

Comments from Karen Botvin
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Real-Time Tax System Initiative

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Commissioner Shulman and Deputy Commissioners Miller and Tucker, thank you for inviting me here today. I appreciate the opportunity to participate in this panel discussion and to provide comments on your Real-Time Tax System Initiative. My professional career, both as chair of IRPAC a few years ago and as a senior tax manager at The Vanguard Group, Inc.¹ (“Vanguard”) for the last thirteen years, has focused on providing investors timely, accurate information they need to calculate their taxes and file their returns. We at Vanguard take seriously our role in helping our clients and the IRS in this regard and look forward to working with you in the coming years to improve the process.

I want to start by thanking you for extending invitations to broad stakeholder groups of tax form producers, preparers, software vendors, and other governmental agencies to collaboratively explore your vision for a Real-Time Tax System. Implementing your vision will require close coordination among these stakeholder groups. We believe this collaboration will be time well spent if as a result our clients – also taxpayers – find it easier to file their returns and pay their taxes. While we believe there will be challenges, such a system could help our clients by allowing them to learn when filing their returns whether they have made omissions or understatements in calculating their taxes. If designed and implemented effectively, this upfront validation could reduce administrative burdens on our clients and lessen the risk that they may owe penalties and interest for errors your systems currently find well after-the-fact. It could also allow you to focus your resources on more complex compliance issues, which should improve efficiency and fairness for all.

You asked me to focus today on aspects of producing Forms 1099-R that you should keep in mind as you design and implement such a system. As you know, we are quite familiar with this Form, producing approximately 2 million of them each year in our role as record-keeper for thousands of qualified plans having millions of participants and for millions of Individual Retirement Accounts (“IRAs”).

More corrected 1099-Rs: balancing accuracy and timing.

¹ Headquartered in Valley Forge, Pennsylvania, Vanguard is one of the world’s largest mutual fund firms. We offer more than 170 US mutual funds with combined assets of approximately \$1.7 trillion. We serve millions of shareholders including retirees, workers, families, and businesses whose objectives include saving for retirement, for children’s education, or otherwise for the future.

A Real-Time Tax System would accentuate the current trade-off between accuracy and timing, likely leading to more amendments or corrections to the Forms 1099-R we file with the IRS.

Today, we aim to deliver these forms to plan participants and investors as soon as possible after year-end, taking pride if we can do so more quickly this year than we did last year. But there are limits on our ability to compress the existing timeline further, some of which I will highlight in a minute. At the same time, we also aim to deliver the Form 1099-R data to the IRS within the allowed timeframe, emphasizing completeness and accuracy of the initial filing.

Your research shows that less than 1% of total information return volume is currently from amendments or corrections to the original return. The length of time from when the tax forms are due to the taxpayer to when the electronic file is due to the IRS strongly influences this percentage. For example, we mail our Forms 1099 to our investors starting the middle of January and continuing through the middle of February, depending on the specific version of the form. But we are not required to file our data with the IRS until April or May, with extensions. We use that 2-3 month period to make any needed corrections that are identified by plan participants and clients when they review the forms, allowing us to provide the IRS with one initial form that incorporates these changes rather than an initial form that does not and then multiple corrected forms thereafter. In fact, of the roughly 2 million Forms 1099-R we produce each year, less than 1,000 are amended forms.² Under the Real-Time Tax System proposal, we could be required to file our data with the IRS much earlier, which would require us to file amendments and corrections throughout the tax season.

Current law makes it costly for information return producers to send data to the IRS before ensuring it is as accurate as possible. To the extent the new tax system requires us to emphasize timing rather than initial accuracy, we would ask you to consider providing relief from 972CG penalty notices for correcting more than ½ of 1% of forms filed (see IRC §6721 and §6722).

Information return producers also emphasize accuracy over timing because doing so protects clients from concerns they may have about incomplete or inaccurate initial data being provided to the IRS. Under the new system, our clients could presumably try to file their returns with the IRS, receive a “failure to match” notice in real time, call us to discuss accuracy, and then try filing again with the IRS. We recommend keeping an eye on this potential back-and-forth process as you design the new system, taking care to ensure an efficient, positive experience for taxpayers.

² We offer a daily valuation service. We understand that some plan record keepers offer monthly or quarterly valuation services, which we expect would make it even more difficult for them to handle an accelerated filing schedule.

We expect this trade-off between accuracy and timing to play out more dramatically for earlier reporting of distributions from qualified plans under IRC §401(a) and 403(b) than from IRAs under IRC §408.

Record keepers generally coordinate with plan sponsors and third parties to ensure accurate reporting for all plan participants. This takes time.

- For example, we coordinate with plan sponsors in deeming delinquent plan loans. A third quarter delinquent loan becomes deemed at the end of its cure period of 12/31. Plan sponsors generally need time to review each deemed loan to ensure accurate processing. Only after that time can we calculate the accrued interest and actually deem the loan. Accelerating the timeframe for reporting in this case would sacrifice accuracy.
- We also need to receive data from third parties, in addition to plan sponsors, before we can accurately report. For example, calculating the tax on an employee's share of life insurance premiums paid by the employer, otherwise known as PS 58 costs in a qualified plan, requires information from insurance companies. This data generally is provided within 5 to 6 business days after year end and can only then be loaded into our systems for inclusion on Forms 1099-R.
- Coding qualified plan distributions can also require coordination after year-end to ensure accuracy. For example, when a participant takes multiple distributions throughout the year ending with a total distribution within that same calendar year, we have to update the coding of those previous distributions to ensure the correct lump sum distribution code is reported on the tax form.

Some have proposed managing this tension between timeliness and accuracy by changing the time period for filing individual tax returns. Currently that period runs simultaneous with the period for information return producers to check their data and send to the IRS. Making these filing periods consecutive rather than simultaneous may alleviate some trade-offs between accuracy and timing, but it would involve considerable change management. Individuals have settled expectations about when their tax returns are due each year.

Limitations beyond timing

In addition to finding the right balance between accuracy and timing, we suggest keeping in mind that the new system may fall short of the ideal goal of perfect real-time matching.

- For example, excess deferral processing under IRC §402(g) may produce 2 different tax forms: one for the prior year excess deferrals removed from the

plan prior to April 15th of the year after the excesses were contributed and another for the accrued earnings in the year the excess is distributed. This will cause a mismatch between information returns and the Forms 1040 in both years.

- As another example, taxpayers can take a distribution from a retirement vehicle (qualified plan or IRA) and have 60 days in which to roll that money over or place it back into the same retirement vehicle. The initial distribution will produce a Form 1099-R coded as a normal distribution or early distribution subject to excise tax. However, if the money is ultimately rolled over within 60 days, a Form 5498 will be produced in May of the year following the distribution. This causes confusion today with some taxpayers as the Form 5498 lags behind the Form 1040 filing season. It will also cause a mismatch of data to the IRS.

Coordinating with states

We would encourage the states to conform their respective information return requirements to the new federal system as much as possible. 31 of the 41 states (including the District of Columbia) that have a state income tax currently participate in the combined filing program. We would urge them to partner with you to further simplify the filing process and eliminate any unnecessary duplication of data transmissions. This will reduce demands on our resources and help safeguard client data.

Systems, staff, and procedures

We would need adequate time to implement a Real-Time Tax System. In particular, we would need time to modify our systems and to build a new client service model during tax season.

- *Systems.* Vanguard issues roughly 6 million Forms 1099 each year shortly after posting year-end dividends and interest payments to client accounts. While producing these forms, we are also producing monthly and quarterly client statements and continuing to do normal daily processing on the same systems. Providing substantially more data to the IRS in the same timeframe would require us to modify, perhaps expand, and certainly to test these systems before running live processing.
- *Client service staff and procedures.* We would also need to staff our client support and tax reporting areas differently during the tax season to ensure the need for clarification and/or corrected tax forms can be handled appropriately and in a timely manner for our clients. "Timely" could mean as soon as 24 hours depending on how the IRS chooses to reject the Form 1040 filing for mismatched data.

Coordinating the roll-out with other initiatives

Finally, while we support efforts to simplify and improve our clients' experience filing tax returns with the IRS, and genuinely look forward to working with you on this initiative in the future, we nonetheless want to mention that we view these efforts in a broader, already challenging operating context.

Information return producers are adjusting their systems, staffing, and procedures to comply with multiple information reporting changes already underway.

- *Cost basis.* For example, 2012 marks the first year that brokers are required to provide cost basis data for stocks. Reporting expands next spring to include mutual fund shares and dividend reinvestment plans, and then again the following year to cover bonds and derivatives. Modifying our systems to comply with these regulations has kept us quite busy for several years and will continue doing so into the foreseeable future.
- *FATCA.* Information return producers are preparing to modify their global systems to comply with FATCA. At this writing, we are awaiting regulations that will outline a phased-in reporting and withholding regime starting in 2014. We expect this initiative to require more systems changes and resources than cost basis.
- *State reporting.* Finally, we are increasingly seeing the states mandating different types of tax reporting and withholding, requiring our systems and employees to be flexible and adaptable along multiple dimensions.

Notwithstanding the challenges identified in this writing, Vanguard supports your goals for the Real-Time Tax System Initiative – particularly your goal of making it easier for taxpayers to calculate and pay their taxes – and appreciates the opportunity to work with you as you design and implement it.