

GAO

Report to the Chairman, Subcommittee on
Commerce, Consumer, and Monetary
Affairs, Committee on
Government Operations
House of Representatives

April 1986

DATA QUALITY

IRS' Actions to Improve the Accuracy of Non-wage Income Data Are Vital



035361

**Information Management and
Technology Division****B-221001**

April 21, 1986

The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

As you requested in your January 16, 1986, letter, we are providing you with the results of our review of the Internal Revenue Service's (IRS) controls over the accuracy of interest and dividend information that banks and other payers submit on computer tapes and disks. IRS matches this and other income information to income reported on tax returns to identify taxpayers who have underreported their income or have failed to file tax returns. This program, the Information Returns Program, is a major tax-enforcement tool through which IRS collected \$1.6 billion in additional revenue for tax year 1981 at a cost of \$116 million. While IRS has not yet determined the additional revenue collected for the tax years after 1981, it estimates that the program will produce a net yield of \$2.7 billion in tax year 1986.

We reviewed tax year 1983¹ interest and dividend income data reported on magnetic tapes and disks by banks, corporations, and other payers. About 88 percent of the Information Returns Program's data is reported on tapes and disks; about 12 percent is received on paper. We found that IRS had inadequate automated or manual controls to ensure accurate coding or posting of this data. We identified

- about 4.1 million unprocessed information returns (from the Atlanta, Cincinnati, and Kansas City Service Centers) on 58 tapes, possibly amounting to over \$3 billion in interest and dividend income not recorded on the IRP master file, and
- over 700,000 information returns from all 10 of IRS' service centers, involving \$550 million in interest and dividend income miscoded on the master file.

Because of these problems, IRS is not able to identify all of the income that taxpayers should have reported. Therefore, it will not collect all the

¹Tax year 1983 was the latest year for which information return filing data were available at the time of our review.

taxes due for tax year 1983. There are additional ramifications. One is that unreliable data affect other programs: IRS bases its decision to refer cases for audit or criminal investigation in part on the Information Returns Program data. Another is that the agency must use its limited resources to (1) correct and reprocess miscoded data and (2) make sure that taxpayers are not erroneously sent notices indicating that they underreported their income or failed to file tax returns.

While the number of miscoded and unrecorded information returns may seem small in relation to the 500 million returns processed for tax year 1983, they still represent a significant amount of interest and dividend income (about \$3.5 billion) that, if unreported, could result in a loss of several million dollars of tax revenues.

There were several causes for the miscoded and unposted income data.

- Over 20 percent of the organizations submitting data to IRS on tapes and disks used the agency's instructions for tax year 1982 for coding and formatting their data instead of the updated 1983 instructions.
- While IRS returned much of the miscoded information to the filing organizations for correction, it did not have adequate controls for checking the accuracy of all of the interest and dividend income data before posting them on the master file.
- IRS did not have adequate controls to ensure that all computer tapes containing income information were processed in a timely manner or even processed at all.

Because 58 tapes were not processed on time (33 tapes will never be processed because they were erased), agency records will incorrectly indicate that over 1,700 payers did not report interest and dividends they had paid to taxpayers. In April 1985 IRS incorrectly notified some of these payers of their apparent failure to report and the penalties "owed." The agency told us it suspended the portion of the program calling for penalties on late filers because so many payers, especially paper filers, indicated they had filed previously. With respect to the 33 erased tapes, IRS said it would not request replacements from the payers because too much time had elapsed and because "...public relations are currently strained and to request these replacements due to [agency] negligence would only further strain [its] public relations."

We reported our preliminary findings on the unrecorded and inaccurate income data to IRS in March and May 1985 (see appendixes III and V) so the agency could make appropriate adjustments to the tax year 1983

Information Returns Program processing cycle. Further details on our findings, as well as our objectives, scope, and methodology, are in appendix I.

The agency responded to our March and May letters in May and July 1985, respectively (see appendixes IV and VI), and described corrective actions it had taken or planned. To help prevent a recurrence of "bad data," IRS would (1) use automated edit checks (instituted in May 1984) and (2) again impress on staff the importance of analyzing all tapes for correct coding of data. The agency said that it would complete a study, by January 1986, to identify why some payers repeatedly report "bad data" and what corrective actions are needed. As of early March 1986, this study had not been completed; instead staff are working on a plan aimed at identifying all payers who report bad data, not just repeaters.

To help ensure that Information Returns Program tapes are processed on time, that data are properly posted to master files, and that the likelihood of unposted data is reduced, IRS has made two changes. First, effective January 1, 1986, it centralized the receipt of information return tapes at its National Computer Center. Staff at its 10 service centers no longer handle Information Returns Program tapes sent by payers. This eliminates a step that contributed to the data-posting problems we identified. The agency had planned this change prior to our findings on tape-control problems. Second, IRS added a daily, problem-tape log to record tapes dropped from processing so that necessary follow-up action could occur. These initiatives, if properly implemented, should improve controls over the handling of IRP tapes that must be returned to payers for correction and then be reprocessed.

Another program affected by unrecorded income data is the "stop-filer" program, designed to identify payers failing to file information returns and to assess appropriate penalties. To ensure this program's effectiveness, IRS told us it would conduct two studies of payers receiving these notices—one study would focus on those responding that they had properly reported and the other would focus on those not responding adequately to the notices. In March 1986, the agency told us that it had not done this latter evaluation and has no plans to because so much time has elapsed since the notices first went out.

A random sample of 100 payers claiming that they had filed was taken from each of eight service centers to determine if these payers had, in fact, reported and why the notices were erroneously sent. IRS stated that virtually all the payers it sampled had filed their returns on paper

rather than on tapes or disks. Therefore, staff did not specifically evaluate those notices, which were generated as a result of the unprocessed tapes we identified. However, the sample uncovered additional processing problems with data filed on paper; the problems could affect the effectiveness of the stop-filer program. The agency is considering further study to identify the causes of the problems.

We are making no recommendations at this time because of the controls IRS has in place for checking the coding of data and handling of tapes; the centralization of the program at the National Computer Center should help prevent recurrence of the problem. However, we will continue to provide the Congress with information about the Information Returns Program as the need arises.

IRS generally agreed with our findings and conclusions. We have included their comments in this final report (see appendix II).

As arranged with your office, unless you release its contents earlier, we plan no further distribution of this report until 30 days from its issue date. We will then send copies to interested parties and make copies available to others upon request.

Sincerely yours,

A handwritten signature in cursive script that reads "Warren G. Reed". The signature is written in black ink and is positioned above the typed name and title.

Warren G. Reed
Director

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Abbreviations

IRP	Information Returns Program
IRS	Internal Revenue Service
NCC	National Computer Center

Results of Our Review of IRS' Controls Over Non-wage Data Inputs to the Information Returns Program

The Information Returns Program (IRP) is a major tax-compliance enforcement tool whereby IRS identifies taxpayers who have underreported their income or who have failed to file a return. The agency identifies these taxpayers by matching income information reported by payers of income (e.g., employers, banks, and corporations) to the information reported by taxpayers on their tax returns. For tax year 1981, the latest year for which complete data are available, IRS collected an additional \$1.6 billion in revenue at a cost of \$116 million. For tax year 1986, it estimates that IRP will produce a net yield of \$2.7 billion.

Success of this program depends on recording complete, accurate, and timely income data on a master file to be used in the matching process. We reviewed a major category of this data—interest and dividend income data—reported to the agency on magnetic tapes and disks by banks, corporations, and other payers of such income for tax year 1983.² We found that IRS did not have adequate controls in place to help ensure that data posted to the master file were accurate and that data requiring correction were corrected promptly.

We identified

- over 700,000 information returns from all 10 service centers (involving \$550 million in interest and dividend income) incorrectly recorded on the IRP master file,³ and
- 58 tapes with about 4.1 million unprocessed information returns (from the Atlanta, Cincinnati, and Kansas City Service Centers), possibly amounting to over \$3 billion in interest and dividend income, not recorded on the IRP master file.

While the number of miscoded and unposted information returns may seem small relative to the 500 million returns processed for tax year 1983, still, they represent a significant amount of income (about \$3.5 billion), which can adversely affect the program. Even minor underreporting could mean losses of several million dollars in potential tax revenues to the Treasury.

²Tax year 1983 was the latest year for which the agency had information return data available at the time of our review. IRS pursued tax year 1983 underreporter cases in 1985, since the program's processing cycle generates these cases about 18 months after the tax year for which income is reported.

³Our March 28, 1985, letter notified IRS of an additional 1.4 million returns that may also have been miscoded. See appendix III.

Objectives, Scope, and Methodology

To determine the quality controls over certain data posted to the Information Returns Program master file, we reviewed tax year 1983 interest and dividend income data submitted on magnetic tapes or disks to the 10 service centers by transmitters.⁴ We selected magnetic tape and disk, as opposed to paper, input because it accounts for about 88 percent of non-wage information reported to the agency. Our review did not include wage data that go from employers to the Social Security Administration (for processing), then to IRS.

We conducted our review from July 1984 to February 1986 at the National Computer Center (NCC) in Martinsburg, West Virginia; IRS headquarters in Washington, D.C.; and the Andover, Massachusetts, Service Center. We wrote computer programs to test the quality of IRP data from all 10 of the service centers. However, our data from three service centers—Brookhaven, Memphis, and Philadelphia—were incomplete because these centers had not finished processing at the time of our data testing.

Our work included the following activities and was performed in accordance with generally accepted government auditing standards.

- To understand the IRP processing cycle and its controls at each step, we reviewed Internal Revenue manuals, interviewed IRS officials involved with the processing, and devised a flowchart of the cycle.
- We tested the quality of IRP data received and processed at all 10 service centers; we did so by writing computer programs that checked for miscodings and other apparent problems with the data.
- We discussed the results of our data testing with staff from the Computer Services Branch at headquarters, at NCC, and at all 10 service centers to follow up on potentially miscoded and unposted data.

We devised a questionnaire to obtain the views of 433 randomly selected transmitters on the agency's processing of IRP tapes and disks.

IRP is a Critical Enforcement Tool

The Congress established IRP in 1962 to encourage taxpayer compliance with the tax laws and to generate additional revenues. Congressional interest in the program remains strong as a means to slow the growing tax gap⁵ created by the underreporting and non-reporting of income. It

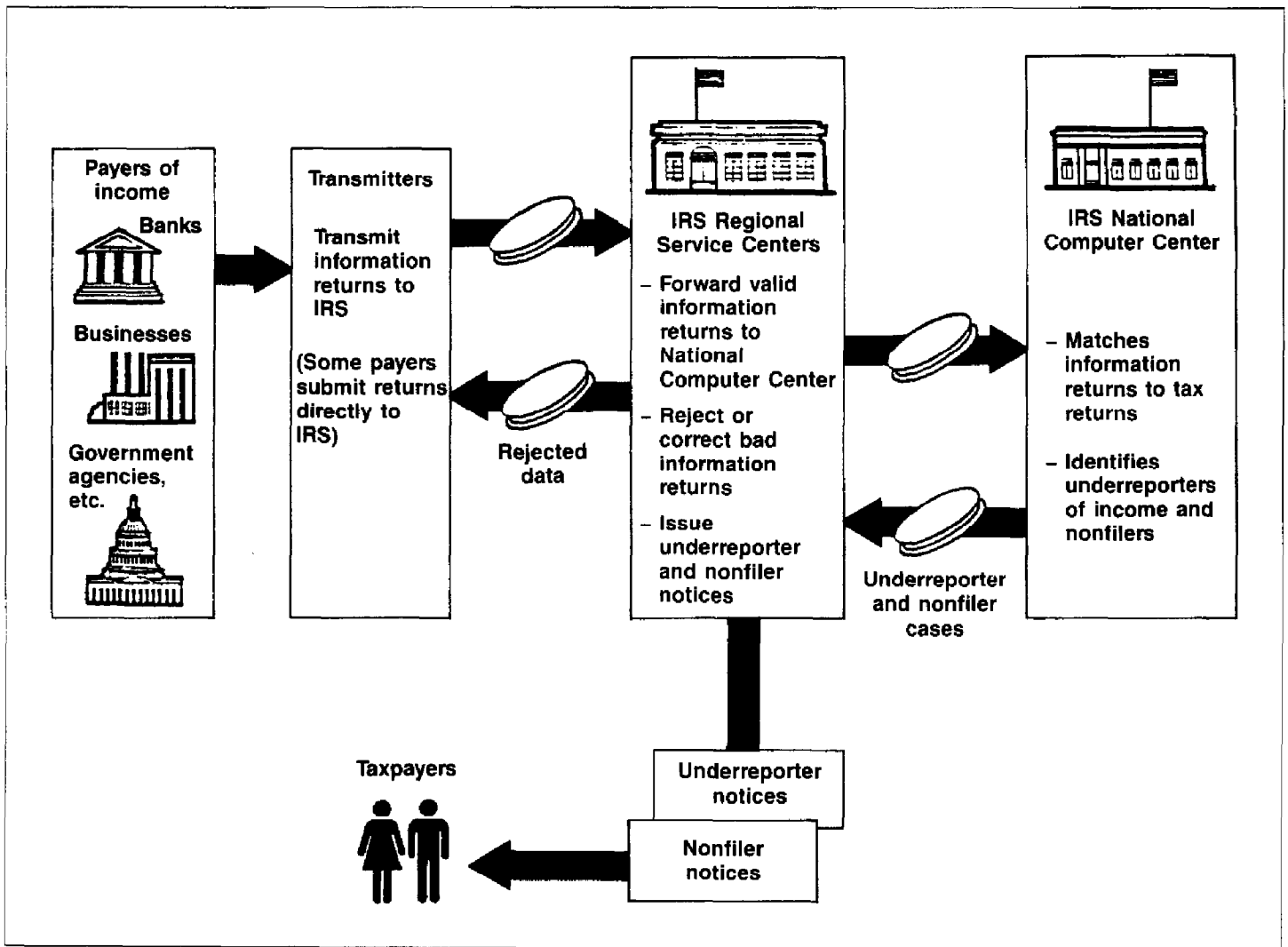
⁴Transmitters may be payers or service organizations employed by payers to send the data to IRS.

⁵Tax gap applies to the amount of tax revenue that IRS estimates is lost to tax evasion.

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has passed legislation⁶ to increase the types of information that must be reported (e.g., broker transactions, mortgage interest, and state income tax refunds). This legislation is expected to increase the volume of non-wage IRP documents from 500 million for tax year 1983 to a projected 800 million for tax year 1985.

Figure I.1: Overview of IRS' Non-wage Information Returns Program Processing System



⁶The Tax Equity and Fiscal Responsibility Act of 1982, the Interest and Dividend Tax Compliance Act of 1983, and the Deficit Reduction Act of 1984.

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Payers send non-wage information returns directly to IRS or use service organizations called transmitters that submit this information for them (see figure I.1). About 88 percent of these returns are submitted on computer tape or disk, which are generally cheaper to prepare and process than paper.

The 10 service centers received these returns⁷ and performed manual and automated edits or validity checks on them. Inaccurate returns are rejected and returned to the filers for correction. These validity checks are important since (1) they are the only checks on IRP data normally performed by IRS, and (2) it is less costly for the agency to correct errors identified at an early stage of processing. After edit checking, the service centers further process the data before sending them to NCC to be placed on the master file.

At the National Computer Center, the information returns are matched to tax returns. This matching identifies taxpayers either underreporting their income or failing to file tax returns. NCC sends these cases to the service centers for follow-up. IRP data are also used to develop criminal cases, to detect banks and other payers of income who have stopped filing information returns, and to determine if these payers are complying with tax laws that require them to report various types of income data.

The importance of having good quality input data to the IRS programs is increasing as the Congress adds more income and deduction items to the matching program. IRS is even proposing a "return free" tax system for some time in the future. Such a system would match information returns and wages and calculate refunds or bills for taxpayers. A quality system will require accurate, complete, and timely data inputs from all payers of income and adequate controls by IRS.

Controls in IRP Processing

Input controls are designed to ensure the accuracy, completeness, and timeliness of data being entered into an automated system like IRP. These controls are intended to detect errors in the data and may be used at various stages in the flow of data into a program. In general, data should be validated as soon as possible after they have been entered, and as closely as possible to the source of the data. Main areas that require attention to data-input controls are (1) converting data into

⁷Starting January 1, 1986, for tax year 1985 returns, all information returns were submitted directly to NCC by payers and transmitters.

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machine-readable format for entry into an automated system, (2) validating and editing the data to ensure their accuracy before processing, and (3) promptly correcting errors detected by the system.

**Data Conversion and
Entry Controls**

Most data conversion and entry functions for information submitted on magnetic tapes and disks are performed by transmitters and payers. They input the data according to revenue procedures that IRS sends them annually. Transmitters must comply with these procedures (which include formatting and coding instructions) in forwarding tapes and disks to the agency.

**Data Validation and
Editing Controls**

Data validation and editing were performed at the service centers until January 1986 when these functions were centralized at NCC. A "magnetic media coordinator" at each service center ensured that the tape and disk files submitted by transmitters complied with the revenue procedures and forwarded the data to NCC to be matched.

Detailed guidance for coordinators in the Internal Revenue Manual requires a manual review of some of each transmitter's data, followed by automated validation and editing checks of all the data.

Error-handling Controls

Errors detected at any stage of data input need correction; corrected information needs timely processing. Error-handling procedures for magnetic media at the service centers are contained in sections of the Internal Revenue Manual. Coordinators are told what action to take to correct information not complying with the revenue procedures. The manual also contains procedures for controlling the high volume of tapes sent between NCC and the service centers. NCC officials state that they store processed tapes for 365 days before reusing and returning them to the service centers. Also, when the National Computer Center cannot process tapes, the service centers must replace them according to Internal Revenue Manual procedures.

When NCC could not process IRP tapes at the time of our review, they telephoned service-center personnel to request replacement tapes. The tapes were then either sent back to the service centers for correction or the service centers sent new tapes.

IRP Data Quality Suffered From Poor Input Controls

Although input controls were in place at the service centers and at NCC, we identified (1) miscoded tax year 1983 interest and dividend data being posted to the IRP master file, and (2) data never posted to the master file.

Miscoded Data

Data from over 700,000 miscoded interest and dividend returns (and possibly 1.4 million more)⁸ were posted to the IRP master file between July 1984 and January 1985. This occurred because (1) over 20 percent of transmitters used the outdated 1982 coding instructions and therefore did not comply with the coding changes specified in the tax year 1983 revenue procedures, and (2) the service centers' validation and editing techniques were inadequate to detect all the miscoded data. The most common coding errors we found were

- "interest income" coded as "amount of forfeiture" (interest forfeited due to premature withdrawal of time deposits);
- "interest income" coded as "federal income tax withheld";
- "dividends qualifying for exclusion" coded as "federal income tax withheld"; and
- "dividends not qualifying for exclusion" coded as "capital gains dividends."

Tax year 1983 miscoding problems began in early 1984 when transmitters submitted many miscoded information returns. Magnetic media coordinators told us that they returned for correction about 23 percent of the transmitters' tapes and disks during tax year 1983. About 19 percent of the transmitters responding to our questionnaire said they had tapes and disks returned for correction. To determine why so many transmitters did not comply with the revenue procedures, we asked if the instructions were understandable and easy to follow. About 47 percent of the transmitters had at least some difficulty understanding IRS' directions.

Before May 9, 1984, the service centers' automated edit checks consisted of verifying that valid codes were being used. They did not verify that the codes were being used in valid combinations. For example, a 1983 interest return could have only four possible valid codes (1, 2, 3, or 4)—but the first field must be a "1" to identify the amount as interest

⁸See appendix III.

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income. Should any other code be placed in the first field, the returns become miscoded.

Early in 1984, NCC and service-center personnel noticed the high volume of miscoded IRP documents; IRS initiated efforts to correct the problem. First, NCC returned to the service centers 156 tapes with over 9 million information returns to manually check them for miscodings not initially detected by the service centers. Also, on May 9, 1984, about 4 months after service centers had started processing information returns, IRS added three automated edit checks to help its service centers identify miscodings of interest, dividends, and all savers⁹ interest.

Although IRS made additional efforts to detect errors in 1983 information returns, we found that over 700,000 miscoded interest and dividend returns had been placed on the IRP master file for tax year 1983 during the latter part of 1984.

Unposted Data

Of the 156 tapes NCC returned to the service centers for correction, 58 did not get posted to the IRP master file. This occurred primarily because the National Computer Center did not follow up with the service centers to ensure that rejected tapes, returned to the service centers, were replaced promptly. We found that the rejected tapes were not always uniquely identified and were, therefore, not distinguishable from other tapes NCC routinely returned to the service centers. The 58 tapes contained about 4.1 million documents filed by over 1,700 payers and accounted for an estimated \$3 billion of interest and dividend income.

In early 1984, the National Computer Center returned 33 of the 58 tapes to two service centers (22 to Cincinnati and 11 to Atlanta) for replacement; service-center personnel put them in the tape library. Since NCC did not follow up when it did not receive the tapes, they stayed in the tape library where they were erased 365 days after their receipt (per IRS' standard procedures). The tapes contained about 2.8 million returns from 519 payers; these data will never be put on the IRP master file. IRS informed us that there is no way to recover the data without straining the agency's public relations with payers.

Around August 1984, the other 25 tapes (19 from Atlanta and 6 from Kansas City) with about 1.3 million documents from 1,222 payers were sent back to NCC. IRS officials told us these tapes were overlooked

⁹Interest paid to taxpayers for All-Savers Certificates.

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because a new employee in the National Computer Center's tape library had not been properly trained to appropriately distribute the notifications when the tapes came to the library. We brought these unprocessed replacement tapes to the agency's attention on May 21, 1985; IRS later processed them and added the information to the IRP master file.

The condition we identified with unposted data is similar to a problem investigated by IRS' Internal Audit Division in April 1985¹⁰ when a federal tax deposit tape not processed on time prompted erroneous dunning notices to be sent to businesses that had properly remitted withholding taxes to the Treasury. This mailing occurred because a service center did not promptly replace an unprocessable tape that NCC had returned for correction. Tapes normally are replaced in 4 days; in this case, the service center took 54 days. Final processing of the tape was delayed another 44 days. Since the tape was not timely processed, most businesses listed on it received at least one erroneous balance-due notice and were erroneously assessed penalties and interest. The report cited the lack of follow-up procedures and stressed the need for tighter controls to ensure prompt replacement of federal tax deposit tapes.

Effects of Unposted and Miscoded IRP Data

Unposted and miscoded data reduce IRP's effectiveness as a major enforcement tool. This situation causes IRS to use its limited resources to correct and reprocess data and to review and screen potentially erroneous notices that unposted or miscoded data may generate. Unposted or miscoded income data prevent identification of all taxpayers underreporting their income or not filing tax returns. Consequently IRS may not collect all the taxes it is due. For example, the Treasury could lose several million dollars if only one percent of an estimated \$3.5 billion not posted or incorrectly posted to the master file is unreported by taxpayers and not detected by IRS.

Unposted information returns can also hurt the agency's public relations by causing it to incorrectly identify certain payers as not filing IRP returns even though they had actually filed them. IRS told us that nearly 41,000 stop-filer notices for tax year 1983 were sent to payers by eight service centers. While the agency does not know how many notices were erroneous, it told us that a high volume of these payers informed IRS they had already filed.

¹⁰The Service Needs Controls to Ensure Prompt Replacement of Unprocessable Tapes, IRS Internal Audit Report, April 1985.

In addition, unposted information returns can weaken agency enforcement of filing regulations. When IRS learned that some notices were incorrect, it decided not to pursue any payers not responding to the notices. The agency has decided not to assess penalties on these cases except when a payer voluntarily admits to not filing.

Several offices will have incomplete data when making decisions and pursuing cases. IRS Examination/Classification personnel use IRP information to help decide whether to refer cases for audit or further examination. The Collection Division uses the data to identify taxpayers not filing tax returns, and the Criminal Investigation Division uses the income information in developing criminal cases.

IRS places an additional burden on its limited resources by not having sufficient controls over IRP input. For tax year 1983 data, the agency had to (1) recheck much information when miscodings were found, (2) check that rejected tapes were corrected and reprocessed, and (3) research and resolve that notices to taxpayers were valid. On the latter, IRS noted that some miscodings may have generated potential credit discrepancy cases (which could incorrectly create a refund not due a taxpayer), and it determined that such cases would be reviewed to prevent possible erroneous notices.

IRS' Corrective Actions and IRP's Future Direction

After we informed IRS in March and May 1985 of our findings regarding miscoded and unposted data, it outlined several actions planned and taken to correct the conditions identified and to prevent them from recurring (see appendixes III - VI).

To help prevent a recurrence of bad data reaching the IRP master file and to minimize the submission of bad data, the agency told us it

- instituted automated edit checks in the computer programs that process data initially received from payers;
- reinforced previous instructions to its staff to continue visual review for correct coding of portions of the documents printed out from the tapes received from payers;
- instructed its staff to analyze payers' 1985 information returns to verify that mistakes they previously made were not repeated; and
- instructed its staff to contact payers or transmitters who consistently submit miscoded data to help them with their filings.

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In addition, IRS initially told us that it would complete, by January 1986, a study to identify why some payers repeatedly report bad data and what corrective actions could prevent this from continuing. As of early March 1986, IRS had not completed this study; instead it is working on an action plan aimed at identifying all payers who report bad data, not just those that repeatedly report bad data.

To help ensure that tapes are processed on time and that data are properly recorded on IRP master files, IRS has made two changes that should help reduce the likelihood of unposted data. First, effective January 1, 1986, service-center staff no longer handle IRP tapes. Instead, payers send information returns directly to NCC. The agency planned this change prior to our findings on tape-control problems. Second, IRS stated that it was adding a daily problem-tape log to record tapes dropped from processing so that necessary follow-up action can be taken. The log contains information on tapes dropped from processing and documents (1) reel numbers, (2) nature of any problems, (3) the time and date a replacement is requested, (4) the replacement reel number, and (5) the cycle through which the replacement reel is processed. According to IRS, this report is reviewed daily for any necessary follow-up action.

Regarding the 58 unposted tapes, the agency processed 25 of them to the master file. IRS told us that about 5,300 Individual Retirement Account records were processed in time to identify potential underreporters. The remaining 1.3 million information returns on these tapes were not processed in time for the underreporter program. The agency will not try to recover the data from the other 33 erased tapes because that would require going back to the payers. Furthermore, IRS told us, too much time had elapsed since payers had originally filed and "...public relations are currently strained and to request these replacements due to [agency] negligence would only further strain [its] public relations." (See appendix VI.)

To help ensure the effectiveness of its program for identifying payers who have stopped filing information returns, IRS stated (in its July 1985 response) that it would conduct two studies of payers who received stop-filer notices (notices that payers had filed information returns for a previous year but not the year in process). One study would focus on payers who responded that they had properly reported; the other would focus on those who had not responded adequately to the notices. In March 1986, the agency told us that it had not done this latter study and does not plan to because so much time has elapsed since the original notices went out to payers.

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A random sample of 100 payers responding that they had filed their returns was taken from each of the eight service centers that sent out stop-filer notices. This sample was to determine if they had, in fact, filed their returns and if the notices were erroneously sent. Because of the way the agency structured its sample, virtually all the payers had filed their returns on paper rather than on magnetic tape and disk. Therefore, IRS did not specifically evaluate notices generated as a result of the unprocessed tapes we identified. However, its sample disclosed two significant problems with the paper filings. First, information on payers was not properly recorded on the master file that identifies payers who have stopped filing returns. Also, information was not properly recorded on the records of individual taxpayers receiving income from these payers. While IRS identified problems (such as wrong taxpayer identification number, wrong name) that may have prevented the data from being properly recorded, about 59 percent of the sample had no apparent problems and should have been properly recorded. Accordingly, IRS is recommending further study to determine why this payer data did not get recorded on the file.

IRP Input Function
Centralized at NCC

Starting in January 1986, the National Computer Center assumed full responsibility for IRP input on magnetic media. Functions previously performed at the 10 service centers—mailing annual revenue procedures, assisting transmitters, and implementing input controls during data validation, editing, and error handling—became centralized at NCC.

IRS decided to centralize data input on magnetic media, to use computer capacity and staff available at NCC, and to relieve the service centers of the burden of using their computer capacity for IRP processing. The agency also believes that centralization should provide for tighter controls over replacement tapes and improve coordination between various NCC groups responsible for processing, scheduling, and validating tapes.

The IRP input function involves substantial contact with the companies that transmit information returns. The coordinators at the 10 service centers told us they spent much of their time assisting these companies by answering their questions concerning tape and equipment compatibility, new information returns, coding changes, and clarification of revenue procedures. Our transmitter questionnaire results indicate that transmitters are very satisfied with the support and assistance they had received from the regional coordinators and they have come to expect this service. This will continue to be an important aspect of the magnetic

media program. NCC is establishing procedures to address its new responsibility for transmitter assistance.

To gain expertise prior to full implementation, NCC processed tax year 1984 IRP magnetic media for three service centers. Filers for the remaining seven service centers received notification of the centralization plans when they received the tax year 1985 revenue procedures. IRS told us that during the transition to centralization, transmitters are likely to continue calling the service centers and may ship them some tapes. They indicated that preparation for a certain amount of confusion during the transition year is necessary, and efforts to smooth the transition had been handled in discussions between the NCC and service-center personnel. The IRP Branch had also developed an implementation action plan to carry out the centralization project.

Conclusions

Programs that identify taxpayers underreporting income, taxpayers failing to file a tax return, and payers of income who have stopped filing information returns are important to agency efforts to help ensure voluntary compliance with the tax laws. The effectiveness of these and future programs depends on quality inputs of information return data for as many taxpayers as possible.

The Congress' interest in IRP remains strong; its changes to the program have been frequent. Legislation passed in 1982, 1983, and 1984 has increased the types and volume of information returns that must be reported to IRS.

Our review of quality controls over tax year 1983 data inputs indicates that IRS might have better communicated coding changes to companies filing information returns and better determined that the data submitted by these companies were correctly coded. Too many of these organizations—about 20 percent (based on what was reported by IRS and the transmitters responding to our questionnaire)—did not comply with IRS' coding instructions. Also, the service centers' input controls were ineffective in detecting and correcting all the miscoded data. Efforts to correct the miscoded data exposed weaknesses in agency controls over magnetic tapes, resulting in 25 tapes not being timely posted to the master file, and 33 tapes never being posted.

While the 4.8 million miscoded or unposted information returns may seem small in relation to the 500 million returns processed for tax year 1983, they do represent about \$3.5 billion in reportable income. This

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could mean the loss of several million dollars in tax revenues if only a very small portion (1 percent) is not reported and goes undetected by IRS.

We reported our findings in letters to the agency, and were informed that the miscoded and unposted data will have an adverse effect on its efforts to identify taxpayers underreporting their income or failing to file a tax return. Also, erroneous notices were sent to payers of income who did file their returns, a situation that hurts IRS' public relations. Other functions that will be adversely affected include examination, collection, and criminal investigation.

In response to our letters, the agency cited several actions it plans to take to correct the problems we identified. Initiatives include contacting those submitting miscoded data, processing some unposted data to the master file (although not in time for the IRP matching program), and instituting follow-up procedures to ensure that corrected data are posted. We believe these recent actions should improve IRS' implementation of changes to IRP and its controls over the quality of data inputs. Also, centralization of IRP processing functions at NCC should help reduce the risk of misplacing and not processing tapes.

Advance Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

APR 9 1986

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

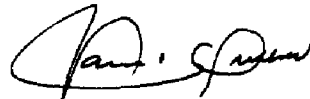
Dear Mr. Anderson:

We appreciate the opportunity to review your recent draft report entitled "Data Quality: IRS' Non-Wage Information Can Be Improved Through Better Input Controls and Other Measures."

We generally agree with the findings and conclusions of the report. As requested in your March 17, 1986 transmittal letter, we have provided your staff with technical comments to improve the accuracy of the report. We hope those comments will be beneficial in preparing your final report.

With kind regards,

Sincerely,



Acting Commissioner

See comment 1.

Department of the Treasury Internal Revenue Service

**Appendix II
Advance Comments From the
Internal Revenue Service**

The following is a GAO comment on the Internal Revenue Service's letter dated April 9, 1986.

GAO Comment

1. We have changed the report text to reflect IRS' technical comments. IRS refers to the report's draft, not final, title in this letter.

Letter Dated March 28, 1985, From the General Accounting Office to IRS



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

March 28, 1985

INFORMATION MANAGEMENT
& TECHNOLOGY DIVISION

Mr. Percy P. Woodard, Jr.
Assistant Commissioner, Examination
Internal Revenue Service
Room 2501
1111 Constitution Ave., N.W.
Washington, D.C., 20224

Dear Mr. Woodard:

Subject: Coding Errors Found in the Internal Revenue
Service's Information Returns Program
(Job Code 510073)

We are reviewing IRS' controls over the accuracy of interest and dividend information that banks and other payers submit on computer tape or disk. While our review is not yet complete, we have found coding errors on over 700,000 of these tax year 1983 information returns, involving over \$550 million of interest and dividend income. We also have indications that about 1.1 million other returns valued at about \$588 million may be incorrect or may not be recorded on the Information Returns Program (IRP) master file. Because of these errors, IRS cannot properly determine through its IRP whether this income has been reported by taxpayers.

The purpose of this letter is to: (1) describe the errors and potential errors found, (2) bring this matter to your attention before processing of the master file begins on about April 4, and (3) request your response on the actions IRS plans to take on this matter. We will continue our review of this topic, and your response will be helpful for our final report on the Magnetic Media Program for IRP.

Our initial testing of information returns submitted through the 10 service centers to the National Computer Center indicated that as many as 4.2 million erroneous returns may have passed IRS quality controls and been recorded incorrectly on the IRP master file. The errors occurred because interest and dividend information returns for tax year 1983 were submitted to IRS using 1982 codes. As you know, codes for these and several other items were different in 1982 and 1983. With the help of IRS' Computer Services office, we researched 2.8 million of these returns and found that:

--about 700,000 returns, involving about \$550 million of interest and dividend income were incorrectly recorded on the master file;

Appendix III
Letter Dated March 28, 1985, From the
General Accounting Office to IRS

--nearly 1.1 million additional returns valued at about \$588 million may also be incorrect or may not be recorded on the IRP master file, but additional research is needed before it can be confirmed; and

--about 1 million other returns were corrected by IRS staff before being placed on the master file, when they discovered that some filers were using 1982 instead of 1983 coding instructions.


The remaining 1.4 million returns very likely fall into the above three categories but were not researched because of time and programming constraints.

On March 13, 1985, we met with Mr. Leon Hewerdine of your staff and representatives from Computer Services and Returns Processing on this matter. We summarized the work to date and provided them with relevant information about the errors and potential errors, including the names of the payers, their Employer Identification Numbers, and number of documents involved. We brought this to Mr. Hewerdine's attention so that IRS could take appropriate corrective action before April 4, the date IRS plans to begin processing the master file to identify taxpayers who are underreporting their income. In addition, we suggested IRS may wish to examine whether these payers are submitting inaccurate returns for tax year 1984.

To assist us in completing our review of the IRP Magnetic Media Program, we would appreciate hearing from you within 30 days on the action IRS takes or intends to take. Please provide us with your assessment of the impact these errors will have on IRP or any other IRS program. We will continue our review of IRS' input quality controls, and your reply will be helpful to our final report.

The verification of these miscoded documents has been a cooperative GAO/IRS effort and we appreciate the time and effort of your staff and those in the Computer Services office. If you have any questions, please call Ted Gonter on 275-3455 or Bill Moffitt of our Boston Regional Office on (FTS) 223-5945.

Sincerely yours,


James R. Watts
Senior Group Director

cc: Mr. Thomas Laycock, IRS/Computer Services
Mr. Stanley Goldberg, IRS>Returns and
Information Processing

Letter Dated May 9, 1985, From IRS to the General Accounting Office

Internal Revenue Service

Department of the Treasury

Assistant Commissioner
(Examination)

Washington, DC 20224

MAY 9 1985

> Mr. James R. Watts
Senior Group Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Watts:

This is in response to your letter of March 28, 1985, concerning coding errors found in the Internal Revenue Service's Information Returns Program (Job Code 510073). The purpose of this letter is to describe the impact of the coding errors detected on the Information Returns Program (IRP), and to discuss the actions planned or already undertaken to address the problem.

The coding errors were caused by payers entering money amounts in the wrong fields for magnetic media filing of information returns. These coding errors and their impact are outlined as follows:

1. "Interest" income erroneously reported as "Amount of Forfeiture"

Impact

This error would cause an interest forfeiture (early withdrawal penalty) discrepancy only if interest income is also underreported. If the taxpayer properly reports interest income, no case would be created.

2. "Interest" income erroneously reported as "Federal Income Tax Withheld"
3. "Dividends Qualifying for Exclusion" erroneously reported as "Federal Income Withholding"

Impact

These errors would cause withholding per IRP documents to exceed withholding per return and an incorrect withholding discrepancy case would be created. However, we will identify and correct this item before a notice is issued to the taxpayer. In addition, for error three, since the dividend match does not use qualifying and non-qualifying fields, dividend income matching would not be affected by this error.

Mr. James R. Watts

4. "Dividends not Qualifying for Exclusion" erroneously reported as "Capital Gain Dividends"

Impact

This error would create an erroneous dividend discrepancy (overreported dividends) only if dividend income per return is less than \$400.00. This overreporting alone would not create a case. However, since overreported dividend and underreported interest discrepancies are offset, it could erroneously reduce underreported interest income.

Based on our analysis of the coding errors, we conclude that these errors may reduce the effectiveness of matching but will not result in erroneous notices being sent to taxpayers. As indicated in item two, erroneous withholding will be screened out manually prior to issuance of notices. Unnecessary taxpayer contact will be eliminated by including these payers on the Bad Payer List used in the analysis of potential underreporter cases. This will allow the Service to eliminate potential adjustments caused by coding errors. None of the errors verified were of significant magnitude to warrant a delay in correlation to eliminate or modify payer data.

The coding error problem was recognized by the Service in April 1984. At that time magnetic media coordinators were instructed to analyze all tapes to ensure that the return codes for type of information returns filed matched the amount indicator codes. All tapes were also to be analyzed as to whether the data they contained was "good" or "bad". In addition, in May 1984 certain validity checks were instituted; e.g., Form 1099-INT must have an amount for gross interest. The validity checks cause a run to stop if an anomalous condition arises. The tape is then to be checked and the magnetic media coordinator can override the validity checks if the data is deemed "good".

Appendix IV
Letter Dated May 9, 1985, From IRS to the
General Accounting Office

Mr. James R. Watts

To prevent a recurrence of bad data being input, the instructions given to magnetic media coordinators in April 1984 have been reinforced. At the same time, problem transmittals are being addressed. The following steps are being taken:

- 1) If a payer has sent questionable data in the past, that payer's transmittals received in 1985 are to be analyzed to verify that the mistakes have not been repeated.
- 2) A listing of filers of bad data has been sent to Social Security Administration and SSA has been requested to verify payer transmittals received in 1985.
- 3) If a payer or transmitter consistently sends bad data, the magnetic media coordinator will contact or visit the payer or transmitter to correct the problem.
- 4) A study to prevent "repeaters" of bad data is currently in process. Returns Processing is working with National Computer Center to develop a method of sampling payer data and informing management, payers and payees that the data is bad. The study will be completed January 1, 1986.

We appreciate the time and effort that have been expended in identifying these coding errors and intend to continue to take steps to make sure there is no repetition of the problem. If you have any questions, please call Paula Diamond on (FTS) 535-4316.

Sincerely Yours,


Percy Woodard Jr.

Letter Dated May 30, 1985, From the General Accounting Office to IRS



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

INFORMATION MANAGEMENT
& TECHNOLOGY DIVISION

MAY 30 1985

Mr. Percy P. Woodard, Jr.
Assistant Commissioner, Examination
Internal Revenue Service

Dear Mr. Woodard:

Subject: Problems Found in the Internal Revenue
Service's Information Returns Program Data
(Job Code 510073)

In a March 28, 1985 letter to you we described problems found in the accuracy of interest and dividend information for tax year 1983. We noted that (1) 700,000 information returns were incorrectly recorded by Internal Revenue Service and (2) another 1.1 million returns required further research, but appeared to have either been recorded incorrectly or not recorded at all on Internal Revenue's Information Returns Program (IRP) master file. We continued to research the 1.1 million returns. The purpose of this letter is to report the results of our research, describe problems found, and ask what corrective actions you intend to take.

Research on the 1.1 million returns revealed that

- about 986,000 interest and dividend returns, involving hundreds of millions of dollars, were not recorded on the IRP master file due to problems in the receipt and control of computer tapes at the Atlanta and Cincinnati Service Centers and at the National Computer Center (NCC),
- about 14,000 inaccurate interest returns were recorded on the master file, and
- about 90,000 interest and dividend returns were corrected before being recorded on the master file.

We are primarily concerned about the 986,000 unrecorded returns, because they may represent an even larger problem. In fact, our research of these returns revealed that at least an additional 2.9 million returns from tax year 1983 also have not been recorded. Even more unrecorded returns may be disclosed if you research this problem further because our examination did not include all service centers.

Appendix V
Letter Dated May 30, 1985, From the
General Accounting Office to IRS

We traced these unrecorded returns to 52 computer tapes which were never processed onto the IRP master file. We determined that NCC returned 30 of these tapes to the Atlanta Service Center for correction. Of these 30 tapes, 19 were corrected and resubmitted to NCC, but NCC did not record them onto the master file; and the tapes are now in NCC's tape library. Atlanta did not correct the other 11 tapes and the data on them has been erased. A similar situation occurred at the Cincinnati Service Center where NCC returned 22 unprocessable tapes for correction. These tapes were not corrected and have been erased at the service centers.

On May 21, we met with Mr. Worley King of your staff and provided him with a list which identified the unprocessed tapes, name of the bank or other organization involved, number of IRP returns and other appropriate information.

At least two major consequences can occur when returns are not recorded. First, it can compromise the effectiveness of IRP as an enforcement tool, which as you know, has been used to recover over a billion dollars in taxes for tax year 1982. Secondly, it can cause stop filer notices to be sent to banks and other organizations erroneously advising them that they are subject to fines and other penalties for failure to report information they have already reported. We understand that Internal Revenue has already sent such notices from the Atlanta, Cincinnati, and other service centers and some of the recipients have complained about them.

The returns were not recorded on the master file apparently because of inadequate controls over unprocessable tapes returned to service centers by NCC. On a related note, Internal Revenue's Internal Audit Division recently issued a report that stressed the need for tighter controls to ensure prompt replacement of Federal Tax Deposit (FTD) tapes which NCC had returned to service centers. The auditor who wrote the report told us that the report's scope did not include an examination of possible problems with replacement of IRP tapes. Although the problems we noted at Atlanta and Cincinnati involved IRP replacement tapes, they are similar to the problems with FTD tapes noted in the Internal Audit report.

Given the situations noted above, we would appreciate your responses to the following questions:

- Is Internal Revenue aware of any service centers other than Atlanta and Cincinnati for which IRP computer tapes did not get processed to the master file? If so, how many tapes and how many IRP returns were on them?

Appendix V
Letter Dated May 30, 1985, From the
General Accounting Office to IRS

--Since a major problem seems to be inadequate controls over IRP replacement tapes requested by NCC, what specific controls do you plan to institute to ensure that (1) service centers promptly replace unprocessable IRP tapes and (2) NCC promptly processes the replacements?

--Since 19 tapes with IRP data are recoverable, how does Internal Revenue plan to use them in implementing the IRP program for the 1983 tax year and the 1983 and 1984 Payer Master File (PMF)? Other than IRP and PMF, what other programs may benefit from posting this IRP data?

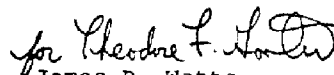
--Since 33 tapes from Atlanta and Cincinnati containing IRP data have been erased, what impact will this have on the IRP program and on the Payer Master File for tax years 1983 and 1984? What corrective actions are planned?

- - - - -

We wish to express appreciation for the assistance of Internal Revenue's Computer Services and the Internal Revenue personnel at NCC. Over the last several weeks, they have been helping us verify these unrecorded returns.

To assist us in completing our review of the quality of IRP data, we would appreciate your response within 30 days. We will continue to keep you informed as our work progresses. Your response will be helpful for our final report. Since the problems involve data processing controls, I am also sending a copy of this letter to Mr. Heironimus, Associate Commissioner, Data Processing. If you have any questions, please call Ted Gonter on 275-3455 or Bill Moffitt of our Boston Regional Office on (FIS) 223-5945.

Sincerely yours,


James R. Watts
Senior Group Director

cc: Mr. Thomas Laycock, IRS Computer Services
Mr. Stanley Goldberg, IRS>Returns and
Information Processing

Letter Dated July 10, 1985, From IRS to the General Accounting Office

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

JUL 10 1985

Mr. James R. Watts
Senior Group Director
Information Management & Technology Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Watts:

This is in response to your letter of May 30, 1985, to the Assistant Commissioner (Examination) regarding problems found in IRS' Information Returns Program data. Enclosed are our responses to the four questions posed in your letter.

We hope this information will be helpful in completing your review of the quality of IRP data and in preparing your final report.

With kind regards,

Sincerely,



Tom E. Persky
Assistant to the Commissioner
(Legislative Liaison)

Enclosures

Department of the Treasury Internal Revenue Service

Appendix VI
Letter Dated July 10, 1985, From IRS to the
General Accounting Office

Question #1

Is Internal Revenue aware of any service centers other than Atlanta and Cincinnati for which IRP computer tapes did not get processed to the master file? If so, how many tapes and how many IRP returns were on them?

Comment

In addition to Atlanta and Cincinnati's unprocessed tapes, there were 6 tapes that Kansas City returned to NCC but were not processed. These 6 tapes contained 40,985 documents (35,727 Forms 1099 INT/DIV and 5,258 Forms 5498-IRA). Through a recovery at NCC, these 6 tapes have been posted to the IRP TY 1983 master file. The associated payer records are currently being held for input to the Payer Master File (PMF) update for late July 1985.

Question #2

Since a major problem seems to be inadequate controls over IRP replacement tapes requested by NCC, what specific controls do you plan to institute to ensure that (1) service centers promptly replace unprocessable IRP tapes and (2) NCC promptly processes the replacements?

Comment

At NCC we have taken recent measures to help us ensure that service centers promptly replace unprocessable IRP tapes. We have added the IRP replacement requests to the Monthly Problem Tape Report we send to the service centers. That report documents replacement requests and resultant actions that occurred during the month since the prior report. Each center can determine from a review of the report what requests for replacements have not been honored.

A new report has been initiated for use in the Production Control area of Operations Division at NCC. The report is a daily Problem Tape Log. It contains information regarding tapes dropped from processing and documents the reel number, nature of the problem, the time and date a replacement is requested, replacement reel number and what cycle the replacement reel is successfully processed through. This report is reviewed daily for any necessary follow-up action.

Additional cross-checks will be added in the new IRP Branch at NCC. In addition, once NCC assumes responsibility for the magnetic media processing for the whole country all requests for any replacement files from transmitters will be centralized at NCC. This should provide tighter controls between the IRP Branch and Production Control.

Question #3

Since 19 tapes with IRP data are recoverable, how does Internal Revenue plan to use them in implementing the IRP program for the 1983 tax year and the 1983 and 1984 Payer Master File (PMF)? Other than IRP and PMF, what other programs may benefit from posting this IRP data?

Comment

NCC recovered the 19 tapes from Atlanta and they are now posted to the IRP TY 1983 master file. These tapes contained 1,277,231 Forms 1099 Interest and Dividends. The associated payer records are currently being held for input to the PMF update scheduled for late July 1985.

The 19 tapes with recoverable IRP data will be used in the Information Returns Selection System (IRSS), but not in the TY 1983 Underreporter Program since IRP correlation has been completed.

The data recovered from these tapes will be posted to the Payer Master File (PMF). These tapes are no longer usable for the TY 1983 stop-filer program, as this program has been completed. Since the data will be posted to the PMF before the TY 1984 programs are run, the data will be used as if input timely.

Other functions/programs that benefit from posting of IRP data on IRSS are: Examination Classification which uses IRSS transcripts to classify returns for examination; Collection Division which uses IRP/IRSS data to identify taxpayers who are nonfilers and stopfilers; and Criminal Investigation Division which uses IRP/IRSS data in development of criminal cases.

Question #4

Since 33 tapes from Atlanta and Cincinnati containing IRP data have been erased, what impact will this have on the IRP program and on the Payer Master File for tax years 1983 and 1984? What corrective actions are planned?

Comment

The 22 tapes which were unprocessed by the Cincinnati Service Center contained 171 payers reporting 1,656,422 documents (1,360,435 Form 1099 INT, 279,440 Forms 1099 DIV, 13,956 Forms 1099 ASC, and 2,591 Forms 1099B).

The 11 tapes which were unprocessed by the Atlanta Service Center contained 348 payers reporting 1,111,588 Forms 1099 INT and 9,397 Forms 1099 DIV.

Appendix VI
Letter Dated July 10, 1985, From IRS to the
General Accounting Office

Replacements for the 33 tapes will not be requested from the filers. Too much time has elapsed since the original submission and we have no means of recovery at this late date. In addition, our public relations are currently strained and to request these replacements due to our negligence would only further strain our public relations.

The 33 tapes that were erased will result in an under-developed Underreporter Program since the Service did not have all the information documents to match with taxpayer returns. In addition, all the other functions (Classification, Collection, and Criminal Investigation) will have incomplete data when pursuing cases for underreported income, stopfilers and nonfilers, etc. As a result, the Service could lose tax dollars due on interest and dividend income if the taxpayer failed to report the income.

For the PMF, the impact of not processing the payer transmittal documents could be on the creation of cases for the TY 1983 stop-filer program. Stop-filer cases are created when payers filed transmittal documents for TY 1982 but did not file transmittals for the same type of information return for TY 1983. The TY 1983 stop-filer notices were issued in April 1985. Because of the high volume of payers indicating that they had previously filed, part of which may be due to the unprocessed tapes, the Service suspended those portions of the payer stop-filer program calling for penalty assertions on late filers and field contacts on no-response cases.

However, penalties will be assessed when payers submit checks intended to be applied to self-assessed penalties and submitted original delinquent transmittal documents as a result of the notice. In those cases the Service should continue to assess penalties for failure to file unless the payer can show that reasonable cause existed or that due diligence was exercised in not filing timely.

To ascertain the deficiencies in the TY 1983 PMF stop-filer program and to improve the program for future years, the following actions will be taken.

1. A group of 500 no-response/insufficient response cases from both the Ogden and Kansas City Service Centers will be selected for field contact, evaluation of the degree of noncompliance among these payers and identification of any program problems within the stop-filer program.
2. The ten service centers will forward to the National Office a random sample of 100 responses where the payer responded that information returns were previously filed and attached copies of the documents. These responses will be evaluated to determine if the payer filed the same type of documents, if the payer filed with the same name and Taxpayer Identification Number (TIN) as were used in TY 1982, or if the problem was due to unprocessed tapes.

Appendix VI
Letter Dated July 10, 1985, From IRS to the
General Accounting Office

The unprocessed TY 1983 tapes will have a minor impact on the TY 1984 Payer Master File programs. They will not cause notices to the payer regarding nonfiling. TY 1984 stop-filer program is a comparison of filings by category of payment for Tax Years 1983 and 1984. Notices will be sent to stopfilers. If the payer filed for TY 1984, no notice or case will be created for that category of payment. If the payer did not file for TY 1984, the absence of filing data for the same payment category for TY 1983 will prevent the creation of a stop-filer case. The payer may still appear as a nonfiler, however, if no Form 1099 of any type or for any category of payment is filed for TY 1984, the payer is not identified as a stopfiler, and the payer files an income tax return which is posted to the Business or Individual Master Filer for TY 1984. The TY 1984 nonfiler program will match the PMF with the appropriate master files for TY 1984 and generate the educational notice calling the potential filer's attention to IRP filing requirements.



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