

Status Update: The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

RESPONSIBLE OFFICIAL

Faris Fink, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The IRS and the Social Security Administration (SSA) jointly administer the Combined Annual Wage Reporting (CAWR) program, which compares employer data reported to the IRS with the employer/employee data reported to SSA to ensure accurate reporting of taxpayers' wages. Employers file Form 941, *Employer's Quarterly Tax Return* with the IRS, and file Form W-2, *Wage and Tax Statement* for each employee with SSA. Ideally, all information reported on Forms 941 should match the information on Forms W-2 for all employees in a given year. In practice, however, that is not always the case. The IRS and SSA both use a reconciliation process to ensure employers filed the correct W-2s timely and withheld and paid the proper amount of tax.

In prior Annual Reports to Congress, the National Taxpayer Advocate raised concerns about problems employers encountered with the IRS's reconciliation process.¹ The IRS has significantly improved the CAWR program by:

- Adjusting its workload to better align with resources;
- Improving inventory management and case selection;
- Issuing interim letters to taxpayers with updates on their cases; and
- Providing copies of CAWR notices to authorized third parties.

While these changes have reduced problems, the IRS should continue improving CAWR procedures by exploring the causes for and resolving these issues:

- The IRS's untimely responses to employers' correspondence cause unnecessary assessment and subsequent abatement of penalties.
- The low employer response rate to CAWR notices leads to rework for the IRS.
- The assessment of penalties by the IRS may not improve employers' reporting compliance.

¹ National Taxpayer Advocate 2003 Annual Report to Congress 220 (Most Serious Problem: *Combined Annual Wage Reporting (CAWR) Reconciliation*); National Taxpayer Advocate 2008 Annual Report to Congress 316 (Most Serious Problem: *Inefficiencies in the Administration of the Combined Annual Wage Reporting (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resource*); National Taxpayer Advocate 2010 Annual Report to Congress 291 (Most Serious Problem: *The Combined Annual Wage Reporting Program Continues to Impose a Substantial Burden on Employers*).

ANALYSIS OF PROBLEM

Background

In the 1970s, Congress grew increasingly concerned about the burden the wage and tax reporting system placed on employers, especially small businesses. Before tax year 1978, employers filed Form 941 to report wages in the aggregate for all employees, and also filed Form 941-A, listing employees by name, Social Security number and the amount of wages paid to each employee in that quarter. After processing the returns, the IRS sent the Forms 941-A to SSA for posting to individual employees' wage records.

In 1976, Congress enacted legislation to address the reporting and filing burden for employers.² The new provision authorized the IRS and SSA to enter into an agreement to process wage and tax information starting with tax year 1978. Under CAWR, employers no longer reported wages earned by individual employees quarterly, but only reported the aggregate total of wages paid to all employees. This change may have reduced the filing burden for employers, but it increased the potential for discrepancies. Under CAWR, employers submit wage and tax data to the IRS and SSA in different formats and at different times during the year.

Currently, employers must file employment tax returns *i.e.*, Forms 941, *Employer's Quarterly Federal Tax Return*, with the IRS.³ Employers also file Forms W-2 and Form W-3, *Transmittal of Wage and Tax Statements* with SSA. The IRS and SSA have their own systems for reconciling discrepancies in wages reported.⁴ When more wages are reported to SSA than to the IRS, the IRS examines the discrepancy as an IRS-CAWR case to determine if the employer underpaid Social Security tax and additional tax is due. However, an employer's failure to file correct Forms W-2 timely can adversely affect an employee's eligibility for SSA benefits. In an SSA-CAWR case, SSA matches Form 941 data with Forms W-2 and W-3 and notifies the employer of missing or incorrect W-2 forms. If the employer does not respond, SSA refers the case to IRS for enforcement action.⁵

In either an IRS-CAWR or SSA-CAWR case, the IRS attempts to reconcile the discrepancy by sending notices to the employer requesting additional information to clarify wages paid and taxes withheld. The IRS can penalize employers that do not respond and also can assess penalties if employers fail to file information returns such as Forms W-2 or file them

² Pub. L. No. 94-202, § 8, 89 Stat. 1137, (1976).

³ Employment tax returns include Form 941 (*Employer's Quarterly Federal Tax Return*), Form 943 (*Employer's Annual Tax Return for Agricultural Employees*), and Form 944 (*Employer's Annual Federal Tax Return*). Taxpayers also file Form 945 (*Annual Return of Withheld Federal Income Tax*), Schedules H (*Household Employment Taxes*) with Forms 1040 (*U.S. Individual Income Tax Return*) or 1041 (*U.S. Income Tax Return for Estates and Trusts*).

⁴ Agreement between the SSA and IRS (2007).

⁵ The IRS reconciliation process takes place two to three years behind the current year. For example, in 2012, the IRS is examining IRS-CAWR cases for tax year 2010 and SSA-CAWR cases for tax year 2009. An IRS-CAWR case involves underpayment of taxes, excess withholding tax, or Advanced Earned Income Tax Credit (AEITC), which Congress repealed for years after tax year 2010. An SSA-CAWR case is generated when an employer does not file proper wage and tax statements (Forms W-2).

The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

after the due date.⁶ Recent legislation has increased the penalties under Internal Revenue Code (IRC) § 6721(a) from \$50 to \$100, beginning with tax year 2011, for each information return an employer fails to file timely and correctly.⁷ IRC § 6721(e) provides for a harsher penalty if an employer intentionally disregards filing requirements. The Treasury Regulations define “intentional disregard” as knowing or willful conduct.⁸ Whether a person knowingly or willfully fails to file timely or fails to include correct information is determined based on all the known facts and circumstances in the particular case.

The IRS Took Steps to Improve the CAWR Program but Needs to Address Ongoing Delays.

As of May 2010, the IRS failed to work almost 87 percent of all CAWR correspondence timely.⁹ The IRS has since implemented improvements in the program that reduced its overaged correspondence rate to 25.6 percent.¹⁰ The figures below show the inventory and the percentage of overage CAWR cases at the end of fiscal years (FY) 2010, 2011, and 2012.¹¹

⁶ IRM 4.19.4.3.1 (Apr. 3, 2012).

⁷ Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2102, 124 Stat. 2504 (2010). The effect of the change in the amount of the penalty will not be known until 2014, when IRS reconciles 2011 wage and tax data.

⁸ Treas. Reg. § 301.6721-1(f)(2) (2010).

⁹ National Taxpayer Advocate 2010 Annual Report to Congress 291 (Most Serious Problem: *The Combined Annual Wage Reporting Program Continues to Impose a Substantial Burden on Employers*).

¹⁰ Small Business/Self-Employed Division (SB/SE) response to TAS information request (Oct. 15, 2012).

¹¹ Inventory is considered overage after 90 days from the IRS-received date of taxpayer correspondence. SB/SE response to TAS information request (Dec. 5, 2012).

The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

FIGURE 1.S6.1, Inventory and Overage CAWR Cases¹²

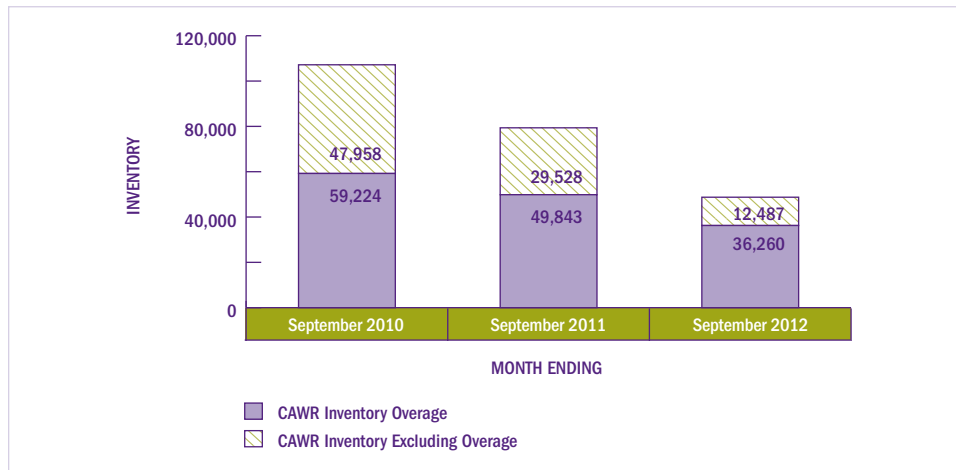
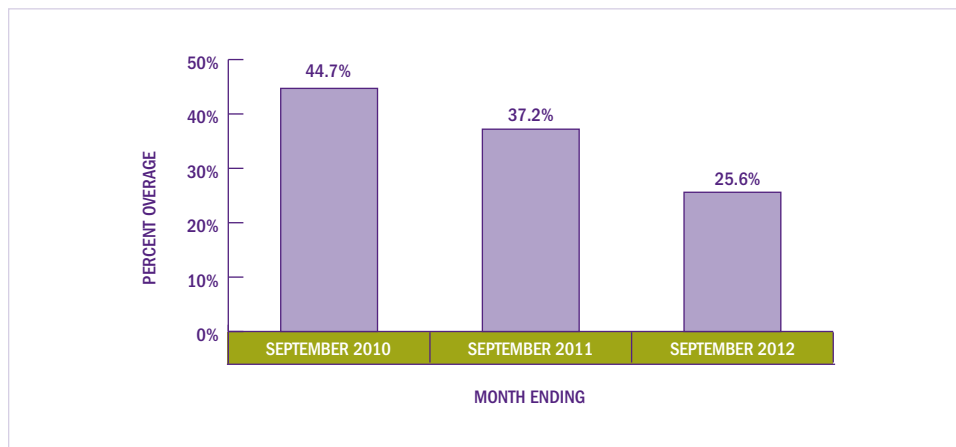


FIGURE 1.S6.1, Percent of Overage CAWR Cases¹³



As part of the effort to improve the program and reduce overage cases, in 2012 the IRS completed its consolidation of the program from three to two campuses located in Memphis and Philadelphia¹⁴, but staffing decreased by 28 percent over FY 2010 levels.¹⁵ In contrast, the volume of correspondence continues to increase.¹⁶ While the IRS uses reports

¹² SB/SE response to TAS information request (Oct.15, 2012).

¹³ *Id.*

¹⁴ Servicewide Electronic Research Program (SERP) Alert 12A0394, CAWR IRM 4.19.4 and FUTA 4.19.5 Case Routing Changes (June 18, 2012). The consolidation of the CAWR program started in Nov. 2010, available at <http://mysbse.web.irs.gov/Collection/toolsprocesses/CaseRes/adj/send/cf/JobAids/18009.aspx> (last visited Dec. 5, 2012).

¹⁵ Total staffing in the CAWR Unit in FY 2010 was 164 employees and in FY 2012 136 employees. SB/SE response to TAS information request (Oct. 5, 2012).

¹⁶ SB/SE response to TAS information request (Sept. 26, 2012).

The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

to monitor inventory and address further aging of cases, factors such as the decrease in staffing, increased workloads, and competing priorities continue to contribute to the delays in resolving overage CAWR cases.¹⁷

The Low Response Rate to CAWR Notices Leads to Rework for the IRS.

In FY 2012, the IRS closed 52 percent of CAWR cases because it did not receive responses from employers.¹⁸ In these cases, the IRS assesses the proposed tax and penalty and begins collection efforts, at which point employers may request abatement of the assessment. All of these events cause rework for the IRS. The table below shows the number of responses in CAWR cases closed in a fiscal year.

FIGURE 1.S6.3, Response to CAWR Notices¹⁹

Fiscal Year	Closure Notices	Replies	Late Replies ²⁰	No Replies	Undeliverable Notices
2010	289,244	40,447	5,376	156,617	15,537
2011	204,287	23,844	6,206	129,579	14,666
2012	266,801	60,816	10,977	139,204	5,929

¹⁷ IRM 4.19.4.10.1 (Apr. 3, 2012) describes the CAWR Tax Examiner's responsibilities and priorities.

¹⁸ SB/SE response to TAS information request (Oct. 5, 2012). The response rate is the number of timely replies divided by the number of closure notices.

¹⁹ SB/SE responses to TAS information requests (Sept. 26, 2012 and Oct. 5, 2012). The figure includes data about the notices IRS sends in IRS-CAWR and SSA-CAWR cases.

²⁰ Late replies are cases in which the employer's response is received by the IRS after the initial case is closed on the CAWR Automated Program (CAP system). IRM 4.19.4.6 (Apr. 1, 2010). The late replies listed in the figure represent notices issued for specific tax years worked during each fiscal year.

The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

FIGURE 1.S6.4, Response Rate to CAWR Notices²¹



As shown above, the response rate almost doubled and the number of employer replies for FY 2012 increased by 155 percent compared to FY 2011. Additionally, the number of undeliverable notices declined by 60 percent during that time.²² The IRS revised CAWR notices to provide more detailed wage and tax information to help employers reconcile discrepancies and began sending notices to authorized third parties, which may explain the increase in employer replies. Although the IRS has improved its communications to employers, the IRS should research and study potential reasons behind the low response rate and develop approaches to address the problem, including establishing toll-free phone lines in CAWR operations or allowing employers to establish alternate business addresses for employment tax matters.²³

The IRS Should Establish a Toll-Free Number for CAWR Units.

CAWR notices generally do not include a telephone number for direct access to the CAWR unit, but instead list a toll-free number answered by an automated system. The employer may reach a live assistor at the general IRS toll-free number who has no access to the CAWR discrepancy data and will simply advise the taxpayer to respond immediately by mail or fax.²⁴ The National Taxpayer Advocate recommended the IRS include a toll-free number for the CAWR units so employers can reach the employee working the actual case or at least with access to CAWR data. The IRS did not agree with the specific recommendation, but did commit to explore whether this idea was practical. In 2011, SB/SE asked

²¹ SB/SE responses to TAS information requests (Sept. 26, 2012 and Oct. 5, 2012). The figure includes data about the notices the IRS sends in IRS-CAWR and SSA-CAWR cases.

²² *Id.*

²³ Many employers have separate offices handling income tax matters and employment tax/payroll matters. They have suggested to the National Taxpayer Advocate that the IRS allow them to designate a separate address for employment tax correspondence, to eliminate routing delays and losses. Conversations between Information Reporting Program Advisory Committee (IRPAC) and the National Taxpayer Advocate, 2011 and 2012.

²⁴ IRM 4.19.4.11 (Feb. 1, 2008).

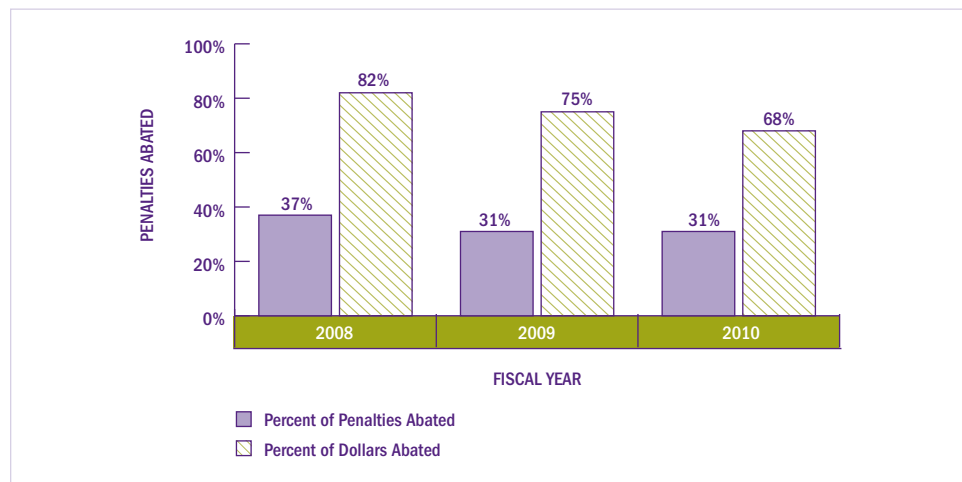
The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

for funding to establish a toll-free number in the CAWR units in 2013.²⁵ As SB/SE noted in the request, by the time the IRS receives the employer's correspondence, the case often has advanced to the next phase of assessment, which contributes to reconsideration cases and has led the National Taxpayer Advocate to list CAWR as a Most Serious Problem in her last two Annual Reports.²⁶ We applaud SB/SE for initiating this request and urge the IRS to move forward with implementation. Providing employers direct access to the CAWR operation would help to resolve cases, reduce correspondence backlogs, and vastly improve customer satisfaction.²⁷

The Decline in Penalty Abatements Warrants Further Study.

As the figure below shows, the percentages of penalty dollars and number of penalties abated in CAWR cases under IRC § 6721 (a) and (e) are declining.²⁸

FIGURE 1.S6.5, Percentage of CAWR Penalty Abatements²⁹



²⁵ SB/SE FY 2013 Initiative Business Case Justification CAWR FUTA Toll-Free Telephones (Jan. 2011).

²⁶ SB/SE considers late replies from taxpayers as reconsideration cases because they have already been closed and the IRS reopens it to consider the taxpayer's information to resolve the wage and tax discrepancy. See IRM 4.19.4.6 (Apr. 1, 2010).

²⁷ SB/SE FY 2013 Initiative Business Case Justification CAWR FUTA Toll-Free Telephones (Jan. 2011).

²⁸ IRS Enforcement Revenue Information System (ERIS), IRC § 6721, Penalty Data on Failure to File Information Return and Intentional Disregard Penalties from the Compliance Data Warehouse.

²⁹ IRS Enforcement Revenue Information System (ERIS), IRC § 6721(a) and (e), Penalty Data on Failure to File Information Return and Intentional Disregard Penalties from the Compliance Data Warehouse. ERIS captures data on civil monetary penalties.

The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

The IRS attributes the declines in abatement of penalty dollars and the number of penalties to clarified guidance, employee training, outreach, and education to employers. While this may be correct, the IRS has not gathered data to support its position. Moreover, the IRS has not determined the effect of the penalty on voluntary compliance. While the decline may suggest the penalties assessed are justified, the IRS cannot validate this assumption. The IRS maintains that penalties are meant to encourage compliance by increasing the cost of noncompliance.³⁰ In a final report issued in 2012, SB/SE Research stated that due to limited data, it cannot draw any conclusion about the long-term effects of penalties, and recommended further analysis when more data is available.³¹ However, SB/SE indicated it has no plans to continue the research.³² The National Taxpayer Advocate believes further analysis of the decline in penalty abatement and of the penalty's impact on compliance is warranted, and urges the IRS to continue its research.

CAWR Improvements Scheduled for FY 2014

The IRS plans to launch a redesigned CAWR system in FY 2014 as part of the Information Reporting Document Matching (IRDM) effort.³³ The new system is expected to upgrade automation and technology to support data-driven CAWR case creation and selection, better case management at the individual employer level, interest calculation capabilities, and various other inventory tracking and report functions. The National Taxpayer Advocate supports the IRS efforts to create a new CAWR system.

The National Taxpayer Advocate recommended the IRS redesign CAWR notices to include specific information to help employers comply or allow them more time to respond. The IRS has revised the notices to provide more detailed wage and tax information to help employers reconcile discrepancies, and has created a new notice to match non-payroll payments reported on Form 945, *Annual Return of Withheld Federal Income Tax*.³⁴ The new notices will be part of the launch of the new CAWR system in FY 2014.

³⁰ IRS Penalty Policy Statement 20-1, IRM 1.2.20.1.1(3)2 (June 29, 2004).

³¹ SB/SE Research Philadelphia, *Penalty Assessments on Information Returns*, Project ID: PHIL0164 (Feb. 2012).

³² SB/SE response to TAS information request (Sept. 28, 2012).

³³ See Most Serious Problem: *The Preservation of Fundamental Taxpayer Rights is Critical as the IRS Develops a Real-Time Tax System*, *supra*.

³⁴ SB/SE response to TAS information request (Sept. 28, 2012). Non-payroll payments include: pensions (including distributions from tax-favored retirement plans and annuities, military retirement, gambling winnings, Native American gaming profits, voluntary withholding on certain government payments, and backup withholding reported on Form 1099-R, *Distribution from Pensions*, Form 1099-MISC, *Miscellaneous Income*, and Form W-2G, *Certain Gambling Winnings*).

The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

CONCLUSION

Since 2010, the IRS has taken significant steps to improve the CAWR program and plans further improvements in FY 2014. The IRS should continue to evaluate the CAWR program's effectiveness and implement improvements. The National Taxpayer Advocate recommends that the IRS:

- Evaluate the late-response and no-response cases to determine if the current timeframe for employer response is reasonable and whether response would improve if employers could designate a dedicated address for employment tax notices.
- Study the reasons for the low employer response to CAWR notices and develop approaches to improve that rate.
- Continue research to determine whether the assessment of Failure to Timely File Information Returns penalty and the Intentional Disregard penalty increase employer compliance.
- Establish a toll-free operation dedicated to the CAWR units.
- Launch a redesigned and improved CAWR Program as part of the IRDM in FY 2014, as planned.