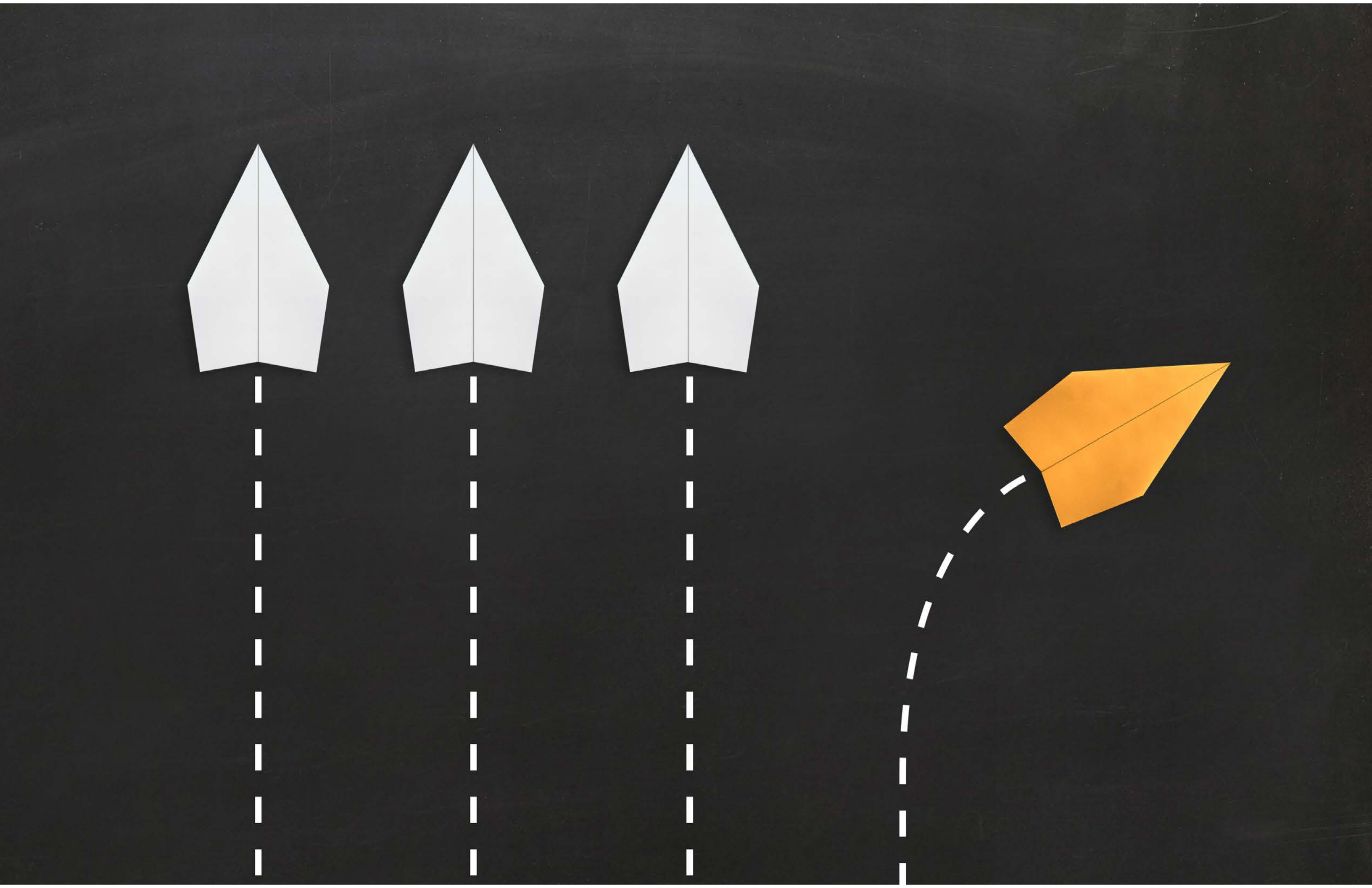
Gotchas in Year-End Tax Reporting & Best Practices for Avoiding Them



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The end of the year is rapidly approaching and that means that tax season is nearly upon us. For the last 30 years, Sovos has helped clients Solve Tax For Good by providing technology and services that help them comply with IRS withholding and information reporting requirements. And during that time, we have seen many businesses fall victim to last-minute hurdles and obstacles related to year-end reporting.

Below are some of the most common issues we've seen, followed by the best practices to help your business avoid them.

Tracking due dates

The IRS has different due dates for filing information and providing recipients with their tax forms. These dates depend on the types of forms and information that your organization generates. A few examples include:

- Form 1099-MISC with non-employee compensation amounts (box 7) is required to be filed with IRS, and most of the states, by January 31st. But, the rest of the boxes on that form are not due to be filed until the end of March, if filing electronically.
- Form 1042-S is due to be filed to the IRS by March 15th.
- Form 5498 is due to be filed by May 31st.

The states all have unique due dates for the various information returns too. Failure to file information returns by the due date and failure to issue 1099's to recipients by the due date can result in penalty assessments from the IRS. And unless there is some catastrophic event that can be cited as a mitigating factor for non-compliance, there is little to no chance of getting those penalties abated.

Communicating due dates to partners

Many organizations have multiple people involved with the year-end reporting process. Their responsibilities include extracting data from different systems, approving data before it is printed and mailed to recipients, and more. When business partners do not prioritize the tax reporting activities during January, it can wreak havoc on the entire downstream process. Files might be sent late for printing and mailing, which can result in a storm of customer and vendor calls looking for the form. Employees may have to work unnecessarily long hours during January just because other employees upstream failed to do their part in a timely manner.

Testing data quality

Throughout the year, the states and IRS change the tax reporting requirements. At the same time, your business changes your operating systems. These changes can cause a whole host of problems when it's time to report. We have heard a variety of horror stories from our clients that failed to test the year-end process before January. One client mailed 40,000 forms with the social security number (SSN) instead of the dollar amounts paid in the income boxes. Another client mailed 50,000 forms that contained a decimal point error. This caused the income paid amounts to appear far greater than what was actually paid to the recipient. The headlines screamed of organizational incompetence, causing reputational issues with clients and regulators.

Testing all outputs

Each of the states and the IRS have different format requirements for electronic and paper filings. The IRS also requires a specific printed statement or electronic statement format to be provided to recipients. Clients that do not test the creation of all these various outputs inevitably run into a problem during busy season and find themselves scrambling to get it resolved. One client failed to test the print and mailing process of tax forms and mailed a large volume of forms with the Taxpayer Identification Number (TIN) showing in the window envelope. Another client failed to test the electronic statement process. When their customers clicked the link where the form was supposed to be located, they received the dreaded "404 Not Found" error. Again, these issues create risk for the organization in terms of customer retention, reputation issues and potential penalties from the IRS and states.

Balancing withholding amounts before filing

Throughout the year, withholding is applied to transactions and remitted to the IRS and states. At the end of the year, organizations are required to file Form 945 (and/or the state equivalent) to reconcile all of the withholding taxes that were submitted and reported on Form 1099. When the IRS cannot balance the amounts reported on Form 945 to the sum of all of the withholding amounts reported in Box 4, the organization will receive a penalty notice. To make matters worse, the IRS doesn't usually send these notices until three years after the original filing date. This allows time for the organization to file corrected 1099s or amended Form 945s to resolve the outage. This delay in time can make it difficult to pinpoint where outages have occurred and correct them.

Filing extensions

The IRS and some states offer extensions for filing information and mailing statements to recipients. Many organizations file forms with the IRS and states after the due dates, rather than taking advantage of extensions available to them. Missing reporting deadlines with the states and IRS can result in penalties. Sending recipient statements after the due date also subjects the organization to penalties and reputational issues. What's worse, if recipients start complaining to the IRS that they haven't received their tax information, your organization might find itself under audit.

Communicating changes to recipients

When a significant regulatory change occurs, there is usually a lot of communication from the IRS and states to tax professionals. Tax professionals summarizing this information and passing it along to recipients is extremely important because it is the only way for them to receive updates. And even if recipients did receive updates, they don't always understand what they mean. Changes can also occur in the process. Maybe your organization decides to change the layout of the tax forms they issue to make it easier for clients to understand the information, for example. When changes occur that will impact the recipient, organizations that fail to notify them can find themselves in hot water. Customers calling with tax questions that a customer service team cannot answer can lead to misinformation being communicated to the recipient and reputational risk for the organization.

Balancing file data

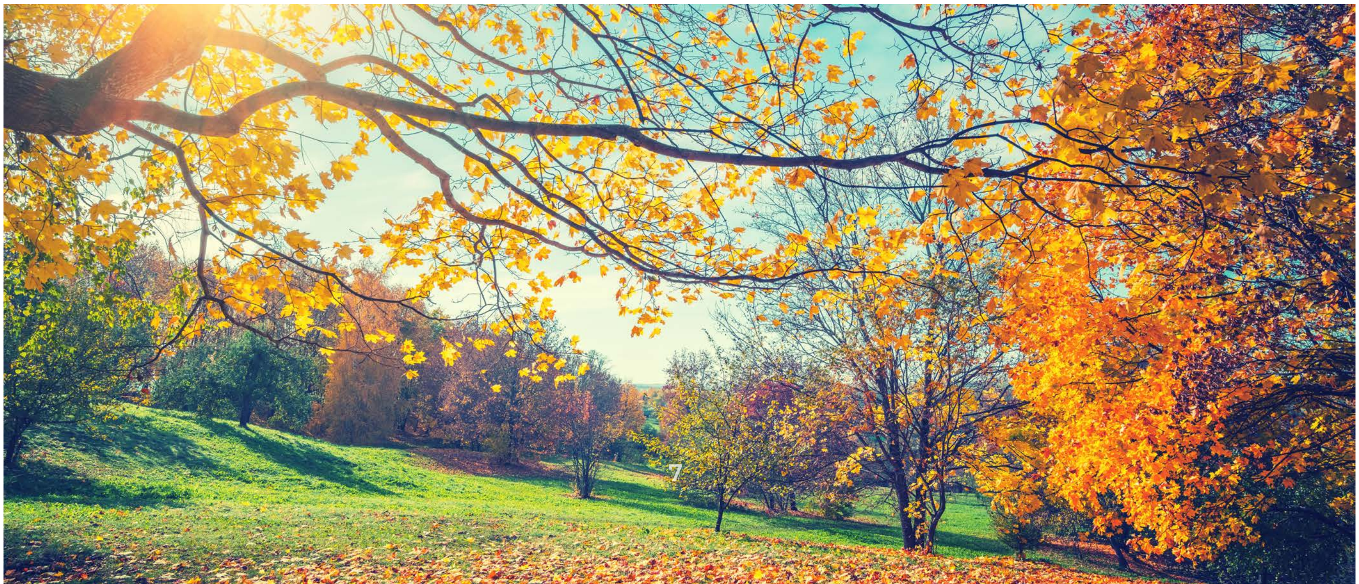
Tax information can be generated from various source systems. Once imported into the tax solution, records are converted to the IRS and state outputs, as well as print outputs for the recipients. When information is imported from various sources, records can be dropped and information can be misread. One prospective client found out the hard way that hundreds of 1099 forms had been dropped during the import process when the recipients began calling in February looking for their forms. Similarly, when information is carved out of the tax solution and funneled into various print and electronic outputs, the same issues can occur. Another client received IRS penalties because the information that they printed and mailed to recipients was not the same information that was filed with the IRS electronically.

Protecting recipient's private information

Tax information is sensitive. TINs, names, addresses, account numbers and other private information is all contained in one document. Clients have reported a number of problems when tax information is printed and mailed. One client mailed 1099s that contained the wrong social security numbers (SSNs), which exposed the recipient's SSNs to other recipients. Another client received numerous calls from a swath of recipients whose forms showed up with ripped and taped together envelopes, clearly indicating that they had been opened. Every year, we hear about private information being leaked and the repercussions are significant. There are state laws that require companies to report breaches and provide protection to the impacted recipients. There is a significant reputational risk as recipients lose faith in your organization's ability to protect their private information.

A year-round process

Perhaps one of the biggest issues that we see in tax reporting is organizations that treat this as a once-a-year obligation. Larger organizations that wait until the end of the year to begin preparing for the busy month of January often find themselves working long hours, mailing out incorrect tax information and filing corrections and amended corporate returns. One client was pulling together multiple source data files of names, addresses and TINs and the data quality was so poor that they had to file extensions to print and mail by January 31st. Another client experienced a $300,000 proposed penalty, not including B-notice expenses, from the IRS because they did not have time to analyze data quality and failed to recognize that they had a large amount of missing or obviously invalid TINs.



Best practices

In addition to the most common issues businesses deal with during year-end reporting, we have also kept track of some best practices that we and other clients use to avoid these issues.

Tracking due dates

- Create a calendar of due dates for IRS and state filings. Keep in mind that some tax forms have different due dates from other forms.
- Develop a project plan that includes all activities necessary to generate each file and set specific due dates for each task.

Communicating with partners

- Hold an annual kickoff meeting with all partners in October. Review the calendar of due dates with partners and communicate applicable penalties and consequences for not adhering to the timelines.

Testing data quality

- Utilize modern tax technology that validates data according to IRS and state reporting rules for the form. Create relevant test cases to ensure that demographics, dates, amounts, codes and checkboxes are all appropriately updating according to the source data.

Testing outputs

- Create balancing reports to confirm record counts and dollar amounts imported from source transaction systems into the tax solution.

Balancing file data

- Balance source systems to the tax solution.
- Balance the tax solution to the IRS file.
- Balance the tax solution to the print file.

Balancing withholding amounts

- Utilize modern tax technology (not Excel) to compare general ledger withholding tax liabilities to Box 4 of the Forms 1099 before filing with the IRS.
- Balance withholding amounts to Forms 1099 quarterly to ensure that outages are pinpointed early and cleared up. This will avoid downstream penalty issues with the IRS.

Filing extensions

- Anticipate issues and file extensions early. Extensions can be filed for reporting most Forms 1099 and other forms. Wait for approval. Extensions of time to print and mail tax statements must be approved by the IRS. Make sure to submit the extension early so that there is time to receive that approval.

Communicating changes to recipients

- Provide customer service teams with FAQs about how they should answer inquiries.
- Document discussions about changes with stakeholders and record the details in follow-up notes.

Protecting private information

- Use TIN masking. The IRS allows filers to mask the TIN on the printed tax statement so that this very private information is not exposed in the event of an issue in the mailing process.
- Apply National Change of Address (NCOA) to data before mailing data and reroute tax statements to the most updated address on file with the USPS.

A year-round process

- Run a quarterly data cleanse. Clean up missing and invalid TIN information and demographic issues with names and addresses. Balance withholding to the 1099s quarterly. Pinpoint outages and resolve them before January so that your organization can file an accurate Form 945 by the due date.

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