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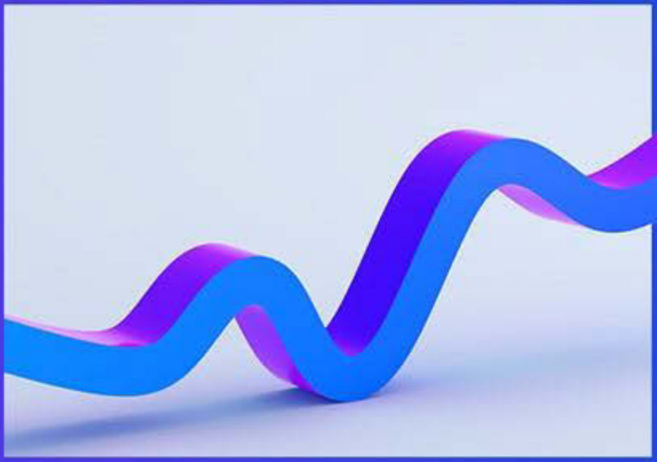

Back to Basics: The Combined Federal State Filing Program

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> As taxpayers work to become compliant with state information reporting requirements, many businesses increasingly rely on the Combined Federal State Filing Program (CFSFP). However, many taxpayers are quickly becoming aware that their filings do not satisfy state reporting requirements due to a number of reasons, including updated state filing requirements that disallow use of the CFSFP or even state reporting nuances that taxpayers may be unaware of. Despite their best efforts to comply via the CFSFP, many taxpayers are receiving state notices, an issue that will only escalate as state agencies shift focus to issues such as unreported gig economy income. In *Back to Basics: The Combined Federal State Filing Program*, we discuss the purpose of the CFSFP, how to participate, and common misconceptions experienced by taxpayers.

Due to increasing information return compliance initiatives by many states, taxpayers are becoming increasingly aware of their state reporting obligations and, unfortunately, their state filing shortcomings. Some states have begun implementing updated processing systems with more efficient matching programs, allowing states agencies the ability to identify information reporting deficiencies. Although many taxpayers have historically relied on the Combined Federal State Filing Program (CFSFP), not all participating states allow use of the CFSFP to satisfy state reporting obligations. In other cases, for a variety of reasons, taxpayers may be unaware that they are not actively using the program. Thus, taxpayers should actively review their processes in order to determine whether they are properly using the program and update processes to include direct reporting, as necessary. The guide below provides a high-level review of the CFSFP, as well as issues that may derail efforts to utilize the program.

Background

The CFSFP was introduced by the Internal Revenue Service (IRS) in order to help reduce taxpayer compliance efforts by forwarding certain information to participating states. Thus, taxpayers are spared the additional cost and burden of filing each form separately for federal and state purposes. At a high level, the IRS collects information for original and corrected returns submitted through the Filing Information Returns Electronically (FIRE) system, and makes that information available to participating states by uploading information to the CFSFP system (provided in roughly six runs per year). Participating states are then able to go to the system and pull information as needed.

Each year, the IRS issues Publication 1220, here, identifying which forms it will forward, as well as the states that have opted to participate in the program. For the 2022 tax year, Publication 1220 notes that there are currently 30 participating states and includes the following forms: Forms 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-K, 1099-MISC, 1099-NEC, 1099-OID, 1099-PATR, 1099-R, and Form 5498. The inclusion of Form 1099-NEC is noteworthy, as this form was re-introduced for the 2020 tax year, but the IRS did not include the form in the CFSFP until the 2021 tax year, causing quite a bit of confusion for states and taxpayers that had historically relied on the CFSFP. See more on this issue in a prior KPMG Blog Alert, here, discussing changes to state processes and guidance to permit use of the CFSFP for the form leading up to the deadline. However, the list of states and forms provided in Publication 1220 is deceptive, as discussed below.

In order to participate in the CFSFP, taxpayers must first request approval from the IRS. As detailed in on the IRS *FIRE System Test Files* webpage, here, taxpayers must apply by submitting a test file through FIRE coded for the CFSFP in the first year of use. The IRS recommends that taxpayers submit test files on an annual basis, but it is not required. Note that the FIRE testing periods are limited each year to specified windows (see the IRS *FIRE* webpage, here), typically in the fall. Thus, first time filers will need to ensure that they plan accordingly. Once approved, the IRS will send a letter of approval to eligible filers.

State CFSFP Reporting Issues

Although the federal onboarding process is relatively straightforward, use of the CFSFP can quickly become a headache when reviewing state reporting requirements. For starters, a letter of approval with the IRS does not necessarily mean that a taxpayer is approved to use the CFSFP for each state. Note that a number of states have a notification requirement, where the taxpayer is required to let the state know that they intend to submit their state information through the CFSFP. For example, Missouri requires that taxpayers provide a copy of the IRS approval letter to the Missouri Department of Revenue (see the Missouri Employer's Guide, here). Though this requirement has been phased out for many states, there are still a handful (such as Massachusetts, Mississippi, and North Dakota) that will not recognize a taxpayer as an eligible CFSFP filer until this requirement has been met.

In addition, the list of participating states issued by the IRS each year is a bit misleading, as it does not indicate whether each state will deem use of the CFSFP to satisfy state reporting requirements. For example, Montana is listed as a participating state, but requires that taxpayers submit all required forms directly to state. The DOR responded that this requirement is due to the lack of information it receives through the CFSFP. In other cases, states have voiced concerns that the information they receive is often delayed, which presents an issue when auditing income tax returns. Thus, many states have begun removing some, but not all, forms from the CFSFP, which can be problematic for taxpayers seeking to broadly utilize the CFSFP for all forms. For example, Massachusetts allows use of the CFSFP for Forms 1099-B and 1099-OID, but specifically disallows it for other forms (see the DOR *Form 1099 Filing Requirements* webpage, here). This piecemeal approach is utilized by a number of states and seems to be particularly problematic with Form

1099-K. For example, Connecticut generally allows Forms 1099 without withholding to be submitted via CFSFP, but specifically excludes Form 1099-K (see *IP 2021(15)*, here). Also, as noted above, the re-introduction of Form 1099-NEC created reporting issues as the IRS did not include it in the first year of reporting, leaving many states scrambling to adjust reporting processes and guidance. The IRS added the form for the 2021 tax year, but some states still have not updated their guidance, such as Oklahoma, which still lists the form as not being a part of the CFSFP (see the Oklahoma FAQs, here). In other cases, states have remained silent on CFSFP use for state purposes, leaving taxpayers guessing whether direct reporting will be required going forward. Simply put, tracking which states allow each form can be a grueling process, which must be exercised annually to ensure that taxpayers are compliant.

Adding to the issue above, most states do not permit use of the CFSFP when reporting state withholding amounts. Generally speaking, states require taxpayers to submit an annual reconciliation form summarizing the amounts withheld and the number of forms submitted. Typically, states require that all Forms 1099 be submitted with the annual reconciliation to ensure that the sum reported across the forms matches the total amounts reported. Thus, reliance on the CFSFP is not permitted. However, there are a handful of states (including Nebraska, Missouri, and Idaho) that still allow use of the CFSFP despite withholding, with a caveat that the taxpayer must check a box on the annual reconciliation form indicating that Forms 1099 were filed through the CFSFP. As an example, see Line 1 of the Nebraska Form W-3N, here. Taxpayers should be sure to confirm that the Forms 1099 being submitted can be filed through the CFSFP before relying on this checkbox.

To add another layer of complexity, state thresholds do not always match the federal threshold. For example, New Jersey typically requires reporting on payments of $1,000 or more (see NJ-WT, here). Other states with different thresholds include Alabama, Arkansas, and Missouri (Illinois recently aligned its Form 1099-K reporting requirements with federal thresholds, see *Publication 110*, here). Until recently, this was problematic for Form 1099-K, which previously provided a federal de minimis threshold for certain entities (third party settlement organizations, TPSOs) of $20,000 across 200 transactions per year. However, as discussed in a recent KPMG Blog Article (here), this issue was rendered obsolete thanks to passage of the American Rescue Plan Act of 2021, which dropped the threshold to $600 with no limit on the number of transactions. Thus, these state thresholds are larger than the federal thresholds for Forms 1099. From a practical perspective, taxpayers typically do not separate out the forms below the state threshold, opting instead to submit all forms that meet the federal threshold through the CFSFP, allowing states to determine which forms are required.

To a lesser extent, taxpayers should be aware of state deadlines. However, almost all states permit taxpayers to rely on federal deadlines when submitting forms through the CFSFP. The issue only becomes problematic when taxpayers erroneously rely on the CFSFP to file state annual reconciliation forms, which are not transmitted by the IRS. Alternatively, a taxpayer that incorrectly believes that forms may be submitted via CFSFP instead of direct reporting, such as forms showing amounts withheld, may be surprised to learn that penalties and interest will be assessed from the earlier state deadline, rather than the federal deadline. Thus, taxpayers should be aware of differing deadlines, but must first ensure that use of the CFSFP is permitted.

Finally, taxpayers should ensure that all information required by the IRS and each state is included on the forms. A common error is the failure to include information in the state specific boxes (for example, Boxes 5-7 on Form 1099-NEC), as taxpayers assume information will automatically flow from the federal inputs. This is especially important for the box indicating the state to which the payment is sourced, as this is the box that the IRS uses when determining where to send the forms. Note that some third-party vendors may bypass this input when preparing the records for upload to FIRE, while properly indicating the state in the layout; however, this can still be problematic as some payments are sourced to multiple states. In addition, payees often rely on the information presented on the recipient copy when populating software inputs for income tax purposes. Thus, payors should ensure that the state and amount (and amount withheld, if any) is included in the state boxes. A lesser-known issue is the failure to include State IDs (listed as “Payer’s state no.” on the form), which are used by states to connect Form 1099 information to a payor registered in the state system.

Many states limit the State ID requirement to those payors submitting returns reporting withholding; however, as discussed in a previous KPMG Blog Alert (see here), this requirement varies by state. Failure to include the State ID may raise an issue when the state is unable to identify whether a taxpayer registered with the agency has submitted returns for the year.

Conclusion

Use of the CFSFP can be an efficient tool to help reduce cost and time by reducing duplicative efforts across federal and state filings. However, there are many nuances that taxpayers must review when relying on state usage of the CFSFP, including state notification, state participation (on a form-by-form basis), withholding requirements, thresholds, deadlines, and basic data inputs. KPMG has seen a number of states shifting away from the CFSFP for some, or all, forms and expects that trend to continue as states continue to leverage information from Forms 1099 to identify income tax return deficiencies, particularly in the gig economy. This is particularly likely for states that have recently updated their filing portals and intend to leverage newer software systems to compare amounts being reported by payors and payees. Thus, taxpayers should ensure that they are aware of the state reporting rule, and review for changes annually, before relying on the CFSFP.