Improve the Filing Process

#4 REVISE E-FILING PROCEDURES SO THAT TAXPAYERS ARE INFORMED OF E-FILING ERRORS AND ARE NOT SUBJECT TO FAILURE-TO-FILE PENALTIES WHEN THOSE ERRORS ARE TIMELY CORRECTED

Present Law

Internal Revenue Code (IRC) § 6651 imposes an addition to tax when a taxpayer fails to file a return by the return due date, unless the taxpayer can show the failure was due to reasonable cause and not to willful neglect (hereinafter, the "failure-to-file penalty").

In the IRS Restructuring and Reform Act of 1998, Congress adopted a policy that "paperless filing should be the preferred and most convenient means of filing Federal tax and information returns" and directed the IRS to set a goal of having at least 80 percent of all tax and information returns e-filed by 2007.[22]

IRC § 6011(f) provides the IRS with broad authority to issue regulations to promote e-filing. However, it does not establish standards for processing e-filed returns.

In the paper filing context, courts have held that a taxpayer's submission to the IRS is presumptively valid as a tax return to be accepted for processing if it, among other things, contains sufficient information to calculate a tax liability.[23]

Under current IRS policy, authorized e-file providers of business returns are given ten days to resubmit a return after an e-filed return is rejected.[24]

Reasons for Change

Unlike with paper-filed returns, IRS procedures provide that e-filed returns may be rejected, and thus considered "not filed," for a variety of reasons not essential to calculating tax liability.[25] If a taxpayer fails to timely refile a return after it is rejected, he or she will be subject to the failure-to-file penalty. Thus, a taxpayer who e-files a return may be subject to penalties in circumstances where the identical return submitted on paper would be accepted and deemed timely filed.

The IRS's procedures that govern rejected e-filed returns raise the following concerns:

- *Taxpayers are not directly notified by the IRS if it rejects a return.* The majority of taxpayers file returns electronically and generally assume they have fulfilled their tax obligations unless they receive an IRS notice in the mail or a notification from the software provider or preparer they used. However,

22 Pub. L. No. 105-206, § 2001(a), 112 Stat. 685, 723 (1998).

23 *See*, *e.g.*, *Beard v. Comm'r*, 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986). Under the test, a return will be valid if (i) the information on the return is sufficient for the IRS to calculate the tax liability; (ii) the filed document purports to be a tax return; (iii) the return makes an honest and reasonable attempt to comply with the tax laws; and (iv) the taxpayer executes the return under penalties of perjury.

24 *See* IRS Pub. 4163, Modernized e-File (MeF) Information for Authorized IRS e-File Providers for Business Returns 53-54 (Dec. 2018).

25 *See* IRS Pub. 1345, Handbook for Authorized IRS e-File Providers of Individual Income Tax Returns (Feb. 2019). Reasons for rejections include missing forms, misspelled names, and duplicated or mismatched Social Security numbers. *See* IRS Pub. 4164, Modernized e-File (MeF) Guide for Software Developers and Transmitters (Nov. 2019).

the IRS does not directly notify taxpayers of rejected e-filed returns. Instead, it provides notification to the electronic return originator (generally, the software company). Moreover, when a taxpayer relies on a return preparer to prepare and e-file a return, as most taxpayers do, the electronic return originator provides notification of a rejection to the preparer — not the taxpayer. The IRS does not mail taxpayers a notification stating whether it received and accepted an e-filed return, so a taxpayer will not necessarily find out quickly if his or her return is rejected.

- *Taxpayers are limited in their ability to proactively determine whether their returns or other filings have been received by the IRS.* The IRS's "Where's My Refund" feature is not available for all forms or for taxpayers who are not claiming a refund. When taxpayers are unaware their returns have been rejected, they are unable to timely address the reason for the rejection and are at risk of incurring a failure-to-file penalty.[26]
- *The IRS does not provide sufficient time for taxpayers to resubmit rejected returns.* If an e-filed return is rejected, the taxpayer must fix the underlying problem and resubmit a paper return by the latter of the return due date or ten days from the date the error notification was received. While ministerial errors, like misspelled names, can be corrected easily, other issues may require more time (*e.g.*, where a taxpayer must locate additional documentation or where a taxpayer needs to consult with a tax professional). Taxpayers in vulnerable populations that use free tax return preparation services, such as the Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs, may face delays in scheduling a time to return for assistance. Taxpayers who are sick or traveling face similar challenges, as they may not have immediate access to documents required to correct mistakes.
- *Treating rejected returns as "not filed" and subject to a penalty discourages taxpayers from e-filing.* Although Congress has directed the IRS to facilitate and encourage e-filing, taxpayers who choose to do so are held to a higher standard than taxpayers who file paper returns. Unlike in the case of e-filed returns, if a taxpayer's paper return contains an error, such as a mismatched Social Security number, the IRS will still accept the return for processing instead of rejecting it. The IRS has procedures for resolving errors of this nature through internal editing and correspondence with the taxpayer, thus precluding the risk of a failure-to-file penalty.[27] The fact that taxpayers who e-file their returns are at greater risk than paper filers of having their returns rejected and being subject to the failure-to-file penalty serves as a deterrent to e-filing, which undermines Congress's and the IRS's policy objective.

Recommendations

- Amend IRC § 6011(f) as follows:
  - Require the IRS to send taxpayers an "e-filing receipt" via the taxpayer's chosen method of correspondence to indicate the IRS's acceptance or rejection of a return and, in the case of a rejected return, to provide information about the steps necessary to resolve the problem.
  - Provide a ten-day window after an e-filed return is rejected for taxpayers to resubmit the return.
  - Convert rejected e-filed returns into paper-processible returns if they remain unresolved after the ten-day window closes.

26 For a related recommendation, see National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Extend Reasonable Cause Abatement of the Failure-to-File Penalty to Taxpayers Who Rely on Return Preparers to e-File Their Returns)*, *infra*.

27 *See, e.g.*, IRM 3.11.3.13.4, Dependent's Name Control and TIN (Jan. 1, 2016).

- Amend IRC § 6651 as follows:
  - Provide that a return timely resubmitted and accepted by the IRS within the ten-day window (as proposed in the second recommendation to amend IRC § 6011(f) above) will be treated as timely filed and therefore not subject to the failure-to-file penalty.
  - Provide that the failure-to-file penalty will not be imposed when the IRS converts an e-filed return into a paper-processible return (as proposed in the third recommendation to amend IRC § 6011(f) above).

#5 TREAT ELECTRONICALLY SUBMITTED TAX PAYMENTS AND DOCUMENTS AS TIMELY IF SUBMITTED BEFORE THE APPLICABLE DEADLINE

Present Law

Internal Revenue Code (IRC) § 7502(a)(1) provides that if certain requirements are satisfied, a mailed document or payment is deemed to be filed or paid on the date of the postmark stamped on the envelope. Therefore, if the postmark shows a document or payment was mailed on or before the due date, it will be considered timely, even if it is received after the due date.

IRC § 7502(b) and (c) provide that this timely mailed/timely filed rule (commonly known as the "mailbox rule") applies to documents sent by U.S. postal mail, private delivery services, and electronic filing through an electronic return transmitter. However, the statutory mailbox rule does not apply to all filings and payments. With respect to certified mail and electronic filing, the Secretary is authorized to promulgate regulations describing the extent to which the mailbox rule shall apply.[28] To date, the only regulations the Secretary has promulgated relating to electronic filing cover documents filed through an electronic return transmitter.[29]

Reasons for Change

The statutory mailbox rule in IRC § 7502 does not apply to the electronic transmission of payments to the IRS. In addition, the mailbox rule does not apply to the electronic filing of time-sensitive documents (except documents filed electronically with an electronic return transmitter).[30] If the IRS does not receive an electronically submitted document (including a facsimile transmission) or payment until after the due date, the document or payment is considered late, even if the taxpayer can produce a confirmation that he or she transmitted the payment or document before the due date. The comparatively unfavorable treatment of electronically submitted documents and payments undermines the IRS's efforts to encourage greater use of digital services and imposes additional cost and burden on taxpayers and the IRS alike.

Along similar lines, the IRS encourages U.S. taxpayers to make payments electronically using the Treasury Department's Electronic Federal Tax Payment System (EFTPS). However, the EFTPS website displays the following warning: "Payments using this Web site or our voice response system must be scheduled by **8 p.m. ET the day before the due date** to be received timely by the IRS. The funds will move out of your banking account on the date you select for settlement" (emphasis in original).[31] This limitation applies to all payments.

Example: If a taxpayer owes a balance due on April 15 and mails the payment to the IRS before midnight on April 15, the payment will be considered timely, even though it will probably take about a week until the IRS receives, opens, and processes the check. If the same taxpayer submits the payment on EFTPS, the payment will be considered late if submitted after 8 p.m. on April 14 (28 hours earlier), even though the payment generally would be debited from the taxpayer's account on April 16 — about one week sooner than if submitted by mail.

This disparity in the treatment of mailed and electronically submitted payments makes little sense. As compared with a mailed check, an electronic payment is received more quickly, is cheaper to process, and

28 IRC § 7502(c)(2).

29 Treas. Reg. § 301.7502-1(d).

30 *See* Treas. Reg. § 301.7502-1(d)(3)(i) (containing a definition of an electronic return transmitter). *See also* Rev. Proc. 2007–40, 2007–1 C.B. 1488 (providing a list of documents that can be filed electronically with an electronic return transmitter).

31 *See* www.eftps.gov (last visited Aug. 29, 2019).

eliminates the risk that a mailed check will be lost or misplaced. Yet rather than encouraging taxpayers to use EFTPS, the earlier deadline serves as a deterrent.

Recommendation

- Amend IRC § 7502 to direct the Secretary to issue regulations that apply the mailbox rule comparably to all documents and payments submitted by a taxpayer regardless of whether they are submitted electronically or by mail.

#6 AUTHORIZE THE IRS TO ESTABLISH MINIMUM COMPETENCY STANDARDS FOR FEDERAL TAX RETURN PREPARERS

Present Law

Current law imposes no competency or licensing requirements on tax return preparers. Attorneys, certified public accountants, and enrolled agents are required to take courses and pass competency tests. Volunteers are required to pass competency tests as part of the Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs. But most preparers are non-credentialed and are not required to pass any competency tests or take any courses in tax return preparation.

Reasons for Change

The IRS receives more than 150 million federal income tax returns every year, and the majority are prepared by paid tax return preparers. For that reason, both taxpayers and the tax system depend heavily on the ability of preparers to prepare accurate tax returns. Yet numerous studies have found that non-credentialed tax return preparers routinely prepare inaccurate returns, which has the effect of harming taxpayers, the public fisc, or both.

To protect the public, federal and state laws generally require lawyers, doctors, financial planners, actuaries, appraisers, contractors, motor vehicle operators, and even barbers and beauticians to obtain licenses or certifications, and in most of these cases, they are required to pass competency tests. Taxpayers and the tax system would benefit from requiring minimum standards of tax return preparers as well.

The following studies illustrate the extent of inaccurate return preparation:

Government Accountability Office (GAO). In 2006, GAO auditors posing as taxpayers made 19 visits to several national tax return preparation chains in a large metropolitan area. Using two carefully designed fact patterns, they sought assistance in preparing tax returns. On 17 of 19 returns, preparers computed the wrong refund amounts with variations of several thousand dollars. In five cases, the prepared returns reflected unwarranted excess refunds of nearly $2,000. In two cases, the prepared returns would have caused the taxpayer to overpay by more than $1,500. In five out of 10 cases in which the Earned Income Tax Credit (EITC) was claimed, preparers failed to ask where the auditor's child lived or ignored the auditor's answer to the question and consequently prepared returns claiming ineligible children.[32]

The GAO conducted a similar study in 2014. It again found that preparers computed the wrong tax liability on 17 of the 19 returns they prepared.[33]

Treasurer Inspector General for Tax Administration (TIGTA). In 2008, TIGTA auditors posing as taxpayers visited 12 commercial chains and 16 small, independently owned tax return preparation offices in a large metropolitan area. All preparers visited by TIGTA were non-credentialed. Of 28 returns prepared, 61 percent were prepared incorrectly. The average net understatement was $755 per return. Of seven returns involving EITC claims, *none* of the preparers exercised appropriate due diligence as required under IRC § 6695(g).[34]

32 GAO, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* (Apr. 4, 2006) (statement of Michael Brostek, Director – Strategic Issues, Before the Committee on Finance, U.S. Senate).

33 GAO, GAO-14-467T, *Paid Tax Return Preparers: In a Limited Study, Preparers Made Significant Errors* (Apr. 8, 2014) (statement of James R. McTigue, Jr., Director – Strategic Issues, Before the Committee on Finance, U.S. Senate).

34 TIGTA, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008).

New York State Department of Taxation and Finance. During 2008 and 2009, agents conducted nearly 200 targeted covert visits in which they posed as taxpayers and sought assistance in preparing income or sales tax returns. In testimony at an IRS Public Forum, the Acting Commissioner of the New York Department of Taxation and Finance testified that investigators found "an epidemic of unethical and criminal behavior."[35] At one point, the Department reported that it had found fraud on about 40 percent of its visits, and it had made more than 20 arrests and secured 13 convictions.[36]

IRS Study on EITC Noncompliance. The IRS conducted a study to estimate compliance with EITC requirements during the 2006-2008 period. Among the findings of the study, unaffiliated unenrolled preparers (*i.e.*, non-credentialed preparers who are not affiliated with a national tax return preparation firm) were responsible for "the highest frequency and percentage of EITC overclaims." The study found that half of the EITC returns prepared by unaffiliated unenrolled preparers contained overclaims, and the overclaim averaged between 33 percent and 40 percent.[37]

In 2002, before these studies were published, the National Taxpayer Advocate began recommending that Congress authorize the IRS to conduct preparer oversight based on her experience in private practice. Her proposal received widespread support from stakeholders and members of Congress. The Senate Committee on Finance twice approved legislation authorizing preparer oversight on a bipartisan basis under the leadership of Chairman Grassley and Ranking Member Baucus,[38] and on one occasion, the full Senate approved it by unanimous consent.[39] In 2005, the House Ways and Means Subcommittee on Oversight held a hearing at which representatives of five outside organizations expressed general support for preparer oversight.[40]

In 2009, the Commissioner of Internal Revenue concluded that the IRS had the authority under § 330 of Title 31 of the U.S. Code to impose minimum standards without statutory authorization. The IRS initiated an extensive series of hearings and discussions with stakeholder groups to receive comments and develop a system within which all parties believed they could operate.[41] The IRS began to implement the program in 2011, but it was terminated after a U.S. District Court rejected the IRS's legal position, concluding it does not have the authority to impose preparer standards without statutory authorization.[42]

Since that time, members of the House and Senate have introduced legislation that would provide the IRS with the statutory authorization to establish and enforce minimum standards. In the Senate, Senators Portman and Cardin sponsored bipartisan authorizing legislation in 2018,[43] and Senators Wyden and Cardin sponsored similar legislation in 2019.[44] In the House, Congressman Yoho and Congressman Panetta sponsored

35 Statement of Jamie Woodward, Acting Commissioner, New York Dept. of Taxation and Finance, before IRS Tax Return Preparer Review Public Forum (Sept. 2, 2009).

36 *Id.*; *see* Tom Herman, *New York Sting Nabs Tax Preparers*, Wall Street Journal (Nov. 26, 2008).

37 IRS Pub. 5162, Compliance Estimates for the Earned Income Tax Credit Claimed on 2006-2008 Returns 24–26 (Aug. 2014).

38 Tax Administration Good Government Act, H.R. 1528 (incorporating Tax Administration Good Government Act, S. 882), 108th Cong. § 141 (2004); Telephone Excise Tax Repeal Act, S. 1321 (incorporating Taxpayer Protection and Assistance Act, S. 832), 109th Cong. § 203 (2006).

39 Tax Administration Good Government Act, H.R. 1528 (incorporating Tax Administration Good Government Act, S. 882), 108th Cong. § 141 (2004).

40 The organizations were the American Bar Association, the American Institute of Certified Public Accountants (AICPA), the National Association of Enrolled Agents, the National Society of Accountants, and the National Association of Tax Professionals. *See Fraud in Income Tax Return Preparation*: *Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109th Cong. (2005).

41 *See* IRS Pub. 4832, Return Preparer Review (Dec. 2009).

42 *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. 2013), *aff'd*, 742 F.3d 1013 (D.C. Cir. 2014).

43 Protecting Taxpayers Act, S. 3278, 115th Cong. § 202 (2018).

44 Taxpayer Protection and Preparer Proficiency Act, S. 1192, 116th Cong. (2019).

bipartisan authorizing legislation in 2019,[45] and former Congresswoman Black and former Congressman Becerra, both members of the Ways and Means Committee, sponsored similar legislation in the recent past.[46]

The IRS's evolving "Future State" plan provides an important additional basis for establishing preparer standards. The IRS envisions giving preparers access to taxpayer information through online accounts. The security risks of this plan are significant, and if the IRS proceeds with it, steps must be taken to mitigate the risks. Minimum standards for preparers are one important step. Some have argued that requiring preparers to pass a competency test and take annual continuing education courses would address only the issue of competence and would not ensure preparers conduct themselves ethically. The National Taxpayer Advocate agrees that competency and ethical conduct are distinct issues. However, we think preparer standards would serve to raise ethical conduct as well as competency levels. A preparer who learns enough about tax return preparation to pass a competency test and takes annual continuing education courses would be demonstrating a commitment to return preparation as a profession. As such, the preparer would be more likely to understand and feel like a part of the tax system and would have more to lose if he or she is found to have engaged in misconduct.

In sum, the GAO, TIGTA, and other compliance studies described above suggest that tax returns prepared by non-credentialed preparers are often inaccurate. Minimum standards would directly improve preparer competency levels and are likely to raise ethical norms as well.

Recommendation

- Amend Title 31, § 330 of the U.S. Code to authorize the Secretary to establish minimum standards for federal tax return preparers.[47]

45 Taxpayer Protection and Preparer Proficiency Act, H.R. 3330, 116th Cong. (2019).

46 *See* Tax Return Preparer Competency Act, H.R. 4141, 114th Cong. § 2 (2015) (Cong. Black) and Taxpayer Rights Act of 2015, H.R. 4128, 114th Cong. § 202 (2015) (Cong. Becerra).

47 For legislative language generally consistent with this recommendation, see Taxpayer Protection and Preparer Proficiency Act, S. 1192 & H.R. 3330, 116th Cong. (2019) and other bills cited herein.

#7 DIRECT THE IRS TO SET GOALS OF SUBSTANTIALLY INCREASING THE USAGE RATE AND THE RETENTION RATE OF THE FREE FILE PROGRAM BY FILING SEASON 2025 AND TO REPLACE FREE FILE WITH AN ALTERNATIVE APPROACH IF THOSE GOALS ARE NOT ATTAINED

Present Law

Section 2001(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) directed the IRS to set a goal of increasing the e-file rate to at least 80 percent by 2007.[48]

Reasons for Change

In response to the RRA 98 directive, the IRS in 2002 entered into an agreement with a consortium of tax return preparation software providers known as the Free File Alliance.[49] Under the agreement, the software companies make their products available for free to, in the aggregate, 70 percent of all taxpayers, or about 105 million taxpayers in tax year (TY) 2018. In exchange, the IRS refrains from competing with these companies; therefore, the IRS does not develop or make its own software available to taxpayers. Eligibility for Free File software is based on adjusted gross income (AGI). Taxpayers with incomes currently below about $66,000 qualify. All taxpayers, including taxpayers with higher AGIs, may use Free File Fillable Forms, the electronic version of IRS paper forms.[50]

As presently organized and operated, the Free File program provides limited benefits to taxpayers and consumes IRS resources to administer. The program should be substantially improved or replaced.

While the IRS and the software industry often tout Free File as a model public-private partnership, the reality is the parties to this transaction have opposite objectives in key respects. The IRS is (or should be) aiming to make the filing process as painless and inexpensive for taxpayers as possible. Therefore, it should be advertising the Free File program and more actively evaluating and improving it on a regular basis to ensure it is taxpayer-friendly and widely used. By contrast, the software companies have a financial incentive to keep the usage rate low, because every taxpayer who uses Free File is a taxpayer who is not purchasing a paid product.[51]

From a taxpayer perspective, Free File has largely failed to achieve its objectives. Despite the fact that 70 percent of taxpayers qualify to use Free File software, less than two percent of taxpayers (2.5 million) used Free File software to file their returns during 2019.[52] Moreover, data on repeat usage suggests that taxpayers

48 *See* RRA 98, Pub. L. No. 105–206, § 2001, 112 Stat. 685, 723.

49 In 2014, the Free File Alliance formally changed its name to Free File, Inc. (FFI), and the new name is used on legal documents. However, the IRS and the organization itself continue to use the name “Free File Alliance” on their respective websites.

50 For a description of the program as well as access to all the associated Free File agreements and Memoranda of Understanding, see IRS, *Free File: About the Free File Alliance*, https://www.irs.gov/e-file-providers/about-the-free-file-alliance (last visited Nov. 11, 2019).

51 As noted below, software companies make their tax software products available for free to many taxpayers on their companies’ websites. However, they can cross-sell ancillary products on their companies’ websites and generally may not do so when taxpayers access tax software through Free File.

52 IRS response to TAS fact check (Dec. 20, 2019).

who have used Free File have generally been dissatisfied with it. Among taxpayers who used Free File software during the last four years, the majority did not use Free File software again in the following year.[53]

If Free File is discontinued, taxpayers would still have free e-filing options. Leading tax software companies have long offered their products to taxpayers at no charge. The Free File Alliance reports that its members provided free tax software to at least 17.7 million taxpayers outside the Free File program during the 2019 filing season.[54] It is therefore likely that most, if not substantially all, of the 2.5 million taxpayers who used Free File software last year would have been able to file for free through company websites if Free File did not exist.

The Free File program is also of questionable value to the IRS for two reasons. First, taxpayers enter the Free File program through the IRS's website, IRS.gov, and if they are dissatisfied with the program, it reflects poorly on the agency. Given the low repeat usage rate, it appears many taxpayers are not satisfied with the program. Second, the IRS incurs costs to administer the program. Particularly in an environment where IRS resources are tightly constrained, the costs of maintaining the program can only be justified if the usage rates and taxpayer satisfaction rates are increased.

While the Free File program provides only limited benefits to taxpayers and drains IRS resources, it is providing a valuable insurance policy for the software industry. Leading software companies understandably are concerned that their businesses could be adversely affected if taxpayers could e-file their returns directly with the IRS without going through a software company. For the tax software industry, the key provision in the Free File agreement provides: "[T]he federal government has pledged not to enter the tax [return] preparation software and e-filing services marketplace."[55]

Over the past decade, certain software companies have lobbied heavily for legislation that would make the Free File agreement permanent, effectively locking into place the current arrangement under which fewer than two percent of taxpayers are using free tax software that most could get from the members' websites directly, while permanently barring the IRS from allowing taxpayers to file returns directly with the government. A provision to codify Free File was included in a House-passed version of the Taxpayer First Act,[56] but was removed before enactment after a series of articles published in 2019 suggested that some members of the Free File Alliance had not acted in the best interests of taxpayers by steering them away from Free File software options.[57] Under congressional pressure, the IRS requested an independent assessment of the program from

53 IRS Compliance Data Warehouse, Electronic Tax Administration Research and Analysis System (ETARAS) MEF 1544 Table. For each year, TAS identified returns submitted through Free File and processed by the end of the fiscal year and then determined whether returns bearing the same taxpayer identification number (TIN) were submitted through Free File in the following year. Looking at all returns over the four-year period, only about 46 percent of taxpayers who used Free File in one year used it again the following year. However, for the most recent year (taxpayers who used Free File software in 2018 and then again in 2019), the percentage of repeat users rose to 54 percent.

54 MITRE, *Independent Assessment of the Free File Program x* (Oct. 3, 2019) (hereinafter "Free File Report"). To access the Free File Report, see IRS, *IRS Statement on Free File Program* (Oct. 11, 2019), https://www.irs.gov/newsroom/irs-statement-on-free-file-program.

55 Eighth Memorandum of Understanding on Service Standards and Disputes Between the Internal Revenue Service and Free File, Incorporated, Art. 2, at 5 (signed on Oct. 31, 2018 for a three-year term), https://www.irs.gov/pub/irs-utl/Eight%20Free%20File%20MOU.pdf.

56 Taxpayer First Act, H.R. 1957, 116th Cong. § 1102 (2019).

57 *See, e.g.*, ProPublica, *The TurboTax Trap: How Tax Prep Industry Makes You Pay*, https://www.propublica.org/series/the-turbotax-trap (last visited Nov. 11, 2019).

MITRE.[58] The MITRE 2019 Free File Report found that five companies used a coding device to exclude their Free File landing page from organic searches on search engines such as Google or Bing.[59]

The National Taxpayer Advocate believes the Free File program should be significantly improved to meet taxpayer needs or should be replaced. Before entering into a new agreement with the Free File Alliance, the IRS should conduct research studies, develop actionable goals, create measures evaluating taxpayer awareness and satisfaction, test each member's software, provide options for English as a second language taxpayers, and conduct more outreach.[60] It should set a goal of increasing the Free File usage rate to a significantly higher yet attainable level, such as ten percent of the 70 percent of taxpayers eligible to use the program, and a goal of increasing the retention rate to 75 percent of taxpayers who used the program in the preceding year. If these targets are not attained, the IRS should avail itself of another private sector option; namely, entering into a sole-source or multi-source contract with tax software manufacturers to make tax software available to all taxpayers at no or low cost.

Recommendations

- Mandate that the IRS, in consultation with the National Taxpayer Advocate, submit a report to Congress by June 30, 2020, summarizing the actions it has taken to address the recommendations in the MITRE 2019 Free File report as well as recommendations made in the National Taxpayer Advocate's 2019 Annual Report to Congress to improve the Free File program by filing season 2021.
- Direct the IRS to set a goal of increasing the usage rate of the Free File program to a significantly higher yet attainable level (*e.g.*, 10 percent of the 70 percent of taxpayers eligible to use the program) and a goal of increasing the retention rate to 75 percent of taxpayers who used Free File in the preceding year and, if those goals are not attained by 2025, to replace Free File with an alternative approach to make tax software available to taxpayers at no or low cost, such as through the use of sole-source or multi-source contracts with tax software companies.

58 To access the MITRE 2019 Free File Report, see IRS, IRS Statement on Free File Program (Oct. 11, 2019), https://www.irs.gov/newsroom/irs-statement-on-free-file-program.

59 MITRE 2019 Free File Report, at vi-vii, 46. The members took the position that such practice keeps them in compliance with their agreement with the IRS to require the program software to be accessible only through IRS.gov. Despite the industry's stated rationale, the resulting practice of steering taxpayers away from program software appears deceptive in nature. To eliminate this seemingly deceptive practice, the IRS should consider proposing to change the next MOU so that IRS.gov is just one way to access program software.

60 For additional background, see FREE FILE: The Free File Program Is Failing to Achieve Its Objectives and Should be Substantially Improved or Eliminated, National Taxpayer Advocate Blog (Mar. 15, 2019), https://taxpayeradvocate.irs.gov/Free_File_Program_Is_Failing_to_Achieve_Objectives?category=Tax%20News; National Taxpayer Advocate 2019 Annual Report to Congress 46-54 (Most Serious Problem: *Free File: Substantial Free File Program Changes Are Necessary to Meet the Needs of Eligible Taxpayers*); Naomi Jagoda, Warren, Brown, *Press IRS on Study Reviewing Free File Program*, The Hill (Nov. 15, 2019), https://thehill.com/policy/finance/470601-warren-brown-press-irs-on-study-reviewing-free-file-program.

#8 REQUIRE THAT ELECTRONICALLY PREPARED PAPER TAX RETURNS INCLUDE A SCANNABLE CODE

Present Law

Present law does not address the treatment of tax returns that are prepared electronically but filed on paper.

Reasons for Change

In recent years, more than 85 percent of individual income tax returns have been submitted electronically. While this percentage is relatively high, almost 20 million returns are still submitted on paper. When the IRS cannot capture the data from a tax return electronically, IRS employees must enter the data from paper-filed returns manually. The manual transcription of millions of lines of return data is expensive, produces transcription errors, and delays return processing.

Scanning technology is available that would allow the IRS to scan paper returns prepared with tax return preparation software and capture the data in an efficient manner. Many states have been using scanning technology for paper-based returns for many years. To allow the IRS to utilize scanning technology, a horizontal or vertical bar code containing the return information would be imprinted on paper copies of a return prepared with tax return preparation software. Upon receiving the paper return, the IRS would scan it, capture the data, decode it, and process the return just as if it had been transmitted electronically.

While scanning technology does not convert taxpayers to e-file, it produces significant advantages over paper filing, including: (1) faster processing of tax returns; (2) more accurate recording of tax return information; and (3) cost savings due to the reduction in manual data transcription. Despite these benefits, the IRS has not fully availed itself of this or similar technology for individual income tax returns. The IRS can achieve savings by working with tax software companies to incorporate scannable bar codes into their individual tax return preparation software. The IRS already provides scanning technology as an option for filers of Schedules K-1 (Form 1065).[61] The IRS is also using character recognition software to capture data on some paper returns.[62] It is unclear whether character recognition software is more accurate than scanning technology in the context of tax return data.

Recommendation

- Require the IRS to report to Congress, within 180 days of enactment, on its plans to reduce the monetary costs and transcription errors associated with the processing of individual income tax returns prepared electronically but filed on paper.[63]

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61 Internal Revenue Manual (IRM) 3.0.101.5.3, Substitute Schedule K-1 (Jan. 1, 2018).

62 IRM 3.41.275.1, Program Scope and Objectives (Nov. 14, 2017).

63 For legislative language that would impose this requirement, see Taxpayer First Act of 2018, S. 3246, 115th Cong. § 2104 (2018). *See also* Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* 227 (Mar. 2014).

#9 EXTEND THE TIME FOR SMALL BUSINESSES TO MAKE SUBCHAPTER S ELECTIONS

Present Law

Internal Revenue Code (IRC) § 1362(b)(1) provides that a small business corporation ("S corporation") may elect to be treated as a passthrough entity by making an election at any time during the preceding taxable year or at any time on or before the 15th day of the third month of the current taxable year. The prescribed form for making this election is Form 2553, Election by a Small Business Corporation.

IRC § 6072(b) provides that income tax returns of S corporations made on a calendar-year basis must be filed on or before March 15 following the close of the calendar year and returns of S corporations made on a fiscal-year basis must be filed on or before the 15th day of the third month following the close of the taxable year.

Reasons for Change

Many small business owners are not familiar with the rules governing S corporations, and they learn about the effects of S corporation status for the first time when they hire a tax professional to prepare their corporation's tax return for its first year of operation. By that time, the deadline for electing S corporation status has passed. The failure to make a timely S corporation election can cause significant adverse tax consequences for businesses, such as incurring taxation at the corporate level and rendering shareholders ineligible to deduct operating losses on their individual income tax returns.[64] For context, more than 5.1 million S corporation returns were filed in fiscal year 2018, which accounted for about 71 percent of all corporate returns.

Taxpayers may seek permission from the IRS to make a late S corporation election under the provisions of Revenue Procedure 2013-30 or through a private letter ruling (PLR) request. Under the revenue procedure, a corporation that failed to timely file Form 2553 may request relief by filing Form 2553 within three years and 75 days of the date the election is intended to be effective. In addition, the corporation must attach a statement explaining its reasonable cause for failing to timely file the election and its diligent actions to correct the mistake upon its discovery.

Finally, all shareholders must sign a statement affirming they have reported their income on all affected returns as if the S election had been timely filed (*i.e.,* during the period between the date the S election would have become effective if timely filed and the date the completed election form is filed). If an entity is unable to comply with the requirements of the revenue procedure, it may request relief through a PLR, for which the IRS charges a user fee ranging from $5,800 to $30,000 per request.

The current S corporation election deadline burdens small businesses by requiring them to pay tax professionals and often IRS user fees to request permission to make a late election. It also burdens shareholders, because when the IRS rejects an S corporation return due to the absence of a timely election, the status of the corporation is affected, and that, in turn, may result in changes on the shareholders' personal tax returns. In addition, the current deadline and relief procedures require a commitment of significant resources on the part of the IRS to process late-election requests.

64 The value of an S corporation election increased for many taxpayers with the passage of the Tax Cuts and Jobs Act, which generally allows an individual taxpayer to deduct 20 percent of domestic "qualified business income" (QBI) from a passthrough business, including an S corporation, effectively reducing the individual income tax rate on such income by 20 percent. The deduction is subject to certain income thresholds (first $315,000 of QBI for joint filers and $157,500 for single returns), phase-outs for professional services, and limitations based on W-2 wages paid or capital invested by a business owner for larger pass-through entities. *See* IRC § 199A, Pub. L. No. 115-97, § 11011 (2017); H.R. Rep. No. 115-466, at 205-224 (2017) (Conf. Rep.).

Because small business owners often consider the S corporation election for the first time in connection with the preparation of their company's first tax return, the burdens described above would be substantially eliminated if corporations could make an S election on their first timely filed tax return.

Recommendation

- Amend IRC § 1362(b)(1) to allow a small business corporation to elect to be treated as an S corporation by checking a box on its first timely filed (including extensions) Form 1120S, U.S. Income Tax Return for an S Corporation.[65]

65 For legislative language generally consistent with this recommendation, see Protecting Taxpayers Act, S. 3278, 115th Cong. § 304 (2018).

#10 ADJUST ESTIMATED TAX PAYMENT DEADLINES TO OCCUR QUARTERLY

Present Law

Under Internal Revenue Code (IRC) § 6654(c)(2), taxpayers are required to make estimated tax payments in four installments due on the following dates: April 15, June 15, September 15, and January 15.

Reasons for Change

Although estimated tax installment payments are sometimes referred to as “quarterly payments,” they do not coincide with calendar year quarters and the payment dates are not evenly spaced. The April 15 and June 15 installments are due two months apart; the June 15 and September 15 installments are due three months apart; the September 15 and January 15 installments are due four months apart; and the January 15 and April 15 installments are due three months apart.

These dates are not intuitive and create compliance burdens. Small business owners and self-employed taxpayers are disproportionately affected by the estimated tax rules because their incomes generally are not subject to wage withholding. Yet small businesses are far more likely to keep their books on the basis of regular three-month quarters than on the basis of the seemingly random intervals prescribed by IRC § 6654.

These uneven intervals make it more difficult for many taxpayers to calculate net income and save appropriately to make payments. They also cause confusion as taxpayers struggle to remember the due dates. This confusion affects traditionally self-employed workers as well as workers in the gig economy. Setting due dates to fall 15 days after the end of each calendar quarter would make it substantially easier for taxpayers to remember and comply with the due dates.

Recommendation

- Amend IRC § 6654(c)(2) to set the estimated tax installment deadlines on April 15, July 15, October 15, and January 15.[66]

66 For legislative language generally consistent with this recommendation, see Protecting Taxpayers Act, S. 3278, 115th Cong. § 305 (2018); Small Business Owners’ Tax Simplification Act, H.R. 3717, 115th Cong. § 2 (2017).

#11 HARMONIZE REPORTING REQUIREMENTS FOR TAXPAYERS SUBJECT TO BOTH THE REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS AND THE FOREIGN ACCOUNT TAX COMPLIANCE ACT BY ELIMINATING DUPLICATION AND EXCLUDING ACCOUNTS A U.S. PERSON MAINTAINS IN THE COUNTRY WHERE HE OR SHE IS A *BONA FIDE* RESIDENT

Present Law

The Currency and Foreign Transaction Reporting Act of 1970 (commonly known as the Bank Secrecy Act) requires U.S. citizens and residents to report any foreign account with an aggregate value exceeding $10,000 at any time during the calendar year.[67] FinCEN Report 114, Report of Foreign Bank and Financial Accounts (FBAR), has been prescribed for filing this report.

The Foreign Account Tax Compliance Act (FATCA)[68] added Internal Revenue Code (IRC) § 6038D, which requires U.S. citizens, resident aliens, and certain non-resident aliens to file a statement with their federal income tax returns to report foreign assets exceeding specified thresholds. Form 8938, Statement of Specified Foreign Financial Assets, has been prescribed for filing this statement. As codified by FATCA, IRC §§ 1471-1474 provide that foreign financial institutions (FFIs) that do not register with the IRS and agree to report certain information about their "United States accounts,"[69] including accounts held by U.S. persons and accounts of certain foreign entities with substantial U.S. owners, are subject to a 30 percent withholding tax on certain U.S. source payments they receive.

IRC § 1471(d)(1) authorizes the IRS to issue regulations to eliminate duplicative reporting requirements. IRC § 6038D similarly authorizes the IRS to issue regulations or other guidance to provide appropriate exceptions from FATCA reporting when such reporting would be duplicative of other disclosures.

Reasons for Change

Many U.S. taxpayers, particularly those living abroad, face increased compliance burdens and costs as a result of FATCA reporting obligations that significantly overlap with the FBAR filing requirements.[70] The IRS has exercised its regulatory authority to eliminate duplicative reporting of assets on Form 8938 if an asset is reported or reflected on certain other timely filed international information returns (*e.g.*, Forms 3520, 3520A, 5471, 8621, 8865, or 8891).[71] It has also provided an exception from the reporting rules for financial accounts held in U.S. territories for *bona fide* residents of such territories.[72]

However, the IRS has repeatedly declined to adopt the recommendations of the National Taxpayer Advocate that are also supported by other stakeholders, including the Government Accountability Office, to eliminate duplicative FATCA reporting where assets have already been reported on an FBAR[73] and to provide a same-country exception for reporting financial accounts held in the country in which a U.S. taxpayer is a *bona fide* resident. These recommendations, if adopted, would reduce the compliance burdens on U.S. taxpayers, who

67 *See* 31 U.S.C. § 5314(b)(3) and 31 C.F.R. § 1010.306(c).

68 Pub. L. No. 111-147, Title V, Subtitle A, 124 Stat. 71, 97 (2010).

69 *See* IRC § 1471(d)(1) for a definition of "United States account."

70 IRS, Comparison of Form 8938 and FBAR Requirements, http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements.

71 Treas. Reg. § 1.6038D-7(a)(1).

72 Treas. Reg. § 1.6038D-7(c).

73 *See, e.g.*, Government Accountability Office, GAO-12-403, *Reporting Foreign Accounts to the IRS: Extent of Duplication Not Currently Known, but Requirements Can Be Clarified* (Feb. 2012).

now must file additional complex forms themselves or pay higher tax return preparation fees. They would also reduce the compliance burdens on FFIs, some of which are declining to do business with U.S. expatriates because of the significant costs and regulatory risks associated with ongoing FATCA compliance. In addition, the unwillingness of certain FFIs to do business with U.S. expatriates makes it difficult for U.S. citizens to open bank accounts in certain countries.

Recommendations

- Amend IRC § 6038D (i) to eliminate duplicative reporting of assets on Form 8938, Statement of Specified Foreign Financial Assets, where an asset is or has been reported or reflected on an FBAR and (ii) to exclude financial accounts maintained by a financial institution organized under the laws of the country of which the subject U.S. person is a *bona fide* resident from the specified foreign financial assets required to be reported on Form 8938.[74]
- Amend IRC § 1471 to exclude financial accounts maintained by a financial institution organized under the laws of the country of which the subject U.S. person is a *bona fide* resident from the definition of "financial account" subject to reporting by FFIs.[75]

74 For legislative language similar to this recommendation, see H.R. 2136, 115th Cong. §§ 1 & 2 (2017) (providing an exception from certain reporting requirements with respect to the foreign accounts of individuals who are *bona fide* residents of the countries in which their accounts are maintained).

75 For additional information on the National Taxpayer Advocate's recommendations, see National Taxpayer Advocate 2015 Annual Report to Congress 353-363 (Legislative Recommendation: *Foreign Account Reporting: Eliminate Duplicative Reporting of Certain Foreign Financial Assets and Adopt a Same-Country Exception for Reporting Financial Assets Held in the Country in Which a U.S. Taxpayer Is a* Bona Fide *Resident*).