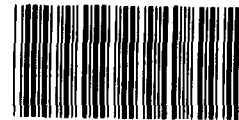


July 1990

TAX ADMINISTRATION

Data Needed on Whether to Regulate Filers of Information Returns for Others



141864

205

General Government Division

B-240124

July 3, 1990

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

This report responds to section 7715 of the Omnibus Budget Reconciliation Act of 1989. Section 7715 requires that we study whether service bureaus that transmit information returns or other documents to the Internal Revenue Service (IRS) on behalf of other persons (payors) should be subject to registration or other regulation. On the basis of discussions with the House Ways and Means Committee, we limited our review to service bureaus that submit information returns on magnetic media for payors.

In a 1989 study of civil tax penalties, IRS reported that its Martinsburg Computing Center (MCC) often has to reject information returns submitted on magnetic media by service bureaus because the media cannot be processed. Magnetic media include magnetic tape, 8" disks, and floppy disks. According to the study, these media contain errors, such as missing data elements or incorrect record formats, that prevent them from being processed on IRS' computers. When incorrect magnetic media are returned to service bureaus, payors who are responsible for filing these information returns may be assessed late filing penalties. Also, if the returns are not corrected, IRS may not be able to use the rejected information returns in its document matching programs. However, the Internal Revenue Code has no provisions to penalize those service bureaus that may be responsible for submitting unacceptable information returns on magnetic media.

IRS could not identify how many service bureaus file information returns on magnetic media and could not provide us with any quantitative analysis on problems specifically relating to service bureaus. However, using IRS databases, we were able to estimate the potential population of service bureaus using magnetic media and compare problems related to service bureau filings with problems of payors filing information returns for themselves.

Results in Brief

IRS does not appear to have more of a problem with service bureaus that file magnetic media than it has with those who file magnetic media information returns for themselves. We found that over 96 percent of the tax year 1988 information returns submitted on magnetic media by all filers, including service bureaus, were readily processed, that is, processed the first or second time they were submitted.

Our analysis shows that rejection rates for disks and magnetic tape of filers likely to be service bureaus was 12.4 percent for the first time they were submitted and 2.3 percent for the second time for tax year 1988. These figures were about the same as the 12.5 percent first-time and 2.2 percent second-time rejection rates for businesses filing their own information returns on magnetic media.

While the vast majority of magnetic media submitted for tax year 1988 was readily processed, IRS had to use resources to resolve problems with over 23 million information returns that were not acceptable the second time submitted. As many as 6 million of these returns may have been submitted by up to an estimated 203 filers that are likely to be service bureaus. The 203 filers were filing information returns for 8,757 payors. These 203 service bureaus represent about 5 percent of the universe of potential service bureaus. We do not know to what extent payors paid penalties due to problem returns submitted by service bureaus because IRS does not have a database that identifies service bureaus or their customers.

The potentially large number of magnetic media information returns and payors affected by these service bureaus, coupled with IRS' lack of hard data on service bureaus filing information returns on magnetic media, suggests that IRS needs information to better define the problem. IRS should know who the service bureaus are, exactly what kind of magnetic media processing errors they cause, and how much regulating or controlling service bureaus would cost IRS and the industry. As part of the cost, IRS should consider the impact any regulation or control would have on new small businesses entering into the industry so industry growth or viability would not be unduly stifled.

Once IRS has this type of information, it will be better able to consider whether various options for regulating service bureaus are warranted. Imposing the same controls on service bureaus submitting information returns as IRS imposes on filers of other returns is one way to deal with all service bureaus, including the problem ones. IRS does not oversee those that submit information returns for others on magnetic media

with the same level of standards and controls that it imposes on those that submit income and employment tax returns for others, either electronically or on magnetic media. For these latter filers, IRS sets specific media standards and controls for approving, denying, and revoking filing privileges.

However, the overall error rates may be too low to justify new regulations for the whole industry when the problems appear to be caused by relatively few service bureaus. Other options are available that would allow IRS to deal more effectively with the relatively few service bureaus causing problems without subjecting the entire industry to regulation or other controls. These options would include applying penalties to service bureaus with repeated transmission errors, authorizing IRS to revoke transmission privileges, and providing information to payors on service bureaus with repeated transmission problems. These other options would only be applicable to that small percentage of service bureaus failing to correct errors after reasonable notice and feedback from IRS.

Background

Service bureaus may file information returns with IRS on payments made by payors for interest, dividends, and other types of income. Service bureaus filing these returns are the ones the 1989 act intended for us to study. Service bureaus may also file other returns such as employment tax returns and wage and tax statements (Form W-2).

Before tax year 1989, information returns sent to IRS generally had to be submitted on magnetic media if the payor submitted 50 or more of a single type of information return. The 1989 Omnibus Budget Reconciliation Act raised this threshold to 250. Thus, payors who submit fewer than 250 of a single return may now use paper information returns. The 250-return threshold applies separately to each type of return and separately to both original and corrected returns. Thus, corrections to returns originally filed on magnetic media, if less than 250, may be made using paper forms.

Payors must send information returns required to be filed on magnetic media directly to MCC, while information returns that are filed on paper forms must be sent to the appropriate IRS service center. Most information returns are due on February 28, the major exception being the Individual Retirement Account return (Form 5498), which is due on May 31. Payors may be assessed a penalty of up to \$50 for each information return that is incorrect, not filed on time, or not filed in the proper

format, depending on when a corrected information return is filed. The objective of the penalty is to encourage payors to file the information returns in a usable format in time for use by IRS. IRS uses the returns to identify taxpayers who may not have filed an income tax return or reported all their income.

For tax year 1988, MCC received 670,309,254 information returns in 66,793 shipments of magnetic media from over 32,011 filers.¹ These numbers do not include Forms W-2 (Wage and Tax Statements) and W-2p (Statements for Recipients of Annuities, Pensions, Retirement Pay, or IRA Payments) because they are filed with the Social Security Administration.

Objectives, Scope, and Methodology

Pursuant to the Omnibus Budget Reconciliation Act of 1989 and our discussions with the House Ways and Means Committee, our objectives were to (1) determine the extent of any problems IRS had with magnetic media information returns filed by service bureaus and (2) explore the need for any administrative or legislative measures to regulate the service bureaus submitting these returns.

IRS does not maintain information that readily identifies service bureaus or any problems encountered with the information returns they submit. As a result, IRS does not know how many service bureaus submit information returns on magnetic media and could not identify problems specifically relating to service bureaus. Therefore, to meet our first objective we first estimated the number of potential service bureaus sending in information returns on magnetic media. To do this, we matched the employer identification number (EIN) of the payor(s) in IRS' Payor Master File against the EIN of the filer in MCC's tax year 1988 information returns database. This comparison identified 4,102 filers with EINs that did not match those of the payor. These 4,102 filers became our population of potential service bureaus.

Thus, we defined a potential service bureau submitting information returns as any organization that filed information returns on magnetic media to MCC for payors identified by a different EIN. This definition could also encompass filers that submitted magnetic media information returns for only one other EIN, financial institutions that filed for trusts,

¹These figures do not include about 7.5 million returns shipped from IRS' Detroit Data Center that were erroneously included in the transmitter database.

and parent organizations that filed for subsidiaries and affiliates.² We had to adopt this broad definition because IRS data do not identify service bureaus separately. While this definition is imperfect—for instance, it includes related parties, such as parent companies, as potential service bureaus—we believe and IRS agreed it presents the best definition possible given the limited information IRS had available in its database.

We matched these potential service bureaus against those filers whose magnetic media were rejected by MCC to identify potential service bureaus that had problems providing acceptable magnetic media to MCC.

To meet our second objective of exploring the need for administrative or legislative measures to regulate service bureaus filing information returns, we interviewed IRS officials; representatives of service bureaus; and an official of a data processing association—an umbrella group representing service bureaus filing on magnetic media. In addition, we reviewed existing regulatory and statutory requirements concerning the regulation of service bureaus filing other types of tax returns on magnetic media to determine IRS' authority to regulate service bureaus that submit information returns. Our review was done between January and June 1990 using generally accepted government auditing standards.

The Number of Media Submissions Rejected Has Declined, but Millions of Returns Still Cannot Be Readily Processed

The proportion of magnetic media submissions rejected from all filers including service bureaus has significantly declined since 1987. However, over 99 million of the 670 million information returns submitted on magnetic media for tax year 1988 could not be processed the first time submitted, and over 23 million could not be processed the second time submitted. Our analysis of IRS data shows that the returns submitted on magnetic media by potential service bureaus do not create more problems for IRS than the information returns it receives on magnetic media from other filers.

Problems With Magnetic Media Have Declined

MCC data show substantial improvements for all filers, including service bureaus, in the percentage of all magnetic media information returns received that can be processed. As shown in table 1, MCC reported it rejected 27 percent of magnetic media submissions for tax year 1987, 16

²We did not include as service bureaus organizations that converted paper returns to magnetic media when the media were transmitted directly by the payor. In these cases the payor and transmitter were the same entity, and the payor would be the first to know if the media submitted could not be processed.

percent for tax year 1988, and 7 percent for tax year 1989 as of June 1, 1990.³ Because most media submissions contain hundreds of information returns, the table also shows our calculations of rejection rates for the number of returns contained on the rejected media, which showed a similar decline.

Table 1: Magnetic Media and Information Returns Received by MCC and Returned to Transmitters

Tax year	Media submissions			Number of information returns		
	Received	Returned ^a	Percent	Received	Returned ^b	Percent
1987	108,736	29,213	27	687,627,224	226,405,275	33
1988	90,769	14,418	16	670,309,254	99,183,103	15
1989 ^c	82,885	5,670	7	645,805,046	80,429,737	12

^aNumbers returned at any time for resubmission. MCC adds one each time the media replacement is rejected.

^bNumbers returned the first time for resubmission.

^cInformation returns for tax year 1989 were being processed at the time of our review. The number of media and documents received and returned are as reported by MCC for the period ending June 1, 1990, and are adjusted to exclude those received but not worked.

MCC officials stated that an IRS format change for submitting magnetic media in tax year 1987 probably contributed to the high rejection rate that year. The lower rejection rate for tax year 1989 suggests that filers may be improving their submissions as they acquire more experience with IRS' format requirements.

Lower Error Rates When Using Criteria for Processing Paper Documents

For tax year 1988, IRS did not have written criteria for how many times magnetic media could be returned to the submitter for correction before a penalty may be considered. However, it does have written criteria for processing information returns submitted on paper documents. These criteria for paper state that if the first document submitted is not acceptable, the problem should be identified and the document returned to the payor with a request that it be corrected. The payor is allowed a second opportunity to submit an acceptable paper document before it is subject to a failure-to-file or late-filer penalty. An IRS official informed us that MCC was orally told to apply the paper information return criteria to magnetic media information returns submitted for tax year 1989.

³See appendix I of this report for our assessment of the questionable methodology IRS used to calculate its media error rates.

Using the IRS criteria for processing paper returns, we found that over 96 percent of all 1988 information returns submitted on magnetic media by all filers were acceptable and successfully processed. According to MCC's database, 85.4 percent of the over 670 million 1988 information returns sent to MCC on all types of magnetic media were successfully processed the first time through. After the rejected media had been submitted a second time, 96.5 percent of all information returns originally submitted on magnetic media were successfully processed.

Service Bureau Problems and Rejection Rates Are Similar to Those of Other Transmitters

While MCC officials described a number of problems they have encountered with specific service bureaus, they said no problems are unique to service bureaus in general. They said that some of these problems include incorrect format and unreadable media. Because MCC's database of magnetic media filers does not identify which filers are service bureaus, MCC officials could not provide us with any quantitative analysis concerning information return shipments rejected from service bureaus. However, by matching MCC's database of filers with IRS' Payor Master File, which shows the payors that filed information returns, we were able to estimate the potential number of service bureaus that submitted tax year 1988 information returns on magnetic media and the extent to which these service bureaus caused MCC processing problems. We defined a potential service bureau submitting information returns as any organization that submitted information returns on magnetic media to MCC for payors identified by an EIN different from the submitting organization's.

We estimate that of 31,300 filers of magnetic media information returns for tax year 1988, 4,102 (13 percent) were potentially service bureaus while the remaining 27,198 were payors that submitted their own information returns.⁴

We found that the rejection rates for service bureaus were about the same as the rejection rates for payors submitting for themselves, whether measured in the number of shipments, information returns, or media, as shown in table 2.

⁴The file of transmitters we analyzed consisted of 32,011 transmitters, but we could not determine if 711 filers filed for themselves or for others because updated information was not included on our copy of the Payor Master File. Table 1 includes the 711 filers but table 2 does not.

Table 2: Comparison of Potential Service Bureaus' and Other Transmitters' Rejection Rates for Tax Year 1988

Potential service bureaus^a						
	Shipments^b	Percent	Information returns	Percent	Units of media^c	Percent
Total	15,425	100.0	183,856,261	100.0	23,096	100.0
Rejected once	1,563	10.1	29,466,490	16.0	2,874	12.4
Rejected twice	235	1.5	5,974,392	3.2	522	2.3
Other payors/ transmitters						
Total	50,492	100.0	484,021,638	100.0	66,438	100.0
Rejected once	5,791	11.5	68,330,726	14.1	8,300	12.5
Rejected twice	966	1.9	17,101,572	3.5	1,483	2.2

^aSee appendixes II and III for stratified data on information returns submitted by service bureaus for payors and rejected for tax year 1988.

^bOne shipment can contain one or more pieces of media (8" disk, 5 1/4" or 3 1/2" floppy disk, or magnetic tape).

^c"Units of media" refers to the combined total number of 8" disks, 5 1/4" and 3 1/2" floppy disks, and magnetic tape.

The 23 million tax year 1988 information returns from both service bureaus and payors that had to be returned for correction a second time is a relatively small proportion of the 670 million information returns that were submitted on magnetic media. Of these 23 million returns, over 25 percent (about 6 million) were submitted by potential service bureaus that filed information returns for 8,757 payors. Of the 4,102 potential service bureaus in our universe, 203 (5 percent) were responsible for these erroneous transmissions. Eight of these potential service bureaus sent in 13 pieces of magnetic media containing 226,105 information returns that were rejected four or more times because the media were unacceptable.

As noted before, IRS headquarters told MCC to apply paper information return procedures that could result in penalties for payors whose information returns filed on magnetic media are not acceptable on the second processing attempt. Applying these criteria would suggest that less than 4 percent (6 million) of these information returns would have been subject to penalties. Since service bureaus are not subject to penalties, the penalties would have been assessed against as many as 8,757 payors that were clients of the 203 potential service bureaus that submitted faulty magnetic media.

IRS Needs Better Data Before Regulation Decisions Can Be Made

We found that 3,899 (95 percent) of the 4,102 potential service bureaus submitted acceptable information returns on magnetic media. With this level of compliance, it may not be necessary to impose standards or controls over service bureaus. However, before this determination can be made, IRS needs to obtain better data on the nature and extent of any problems it may have with these service bureaus.

Although we found that large numbers of information returns were being rejected by IRS as unacceptable for processing, we could not definitively determine how many of these returns were filed by service bureaus. Our definition of potential service bureaus included some organizations, such as parent corporations filing for their subsidiaries, that were not service bureaus. However, our estimates were the best we could make in a restricted amount of time given the limitations of IRS' data.

IRS does not know how many service bureaus submit information returns on magnetic media and cannot identify the extent of the problems specifically relating to service bureaus. It does not record which shipments of information returns come from service bureaus, although MCC has the capability of identifying the shipments by service bureaus from the accompanying forms currently used to post information to the database. Having such information readily available would enable IRS to analyze and compare the rejection rates for media from service bureaus with those for media from other filers. These data could also provide the information necessary to justify, if warranted, some type of regulation or control of problem service bureaus continually submitting unacceptable information returns for payors.

To identify whether or not a filer is acting as a service bureau, IRS could add a one-digit field to its transmitter control code database. With this information, IRS could compile and sort, by type of filer, information already in the database, such as the number of times media were returned for replacement and the reason they were rejected. Such information could provide a statistical basis for comparing data on media from service bureaus with data on media from other filers. It would allow IRS to determine if it returns media submitted by service bureaus more often than it returns media submitted by others, and if so, what types of problems service bureaus most often have.

IRS could also obtain better data on the frequency and types of magnetic media errors made by filers. The structure of the database fields IRS uses

to record media problems is too limited for detailed quantitative analysis. Each of the three "problem code" fields, which record the reasons for returning media for replacement, allows two entries. Some of the media submitted had as many as five types of errors, but MCC personnel can list only two of them in the database for each time the media are returned.

In addition, IRS' current method of calculating the media return rate is flawed. The Magnetic Media Status Reports for tax year 1988 showed a rejection rate of 15.9 percent for all media received from all transmitters. Our calculation of the same information shows a rejection rate of 13.9 percent. As appendix I describes in greater detail, the difference in IRS' and GAO's calculated rejection rates results from including different numbers in the rates' denominators.

We believe and IRS agreed that making the modifications described above to the existing database would enable IRS to identify magnetic media transmitters that are service bureaus. In addition, IRS would be better able to identify the types of errors filers are making so that appropriate corrective action can be taken.

However, before it makes a determination of whether to impose standards and controls over service bureaus, IRS also needs to obtain data on the additional cost such regulation would impose on IRS and service bureaus. IRS should also consider the impact any regulation or control may have on the entry of new small businesses into the service bureau industry. If considered regulatory approaches are so onerous that new firms will be reluctant to compete with current service bureaus or take the place of firms that leave the business, these possibilities have to be weighed before any regulation is adopted.

Regulation of Service Bureaus: Options for Consideration

Once IRS obtains data identifying service bureaus and the extent and nature of any problems with them, several options for regulation or control can be considered. These options range from keeping things as they are now to extending current IRS controls over service bureau filing of other returns to information returns.

Several criteria should be kept in mind in considering the need for regulation and the various options. These criteria include (1) the prevalence of problems in service bureau transmissions; (2) the impact of such problems on the tax system; (3) the added burden imposed by regulatory options on IRS and the service bureau industry, including the impact

of added requirements on the ability of new firms to enter the market; and (4) which option can best address current problems with the least increase in costs and burden to the system.

The Current Oversight System

IRS does not regulate filers who provide information returns on magnetic media. Anyone who has a valid business EIN and requests a transmitter control code number is given one. This transmitter code generally identifies the filer and the type of magnetic media submitted. Once a transmitter code is obtained, filers do not have to reapply each year. Filers need only request a new number if the old transmitter code has not been used for a year.

Under current procedures, a filer is not required to submit test files either before or after IRS gives it a transmitter code. For any filer who wishes to submit test files, IRS will review them for such things as proper format to identify any processing problems before the filing season.

In addition, current procedures do not provide for withdrawing the transmitter code of those service bureaus or payors that continuously file unacceptable files. Media that contain processing problems, such as coding or format errors, are returned to the filer for correction.

Service bureaus submitting information returns on magnetic media are not subject to any penalties. However, the payor employing the service bureau may be subject to failure-to-file or late-filer penalties if the service bureau continues to submit unacceptable data or is late submitting acceptable data to MCC.

The current system essentially relies on the market mechanism to weed out service bureaus continually transmitting media that cannot be processed. Payors penalized by a service bureau's mistakes can use a different service bureau; payors also have recourse to the legal system to sue a service bureau or take other legal action. However, relying on penalized payors to rid the system of service bureaus who file improperly may be of limited effectiveness. First, payors may not be penalized and as a result either may not be aware of problems or may lack incentive to correct them. Second, even if there are occasional penalties, the probability of a payor being penalized and dismissing a service bureau may be so low that service bureaus lack sufficient incentive to perform properly. Third, even if penalties are assessed, problem service bureaus may move on to new customers without their reputations catching up to

them. Fourth, payors may have insufficient information on service bureau performance to know in advance to avoid those bureaus with continual problems, so the discipline of the market can be exercised only after the damage has been done.

Another Option: Extending IRS Regulation of Other Activities to Service Bureaus Filing Information Returns

Current IRS regulations applying to service bureaus submitting other types of tax data, such as employment tax returns, could be extended to service bureaus submitting information returns. Such controls include IRS preapproval of formats and revocation of filing privileges for service bureaus with repeated errors. Such controls could affect all service bureaus submitting information returns.

IRS allows and encourages service bureaus to file other types of returns besides information returns but puts strict requirements on those that do. For example, to participate in the individual income tax electronic filing program, filers, including service bureaus, must agree to follow certain requirements and specifications.⁵ All electronic filers who function as transmitters are required to complete acceptance testing and pass required suitability checks. Some of the factors to be considered in a suitability check include a clean criminal record, a history of paying and filing tax returns correctly and on a timely basis, and a background of never having been suspended from practice before IRS. IRS reserves the right to revoke the electronic filing privilege of any electronic filer who varies from these requirements and specifications or who does not consistently submit error-free income tax returns.

IRS also sets requirements and conditions under which service bureaus can furnish the following returns on magnetic tape instead of on paper: Form 940, Employer's Federal Unemployment Tax Return;⁶ Form 941, Quarterly Federal Tax Return; and Form 941E, Quarterly Return of Withheld Federal Income Tax.⁷ IRS requires these service bureaus to submit an application and a test magnetic tape that must be approved by an IRS service center before permission to file on magnetic media is granted. The service center approves, denies, and revokes magnetic tape filing privileges for service bureaus and other filers. Generally, a filer must submit magnetic tapes that can be read on IRS' computers and that

⁵Revenue Procedure for Electronic Filing of Individual Income Tax Returns (Tax Year 1989) (Oct. 11, 1989) IRS Publication 1345.

⁶Revenue Procedures for Magnetic Tape Reporting of Form 940 (Aug. 8, 1988) IRS Publication 1314.

⁷Revenue Procedures for Magnetic Tape Reporting of Form 941, Quarterly Federal Tax Return, and 941E, Quarterly Return of Withheld Federal Income Tax (Aug. 8, 1988) IRS Publication 1264.

have an error rate on the returns of 5 percent or less in order to have its application for filing and its continuation of filing privileges approved.

Extending this kind of regulatory regime to service bureaus filing information returns may serve to weed out in advance those firms whose transmissions are likely to be the most troublesome. However, several issues should be considered in deciding whether to extend these standards. First, such controls would apply to all service bureaus, regardless of their track record. If subsequent IRS data prove that 95 percent of service bureaus cause no problems, such a broad regulatory scope may not be cost effective. A second concern is that standards can be set so high that effective competition may be hindered. For example, if standards specify certain media while disallowing other media currently used, some smaller service bureaus could be significantly affected. Third, prior approval and testing of service bureau magnetic media submissions could impose significant burdens and costs on both service bureaus and IRS. Finally, if revoking filing privileges is considered too severe a response to careless submissions, the regulatory standards might fall into disuse by IRS.

Other, More Targeted Options

Other options could be considered that would target sanctions to those service bureaus submitting magnetic media information returns with repeated errors in data transmission. These options would include (1) applying penalties to service bureaus, (2) revoking filing privileges for those with repeated problems, and (3) providing information to payors on service bureaus with repeated data filing errors. Unlike the more extensive regulations applied to service bureaus filing other returns, these other options would only be applicable to that small percentage of service bureaus failing to correct errors after reasonable notice and feedback from IRS.

As far as penalties go, current IRS regulations focus responsibility on the payor, not the service bureau, for submitting correct information returns on magnetic media. However, payors using service bureaus as filers may not know that the magnetic media submitted are unacceptable until they receive a notice of a failure-to-file or late-filer penalty. Payors employing problem service bureaus can terminate the relationship once they discover the problems, allowing the free market system to weed out service bureaus continually submitting unacceptable magnetic media.

However, if IRS were to have the legal authority to assess penalties against service bureaus—something that would require legislation—it would not have to rely only on the free market system. If these penalties were reasonably certain and of sufficient magnitude, they could provide the incentive for proper filing by service bureaus. They could also cause enough financial burden that low-quality firms would be forced out of business.

Another option IRS could explore would enable it to revoke the filing privileges of service bureaus that repeatedly make filing errors. Unlike IRS' current oversight of filers of Form 940 and electronic income tax forms, this option would enable IRS to revoke filing privileges without first having gone through the process of approving those privileges. Of course, IRS would have to develop criteria governing the circumstances under which it would use its revocation measures. It would also have to be mindful of the pitfalls of revocation that we discussed earlier, such as the cost and burden imposed on both service bureaus and IRS.

A final option that IRS might want to consider is making information available to the payor community on service bureaus that have repeated filing problems. If public disclosure requirements permit, IRS could publish lists of problem service bureaus or tell payors that request information which service bureaus have had a history of problems. Payors would then not be as likely to first find out about faulty service bureau submissions when they receive penalty notices from IRS. They might also then be able to see if paying more for the work of particular service bureaus is worth it if they receive higher-quality submissions. Making more information available to the consumers of service bureau services upfront would make the current market relationship between payor and service bureaus work more efficiently.

Conclusions

Service bureaus generally appear to be submitting data that IRS can process. Moreover, their error rates are similar to those of the general payor community submitting information returns on magnetic media. Nevertheless, although filing errors seem to be confined to about 5 percent of the potential service bureaus in our universe, they involve processing delays affecting nearly 6 million information returns and could result in penalties to over 8,700 payors.

Because the percentage of service bureau transmissions with repeated errors is so small, we believe that a broader regulatory scheme applying to all service bureaus may not be appropriate at this time. However, the

lack of more definitive information on service bureau filings and the large numbers of returns and payors affected by those relatively few filings with repeated errors suggest that IRS needs more information on the scope and extent of the problem.

Specifically, IRS needs to modify its records to identify which filers are service bureaus, better pinpoint the types of errors involved, and develop a more accurate way of calculating the error rates of various types of filers. IRS needs information on the costs to IRS and service bureaus of imposing additional regulatory standards and controls, including the potential impacts of regulation on the entry of additional businesses into the industry.

With this information, IRS and Congress will have a better basis to decide whether regulation is warranted. At this point, a number of regulatory tools could be considered. Current IRS regulations applying to service bureaus submitting other types of tax data, such as employment tax returns, could be extended to service bureaus submitting information returns. Such controls include procedures for revoking transmission privileges for service bureaus with repeated errors and IRS preapproval of formats. Such controls would affect all service bureaus submitting information return data. Although promising to further reduce the error rate, preapproval requirements could increase the burden on both the service bureaus and IRS.

Other options to be considered would target sanctions at those service bureaus with repeated errors in data filing. These options would include applying penalties to service bureaus, authorizing IRS revocation of filing privileges for those with repeated problems, and providing information to payors on service bureaus with repeated data filing errors. Unlike prior approval requirements, these options would be applicable only to that small percentage of service bureaus failing to correct errors after reasonable notice and feedback from IRS. Although further study is needed, these options could offer IRS and the payor community protection from problem service bureaus at less overall cost and burden for everyone involved.

Recommendations

We recommend that the Commissioner of Internal Revenue collect information on problems caused by service bureaus that submit information returns. Specifically, IRS should

- modify its records to identify which filers are service bureaus,

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- modify its records to more accurately identify magnetic media processing errors,
 - modify its method of calculating the magnetic media rejection rate,
 - obtain data on the cost and benefits to IRS and service bureaus of instituting standards and controls, and
 - obtain data on the impact any regulation or control may have on the entry of new small businesses into the service bureau industry.

This information should be used by the Commissioner to decide what type of regulation or control, if any, is warranted.

The contents of this report were discussed with IRS officials. They generally agreed with the facts presented and with our recommendations, and their comments were considered in preparing our final report.

Major contributors to this report are listed in appendix IV. If you have any questions regarding this report, please call me on 272-7904.



Paul L. Posner
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Abbreviations

EIN	employer identification number
IRS	Internal Revenue Service
MCC	Martinsburg Computing Center

GAO Recalculation of IRS' Overstated Media Error Rates

In its Magnetic Media Status Report, IRS' calculation of the percentage of media submissions returned overstates the rejection rate. IRS calculates its rejection rate by dividing "media returned for replacement" by "returns received." This calculation overstates the rejection rate because IRS includes the number of times each piece of media was rejected in its calculation of the number returned for replacement (numerator) but excludes the receipt of replacements from its calculation of the total number of information returns received (denominator). The following formula represents the IRS calculation:

$$\frac{\text{sum (number returned} \times \text{number of times returned)}}{\text{sum (number received, excluding replacements received)}} \times 100$$

IRS would have provided a more accurate representation of the percentage of media submissions returned by also weighting the total number of media received by the number of times each piece was received (denominator) as shown below:

$$\frac{\text{sum (number returned} \times \text{number of times returned)}}{\text{sum (number received} \times \text{number of times received)}} \times 100$$

Applying each of these methods to the data on the Magnetic Media Status Report for 1988 information returns produces the following results:

IRS calculation

Returned for Replacement	$\frac{14,420}{90,769} \times 100 = 15.9\%$
Returns Received	

GAO calculation

Returned for Replacement	$\frac{14,420}{90,769 + 12,974} \times 100 = 13.9\%$
Returns Received plus	
Replacements Received	

1988 Service Bureau Information Returns Submitted on Magnetic Media

Number of payors per service bureau	Number of service bureaus	Number of payors	Number of information returns submitted	Number of information returns rejected first time
1-50	3,820	21,865	77,343,784	8,884,193
51-100	128	9,096	29,098,660	6,095,977
101-150	65	8,038	23,619,319	1,673,782
151-200	26	4,481	17,039,029	7,998,322
201-250	12	2,648	1,218,142	488,914
251-300	9	2,467	2,764,992	147,961
301-350	8	2,599	2,851,092	636,914
351-400	4	1,513	1,203,078	263,910
401-450	11	4,668	8,590,230	922,462
451-500	6	2,896	7,064,072	760,287
501-1,000	6	4,155	7,293,056	1,356,349
1,001-2K	2	2,835	303,808	0
2,001-3K	2	5,399	156,302	113,810
3,001-4K	1	3,985	496,128	30,319
7,001-8K	1	7,658	2,147,440	62,998
Over 10K	1	10,823	73,015	71,864
Total	4,102	95,126	183,262,147	29,508,062

1988 Service Bureau Information Returns Submitted on Magnetic Media and Rejected a Second Time

Number of payors per service bureau	Number of service bureaus	Number of payors	Number of information returns rejected second time
1-50	168	1,426	2,215,224
51-100	12	901	2,431,329
101-150	3	366	150,985
151-200	4	651	353,103
201-250	4	895	185,051
251-300	2	576	4,749
301-350	3	990	77,051
351-400	2	721	51,542
401-450	3	1,284	445,686
451-500	2	947	57,063
Total	203	8,757	5,974,392

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