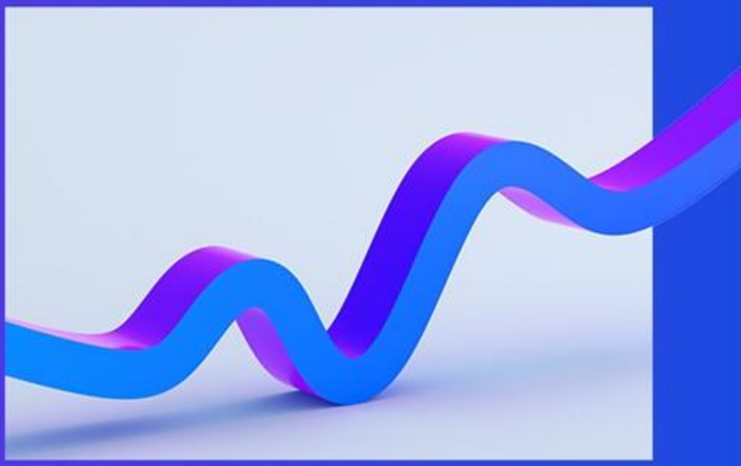
KPMG

Tax IRW Ops Insights Quick Tips & Updates

KPMG Information Reporting & Withholding Tax Services



More (IRS) Money, More (Taxpayer) Problems? The Impact of IRS Funding on Information Reporting

By Martin L. Mueller, Jr., and Cyrus Daftary

> The IRS recently unveiled plans to utilize roughly $80 billion allocated to it under the Inflation Reduction Act of 2022. Large portions of the budgeted amount will target system upgrades and improving taxpayer guidance and resources. Per early reports, the increased spending has already resulted in efficiency upgrades. Despite IRS reassurances, taxpayers remain apprehensive about upcoming changes to information reporting requirements, increased enforcement, and potential audits. In this article, we discuss reporting deficiencies that the IRS is seeking to correct, upcoming reporting changes, and proposed improvements under the $80 billion budget.

Background

In August 2022, President Biden signed the Inflation Reduction Act of 2022 (IRA)[1] into law, with a stated goal of reducing inflation and the federal deficit. Per the Congressional Budget Office (CBO), IRA is expected to result in a net decrease in the deficit totaling $90 billion over the ten-year period from 2022 to 2031.[2] A key revenue raiser is an increase in IRS funding, with appropriations totaling nearly $80 billion over the ten-year

[1] See the Inflation Reduction Act of 2022 at https://www.congress.gov/bill/117th-congress/house-bill/5376/text.
[2] See CBO *Estimated Budgetary Effects of H.R. 5376, the Inflation Reduction Act of 2022* at https://www.cbo.gov/system/files/2022-08/hr5376_IR_Act_8-3-22.pdf.

span. In an October 2022 report, the IRS determined that there was a tax gap of $496 billion per year (net $428 billion per year after accounting for enforcement activities), for the 2014 to 2016 period.[3] The tax gap is projected to increase to $540 billion (net $470 billion) per year for the 2017 to 2019 period. Through both sets of time periods, the primary tax gap culprit is underreported income, which information reporting requirements seek to reduce. To address this annual tax gap and increase revenue, IRA allocates set amounts totaling nearly $80 billion to taxpayer services, enforcement, operations support, and business systems modernization, along with additional amounts for other administrative costs.

Early projections drove concerns that the enforcement budget would lead to increased scrutiny and audit activity for small businesses and middle-class individuals. Prior to leaving office, Former IRS Commissioner Rettig assured taxpayers that this was not the goal.[4] Rather, IRS appropriations would be invested in employees and IT systems in order to enhance taxpayer services and provide resources necessary to comply with tax laws. Per Commissioner Rettig, the IRS has fewer employees than at any time since the 1970s, with fewer experienced examiners in the field than at any time since World War II. Understaffing and inadequate technology has prevented the IRS from pursuing examinations of those taxpayers, as well as large corporations and high net worth individuals. Indeed, deficiencies in IRS resourcing have led to recent compliance issues in the information reporting world.

In March 2021, the IRS destroyed an estimated 30 million paper-filed information returns. Per a September 2021 report by the Treasury Inspector General for Tax Administration (TIGTA),[5] IRS management informed TIGTA auditors during a walkthrough of the IRS Ogden Tax Processing Center that the destruction was due to the pending backlog of higher priority returns compounded with technology and resourcing issues. Notably, the system that is used to scan and process returns, the Service Center Recognition Imaging Processing System (SCRIPS), is taken offline at the end of each tax year for programming updates ahead of the next filing season. Due to this decision, tax year 2020 information returns, e.g., Forms 1099, were unavailable for the IRS's Automated Underreporter Program, which compares amounts reported on income tax returns against third-party information to identify underreporting.

The IRS justified this action, noting that the bulk of information returns are filed electronically. However, the impact was not insignificant, as the paper filing threshold in 2020 was 250 returns and applied separately to each type of form (i.e., a payor required to submit 200 each of Forms 1099-MISC and 1099-NEC would be permitted to submit all 400 via paper filing). In addition, the paper filing threshold is determined at the payor level, not the payee level. It is highly likely that payees performing services for multiple payors escaped further IRS scrutiny for underreporting, as income matching was rendered impossible. TIGTA followed up on its report in May 2022,[6] noting that IRS efforts to modernize paper tax return processing have been unsuccessful, and required a Service-wide strategy to increase business e-Filing. In December 2022,[7] TIGTA noted that the IRS had shifted resources to information return processing due to the 2021 issue, but pointed out that 18.7 million information returns had yet to be processed in October 2022. Given the year end processing issue with SCRIPS, TIGTA reiterated its concerns that the IRS was not meeting its goals. Thus, it is apparent that IRS resourcing and technology could use additional help.

---

[3] See Publication 1415, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016* at https://www.irs.gov/pub/irs-pdf/p1415.pdf.
[4] See Commissioner Rettig's letter to the U.S. Senate at https://www.irs.gov/pub/irs-utl/commissioners-letter-to-the-senate.pdf.
[5] See TIGTA, *Effects of the COVID-19 Pandemic on Business Return Processing Operations* at https://www.tigta.gov/sites/default/files/reports/2022-02/202146064fr.pdf.
[6] See TIGTA, *A Service-Wide Strategy is Needed to Address Challenges Limiting Growth in Business Tax Return Electronic Filing* at https://www.tigta.gov/sites/default/files/reports/2022-02/202146064fr.pdf.
[7] See TIGTA, *Backlogs of Tax Returns and Other Account Work Will Continue Into the 2023 Filing Season* at https://www.tigta.gov/sites/default/files/reports/2022-12/202346007fr.pdf.

Reporting Upgrades and Strained Resources

Over the past few years, legislative changes have called for a number of compliance and reporting changes that are slowly going into effect. Each change is designed to make reporting more impactful but, in many cases, they have effectively shifted compliance burdens from the IRS to taxpayers. This shift will likely require dedicated taxpayer guidance and increased IRS responsiveness to ensure a smooth transition, as many smaller taxpayers previously not subject to reporting nuances will soon be called upon to meet these requirements. The high-level rundown below provides a glimpse into some of those changes, along with practical impacts to the IRS and taxpayers.

e-Filing Changes & System Updates

Under the Taxpayer First Act of 2019,[8] Treasury and the IRS were given authority to issue regulations to lower certain electronic filing requirements, notably the threshold at which taxpayers are required to e-File information returns. Proposed regulations were issued in 2021 but, due to delays, were not finalized until February 2023, effective for returns required to be submitted in 2024. The regulations stipulate that taxpayers with 10 or more information returns, determined based on an aggregate of all types of information returns (including the Forms 1099 series and Form 1042-S), must e-File. This was a significant reduction from the previous threshold of 250 returns, which applied on return-by-return basis.

In early 2023, the IRS launched a new system to accommodate the lower e-Filing thresholds and push more taxpayers to electronic filing. The system, Information Returns Intake System (IRIS),[9] allowed small filers the ability to begin preparing and filing tax year 2022 returns, request extensions, file corrections, validate basic data, and download recipient copies for distribution to payees. Notably, taxpayers are not required to obtain special software or pay service providers for IRIS submissions. IRIS is expected to eventually replace the Filing Information Returns Electronically (FIRE) system.

In addition, the regulations set forth e-Filing requirements for Form 1042, a form for which there was no electronic filing system prior to 2023. The regulations require certain withholding agents with 10 or more returns, partnerships with more than 100 partners, and all financial institutions to e-File Form 1042, beginning in 2024. To accommodate this filing requirement, the IRS circulated Form 1042 XML Schema and Modernized e-File (MeF) rules in October 2022. Taxpayers are expected to update their processes for the new filing requirements and begin e-Filing in 2024, though optional e-Filing is available in 2023 for tax year 2022.

From an IRS perspective, the lower threshold presents a drastic increase in compliance efficiency. As noted in the May 2022 TIGTA report,[10] e-Filed returns are subjected to upfront validations that check over 1,000 possible errors before IRS acceptance. Conversely, TIGTA found that the error rate on paper-filed returns was significantly higher, largely due to IRS employee keypunch errors (the study determined the error rate was ten times greater than e-Filing error rate on 2020 tax year returns). However, taxpayers unfamiliar with e-Filing systems will need significant guidance through the transition, which will likely require dedicated in-person and call center resources.

Form 1099-K Changes

Under the American Rescue Plan Act of 2021 (ARPA),[11] the de minimis threshold for reporting third party service organizations (TPSOs) was lowered from $20,000 and 200 transactions to $600, with no regard for

[8] See the Taxpayer First Act of 2019 at https://www.congress.gov/bill/116th-congress/house-bill/3151.
[9] Further information on IRIS can eb found at https://www.irs.gov/filing/e-file-forms-1099-with-iris.
[10] See TIGTA, *A Service-Wide Strategy is Needed to Address Challenges Limiting Growth in Business Tax Return Electronic Filing* at https://www.tigta.gov/sites/default/files/reports/2022-02/202146064fr.pdf.
[11] See the American Rescue Plan Act of 2021 at https://www.congress.gov/bill/117th-congress/house-bill/1319/text.

the number of transactions. The lower threshold became effective for payments made in the 2022 tax year. However, thanks to late transitory relief by the IRS, the threshold was pushed back for at least one year. There are ongoing legislative challenges that may ultimately nullify the ARPA changes or establish a middle ground threshold ($5,000 and $10,000 have been proposed as a compromise).[12] However, the current law will give rise to a drastic increase in Form 1099-K reporting this year (in one case, a taxpayer estimated their compliance burden to increase from tens of thousands to millions of forms annually). Aside from an increase in forms, the change will require many taxpayers previously exempt from reporting to begin filing on an annual basis.

As discussed in *Delayed Thresholds, Immediate Confusion: Form 1099-K Reporting Thresholds*,[13] many payors were previously unlikely to engage in certain due diligence practices, such as TIN validation for smaller payees, under the prior thresholds. The lower threshold will subject significantly more taxpayers to backup withholding obligations and additional compliance burdens. From an IRS perspective, the volume of forms will drastically increase but, due to the lower e-Filing threshold, the filing burden will be relatively minimal. Rather, the greater issue will be accommodating taxpayer questions as they navigate Form 1099-K reporting for the first time. To this end, the IRS provides FAQs specific to Form 1099-K, updated regularly to address changes, but this will be insufficient to meet taxpayer needs. Thus, dedicated resources will be needed to address the influx of questions, particularly during filing season.

Form 1042 Audits

In a number of conferences and webinars, IRS representatives have stated that Form 1042 audits, and subsequent notices, will increase going forward. They attribute this uptick to better technology and the ability to compare Form 1042 inputs against Form 1042-S totals. IRS representatives spent time educating taxpayers on two public webinars about common errors that occur across Forms 1042 and 1042-S. The representatives warned taxpayers that the IRS will be cracking down on these, beginning in 2023, in the form of notices and potential penalties. The representatives also discussed the recent rollout of the Form 1042-S Data Integrity Tool,[14] and praised its ability to identify most facial errors upfront. Although use of the tool is not required for filing, the representatives highly recommended that taxpayers utilize the tool to reduce basic errors and mitigate potential penalties. Combined with the new e-Filing requirement for Form 1042, it is clear that the IRS is working to utilize technology to more efficiently review these returns and prioritize instances of true non-compliance. However, given the increased use of technology, additional resources will be required to onboard taxpayers. The additional notices will also necessitate customer-facing resources that can help taxpayers resolve any errors.

Cryptocurrency and Digital Assets

Due to the proliferation of cryptocurrencies, worldwide revenue agencies (through the OECD) have begun working to institute global reporting as a means to ensure improvements in tax transparency are not eroded through decentralized asset exchanges.[15] Likewise, the U.S. has enacted provisions and set forth goals to combat offshore tax evasion, with a particular focus on cost basis reporting of digital assets. Under the Infrastructure Investment and Jobs Act of 2021 (the Infrastructure Act),[16] which defined relevant digital asset terms and included expanded reporting requirements, reporting was expected to begin for transactions

[12] See *Delayed Thresholds, Immediate Confusion: Form 1099-K Reporting Thresholds* for further information at https://tax.kpmg.us/content/dam/tax/en/pdfs/2023/012323-irw-gt-delayed-thresholds-form-1099K.pdf.
[13] *Id.*
[14] See further information about the IRS Form 1042-S Data Integrity Tool at https://www.irs.gov/businesses/international-businesses/form-1042-s-data-integrity-tool.
[15] See further information on the Crypto-Asset Framework (CARF) at https://www.oecd.org/tax/exchange-of-tax-information/crypto-asset-reporting-framework-and-amendments-to-the-common-reporting-standard.htm.
[16] See the Infrastructure Act at https://www.congress.gov/bill/117th-congress/house-bill/3684/text.

occurring in 2023. Due to late transitory relief, the IRS effectively parked these reporting requirements until such time that it issues new regulations (these are expected any day now). While it remains to be seen what changes the IRS will implement, details on the Office of Information and Regulatory Affairs (OIRA) webpage[17] indicate that Treasury and the IRS intend to institute additional Form 1099-K reporting requirements, in addition to changes in cost basis reporting. Futhermore, it is widely expected that a new reporting form will be issued to accommodate information reporting for digital assets. For further information see *Crypto Crackdown: Information Reporting in a Digital Asset World*.[18]

While it is yet to be seen what the final iteration of digital asset reporting will look like, it is clear that reporting will increase, and will likely require many taxpayers unfamiliar with the process to establish due diligence processes. Including digital assets in Form 1099-K reporting will involve a new layer of complexity for taxpayers and the IRS to navigate. Similar to the points above, the increased reporting will necessitate additional taxpayer-facing resources and system upgrades to ensure that the additional effort results in actionable data for the IRS.

Going Forward – Increased Reporting and the Impact of Additional IRS Funding

A persistent theme in each reporting change identified above is the need for additional IRS resources, both to discuss technical issues during filing season and to assist taxpayers in resolving filing errors. In early April, the IRS issued a document discussing its ten-year plan to utilize the nearly $80 billion in IRA appropriations (the Plan).[19] Predictably, the Plan details an initiative to increase hiring across the enforcement and customer service lines of business. The Plan notes that new tax law provisions and legislative expansion of IRS authority over the last decade has resulted in the need for new resources to address taxpayer inquiries. In addition, the Plan outlines initiatives to further boost technology, digitize the filing process, and convert IRS notice communications to an online system.

In a follow up letter to the Senate Finance Committee,[20] Commissioner Werfel acknowledged that the Plan's collection of objectives, initiatives, and milestones was incomplete and noted that more details would be forthcoming. However, the Commissioner pointed out that, due to IRA funds already put in place, the IRS has made significant early strides in assisting taxpayers during the recently completed 2022 tax year filing season. Notably, the IRS was able to answer more taxpayer calls, achieving an 87% level of service (LOS) compared to 16% over the same period and lowering average call times from 27 minutes to four minutes. The IRS was also able to provide more in-person assistance, assisting 474,000 taxpayers face-to-face compared to 361,000 in the prior year, thanks to IRA funds to restaff and reopen Taxpayer Assistance Centers (TACs). Commissioner Werfel highlighted the new IRIS portal, pointing out how it has already been helpful for small businesses that historically submit Forms 1099 on paper. In addition, the new option to upload documents and notice responses electronically through the Document Upload Tool is expected to help serve 500,000 taxpayers annually.

As discussed above, each of the information reporting changes on the horizon will require significant assistance from the IRS. Concerns abound, many justified, about the amount provided to the IRS and what the agency will do with it. An oft-cited fallacy is that the IRS will use enforcement efforts to pursue lower and middle-class workers. However, Commissioner Werfel and other IRS representatives have reiterated that this will not be the case, that the IRS will not only prioritize large corporations and high-income taxpayers, but that

[17] See the OIRA webpage at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202210&RIN=1545-BP71.
[18] See *Crypto Crackdown: Information Reporting in a Digital Asset World* at https://tax.kpmg.us/content/dam/tax/en/pdfs/2023/031723-crypto-crackdown-information-reporting.pdf.
[19] See *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan, FY2023-2031* at https://www.irs.gov/pub/irs-pdf/p3744.pdf.
[20] See the *Written Testimony of Daniel Wefel Commissioner Internal Revenue Service Before the Senate Finance Committee on the Filing Season and the IRS Budget* at https://www.finance.senate.gov/imo/media/doc/2023%20FINAL%20CIR%20testimony%20SFC%20Filing%20Season%20041923.pdf.

it will adhere to the Treasury Department's directive not to increase audit rates for small businesses and households earning $400,000 or less per year. Given the many changes in the pipeline, resulting in increased reporting and the transition to new software and due diligence processes, the IRA funding may be seen as welcome news for some taxpayers seeking to ensure that they are compliant.

.

Contact us

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia