

Internal Revenue Service Public Hearing
Proposed Real-Time Tax System
Comments from the National Payroll Reporting Consortium
January 25, 2012

Early in 2011 the IRS began speaking about its vision for a “Real Time Tax System,” in which information returns (e.g., W-2s and 1099s) would be on file with the IRS when the Income tax season started, moving from a “look back” compliance model to more concurrent matching of information returns to tax returns as they are filed.

Availability of third party information reporting to the tax system during the processing season would enable dramatic improvements to the U.S. tax system in terms of efficiency, accuracy and reduced taxpayer burden. Taxpayers would be able to correct their returns before the IRS processed them, at the time when relevant records are most easily available and memories are freshest. Aside from improving accuracy and taxpayers’ filing experience, this initiative is also necessary to combat tax refund fraud. The IRS optimally needs to be able to validate taxpayer income and withholding claims before releasing refunds, which is not possible with current systems, rules and deadlines.

We appreciate the initiative of Commissioner Shulman and the Service for soliciting stakeholder comments and holding these public meetings. Given the dramatic advances in technology since the information reporting and matching programs were initially designed, it seems a very timely and appropriate issue to consider.

The National Payroll Reporting Consortium (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 an important role in our nation's tax collection system 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 employment tax administration.

NPRC members have followed this proposal closely over the past year and commissioned a formal 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 LLP to summarize the processes that employers follow in preparing Forms W-2; challenges organizations face in reporting such information timely; the impact of accelerating current filing deadlines, and policy considerations that may hasten the availability of W-2 data. The report was intended to inform those involved in considering IRS Information Reporting program improvements.

The report summarizes a key issue for the Real Time Tax System initiative. 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 31. See appendix I for examples.

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. Any “Real Time Tax System” would need to address Form W-2 reporting to be effective. As tax laws have evolved, Form W-2 has also become the most complex information return, 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. One of these is Box 12, in which more than 26 defined monetary amounts are reported along with an alpha code to identify the amount being reported; the other is Box 14 (“Other”), in which more than a dozen tax, insurance and various other state and locally-defined deductions are reported, in addition to optional use by the employer. (See appendix II for current Box 12 codes).

Each data element represents a distinct determination and recordkeeping responsibility of the employer and virtually all are subject to extensive regulations. Interested parties should review the full [Ernst & Young LLP report](#) for a comprehensive discussion of employer W-2 and wage reporting obligations.

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 briefly explain why employers require a certain amount of time to accurately administer Forms W-2, and to summarize some alternatives that could be explored to accelerate availability of information returns to the IRS. Each would need significant additional study to assess its feasibility and effectiveness in achieving the RTTS vision.

Moving to Solutions: Possible Alternatives to Accelerate Availability of Tax Information

Potential alternatives generally fall into one of the following general categories:

- Earlier annual reporting deadlines
- Preliminary and final/corrected submissions
- Expansion of the special rule for recognition of non-cash fringe benefits
- More frequent (i.e., quarterly) W-2 reporting
- Reporting to the IRS directly
- Expand 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. 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.

An earlier annual reporting deadline would likely invoke a trade-off between timeliness and accuracy, for reasons described in more detail below. IRS statistics indicate that less than 1% of W-2s are subsequently amended. This low percentage is possible in part because current deadlines provide time for employees to review the forms and notify their employer of adjustments needed.

The payroll services industry may be able to contribute statistics to illuminate the potential volume of W-2s that might need to be amended or corrected given an earlier deadline. As clients of payroll service providers submit final adjustments and payroll data at the end of each quarter for reporting, some payroll firms track the volume of client submissions by date. Such firms also track the volume of subsequent adjustments submitted by clients after their original quarter summarization, which is in the range of 6% - 8% of *employers*, under current deadlines.

Adjustments prior to an input cutoff date are incorporated into original filings (W-2s), and earlier deadlines would increase the volume of amended W-2s. The volume of amended W-2s would likely be much higher than the 6% - 8% range noted, because large employers have more complex compensation and benefits offerings, and make up much of the population with adjustments.

The current March 31 deadline was established largely to provide an incentive and benefit for filing electronically. However, aside from permitting time for employers to make adjustments, the March 31 deadline offered few benefits, given that the information was 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 feasible deadline without compromising accuracy or imposing undue employer burden.

Preliminary and final/corrected submissions

The Ernst & Young LLP report effectively explains the crucial issue and reason that employers need at least one month to prepare Forms W-2. That is, in addition to cash wages, employers are responsible for gathering and reporting as many as fifty elements of compensation, some of which are administered by third parties (see appendix I). Whereas cash wages are known as of the last day of the year, the value of benefits and certain other types of compensation is often not determinable for two weeks or more after December 31.

For example, some third party administrators are not required to provide such information to employers until as late as January 15. Without legislative and/or regulatory changes, employers can not be expected to receive and process third party information much earlier than January 20th. Additional time would still be necessary to process such input; to produce and check revised W-2 reports and electronic files; to review final output with tax advisors and to submit the reports to the government. Given the diverse sources and timing of reportable compensation information, a deadline prior to January 31 may be very problematic.

Alternatively, to the extent that preliminary reports would be helpful in solving some of the challenges faced by the IRS, particularly in the area of refund fraud, consideration of a system to accept preliminary and final submissions may be warranted. That is, since cash wages and withholding are generally known by the last day of the year, initial reports could be submitted much earlier, followed by subsequent revisions which would replace earlier versions. Again, this approach would be most useful in terms of preventing refund fraud (i.e., identifying false W-2s that were not actually issued by an employer, overstated claims of withholding, etc.) and less useful in enabling earlier validation of income tax returns.

If this is of interest, consideration should be given to revising the existing Form W-2C amendment process, which some view as a process more appropriate when the technology of

the day involved showing one's work and attaching an adding machine tape for auditor review. Form W-2C requires that amounts originally reported be set out, as well as corrected amounts and difference amounts. There is a substantial amount of unnecessary workload, errors and notice volume associated with version control; e.g., ensuring that any "originally reported" figures match what the IRS may have received and posted.

Instead, the IRS may wish to consider a replacement arrangement, in which revised W-2s have a date/time stamp and any subsequent versions between the same employer and employee would represent the most current and complete version (i.e., replacement, not supplemental, unless specifically marked as supplemental). Separate employment tax forms (e.g., form 941X) would continue to guide employers through the process of determining and reporting any tax differences. In any event, the respective computer systems producing and receiving the revised W-2s can determine any tax differences. Employees already typically need a separate explanation detailing the reason(s) for any Forms W-2C.

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

It may help to expand of the special rule¹ 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.

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

The notion of more frequent reporting of W-2s has been identified as an Administration budget proposal for several years. We are also reminded that the IRS used to receive quarterly reports of each employee's earnings with Forms 941. It wasn't until 1976 that Congress shifted this quarterly reporting to the annual system that we know today, and authorized the Social Security Administration to receive and process Forms W-2 for the IRS². This alternative deserves further study as to the costs and benefits.

The IRS may find substantial help from the states, 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, and employer changes such as acquisitions and successorships?

¹ Announcement 85-113 (1985-31 I.R.B. 31, August 5, 1985)

² Public Law 94-202, January 2, 1976

In addition, this approach would tend to increase the volume of required 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, there may need to be requirements that once an employee is reported, the employer must continue to report them for the balance of the year, even if there are no current-quarter wages. New York requires reporting of year-to-date wages subject to income tax and withholding in fourth quarter only, with a due date of January 31. Massachusetts requires reporting of quarterly wages and withholding, in addition to annual W-2s.

Reporting to the IRS Directly

Increasingly in recent years, large employers are being contacted by specialized units within the IRS to request electronic W-2 data long before it is due to be filed with the Social Security Administration. This information is requested on a voluntary basis in order to enable the Service 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 the employer is able to provide; typically a copy of the W-2 file prepared for submission to the SSA is accepted. Thus, in practice, earlier availability of W-2 data to the IRS from employers directly has proven valuable. This system should be carefully studied to assess feasibility, costs and benefits. However, an unpredictable and ad-hoc system is costly and difficult for employers and the Service 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 struggled to keep up with the need to continuously revise their data formats and systems to accommodate the need for increasingly detailed information required for tax administration purposes. Recently the SSA has had to consider redesigning core systems, in part to accommodate the more than 26 separate elements of compensation reported in Box 12 of the W-2, which have been subject to frequent additions.

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 and processing arrangements 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)³ 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

³ Public Law No: 97-248

sector workforce⁴. The threshold for electronic filing recognized the substantial costs and difficulty involved at the time, 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 little or nothing, and supporting software and services are widely available. As a best practice, payroll service providers have generally reported all Forms 941 and W-2s 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 website⁵.

Again, the Service should look to the states for their experience in expanding electronic filing of employment taxes, quarterly wage data, 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 earnings reports hastened availability to the agency by one month over paper. The report identifies state electronic filing thresholds as of January 2011.

In closing, NPRC appreciates this opportunity to be of service in reassessing IRS Information Reporting systems and reporting deadlines. We would welcome the opportunity to work with the IRS and other stakeholders to consider these and other alternatives in more detail.

⁴ BLS Quarterly Census of Employment and Wages 2011Q1, by size

⁵ 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
- CC (For employer use only)—HIRE exempt wages and tips [2010 only]
- 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.