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TAX ADMINISTRATION

Electronic Filing Falling Short of Expectations

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The Honorable John Glenn
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

Dear Senator Glenn:

Electronic filing is a cornerstone of the Internal Revenue Service's (IRS) plan to move away from the traditional paper-based return filing. In May 1993, IRS established a goal of receiving 80 million tax returns electronically in 2001—about 36 percent of all the tax returns it expects to receive that year. Our July 1995 report on IRS' multibillion dollar modernization effort, known as Tax Systems Modernization, included a discussion of the need for IRS to develop a strategy to maximize electronic filing.[1] This report, prepared under our basic legislative authority, builds on that message by assessing (1) IRS' progress in broadening the use of electronic filing, (2) the availability of data needed to develop an electronic filing strategy, and (3) the implications for IRS if it does not significantly reduce its paper-processing workload.

Background

IRS is in the midst of a major modernization effort, which, if implemented as intended, will change the way IRS receives, processes, stores, and retrieves information needed to administer the tax system and change the way taxpayers and IRS interact. As part of this effort, IRS plans to (1) shift from a paper-based to an electronic tax-processing system, (2) consolidate fragmented telephone assistance into fewer centrally managed locations to handle almost all taxpayer calls, and (3) develop a database that contains all pertinent taxpayer account information and make that information readily available to all employees who need it. These plans are all part of what IRS calls its new business vision.

IRS is making organizational changes to accommodate this new vision by (1) moving responsibility for processing electronic returns from 5 service centers to 3 computing centers; (2) consolidating in 5 submission processing centers, the paper-processing activities now done in 10 service centers; and (3) consolidating in 23 sites, the customer service activities now done in over 70 sites.

[1] Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995).

Electronic filing is one of IRS' first ventures into a more modern environment. This alternative to the traditional filing of paper returns started as a test in 1986 and became available nationwide in 1990. Some taxpayers can file electronically by telephone, but most electronic filing is done through a tax return preparer or an electronic return transmitter. Once received by IRS, electronic returns are automatically edited, processed, and stored—functions that are performed manually for paper returns.

Electronic filing benefits taxpayers. The benefits include receipt of their refunds several weeks sooner than if they had filed paper returns and greater assurance that (1) IRS has received their returns, (2) the returns are mathematically accurate, and (3) information on the returns has been accurately posted to the taxpayers' accounts in IRS' records.

Compared with IRS' current procedures for processing paper returns, electronic filing has several benefits for IRS. These benefits include reduced costs of processing, storing, and retrieving returns and faster, more accurate processing of returns and refunds. Also, with electronic filing, IRS gets 100 percent of the return information in its computers compared with the approximate 40 percent IRS inputs from paper returns.

As part of its future business vision, IRS plans to capture 100 percent of the information on paper returns using new scanning technology. However, the cost of scanning the data from paper returns will most likely be higher than the cost of obtaining it electronically because (1) manual labor will still be required to prepare the paper documents for scanning and (2) IRS test indicate that scanning cannot always correctly read the information on paper returns, thus requiring rework and manual intervention. Therefore, electronic filing would continue to provide a more efficient way of obtaining tax return data than having taxpayers submit paper returns.

Results in Brief

Since IRS first offered electronic filing in 1986, its marketing has been targeted primarily at professional tax return preparers. That approach has not resulted in the level of electronic filing needed to achieve IRS' long-term goal nor has it attracted those taxpayers who file the kinds of returns that contribute most to IRS' paper-processing workload and costs.

If electronic filing continues to grow at its recent pace, IRS will fall far short of 80 million electronic returns in 2001.[2] From 1992 through 1994, the number of returns filed electronically grew from 12.6 million to 16.4 million, an annual growth rate of 14 percent. In 1995, the number of electronic returns is expected to drop to about 14.8 million, which IRS attributes to various actions it took to crack down on refund fraud. It is impossible to accurately predict how the number of electronic returns will change in future years. For illustrative purposes, however, if 1995 is considered an aberration, as IRS believes, and the 14 percent annual growth rate of the preceding 2 years is resumed, we estimate that only about 33 million returns will be filed electronically by 2001.

Most of the electronic returns IRS received in 1994 were individual income tax returns that could have been filed on Form 1040A or 1040EZ—forms that are among the least costly paper returns to process. Individual tax returns that would have otherwise been filed on the more costly to process Form 1040 accounted for only about 20 percent of the individual tax returns filed electronically, although 59 percent of all individual income tax returns (paper and electronic) filed in 1994 were on Form 1040. In addition, IRS has made little headway in increasing the number of electronically filed business returns, which are generally more complex and thus more costly to process on paper than individual returns. In 1994, about 2.4 million, or 6 percent of the approximate 42 million business returns were filed electronically.

A major impediment to the expansion of electronic filing is its cost to the general public. Taxpayers must generally file an electronic return through a preparer or electronic filing transmitter and pay from $15 to $40 for such services. In January 1993, we reported that electronic filing appealed primarily to taxpayers who most needed their refunds and that other taxpayers saw little reason to incur the filing cost.[3]

According to the American Institute of Certified Public Accountants (AICPA), many preparers are also concerned about the costs associated with preparing and transmitting electronic returns. One aspect of IRS' current electronic filing program that contributes to this cost is the need

[2]Since establishing its electronic filing goal, IRS has modified its definition of electronic returns to include returns filed on magnetic media (tape and computer diskette). IRS has said that returns filed on magnetic media will be mostly business returns. To be consistent with IRS' definition, further reference to electronic returns in this report will include, unless otherwise noted, returns filed on magnetic media.

[3]Tax Administration: Opportunities to Increase the Use of Electronic Filing (GAO/GGD-93-40, Jan. 22, 1993).

for taxpayers to submit a paper signature document to affirm that the information on the electronic return is accurate.

The fact that less complex returns comprise a disproportionate share of electronic filing may be due, at least in part, to IRS' goal of 80 million returns. Focusing solely on this goal could cause IRS to target its efforts at groups of taxpayers or types of returns that provide the greatest opportunity to increase the number of electronic returns but not the greatest opportunity to reduce IRS' paper-processing workload and operating costs. Although a marketing strategy that focuses on reducing paper and costs may generate less than 80 million returns, it could have a more significant impact on IRS' overall operations.

Although business returns and returns filed on Form 1040 would appear to offer the greatest opportunity to reduce IRS' costs if filed electronically, IRS does not have enough data to make that determination. Although IRS has some comparative data on the cost to process electronic and paper returns, it does not have comparative data on other costs (such as storage and retrieval) that can vary depending on how a return is filed. IRS also does not have (1) adequate data on why taxpayers do not file electronically and what it would take to get them to do so and (2) estimates of the number of electronic returns IRS can expect to receive from those taxpayers after some market intervention. IRS awarded a contract in May 1995 that may provide at least some of this information. With this information IRS could (1) identify those groups of taxpayers that offer the greatest opportunity for reducing operating costs and (2) develop an appropriate marketing strategy for those groups.

Assumptions about increases in electronic filing and decreases in paper return filing were critical factors in several of IRS' modernization decisions, such as deciding on the number of sites and staff needed to process paper returns and provide customer service. Without a significant change in the trends in electronic filing, IRS' paper-processing and customer-service workloads will exceed expectations, and IRS may have to alter various aspects of its modernization. IRS does not have contingency plans for this eventuality.

Objectives, Scope, and Methodology

Our objectives were to assess (1) IRS' progress in achieving its electronic filing goal, (2) the availability of data needed to develop an electronic filing strategy, and (3) the implications for IRS if it does not reach its electronic filing goal and reduce its reliance on paper.

To accomplish our objectives, we did the following:

- We analyzed IRS data for calendar years 1990 through 1994 on the number and composition of electronic filings. For calendar year 1995, we analyzed such data through May 1995.
- We determined IRS' potential shortfall in meeting its 80-million goal for 2001 by using the annual growth rates for 1993 and 1994. We did not use the 1995 growth rate because IRS officials believe the 1995 rate is an aberration, and they expect the growth of electronic filing to resume in 1996.
- We used IRS data on the average cost to process electronic returns and various types of paper returns in 1993 (the latest available)[4], along with data on the number of returns filed in 1994, to estimate (1) the potential savings if all forms 1040, 1040A, and 1040EZ had been filed electronically in 1994 and (2) the portion of potential savings that IRS realized, given the number of returns that were actually filed electronically in 1994. We did not assess the reliability of IRS' data on average processing costs for paper and electronic returns.
- We interviewed officials and staff who had electronic filing responsibilities in IRS' National Office; 2 of its 7 regional offices (Central and Mid-Atlantic); 5 of its 63 district offices (Baltimore, Cincinnati, Cleveland, Indianapolis, and Richmond); and 4 of its 10 service centers (Andover, Cincinnati, Memphis, and Philadelphia). We judgmentally selected IRS field offices that were involved with unique electronic filing initiatives and/or were convenient to our audit staff.
- We reviewed information related to the electronic filing program, including IRS' electronic filing strategy, related legislative proposals, and surveys of preparers and taxpayers done by the AICPA and other organizations.
- We reviewed IRS' modernization plans, including documents on the sizing of submission processing centers and discussed with returns processing and information systems managers in IRS' National Office, IRS' plans in the event electronic filing falls short of expectations.

We did our work between April 1994 and May 1995 in accordance with generally accepted government auditing standards. We requested

[4]As computed by IRS, processing costs for paper returns include the costs incurred for such things as opening and sorting the mail, preparing the returns for data transcription, keypunching data from the returns into the computer, and correcting errors made by taxpayers in preparing the returns and by IRS in processing them. Processing costs for electronic returns include those costs IRS incurs after the return is received. (Processing costs do not include the telecommunications costs associated with receiving the return because they are currently incurred by the taxpayer/preparer.) These costs include upfront validity checks and other costs associated with preparing return data so they can be merged with data from paper returns on magnetic tape.

comments on a draft of this report from the Commissioner of Internal Revenue or her designee. On July 27, 1995, IRS' Executive for Electronic Filing and the Site Executives for IRS' Computing Centers and Submission Processing provided oral comments. Those comments and our evaluation are summarized on pages 17 to 20 and are incorporated in this report where appropriate.

IRS' Electronic Filing Strategy Has Not Produced the Kind of Results Needed to Meet IRS' Goal

Since the inception of electronic filing, IRS' marketing strategy has been targeted primarily at professional tax return preparers. That strategy has not resulted in the level of electronic filing that will bring IRS to its long-term goal nor has it attracted those taxpayers who file the kinds of returns that contribute most to IRS' paper-processing workload and costs. One impediment to the growth of electronic filing that IRS has yet to adequately address is its cost to taxpayers and preparers.

Focus of IRS' Marketing Efforts Has Not Changed Much Since Electronic Filing Began

When electronic filing started in 1986, IRS' marketing approach was to encourage tax return preparers to provide electronic filing in hope that they would market the service to the general public. IRS' rationale for this approach was based primarily on the large number of returns prepared by professional preparers—about 57 million for tax year 1993.

Because we saw the need for IRS to expand the appeal of electronic filing, we recommended, in January 1993[5], that IRS identify additional market segments and specify national strategies for attracting those market segments to electronic filing. To that end, an IRS task group, in May 1993, presented a strategy that encompassed 21 initiatives for increasing the number of electronically filed returns.

A few of the 21 initiatives have been implemented and have resulted in modest increases in the number of electronic returns. For example, one initiative called for expanding TeleFile—a program that allows taxpayers who meet certain criteria to file 1040EZ returns by telephone. About 680,000 taxpayers in 10 states filed returns using this method in 1995 compared with 149,000 in 1 state in 1993, and IRS plans to expand the program nationwide in 1996. Another initiative called for expanding cooperative arrangements with states that would allow electronic filers to jointly file their federal and state tax returns. As of June 9, 1995, about 1.5 million taxpayers in 29 states had used this program compared with about 635,000 taxpayers in 15 states in 1993.

[5]GAO/GGD-93-40.

However, other initiatives included in the 1993 strategy have been delayed or dropped. According to the IRS task group, several of these initiatives required legislation. For example, the task group had estimated that IRS could obtain 37 million electronic returns by legislatively mandating that tax return preparers who prepare a large number of individual returns offer electronic filing. That initiative was dropped because, according to IRS and Treasury officials, there was little chance that Congress would pass such legislation. Appendix I provides additional information on those initiatives that the task group said would require legislation.

Because several initiatives that were designed to attract large numbers of taxpayers to electronic filing have not been implemented, IRS' default strategy has been to continue marketing electronic filing to tax preparers. However, that strategy has resulted in a program that primarily attracts individuals who file simple tax returns, are due refunds, and are willing to pay the fees associated with electronic filing to get those refunds sooner.

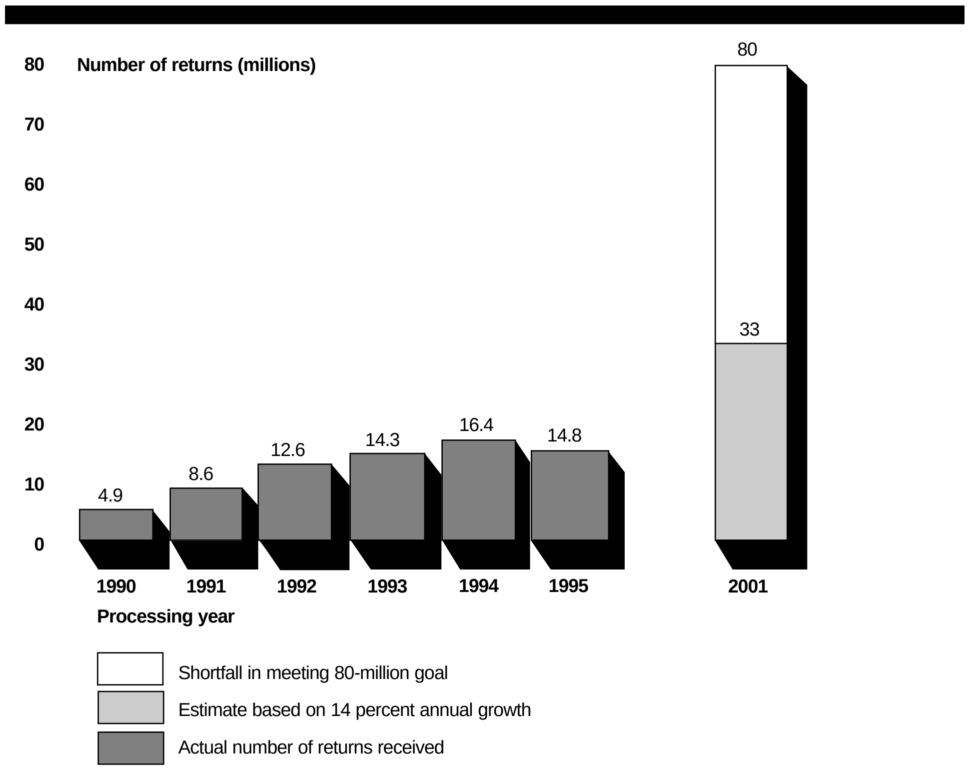
Number of Taxpayers Using Electronic Filing Relatively Low Compared With IRS' Goal

As shown in figure 1 on page 8, the number of electronic returns increased from about 4.9 million returns in 1990, when electronic filing became available nationwide, to a high of 16.4 million returns in 1994, before dropping to an estimated 14.8 million returns in 1995.

IRS attributes the decrease in electronic filing in 1995 to steps it took to prevent refund fraud. As a result of these steps, refunds for millions of taxpayers were delayed, thereby reducing the major appeal of electronic filing. IRS officials believe that the decrease is temporary.

Even if electronic filing begins growing again, IRS will be hard pressed to reach its electronic filing goal. We estimate that electronic filing, including returns filed on magnetic media, would need to grow at an annual rate of about 32 percent to reach 80 million returns in 2001. That rate contrasts with the 14 percent annual growth rate IRS achieved in 1993 and 1994. As shown in figure 1, if annual growth were to continue at 14 percent, we estimate that only about 33 million returns would be filed electronically in 2001.

Figure 1: Number of Returns Filed Electronically in Calendar Years 1990 Through 1995 and Estimated Shortfall in Meeting 80-Million Goal for Calendar Year 2001



Note 1: The 1995 figure is an estimate.

Note 2: These data include business returns filed mostly on magnetic media and, for 1994 and 1995, include an estimated 2.4 million and 3 million such returns, respectively.

Source: GAO computations using IRS data.

The More Complex Tax Returns Are Not Being Filed Electronically

Not only is the number of electronic returns relatively low, but the returns being filed electronically are generally those that contribute least to IRS' paper-processing workload and operating costs. Electronic filing has not yet attracted a representative number of taxpayers who file individual income tax returns on the more complex Form 1040 and business returns.

Since electronic filing began, IRS has focused its marketing efforts on individual income tax returns. Accordingly, those returns, which accounted for about 56 percent of all returns filed in 1994, accounted for 86 percent of those filed electronically. Despite the focus on individual returns, electronic filing is not attracting those taxpayers who represent the largest segment of individual filers and those who file the most costly individual income tax form to process on paper. As a result, potentially significant cost savings may be going unrealized.

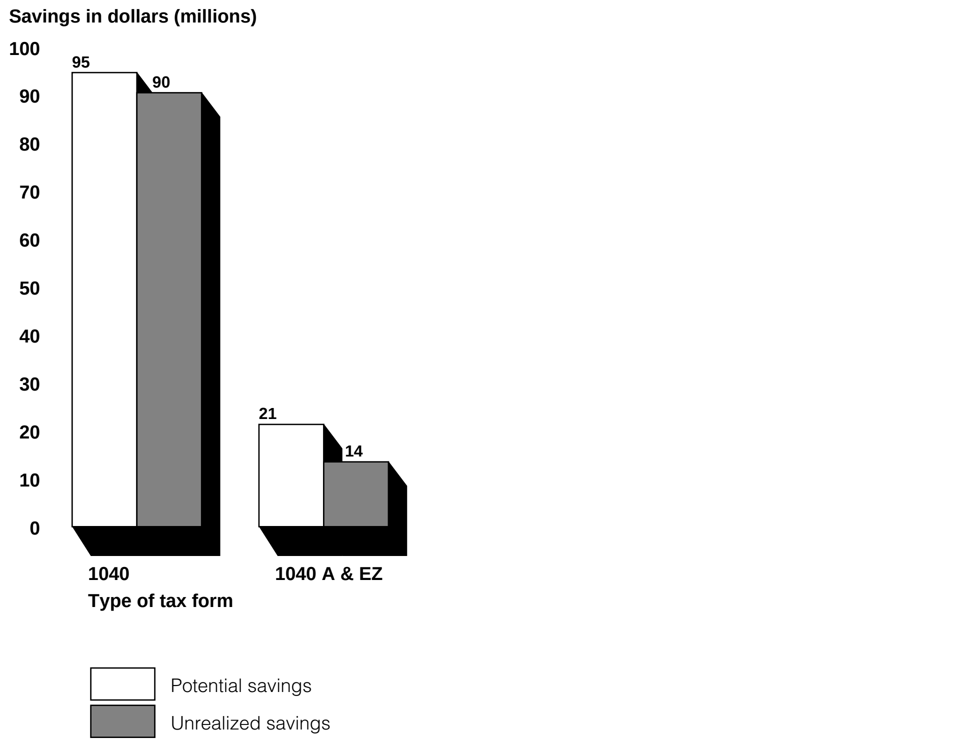
On the basis of IRS' 1993 service center processing cost estimates (the latest available), it cost IRS $4.53 to process a paper Form 1040, $3.95 to process a paper Form 1040A, and $3.36 to process a paper Form 1040EZ.[6] The most costly of the three (Form 1040) accounted for about 59 percent of all individual returns (paper and electronic) processed in 1994, yet Form 1040 accounted for only about 20 percent of the individual returns filed electronically.

On the basis of IRS' processing cost estimates for paper returns and its estimated average cost of $3.08 to process each electronic individual return, we estimated (1) the total potential processing savings that could have been achieved if all individual income tax returns had been filed electronically in 1994 and (2) the portion of those potential savings that went unrealized.[7] Figure 2 shows that the greatest amount of unrealized savings, about $90 million, was for returns filed on Form 1040.

[6]The 1040A and 1040EZ are less costly to process because they generally contain fewer pages than the 1040 and thus less data for IRS to input and less opportunity for taxpayers or IRS to err. The 1040EZ has one page with no supporting schedules. The 1040A has two pages, like the 1040, but generally has fewer supporting schedules because of limitations as to who can file a 1040A. A 1040A filer, for example, cannot claim itemized deductions, self-employment income, rents and royalties, or capital gains. According to IRS data, it takes an average of 89 and 159 keystrokes, respectively, to enter data into the computer from a paper 1040EZ and 1040A compared with 247 keystrokes for an average 1040.

[7]The savings from electronic filing would be even more if IRS did not have to process the paper signature document (Form 8453) that electronic filers are required to send to IRS. IRS data show that it costs 30 cents to process each of those forms, or about $4.3 million in 1994.

Figure 2: Estimated Savings That Could Have Been Realized If All Individual Income Tax Returns Were Filed Electronically in 1994 and Estimated Amount That Went Unrealized



Source: GAO computations using processing cost data in IRS' Service Center Costing Handbook for 1993 and return filing data from IRS' Management Information System for Top Level Executives.

Because paper returns filed by businesses are more expensive to process than paper returns filed by individuals, according to IRS data, they would seem to represent a potential source of significant savings if filed electronically. IRS estimated, for example, that in 1993 it cost $6.97 to process each partnership return (Form 1065), $6.95 to process each corporate income tax return (Form 1120), and $6.19 to process each Employers Quarterly Federal Tax Return (Form 941).

In 1994, about 6 percent of all business returns were filed electronically (2.4 million out of 42 million), while the participation rate for individual returns was about 12 percent (14 million out of 115 million). Of the

2.4 million electronically filed business returns, all but about 46,000 were filed on magnetic media.[8]

IRS officials said that the lower participation rate for business returns reflects, in part, the priority IRS has attached to increasing the number of electronically filed individual returns. That priority is reflected in IRS' May 1993 strategy. The more traditional marketing aspects of IRS' strategy were focused on getting individual returns filed electronically. For business returns, IRS' strategy was to rely on legislative mandates. More specifically, the 1993 strategy included an initiative that called for developing a legislative proposal that would (1) mandate electronic filing of many business returns, including those filed by fiduciaries (Form 1041), partnerships, and corporations and (2) require the electronic transmission of Employers Quarterly Federal Tax Returns by businesses with 10 or more employees. IRS has since decided to pursue mandates only as a last resort but has not developed an alternative strategy for getting large numbers of business returns filed electronically.

Cost Is a Major Impediment to the Growth of Electronic Filing

IRS has not been successful in dealing with a major impediment to greater taxpayer and preparer participation in electronic filing, i.e., its cost.

For most taxpayers, the only way to file electronically is through a tax return preparer or electronic filing transmitter at a cost of from $15 to $40. This cost is in addition to any costs associated with preparing the return. In January 1993, we reported that electronic filing appealed primarily to taxpayers who most needed their refunds and that other taxpayers due refunds were unwilling to pay the going fees for that benefit.[9] Cost is even more of an impediment to taxpayers owing money because those taxpayers see little, if any, benefit to filing electronically. We know of little that has changed since 1993 to alter that opinion. As a result, less than 2 percent of the individual income tax returns filed electronically in 1995 were from taxpayers owing money.

In response to a recommendation in our January 1993 report and one of the initiatives in IRS' May 1993 strategy, IRS has (1) increased the number of

[8]Although returns filed on magnetic media are less costly to process than returns filed on paper, IRS does not achieve all the benefits from magnetic media that it does from electronic filing. For example, errors on magnetic media returns are printed out on paper and mailed back to the sender. The electronic filing system, however, includes filters that check for such errors as mathematical mistakes and incorrect Social Security numbers. If an error is identified, the system is designed to reject the return and electronically notify the sender of the problem.

[9]GAO/GGD-93-40.

walk-in sites that offer free electronic return preparation and transmission and (2) provided additional support for similar services at sites staffed by volunteers. As of April 29, 1995, about 246,000 taxpayers had availed themselves of these free services.

The free electronic filing at IRS and volunteer sites is generally available to low-income taxpayers who file less complex returns. Cost is at least one factor that deters electronic filing by a potentially more lucrative market of individual taxpayers—those with home computers. Since 1992, taxpayers using tax preparation software could file returns from home computers and transmit them from home through an approved computer service. However, these filers must pay a fee of about $15 and must still send paper, including a signature document (Form 8453) and wage and withholding statements (Forms W-2), to IRS. Only about 1,400 taxpayers had filed their returns through this program as of May 5, 1995.

For those taxpayers who prepare their returns on computers but are unwilling to pay to transmit the returns electronically, the result is inefficient and counterproductive. The taxpayer prepares the return on a computer and then converts it to paper for mailing to IRS, which then employs a labor intensive, error prone process to input that information back into a computer.

IRS has completed a draft strategy for increasing the number of taxpayers filing from home computers. Part of the strategy focuses on eliminating the fees these taxpayers incur for having a third party transmit their returns to IRS.

Cost also deters some preparers from participating in the electronic filing program. In September 1994, the Chairman of the AICPA's Tax Practice and Procedures Committee provided us with summary information on members' experiences with electronic filing. He said that some practitioners have been filing electronically for several years with positive experiences, while others discontinued doing so because IRS' current electronic filing program "did not fit into their 'office routine' or because they or their clients did not receive any additional benefit from the program to offset the additional cost." He said that many practitioners are concerned with the additional input, transmitting, and monitoring time required with the current electronic filing program and the fact that electronic filing is not yet a paperless system. Among the paper documents, the most problematic, according to the AICPA, is the signature document. That document, which is used to affirm that the information on the electronic return is accurate, must be signed by the taxpayer and filed with IRS within 24 hours after IRS has acknowledged acceptance of the electronic return.[10]

IRS has recognized for years the potential benefit of paperless electronic filing but thought that legislation was needed to authorize an alternative to the paper signature document. Information on IRS' efforts to obtain such legislation is presented in appendix I. In April 1995, however, IRS' Office of Chief Counsel concluded that IRS had regulatory authority to prescribe signature alternatives. An IRS official said that IRS plans to test signature alternatives in 1996.

IRS Does Not Have Adequate Data to Focus Its Electronic Filing Strategy

IRS recognizes that it needs to increase the appeal of electronic filing to attract more taxpayers. IRS also recognizes that it does not have unlimited staff or funds to apply to that effort. However, IRS' ability to effectively target its limited resources is hampered by inadequate data on the relative costs and benefits of processing different types of returns electronically versus on paper. Business and complex individual returns would seem to offer opportunities for significant cost reductions if filed electronically. However, IRS does not have sufficient data to determine (1) what it would cost to get those returns filed electronically, including the costs of any incentives that might be needed to prompt certain groups of taxpayers to file electronically and (2) how that cost compares to the expected benefits from electronic filing.

As discussed earlier, IRS has data on some of the costs incurred in processing returns. However, IRS does not have data on other costs that can vary depending on how a return is filed. Those costs include (1) costs to store and retrieve returns and to administer certain fraud controls, such as those established to assess the suitability of preparers and transmitters who apply to participate in the electronic filing program and (2) certain nonservice center costs incurred in resolving taxpayer account errors that are made during IRS' manual processing of paper returns (such as the costs associated with handling the extra telephone calls generated by those errors). Without better data on the relative costs and benefits of electronic filing as well as data on why taxpayers do not file electronically and what it would take to get them to do so, IRS cannot make sound decisions on

[10]The AICPA mentioned that another big obstacle to practitioner participation in electronic filing is that many of the returns prepared by its members involve forms that cannot be filed electronically. Thus, a firm would have to incur the costs of two processes—one for paper returns and one for electronic returns.

such things as the feasibility of offering incentives (such as a tax credit) to encourage greater participation in the program.

IRS awarded a contract in May 1995 that may provide at least some of the needed cost/benefit data. Among other things, the contract calls for a systematic analysis of the costs and benefits of each step in the electronic filing process. We believe this aspect of the contract is critical to helping IRS focus its resources on those taxpayers or returns that provide the greatest opportunity for reducing overall operating costs. Data on the cost and benefits of electronic filing versus paper filing for various taxpayers or returns, coupled with estimates of the number of electronic returns IRS can expect to receive from these market segments, should provide IRS with a foundation for focusing future electronic filing marketing strategies.

It is not clear whether the contractor will be doing any taxpayer focus groups or surveys to determine what changes IRS needs to make to better motivate taxpayers to participate in electronic filing. IRS' most recent taxpayer opinion data on electronic filing were collected in 1991 and those did not include data from businesses. Unless IRS obtains more current information from taxpayers, it may have difficulty reliably estimating the number of electronic returns it can expect to receive from different market segments.

A complicating factor in any cost/benefit analysis is IRS' plan to change the way it processes paper returns in the future. Instead of the current manually intensive process by which tax return data are keypunched into the computer, IRS plans to scan paper returns. If scanning reduces the cost of processing paper returns, as expected, it could alter any analysis of the relative costs and benefits of electronic filing.

IRS Does Not Have Contingency Plans in Case Electronic Filing Goals Are Not Reached

In deciding on 5 submission processing centers and 23 customer service centers and in determining the number of persons needed to staff those centers, IRS relied, in large part, on expectations that it would be receiving a minimum of 61 million electronically filed returns by 2001. Using IRS' return filing projections for 2001, we estimated that submission processing centers would thus be expected to process about 163 million paper returns.

If fewer returns are filed electronically or if the returns filed electronically do not substantially decrease IRS' paper-processing workload, IRS will have to process more paper, which would decrease productivity and increase costs. The need to process more paper could also cause IRS to revise its plans for the submission processing centers. Staffing and equipment needs could be expected to increase at the sites if more paper returns have to be processed. A National Office official told us that if another submission processing site is needed, site preparation costs alone would amount to more than $17 million.

A substantial increase in the number of paper returns could also affect IRS' plans for its 23 customer service centers and the availability of staff to work in compliance positions. The customer service centers are responsible for handling taxpayer telephone and correspondence contacts, many of which are a byproduct of questions that arise from processing taxpayers' returns. Because of the substantially higher error rates associated with paper returns, according to IRS data (23 percent versus 2 percent for electronic returns), customer service centers would likely need to field more questions if IRS receives more paper returns than it has projected. And, if IRS needs more staff to process paper returns and provide customer service, it may have fewer staff to redeploy to compliance positions, thus decreasing the amount of additional tax revenue anticipated from such a redeployment.

IRS National Office officials told us that they had not developed contingency plans for the possibility that electronic filing will fall short of expectations. They believe that IRS will be successful in achieving the level of electronic filing needed to support the projected workloads for the submission processing and customer service centers. In the event of a shortfall, they believe IRS will have time later to develop alternative plans. IRS has developed a contingency plan for the document imaging system that is to eventually replace IRS' current paper-processing system. The purpose of that plan is to ensure that the project office overseeing implementation of this automated system can help submission processing centers process tax documents if the automated system does not meet prescribed efficiency rates. The plan does not indicate how IRS' plans for the new imaging system would have to be revised if IRS receives more paper returns than the system is being designed to handle. The plan, given its focus on submission processing, also does not address the impact of a shortfall in electronic returns on IRS' plans for customer service.

We believe that contingency plans are needed now. IRS is beginning to implement its customer service vision and is preparing to pilot the imaging system. In conjunction with those efforts, IRS needs to identify and take into account the impact of possible shortfalls in electronic filing. The longer IRS waits, the fewer its options become and the less time it will have to fully consider alternatives.

Conclusions

IRS' ability to effectively process tax returns and assist taxpayers in the future largely depends on how successful IRS is in converting to an electronic environment and reducing its reliance on paper. Electronic filing of tax returns is a critical part of that conversion. However, without some dramatic changes in IRS' current electronic filing program over the next 6 years, many of the benefits available from electronic filing could go unrealized.

The number of electronic returns has been growing at a pace that will leave IRS far short of its 80-million goal in 2001. Even more important to the ultimate success of electronic filing, in our opinion, is the fact that the returns being filed electronically are generally the less complex returns that are the least costly for IRS to process when filed on paper.

The heavy representation of less complex returns may be influenced, at least in part, by IRS' goal of 80 million returns. Focusing solely on this goal could cause IRS to expend its limited resources on initiatives that are directed toward groups of taxpayers or types of returns that provide the greatest opportunity to increase the number of electronic returns but not the greatest opportunity to reduce IRS' paper-processing workload and operating costs. Although a marketing strategy that focuses on reducing paper and costs may generate fewer than 80 million returns, it could have a more significant impact on IRS' overall operations. The contract IRS awarded in May 1995 may provide cost/benefit data IRS can use to reassess its strategy. That information may help IRS identify effective steps to make electronic filing more attractive to those taxpayers and tax return preparers who are now put off by its cost.

If the growth and impact of electronic filing fall short of expectations, IRS' paper-processing workload will increase. More paper means more errors, which, in turn, would create a need for more taxpayer contacts. Depending on the extent of the electronic filing shortfall, IRS may need to increase the number and/or size of submission processing and customer service centers and adjust plans for equipping and staffing the centers. However, IRS is not prepared to make those adjustments because it has no contingency plans.

Recommendations to the Commissioner of Internal Revenue

To help better ensure the success of IRS' modernization, we recommend that the Commissioner do the following:

- Identify those groups of taxpayers who offer the greatest opportunity to reduce IRS' paper-processing workload and operating costs if they were to file electronically and develop strategies that focus IRS' resources on eliminating or alleviating impediments that inhibit those groups from participating in the program, including the impediment posed by the program's cost.
- Adopt goals for electronic filing that focus on reducing IRS' paper-processing workload and operating costs. These goals could be used in addition to the existing electronic filing goal to assess IRS' progress in achieving the intended benefits of electronic filing.
- Prepare contingency plans for the possibility that the electronic filing program will fall short of expectations.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Commissioner of Internal Revenue or her designated representative. Responsible IRS officials, including IRS' Electronic Filing Executive and Site Executives for Computing Centers and Submission Processing, provided IRS' comments in a July 27, 1995, meeting. These officials provided a few factual clarifications that we have incorporated in this report where appropriate. The officials also said that they generally agreed with our report recommendations. They stated that they recognized that much work needed to be done to increase the number of electronic returns and identified plans or actions that were under way that they believe address the recommendations. We agree that IRS has developed plans and is taking action to increase the number of electronic returns. However, we remain concerned that unless those actions or plans are supported by the type of analysis and goal setting that we are recommending, IRS may not be effectively targeting its limited resources for marketing the electronic filing program.

On our first recommendation on identifying taxpayers who offer the greatest opportunity to reduce IRS' paper-processing workload and costs, IRS officials said that (1) they strongly believe that the electronic filing program already focuses on those taxpayers who offer the greatest opportunity to reduce IRS' paper-processing workload—essentially individual taxpayers—but had not yet prepared a business case to support that belief, (2) they were expanding TeleFile nationwide for the 1996 filing season to make electronic filing available to more individual taxpayers, and (3) research was under way to help make electronic filing more appealing to taxpayers and to help IRS expand the program to more individual taxpayers. In addition, IRS believes its current focus on individual taxpayers is appropriate because the bulk of its processing costs stem from having to process large numbers of individual returns in a short time period. IRS officials also said they are working with some large businesses on electronic filing of employment tax returns. These returns represent a large portion of all business returns filed.

Although the actions IRS mentioned may help expand the electronic program, we believe the second and third items discussed above will most likely have an effect on those taxpayers that are already attracted to IRS' electronic filing program—those individual taxpayers who file relatively simple returns. The expansion of TeleFile in 1996, for example, will have no impact on those individual taxpayers that file more complex tax returns. As we discuss on page 6, the expansion IRS refers to is a geographic one—going from 10 states to all states in the 1996 filing season. The TeleFile program will continue to focus on those taxpayers who file the simplest individual tax return (Form 1040EZ).

IRS' comment regarding research to make electronic filing more appealing refers to analysis being done to profile (1) those taxpayers who currently file electronically and (2) those who could file electronically, but currently do not. IRS believes this profiling will assist in marketing electronic filing to those individual taxpayers who do not currently use electronic filing. We agree that such an analysis may be helpful as a marketing tool for district offices. However, it is uncertain how this analysis will help alleviate some of the current impediments to electronic filing for many individual taxpayers, such as the cost to the taxpayer.

With respect to our second recommendation on adopting goals for electronic filing that focus on reducing IRS' paper-processing workload and costs, IRS officials provided several examples of actions that they believed indicated that they have adopted such goals. These examples included (1) the contract to conduct cost and marketing analyses that we discuss on page 14, (2) another contract that was awarded to develop a strategy to reach taxpayers who could file from home computers, and (3) IRS' plans to eliminate processing of signature documents for electronic returns.

We agree that some of the actions IRS mentioned may reduce paper-processing workload and costs. However, these actions are steps IRS is taking to achieve its existing performance goal of 80 million returns. The intent of our recommendation is for IRS to develop other performance goals based on the analysis done in response to the first recommendation.

IRS' current performance goal provides little incentive to identify and pursue opportunities for reducing the paper-processing costs associated with more complex returns that may not represent a large number of returns. The analysis called for in our first recommendation would put IRS in a better position to develop specific goals for receiving certain types of returns electronically based on the their contribution to reducing overall paper-processing costs. For example, goals such as "receive 75 percent of all corporate returns electronically by 2001" or "reduce the number of paper returns processed (in terms of number of pages rather than number of returns) by 50 percent," might result in different decisions on how IRS should focus its limited marketing resources than those decisions currently being made.

On our third recommendation regarding contingency planning, IRS agreed that it needed to prepare for the eventuality of receiving fewer electronic returns in 2001. However, IRS representatives said that contingency planning is not the only way to prepare for this eventuality. IRS officials said IRS is using a program management approach to phase in operations under its new business vision. IRS officials expected this approach to provide the flexibility for adjusting program plans to address any significant shortfall in the number of electronic returns received. In addition, IRS officials said that the contract for procuring new scanning equipment for paper returns is flexible. Therefore, IRS expects to have an option to buy additional equipment if it needs to process more paper returns than it originally estimated.

We reviewed a November 29, 1994, memorandum from IRS' Modernization Executive to the heads of offices that are involved in IRS' modernization program. That memorandum described the program management approach that IRS refers to above and a program control process for helping to ensure that IRS achieves its modernization goals. According to the memorandum, the program control process will include risk assessments that are to (1) identify impediments to delivering various aspects of IRS' business vision and (2) prompt the development of mitigation strategies to address identified risks.

IRS would be responsive to our recommendation if it succeeds through its program management approach in (1) promptly developing mitigation strategies if more paper tax returns have to be processed in future years than IRS currently expects and (2) specifying alternative actions for processing paper returns and implementing its customer service vision.

As agreed with your staff, unless you publicly announce the contents of this report earlier, we plan no further distribution for 30 days. At that time we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others on request.

The major contributors to this report are listed in appendix II. If you or your staff have any questions about this report, you can reach me at (202) 512-8633.

Sincerely yours,

Lynda D Willis

Lynda Willis
Associate Director, Tax Policy and
Administration Issues

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
IRS	Internal Revenue Service

Legislative Needs Cited in IRS' May 1993 Electronic Filing Strategy

In May 1993, the IRS Electronic Filing Strategy Task Group issued a report that included 21 initiatives directed at increasing the use of electronic filing. Five of those initiatives cited the need for legislation. As discussed below, none of that legislation has been enacted and, in some cases, IRS has decided not to seek legislation.

Permit Payment of Taxes by Credit Card

One of the 21 initiatives was directed at increasing the number of balance due returns filed electronically. Critical to the success of this initiative, according to the task group, was legislation that would allow credit card payments of tax obligations. Such a provision was included in section 4122 of H.R. 11, the Revenue Act of 1992, which was passed by both houses of Congress but vetoed by the President. A similar provision was included in other bills, none of which were enacted. Most recently, IRS included this proposal in a package of legislative initiatives sent to the Assistant Secretary of the Treasury for Tax Policy in January 1995. In February 1995, Treasury's Office of Fiscal Assistant Secretary raised several questions about the potential costs associated with this proposal and how those costs would be funded. As of June 26, 1995, IRS and Treasury had not resolved these cost issues.

Mandate Electronic Filing by Certain Tax Return Preparers and Businesses

The task group estimated that 46 million more electronic returns would be received if (1) preparers of 100 or more individual returns were required to offer electronic filing and (2) businesses with 10 or more employees were required to file their returns electronically. The business returns specifically identified by the task group were Form 1041 (U.S. Fiduciary Income Tax Return), Form 1065 (U.S. Partnership Return of Income), Form 1120 (U.S. Corporation Income Tax Return), Form 1120S (U.S. Income Tax Return for an S Corporation), forms 5500 and 5500 C/R (Annual Return/Report of Employee Benefit Plan), and Form 941 (Employer's Quarterly Federal Tax Return).

In a November 1993 testimony before a subcommittee of the then House Committee on Government Operations, the Assistant Secretary of the Treasury for Tax Policy made the following comments:

> "The Service has proposed that the Secretary be given regulatory authority to require that tax returns be filed other than in paper form, including electronically or by magnetic media. . . . Broad regulatory authority to require that returns be filed other than in paper form is appropriate and essential to the Service's ability to modernize its systems, streamline its operations and, in general, deliver quality services at the least cost. However,

in view of the potential burdens on taxpayers and preparers in complying with electronic or magnetic media filing requirements, we currently are considering whether legislative refinements to this proposal may be necessary to clarify the intended scope and timing of the conversion to a non-paper based system."

The proposal was eventually dropped because IRS and Treasury officials believed that Congress would not pass legislation that would enable IRS or Treasury to dictate who would have to file electronically.

Eliminate Requirements for Paper Submissions in Electronic Filing

The task group noted that "In virtually every study conducted on electronic filing, the issue of processing paper documents has been identified as impacting negatively upon IRS' ability to realize electronic filing's full savings potential." The task group further said that "Eliminating the requirement to prepare and submit paper documents could have a significant impact on reducing the cost electronic filers pass on to their customers."

This initiative called for eliminating the paper documents associated with electronic filing by proposing legislation that would (1) allow alternatives to the paper signature document and (2) eliminate the submission of paper attachments to the electronic return. H.R. 11, referred to earlier, included a provision (section 4933) that would have addressed the first of those two legislative needs by authorizing the Secretary of the Treasury to prescribe alternative methods of verifying returns on a trial basis. IRS' latest proposal, included in its January 1995 submission to the Assistant Secretary for Tax Policy, was broader. It would have authorized the Secretary of the Treasury to permit alternative methods of (1) verifying, signing, and subscribing returns and other statements and (2) submitting written declarations, statements, or other documents required by the Internal Revenue Code.

In April 1995, IRS' Office of Chief Counsel concluded that IRS had regulatory authority to prescribe alternative methods for signing and submitting tax returns and other written documents. An IRS official said that IRS plans to test signature alternatives in 1996.

Institute a Promotional Campaign

The task group determined that "a full scale, high-powered promotional campaign" was needed to "maximize the number of electronic returns." Because of the anticipated scope of the promotional campaign, the task group recommended that IRS obtain an appropriations rider for paid advertising. IRS has taken no action to get such a rider because of concerns that a paid advertising campaign might jeopardize current free public service advertising.

Propose Tax Incentives

To encourage greater participation in electronic filing, the task group proposed that IRS initiate legislative action to provide tax incentives for businesses and preparers. The group suggested consideration of such incentives as a more accelerated depreciation schedule for electronic filing equipment and a higher percentage of investment tax credit. IRS has decided not to pursue such legislation. As noted in this report, IRS does not have the data needed to determine what kind of incentives would be most effective and what level of incentives makes sense given the benefits of electronic filing.

Major Contributors to This Report

General Government Division, Washington, D.C.

David J. Attianese, Assistant Director
Monika Gomez, Evaluator
John Lesser, Senior Evaluator
Sherrie Russ, Senior Evaluator

Cincinnati Regional Office

Daniel J. Meadows, Evaluator-in-Charge
Linda Standau, Senior Evaluator
Laurie Housemeyer, Evaluator
Robert I. Lidman, Regional Assignment Manager

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