns to IRS.

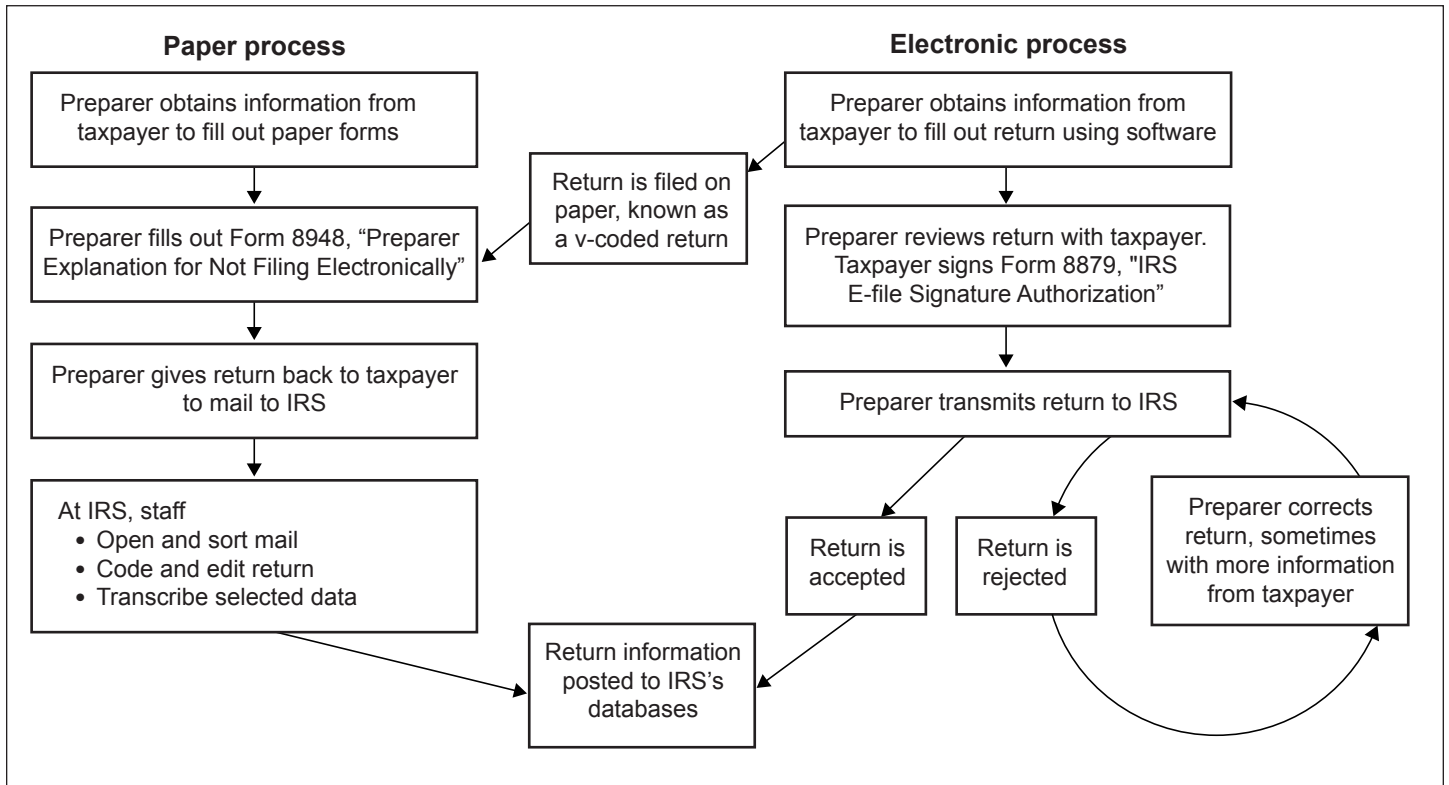
New steps in preparing returns for those who have never e-filed could include obtaining a taxpayer's signature on Form 8879, "IRS e-file Signature Authorization," to document that the taxpayer has reviewed the return and that it is ready for transmission to IRS. Also, preparers who e-file receive an acknowledgement from IRS stating that the return was accepted or rejected into IRS's e-file system.<sup>1</sup> When a return is rejected, the preparer must correct the error, sometimes with more information from the taxpayer, in order to resubmit it to IRS. In instances when a preparer needs to file a return on paper, the preparer must submit Form 8948, "Preparer Explanation for Not Filing Electronically."

Figure 4 compares the processes preparers go through to submit a return electronically versus on paper.

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<sup>1</sup>IRS does not send an acknowledgment when a paper return is filed. IRS may send correspondence to the taxpayer when an error is identified.

Figure 4: Preparation and Filing Methods for Preparers



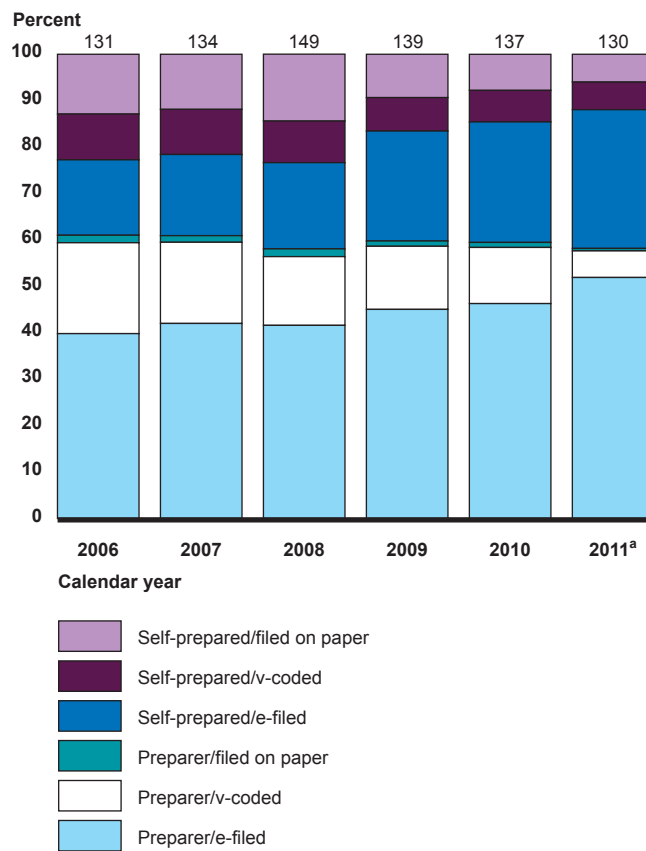
Source: GAO analysis of IRS information.



# Appendix III: Trends in Preparer and Self-Prepared Filing Methods

As of July 2, 2011, almost 60 percent (about 76 million) of all individual income tax returns were completed by a preparer and the remainder (54 million) were self-prepared by taxpayers (see fig. 5). Filing methods include electronic filing (e-filing) and paper filing. Returns that are prepared using software, but are printed and mailed to the Internal Revenue Service (IRS), are called “v-coded” returns.

**Figure 5: Trends in Preparer and Self-prepared Filing Methods, Calendar Years 2006 to 2011 (percentages, with volumes in millions)**



Source: IRS's Individual Return Transaction File data.

<sup>a</sup>Data as of July 2, 2011.

# Appendix IV: E-file Application Processing

In order to e-file, a preparer must be an Authorized E-file Provider. The requirements to become an Authorized E-file Provider include submitting an application and passing background and suitability requirements. The Internal Revenue Service (IRS) issues an Electronic Filing Identification Number (EFIN) to firms or sole practitioners who meet these requirements.

As of June 30, 2011, IRS processed 36,714 applications for preparers to become Authorized E-file Providers, 19 percent more than during the same time period in 2010—an increase that IRS officials said was due predominantly to the mandate. Applications that were submitted electronically had an average processing time of 18 days, while those submitted on paper had an average processing time of 26 days—both within IRS’s normal 45-day processing time. Overall, 89 percent of e-file applications were processed in fewer than 45 days. For 2012, when the mandate threshold is lowered to more than 10 returns, IRS officials project that e-file applications will increase by 38 percent over the average annual applications based on prior years. Electronic Products and Support Services officials anticipate the preparers who apply to become Authorized E-file Providers in 2012 will require additional assistance resulting in longer calls or multiple calls. As shown in table 3, IRS officials told us they will need 11 additional full-time equivalents (FTE) to manage this workload.

**Table 3: Estimated Number of New E-file Applications, 2011 and 2012**

Fiscal year		2011	2012
E-file applications	Average annual applications based on prior years	30,000	30,000
	Increase projected due to e-file mandate	22,401	11,643
	<b>Total</b>	<b>52,401</b>	<b>41,643</b>
Percent increase over average annual applications based on prior years		75%	38%
Additional full-time equivalents (FTE) needed to process applications		41	11 (in addition to the 41 added in 2011)

Source: IRS data.

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# Appendix V: Calculation of Costs of Transcribing Data Lines from Paper Returns

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We used the Internal Revenue Service (IRS) data to develop calculations to illustrate the potential variability of transcription costs across different tax return lines that IRS included in its priority listing. The formula we used to calculate the cost of transcribing a line of data is the following:

$$\text{Cost of transcribing line} = \frac{\text{cost}}{\text{keystroke}} \times \frac{\text{average keystrokes}}{\text{line}} \times \text{paper volume of form} \times \text{occurrence rate of line}$$

All of these elements can vary:

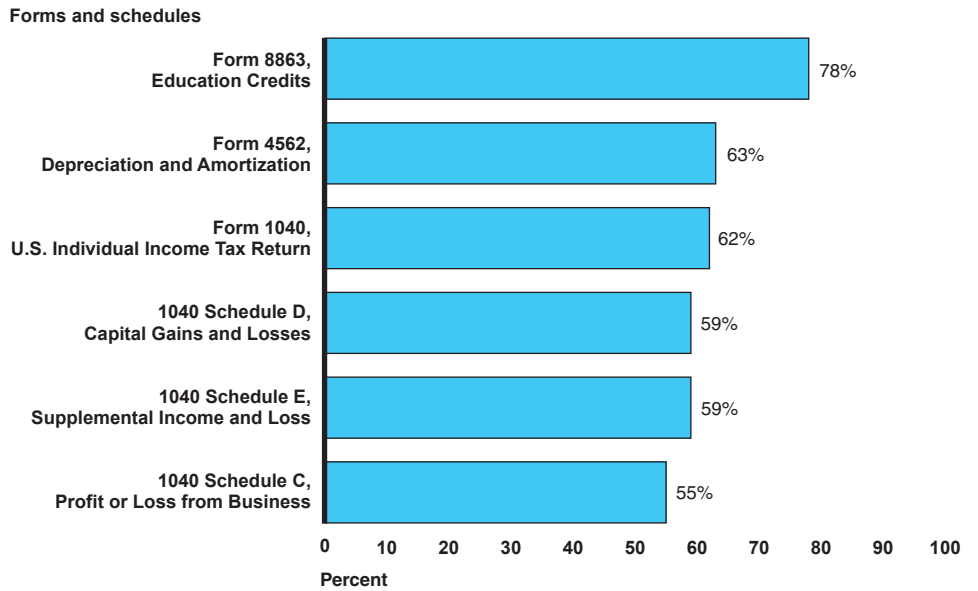
- Cost/keystroke is based on the hourly rate for transcription staff multiplied by number of keystrokes per hour. Number of keystrokes per hour varies slightly for different forms.
- Average keystrokes per line varies for different data lines, from 1 to several hundred, with most under 10, as shown in figure 7.
- Paper volume of the form is the number of forms that are submitted to IRS on paper. For example, if 10,000 taxpayers submit paper returns that include a given form, the paper volume of that form is 10,000. Paper volume is related to the total volume of the form and the e-file rate of the form:

$$\text{Paper volume} = \# \text{ taxpayers who submit the form} \times (1 - \text{e-file rate of form})$$

- E-file rates vary significantly for different forms, as shown in figure 6; for example, 78 percent of Form 8863s were e-filed for tax year 2009, compared to 55 percent of Schedule C's.
- Number of taxpayers who submit the form varies significantly for different forms, from under 10,000 to over 50 million.
- Occurrence rate of the line is the rate at which the line is filled in. Some lines are left blank most of the time, while others are filled in more often or always. Occurrence rates vary from 1 percent to 100 percent.

IRS has all of these data for over 500 lines identified by its Business Operating Divisions as high priorities for transcription. As an example of variations in these factors, different e-file rates for some high-volume forms are shown in figure 6. All other variables being equal, a line on a form such as Schedule C with a 55 percent e-file rate (45 percent paper file rate) would be about twice as expensive to transcribe as a line on a form such as Form 8863 with a 78 percent e-file rate (22 percent paper file rate). This is because there would be about twice as many returns from which to transcribe that line ( $45 \div 22$ ).

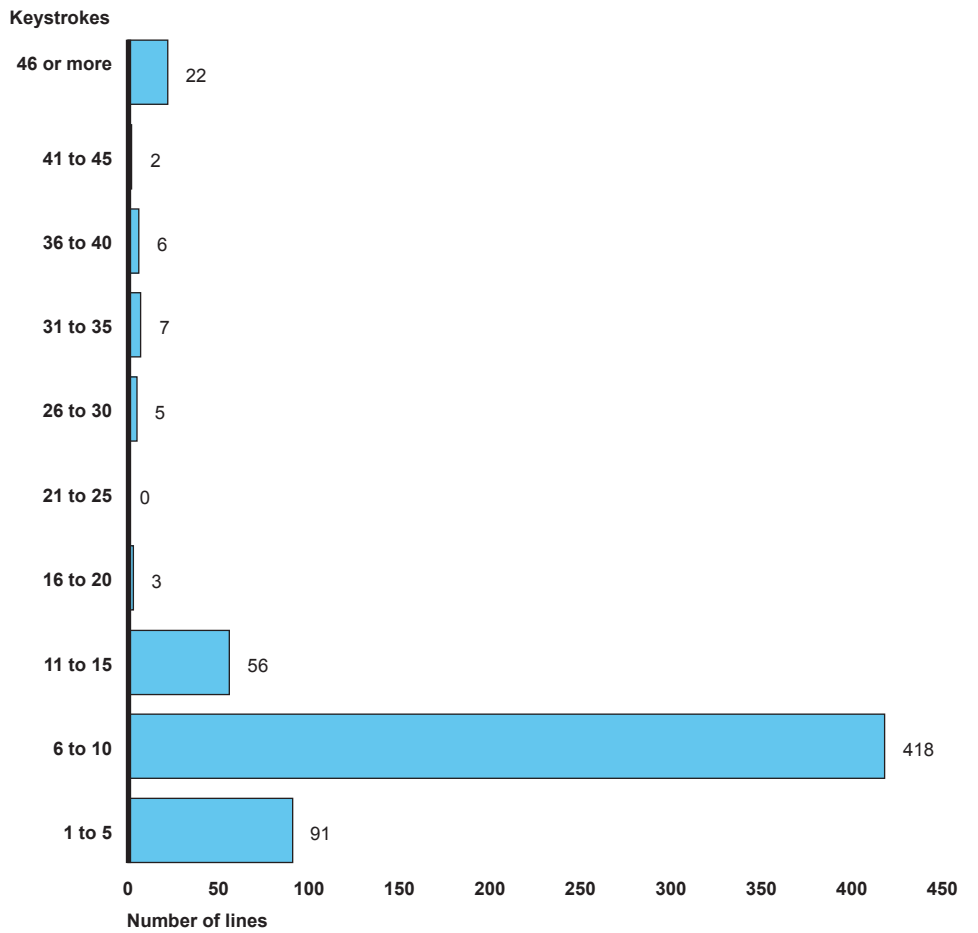
Figure 6: E-file Rates for High Volume Forms and Schedules, Calendar Year 2009



Source: GAO analysis of IRS data.

As another example, figure 7 is a frequency chart showing that most lines would require 1 to 15 keystrokes to transcribe, while some would require 46 or more. All other variables being equal, a line that required 46 keystrokes would be 46 times more expensive to transcribe than one requiring 1 keystroke.

Figure 7: Frequencies of Keystroke Lengths for Different Lines to Transcribe



Source: GAO analysis of IRS data.

# Appendix VI: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

September 26, 2011

Mr. James R. White  
Director, Tax Issues  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, DC 20548

Dear Mr. White:

I have received your draft report entitled, "E-FILING TAX RETURNS: Penalty Authority and Digitizing More Paper Return Data Could Increase Benefits" (GAO-12-33). Increasing electronic filing has been a priority for the IRS and we appreciate the recognition of the noticeable increase in e-file participation this year. As mentioned in the Report, the preparer e-file mandate is one of the reasons for the increase.

We are committed to enhancing efficiency of return processing as we recognize paper returns will continue to be filed. We are taking a number of steps to better align electronic and paper data capture and to increase processing efficiency. Analysis is currently being performed in areas such as barcoding and transcription of additional tax return information. We are also working to ensure that all tax forms become eligible for e-file in order to continue to increase electronic submissions.

We will take appropriate actions to address or further review issues as they are identified. We agree with your recommendations, and look forward to continued engagement by the Government Accountability Office. Our specific comments regarding your recommendations are enclosed.

If you have any questions, please contact me, or members of your staff can contact David R. Williams, Return Preparer Office, at (202) 927-6428.

Sincerely,

A handwritten signature in black ink, appearing to read "S. T. Miller".

Steven T. Miller

Enclosure

Enclosure

**RECOMMENDATION # 1**

Develop a plan for and schedule to conduct a study that identifies and documents lessons learned from the implementation of the e-file mandate.

**COMMENTS**

The IRS agrees with this recommendation. A lessons learned study will be conducted in order to gather important information that could be useful in implementing any future e-file mandates.

**RECOMMENDATION # 2**

Determine whether and to what extent the benefits of barcoding would outweigh the costs.

**COMMENTS**

The IRS agrees with this recommendation. A cost/benefit analysis of 2-D barcoding is already in process and will be finalized in the near future.

**RECOMMENDATION #3**

Determine the relative costs and benefits of transcribing different individual lines of tax return data.

**COMMENTS**

The IRS agrees with this recommendation. Submission Processing has determined the relative costs of transcribing individual lines of tax forms and schedules. This information was provided to GAO in June 2011. If the budget environment supports additional transcription, prioritization from a compliance perspective will be determined.

**RECOMMENDATION #4**

Develop and prioritize a list of forms that still need to be added to the Modernized E-File systems.

**COMMENTS**

The IRS agrees with this recommendation. Budget permitting, Modernized e-File (MeF) Release 7 (Filing Season 2012) will deploy the remaining 1040 forms and schedules currently processed through Electronic Management System/Electronic Filing System (EMS/ELF). Budget permitting, MeF Release 8 (Filing Season 2013) will migrate the 94x form family from EMS/ELF to MeF. MeF Release 9 (Filing Season 2014) will migrate the 1041 form family from EMS/ELF to MeF. After the deployment of MeF Release 9 all components of the legacy EMS/ELF system will be retired.

2

**RECOMMENDATION #5**

Create a timetable to add additional forms to the Modernized E-File systems, particularly for high volume forms, such as the 1040X and 1040-NR.

**COMMENTS**

The IRS agrees with this recommendation. The IRS is currently updating its MeF Sequencing Plan for future MeF releases beyond Filing Season 2014, and Forms 1040-X and 1040-NR are included in the discussion.



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# Appendix VII: GAO Contact and Staff Acknowledgments

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## GAO Contact

James R. White, (202) 512-9110, or [WhiteJ@gao.gov](mailto:WhiteJ@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Libby Mixon, Assistant Director; Amy Bowser; Michele Fejfar; Cynthia Saunders; Robyn Trotter; and Meredith Trauner made key contributions to this report.

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