

## IMPROVE THE FILING PROCESS

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### Legislative Recommendation #3

## Treat Electronically Submitted Tax Payments and Documents as Timely If Submitted Before the Applicable Deadline

### PRESENT LAW

IRC § 7502(a)(1) provides that if certain requirements are satisfied, a mailed document or payment is deemed filed or paid on the date of the postmark stamped on the envelope. Therefore, if the postmark shows a document or payment was mailed by 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 and payments sent by U.S. postal mail, designated 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 electronic filing, the Secretary is authorized to promulgate regulations describing the extent to which the mailbox rule shall apply.<sup>1</sup> To date, the only regulations the Secretary has promulgated relating to electronic filing cover documents filed through an electronic return transmitter (*i.e.*, documents that are e-filed).<sup>2</sup>

### 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 through an electronic return transmitter), including those transmitted by fax, email, the digital communication portal, or upload to an online account.<sup>3</sup> If the IRS does not receive an electronically submitted document 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. This 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.

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” (emphasis in original).<sup>4</sup> 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 may take a week or longer for the IRS to receive, open, and process the check. If the same taxpayer submits the payment using EFTPS, the payment will be considered late if submitted after 8 p.m. on April 14 (28 hours

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<sup>1</sup> IRC § 7502(c)(2).

<sup>2</sup> Treas. Reg. § 301.7502-1(d).

<sup>3</sup> 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).

<sup>4</sup> See Electronic Federal Tax Payment System, <https://www.eftps.gov/eftps> (last visited Nov. 9, 2021).

earlier), even though the payment generally would be debited from the taxpayer's account on April 16 – often a 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 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 statutory mailbox rule to all time-sensitive documents and payments electronically submitted to the IRS in a manner comparable to similar documents and payments submitted through the United States Postal Service or a designated delivery service.

**Legislative Recommendation #4****Authorize the IRS to Establish Minimum Competency Standards for Federal Tax Return Preparers****PRESENT LAW**

Federal law imposes no competency or licensing requirements on paid tax return preparers. Credentialed individuals who may prepare tax returns, including attorneys, certified public accountants (CPAs), and enrolled agents (EAs), are generally required to pass competency tests and take continuing education courses (including an ethics component). Volunteers who prepare tax returns as part of the Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs also must pass competency tests. However, the vast majority of paid preparers are non-credentialed and are not required to pass competency tests or take any courses in tax return preparation.

**REASONS FOR CHANGE**

The IRS receives over 160 million individual income tax returns each year, and paid tax return preparers prepare the majority of these returns. 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 harms taxpayers and the public fisc.

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

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 ten 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 and prepared returns claiming ineligible children.<sup>1</sup>

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.<sup>2</sup>

*Treasury 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

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1 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).

2 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).

involving EITC claims, none of the non-credentialed preparers exercised due diligence as required under IRC § 6695(g).<sup>3</sup>

*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.”<sup>4</sup> At one point, the Department reported that it had found fraud on about 40 percent of its visits, and it had made over 20 arrests and secured 13 convictions.<sup>5</sup>

*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 overclaims averaged between 33 percent and 40 percent.<sup>6</sup>

In 2002, before these studies were published, the National Taxpayer Advocate recommended that Congress authorize the IRS to conduct preparer oversight. 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.<sup>7</sup>

On one occasion, the full Senate approved the legislation by unanimous consent.<sup>8</sup> 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.<sup>9</sup>

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 regulate tax return preparation as “practice” before the IRS. The IRS initiated extensive hearings and discussions with stakeholder groups to receive comments and develop a system within which all parties believed they could operate.<sup>10</sup> The IRS, together with the Treasury Department, implemented the program in 2011. However, it was terminated two years later after a U.S. district court upheld a challenge to the IRS’s authority to regulate tax return preparation. The court concluded that “mere” tax return preparation did not constitute “practice” before the IRS.<sup>11</sup>

In response, the IRS created a voluntary “Annual Filing Season Program.” Non-credentialed preparers who participate must meet specific requirements, including taking 18 hours of continuing education each year,

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

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

5 *Id.* See also Tom Herman, *New York Sting Nabs Tax Preparers*, WALL STREET JOURNAL (Nov. 26, 2008).

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

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

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

9 The organizations were the American Bar Association, the American Institute of Certified Public Accountants, 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).

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

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

which includes an examined tax refresher course. If they meet the requirements, the IRS will provide them with a “Record of Completion” that they presumably can use in their marketing to attract potential clients.<sup>12</sup> However, the program is less rigorous than the one the IRS implemented in 2011, and most non-credentialed preparers do not participate. This voluntary program does not satisfy the objectives of a comprehensive regime.

Since the 2011 program was invalidated, House and Senate members have introduced legislation to provide the IRS with the statutory authority to establish and enforce minimum standards. In the Senate, Senators Portman and Cardin sponsored bipartisan authorizing legislation in 2018,<sup>13</sup> and Senators Wyden and Cardin sponsored similar legislation in 2019.<sup>14</sup> In the House, Congressman Panetta and Congressman Rice sponsored bipartisan authorizing legislation in 2021.<sup>15</sup> In the recent past, former Congresswoman Black and former Congressman Becerra, both members of the Ways and Means Committee, sponsored similar legislation.<sup>16</sup>

The IRS’s Taxpayer Experience Strategy provides an additional basis for establishing preparer standards.<sup>17</sup> The IRS envisions giving preparers access to taxpayer information through online accounts. While there are considerable benefits to this plan, there are also significant security risks, including identity theft and other fraud. If the IRS proceeds with such access, it must try to mitigate the risks. Requiring minimum standards for preparers is one critical step.

Some have argued that requiring preparers to pass a competency test and take annual continuing education courses would address competence but would not ensure preparers conduct themselves ethically. The National Taxpayer Advocate agrees that tax law competency and ethical conduct are distinct issues. However, we believe preparer standards would raise both competency and ethical conduct levels. A preparer who invests in learning enough about tax return preparation to pass a competency test and takes annual continuing education courses would demonstrate a commitment to return preparation as a profession. The preparer would be a vested partner in the tax system and would have more to lose if he or she is found to have engaged in misconduct, just like attorneys, CPAs, EAs, and other credentialed partners. If tax preparation is characterized as “practice” before the IRS – as the 2011 plan did – the Office of Professional Responsibility would have oversight authority over preparers and could impose sanctions in cases of unethical conduct.

In sum, the GAO, TIGTA, and other compliance studies described above have consistently found 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.

## RECOMMENDATION

- Amend Title 31, § 330 of the U.S. Code to authorize the Secretary to establish minimum standards for federal tax return preparers.<sup>18</sup>

<sup>12</sup> Rev. Proc. 2014-42, 2014-29 I.R.B. 192.

<sup>13</sup> Protecting Taxpayers Act, S. 3278, 115th Cong. § 202 (2018).

<sup>14</sup> Taxpayer Protection and Preparer Proficiency Act, S. 1192, 116th Cong. (2019).

<sup>15</sup> Taxpayer Protection and Preparer Proficiency Act, H.R. 4184, 117th Cong. (2021).

<sup>16</sup> 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).

<sup>17</sup> IRS Pub. 5426, Taxpayer First Act Report to Congress 42-45 (rev. Jan. 2021).

<sup>18</sup> 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.

**Legislative Recommendation #5****Require the IRS to Work With Tax Software Companies to Incorporate Scanning Technology for Individual Income Tax Returns Filed on Paper****PRESENT LAW**

Present law does not address the treatment of individual income tax returns prepared electronically but mailed and filed on paper.

**REASONS FOR CHANGE**

In recent years, about 90 percent of individual income tax returns have been submitted electronically. While this percentage is relatively high, more than 15 million individual income tax returns are still submitted on paper.<sup>1</sup> 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 and the payment of tax refunds. Because of the impact of the COVID-19 pandemic on IRS operations, backlogs in the processing of paper returns have often exceeded six months, delaying refunds for, and in some cases inflicting financial hardships on, millions of taxpayers.

Technology is available that would allow the IRS to scan paper returns prepared with tax return preparation software and capture the data quickly and efficiently. To enable the IRS to utilize one form of scanning technology, known as “2-D barcoding,” tax return preparation software would generate and imprint a horizontal or vertical barcode containing all return information on the return. The IRS, upon receiving the paper return, would scan the barcode, capture the data, decode it, and process the return as if it had been transmitted electronically. Many states have been using 2-D barcoding for paper-based income tax returns for more than a decade. The IRS itself has partnered with the software industry to enable Schedules K-1 to be filed with a 2-D bar code.

In addition, the IRS has adopted another type of scanning technology, known as “optical character recognition” (OCR), to process certain forms filed on paper. With OCR technology, the IRS scans the paper-filed return (without a barcode), captures the data, stores the tax form images and data in an electronic format, and processes the return as if it had been e-filed.<sup>2</sup> A major advantage of OCR technology is that it is not limited to digitizing returns prepared with software. It can scan all paper tax returns, including handwritten returns, preventing the need for manual data entry.<sup>3</sup>

While scanning technology is not considered e-file and still involves the submission of a paper return, it produces significant advantages over traditional paper filing, including (i) faster processing of tax returns and therefore delivery of refunds, (ii) more accurate recording of tax return information, and (iii) cost savings due to the reduction in training, recruiting, and staffing for manual data transcription. Despite these benefits, the IRS does not have updated scanning technology for many paper-filed returns, including individual income tax returns. The IRS has indicated an interest in adding 2-D barcodes on all IRS forms and outgoing

<sup>1</sup> IRS, Filing Season Statistics Report, Week Ending October 23, 2021.

<sup>2</sup> See Internal Revenue Manual (IRM) 3.41.274, General Instructions for Processing via SCRIPS (Nov. 5, 2019); IRM 3.41.275.1, Program Scope and Objectives (Nov. 14, 2017).

<sup>3</sup> In the case of handwritten returns, there will be some scanning errors. For example, a scanner might read a sloppily written “1” as a “7” or vice versa. However, similar errors are made when IRS employees transcribe returns, along with others, so OCR scanning should still be more accurate while reducing processing times.

correspondence due to the industry-proven efficiencies associated with extracting machine-readable data from paper returns and correspondence. It is exploring both 2-D barcode and OCR technology with the software industry as part of a pilot program.<sup>4</sup> However, widescale expansion of these two technologies will require additional multiyear funding.

## RECOMMENDATION

- Provide the IRS with dedicated multiyear funding to purchase and implement scanning technology in order to improve the speed and accuracy of paper returns and correspondence processing.<sup>5</sup>

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4 U.S. Department of the Treasury, Pilot IRS Informational Posting (Apr. 2, 2021), <https://sam.gov/opp/5eb4fcfbdfd342bd94c0af400dbcca38/view?index=opp&naics=541&page=9>; Department of the Treasury, Pilot IRS: EDCMO Digitalization Technology Pilot OCR Awards (July 26, 2021), <https://sam.gov/opp/3d9a450e51df4bc9b3f75ddc12b9a578/view>.

5 For legislative language that would impose a requirement for 2-D barcode, or scannable code, technology, see Taxpayer First Act of 2018, S. 3246, 115th Cong. § 2104 (2018), <https://www.congress.gov/bill/115th-congress/senate-bill/3246>.

**Legislative Recommendation #6****Extend the Time for Small Businesses to Make Subchapter S Elections****PRESENT LAW**

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 income tax 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 income tax return for its first year of operation. By that time, the deadline for electing S corporation status has passed. 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.<sup>1</sup> For context, about five million S corporation returns were filed in fiscal year 2020, which accounted for 73 percent of all corporate returns.

Taxpayers may seek permission from the IRS to make a late S corporation election under 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 corporation election had been timely filed (*i.e.*, during the period between the date the S corporation election would have become effective if timely filed and the date the completed election form is filed). If an entity cannot comply with the revenue procedure, it may request relief through a PLR, for which the IRS charges a user fee ranging from \$6,200 to \$30,000 per request.<sup>2</sup>

The 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 may cause changes on the shareholders’ personal income tax returns. In addition, the

<sup>1</sup> The value of an S corporation election increased for many taxpayers with the passage of the Tax Cuts and Jobs Act, which generally allows individual taxpayers 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 passthrough entities. See IRC § 199A; Pub. L. No. 115-97, § 11011 (2017); H.R. REP. No. 115-466, at 205-224 (2017) (Conf. Rep.).

<sup>2</sup> See Rev. Proc. 2020-1, 2020-1 I.R.B. 1. User fees for PLRs are set forth in the first revenue procedure of each year.



deadline and relief procedures require a commitment of significant resources by the IRS to process late-election requests.

Because small business owners often consider the S corporation election for the first time when they prepare their company's first income tax return, the burdens described above would be substantially eliminated if corporations could make an S corporation election on their first timely filed income 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.<sup>3</sup>

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<sup>3</sup> For legislative language generally consistent with this recommendation, see Protecting Taxpayers Act, S. 3278, 115th Cong. § 304 (2018).

**Legislative Recommendation #7****Adjust Individual Estimated Tax Payment Deadlines to Occur Quarterly****PRESENT LAW**

Under IRC § 6654(c), individual taxpayers generally are required to make estimated tax payments in four installments due on or before April 15, June 15, September 15, and January 15. Under IRC § 6654(l), the same deadlines apply for estates and trusts.<sup>1</sup>

**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 based on regular three-month quarters than based on 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 estimated tax payments, and thus may reduce compliance.<sup>2</sup> They also cause confusion, as taxpayers struggle to remember the due dates. This confusion affects both traditionally self-employed workers and 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 15 days after the end of each calendar quarter (*i.e.*, April 15, July 15, October 15, and January 15).<sup>3</sup>

1 Under IRC § 6655(c), corporate taxpayers generally are required to make estimated tax payments in four installments due on April 15, June 15, September 15, and December 15. Some of the benefits of establishing uniform quarterly estimated payment deadlines apply to corporate taxpayers to the same extent as individuals. However, we have not analyzed the implications of changing the corporate estimated payment deadlines, so this recommendation is limited to the deadline applicable to individual taxpayers.

2 Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 12 (Feb. 2004).

3 For legislative language generally consistent with this recommendation, see Tax Deadline Uniformity Act of 2020, H.R. 5979, 116th Cong. § 2 (2020). See also Tax Deadline Simplification Act, H.R. 4214, 117th Cong. § 2 (2021); Protecting Taxpayers Act, S. 3278, 115th Cong. § 305 (2018); Small Business Owners’ Tax Simplification Act, H.R. 3717, 115th Cong. § 2 (2017).

## Legislative Recommendation #8

# 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 Maintained by U.S. Persons in the Countries Where They Are *Bona Fide* Residents

## 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 to the Financial Crimes Enforcement Network (FinCEN).<sup>1</sup> FinCEN Report 114, Report of Foreign Bank and Financial Accounts (FBAR), has been prescribed for complying with this requirement.

The Foreign Account Tax Compliance Act (FATCA)<sup>2</sup> added 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. IRS Form 8938, Statement of Specified Foreign Financial Assets, has been prescribed for complying with this requirement. 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,”<sup>3</sup> 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 exceptions from FATCA reporting when such reporting would duplicate other disclosures.

## REASONS FOR CHANGE

Many U.S. taxpayers, particularly those living abroad, face increased compliance burdens and costs because the FATCA reporting obligations significantly overlap with the FBAR filing requirements.<sup>4</sup> The IRS has exercised its regulatory authority to eliminate duplicative reporting of assets on Form 8938 if the assets are reported or reflected on certain other timely filed international information returns (*e.g.*, Forms 3520, 3520A, 5471, 8621, 8865, or 8891).<sup>5</sup> The IRS has also provided an exception from the reporting rules for *bona fide* residents of U.S. territories for financial accounts held in such territories.<sup>6</sup>

However, the IRS has not adopted 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 been reported on an FBAR.<sup>7</sup> Although FBARs are filed with FinCEN,

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

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

3 See IRC § 1471(d)(1) for a definition of “United States account.”

4 IRS, Comparison of Form 8938 and FBAR Requirements, <https://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements> (last visited Nov. 6, 2020).

5 Treas. Reg. § 1.6038D-7(a)(1).

6 Treas. Reg. § 1.6038D-7(c).

7 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).

the IRS has access to the information on those forms. We understand the IRS is concerned that FinCEN could change the FBAR, leaving the IRS without access to information about foreign accounts that are not required to be reported on a Form 8938. However, this should not be a concern if only accounts actually reported on an FBAR may be omitted from a Form 8938 on which they would otherwise have to be reported.

In addition, the IRS has not adopted the National Taxpayer Advocate's recommendation to provide an exception from FATCA reporting for financial accounts held in the country in which the U.S. taxpayer is a *bona fide* resident. If adopted, these recommendations would reduce compliance burdens for U.S. taxpayers, who currently must file additional complex forms themselves or pay higher tax return preparation fees. If adopted, these recommendations could also reduce the compliance burdens for FFIs, some of which are reluctant to do business with U.S. expatriates because of the significant costs and regulatory risks associated with ongoing FATCA compliance. This reluctance makes it difficult for U.S. citizens to open bank accounts in certain countries.

## RECOMMENDATIONS

- Amend IRC § 6038D to (i) eliminate duplicative reporting of assets on Form 8938 where an asset is reported or reflected on an FBAR, and (ii) exclude financial accounts maintained by a financial institution organized under the laws of the country of which the U.S. person is a *bona fide* resident from the specified foreign financial assets required to be reported on Form 8938.<sup>8</sup>
- Amend IRC § 1471 to exclude financial accounts maintained by a financial institution organized under the laws of the country of which the U.S. person is a *bona fide* resident from the definition of “financial account” subject to reporting by FFIs.<sup>9</sup>

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8 For legislative language similar to this recommendation, see The Overseas Americans Financial Access Act, H.R. 4362, 116th Cong. §§ 2 & 3 (2019) (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); H.R. 2136, 115th Cong. §§ 1 & 2 (2017) (same).

9 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*).

**Legislative Recommendation #9****Adjust the Filing Threshold for Taxpayers Filing as Married Filing Separately and Nonresident Alien Individuals****PRESENT LAW**

IRC § 6012(a)(1)(A) generally requires individuals to file tax returns if their gross income equals or exceeds the sum of (i) the “exemption amount” provided in IRC § 151 and (ii) the applicable standard deduction amount provided in IRC § 63(c). However, some individuals must file returns if their gross income equals or exceeds solely the exemption amount. They are:

- U.S. resident taxpayers who are married but file separate (MFS) returns; and
- Nonresident alien individuals, regardless of their filing status.<sup>1</sup>

If the Tax Cuts and Jobs Act of 2017 (TCJA) had not been enacted, the exemption amount for a single taxpayer for tax year (TY) 2018 would have been \$4,150, meaning that these two groups of taxpayers would be required to file returns only if their incomes exceeded that amount.<sup>2</sup> However, the TCJA suspended the personal exemption for TYs 2018-2025, effectively reducing it to zero.<sup>3</sup> As a result, MFS taxpayers and nonresident alien individuals must file tax returns if they have gross income equal to or greater than zero dollars, even if, after taking into account allowable deductions and other adjustments, their taxable income is zero and they owe no tax.

**REASONS FOR CHANGE**

The House Ways and Means Committee report accompanying the TCJA clarified that its intent in suspending the personal exemption, which was accompanied by an increase in the standard deduction, was to “simplif[y] the tax code while allowing a minimum level of income to be exempt from Federal income taxation.”<sup>4</sup> For the majority of taxpayers, the TCJA raised the threshold at which the taxpayer must file a return.<sup>5</sup> However, the result for MFS taxpayers and nonresident alien individuals, who now must file tax returns even if they have zero dollars of gross income, runs contrary to this congressional intent.

Married taxpayers may file MFS for several reasons, ranging from a choice to pay as little tax as possible under the law to a need to protect their privacy in a domestic abuse situation involving a spouse. Without at least a minimum filing threshold, these taxpayers and nonresident aliens must file returns even if they are not working or earning any income during the tax year.

The IRS, recognizing congressional intent and the administrative burden on taxpayers, provided relief to MFS taxpayers by setting the filing threshold at \$5 for TYs 2018, 2019, and 2020.<sup>6</sup> For nonresident alien individuals, the IRS similarly set the filing threshold at \$5 for TY 2018, but it did not do so for TY 2019 or

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1 IRC § 6012(a)(1)(A) (imposing a tax-return filing requirement on married taxpayers filing separate returns without taking into account the standard deduction) and § 63(c)(6) (providing that nonresident alien individuals have a standard deduction amount of zero).

2 TCJA, Pub. L. No. 115-97, 131 Stat. 2054 (2017); Rev. Proc. 2017-58, § 3.24, 2017-45 I.R.B. 489, 494. Having a filing requirement does not necessarily mean there is a tax liability. For example, in TY 2018, tax was imposed on MFS taxpayers whose taxable income exceeded \$9,525. Rev. Proc. 2017-58, § 3.01, 2017-45 I.R.B. 489, 491.

3 TCJA, Pub. L. No. 115-97, § 11041, 131 Stat. 2054, 2082 (2017) (codified at IRC § 151(d)(5)(A)).

4 H.R. REP. No. 115-409 at 125 (2017).

5 If the TCJA had not been enacted, the standard deduction for a single individual taxpayer for TY 2018 would have been \$6,500 and, as noted, the exemption amount would have been \$4,150, resulting in a filing requirement if gross income equaled or exceeded \$10,650. Rev. Proc. 2017-58, §§ 3.14 and 3.24, 2017-45 I.R.B. 489, 493-494. For TY 2018, the TCJA suspended the personal exemption but raised the standard deduction to \$12,000 for an individual, an increase in the filing threshold of \$1,350. TCJA, Pub. L. No. 115-97, § 11021, 131 Stat. 2054, 2072 (2017) (codified at IRC § 63(c)(7)(A)).

6 IRS Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, 3 (2018-2020 versions).

2020.<sup>7</sup> Although establishing a \$5 filing threshold removes the requirement that these taxpayers file returns when they have no income, it continues to impose a filing burden on those whose income exceeds \$5 but who do not have a tax liability. This filing requirement also imposes an additional burden on the IRS because it must process these returns despite the taxpayers having zero tax liability. Returning the filing threshold for MFS taxpayers and nonresident alien individuals to an amount equal to the personal exemption prior to its suspension would reduce burden for both taxpayers and the IRS. Such a change would also be consistent with Congress's intent to preserve a minimum level of individual income exempt from tax.

## **RECOMMENDATION**

- Amend IRC § 6012(a)(1)(A) to provide that MFS and nonresident alien taxpayers whose gross income does not equal or exceed \$4,150 for TY 2018, adjusted for inflation for TYs 2019-2025, are not required to file a tax return.

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<sup>7</sup> IRS Pub. 519, U.S. Tax Guide for Aliens, 35-36 (Feb. 2019); IRS Pub. 519, U.S. Tax Guide for Aliens, 34 (Mar. 2020); IRS Pub. 519, U.S. Tax Guide for Aliens, 35 (Feb. 2021).

**Legislative Recommendation #10****Amend the Lookback Period for Allowing Tax Credits or Refunds Under IRC § 6511(b)(2)(A) to Include the Period of Any Postponement of Time for Filing a Return Under IRC § 7508A****PRESENT LAW**

IRC § 6511(a) provides that taxpayers who believe they have overpaid their taxes may file a claim for credit or refund with the IRS by the later of:

1. Three years from the date the return was filed, or
2. Two years from the date the tax was paid.

IRC § 6511(b) places limits on the amount the IRS may credit or refund by using a two- or three-year lookback period:

1. Taxpayers who file claims for credit or refund within three years from the date the original return was filed will have their credits or refunds limited to the amounts paid within the three-year period before the filing of the claim plus the period of any extension of time for filing the original return (the “three-year lookback period”). See IRC § 6511(b)(2)(A).
2. Taxpayers who do not file claims for credit or refund within three years from the date the original return was filed will have their credits or refunds limited to the amounts paid within the two-year period before the filing of the claim. See IRC § 6511(b)(2)(B).

For calendar-year taxpayers, IRC § 6513(b) provides that any tax deducted and withheld on wages and any amount paid as estimated tax are deemed to have been paid on April 15 in the year following the close of the taxable year to which the tax is allowable as a credit.

Under IRC § 7508A, when the Secretary determines that a taxpayer has been affected by a federally declared disaster, the Secretary is authorized to “disregard” for up to one year certain acts a taxpayer is required to undertake under the Internal Revenue Code, including the filing of a tax return. The word “disregard” in this context has been interpreted to mean “postpone.” For example, the Secretary exercised this authority to address the COVID-19 pandemic by postponing the filing deadline in 2020 to July 15, and the filing deadline in 2021 to May 17, for calendar-year individual income taxpayers.<sup>1</sup>

**REASONS FOR CHANGE**

For purposes of determining the lookback period for the allowance of tax credits or refunds, there is a legally significant distinction between a return filed after the regular filing deadline due to an *extension* of the filing deadline and a return filed after the regular filing deadline due to a *postponement* of the filing deadline. When a taxpayer files a Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, IRC § 6511(b)(2)(A) extends the three-year lookback for the period of extension (generally by six months). When a filing deadline is postponed under IRC § 7508A, however, the three-year lookback period

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<sup>1</sup> See Notice 2020-23, Update to Notice 2020-18, Additional Relief for Taxpayers Affected by Ongoing Coronavirus Disease 2019 Pandemic; Notice 2021-21, Relief for Form 1040 Filers Affected by Ongoing Coronavirus Disease 2019 Pandemic. These notices did not affect the date on which any withheld tax or estimated tax for 2019 is deemed paid. Any withheld tax or estimated tax for 2019 is deemed paid on April 15, 2020, for calendar-year taxpayers.

on amounts paid is not extended to include payments made more than three years earlier than the postponed filing date.<sup>2</sup>

*Example:* In 2019, a taxpayer had income tax withheld from his paycheck every two weeks. In 2020, the taxpayer filed his 2019 return on the postponed filing deadline of July 15. The taxpayer's 2019 tax liability was fully paid through withholding, which was deemed paid on April 15, 2020, the due date of the return. Based upon the filing deadline postponement to July 15, the taxpayer timely files a claim for refund on July 14, 2023. Under IRC § 6511(a), the claim for refund is timely. Under the three-year lookback period of IRC § 6511(b), however, the amount of the taxpayer's refund is limited to payments made in the three years prior to filing the claim (*i.e.*, payments made on or after July 15, 2020). The withholding deemed paid on April 15, 2020, falls outside that period (as would any estimated tax payments), so the claim for refund will be denied.

By contrast, if the taxpayer had requested a filing *extension* until October 15, 2020, the taxpayer would have had until October 16, 2023 (October 15, 2023, is a Sunday)<sup>3</sup> to be eligible to receive a refund.

We do not believe the outcome in the above example was intended. More likely, it is an unanticipated result of the interaction between the rules governing the filing of a claim for credit or refund and the rules limiting the amount of a credit or refund that may be allowed. The date for filing a claim for credit or refund and the lookback period generally align, but they do not align in these circumstances. Because of the large number of taxpayers who relied on the *postponed* filing deadlines in 2020 and 2021, the National Taxpayer Advocate recommends that Congress act quickly to authorize the IRS to pay refunds with respect to amounts paid within the preceding three-year period plus the period of any postponement of the filing deadline pursuant to IRC § 7508A before these refund claims are filed.

## RECOMMENDATION

- Amend IRC § 6511(b)(2)(A) to provide that when the Secretary postpones a filing deadline pursuant to IRC § 7508A, amounts paid in the three-year period preceding the filing of a claim for credit or refund plus the period of any postponement of the filing deadline are eligible for credit or refund.

2 See Chief Counsel Advice 2020-53013 (Dec. 31, 2020) (concluding that the additional time prescribed by Notice 2020-23 is not an "extension" within the meaning of the three-year lookback period). By contrast, an extension of the filing deadline until October 15 will extend the lookback period until October 15. See IRC § 6081; Treas. Reg. § 1.6081-4.

3 See IRC § 7503 (when last day for filing falls on a Saturday, Sunday, or legal holiday, the act will be timely if performed on the next business day).