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RE: The Commissioner's Vision for a Real-time Tax System

I would like to thank the Internal Revenue Service for the opportunity to present a statement on behalf of my employer, CACI, Inc., and the members of the American Payroll Association (APA) regarding Commissioner Shulman's vision for a real-time tax system that would give the Service access to third-party information returns before processing individual income tax returns, which would allow a front-end match to be done. This would ideally result in a more efficient return processing procedure and a dramatic reduction in fraudulent income tax refunds being paid, leading to an increase in taxpayer confidence in the tax system and a decrease in the tax gap.

The APA is a nonprofit association of over 20,000 payroll professionals, most of whom are responsible for the payroll of approximately 17,000 employers throughout the 50 states, the District of Columbia, and U.S. territories. Our membership also includes representatives of large, medium, and small payroll service providers, who in turn process payroll for an additional 1.5 million employers, representing an aggregate total of one-third of the private-sector workforce. The employers for whom APA members process payrolls are diverse in size and industry.

I am the Director of Payroll for CACI International Inc. (CACI), a government contractor based in Arlington, Virginia that has been in business for 50 years. CACI proudly employs 14,300 employees in all 50 states and the District of Columbia as well as multiple countries around the world. In 2011, we filed 18,000 Forms W-2.

### **Commissioner's Vision**

In remarks at the National Press Club on April 6, 2011, Commissioner Shulman told the audience that the IRS's current approach to compliance, the "look-back" model it has been using since the creation of the Service in 1862, creates significant problems for both the IRS and taxpayers because it does not address taxpayer issues "up-front." Audits are carried out up to three years or more after a taxpayer files a tax return, when refunds have been spent, evidence has been thrown out or lost, and possible penalties and interest have accrued to an uncomfortably high amount. This damages the IRS's image and creates the impression that the Service is out to penalize and harass unwary taxpayers, when the problems could have been resolved much more efficiently and cheaply had they been detected and addressed up front, when the taxpayer filed his or her return.

Commissioner Shulman next noted that in moving to resolve issues on the front end, many of the issues the IRS must deal with involve third-party information returns provided to taxpayers and the IRS during the filing season. These information documents contribute greatly to the current success of our system of voluntary compliance and make it much easier for taxpayers to compile the information necessary to file their returns. When a deeper analysis is done, however, what is discovered is that the IRS often receives the information returns after the taxpayer's return is filed, processed, and a refund is sent out or a payment accepted. In moving the tax system forward, Shulman said, information returns are "the source of the next generation of innovation."

The fundamental aspect of Commissioner Shulman's vision is pretty straightforward. "The IRS would get all information returns from third parties (W-2s, 1099s, etc.) before individual taxpayers filed their returns. ... We would embed this core third-party information into our pre-screening filters, and would immediately reject any return that did not match up with our records." The taxpayer then would be asked to fix the problem before IRS would process the return, resulting in more accurate returns, quicker problem resolution at the front-end, and fewer back-end audits. Such a system would lead to fewer interactions between the IRS and compliant taxpayers, which is a key goal, and would help detect the bad actors and tax evaders sooner, before they would be sent undeserved refunds.

Commissioner Shulman recognized that to make his vision of a real-time tax system work, third-party information returns would have to get to the IRS sooner than they do now, which means that information return filing deadlines "would need to be on the table for discussion." There will also have to be a fundamental change in the way payroll professionals, service providers, and tax practitioners think and work when it comes to preparing and filing information returns.

### **Current Information Return Filing System**

Under the current Internal Revenue Code and IRS Regulations, the wage reporting filing system works in the following manner:

- Employers provide Form W-2, *Wage and Tax Statement*, to each employee by January 31. On this form, the employer reports the employee's prior year wages and tips subject to federal, state, and local income tax as well as social security and Medicare taxes, plus the amounts withheld for those taxes. Other amounts related to tax administration are also reported, including:
  - Dependent care benefits
  - Nonqualified deferred compensation distributions
  - Elective deferrals to retirement plans, including designated Roth contributions
  - Uncollected social security and Medicare taxes on tips or group-term life insurance provided to former employees
  - Taxable cost of group-term life insurance provided to current employees
  - Substantiated employee business expenses if the employee is reimbursed more than the IRS allowable per diem or mileage allowance
  - Nontaxable moving expense reimbursements paid to employees
  - Nontaxable combat pay paid by a military employer

- Contributions to medical savings accounts and health savings accounts
  - Qualified adoption expense reimbursements
  - Nonstatutory stock option income at exercise
  - Deferrals (requirement temporarily suspended) and income under a §409A nonqualified deferred compensation plan
  - Cost of employer-sponsored health coverage (new for 2012 W-2s)
- Employers provide Form W-2 to the Social Security Administration (SSA) by the last day of February (paper copies) or March 31 (electronic file required if 250 or more W-2s). If the employer files paper W-2 copies with the SSA, it must also submit a Form W-3, *Transmittal of Wage and Tax Statements*, along with the paper W-2s. If the employer files electronically, the W-3 information is included as part of the file.
  - After processing the Forms W-2 so it can apply each employee's social security wages to their individual earnings account, the SSA transfers its W-2 files to the IRS. This transfer is made several months after SSA receives the W-2 information.
  - Employees file their personal income tax returns either on paper or electronically from early January through April 15. The IRS processes the returns based on the information provided by the employees, including any Forms W-2 attached by the employees.

The Form 1099 series filing system runs along a somewhat parallel path, with payers providing payees with their copies of the various 1099 forms by January 31 (February 15 for Forms 1099-MISC with amounts in Box 8 or 14) and filing other copies of the forms either on paper (fewer than 250) by February 28 or electronically (250 or more) by March 31 with the IRS. For payroll and accounts payable professionals, the 1099 forms they deal with include Form 1099-MISC, *Miscellaneous Income*, and Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Again, many payees/taxpayers have filed their personal income tax returns before the IRS has access to the data from the third-party Forms 1099, even though they are filed directly with the IRS rather than going to the SSA first.

### **Issues Concerning Accelerating Filing Deadlines**

In his remarks to the National Press Club last April, Commissioner Shulman said that “In order to execute a more real-time tax system, we would also need to get information returns, like [W-2s and] 1099s, into the system earlier.” The issue for employers and filers of business information returns when it comes to acceleration of filing deadlines is one of feasibility, driven by the following considerations:

- When can final information be obtained to produce an accurate Form W-2 or 1099 for an employee, former employee, or nonemployee provider of services?
  - Third-party sick pay and state disability pay information is not due to employers until January 15 for inclusion on employee's Form W-2.
  - Information often comes to payroll from accounts payable systems and third party vendors after year-end for taxable payments such as nonqualified moving expenses, prizes and awards, noncash fringe benefits, stock transactions, etc.

- As more businesses go global, more information must be gathered from far-flung regions of the globe from employees and local and regional payroll providers.
- How long will it take to reconcile any discrepancies uncovered by the employer and/or its service provider so that fewer corrected returns will be necessary?
- Will employers have to send separate Form W-2/W-3 files to the SSA and IRS, in addition to the states where they have employees, so the IRS gets W-2 data more quickly, or will the current system of sending data to the SSA first be maintained?
- In 2012, employers that filed at least 250 Forms W-2 last year will have to include the cost of employer-sponsored health care coverage on each employee's Form W-2. This is the first time that such pure non-wage data that does not impact the employee's tax return in any way must be included on the W-2. The data-gathering process needed to meet this requirement is totally new to employers this year and no one is sure whether it will cause delays in W-2 preparation going into 2013. Is this inclusion of non-wage data on the W-2 a harbinger of things to come that could make acceleration of filing deadlines more problematic?

Despite these challenges, there are opportunities for accelerating the filing of Forms W-2, especially as it concerns filing electronically with the SSA. The extension of the original, end of February filing deadline for electronically-filed W-2s (and 1099s) was put in place by the IRS when electronic filing was new to employers. It gave employers and service providers some extra time to make sure their electronic files were formatted correctly before they were transmitted. It made sense because it took the SSA much less time to process electronic files than paper copies, so even with the extension, processing of the electronic files was often completed first. Now that employers and service providers have had several years to perfect their electronic filing processes (electronic filing of Forms W-2 has been required for employers filing 250 or more W-2s since 2008), the one-month extension for electronic filing is probably an unnecessary anachronism.

What about moving the Form W-2 filing deadline earlier than the end of February? Given advances in technology and the increasing incidence of electronic information gathering, it seems that employers may be able to accelerate this historic filing deadline somewhat given enough time to make it happen. As long as employees will still receive their W-2 information from their employers, there will still need to be some time between when that happens and when the employer files with the SSA (or the IRS, if that change is made) to correct items without having to go through the process of filing corrected forms with the federal government.

### **Accelerating the Provision of Forms W-2 to Employees**

In his National Press Club remarks, Commissioner Shulman alluded to possibly having employees and/or their tax return preparers access their W-2 information directly from the IRS rather than getting it from the employer, once the employer has sent its W-2 file to the IRS and it has been loaded into the Service's databases. While such a system might relieve employers of their current duty to provide Forms W-2 to employees, it would require adequate time for

internal reconciliation of discrepancies before the W-2 file is transmitted so that employees would not be burdened with interacting with the IRS to correct perceived errors in their W-2 data before they can file their personal tax return. Such increased interaction with the IRS would run counter to one of the major goals of a real-time tax system.

Another alternative is moving the deadline for providing Forms W-2 to employees earlier than the current deadline of January 31, which in turn may allow an earlier deadline for filing W-2 information with the SSA and/or IRS. As was mentioned earlier, there are currently some obstacles to moving up this deadline that primarily deal with collecting accurate information from sources other than an employer's payroll department before the end of the prior year. Some of those obstacles may apply to only a small percentage of employees, but if the January 31 deadline were to be accelerated, some allowance would have to be made to prevent employers from being subjected to noncompliance penalties caused by eventualities beyond their control.

### **Electronic Filing Changes**

A real-time tax system, as Commissioner Shulman acknowledged, would require matching the W-2 data the IRS receives from the SSA months earlier than they do now, and getting 1099 data into their systems before individual tax returns are filed. If the time needed by SSA to process W-2 files before sending them to the IRS cannot be reduced significantly, there are a couple of alternatives. One is having the SSA send the files to the IRS before processing them, so long as IRS could accept the unprocessed files and load them into their systems. The other alternative is having employers submit the same W-2 file to both the SSA and the IRS at the same time, again assuming that the IRS's systems can process the files sent by employers.

One other thing that could improve IRS's processing time is to require electronic filing of W-2 and 1099 data by more employers and payers. Currently, only those employers and payers filing 250 or more of any one type of information return are required to file those returns electronically. The SSA still receives some 40 million paper Forms W-2, and they take much longer for the SSA to process, as would be expected. The American Payroll Association, through its representatives on the IRS's Information Reporting Program Advisory Committee, has advocated for several years that the electronic filing threshold for Forms W-2 be greatly reduced, to as few as 5 or 10 forms, which would significantly reduce the number of paper W-2s being filed and processed.

### **State W-2 Filing Processes and Deadlines**

In moving toward a real-time tax system, the IRS also needs to consider employers' and payers' obligations to file information returns with the states where they do business. In addition to filing Form W-2 information with the SSA, employers also are required to file this information with the states where they pay employees that have a state income tax. Currently, 41 states have a state income tax, and nearly all of them require that employers file W-2 information with them. The requirements for electronic versus paper filing vary among the states, although many use the same 250-return threshold that governs W-2 filing with the SSA. The states that do require electronic filing of W-2 information all accept the same format used for filing with the SSA. The deadlines for state filing also vary, and can be anywhere from January 31 to March 31, including

extensions for electronic filing that parallel those at the federal level. A few states require quarterly filing, which has eliminated the W-2 filing requirement in those states, although an annual reconciliation return is still required.

### **What About Delaying the Filing Season?**

Currently, taxpayers can begin filing their individual tax returns by the second week of January if they have all their applicable third-party information, even though the IRS may have nothing to match against the information on the return for 6 months or more. If the IRS is realistic about moving toward a real-time tax system where the IRS has all the applicable third-party return information before a taxpayer files a tax return, they need to be thinking about delaying the filing season until all that information is filed with the IRS and loaded into their new database systems. Even if employers and other payers may be able to file their W-2 and 1099 information earlier than is currently required, delaying the filing season somewhat seems inevitable.

### **Where to Go From Here?**

Commissioner Shulman has recognized that a long road lies ahead to realize his vision of a real-time tax system that would provide the significant benefits he touted in his speech. There is much work to be done by all those involved – employers, service providers, financial institutions, the SSA, and the IRS, among others – in building that road. The benefits at the end of the road seem well worth aiming for, and this is as good a time as any to begin the discussion. Thank you again for the opportunity to represent the employers of America on this distinguished panel.

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