

# TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



## Progress Update on Tax Return Scanning Initiatives

December 20, 2023

Report Number: 2024-408-013

## HIGHLIGHTS: Progress Update on Tax Return Scanning Initiatives

Final Audit Report issued on December 20, 2023

Report Number 2024-408-013

### Why TIGTA Did This Audit

This audit was initiated to evaluate the IRS's efforts to scan paper-filed individual tax returns into an electronic format for the 2023 Filing Season.

On September 15, 2022, the Secretary of the Treasury detailed plans for using the Inflation Reduction Act funding and set expectations for the 2023 Filing Season. One of these expectations was that the IRS will automate the scanning of millions of individual paper tax returns.

### Impact on Tax Administration

The need to completely modernize the processing of individual and business paper tax returns did not become apparent until the Coronavirus Disease 2019 pandemic, when the IRS closed its Tax Processing Centers during the 2020 Filing Season.

As a result of the closures, the IRS held large amounts of unopened mail, including paper tax returns and correspondence, in trailers until employees were able to return to work in-person to begin processing these documents.

For paper-filed individual tax returns, processing means an IRS employee manually enters the information from the tax return into the IRS's tax processing systems. According to the IRS's Inflation Reduction Act Strategic Operating Plan, paper filings take longer, cost more, and are more prone to errors, leading to a downward spiral in service quality. In addition, more errors create longer customer service wait times, which increase the IRS's support costs and the volume of issues it must work to resolve.

### What TIGTA Found

The IRS's current scanning pilots are the Lockbox, Scanning as a Service (SCaaS), and Submission Processing Modernization (SPM). Even when considering the business tax returns that were scanned as part of the various pilots, the IRS still will not reach the Secretary's expectation to scan millions of individual tax returns before the end of Calendar Year 2023. As of June 30, 2023, the IRS had scanned fewer than 35,000 paper-filed Forms 1040, *U.S. Individual Income Tax Return*.



IRS management advised that they will begin testing an additional scanning solution during the 2024 Filing Season, referred to as the Modernized Paper Processing System, which will combine artificial intelligence, *i.e.*, machine learning, with existing Service Center Recognition Image Processing System technology to scan tax returns directly into IRS tax processing systems.

A centralized oversight of scanning efforts is critical to selecting a scanning solution that will accomplish the IRS's new transformation goals. In its July 2020 Digitalization Strategy, the IRS recommended establishing a centralized office responsible for enterprise-wide governance. However, as of June 2023, the IRS had not transitioned oversight of its digitalization efforts to this office. Further, in July 2023, IRS management stated that a group within the Transformation and Strategy Office will be responsible for the IRS's digitalization efforts under the Strategic Operating Plan Initiative 1.2, which includes the digital processing of paper-filed tax returns. However, management also noted that the current tax return scanning pilots, *i.e.*, the SCaaS, Lockbox, and the SPM, were not included as part of Initiative 1.2.

### What TIGTA Recommended

The Chief Transformation and Strategy Officer should: 1) evaluate the potential benefits, challenges, and cost of each of the processes the IRS piloted when deciding which digital processing solution to implement for the 2025 Filing Season and beyond, and 2) once a digital processing solution has been identified, develop a detailed plan with measurable milestones for implementing the solution before the start of the 2025 Filing Season. The IRS agreed with both recommendations and plans to implement them prior to the start of the 2025 Filing Season.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**U.S. DEPARTMENT OF THE TREASURY**  
**WASHINGTON, D.C. 20024**

December 20, 2023

**MEMORANDUM FOR:** COMMISSIONER OF INTERNAL REVENUE

A handwritten signature in black ink, appearing to read "M. Weir", is positioned above the "FROM:" field.

**FROM:** Matthew A. Weir  
Acting Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Progress Update on Tax Return Scanning Initiatives  
(Audit # 202340829)

This report represents the results of our review to evaluate the Internal Revenue Service's (IRS) efforts to scan paper-filed individual tax returns into an electronic format for the 2023 Filing Season. This review was part of our Fiscal Year 2023 discretionary audit coverage and addresses the major management and performance challenge of *Modernizing IRS Operations*.

Management's complete response to the draft audit report is included as Appendix IV. If you have any questions, please contact me or Diana M. Tengesdal, Assistant Inspector General for Audit (Returns Processing and Account Services).

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### Background

Since Calendar Year 1991, the Internal Revenue Service (IRS) has used the Service Center Recognition Image Processing System to scan paper-filed business tax returns.<sup>1</sup> However, the need to completely modernize the processing of individual and business paper tax returns did not become apparent until the Coronavirus Disease 2019 (COVID-19) pandemic.

As we reported in June 2020, the IRS closed its Tax Processing Centers during the 2020 Filing Season.<sup>2</sup> As a result of the closures, the IRS held large amounts of unopened mail, including paper tax returns and correspondence, in trailers until employees were able to return to work in-person to begin processing these documents. For paper-filed individual tax returns, processing means an IRS employee manually enters the information from the tax return into the IRS's tax processing systems.

To help the IRS achieve digital transformation, it developed a document in July 2020 called the IRS Digitalization Strategy. This strategy acknowledges that the large volume of paper presents an enormous cost and time burden to the IRS in both the resources required to handle, assign, and transcribe these documents as well as the cost of physically transporting and storing paper documents. For example, the strategy includes initiatives that will allow the IRS to scan all paper-based documents upon receipt, convert information to digital data based on business need, and dispose of the paper in accordance with appropriate records management policy so the electronic version is the authoritative copy of the document.

In addition, the IRS established the Enterprise Digitalization and Case Management Office (ED&CMO) in July 2020 to support IRS modernization, including the oversight of digitalization projects. According to IRS management, the IRS is in the process of updating the Digitalization Strategy to align with the Inflation Reduction Act Strategic Operating Plan published in April 2023.<sup>3</sup>



Source: IRS management, Taxpayer Advocate Directive, and Secretary of the Treasury.

<sup>1</sup> See Appendix V for a glossary of terms.

<sup>2</sup> Treasury Inspector General for Tax Administration, Report No. 2020-46-041, *Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions* (June 2020).

<sup>3</sup> IRS Publication 3477, *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan FY 2023-2031*, April 2023.

### **The National Taxpayer Advocate directs the IRS to implement scanning**

In March 2022, the National Taxpayer Advocate issued a Taxpayer Advocate Directive directing the IRS to take immediate steps to implement scanning technology for the Form 1040, *U.S. Individual Income Tax Return*.<sup>4</sup> The Taxpayer Advocate Directive notes that during the past 20 years, the IRS has periodically explored using scanning technology to convert paper Form 1040-series tax returns into a digital format so the IRS can process them like electronically filed tax returns. In response, IRS management stated that the IRS is pursuing several pilot initiatives to improve the processing of paper-filed tax returns and will use the results of these initiatives to scale the most viable solutions that can automate and expedite tax return processing for all types of taxpayers. The use of pilot projects is intended to help the IRS quickly test concepts that could inform future large-scale digitalization solutions.

### **IRS Inflation Reduction Act Strategic Operating Plan**

On April 5, 2023, the IRS Commissioner released the IRS's Inflation Reduction Act Strategic Operating Plan. The Plan is structured to accomplish five objectives that, when taken as a whole, provide a vision for the future of Federal tax administration. Each of the objectives in the Strategic Operating Plan will be achieved through various initiatives and projects.

The first objective of the Strategic Operating Plan is to "dramatically improve services to help taxpayers meet their obligations and receive the tax incentives for which they are eligible." There are 12 separate initiatives to support this objective, with one initiative in particular that relates to expanding digital services and digitalization, *i.e.*, Initiative 1.2. As noted in the Strategic Operating Plan,

*Most taxpayers prefer to file IRS documents electronically when available, but the remaining paper-based filings have outsized effects on IRS operations. Paper filings take longer, cost more, and are more prone to errors, leading to a downward spiral in service quality. More issues create longer customer service wait times, which increase our support costs and the volume of issues we must work to resolve.*

Therefore, the IRS plans to provide taxpayers the option to file documents electronically and securely and will process all forms, returns, and certifications digitally regardless of how they are submitted, while maintaining paper submission options. Moreover, the IRS notes that, once successfully implemented, backlogs in paper and manual processes would be eliminated and the accuracy of tax return data would increase.

## **Results of Review**

This report presents the results of our assessment of the IRS's efforts to scan paper-filed individual tax returns into an electronic format for the 2023 Filing Season. The results in this report are presented as of the end of August 2023, with a focus on the IRS's ability to increase

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<sup>4</sup> Taxpayer Advocate Directive 2022-1: *Implement Scanning Technology to Machine Read Paper Tax Returns and Address the Paper Return Backlog*, issued March 29, 2022.

scanning to meet its new "paperless" processing goals. We will continue to assess the IRS's progress to implement a scanning solution that will transform paper processing.<sup>5</sup>

### **Actions Taken to Test Scanning Solutions**

The first major pilot project related to the scanning of the Form 1040 began in March 2021 and ended in November 2022. This pilot evaluated technology to convert paper-filed tax returns prepared by an individual using a tax preparation software package (referred to as V-coded returns) into an electronic format for processing through the IRS's Modernized Electronic Filing (MeF) system.

Although the volume of tax returns scanned as part of the V-Code pilot is relatively low compared to total individual paper tax return receipts, the IRS considered the pilot a success. The pilot confirmed that paper-filed Form 1040 tax returns can be converted to an electronic record and successfully processed through the IRS's MeF system. Figure 1 shows the number of individual tax returns that were scanned and accepted for processing through the MeF system as part of the V-Code pilot.

**Figure 1: V-Code Pilot Tax Returns Accepted Into the MeF System**

Tax Year	Total Returns Accepted
2020	134,592
2021	3,177
Total	137,769

*Source: IRS Wage and Investment Division, Program Management/Process Assurance Office.*

### **Expanding the digitalization of paper-filed tax returns**

The IRS used the lessons learned from the V-Code pilot when developing requirements and contracting for the three, current additional scanning pilots. For example, the V-code pilot used a template-based approach for scanning tax returns. However, the current pilot vendors are using more advanced technologies, such as applying machine learning, artificial intelligence, and intelligent character recognition to scan tax returns.<sup>6</sup> According to IRS management, these technologies will produce higher quality scanning results. Figure 2 provides information about and the status of each of the pilots.

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<sup>5</sup> Treasury Inspector General for Tax Administration, Audit No. 2024400028, *Continued Assessment of Efforts to Digitalize Paper Tax Returns for Processing*.

<sup>6</sup> IRS documentation shows that each of the contractors participating in the scanning pilots completed a security site assessment and met the IRS's suitability requirements. In addition, each contractor is conducting background checks on their employees who handle Federal tax returns and return information.

## Progress Update on Tax Return Scanning Initiatives

**Figure 2: Information About Scanning Pilots<sup>7</sup>**

Pilot Name	Start Date	Description of Pilot
Lockbox	July 2021	Testing the scanning of Forms 940, <i>Employer's Annual Federal Unemployment (FUTA) Tax Return</i> , and 941, <i>Employer's QUARTERLY Federal Tax Return</i> , for electronic processing through the IRS's MeF system via a partnership between the Bureau of the Fiscal Service and financial institutions. The IRS is also working with the Bureau of the Fiscal Service to test scanning of Form 1040. Tax returns are mailed directly to the lockbox site by taxpayers.
Scanning as a Service (SCaaS)	August 2021	Testing available technology to extract data from processed paper-filed Forms 709, <i>United States Gift (and Generation - Skipping Transfer) Tax Return</i> , to create searchable portable document formats that can be sent to a National Archives and Records Administration compliant IRS storage system. This pilot is also testing the transformation of paper-filed Tax Years 2022 and 2023 Forms 941 into machine readable data for processing. Tax returns are mailed to the Tax Processing Center to be sorted and batched and then sent to the contractors for processing.
Submission Processing Modernization (SPM)	August 2022	Evaluating various solutions for opening, extracting, and sorting of mail; remittance identification and processing; digital intake of paper forms for processing; and document management and reporting functions. The current focus is on the digital intake and processing of paper Forms 1040. Vendors began scanning paper Forms 1040 with 10 commonly attached forms and schedules, referred to as Form 1040+10. On June 20, 2023, the IRS expanded the number of attached forms and schedules that can be scanned to 25, referred to as Form 1040+25. See Appendix II for a comprehensive list of forms and schedules. Tax returns are mailed to the Tax Processing Center to be sorted and batched and then sent to the contractors for processing.

*Source: IRS Wage and Investment Division and Enterprise Digitalization Office.*

The scanning pilots use a phased approach to test available technology. Participating contractors must meet established criteria for each phase to advance in the pilot. For example, the IRS began the SPM pilot with five contractors scanning the Form 1040. As the pilot progressed, the IRS narrowed the pilot to two contractors scanning the Form 1040. The IRS is also limiting the amount of inventory each contractor can scan and process until the contractor reaches a specified confidence level with minimal errors. This confidence level is determined by a group in the IRS that compares the transmitted tax returns to the scanned image of the tax return to ensure that the contractor's software captured the tax return data accurately. Once a contractor has reached the desired confidence level, the IRS gives the contractor permission to increase the number of tax returns it scans. Figure 3 illustrates the general process used to scan paper-filed tax returns for processing through the MeF system.

<sup>7</sup> See Appendix III for additional details, *i.e.*, contract award dates, cost, *etc.*, on the phases of each pilot.

**Figure 3: Process to Scan Paper Tax Returns for Processing**



*Source: Treasury Inspector General for Tax Administration analysis of information obtained during walkthroughs and IRS tabletop demonstrations.*

### **The Goal to Scan Millions of Individual Tax Returns Was Not Met; However, Plans Are Underway to Increase Scanning for the 2024 Filing Season**

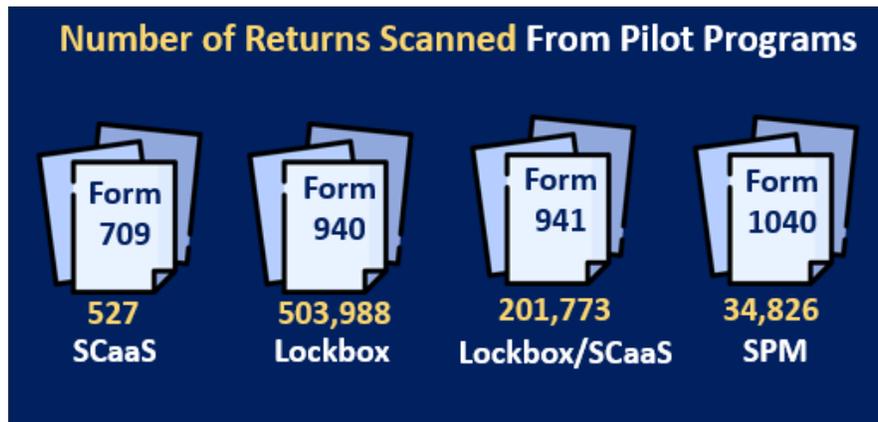
In a September 15, 2022, address to IRS employees, the Secretary of the Treasury (Secretary) detailed plans for using the Inflation Reduction Act funding and set expectations for the 2023 Filing Season.<sup>8</sup> One of these expectations was that the IRS will automate the scanning of millions of individual paper tax returns. In September 2023, we reported that the IRS did not meet this expectation by the end of the filing season.<sup>9</sup> While the filing season usually runs through mid-April, the IRS will continue to receive and process individual tax returns through the end of Calendar Year 2023.

Even with this additional time, the IRS will not scan millions of individual tax returns before the end of Calendar Year 2023. As of June 30, 2023, the IRS had scanned less than 35,000 paper-filed Forms 1040. Even when considering the business tax returns that were scanned as part of the various pilots, the IRS still will not reach the Secretary's expectation to scan millions of paper tax returns. Figure 4 shows the number of tax returns the IRS scanned in the three pilot projects during the 2023 Filing Season, as of June 30, 2023.

<sup>8</sup> Pub. L. No. 117-169, 136 Stat. 1818 (2022).

<sup>9</sup> Treasury Inspector General for Tax Administration, Report No. 2023-IE-R010, *Inflation Reduction Act: Assessment of the IRS's Efforts to Deliver Expected Improvements for the 2023 Filing Season* (Sept. 2023).

**Figure 4: Number of Tax Returns Scanned by the Pilot Projects During the 2023 Filing Season as of June 30, 2023**



Source: IRS Wage and Investment Division and Enterprise Digitalization Office.

As noted in Figure 2, two of the three pilot projects started in Calendar Year 2021 and were well under way when the Secretary outlined their Filing Season 2023 expectations in September 2022. The third pilot project started in August 2022, just one month before the Secretary's announcement. As mentioned previously, the IRS is limiting the number of tax returns the pilot contractors can scan until they reach a desired confidence level. However, the contracts for the three pilots did not include a deliverable/requirement that a specific volume of tax returns needed to be scanned. Moreover, the SPM pilot is the only pilot that planned to test the scanning of the Form 1040 during the 2023 Filing Season. Yet the majority of the individual paper-filed tax returns were processed by the IRS before the actual scanning phase of the SPM pilot began. For example, the first phase of the SPM pilot began in August 2022, and the second phase, which is when the contractors began scanning returns, began in February 2023.

### **Additional scanning of individual tax returns will occur during the 2024 Filing Season**

IRS management advised that they expect to increase the number of paper-filed Forms 940, 941, and 1040 the IRS will scan for the 2024 Filing Season. For example, according to IRS management, the SPM pilot will continue through Calendar Year 2024. IRS management is also considering expanding the Lockbox pilot to include the Form 1040, although the number of supporting forms and schedules the Lockboxes scan is currently anticipated to be limited.

In addition, IRS management advised that they will begin testing an additional scanning solution during the 2024 Filing Season, referred to as the Modernized Paper Processing System. The Modernized Paper Processing System will combine artificial intelligence, *i.e.*, machine learning, with existing Service Center Recognition Image Processing System technology to scan tax returns directly into IRS tax processing systems. Unlike the SPM pilot, paper-filed tax returns will be scanned at the IRS Tax Processing Centers rather than shipped to a contractor for scanning and transmission to the IRS through the MeF system.

## **Centralized Oversight of Scanning Efforts Is Critical to Selecting a Solution That Will Accomplish New Transformation Goals**

The IRS has yet to align its various scanning initiatives under one centralized oversight structure. In its July 2020 Digitalization Strategy, the IRS recommended establishing a centralized Digitalization Office responsible for enterprise-wide governance and use of digital data or efforts. As a result, in July 2020, the IRS created the ED&CMO to help it become a fully digital tax administration system. However, as of June 2023, the IRS had not transitioned oversight of its digitalization efforts to the ED&CMO.

Further, the IRS recently established the Transformation and Strategy Office to lead the execution of the Inflation Reduction Act Strategic Operating Plan. In July 2023, IRS management stated that a group within the Transformation and Strategy Office will be responsible for all of the IRS's digitalization efforts under the Strategic Operating Plan Initiative 1.2, which includes the digital processing of paper-filed tax returns. However, management also stated that the current tax return scanning pilots, *i.e.*, the SCaaS, Lockbox, and the SPM, were not transferred to Initiative 1.2. The Transformation and Strategy Office will oversee the testing of the Modernized Paper Processing System initiative during the 2024 Filing Season as part of Initiative 1.2 of the Inflation Reduction Act Strategic Operating Plan. Whereas, the IRS's Wage and Investment Division will continue to oversee scanning at the Lockboxes, and the ED&CMO, in partnership with IRS business units, will continue to manage the SPM and the SaaS until they reach their natural conclusion or are transitioned to another office.

On August 2, 2023, the Secretary announced another milestone for the IRS called "paperless processing." By Filing Season 2025, the IRS will digitally process 100 percent of paper-filed tax returns and information documents. The Secretary also noted the following:

*This initiative is the key that unlocks other customer service improvements. It will enable taxpayers to see their documents, securely access their data, and save time and money. And it will allow other parts of the IRS to rely on these digital copies to provide faster refunds, reduce errors in tax processing, and deliver a more seamless and responsive customer service experience.*

We commend the IRS for making such a bold commitment to modernize paper tax return processing. However, we are concerned with the IRS's ability to achieve this goal within the desired time frame considering that it has not decided on a final scanning solution and current oversight of the testing efforts is disjointed. As stated previously, we plan to continue our audit coverage to evaluate the IRS's efforts to implement a scanning solution that will transform paper processing.

The Chief Transformation and Strategy Officer should:

**Recommendation 1:** Evaluate the potential benefits, challenges, and cost of each of the processes the IRS piloted when deciding which digital processing solution to implement for the 2025 Filing Season and beyond. This detailed evaluation should be completed and documented regardless of whether the pilot is transitioned to Initiative 1.2 of the Inflation Reduction Act Strategic Operating Plan.

## Progress Update on Tax Return Scanning Initiatives

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**Management's Response:** IRS management agreed and will work with the Enterprise Digitalization office to gather information regarding costs, benefits, and known challenges for pilots addressing digital intake of Forms 940, 941, and 1040 to date. This information will be included as critical factors in drafting the Enterprise Scanning Strategy, in advance of the opening of the 2025 Filing Season.

**Recommendation 2:** Once a digital processing solution has been identified, develop a detailed plan with measurable milestones for implementing the solution before the start of the 2025 Filing Season. This plan should include ensuring that the solution is adequately tested and all identified issues are resolved before the IRS begins processing Tax Year 2024 tax returns.

**Management's Response:** IRS management agreed and has included in the *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan* four priority projects under Initiative 1.2 – Expand digital services and digitalization. Implementation is before the start of the 2025 Filing Season. The projects are designed to create digital forms, expand historical digitalization, expand correspondence digitalization, and expand tax return digitalization. Each project team is responsible for the digital processing solution, based on the types of submissions, and will track and deliver a detailed, comprehensive plan that includes the key activities and operational outcomes associated with successful solution implementation.

## Appendix I

### Detailed Objective, Scope, and Methodology

The overall objective of this audit was to evaluate the IRS's efforts to scan paper-filed individual tax returns into an electronic format for the 2023 Filing Season. To accomplish our objective, we:

- Determined if the IRS achieved the goal of automating the scanning of millions of individual paper-filed tax returns into digital copies by end of the 2023 Filing Season.
- Determined if there was Service-wide oversight of IRS digitalization efforts.
- Determined if the IRS had adequate controls, such as vendor background checks and security site assessments, in place to properly safeguard sensitive tax information maintained by both contractors and subcontractors.

#### **Performance of This Review**

This review was performed with information obtained from the Wage and Investment Division Headquarters in Atlanta, Georgia; the Wage and Investment Division Submission Processing function offices in Covington, Kentucky; the IRS ED&CMO and Information Technology organization in Washington, D.C.; IRS Small Business/Self-Employed Division Examination function in Washington, D.C.; the Bureau of the Fiscal Service in Washington, D.C.; and lockbox sites in Louisville, Kentucky, and Cincinnati, Ohio; during the period October 2022 through July 2023. We conducted this performance audit 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Diana M. Tengesdal, Assistant Inspector General for Audit (Returns Processing and Account Services); Deann Baiza, Director; Sharla Robinson, Audit Manager; Ashley Burton, Lead Auditor; Jerome Antoine, Auditor; and Laura Christoffersen, Data Analyst.

#### **Internal Controls Methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: procedures and processes followed when scanning paper-filed individual tax returns into an electronic format. We evaluated these controls by reviewing the Internal Revenue Manual, meeting with IRS management, and reviewing relevant documentation and data provided by the IRS.

Appendix II

**Submission Processing Modernization Pilot Forms and Schedules**

Tax Form	Form 1040+10	Form 1040+25
Form 1040 <i>U.S. Individual Income Tax Return</i>	✓	✓
Form 1040 (Schedule 1) <i>Additional Income and Adjustments to Income</i>	✓	✓
Form 1040 (Schedule 2) <i>Additional Taxes</i>	✓	✓
Form 1040 (Schedule 3) <i>Additional Credits and Payments</i>	✓	✓
Form 1040 (Schedule 8812) <i>Credits for Qualifying Children and Other Dependents</i>	✓	✓
Form 1040 (Schedule A) <i>Itemized Deductions</i>	✓	✓
Form 1040 (Schedule B) <i>Interest and Ordinary Dividends</i>		✓
Form 1040 (Schedule C) <i>Profit or Loss From Business (Sole Proprietorship)</i>	✓	✓
Form 1040 (Schedule D) <i>Capital Gains and Losses</i>		✓
Form 1040 (Schedule E) <i>Supplemental Income and Loss</i>		✓
Form 1040 (Schedule EIC) <i>Earned Income Credit</i>	✓	✓
Form 1040 (Schedule SE) <i>Self-Employment Tax</i>	✓	✓
Form 2441 <i>Child and Dependent Care Expenses</i>	✓	✓
Form 4562 <i>Depreciation and Amortization (Including Information on Listed Property)</i>		✓
Form 4797 <i>Sales of Business Property</i>		✓
Form 5329 <i>Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts</i>		✓

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Tax Form	Form 1040+10	Form 1040+25
Form 8283 <i>Noncash Charitable Contributions</i>		✓
Form 8582 <i>Passive Activity Loss Limitations</i>		✓
Form 8606 <i>Nondeductible IRAs</i>		✓
Form 8829 <i>Expenses for Business Use of Your Home</i>		✓
Form 8863 <i>Education Credits (American Opportunity and Lifetime Learning Credits)</i>		✓
Form 8880 <i>Credit for Qualified Retirement Savings Contributions</i>	✓	✓
Form 8889 <i>Health Savings Accounts (HSAs)</i>		✓
Form 8959 <i>Additional Medicare Tax</i>		✓
Form 8960 <i>Net Investment Income Tax - Individuals, Estates, and Trusts</i>		✓
Form 8995 <i>Qualified Business Income Deduction Simplified Computation</i>		✓

*Source: IRS management-provided list of the applicable forms and schedules for the Form 1040+10 and Form 1040+25. Form and schedule names obtained from the individual forms and schedules. IRA = Individual Retirement Arrangement.*

Appendix III

Scanning Pilots

Figure 1: The SCaaS

	Phase 1	Phase 2
<b>Description of Phase</b>	<p><b>Testing and Pilot/Initial Deployment:</b> Will consist of a demonstration of the ability of the solution to provide high-resolution scans and to transfer them to the IRS through secure digital channels. The project will focus on scanning. (Not to exceed \$200,000/180 days).</p> <p>Started: August 18, 2021. Ended: February 17, 2022.</p>	<p><b>Deployment:</b> Will focus on scaling the scanning solution and transmission of documents to encompass a significant volume of paper documents. A key component of Phase 2 will be leveraging efficiencies to timely handle the significant scanning workload. (Not to exceed \$7.3 million/4.5 years).</p> <p>Started: February 18, 2022. Ends: August 17, 2024.</p>
<b>Form Type Scanned</b>	Form 709	
<b>Number of Vendors Under Contract</b>	Five	Three
<b>Current Phase</b>	Ongoing – Phase 2	

Source: IRS Request for Proposal dated July 19, 2021, and Notice of Award on August 18, 2021.

Figure 2: The SPM

	Phase 1	Phase 2	Phase 3
<b>Description of Phase</b>	<p><b>Proof of Concept and Prototype:</b> Demonstrate sorting, opening, processing, and reporting on various types of mail. Primarily a demonstration of the solution to perform intake of mail of various shapes and dimensions in large</p>	<p><b>Additional Testing and Pilot/Initial Deployment:</b> Demonstrate the ability to further process mail beyond intake, to include sorting accuracy, reporting functions, remittance identification and management, opening and extracting contents, <i>etc.</i> (Not to exceed \$150,000/180 days).</p>	<p><b>Deployment:</b> Demonstrate the ability to digitize and digitalize data extracted from the mailings, to include how data recording and downstream access will occur; remittance processing; ease of IRS access to extracted data; and the</p>

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	Phase 1	Phase 2	Phase 3
	quantities. (Not to exceed \$75,000/180 days).  Started: August 8, 2022. Ended: February 6, 2023.	Started: February 7, 2023. Ended: May 15, 2023.	ability to interface and be compliant with IRS systems, cybersecurity requirements, hardware, and software, <i>etc.</i> (Not to exceed \$7.275 million/4 years).  Phase III timeline is to be determined.
<b>Form Type Scanned</b>	Form 1040 Refer to Appendix II for a complete list of SPM Pilot Forms and Schedules.		
<b>Number of Vendors Under Contract</b>	Five	Four	Two  Two additional vendors will not scan the Form 1040 for Filing Season 2024; however, they will still be doing other services for the IRS.
<b>Current phase</b>	Modified, ongoing – Phase 3		

*Source: IRS Request for Proposal dated July 12, 2022, and Notice of Award on August 8, 2022.*

The contracts for the SPM and SCaaS pilots were awarded using the Pilot IRS Program. Started in Calendar Year 2019, the Pilot IRS Program was built on the idea that risk in innovation can be mitigated using iterative funding. The program enables the IRS to develop innovative technologies without a dedicated research and development team or non-traditional funding sources. Using multiple funding phases that focus on end results rather than upfront requirements, the program more closely aligns to commercial solutions while still adhering to Federal acquisition guidelines.

In addition, contractors and subcontractors participating in IRS scanning pilots are required to meet all established IRS site security and suitability requirements including background checks, security site assessments, and the protection/security of tax information. IRS documentation shows that each of the contractors participating in the scanning pilots completed a security site assessment and met the IRS's suitability requirements. In addition, each contractor undergoes an onboarding process, including IRS background checks, on employees who handle Federal tax returns and return information.

Management's Response to the Draft Report



COMMISSIONER  
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

December 4, 2023

MEMORANDUM FOR MATTHEW A. WEIR  
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kenneth C. Corbin   
Commissioner, Wage and Investment Division

Digitally signed by Kenneth C.  
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Date: 2023.12.04 08:58:40 -05'00'

SUBJECT: Draft Audit Report – Progress Update on Tax Return Scanning  
Initiatives (Audit # 202340829)

Thank you for the opportunity to review and provide comments on the subject draft report. In press conference remarks at the IRS's New Carrollton facility on September 15, 2022, the U.S. Secretary of the Treasury, after acknowledging pandemic-era achievements and the negative effects of previously stifled agency funding, expressed relief that the budget provided by the Inflation Reduction Act of 2022<sup>1</sup> would allow the Internal Revenue Service to focus more resources on modernization.

We are committed to developing and adopting of technology in a responsible and results-driven environment. We continue to develop several scanning initiatives for modernization of individual tax return processing and digitalization of document storage. The IRS has cautiously limited the scale of scanning and digitalization projects to ensure the best long-term outcomes for the agency and taxpayers.

Scanning-as-a-Service (SCaaS), started in August 2021, creates searchable electronic records from forms submitted on paper. As of October 21, 2023, the SCaaS project has completed the scanning and submission of 220,711 Forms 941, *Employer's Quarterly Federal Tax Return*, during the 2023 calendar year. The rate of successful transmission to the electronic filing system using SCaaS compared to the returns rejected at the point of electronic submission is 99.7 percent.

The Lockbox initiative, started in October 2022, leverages contract banks receiving payments to scan certain forms at their locations and converts them to electronic files for the IRS. As of October 21, 2023, the financial institutions participating in the Lockbox project submitted a total of 483,522 Forms 940, *Employer's Annual Federal*

<sup>1</sup> Pub. L. 117-169

## Progress Update on Tax Return Scanning Initiatives

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*Unemployment (FUTA) Tax Return* to the IRS by electronic filing; representing a 95.3 percent acceptance versus rejection rate. They also submitted 378,162 Forms 941, with a 99.9 percent successful transmission rate, and 1,912 Forms 1040, *U.S. Individual Income Tax Return*, with a 98.2 percent rate of transmission.

The Submission Processing Modernization (SPM) digitalization program, started in July 2022, converts forms submitted by taxpayers on paper to electronic data for processing like an electronically-filed tax return. The SPM pilot has successfully transmitted 93,685 Forms 1040, with additional schedules and forms attached, with a successful submission rate of 100 percent, as of October 21, 2023. We continue to approach modernization with care and we plan to expand existing programs and initiate new projects with the same commitment to taxpayer service.

Our responses to your specific recommendations are enclosed. If you have any questions, please contact me, or a member of your staff may contact Dietra D. Grant, Director, Customer Account Services, at 470-639-3504.

Attachment

Attachment

### **Recommendations**

The Chief Transformation and Strategy Officer should:

#### **RECOMMENDATION 1**

Evaluate the potential benefits, challenges, and cost of each of the processes the IRS piloted when deciding which digital processing solution to implement for the 2025 Filing Season and beyond. This detailed evaluation should be completed and documented regardless of whether the pilot is transitioned to Initiative 1.2 of the Inflation Reduction Act Strategic Operating Plan.

#### **CORRECTIVE ACTION**

Agreed. We will work with the Enterprise Digitalization office to gather information regarding costs, benefits, and known challenges for pilots addressing digital intake of Forms 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*; 941, *Employer's Quarterly Federal Tax Return*; and 1040, *U.S. Individual Income Tax Return*, to date. This information will be included as critical factors in drafting the Enterprise Scanning Strategy, in advance of the opening of the 2025 filing season.

#### **IMPLEMENTATION DATE**

December 15, 2024

#### **RESPONSIBLE OFFICIAL**

Chief, Transformation & Strategy Office

#### **CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control system.

#### **RECOMMENDATION 2**

Once a digital processing solution has been identified, develop a detailed plan with measurable milestones for implementing the solution before the start of the 2025 Filing Season. This plan should include ensuring that the solution is adequately tested and all identified issues are resolved before the IRS begins processing Tax Year 2024 tax returns.

### **CORRECTIVE ACTION**

Agreed. Included in the *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan*, four priority projects are included under Initiative 1.2 – Expand digital services and digitation – and are underway. Implementation is before the start of the 2025 Filing Season. The projects are designed to:

- Create Digital Forms
- Expand Historical Digitalization
- Expand Correspondence Digitalization
- Expand Tax Return Digitalization

Each project team is responsible for the digital processing solution, based on the types of submissions, and will track and deliver a detailed, comprehensive plan that includes the key activities and operational outcomes associated with successful solution implementation.

### **IMPLEMENTATION DATE**

December 15, 2024

### **RESPONSIBLE OFFICIAL**

Chief, Transformation & Strategy Office

### **CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control system.

Glossary of Terms

Term	Definition
Digitalization	Process of converting text, pictures, or sound into a digital form that can be processed by a computer, easily shared, and accessed.
Digitization	Process of converting analog information, <i>i.e.</i> , physical documentation that requires physical storage, into a digital format that can be stored digitally through traditional scanning processes, transcription, or other technology.
Filing Season	The period from January 1 through mid-April when most individual income tax returns are filed.
Modernized Electronic Filing System	A web-based platform for filing approximately 330 forms to the IRS. It serves to streamline filing processes and reduce the costs associated with a paper-based process.
Service Center Recognition Image Processing System	Performs data capture via reading the printed 2D Bar Code or character recognition of data printed on the form. Forms scanned using this system include Form 940, Form 941, and Schedule K-1, <i>Share of Income, Deductions, Credits, etc.</i>
Suitability requirement	Ensures that participants in the IRS E-File program maintain a high degree of integrity and adhere to the highest professional and ethical standards. Suitability checks may include a background check, IRS tax compliance check, credit history check, and prior history check.

**Abbreviations**

COVID-19	Coronavirus Disease 2019
ED&CMO	Enterprise Digitalization and Case Management Office
IRS	Internal Revenue Service
MeF	Modernized Electronic Filing
SCaaS	Scanning as a Service
SPM	Submission Processing Modernization



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contact our hotline on the web at [www.tigta.gov](http://www.tigta.gov) or via e-mail at  
[oi.govreports@tigta.treas.gov](mailto:oi.govreports@tigta.treas.gov).**

**To make suggestions to improve IRS policies, processes, or systems  
affecting taxpayers, contact us at [www.tigta.gov/form/suggestions](http://www.tigta.gov/form/suggestions).**

Information you provide is confidential, and you may remain anonymous.