

IRS Oversight Board Public Forum
Focus Forward – The Next Five Years in Tax Administration
Real Time Tax Initiative Implications for Information Reporting
National Payroll Reporting Consortium
May 1, 2013

The National Payroll Reporting Consortium (NPRC) appreciates this opportunity to provide input to the Internal Revenue Service Oversight Board concerning the challenges and opportunities facing the U.S. tax system over the next five years. The proposed Real Time Tax concept represents a rare and critical change opportunity for federal and state tax administrators, many of which face increasing challenges in combating tax refund fraud armed with infrastructure dating from the 1960s. Our comments are intended to summarize alternatives that could accelerate availability of W-2 information returns to the IRS, to assist in preventing refund fraud.

Early in 2011 the IRS began speaking about its vision for a “Real Time Tax System,” in which information returns (e.g., IRS forms W-2 and 1099) would be on file with the IRS when the Income tax season started, moving to more concurrent matching of information returns to tax returns as they are filed. Availability of information return data during the processing season would enable dramatic improvements to the U.S. tax system in terms of efficiency, accuracy and reduced burden. Taxpayers would be able to correct returns before the IRS processed them, when records are easily available and memories are freshest.

Additionally, to effectively combat tax refund fraud, the IRS must be able to verify taxpayer-reported income and withholding claims before releasing refunds. These improvements can be achieved with moderate changes to systems, rules and deadlines.

We appreciate the insight of the Oversight Board in drawing attention to this important issue. Despite its significance to the tax system (i.e., compliance is over 99% when tax information is reported), information reporting has changed very little since it was implemented. Given the dramatic advances in technology since these programs were designed, the timing and use of information returns will certainly be a critical element of next-generation tax systems.

NPRC is a non-profit trade association whose member organizations provide payroll processing and related services, including electronic payment and filing of employment taxes, and related information returns, to over 1.5 million employers nationwide, covering over one-third of the private sector workforce. Payroll service providers serve as a conduit between employers and government authorities, improving the efficiency of tax collection through electronic filing and improving compliance. NPRC members have been privileged to work with the IRS, SSA and state tax authorities for many years to improve tax administration.

NPRC is strictly policy-neutral, neither endorsing nor opposing any particular proposal affecting employer reporting obligations. NPRC’s comments in this forum should also not be viewed as reflective of the opinions of any particular member company. However, consistent with the NPRC’s historic role in providing impartial feasibility analyses on proposals involving employment tax reporting, our comments are intended to explain why employers require a certain amount of time to accurately administer Forms W-2, and to summarize alternatives available to the IRS.

NPRC members have followed the Real Time Tax proposal closely, and commissioned a study from Ernst & Young LLP concerning the feasibility of accelerating W-2 reporting deadlines,

which is available on <http://www.nprc-inc.org/govc.html>. We asked Ernst & Young to summarize the processes employers follow in preparing Forms W-2; challenges they face in reporting such information timely; the impact of accelerating filing deadlines, and policy options to hasten availability of W-2 data. The report was intended to inform those involved in considering Information Reporting program improvements.

Background on W-2 Reporting

The Ernst & Young report identifies a key issue which may restrict policymakers' options in considering changes to Form W-2 reporting. That is, in addition to cash wages, employers are responsible for gathering and reporting as many as 50 distinct elements of compensation such as health and welfare benefits, equity compensation and various non-cash fringe benefits, many of which are administered by third parties, and/or which may not be determinable for several days or weeks after December 31¹. In a nutshell, a certain amount of time is necessary to ensure that Forms W-2 are correct and complete.

Form W-2 has become an increasingly critical information statement both for taxpayers and tax administrators, representing the primary tax statement for most U.S. taxpayers. As the tax laws have evolved, Form W-2 has become quite complex, with 10 fields for indicative data (names, addresses, EINs, SSN, and state and local information); three check-boxes; 15 monetary fields, as well as two monetary fields which are variably used. In one (Box 12), more than 26 monetary amounts are reported along with an alpha code to identify the amount being reported. (See appendix II for current Box 12 codes).

In the other (Box 14), more than a dozen tax, insurance and state and locally-defined deductions are reported, in addition to optional use by the employer. Each data element represents a distinct determination and recordkeeping responsibility of the employer. Each element is subject to extensive regulations. Refer to the [Ernst & Young LLP report](#) for a comprehensive discussion of employer W-2 and wage reporting obligations.

Alternatives to Accelerate Availability of Tax Information

Potentially feasible alternatives generally fall into one of the following categories:

- Earlier annual reporting deadlines
- More frequent W-2 reporting
- Expansion of the special rule for recognition of non-cash fringe benefits
- Reporting to the IRS directly
- Expanded electronic filing of information returns

Earlier annual reporting deadlines

This is the most obvious alternative. Employers have long been required to furnish Forms W-2 to employees by January 31. Several states and the District of Columbia already require employers to file Forms 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.

¹ See appendix I for examples

An earlier annual reporting deadline could invoke a trade-off between timeliness and accuracy. Currently, IRS statistics indicate that less than 1% of W-2s are subsequently amended. One NPRC member analyzed statistics of client submissions to assess the potential volume of W-2s that might need to be amended given an earlier deadline. Preliminary findings indicate that about 6% - 8% of employers² adjust W-2 data after their original summarization. Given an earlier deadline, some of these adjustments could result in amendments rather than corrected original submissions.

The current March 31 deadline was established to provide an incentive for filing electronically. However, the March 31 deadline was of little value to employers, given that the information is available in final form by the end of January.

The previous February 28th reporting deadline permitted time for review and adjustment, reconciliation with other tax reports, as well as formatting, generation and transmission or delivery of Forms W-2. Further study would be needed to assess the earliest deadline that would not compromise accuracy or impose increased employer burden.

More Frequent (i.e., Quarterly) W-2 Reporting

The notion of quarterly reporting of W-2s has been identified in the most recent Administration budget proposal, as it has been for several years. The IRS used to receive quarterly reports of each employee's earnings with Forms 941 until 1976, when Congress shifted quarterly reporting to the annual system that we know today, and authorized the Social Security Administration to process Forms W-2 for the IRS³.

This alternative deserves further study as to the costs and benefits. The IRS may benefit from seeking states' experiences, some of which have already shifted from annual W-2 reporting to quarterly reporting with a number of variations, such as requiring quarterly reporting instead of, or in addition to, annual W-2s.

One critical decision should be carefully analyzed, which is whether any quarterly report should include compensation paid and taxes withheld *this quarter*, or *this year to date*. If the amounts are quarterly, the IRS would need to build a record for each taxpayer of total earnings and withholding for the year. California and Maine have adopted such a system, and should be consulted as to its effectiveness. For example, are there problems due to Social Security Number or name corrections? This approach would also increase the volume of amendments, since any previously reported earnings and/or withholding would need to be amended.

Reporting earnings and withholding on a year-to-date basis would be closer to the present W-2 reporting system, but could raise other complications. For example, employers may need to report former employees each quarter, even if there are no current-quarter wages. Again, the IRS should consult with states that have relevant experience: New York requires reporting of

² "6% - 8% of employers" may equate to a larger percentage of employees and Forms W-2, because large employers have more complex compensation and benefits offerings, and make up much of the population with adjustments.

³ Public Law 94-202, January 2, 1976

year-to-date wages subject to income tax and withholding in fourth quarter only, by January 31. Massachusetts requires quarterly reports of wages and withholding in addition to annual W-2s.

Finally, the issue noted above and in the Ernst & Young report holds as true for quarterly earnings reports as is does for W-2 reporting: A certain amount of time is necessary to ensure that employer wage reports are correct and complete. There have been several studies to determine if quarterly wage reports could be due by to the 15th of the month following the reporting period. One state enacted a deadline of the 15th, but quickly repealed the law. A comprehensive U.S. Department of Labor study in 1997 (the most recent study available) concluded that most employers would not be able to meet a quarterly wage reporting deadline of the 15th of the month. All states, with one exception, require such reports on the 30th or 31st of the month following the reporting period.

Expand the Special Rule on Recognition of Certain Non-cash Fringe Benefits

It may help to expand of the special rule⁴ which permits employers to report certain in-kind fringe benefits provided during the last two months of a calendar year as paid during the subsequent calendar year; e.g., the taxable value of an employer-provided vehicle.

Particularly for benefits with complex valuation that are often dependent on data sources outside the control of the employer, enabling employers to establish an earlier input cutoff may enable earlier finalization of Forms W-2. However, when valuation involves a third party payee, for example a child care provider, delayed recognition of expense may complicate tax reporting. This alternative may only be useful in limited circumstances, but should be studied.

Reporting to the IRS Directly

Form W-2 is the only information return that is not currently filed directly with the IRS; and as mentioned earlier, the IRS used to receive reports of employee earnings from employers until 1976, when processing was shifted to the Social Security Administration.

In recent years, large employers are increasingly being contacted by specialized units within the IRS to request electronic W-2 data long before it must be filed with the Social Security Administration⁵. This information is requested on a voluntary basis to enable the IRS to validate claims of earnings and withholding *during* the tax season; i.e., to identify potential fraudulent W-2s and prevent refund fraud. The IRS typically accepts such information in any form, such as a copy of the W-2 file prepared for submission to the SSA. Thus, earlier availability of W-2 data to the IRS has proven valuable in practice. This system should be studied to assess larger-scale feasibility, costs and benefits. However, an unpredictable and ad-hoc system is difficult to administer. If warranted, it should be expanded so that employers know what to expect and are able to make arrangements in advance.

Over the years the Social Security Administration has continuously revised their data formats and systems to accommodate the need for increasingly detailed information required for tax

⁴ Announcement 85-113 (1985-31 I.R.B. 31, August 5, 1985)

⁵ See IRM 21.9.1.8 (10-01-2010) Verification of Income

administration purposes. The SSA has done an admirable job of efficiently processing W-2 submissions and making them available to the IRS on a continuous-flow basis during the tax season, so it is not clear that changing the filing destination would yield significant improvements. Much of the current delay in matching Forms W-2 to income tax returns might be eliminated through additional enhancements to IRS infrastructure and processing systems.

Expand Electronic Filing of Information Returns

The requirement to file Forms W-2 electronically was first established by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)⁶ and subsequent regulations. Surprisingly, the threshold for electronic filing remains unchanged some thirty years later, despite dramatic improvements in technology. Employers filing fewer than 250 Forms W-2 are still permitted to file in paper format. According to the Bureau of Labor Statistics, the current threshold affects about half of one percent (.005) of employers, which collectively employ over 25% of the private sector workforce⁷. This threshold for electronic filing recognized the substantial costs and difficulty involved in formatting, generating and mailing magnetic reel tapes, which was the applicable technology at the time.

Today, electronic submission of W-2s does not involve physical delivery, secure transmission of large files typically costs very little, and supporting software and services are widely available. As a best practice, payroll service providers have generally reported all Forms 941 and W-2 electronically and remitted all federal taxes electronically for many years, for improved accuracy and efficiency. Even small employers have been able to simultaneously create Forms W-2 for employees and electronically file them at no cost through the Social Security Administration's innovative Employer Services website⁸.

Again, the states should be consulted for their experience in expanding electronic filing of employment taxes, quarterly wage reports, annual W-2s and other information returns. Many states have successfully adopted a 100% e-file system, while others have adopted e-file thresholds of 25, 10 and even five employees. As documented in the Ernst & Young LLP report, one state administrator noted that shifting to electronic data transmissions had the same effect, in terms of hastening data availability to the agency, as shifting the actual due date one month earlier. The report identifies state electronic filing thresholds as of January 2011.

NPRC appreciates this opportunity to provide input concerning the opportunities facing the tax system over the next five years. We agree that the Real Time Tax concept represents a critical change opportunity for tax administrators, particularly in enabling effective measures to prevent refund fraud. The IRS and taxpayers would benefit from improvements to Information Reporting systems and rules. Each alternative discussed above would require additional study to assess feasibility and effectiveness. We would welcome the opportunity to work with the IRS and other stakeholders to consider these and other alternatives in more detail.

⁶ Public Law No: 97-248

⁷ BLS Quarterly Census of Employment and Wages 2011Q1, by size

⁸ See <http://www.ssa.gov/employer/>

Appendix I: Common Quarterly/Year-End Adjustment Items

W-2 reportable item	Employer	Third party	W-2 reportable item	Employer	Third party
401(k)---W-2 box 13 indicator		x	Expatriate wage update	x	x
Adoption assistance	x	x	Gift cards	x	x
Athletic club memberships	x	x	Gifts-noncash	x	
Award-length of service	x	x	Gross up-federal tax	x	x
Award-recognition	x	x	Gross up-local nonresident tax	x	x
Award-safety	x	x	Gross up-state nonresident tax	x	x
Business expense-non-accountable	x		Insurance-annuity		x
Club memberships	x		Jury duty-offset	x	
Credit card-nonaccountable		x	Living expenses	x	
Deferred comp-distributions		x	Loans-forgiven	x	
Deferred comp-earnings		x	Loans-interest income	x	x
Dependent care facility		x	Medical debit card		x
Dependent care flexible spending	x	x	Non-cash Award	x	x
Dining hall-executive	x		Parking	x	x
Disability pay-HI		x	Relocation- domestic	x	x
Disability pay-NJ		x	Relocation-foreign	x	x
Disability pay-NY		x	Scholarships	x	x
Disability pay-private fund		x	Settlement awards	x	x
Disability pay-PR		x	State disability Offset	x	x
Disability pay-state offset	x	x	Stock-W-2 box 12 indicators		x
Discounts-merchandise	x		Stock-ESPP		x
Discounts-services	x		Stock-ISO		x
Educational assistance	x	x	Stock-nonqualified		x
Expatriate totalization	x	x	Stock-restricted		x
Expatriate taxes	x	x	Transit benefits	x	x

Source: Ernst & Young LLP, *Business Processes and Considerations in Meeting Employee Wage Reporting Deadlines*, September 8, 2011, p. 14. Available on <http://www.nprc-inc.org/govc.html>.

Appendix II: W-2 Box 12 Codes

The following lists possible codes displayed in Box 12 when applicable:

- A—Uncollected social security or RRTA tax on tips.
- B—Uncollected Medicare tax on tips.
- C—Taxable cost of group-term life insurance over \$50,000 (included in boxes 1, 3 (up to social security wage base), and 5)
- D—Elective deferrals to a section 401(k) cash or deferred arrangement. Also includes deferrals under a SIMPLE retirement account that is part of a section 401(k) arrangement.
- E—Elective deferrals under a section 403(b) salary reduction agreement
- F—Elective deferrals under a section 408(k)(6) salary reduction SEP
- G—Elective deferrals and employer contributions (including nonelective deferrals) to a section 457(b) deferred compensation plan
- H—Elective deferrals to a section 501(c)(18)(D) tax-exempt organization plan.
- J—Nontaxable sick pay (information only, not included in boxes 1, 3, or 5)
- K—20% excise tax on excess golden parachute payments.
- L—Substantiated employee business expense reimbursements (nontaxable)
- M—Uncollected social security or RRTA tax on taxable cost of group-term life insurance over \$50,000 (former employees only).
- N—Uncollected Medicare tax on taxable cost of group-term life insurance over \$50,000 (former employees only).
- P—Excludable moving expense reimbursements paid directly to employee (not included in boxes 1, 3, or 5)
- Q—Nontaxable combat pay.
- R—Employer contributions to your Archer MSA. Report on Form 8853, Archer MSAs and Long-Term Care Insurance Contracts.
- S—Employee salary reduction contributions under a section 408(p) SIMPLE (not included in box 1)
- T—Adoption benefits (not included in box 1).
- V—Income from exercise of nonstatutory stock option(s) (included in boxes 1, 3 (up to social security wage base), and 5).
- W—Employer contributions (including amounts the employee elected to contribute using a section 125 (cafeteria) plan) to your health savings account.
- Y—Deferrals under a section 409A nonqualified deferred compensation plan
- Z—Income under section 409A on a nonqualified deferred compensation plan. This amount is also included in box 1. It is subject to an additional 20% tax plus interest.
- AA—Designated Roth contributions under a section 401(k) plan
- BB—Designated Roth contributions under a section 403(b) plan
- DD—Cost of employer-sponsored health coverage. The amount reported with Code DD is not taxable.
- EE—Designated Roth contributions under a governmental section 457(b) plan.