Tax Season Lessons: Extensions, e-file surge mark 2007 filing season

By **Roger Russell**

(June 4, 2007) - Regardless of which of the multiple return dates applied to taxpayers, e-filed returns during the 2007 filing season began pouring in early in the process and kept coming at a steady pace.

Statistics released by the Internal Revenue Service just prior to the end of the 2007 filing season showed e-filed returns up by 5.9 percent over the same period in 2006. Nearly a third of those returns were e-filed during March alone, up by more than 10 percent over last March.

Taxpayers filing electronically from home computers were up 8.3 percent over last year during the same period, with a quarter e-filed in March - an increase of 11 percent over last March. And e-filing by tax professionals was up 5 percent over the same period of last year.

Some taxpayers experienced multiple return due dates as a result of the storms and flooding that impacted the Northeast in mid-April. Initially, the IRS gave affected taxpayers an additional two days to file, but then extended the period until April 26 - nine days after the 2007 filing deadline of April 17. For those in the Presidential Disaster Area, the period was extended to June 25, 2007.

Historically, most e-filed returns have come in during the early part of tax season, when taxpayers who were expecting refunds used the service to get their refunds faster. But recent IRS statistics showed that this year, more late filers abandoned traditional paper returns in favor of e-filing. Traditionally, late filers who owe the government often use paper returns.

E-FILING BUMPS

However, despite the IRS's success with e-filing this past season, many practitioners had a less positive experience.

"It continues to be a challenge on a lot of different levels," said Alan Osmolowski, tax department head at regional New England firm Carlin, Charron & Rosen. "More and more states are mandating it without having the resources to implement it. They continue to change the schema during the season, which means the software vendors have to move quickly. It's made it more of a challenge on our end in getting work done."

"Also, it used to be that once you finished a return, you put it in the mail and your work was done. Now you have to get the client's approval to e-file, then mail them a hard copy to review and see if they agree, so there's an extra step. There's also the rejection notices when something doesn't match," he said. "For example, someone who gets married and never changes their name with the Social Security Administration. Since the name on the return doesn't jibe, it gets rejected."

"The taxing authorities have pushed a lot of the work on us," he continued. "It's especially so with some of the states. One state mandated e-filing, but the system wasn't ready, so then it was okay to paper file for a week, but 'After next Friday it's back to e-file.'"

Arthur Bloom, a partner at the New York office of Marks Paneth & Shron LLP, noted many of the same problems. "We experienced some snags in e-filing," he said. "After the return is done, you have to wait for client authorization to let you file. When it gets close to the deadline, things can get pretty tight. For example, one of our returns got kicked back because a dependent's Social Security number was wrong. The couple had a new child as well as a three-year-old. It took awhile to find that the error wasn't the new dependent's number, but the number of the three-year-old."

"Also, you can't have more than three columns for foreign countries on Form 1116 [Foreign Tax Credit]," he added. "If you have a high number of tax credits from different countries with different sources of foreign income, the return can't be e-filed. And different states have forms or schedules that aren't eligible. It gets frustrating when you don't know that you can't e-file until you're just about done with the return."

Bill Fleming, personal finance managing director with PricewaterhouseCoopers' private company services practice, noted that at one point the IRS got overloaded and couldn't accept e-filed returns. "Something blew the systems out," he said. "It happens at the state levels, as well. Last September 15, we had people late at night trying to shoot corporate returns to the IRS again and again. It's tough to prove, but if you're late and owe money, there are big penalties."

A TEAM EFFORT

Both Bloom and Osmolowski agreed that good staff were vital to a successful season. "Having a quality staff that is well-trained and prepared is key to a successful tax season," said Bloom.

"Our season was a lot smoother in terms of staffing because we had a lot more senior accountants," said Osmolowski. "We hire 12 to 14 college recruits every year, and sometimes it's difficult to keep them all busy. But given the staffing shortage, we knew that we couldn't go out and hire extra help for the tax season. This year it paid off in terms of not having to make people work 70-hour weeks."

For Fleming, one problem that surfaced this filing season was matching estimated tax payments. "A lot of clients don't remember when or how much they paid," he said. "Some states - New York and California - allow you to check online, but most of the states and the IRS don't give you a way to check a payment on an account."

The proliferation of corrected Form 1099s is continuing, according to Fleming. "It was a little better this year, because the IRS gave brokers 30 days extra to get them in. They sent them out at the end of February, instead of January. It compressed our season, but a lot still got revised again and again. We're wondering what will happen with the IRS matching programs, because the amended 1099s keep flying around. If the client overpaid, we don't do anything if the dollar difference is small."

"But some brokers don't track cost basis data on buys and sells," he said. "We have to call and ask them to send the information, then they have to get the client to approve. Often the broker will say they sent it with the monthly statements, but the client threw it away."

OTHER WORRIES

Many charities fall short when it comes to their thank-you notes, said Fleming.

"They are supposed to specify that no services were received, but they don't always say that. Sometimes they don't include the amount of the gift," he said. "The best ones are for gifts of stock, where they tell you how much it sold for, but the deduction is based on the average of the high and the low on the day the stock passed into the hands of the charity."

"One transfer went astray to the wrong charity, the charity mistakenly sold the stock, then sent back the cash," he noted. "What to do now? The taxpayer wanted to give stock and reduce his taxes, but he got back cash - is it now a gain? That's one return we put on extension."

"A lot of nontraditional investments are on extension," said Fleming. "We're still collecting 2005 tax data for some of them. You sit around and put in numbers you think are close and amend it later - a huge pain in the neck."

Fleming observed that this is the first year that brokers and bankers are reporting interest from municipal bonds. "The only way we know if they're subject to alternative minimum tax is to have the original offering materials for the bonds," he said. "If it's a private-activity bond, there are limits to what they can borrow or use the money for, and that's all disclosed in the original offering materials with the opinion of counsel. We don't have access to that."

Fleming also noted that in some states, clients are having trouble making electronic payments. "People thought that they paid, but they didn't. There is also trouble where banks have merged, and the bank routing number you have may be incorrect. In one case, the client paid with checks from a money market account from a brokerage. It ran from a new back office bank and used the wrong number - that won't show up till months later, and you're into penalties and interest by then."

Many families were surprised by the change in the Kiddie Tax, according to Ann-Marie Fisher, director of tax services in the Chicago office of CBiz. The Tax Increase Prevention and Reconciliation Act, which became law in May 2006, retroactively raised the Kiddie Tax age limit from 14 to 18. Parents who sold stock in a child's custodial account based on the expectation that the gain would be taxed at the child's lower tax rate were caught off-guard, said Fisher.

"This was the first year for the age limit increase," she said. "Many taxpayers who never had to deal with estimated tax had to set up a payment schedule. Because of that, there were a lot more questions of how to save for kids to go to college - there was a lot more interest in Section 529 plans."

TECH SAVVY

Technology was a great help during tax season, observed Amy Jamison, tax manager at Brentwood, Tenn.-based Byrd Proctor & Mills.

"This was our second season in going paperless," she said. "You always hear how important training is, but you have to have a positive attitude as well, from the partners on down. Those who embraced the technology were far more efficient than they were before, but those that were reluctantly dragged into it didn't see the same rewards."

In prior years, the firm suspended manager meetings during tax season to save time, said Jamison. "This year we had weekly 15-minute meetings on Saturday mornings to schedule work, with side discussions on staff performance. We found that we were much better able to assign appropriate work to the right people, rather than communicating about it by e-mails, as we did in prior years."