

**Fundamental Changes to Return Filing and Processing Will Assist Taxpayers in Return Preparation and Decrease Improper Payments**

SECTION FIVE

## Fundamental Changes to Return Filing and Processing Will Assist Taxpayers in Return Preparation and Decrease Improper Payments<sup>1</sup>

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## EXECUTIVE SUMMARY

The National Taxpayer Advocate has repeatedly written about the need to develop an accelerated information reporting system to enable the IRS to match third-party reports to return data before issuing refunds. The proposed system would benefit tax administration by protecting revenue. The government would avoid issuing erroneous funds and then chasing down the dollars through future enforcement actions. Taxpayers would benefit by avoiding enforcement and collection actions months or even years after filing the returns. Both tax administration and taxpayers would further benefit if the IRS provides taxpayers and their representatives with electronic access to their third-party data before the return filing deadline to assist in tax preparation.

The IRS acknowledged the need to develop an accelerated information reporting system in 2011 through the creation of the IRS Real Time Tax System Initiative. As part of the initiative, the IRS held two public meetings and solicited comments from a variety of impacted stakeholders, all of whom indicated general support for the proposed system. Further, the IRS promised to include the Taxpayer Advocate Service in any further development of the initiative. However, the National Taxpayer Advocate has not seen any progress since.

In this study, we evaluate various options to achieve upfront matching and enable taxpayers to access and download their third-party information into commercial tax preparation software. The evaluations consider the benefits and risks of each option and try to strike a balance to benefit all impacted stakeholders: taxpayers, the IRS, preparers, third-party report issuers, and software companies.

Ultimately, we recognize that changes to return filing and processing of this magnitude require a great deal of forethought, analysis, and stakeholder engagement. To date, the IRS has not made meaningful progress, which only delays the significant benefits we outlined above and throughout this report. Thus, we reiterate our 2009 legislative recommendation that Congress require the IRS and the Department of Treasury to prepare a report, in consultation with the National Taxpayer Advocate, which provides a plan and timeline to achieve an accelerated third-party information reporting system. In furtherance of this issue, the National Taxpayer Advocate offers the following preliminary recommendations to develop an accelerated third-party reporting system:

**Recommendation 1.1:** Provide taxpayers with access to real-time transcripts of third-party data to aid in return preparation.

**Recommendation 1.2:** Provide a platform from which taxpayers and preparers could download third-party data directly into commercial tax return preparation software.

**Recommendation 2.1:** Develop and implement a one-year pilot to determine if the IRS can screen Form W-2 data as effectively as the Social Security Administration.

**Recommendation 2.2:** Eliminate the March 31 deadline for e-filed information reports. All information reports, whether e-filed or filed on paper, would be due at the end of February.

**Recommendation 2.3:** Minimize corrections by creating a \$50 *de minimis* threshold for corrections.

**Recommendation 2.4:** Further increase electronic filing by reducing the 250 report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.

**Recommendation 3.1:** Issue direct deposit and other electronic refunds by April 30 and paper checks by May 31.

## INTRODUCTION

In the 2009, 2011, and 2012 Annual Reports, the National Taxpayer Advocate wrote about the benefits of accelerated third-party information reporting to both tax administration and taxpayers.<sup>2</sup> The IRS also acknowledged the benefits of such a system through the development of the Real Time Tax System Initiative in 2011, which received widespread support in the associated public hearings.

In this report, we will first discuss the benefits of an accelerated information reporting system to both tax administration and taxpayers. A system that enables the IRS to perform upfront matching has the main benefit of protecting government revenue. Taxpayers also benefit through improved service, modernization, and reduced downstream consequences associated with inadvertent return errors.

As discussed later in this report, taxpayers will not realize the full benefits of this system unless the IRS provides taxpayers and their representatives with the ability to access and download their third-party data from an online account to assist in return preparation. This aspect of the proposal requires development of an online account system, of which the IRS is in the preliminary planning stages.<sup>3</sup>

The goal of this report is to provide a strategic framework and preliminary recommendations to develop an accelerated third-party reporting system. The National Taxpayer Advocate offers a proposal on how to better structure the filing season to reduce fraud and protect the interests of taxpayers and the government. The proposal is based on research conducted by the Taxpayer Advocate Service, including discussions with impacted stakeholder groups, and is meant to serve as the first step toward implementation. We have attempted to address all identified concerns and risks; however, we acknowledge that there will be unexpected challenges and risks before a proposal along these lines is implemented.

There are competing and mutually exclusive goals in tax administration of protecting revenue and delivering refunds. This report tries to balance the competing concerns by maximizing the benefits and minimizing the burdens imposed on impacted stakeholders, namely taxpayers, preparers, third parties, tax software companies, and tax administration. To achieve upfront matching, it is necessary to evaluate the feasibility of adjusting critical dates:

- The date the IRS receives the information reports,
- The dates of the filing season, and
- The date a refund is issued.

The adjustment of any of these dates impacts several stakeholders in varying ways. We attempt to identify how each stakeholder is affected and develop a system that strikes a balance.

Accordingly, we encourage stakeholders from wide-ranging backgrounds to read our analysis and preliminary recommendations and submit comments and suggestions to the Office of the Taxpayer Advocate. We look forward to further discussing the proposal and making any necessary adjustments to move this initiative to the next level — *i.e.*, planning and implementation.

<sup>2</sup> National Taxpayer Advocate 2009 Annual Report to Congress 338-345; National Taxpayer Advocate 2011 Annual Report to Congress 284-295; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

<sup>3</sup> It is our understanding that the IRS Office of Online Services is in the preliminary stages of developing a draft roadmap to develop such an online account. IRS Online Services, *Get Transcript and Account Update: W&I Executive Briefing 12-17* (Nov. 13, 2013).

### *Upfront Matching Benefits Tax Administration by Protecting Revenue*

Third-party information reporting is a crucial element in maximizing tax compliance. Tax gap data show the importance of information reporting compliance, and how third-party reporting is essential to encourage voluntary compliance. Specifically, the data show that when taxpayers have a choice about reporting their income, tax compliance rates are remarkably low. For example, workers who are classified as employees have little opportunity to underreport their earned income because it is subject to both information reporting on Forms W-2 and tax withholding. In fact, IRS data show that taxpayers report about 99 percent of their wages and salaries.<sup>4</sup>

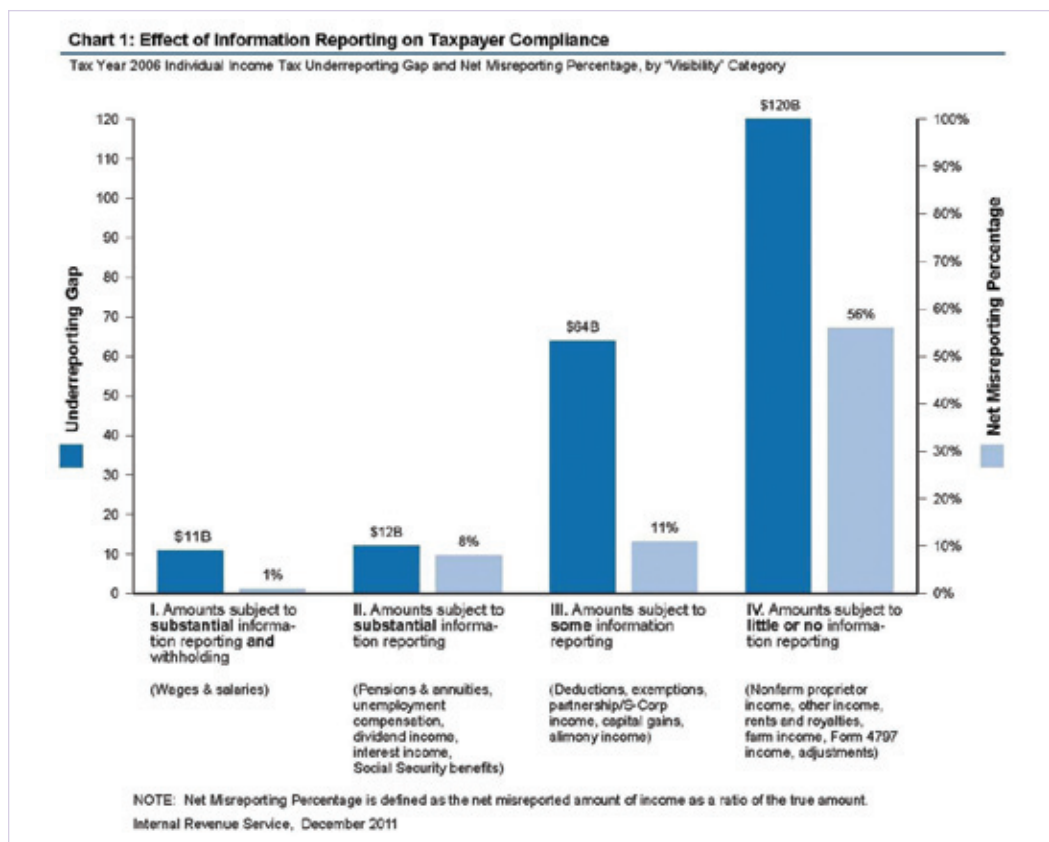
Among workers whose income is not subject to both information reporting and tax withholding, compliance rates plummet. For income subject to substantial information reporting but no tax withholding (such as pensions, annuities, unemployment compensation, dividends, interest and Social Security benefits), taxpayers reported about 92 percent of their income. In contrast, for income subject to little or no information reporting (such as nonfarm proprietor income, rents, royalties, and farm income), taxpayers reported only about 44 percent of their income.<sup>5</sup> Below is the infographic developed by the IRS to illustrate the impact of information reporting and withholding on tax compliance rates.<sup>6</sup>

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<sup>4</sup> IRS, Tax Gap for Tax Year 2006 Overview, Chart 1 (Jan. 6, 2012).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*



The government benefits from the revenue protection aspect of upfront matching. As noted below, the IRS does not match third-party data with items reported on taxpayers' returns until long after the filing season. Accelerated third-party reporting would enable the IRS to protect revenue by identifying and resolving inaccurate income reporting at the time of return filing and preventing the release of erroneous refunds.<sup>7</sup> This system would deter tax fraud, identity theft, and inadvertent errors by stopping the refund associated with a mismatch. In particular, enabling the IRS to receive and process Forms W-2, *Wage and Tax Statement*, before releasing refunds would be an important step toward these goals.<sup>8</sup> Further, the IRS would devote fewer resources to compliance and collection activities on basic omission and understatement cases, and could use the savings to resolve more complex issues.<sup>9</sup>

<sup>7</sup> IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting 2* (Dec. 8, 2011), available at [http://www.irs.gov/pub/irs-utl/rtrts\\_deck.pdf](http://www.irs.gov/pub/irs-utl/rtrts_deck.pdf).

<sup>8</sup> Recently, the Treasury Inspector General for Tax Administration found in an analysis of tax year (TY) 2010 returns that almost 1.5 million returns claiming in excess of \$5.2 billion in refunds were not detected by the IRS as potentially fraudulent. The common characteristic of these tax returns was that the income and withholding they reported were false. Generally, the perpetrators reported fabricated income to maximize credits and increase the amount of the fraudulent tax refunds. TIGTA, Ref. No. 2013-40-083, *Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds 4* (Aug. 7, 2013).

<sup>9</sup> IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting 1* (Dec. 8, 2011), available at [http://www.irs.gov/file\\_source/pub/irs-utl/rtrts\\_deck.pdf](http://www.irs.gov/file_source/pub/irs-utl/rtrts_deck.pdf). When the Automated Underreporter system identifies a mismatch between items reported on the taxpayer's return and information reports, it generates a CP 2000 notice to be mailed to the taxpayer. In TY 2010, the IRS mailed 3,823,766 of these notices with an estimated 45 percent response rate. These numbers have declined from 4,546,817 notices in TY 2009 (with an estimated response rate of 60 percent) and 4,788,360 notices in TY 2008 (with an estimated response rate of 57 percent). IRS response to TAS information request (Oct. 17, 2012) (data through Oct. 16, 2012).

Approximately 97 percent of taxpayers receive at least one information return.<sup>10</sup> In 2010, the IRS closed 4.3 million cases in which it identified a discrepancy between the taxpayer's return and third-party information, leading to \$7.2 billion in additional assessments.<sup>11</sup> The real volume of mismatches is significantly larger, because this data only reflects mismatches large enough for the IRS to actually work and does not include others that did not reach the threshold. For example, the IRS identified almost 23.8 million mismatches on TY 2010 returns, but only worked about 5.3 million cases (22 percent).<sup>12</sup> If the IRS identified mismatches before releasing the refunds claimed on returns, taxpayers would avoid the consequences of paying back refunds months or years after they receive them from the IRS.

### *Upfront Matching Reduces Taxpayer Burden*

Accelerated information reporting would substantially reduce taxpayer burden in several ways:

- First, taxpayers can better answer questions about an underlying economic transaction if the IRS identifies the mismatch within months rather than a year or more after the fact.
- Second, matching data before the IRS releases refunds will prevent taxpayers from facing IRS collection actions long after they have spent the refunds.<sup>13</sup>
- Third, taxpayers will save money by avoiding the long-term accrual of penalties and interest on unintentionally omitted or under-reported items.
- Fourth, upfront matching can potentially reduce taxpayers' vulnerability to identity-theft related refund fraud.<sup>14</sup>
- Fifth, as discussed below, providing taxpayers and their representatives with direct electronic access to third-party data before the filing deadline will help them prepare returns and avoid inadvertent omissions and understatements. The government benefits from the increased compliance and reduced enforcement actions.

### *The Anticipated Benefits Come with Challenges*

As discussed, there are real benefits to the development of an accelerated third-party reporting system. However, each component of the proposed system presents challenges to its development. For example, any changes in filing deadlines or return processing procedures would require IRS computer system updates. The IRS would likely need to reprogram existing systems and install new ones. We assume the IRS could reprogram its systems to change filing deadlines, due to its history of delaying the filing experience. However, any changes to the order of the processing pipeline, such as moving the matching procedures up before refund release, will require extensive system alterations. Finally, e-authentication is also a major

<sup>10</sup> IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting 2* (Dec. 8, 2011), available at [http://www.irs.gov/pub/irs-utl/rtrts\\_deck.pdf](http://www.irs.gov/pub/irs-utl/rtrts_deck.pdf).

<sup>11</sup> *Id.*

<sup>12</sup> IRS response to TAS information request (Oct. 17, 2012).

<sup>13</sup> The Organisation for Economic Co-Operation and Development (OECD) has found that post-assessment matching of third-party information to tax return data results in administrative costs for the revenue body and further administrative burden on taxpayers and/or their representatives. In addition, the OECD has stated that post-assessment matching creates resentment by taxpayers who were under the impression that their tax obligations had already been finalized and believe that they should have been advised of the unreported income when the return was initially filed. Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 6 (Jan. 22, 2008).

<sup>14</sup> William Hoffman, *IRS Oversight Board Brainstorms Real-Time Tax System, ID Theft Initiatives*, Tax Notes Today (May 2, 2013); IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting 1* (Dec. 8, 2011), available at [http://www.irs.gov/file\\_source/pub/irs-utl/rtrts\\_deck.pdf](http://www.irs.gov/file_source/pub/irs-utl/rtrts_deck.pdf). For more information on identity-theft refund fraud, see National Taxpayer Advocate 2013 Annual Report to Congress, *Most Serious Problem: The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden to Such Taxpayers*, *supra*; National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (*Most Serious Problem: The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*).



concern if the IRS provides taxpayers or their representatives access to the third-party data, as discussed in detail below.

It is the goal of this report to acknowledge the burdens imposed on the IRS and other stakeholders and attempt to achieve an acceptable balance between the benefits and burdens.

### **IRS Has Acknowledged the Benefits of Upfront Matching**

During 2011, the IRS launched the “Real Time Tax System Initiative” which acknowledged the benefits of matching information reports before issuing tax refunds. As part of the initiative, the IRS solicited suggestions and concerns from a variety of stakeholders at two public meetings regarding a potential “real-time” tax system (RTTS).<sup>15</sup> During the meeting held on December 8, 2011, the IRS heard statements from the members of three panels: (1) tax practitioners, (2) federal and state government representatives, and (3) taxpayer and consumer advocates. The second meeting held on January 25, 2012 solicited comments from four panels comprised of (1) payroll/W-2 filers, (2) Form 1099 issuers, (3) software providers, and (4) state revenue agencies.<sup>16</sup> While the participants expressed concerns about how the IRS would achieve a real-time tax system, there was consensus that the goal of the initiative would serve both taxpayers and tax administration.<sup>17</sup>

In its response to the National Taxpayer Advocate’s 2012 Most Serious Problem, the IRS acknowledged that it had taken early steps toward development of a real-time tax system with the ultimate goal of reducing taxpayer burden and increasing compliance upfront.<sup>18</sup> The IRS had also committed to include the Taxpayer Advocate Service in further developing the initiative or planning any new initiatives. However, the National Taxpayer Advocate has not seen any real progress on this issue.<sup>19</sup>

## **TAXPAYER ACCESS AND ABILITY TO DOWNLOAD THIRD-PARTY DATA**

### **Proposal to Provide Taxpayers Electronic Access to Third-Party Data**

The National Taxpayer Advocate has proposed several times that the IRS provide taxpayers with the ability to access third-party data electronically.<sup>20</sup> Providing taxpayers and their representatives with direct electronic access to this data would prevent many mismatches from occurring in the first place. Consider taxpayers who have worked several different jobs during the tax year and moved after completing one job early in the year. If the Form W-2 or 1099 associated with the first job is not properly forwarded to the taxpayer’s current address, he or she could inadvertently omit the item from the return and not realize it until the IRS sends a (CP 2000) notice.

15 IRS, IR-2011-114, *IRS to Host Public Meeting Dec. 8 on Real-Time Tax System* (Nov. 30, 2012), available at <http://www.irs.gov/uac/IRS-to-Host-Public-Meeting-Dec.-8-on-Real-Time-Tax-System>.

16 For written and oral statements of panelists at the two RTTS public meetings, see <http://www.irs.gov/Tax-Professionals/Real-Time-Tax-Initiative> (last visited Dec. 17, 2013).

17 *Id.*

18 National Taxpayer Advocate 2012 Annual Report to Congress 190.

19 *Id.* at 180-191.

20 National Taxpayer Advocate 2009 Annual Report to Congress 338-345; National Taxpayer Advocate 2011 Annual Report to Congress 284-295; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

To address inadvertent omissions, the IRS should provide access to real-time transcripts of third-party data to aid in return preparation.<sup>21</sup> Taxpayers and preparers could refer to the transcript to make sure they do not accidentally leave out income. In fact, this issue was raised on the practitioner panel during the December 8, 2011, public meeting.<sup>22</sup> Ideally, taxpayers could access their data through an online account. Recent IRS research has provided a strong rationale for developing an online account product. IRS research found a significant number of taxpayers contact the IRS with account-related issues but indicated low satisfaction for how the IRS met their needs through the phones and the web. Accordingly, the IRS Office of Online Services has taken initial steps to develop a draft roadmap for an online account program.<sup>23</sup>

One step above the transcript would be to provide a platform from which taxpayers and preparers could download third-party data submitted to the IRS or the Social Security Administration directly into tax preparation software. This second option would eliminate transcription errors and provide a one-stop-service to taxpayers who would not need to download the data separately from each third party. The taxpayers (or preparers with permission) could download the data directly into a commercial tax software package or even an improved version of the IRS's Free File Fillable Forms (FFFF).<sup>24</sup> Providing the ability to download into software, including FFFF, would allow both taxpayers and the government to enjoy the benefits experienced by other tax administrations through pre-filled returns, but would still encourage competition in the tax software industry.<sup>25</sup>

IRS data show that less than 20 million “plain vanilla” individual income tax returns were filed in TY 2011. “Plain vanilla” returns are filed by individual taxpayers who report only Form W-2 income, take the standard deduction, use the single filing status, and list no dependents.<sup>26</sup> This amounts to about 13.5 percent of individual returns filed for TY 2011.<sup>27</sup> Because the U.S. tax laws recognize family composition in the calculation of tax liability, because there is no reliable way for the IRS to project the family status of taxpayers prior to filing, and because many taxpayers claim the benefits of tax provisions that have specific eligibility criteria, few taxpayers would be able to rely on third-party data alone to prepare their returns. Nevertheless, all taxpayers would benefit from downloading their data into FFFF or commercial software. The download feature could prevent taxpayers from being victimized by preparer fraud.

### OECD Studies on Benefits and Challenges of Pre-Filled Returns

Many international tax administrations provide taxpayers with pre-filled or pre-populated returns, which are tax returns on which the revenue body populates the fields of the taxpayer's return with information included on third-party information reports. The National Taxpayer Advocate is not recommending that

21 See National Taxpayer Advocate 2012 Annual Report to Congress 189.

22 IRS, *Transcript of the Public Meeting on Real Time Tax System Initiative 42* (Dec. 8, 2011), available at <http://www.irs.gov/Tax-Professionals/December-8,-2011-Meeting>.

23 IRS Online Services, *Get Transcript and Account Update: W&I Executive Briefing 12-17* (Nov. 13, 2013).

24 The IRS provides Free File Fillable Forms (FFFF) through its public partnership with the Free File Alliance. FFFF is an online version of IRS paper tax forms designed for people comfortable preparing their own tax returns. The program does not offer state tax returns and performs only basic calculations.

25 For a detailed discussion of the pre-filled return options available in other countries in 2009 and expected in 2012, see Organisation for Economic Co-Operation and Development, Centre for Tax Policy and Administration, Forum on Tax Administration: Taxpayer Services Sub-Group, *Survey of Trends and Developments in the Use of Electronic Services for Taxpayer Service Delivery 34-38* (Mar. 2010).

26 Individual Master File, Tax Year 2011.

27 IRS, Statistics of Income, Table 1. Individual Income Tax Returns, Tax Year 2011 Preliminary Data: Selected Income and Tax Items, by Size of Adjusted Gross Income (Showing 145,579,530 individual income tax returns filed in TY 2011 based on preliminary data).

the IRS develop pre-filled or pre-populated returns. Rather, her proposal maintains market competition by downloading the third-party data into commercial software as well as an enhanced version of the existing FFFF product. However, to evaluate the benefits and challenges of such a system, it is useful to review the experience of other countries in administering pre-filled returns.

The OECD found in a recent study that revenue bodies have realized significant benefits associated with the provision of pre-filled returns for personal income taxes. These benefits include:

- Substantially reduced compliance burden for taxpayers;
- Greater certainty for taxpayers that they have fully and properly reported their income and deduction entitlements;
- An improved image of the revenue body, resulting from the personalized service and decreased burden imposed on taxpayers;
- Faster processing of tax return information;
- Faster refund payouts; and
- Elimination of much of the work associated with amended assessments that result from unintended taxpayer errors and traditional post-assessment verification programs.<sup>28</sup>

At the same time, the provision of pre-filled returns raises the following concerns:<sup>29</sup>

- The development of pre-filled returns by the tax administrator could be seen as the government competing with private industry.<sup>30</sup>
- Taxpayers, particularly those who have low incomes or speak English as a second language, may feel apprehensive about challenging an error or making an adjustment.
- Maintaining taxpayer privacy is a paramount concern as the tax administrator issues or distributes the returns.<sup>31</sup>

Almost half of the revenue bodies surveyed for a 2013 OECD study reported some use of pre-filing in 2011. Seven countries (Chile, Denmark, Finland, Malta, New Zealand, Norway, and Sweden) provide a service that at year-end can generate a complete electronic or paper personal income tax return (or its equivalent) for most taxpayers who need to file. In addition, four revenue bodies (Singapore, South Africa, Spain, and Turkey) report they offer such services to 30 to 50 percent of their individual taxpayers.

28 OECD, *Information Note: Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations — Country Experiences With the Use of Pre-Populated Personal Tax Returns* 13-14 (Mar. 2006). While there is always the risk that a pre-filled return could encourage taxpayers to not disclose additional income not included on the return generated by the revenue body. However, none of the countries surveyed reported this as a significant issue; See also Thomas Dohrmann and Gary Pinshaw, McKinsey & Company, *The Road to Improved Compliance: A McKinsey Benchmarking Study of Tax Administrations – 2008–2009*, 19, 30 (Sept. 2009) (Identifying pre-population as a best practice after evaluating the tax administrations of the following 13 countries: Australia, Belgium, Brazil, Canada, Chile, Denmark, France, Ireland, Norway, South Africa, Spain, Sweden, and the United States); OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies* 241 (2013).

29 Joseph Cordes and Arlene Holen, *Should the Government Prepare Individual Income Tax Returns?*, Technology Policy Institute (Sept. 2010).

30 The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206 title II, § 2004, 112 Stat. 726 (July 22, 1998), conference report states that the conferees want the IRS and Treasury “to press for robust private sector competition.” H.R. Conf. Rep. No. 105-599, at 235 (1998).

31 Joseph Cordes and Arlene Holen, *Should the Government Preparer Individual Income Tax Returns?*, Technology Policy Institute (Sept. 2010).

Finally, eight additional revenue bodies (Australia, Estonia, France, Hong Kong, Iceland, Italy, Lithuania, and Portugal) report providing at least partially completed pre-filled returns to individual taxpayers.<sup>32</sup>

In general, revenue bodies that offer pre-filled returns have comprehensive systems requiring third parties to report information related to income, assets, and deductions.

- *Income information* generally includes wages, bonuses, severance payments, employee fringe benefits, interest, dividends, pensions, and insurance payments.
- *Asset-related information* includes the sales and purchases of capital assets.
- *Deduction-related information* includes gifts, union fees, home mortgage interest, contributions to unemployment insurance and retirement plans, and child care expenses.

Typically, the third parties face strict and timely end-of-year reporting obligations, with final information reports typically required within three to four weeks after the end of the relevant fiscal year.<sup>33</sup>

Most countries started offering pre-filled returns by requiring taxpayers to respond, either by confirming that the return gave a complete and accurate picture of tax affairs during the tax period, or by advising the revenue body of additional information to adjust the form. A number of countries moved to systems of “deemed acceptance” where no response is required and the return is deemed accepted and complete after a prescribed period. Taxpayers were generally given short response times — between two and six weeks.<sup>34</sup>

The rate of adjustment by taxpayers varies by country. The Nordic countries experienced a 50 to 75 percent rate of returns not requiring adjustment by taxpayers. Iceland had an abnormally high rate of adjustment due to an inability to receive interest income third-party information reports. Denmark was the originator of the pre-filled return concept and has reported a 78 percent rate of non-adjustment.<sup>35</sup>

Based on information received by surveyed revenue bodies, the OECD offered the following list of critical success factors for an effective pre-filled return programs:<sup>36</sup>

- *Accurate Withholding at the Source.* Accurate withholding at the source is necessary to avoid large refunds and the resulting desire by taxpayers to file returns shortly at the end of the fiscal year. To achieve this goal, most revenue bodies surveyed issued a tax card or notification of rate to be applied to taxpayers and their employers just before the new fiscal year. The card or notification provides personal information that can be used to establish individual amounts of withholdings, based on historical tax assessment data. If the IRS were to pursue such an avenue, it would require a major restructuring of our withholding system.<sup>37</sup>

32 OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies* 241 (2013). For other types of taxes, pre-filing was very limited and generally confined to taxpayer identification and demographic information. In addition, Belgium and the Netherlands have developed limited pre-filled return systems. Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 24 (Jan. 22, 2008).

33 OECD, *Information Note: Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations — Country Experiences With the Use of Pre-Populated Personal Tax Returns* 10 (Mar. 2006).

34 *Id.* at 11.

35 OECD, *Information Note: Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations — Country Experiences With the Use of Pre-Populated Personal Tax Returns* 12 (Mar. 2006).

36 *Id.* at 15; Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 4 (Jan. 22, 2008).

37 National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 145-150 (Study: *Analyzing Pay-As-You-Earn Systems as a Path for Simplification of the U.S. Tax System*).

- *High Integrity Taxpayer Identification.* To match large numbers of third-party information reports with tax records, all reports received must have a high-integrity taxpayer identifier, such as the Social Security number used in the United States.
- *Invest Adequate Resources in Supporting Third-Party Reporting Bodies.* The revenue body must allocate adequate resources to educate and support third-party reporting bodies, software developers, and other stakeholders in all aspects of the reporting system's requirements.
- *Comprehensive Third-Party Reporting Systems.* All of the countries surveyed have substantial systems of third-party reporting covering major types of income, important deduction items, capital asset transactions, and other information relevant to determining tax liabilities.
- *Compatible Legislative Framework.* The tax laws must provide a limited scope for tax deductions, rebates, credits, and discretions that cannot be predicted by the revenue body using third-party reports or some other approach. Thus, deductions, tax credits, other items of income must be verifiable by the revenue body for an effective pre-filled return system.<sup>38</sup>
- *High Degree of Automation Among Information Suppliers.* Processing the third-party reports by the revenue body is greatly facilitated if reporting bodies can transmit reports electronically.
- *Large-Scale Information Processing.* Revenue bodies typically have six to ten weeks to process the third-party reports that generate the pre-filled returns. To meet these deadlines, substantial information processing systems are required to capture, validate, and prepare relevant data.
- *Automated and Minimal Interaction with Taxpayers.* To reduce resources associated with processing the pre-filled returns, the surveyed revenue bodies have devised the following mechanisms to ascertain acceptance or adjustment by taxpayers: (1) deemed acceptance if no response is received within a given time, (2) automated acceptance using SMS, phone, or Internet communications, and (3) communication of adjustments through the Internet.

The National Taxpayer Advocate believes a fully populated return for most taxpayers is not possible in the United States given the current state of the Internal Revenue Code. There are too many unverifiable provisions in the Code that have eligibility requirements outside the scope of information reporting documents received by the IRS. For example, approximately 28.3 million taxpayers received the EITC in TY 2011<sup>39</sup> while approximately 51.5 million returns claimed at least one dependent.<sup>40</sup> As noted earlier, the IRS cannot pre-populate the return with family structure because it varies from year to year. However, to reduce the compliance burden on taxpayers, the IRS can make the data available in a way that provides them with a choice of filing method and minimizes inadvertent errors.

**Recommendation 1.1:** Provide taxpayers with access to real-time transcripts of third-party data to aid in return preparation.

38 Verifiable information from third-party information reports is particularly important for the administration of refundable credits. See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 75-104 (Research and Related Studies: *Running Social Programs Through the Tax System*).

39 Statistics of Income, Table 1. Individual Income Tax Returns, Tax Year 2011 Preliminary Data: Selected Income and Tax Items, by Size of Adjusted Gross Income

40 Individual Master File, Tax Year 2011 (51,519,527 returns claimed at least one exemption excluding primary taxpayer and spouse, if relevant).

**Recommendation 1.2:** Provide a platform from which taxpayers and preparers could download third-party data directly into an enhanced Free Fillable Forms product and commercial tax return preparation software.

## BACKGROUND ON RETURN FILING AND PROCESSING

### The Current State of the Filing Season From the Individual Taxpayer's Perspective

The filing season typically begins for taxpayers with the receipt of their information reporting documents from their employers, financial institutions, local governments, and other payors of income. These information reporting documents include, but are not limited to the documents in the following table.

**FIGURE 1, Information Reporting Documents**

Number	Title
Form W-2	Wage and Tax Statement
Form W-2G	Certain Gambling Winnings
Schedule K1- Form 1041	Beneficiary's Share of Income, Credits, Deductions, etc.
Schedule K1- Form 1065	Partner's Share of Income, Credits, Deductions, etc.
Schedule K1- Form 1120-S	Shareholder's Share of Income, Deductions, Credits, etc.
<b>Foreign Information Returns filed by foreign corporations that pay interest or dividend income to U.S. citizens (no standard form)</b>	
Form SSA-1099	Social Security Benefit Statement, and Form RRB-1099, Payments by the Railroad Retirement Board
Form 1042-S	Foreign Person's U.S. Source Income Subject to Withholding
Form 1098	Mortgage Interest Statement
Form 1098-C	Contributions of Motor Vehicles, Boats and Airplanes
Form 1098-E	Student Loan Interest Statement
Form 1098-T	Tuition Statement
Form 1099-A	Acquisition or Abandonment of Secured Property
Form 1099-B	Proceeds from Broker and Barter Exchange Transactions
Form 1099-C	Cancellation of Debt
Form 1099-DIV	Dividends and Distributions
Form 1099-G	Certain Government Payments
Form 1099-H	Health Coverage Tax Credit (HCTC) Advance Payments
Form 1099-INT	Interest Income
Form 1099-K	Merchant Card and Third Party Payments
Form 1099-LTC	Long-Term Care and Accelerated Death Benefits
Form 1099-MISC	Miscellaneous Income
Form 1099-OID	Original Issue Discount
Form 1099-PATR	Taxable Distributions Received from Cooperatives
Form 1099-Q	Payments from Qualified Education Programs (Under Sections 529 and 530)
Form 1099-R	Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
Form 1099-S	Proceeds from Real Estate Transactions
Form 1099-SA	Distributions from an HSA, Archer MSA or Medicare Advantage MSA

Number	Title
Form 3921	<i>Exercise of an Incentive Stock Option Under Section 422(b)</i>
Form 3922	<i>Transfer of Stock Acquired through an Employee Stock Purchase Plan</i>
Form 5498	Form 5498
Form 5498-ESA	<i>Coverdell ESA Contribution Information Form 5498-ESA</i>
Form 5498-SA	<i>HSA, Archer MSA or Medicare Advantage MSA Information</i>
FinCEN 103	<i>Currency Transaction Report by Casinos</i>
FinCEN 104	<i>Currency Transaction Report (CTR) (formerly Form 4789)</i>
Form 8300	<i>Report of Cash Payments Over \$10,000 Received in a Trade or Business</i>

Taxpayers generally receive their information reports in January or early February.<sup>41</sup> However, taxpayers may receive amended or corrected information reports from the payors later on. Once a taxpayer is confident that he or she has all information reports, the taxpayer files a federal income tax return by April 15 or requests an extension until October 15. If the return claims a refund, the government will typically issue it within three weeks.<sup>42</sup> Once the IRS issues the refund, the remaining time depends on the method of refund requested — electronic or paper. As discussed below, if the taxpayer’s return requires further review, the refund turnaround time can take longer.

### IRS Information Report Processing

#### *The IRS Receives Form W-2 Data From the SSA*

Forms W-2 require several more initial processing steps than other information reports. The SSA receives all Forms W-2 before the IRS and compares the name and Social Security number (SSN) combinations against its SSN database to determine whether the names and numbers match. Name/SSN mismatches may arise for a variety of reasons. In some cases, the earnings should be attributed to the worker listed on Form W-2 (*e.g.*, when “Robert Jones” uses “Bob Jones” on his employment paperwork or when a woman marries and takes her husband’s surname but fails to inform SSA). In other cases, the earnings should not be attributed to the worker listed on Form W-2 (*e.g.*, when an undocumented worker uses another person’s SSN to obtain employment).

When the SSA receives Forms W-2 with names and SSNs that do not match, it uses a variety of automated processes in an attempt to correct mismatches that likely are inadvertent. The SSA sends relevant information extracted from Forms W-2 to the IRS in electronic form in mid-March, and it is available for document matching by late March.<sup>43</sup>

41 IRS, *General Instructions for Certain Information Returns — Main Contents*, available at <http://www.irs.gov/instructions/i1099gi/ar02.html#d0e400> (last visited Dec. 17, 2013).

42 See IRS, *What to Expect for Refunds in 2013*, available at <http://www.irs.gov/Refunds/What-to-Expect-for-Refunds-in-2013> (last visited Dec. 17, 2013).

43 TAS, *ARAP Briefing Paper, Information Returns Acceleration Sub-Team* (Oct. 31, 2011). For a detailed discussion of the SSA’s processes, see Government Accountability Office, GAO-06-458T, *Social Security Numbers: Coordinated Approach to SSN Data Could Help Reduce Unauthorized Work* (Feb. 16, 2006) (testimony before the House Ways and Means Subcommittees on Social Security and on Oversight).

### *IRS Receipt and Processing of Information Reports*

The IRS receives approximately 2.29 billion information reports each calendar year, covering a wide array of taxpayer incomes.<sup>44</sup> IRS projections show the number of information reports steadily increasing through 2021.<sup>45</sup> In addition, the IRS will increase the volume of third-party data it receives under new initiatives, including several new third-party information reporting requirements. Most notably, merchant card issuers generally must report the aggregate amount of reportable payments they process for businesses,<sup>46</sup> and brokerage firms generally must report the cost bases (as well as gross proceeds) of stock, bond, and mutual fund sales.<sup>47</sup> The new information reporting requirements of the Affordable Care Act for insurers and employers will further increase the volume and complexity of information reports transmitted to the IRS.<sup>48</sup>

Once the IRS receives the information reports from the payors, or the Social Security Administration (SSA) in the case of Forms W-2, it loads the information onto its Information Returns Master File (IRMF) database. The IRS builds the IRMF database in February for the preceding year and the database is ready to match information reporting documents in mid-March.<sup>49</sup> The IRS runs the tax return through its Automated Underreporter (AUR) system, which compares amounts reported on the return with amounts on third-party information reports, such as the W-2, 1099, 1098, K-1, and 5498 series.<sup>50</sup> AUR case inventory includes payee mismatches over a certain threshold. AUR reviewers manually screen cases to determine if the IRS can resolve the discrepancy without contacting the taxpayer. In the remaining cases, the IRS will typically send a notice, known as the CP 2000, to the payee (taxpayer) to request an explanation of the discrepancies or payment of additional taxes.<sup>51</sup>

44 IRS Publication 6961, *2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses*, Table 2; GAO, GAO-09-238, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* (Jan. 2009).

45 IRS Publication 6961, *2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses*, Tables 2, 3, 4.

46 IRC § 6050W. The projected filings of Form 1099-K, Merchant Card and Third Party Payments, will increase from approximately nine million projected filings in calendar year 2012 to almost 22 million projected filings in CY 2020. IRS Publication 6961, *2012 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses*, 2012-2020, Table 2.

47 IRC § 6045(g).

48 Sections 6055 and 6056 were added to the Code by §§ 1502 and 1514, respectively, of the Patient Protection and Affordable Care Act (ACA), enacted March 23, 2010, Pub. L. No. 111-148. Section 6055 requires annual information reporting by health insurance issuers, self-insuring employers, government agencies, and other providers of health coverage. Section 6056 requires annual information reporting by applicable large employers relating to the health insurance that the employer offers (or does not offer) to its full-time employees. Both are optional in 2014, but will fully apply in 2015. Employers will need to report the cost of coverage under an employer-sponsored group health plan on an employee's Form W-2, *Wage and Tax Statement*, in Box 12, using Code DD. The amount reported does not affect tax liability, as the value of the employer excludible contribution to health coverage continues to be excludible from an employee's income, and it is not taxable. This reporting is for informational purposes only, to show employees the value of their health care benefits. See Notice 2013-45; REG-136630-12, 78 Fed. Reg. 54996 (Sept. 9, 2013).

49 IRS, Overview of the Accelerated Refund Assurance Program, Slide 11 (Oct. 6, 2011); National Taxpayer Advocate 2009 Annual Report to Congress 338-345 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*).

50 IRM 4.19.3.1. The IRS nonfiler program handles cases where no income tax return was filed by a payee. The Automated Substitute for Return (ASFR) program is the key program for enforcing filing compliance by taxpayers who have not filed individual tax returns, but have incurred a "significant" tax liability. IRM 5.18.1.2; IRC § 6020(b).

51 IRM 1.4.19.1; IRM 4.19.3.1; Government Accountability Office (GAO), GAO-09-238, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* 14 (Jan. 2009).



The IRS business operating divisions pursue entities that are required to file information documents and fail to do so by conducting examinations. Once it finds noncompliance, the IRS has the authority to penalize payors for failing to submit or submitting inaccurate information reports.<sup>52</sup>

## DEVELOPMENT OF AN ACCELERATED THIRD-PARTY REPORTING SYSTEM

### What is Necessary to Accomplish a Real Time Tax System?

To develop an effective modern tax system, the IRS needs to achieve the following milestones:

- Improve the accuracy of third-party information reports from payees and the SSA;
- Receive information reports early enough to perform matching before releasing refunds;
- Evaluate the benefits and burdens of delaying the filing season to accommodate document matching; and
- Evaluate the benefits and burdens of delaying refunds to accommodate document matching.

Each of these steps presents challenges to the various stakeholders in the tax preparation and filing process. None of the challenges are insurmountable, but they require careful planning, implementation, and evaluation.

### Improve the Accuracy of Third-Party Information Reporting Data

For any future initiative to benefit both taxpayers and the IRS, the third-party data used to match to the taxpayers' returns must have a high degree of accuracy. In reality, data on information returns is not perfect. Although the IRS does not track corrected information documents, it estimates that less than one percent of information reports are subject to subsequent amendments or corrections.<sup>53</sup> Even if we accept the IRS's estimate, the number is still significant considering that the IRS takes in approximately 2.29 billion information reports per year, with only about 48 million (2.1 percent) received on paper.<sup>54</sup> Further, IRS projections show the number of information reports steadily increasing through 2021.<sup>55</sup>

Taxpayers who already filed their returns before receiving the corrected report might find themselves entangled in the IRS enforcement procedures triggered by a real-time identification of a mismatch during the filing season through no fault of their own. In addition, approximately 4.3 percent of AUR assessments, involving 139,652 taxpayers, were abated in FY 2010.<sup>56</sup> Therefore, the IRS already pulls

52 IRC §§ 6721, 6722. The penalty is generally \$100 per information return with a maximum aggregate penalty of \$1.5 million per calendar year. However, the penalty and maximum penalty are reduced to \$30 per report and \$250,000 per year if the noncompliance is corrected within 30 days of the due date for filing. The rate is slightly higher at \$60 per return with a \$500,000 maximum penalty if the correction is made before August 1. The maximum penalty amounts are lower for small businesses with average annual gross receipts of \$5 million or less for the three most recent tax years.

53 IRS, *PowerPoint, Real Time Tax System Initiative 2*, Public Meeting (Dec. 8, 2011), available at [http://www.irs.gov/pub/irs-utl/rttps\\_deck.pdf](http://www.irs.gov/pub/irs-utl/rttps_deck.pdf).

54 IRS Publication 6961, 2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses, Tables 2, 3; IRS, *PowerPoint, Real Time Tax System Initiative, Public Meeting 2* (Dec. 8, 2011), available at [http://www.irs.gov/pub/irs-utl/rttps\\_deck.pdf](http://www.irs.gov/pub/irs-utl/rttps_deck.pdf).

55 IRS Publication 6961, 2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses, Table 2.

56 In FY 2010, approximately \$1.05 billion of the approximately \$6.9 billion tax assessed through AUR was abated (15.2 percent). In FY 2011, 68,984 taxpayers (or 2.1 percent) received approximately \$307 million in abatements (5.2 percent of the tax assessed through AUR was abated). IRS Enforcement Revenue Information System's FY 2011 database.

compliant taxpayers into enforcement initiatives based on third-party data. This unnecessary burden is imposed in the following situations:

1. The third-party data is inaccurate;
2. The taxpayer reported the income elsewhere on the return but the IRS did not review it closely enough; or
3. The IRS did not use its own internal information to verify the information on the return.

Further, in cases before the Tax Court, the burden of proof for a deficiency of tax shifts to the IRS if the deficiency is based solely on information included on a third-party information report.<sup>57</sup> Therefore, the IRS has an additional incentive to adopt procedures to attempt to verify third-party data through other means, especially through information available internally, to screen out false positives or mismatches before taking enforcement actions.

The following chart provides six of the most common information reports received for TY 2011, the percentage received by April 15, and the percentage corrected or amended:

**FIGURE 2, Common Information Reports Received for TY 2011, by Count, Percent Received by April 15, 2012, and Percent Amended or Corrected<sup>58</sup>**

Form	Count	# Received by 4/15	% Received by 4/15	# Corrected or Amended	% Corrected or Amended
W-2	219,970,807	181,926,210	82.70%	1,904,508	0.87%
1099-B	1,115,720,789	149,412,621	13.39%	83,427,833	7.48%
1099-DIV	83,586,516	5,670,208	6.78%	3,088,862	3.70%
1099-INT	170,520,884	58,916,047	34.55%	500,935	0.29%
1099-MISC	86,756,169	21,684,558	24.99%	929,655	1.07%
1099-R	84,627,773	37,918,483	44.81%	326,331	0.39%

### Earlier Receipt of Information Reporting Documents

To conduct matching before releasing refunds, the IRS must receive information reports from the payors earlier, which would require revising the statutory information reporting deadlines for payors.<sup>59</sup> Currently, payors must generally submit information reports to payees by January 31 and to the IRS by

57 Because third-party information returns can be unreliable and difficult for a taxpayer to disprove, the IRS is not always entitled to rely on its general presumption of correctness in court when its determination is based on them. See *Portillo v. Comm'r*, 932 F.2d 1128, 1134 (5th Cir. 1991) (holding that the IRS “had some duty to investigate” the accuracy of an information return), rev’g in part T.C. Memo. 1990-68. IRC § 6201(d) was enacted following the government’s loss in *Portillo* and requires the IRS to prove that its determination is based on “reasonable and probative information” in any court proceeding regarding a deficiency based on an information return.

58 IRS Compliance Data Warehouse, Information Returns Master File, TY 2011.

59 For example, IRC § 6051 requires employers to provide a written statement to employees each year showing, among other things, wages paid and the amount of tax deducted and withheld. The statement must be furnished to the employee no later than January 31st of the following year. Treas. Reg. § 31.6051-2(a) requires the employer to file the Forms W-2 with the Social Security Administration. Employers have until the end of February to file with the SSA if they file by paper or the end of March if they file electronically. Treas. Reg. § 31.6071(a)-1(a)(3). Similarly, IRC § 6049 provides requirements for interest payments and IRC § 6042 provides requirements for dividend payments.

February 28 or March 31, depending on whether they file by paper or electronically, respectively.<sup>60</sup> Payers submitting 250 or more information reports must submit the forms magnetically or electronically.<sup>61</sup>

**FIGURE 3, CURRENT DEADLINES FOR FILING VARIOUS INFORMATION REPORTS<sup>62</sup>**

Type of Information Report	Deadline to Submit to Payee	Deadline for Paper Filing	Deadline for Electronic Filing
1098-T	January 31st	February 28th	April 1st
1099-DIV	January 31st	February 28th	April 1st
1099-INT	January 31st	February 28th	April 1st
1099-MISC	January 31st (extended to Feb. 15th in certain circumstances)	February 28th	April 1st
1099-R	January 31st	February 28th	April 1st
W-2 (to SSA)	January 31st	February 29th	March 31st

The following discussion provides potential options to enable the IRS to receive third-party data early enough to perform upfront matching.

#### *Filing Forms W-2 with the IRS Directly.*

As discussed above, Forms W-2 are now sent first to the SSA to allow the SSA to “scrub” the data before transmitting it to the IRS.<sup>63</sup> The SSA checks the Form W-2 data against its database to determine if the name and SSN match, then electronically sends data extracted from the forms to the IRS, which conducts its own “scrubbing.”

In order to receive Form W-2 data earlier, the IRS has the following two options:<sup>64</sup>

- Evaluate SSA procedures to determine if processing improvements within the SSA would enable the IRS to receive the data earlier.
- Evaluate whether the IRS could receive Form W-2 data directly from employers and perform the screens itself, as it did prior to 1978. The IRS should conduct a test to determine whether it can screen Form W-2 data as effectively as SSA. If the IRS develops the capacity to screen for name/SSN mismatches and can complete the task more quickly than SSA, it should consider creating a joint processing center. Employers could be directed to submit Forms W-2 to center, and the IRS

60 IRS, General Instructions for Certain Information Returns — Main Contents, available at <http://www.irs.gov/instructions/i1099gj/ar02.html#d0e400> (last visited Sept. 28, 2013); Instructions to IRS Form 1098-T, Tuition Statement; Instructions to 1099-DIV, Instructions to IRS Form 1099-INT, Interest Income; Instructions to IRS Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., Social Security Administration, Deadline Dates to Submit W-2s, available at <http://www.ssa.gov/employer/filingDeadlines.htm> (last visited Sept. 28, 2013).

61 IRC § 6011(e)(2)(A).

62 IRS, General Instructions for Certain Information Returns - Main Contents, available at <http://www.irs.gov/instructions/i1099gj/ar02.html#d0e400> (last visited Oct. 12, 2012); Instructions to IRS Form 1098-T, Tuition Statement; Instructions to 1099-DIV, Instructions to IRS Form 1099-INT, Interest Income; Instructions to IRS Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., Social Security Administration, Deadline Dates to Submit W-2s, available at <http://www.ssa.gov/employer/filingDeadlines.htm> (last visited Oct. 12, 2012).

63 National Taxpayer Advocate 2009 Annual Report to Congress 338-345; Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012) (Noting that the large employers are already voluntarily providing specialized units with the IRS with electronic W-2 data before it is due to be filed with the Social Security Administration).

64 National Taxpayer Advocate 2009 Annual Report to Congress 338-345 (Legislative Recommendation: Direct the Treasury Department to Develop a Plan to Reverse the “Pay Refunds First, Verify Eligibility Later” Approach to Tax Return Processing).

and SSA would both have immediate access to the data. Alternatively, the agencies could create a portal to give the IRS direct access to the SSA database, and both agencies could make use of the data.

### *Eliminate E-File Incentive as Unnecessary.*

The National Payroll Reporting Consortium has noted that the March 31 electronic filing reporting deadline was initially established as an e-file incentive, which may no longer be necessary.<sup>65</sup> The group also points out that the later deadline is likely responsible for the low level of amendments to Forms W-2s, as an earlier deadline would probably translate into a higher rate of amendments. The Consortium estimated the amendment rate would rise from approximately one percent to a range of six to eight percent, due to the complex compensation and benefits offerings from large employers, but added that six states and the District of Columbia already require employers to report Form W-2s by January 31.<sup>66</sup> Thus, the IRS should evaluate the amendment rates experienced by these jurisdictions in determining the most effective way to accelerate third-party reporting.

### *Tighten Information Reporting Deadlines.*

The most straightforward way to enable the IRS to receive third-party information report data earlier is to tighten the current deadlines. To address the increase in erroneous refunds released due to fraudulent Forms W-2 and 1099, the Information Reporting Program Advisory Committee (IRPAC) recommended in 2011 that the IRS work with stakeholder groups to determine if shortening the timeframe for reporting employer/payer information would be feasible.<sup>67</sup> IRPAC's Employee Benefits and Payroll Subgroup specifically mentioned the possibility of filing Forms W-2 by an earlier date, such as February 15. The subgroup also noted that it would be impractical to file Forms 1099 earlier due to information gathering and processing issues.<sup>68</sup>

Any acceleration of deadlines will potentially burden third-party payors and other preparers of information reports. Therefore, the IRS should consult with the stakeholders on an ongoing basis to determine how any change in filing deadlines to accomplish upfront matching would impact payor burden and compliance.<sup>69</sup> The size of the employer or service recipient may make a difference in the burden imposed by earlier deadlines. Large businesses are more likely to have the resources and capability to file forms with the IRS at the same time they send them to payees, but smaller businesses may struggle more to meet tighter deadlines. Moreover, smaller firms may be more likely to use preparers, who may find it difficult to complete the work within compressed deadlines. In fact, the small business community has already expressed concerns about any changes in filing deadlines. For example, for TY 2011, approximately 24 percent of Forms W-2 filed with the IRS were for employers with 50 or fewer employees.<sup>70</sup> These businesses are already trying to comply with the new information reporting requirements under the Affordable Care Act and any changes to basic filing deadlines may be too much to handle at one time.<sup>71</sup>

65 IRS Public Hearing, *Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium* (Jan. 25, 2012).

66 *Id.*

67 IRPAC, IRPAC Report Executive Summary (2011).

68 IRPAC, Employee Benefits and Payroll Subgroup Report, General Report 37-39 (2011).

69 See IRS Public Hearing, *Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium* (Jan. 25, 2012).

70 IRS Compliance Data Warehouse, Business Returns Transaction File and Information Returns Master File, Tax Year 2011.

71 Taxpayer Advocate Service Presentation at the National Small Business Forum (July 16, 2013) (comments received from attendees).

In setting earlier information reporting deadlines, it is necessary to address the burden imposed on third-party reporters due to the complexity of Form W-2. The form has ten fields for “indicative data” such as names, addresses, EINs, SSNs, and state and local information. The form also has three checkboxes and 15 monetary fields, as well as two monetary fields which are variably used, such as Box 12, which has 26 defined monetary amounts along with an alpha code to identify the amount reported. The other variably used field is Box 14, with more than a dozen tax, insurance, and various other state and locally-defined deductions, in addition to optional use by the employer. Each data element represents a distinct determination and recordkeeping responsibility of the employer and is subject to extensive regulations.<sup>72</sup>

Due to the complexity of the W-2, the National Payroll Reporting Consortium has opined that employers need at least one month to prepare the forms. In addition to cash wages, employers are responsible for gathering as many as 50 types of compensation, of which some are administered by third parties. Cash wages may be identifiable by the last day of the year, but the value of benefits and certain other types of compensation often cannot be determined for at least two weeks after the end of the year. In fact, some third-party administrators are not required to provide information to employers until January 15. It is the opinion of the consortium that employers should not be expected to receive and process third-party information earlier than January 20. Thus, it would be problematic to have a filing deadline before January 31 when the quality control and tax professional services are added into the equation.<sup>73</sup> As discussed below, a *de minimis* exception could offset any anticipated errors resulting from earlier deadlines.

In order to minimize burden on payors and taxpayers, the IRS must work closely with state and local tax administrations. Generally, payors submit information reports to local tax administrations as well. These administrations may already have earlier filing deadlines, which may reduce the burden of establishing an earlier federal deadline.<sup>74</sup> However, if the local deadlines are currently later than the federal deadlines, any change may increase the burden substantially.

When determining whether to move the information reporting deadline, it is also helpful to evaluate the experience of foreign tax administrations. In Sweden, all reporting bodies must supply information reports by January 31, one month after the end of the fiscal year. In 2006, all 80 million third-party reports had been received and registered by February 10, the date for sending reminders to overdue reporting bodies. Reporting bodies are advised to make corrections before March 5, when the computer systems begin preparing their pre-filled returns.<sup>75</sup> In Denmark, all reporting bodies must supply information reports by January 20, about three weeks after the end of the fiscal year. The revenue body receives corrections of data once a week until April and once every two weeks until October. The Danish revenue body estimates it receives 98 to 99 percent of corrections by February 15 each year.<sup>76</sup>

72 Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012).

73 *Id.*

74 Six states and the District of Columbia already require employers to report W-2s by January 31. In addition, California and New York require reporting of earnings subject to income tax and withholding in another format by January 31. Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real Time Tax System 2 (Jan. 25, 2012).

75 Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 11 (Jan. 22, 2008).

76 Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 11 (Jan. 22, 2008).

Both Sweden and Denmark provide significant ongoing support to reporting bodies, with special attention provided to the largest reporting entities. Both countries have emphasized the critical importance of building good relations and personal contacts within the group of larger suppliers to contribute to the smooth functioning of the overall system. Denmark interacts with approximately 100 large reporting entities as well as trade organizations and provides detailed technical guidance. Sweden holds annual meetings with the largest companies every June to explain changes in legislation and reporting schemes and ensure that the third parties have time to prepare their systems. Finally, both countries recognize the key role of software developers and Denmark even consults with the developers before enacting legislation that would impact third-party reporting.<sup>77</sup>

Similar to Sweden and Denmark, the IRS has built partnerships with third-party reporters and their representatives. Among other contacts, the IRS has the Information Reporting Program Advisory Committee and it meets regularly with the National Payroll Reporting Consortium. The IRS has the avenues to solicit and receive comments and suggestions. As it works through implementing the recommended future reporting system, it should utilize these partnerships. During these conversations, the IRS should address the concerns of small businesses and their representatives. In a 2009 report, GAO noted that complex reporting requirements contribute to the significant level of 1099-MISC noncompliance. At the time, the IRS, advisory group members, and others interviewed by GAO indicated confusion and lack of awareness over reporting responsibilities, whether payments were reportable due to different dollar reporting thresholds, and whether reporting was required for payments to corporations. GAO recommended the IRS make it easier to comply with the requirements as well as perform more outreach and education to explain them.<sup>78</sup> Accordingly, the IRS must commit to building partnerships with third-party reporters.

### *Minimize Amendments.*

If the IRS experiences a high amendment rate for certain information reports, such as the 7.48 percent rate for TY 2011 Forms 1099-B, it should evaluate different ways to reduce amendments, with a customized approach for each type of report.<sup>79</sup> For example:

- *Bifurcate Information Report Filing Deadlines.* If certain data on an information report lends itself to delays in reporting due to complexity or record-keeping issues, the IRS could split the information report deadlines. For example, if employers need more time to report pension benefit calculations, the IRS could require earlier reporting of the basic Form W-2 data such as wages and withholding, and give employers time to file a supplemental earnings statement with the more complicated items later. Taxpayers and the IRS would receive the information they need for calculating most tax liabilities early in the season and the IRS would receive the other, more complex information soon enough for compliance purposes.<sup>80</sup> We acknowledge that this option may present significant challenges to administer for both the IRS and payors. In our discussions

77 Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 11, 12 (Jan. 22, 2008).

78 Government Accountability Office, GAO-09-238, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* 4 (Jan. 2009).

79 IRS Compliance Data Warehouse, Information Returns Master File, TY 2011.

80 Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012) (In favor of earlier deadlines for more simple types of income if it would reduce the incidence of fraud as long as the IRS revisits the Form W-2C amendment process).

with the IRPAC, members strongly noted that bifurcating W-2 reporting would be fraught with problems and create additional work for reporting entities.<sup>81</sup>

- *Build flexibility into the reporting period.* The IRS should evaluate the feasibility of providing an option for payors to report certain complex transactions occurring during the last two months of the year on the return for the subsequent tax year.<sup>82</sup>
- *Create a de minimis dollar threshold for corrections.* As noted above, earlier information report filing deadlines may increase the number of corrections. In 2012, the IRPAC Burden Reduction Subgroup recommended that the IRS adopt a \$50 *de minimis* dollar threshold for corrections to information returns.<sup>83</sup> Specifically, the advisory group recommended that failure to correct an information return for net changes of \$50 or less of previously reported income would be deemed an “inconsequential error” that is not subject to the penalty provisions of IRC §§ 6721 and 6722.<sup>84</sup> The subgroup stated that the IRS and withholding agents expend substantial resources to correct and process corrected statements that, in many cases have no impact on tax liability. Treasury Regulation § 301.6721-1(d) provides for a *de minimis* number of failures to include correct information on certain information returns, but the exception is based on the number of corrections (the greater of ten or one-half of one percent of all information reports required to be filed), as opposed to the amount of income to be corrected.<sup>85</sup>

### *Increase Electronic Filing Rate of Reports.*

Electronic filing of third-party reports is essential to enable the IRS to process the reports efficiently. Currently the IRS receives approximately 97.9 percent of information reports electronically.<sup>86</sup> The IRS already requires larger reporters to file electronically, but smaller entities are not subject to the e-file requirement.<sup>87</sup>

According to the National Payroll Reporting Consortium, the current 250 return threshold affects about half of one percent (.005) of employers, which employ over 25 percent of the private sector workforce. In the opinion of the Consortium, lowering the threshold is feasible for small employers due to the wide availability of supporting software and services.<sup>88</sup>

81 See National Taxpayer Advocate 2009 Annual Report to Congress 338-345; United States Government Accountability Office, GAO-11-747T, *Hearing before the Committee on Finance, U.S. Senate on Tax Gap: Complexity and Taxpayer Compliance* 14-17 (Statement of Michael Brostek, Director, Tax Issues, Strategic Issues, June 28, 2011).

82 IRS Public Hearing, Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium (Jan. 25, 2012). The IRS already allows this for certain in-kind fringe benefits, such as the taxable value of an employer-provided vehicle. See Announcement 85-113, 1985-31 I.R.B. 31 (Aug. 5, 1985).

83 Burden Reduction Subgroup, Information Reporting Program Advisory Committee, *Burden Reduction Subgroup Report, Information Reporting Program Advisory Committee Public Meeting* 41 (Oct. 24, 2012).

84 IRC § 6721 imposes a penalty for the failure to file a correct information return in the amount of \$100 per return. There is a \$1.5 million maximum penalty per year. There is a *de minimis* exception and lower penalties for corrections within certain timeframes. Section 6722 imposes similar penalties for failure to file correct payee statements.

85 Burden Reduction Subgroup, Information Reporting Program Advisory Committee, *Burden Reduction Subgroup Report, Information Reporting Program Advisory Committee Public Meeting* 41 (Oct. 24, 2012).

86 IRS Pub. 6961, 2013 Update: *Calendar Year Projections of Information and Withholding Documents for the United States and Campuses*, Tables 2-4 (of the 2,288,516,144 information reports received in Calendar Year 2012, 2,240,335,726 were received electronically).

87 IRC § 6011(e)(2)(A).

88 Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012).

The Employee Benefits and Payroll Subgroup of IRPAC has recommended that the IRS work with the payor and information reporting industries to assess whether reducing the threshold of returns required for e-filing is feasible, and whether the reduction would decrease fraudulent refund claims associated with paper Forms W-2. IRPAC suggested the IRS evaluate reducing the threshold from 250 returns to as few as 50.<sup>89</sup>

Alternatively, the IRS could provide an incentive other than a filing extension for payors to e-file their reports, perhaps a designation to payors who meet certain qualifications. The payors could advertise the designation as a way to minimize refund delays. In addition, for payors that will not convert to e-file, the IRS should offer a 2D barcoding technology option.<sup>90</sup>

### *Receipt of Data Earlier Through Quarterly Reporting.*

Another possible option would be to require more frequent reporting, such as quarterly, rather than moving up filing deadlines. Through quarterly reports received before the taxpayer files the return, the IRS might receive enough data to indicate a problems with the return.<sup>91</sup> However, the increase in reporting frequency also increases reporting compliance burden on the payors.<sup>92</sup>

### *Recommendations Based on Analysis of Current Filings*

The Taxpayer Advocate Service evaluated IRS data on receipt dates of the information reports with the highest volumes for TY 2011 and any associated amendments and corrections. The following chart provides the percentage of the total volume received by certain dates for the six TY 2011 information reports with the highest volumes. It also provides the percentage of the returns including these forms that filed extensions.

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<sup>89</sup> IRPAC, Employee Benefits and Payroll Subgroup Report, 2011 General Report 37-39 (2011).

<sup>90</sup> The IRS currently offers the 2D barcode option for filers of Schedule K-1s. See <http://www.irs.gov/uac/Two-Dimensional-Bar-Coding-for-Schedules-K-1> (last visited Dec. 16, 2013). In addition, the National Taxpayer Advocate previously proposed 2D bar-coding as a possible bridge for taxpayers who are reluctant to file electronically. National Taxpayer Advocate 2004 Annual Report to Congress 101-102 (Most Serious Problem: *Electronic Return Preparation and Filing*).

<sup>91</sup> IRS Public Hearing, *Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium* (Jan. 25, 2012) (California and Maine have quarterly reporting requirements for Forms W-2s); William Hoffman, *IRS Oversight Board Brainstorms Real-Time Tax System, ID Theft Initiatives* (May 2, 2013).

<sup>92</sup> Before 1976, the IRS received quarterly reports of each employee's earnings with Forms 941. Congress shifted the quarterly reporting to an annual system and allowed the Social Security Administration to receive and process Forms W-2 for the IRS. Pub. L. No. 94-202, 89 Stat. 1137-1141 (Jan. 2, 1976).



**FIGURE 4, Percent of Top Forms Received by Certain Dates in Filing Season and Percent Associated with an Extension, Tax Year 2011<sup>93</sup>**

Form	2/16/2012	3/01/2012	3/15/2012	3/29/2012	4/13/2012	% Filing Extension
W-2	N/A	N/A	54.38%	64.91%	82.70%	3.90%
1099-B	0.003%	0.08%	0.13%	0.21%	13.4%	22.49%
1099-DIV	0.12%	1.46%	2.00%	4.83%	6.78%	11.2%
1099-INT	4.87%	9.08%	16.50%	27.06%	34.55%	8.36%
1099-MISC	1.41%	4.90%	10.65%	17.74%	24.99%	8.31%
1099-R	2.53%	6.52%	12.15%	23.86%	44.81%	6.59%

The above data for TY 2011 information report filings show that a significant percentage of reports are not filed on a timely basis with existing deadlines. Therefore, to reduce the burden on filers, we suggest any earlier filing deadlines are implemented with a transition period. In addition, to make the transition to earlier deadlines the least burdensome on filers, any date adjustment would need to be coupled with at least one other discussed option, such as providing a *de minimis* threshold for corrected filings, as provided below.

## RECOMMENDATIONS

To enable the IRS to receive information reports earlier, the National Taxpayer Advocate recommends the following:

**Recommendation 2.1:** Develop and implement a one year pilot to determine if the IRS can screen Form W-2 data as effectively as SSA.

**Recommendation 2.2:** Eliminate the March 31 deadline for e-filed information reports. All information reports, whether e-filed or filed on paper, would be due at the end of February.

**Recommendation 2.3:** Minimize corrections by creating a \$50 *de minimis* threshold for corrections.

**Recommendation 2.4:** Further increase electronic filing by reducing the 250-report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.

### *Concerns About Which Compliance Actions the IRS Will Take Upon Detecting a Mismatch in an Accelerated Information Reporting System.*

While receiving the information reports earlier is a main component of an accelerated information reporting system, the type of compliance action the IRS takes upon early identification of a mismatch is also crucial. The compliance action must impose minimum burden on both taxpayers and the IRS. Accordingly, the National Taxpayer Advocate has the following concerns as the IRS develops compliance procedures to achieve a program involving upfront matching:

- *Rejecting Returns With Mismatches Will Create Significant Burden on Taxpayers and the IRS.* The National Taxpayer Advocate cautions against rejecting returns containing mismatches, which

93 IRS CDW, Information Returns Master File, TY 2011.

would impose significant burden on both taxpayers and the IRS, with potentially serious consequences for the taxpayers. For example, such a rejection would cause a significant number of taxpayers or their preparers to call the IRS toll-free line. It could also lead more taxpayers to file by paper if they cannot resolve inaccuracies before the filing deadline. While it is ideal to inform taxpayers about mismatches as early as possible, the IRS does not necessarily need to reject a return to accomplish this goal.<sup>94</sup>

- *Expanding Math Error Authority Will Harm Taxpayers.* The National Taxpayer Advocate also cautions against the expansion of math error authority under IRC § 6213(g) to cover mismatched third-party data.<sup>95</sup> The National Taxpayer Advocate has written extensively about her various concerns with this issue,<sup>96</sup> which were also raised by the taxpayer and consumer advocate panel at the first IRS Real Time Tax System Initiative public meeting.<sup>97</sup> An expansion of math error authority would significantly harm taxpayers, especially low income taxpayers who may not understand math error notices or realize they need to respond timely. Accordingly, these taxpayers may lose their right to contest the adjustment in Tax Court.<sup>98</sup>
- *Provide Taxpayers With Certain Timeframes to Respond to Mismatch.* We encourage the IRS to pursue an option that would entail notifying the taxpayer of the mismatch and providing him or her with a certain timeframe to respond. If the taxpayer does not resolve the issue before the deadline, the IRS could assess the amount and issue a Notice of Deficiency.

### Evaluate the Necessity of Delaying the Filing Season

Another potential avenue for accomplishing upfront matching is to delay the filing season. Once the IRS receives the information reports as early as possible, the tax return filing due date could also be pushed back to enable the IRS to perform matching before releasing refunds. Delaying the filing season would also provide tax preparers the time they need to provide quality service to their clients.

Filing season dates, especially return filing deadlines, are ingrained in taxpayers' lives and psyche. Any changes to these dates would require significant outreach and education by the IRS. However, the IRS has modified filing season dates in the past. Most recently, the IRS announced that it will delay the 2014 filing season by one or two weeks due to the federal government shutdown in October 2013.<sup>99</sup> In addition, the 2013 filing season was delayed due to late tax law changes impacting the 2012 tax year. The IRS did not start processing TY 2012 individual income tax returns until January 30, 2013, eight calendar

94 See, e.g., American Institute of Certified Public Accountants Statement Presented to the Internal Revenue Service on Real Time Tax System 3 (Dec. 8, 2011); Comments of Bonnie Speedy, Vice President and National Director, AARP Foundation Tax-Aide, IRS Public Meeting – Real Time Tax System (Dec. 8, 2011).

95 IRC § 6213(b) or (g) gives the IRS the authority to make an assessment without filing a statutory notice of deficiency (SNOD). Once the IRS notifies taxpayers of math errors, they have 60 days to request abatement of the additional tax. If the taxpayer makes a timely request, the IRS will abate the assessment and follow formal deficiency procedures to reassess the tax (*i.e.*, send the taxpayer a SNOD). However, if the taxpayer fails to request abatement timely, the IRS may collect the additional tax. At this point, the assessment cannot be appealed in the U.S. Tax Court.

96 See National Taxpayer Advocate 2011 Annual Report to Congress 74-92; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

97 IRS, Transcript of the Public Meeting on Real Time Tax System Initiative 92-94 (Dec. 8, 2011), available at <http://www.irs.gov/Tax-Professionals/December-8,-2011-Meeting>.

98 See, e.g., Comments of T. Keith Fogg, Director, Villanova Law School Federal Tax Clinic, IRS Real Time Tax System Initiative 4-5 (Dec. 8, 2011). The IRS sent out over 2.04 million math error notices for TY 2011 returns in CY 2012. IRS Data Book, Table 15. Math Errors on Individual Income Tax Returns, by Type of Error, Calendar Year 2012.

99 IRS News Release, *2014 Tax Season to Start Later Following Government Closure; IRS Sees Heavy Demand As Operations Resume*, IR-2013-82 (Oct. 22, 2013)

days after it had initially planned.<sup>100</sup> Similarly, the 2011 filing season started on February 15 for individuals who claimed itemized deductions on Schedule A, the higher education tuition and fees deduction on Form 8917, or the educator expenses deduction for tax year 2010.<sup>101</sup>

Moving back the filing season would have a broad range of potential consequences. For example, taxpayers need to provide a copy of their most recent tax return for the Free Application for Federal Student Aid (FAFSA) and state financial aid applications.<sup>102</sup> Any change in return filing deadlines could impact the financial aid process.

### Evaluate the Necessity of Delaying Refund Issuance

Another element of this proposal includes delaying the release of refunds. Due to the substantial amount of the average tax refund — \$2,803 in calendar year 2012<sup>103</sup> — many taxpayers rely on their income tax refunds to pay down debt or pay bills.<sup>104</sup> We acknowledge that the later issuance of refunds could have a detrimental impact on low income taxpayers. For example, many low income taxpayers use their tax refunds, including their refundable credits, to pay their winter utility bills.<sup>105</sup> In addition, it is our understanding that certain utility companies refrain from conducting the more aggressive bill collection techniques, including turning off utilities, until the point in the filing season when taxpayers can receive their sizable tax refunds, including refundable credits. Thus, if we delay the issuance of refunds, such arrangements may no longer be available, and taxpayers may not be able to pay their heating bills.

As illustrated in the chart below, IRS data show that over 91 percent of TY 2011 refunds were issued by the end of April 2012

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100 IRS News Release, *IRS Plans Jan. 30 Tax Season Opening For 1040 Filers*, IR-2013-2 (Jan. 8, 2013).

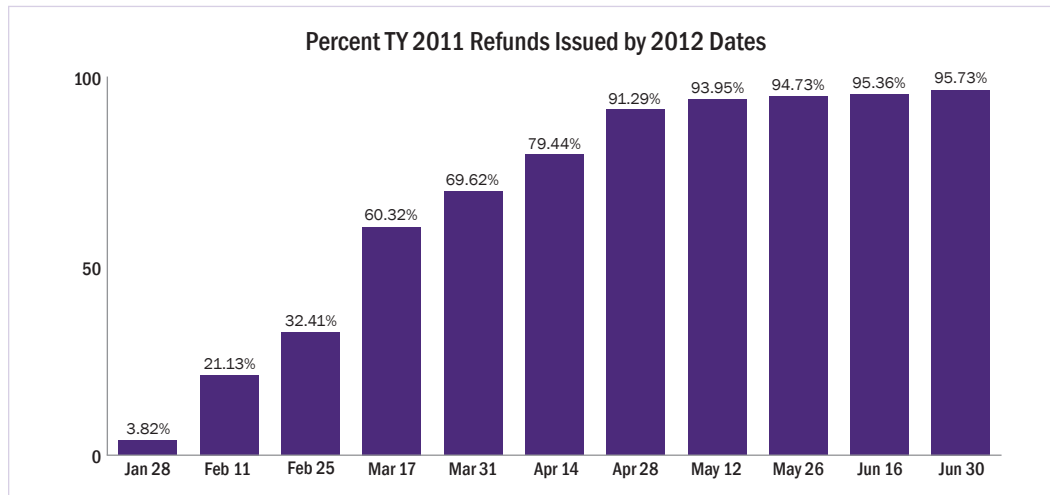
101 IRS News Release, *IRS to Start Processing Delayed Returns on Feb. 14; Most People Unaffected and Can File Now*, IR-2011-7 (Jan. 20, 2011).

102 <http://www.fafsa.ed.gov/deadlines.htm#> (last visited Nov. 4, 2013). While the federal application deadline is June 30th, many state student aid applications are as early as March 1.

103 IRS, 2012 End-of-Year Filing Season Statistics, Cumulative through the weeks ending 12/30/11 and 12/28/12.

104 A recent survey of 1,500 adults conducted by American Express showed that 37 percent of those expecting a refund planned to use it to pay bills and pay down debts. Of those expecting a refund, 37 percent plan to use it to pay down debt or bills, while 26 percent plan to save the money. Only 28 percent said they expect to spend their refund checks on themselves or family, travel, home improvements or a big-ticket item. Melanie Hicken, *Fewer People Expect Tax Refunds This Year*, CNNMoney (Mar. 25, 2013).

105 In fact, utility companies engage in EITC outreach campaigns to raise awareness of the EITC to their low income customers. See Pennsylvania Utility Law Project, *The Earned Income Tax Credit (EITC) as "Energy Assistance" in Pennsylvania* (June 2009); Consumer Energy, *Payment Assistance Programs*, available at <http://www.consumersenergy.com/content.aspx?id=1244#EarnedIncome>.

**FIGURE 5, Percent TY 2011 Refunds Issued by Various 2012 Dates<sup>106</sup>**

In addition, IRS data show that of all TY 2011 refunds delayed or frozen by the IRS due to compliance issues, such as child support, matching, math error, identity theft, over 77 percent were identified and frozen (and some potentially released in part or full) by the IRS by the end of April.

**FIGURE 6, Percentage of TY 2011 Refunds Identified and Frozen by Certain 2012 Dates<sup>107</sup>**

Date	% Identified and Frozen
January 28, 2012	5.88%
February 11, 2012	21.60%
February 25, 2012	35.53%
March 17, 2012	51.15%
March 31, 2012	59.31%
April 14, 2012	67.37%
April 28, 2012	77.21%
May 12, 2012	82.84%
May 26, 2012	85.47%
June 16, 2012	87.66%
June 30, 2012	88.88%

<sup>106</sup> IRS CDW, Individual Master File TY 2011.

<sup>107</sup> *Id.*.

Based on the above data, the National Taxpayer Advocate recommends that the IRS:

**Recommendation 3.1:** Issue direct deposit and other electronic refunds by April 30th and paper checks by May 31

By issuing all refunds on the same date, rather than a rolling date depending on date of filing, the IRS would have less pressure to get the refund out before performing the necessary compliance screens and matching. Another alternative would be to release refunds in stages. Thus, for example, if the taxpayer filed by March 31, the IRS would issue the refund by April 30, in bi-monthly increments.

Pushing back the refund release date until the end of April may have a significant impact on small businesses. IRS data show that 59 percent of Schedules C, E, and F filers claimed refunds in TY 2011.<sup>108</sup> From an economic perspective, small businesses would only feel the financial strain of this proposal in the first year, when the refunds would be released potentially 15 months after the refunds for the previous year. Theoretically, with enough notice, taxpayers could plan to minimize their refund amounts in the first year of implementation. However, we recognize that the reality of such a delay may be very different from theory. Further analysis of IRS data into the date of filing patterns for this population will help quantify the actual impact.

Delaying refunds would also have a significant impact on the commercial refund industry. With the demise of the refund anticipation loan (RAL) industry in 2012, the refund anticipation check (RAC) has become a dominant commercial refund delivery product. In addition, a number of payday lenders and other non-bank businesses are making tax-time loans.<sup>109</sup>

For products with loan components, the length of the loan term increases when refund issuance is delayed. Research has shown that one in six payday loan borrowers repays his or her loans with a tax refund. Until taxpayer-borrowers receive their refund or some other cash infusion (such as financial help from family, selling possessions, etc.), approximately 41 percent of borrowers renew or reborrow the loan, incurring additional fees.<sup>110</sup> In addition, RACs include a loan for the tax preparation fee.<sup>111</sup> If the term of this loan component of the product increases, the product will involve more risk to the financial institution offering the RAC and this risk will likely translate to higher fees charged to the taxpayers. Therefore, delaying refund issuance will likely increase the cost of tax-related loans to the borrowers.

Later refund issuance also results in the lenders assuming an even greater risk if the IRS performs matching before issuing the refund. The more matching performed upfront, the greater the risk that the IRS will not pay out the entire anticipated refund. This greater risk imposed on the providers will make them less profitable and may drive some out of the market. The impact on the consumers of the products with loan components is an important consideration in determining whether delaying the refund is a viable option.

<sup>108</sup> IRS Compliance Data Warehouse, Individual Master File, TY 2011 (of the 44,754,395 returns with Schedule C, E, or F, 32,721,894 claimed refunds).

<sup>109</sup> Chi Chi Wu, National Consumer Law Center, *Something Old, Something New in Tax-Time Financial Products and the New Wave of Quickie Tax Loans* 2-10 (Feb. 2013).

<sup>110</sup> Pew Charitable Trusts, *Payday Lending in America: Report 2: How Borrowers Choose and Repay Payday Loans* 6-7 (Feb. 2013).

<sup>111</sup> Chi Chi Wu, National Consumer Law Center, *Something Old, Something New in Tax-Time Financial Products and the New Wave of Quickie Tax Loans* 6 (Feb. 2013).

Finally, we recognize that there will be many wide-ranging objections to pushing back the refund release date. One potential complaint would be that the government would profit off the “float” – *i.e.*, by holding onto the taxpayer’s money even longer, it will earn more interest. A later tax payment date would not only counter this objection but might encourage taxpayers to minimize the size of their refunds by reducing their withholding.

## RECOMMENDATIONS

The National Taxpayer Advocate recognizes that the changes necessary to accomplish an accelerated third-party reporting system require a great deal of forethought, analysis, and stakeholder engagement. While the IRS has acknowledged the benefits of a real time tax system, it has not made any recent progress in developing a long-term plan for such a system. The IRS’s lack of progress only delays the significant benefits we outlined throughout this report. Thus, we reiterate our 2009 Legislative Recommendation that Congress require the IRS and the Department of Treasury to prepare a report, in consultation with the National Taxpayer Advocate, which provides a plan and timeline to achieve an accelerated third-party reporting system. In furtherance of this issue, the National Taxpayer Advocate recommends that the following administrative and legislative actions be taken to achieve a system that allows the IRS to perform upfront matching to protect government revenue and improve taxpayer service:

**Recommendation 1.1:** Provide taxpayers with access to real-time transcripts of third-party data to aid in return preparation.

**Recommendation 1.2:** Provide a platform from which taxpayers and preparers could download third-party data directly into commercial tax return preparation software.

**Recommendation 2.1:** Develop and implement a one year pilot to determine if the IRS can screen Form W-2 data as effectively as SSA.

**Recommendation 2.2:** Eliminate the March 31<sup>st</sup> deadline for e-filed information reports. All information reports, whether e-filed or filed on paper, would be due at the end of February.

**Recommendation 2.3:** Minimize corrections by creating a \$50 *de minimis* threshold for corrections.

**Recommendation 2.4:** Further increase electronic filing by reducing the 250 report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.

**Recommendation 3.1:** Issue direct deposit and other electronic refunds by April 30<sup>th</sup> and paper checks by May 31<sup>st</sup>.