



*Improvements Are Needed to Verify Refunds
to Nonresident Aliens Before the Refunds
Are Sent Out of the United States*

September 15, 2010

Reference Number: 2010-40-121

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

2(f) = Risk Circumvention of Agency Regulation or Statute (whichever is applicable)

7 = Predecisional Material

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HIGHLIGHTS

IMPROVEMENTS ARE NEEDED TO VERIFY REFUNDS TO NONRESIDENT ALIENS BEFORE THE REFUNDS ARE SENT OUT OF THE UNITED STATES

Highlights

Final Report issued on September 15, 2010

Highlights of Reference Number: 2010-40-121 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

IMPACT ON TAXPAYERS

Control weaknesses in the processing of refunds issued to nonresident aliens could result in significant revenue losses to the United States (U.S.). The probability of recovering fraudulent refunds from nonresidents living outside the U.S. is very low.

WHY TIGTA DID THE AUDIT

The objective of this audit was to review the processing of U.S. Nonresident Alien Income Tax Returns (Form 1040NR) and determine whether controls are in place to ensure taxpayers receiving refunds are entitled to those refunds.

WHAT TIGTA FOUND

Although a statistical sample of Tax Year 2008 returns indicated that control weaknesses discussed in this report had not been exploited to a significant extent, a judgmental sample of Tax Year 2007 and 2008 returns revealed significant control weaknesses in the processing of refunds claimed on Forms 1040NR. For example:

- *****2(f)*****

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- *****2(f)*****
- *****2(f)*****

If the Internal Revenue Service (IRS) does not take immediate steps to address these control weaknesses, the problem could increase significantly. The questionable refunds in the 40 cases that TIGTA identified were very high, totaling more than \$2.3 million. During this audit, TIGTA discussed these control weaknesses with the IRS and it is working on actions to address them.

TIGTA also found that tax treaty provisions regarding the taxability of gambling income are not being applied consistently by the IRS, and that clarification is needed regarding the designation of certain income earned through U.S.-based, multi-level marketing companies as U.S. source income.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Large and Mid-Size Business Division, ensure that plans, developed during the course of this audit to address control weaknesses discussed in this report, are implemented. The Commissioner should also use the Foreign Country Codes on Forms 1040NR to systemically verify the correct rate of tax is applied according to the applicable tax treaty and should work with the Forms and Publications function to clarify instructions on what constitutes U.S source income in regard to income from multi-level marketing companies. The Commissioner, Wage and Investment Division,

- *****2(f)*****

In their response to the report, IRS officials agreed with the recommendations and are taking appropriate corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 15, 2010

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed to Verify Refunds to
Nonresident Aliens Before the Refunds Are Sent Out of the
United States (Audit # 201040036)

This report presents the results of our audit to review the processing of U.S. Nonresident Alien Income Tax Returns (Form 1040NR) and determine whether controls are in place to ensure taxpayers receiving refunds are entitled to those refunds. This audit is included in our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenges of Tax Compliance Initiatives, Erroneous and Improper Payments and Credits, and Globalization. We initiated this review as a result of another audit¹ in which we identified claims for refunds of withheld amounts on Form 1040NR that appeared to be questionable based on the associated tax withholding documents, Foreign Person's U.S. Source Income Subject to Withholding (Form 1042-S).

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

¹ *Validation of Returns With Individual Taxpayer Identification Numbers at the Fraud Detection Centers* (Audit Number 200940031).



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Abbreviations

EIN	Employer Identification Number
IMF	Individual Master File
IRS	Internal Revenue Service
ITIN	Individual Taxpayer Identification Number
SSN	Social Security Number
TIN	Taxpayer Identification Number
TY	Tax Year
U.S.	United States



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Background

Individuals who are nonresident aliens of the United States (U.S.), but who receive U.S. source income from a U.S. trade or business including wages, commissions, interest, dividends, pensions, gambling winnings, etc., report and pay taxes on that income on U.S. Nonresident Alien Income Tax Returns (Form 1040NR). This income is also subject to income tax withholding. Nonresident aliens also file Form 1040NR to request refunds of amounts over withheld. There were approximately 598,000 Tax Year (TY) 2008 Forms 1040NR processed in 2009.¹ Total tax withheld on these returns amounted to more than \$2.4 billion and refunds amounted to more than \$712 million.

***There were approximately
598,000 TY 2008 Forms 1040NR
processed in 2009. Total tax withheld
on these returns amounted to more
than \$2.4 billion and refunds
amounted to more than \$712 million.***

The U.S. business or third-party payer generally reports the amount of income earned along with the amount withheld to the nonresident and to the Internal Revenue Service (IRS) on Wage and Tax Statement (Form W-2), Form 1099 series, or Foreign Person's U.S. Source Income Subject to Withholding (Form 1042-S). In some cases, the nonresident involved owes no taxes because the income was paid by a corporation based in the U.S. but earned outside the U.S., or because the income is exempted by treaty from U.S. taxation. In those cases, the nonresident must file a Form 1040NR to claim a refund of the amounts withheld. A Social Security Number (SSN), an Individual Taxpayer Identification Number (ITIN),² or an Employer Identification Number (EIN) is required to file a Form 1040NR.³

We initiated this review as a result of another audit⁴ in which we identified claims for refunds of withheld amounts on Forms 1040NR that appeared to be questionable based on the associated tax withholding documents, Forms 1042-S. This review was performed at the IRS Campuses⁵ in Philadelphia, Pennsylvania; Austin, Texas; and Ogden, Utah; the Large and Mid-Size Business

¹ These were processed by the IRS from January 2009 to December 2009.

² An ITIN is a nine-digit number issued by the IRS to individuals who are required for U.S. Federal income tax purposes to have a U.S. Taxpayer Identification Number but who do not have, and are not eligible to obtain, an SSN from the Social Security Administration. It does not entitle the individual to Social Security benefits and does not change their immigration status or their right to work in the U.S.

³ Although Form 1040NR is filed by both individual taxpayers and on the behalf of nonresident alien estates or trusts, Form 1040NR data in this report only include figures for individual nonresident alien taxpayers.

⁴ *Validation of Returns With Individual Taxpayer Identification Numbers at the Fraud Detection Centers* (Audit Number 200940031).

⁵ The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Division International offices in New York City, New York; and the IRS National Headquarters in Washington, D.C., during the period September 2009 through June 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

Inaccurate and Fraudulent Forms 1040NR Are Not Being Detected During Processing

To determine whether controls were adequate to prevent improper refunds, we obtained an extract of approximately 635,000 TY 2007⁶ and 598,000 TY 2008 Forms 1040NR from the IRS Individual Master File (IMF).⁷ We reviewed a judgmental sample of 296 Forms 1040NR from these returns. This judgmental sample included return characteristics which we deemed to be of high risk.⁸ We also selected a statistically valid random sample of 420⁹ Forms 1040NR from the TY 2008 returns. From our statistical sample of 420 TY 2008 returns, there did not appear to be a significant percentage of returns which exploited the control weaknesses detailed in this report. However, from our judgmental sample of TY 2007 and TY 2008 returns, we identified significant control weaknesses in the processing of refunds claimed on Forms 1040NR. The control weaknesses referred to in this report were all identified in our judgmental sample. As long as proper controls are not in place, the risk of fraudulent returns and refunds is substantial.

As long as proper controls are not in place, the risk of fraudulent returns and refunds is substantial.

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⁶ These were processed by the IRS from January 2008 to October 2009.
⁷ The IRS database that maintains transactions or records of individual tax accounts.
⁸ See Appendix I for specific details of our judgmental sample.
⁹ Our statistical sample included Forms 1040NR filed with SSNs and ITINs. In TY 2008, 58 percent of the Forms 1040NR were filed with an SSN and 42 percent were filed with an ITIN.



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The Form 1042-S contains five copies (Copy A, B, C, D, and E). The U.S. business or third-party payer sends the original copy (Copy A) to the IRS, sends three copies (Copy B, C, and D) to the taxpayer, and retains one copy (Copy E). The taxpayer should file only Copy C with his or her Form 1040NR. *****2(f)*****

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*****2(f)*****



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In general, casinos are required to withhold 30 percent on the winnings from gambling and issue a Form 1042-S at the time the winnings are paid to nonresident aliens. When these individuals file their tax returns, they could have tens or even hundreds of Forms 1042-S to attach to their returns.

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Businesses who withhold income taxes from income paid to nonresidents are required to remit the amounts withheld to the IRS and report the amounts withheld to the IRS and to the nonresident, generally on Forms 1042-S. The IRS processes paper and electronic Form 1042-S data reported by U.S. businesses and third-party payers. *****2(f)*****

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- *****2(f)*****

¹⁰ In this context, indexing refers to the assignment of a number to each Form 1042-S for the purpose of identifying the taxpayer who filed the Form 1042-S. Indexing also facilitates the storage and retrieval of Form 1042-S data.

¹¹ The taxpayer TIN can be an SSN, an ITIN, or an EIN.



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The Document Perfection function at the Austin Submission Processing Center performs a manual review that is designed to prepare Forms 1040NR for input. This process identifies certain questionable items but it is not designed to identify all questionable refunds.

IRS actions to address control weaknesses

During this audit, we discussed these control weaknesses with the IRS and it is working on actions to address them. These actions include the following:

- The IRS requested and Congress passed a legislative change allowing the IRS 180 calendar days rather than 45 calendar days to process a refund without paying interest on Forms 1040NR. This action will allow the IRS more time to verify the appropriateness of withholding on certain questionable returns before allowing the refunds on these returns.
- On January 28, 2010, the IRS started manually reviewing all Form 1040NR returns with refunds greater than *****2(f)*****Through May 12, 2010, the IRS reviewed 1,745 returns and held the refunds on 94 of these returns. A total of more than \$8.1 million in refunds was claimed on these returns for an average of almost \$87,000 per return. The IRS will use the 180-calendar day period to verify that these taxpayers are entitled to the refunds claimed.
- The IRS has established special handling procedures for returns identified in its manual review process as needing further investigation before a refund is issued. All selected returns are coded with Computer Condition Code “O”, which establishes an “X” freeze on the tax period. The Freeze Code “X” will prevent the refund from generating for 26 weeks. This allows time for the IRS to conduct an investigation and verify a refund claim.

- *****2(f)*****



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- Along with the matching program, the IRS also plans to establish three Large and Mid-Size Business Division International Campus Compliance units at the IRS Austin Campus to conduct examinations. These units will be responsible for running the matching program and working any questionable refunds found from the program. The IRS is developing training material and correspondence letters for the examiners who will be working the Form 1040NR inventory.
- The IRS has created a screen on the IMF which will provide a total of all Forms 1042-S filed electronically and on paper for each withholding agent.¹² This will facilitate the penalty process and improve compliance with the regulations, which require those who submit 250 or more Forms 1042-S to file electronically. *****2(f)*****

- The IRS is working with the Office of Servicewide Penalty and Interest to begin assessing penalties for late filing, inaccurate filing, or erroneous paper filing (filing 250 or more Forms 1042-S on paper instead of electronically) of Forms 1042-S. The IRS plans to automate the penalties for filing Forms 1042-S late and for filing more than 250 Forms 1042-S on paper.

If the IRS does not take immediate steps to address these control weaknesses, the problem could increase substantially if more unscrupulous individuals learn of the control weaknesses.

Notwithstanding these actions, additional steps are necessary to ensure that questionable refunds claimed on Forms 1040NR are identified and stopped prior to issuance. None of the issues discussed previously in this report appeared in our statistical sample of 420 TY 2008 returns. This indicates that the occurrence of these questionable or fraudulent refunds is not yet widespread. However, the questionable refund amounts in the cases that we identified in our judgmental sample appear to be very high. In just the cases that we identified, 40 questionable refunds totaling more than

¹² A withholding agent is generally a U.S. person or entity which makes payments of certain types of U.S. source income to nonresidents. Withholding agents generally must withhold tax at a rate of 30 percent on such payments, unless there are applicable tax treaty provisions allowing for a reduced rate. These payments are generally subject to reporting on Annual Withholding Tax Return for U.S. Source Income of Foreign Persons (Form 1042) and Form 1042-S.



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\$2.3 million were issued. If the IRS does not take immediate steps to address these control weaknesses, the problem could increase substantially if more unscrupulous individuals learn of the control weaknesses. The probability of recovering fraudulent refunds from nonresidents living outside the U.S. is very low.

Recommendations

Recommendation 1: The Commissioner, Large and Mid-Size Business Division, should ensure that plans, developed during the course of our audit to address the control weaknesses discussed in this report, are implemented to:

- List of recommendations including redacted items (2(f)) and specific actions like establishing compliance units and working with the Office of Servicewide Penalty and Interest.

Management's Response: IRS management stated that all the actions described above are in process.

Recommendation 2: The Commissioner, Wage and Investment Division, should develop controls to [redacted]

[Redacted line]

Management's Response: IRS management agreed with this recommendation. Based on their analysis of cases provided by the Treasury Inspector General for Tax Administration, a Unified Work Request will be submitted by January 15, 2011, to add a document identification number as an additional validation criteria.

Since the requested action will be subject to funding and resource prioritization by the Modernization and Information Technology Services organization, submission of the Unified Work Request will complete the corrective action.

Recommendation 3: The Commissioner, Large and Mid-Size Business Division, should determine whether it would be feasible to require payers issuing multiple Forms 1042-S to issue



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a single summary Form 1042-S at the end of the calendar year to simplify reporting for the U.S. business and third-party payer and to decrease taxpayer burden.

Management's Response: IRS management agreed with this recommendation. A team with members from the Large and Mid-Size Business Division International function, Chief Counsel, and other appropriate functions will be formed to consider the feasibility of requiring payers issuing multiple Forms 1042-S to issue a single summary Form 1042-S. The team will issue a report that outlines either the actions needed to implement this requirement, or the reasons why it is not feasible and alternative actions to minimize the risks to the Government and minimize taxpayer burden. The Deputy Commissioner International, Large and Mid-Size Business Division, will be briefed on the results.

Tax Treaty Provisions Regarding the Taxability of Gambling Income Are Not Being Applied Consistently

From the judgmental sample previously identified, we determined that claims for the refund of amounts withheld on gambling winnings are being processed inconsistently. There are a number of tax treaties between the U.S. and other countries that determine the taxability of gambling winnings for nonresident aliens. For example, Japanese citizens are not required to pay tax on U.S. gambling winnings. The treaties can also dictate how the winnings are to be taxed. Canadian citizens can deduct gambling losses from their winnings, but only to the extent of their winnings. ***2(f)***citizens are also taxed on their gambling winnings but are not allowed to subtract their losses. We found that personnel at the Austin Submission Processing Center are not consistently applying these tax treaties when processing Forms 1040NR. For example, in 36 cases, citizens from ***2(f)*** were correctly taxed on their gambling winnings and received no refund, and in 22 other cases, they were not taxed and received refunds totaling more than \$428,000. *****1*****

IRS guidance requires that nonresident aliens filing Form 1040NR indicate their country of citizenship. The IRS converts the country of citizenship to a two-character Foreign Country Code and transcribes the data along with key data from Form 1040NR into the Service Center Replacement System database. *****2(f)*****

*****. We have been informed that a Unified Work Request has been submitted to have the Foreign Country Code transferred from the Service Center Replacement System to the IMF in January 2011. The IRS should use the Foreign Country Code to perform validity checks on key Form 1040NR data to ensure that the proper amount of tax is collected according to the applicable treaty.



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Recommendations

The Commissioner, Large and Mid-Size Business Division, should:

Recommendation 5: *****7*****

Management's Response: *****7*****

*****. The IRS is in the process of identifying taxpayers who received prior year refunds in order to conduct examinations and make assessments as initial steps to recover prior year refunds. The Collection function will assist with this effort. Once the assessments are determined, the IRS will take appropriate actions to recover the refunds.

Recommendation 6: Work with the Tax Forms and Publications function to clarify instructions on what constitutes U.S. source income in *U.S. Tax Guide for Aliens* (Publication 519) and *Withholding of Tax on Nonresident Aliens and Foreign Entities* (Publication 515) with regard to income from multi-level marketing companies.

Management's Response: IRS management agreed with this recommendation. The Director, International Compliance Strategy and Policy, Large and Mid-Size Business Division, will work with the Tax Forms and Publications function to clarify instructions in Publications 519 and 515. The IRS Chief Counsel will review and approve the revisions.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to review the processing of U.S. Nonresident Alien Income Tax Returns (Form 1040NR) and determine whether controls are in place to ensure taxpayers receiving refunds are entitled to those refunds. We initiated this review as a result of another audit¹ where we identified claims for refunds of withheld amounts on Forms 1040NR that appeared to be questionable because of suspect Foreign Person's U.S. Source Income Subject to Withholding (Form 1042-S).

To accomplish this objective, we:

- I. Identified the issues involved with processing Forms 1040NR and Forms 1042-S.
 - A. Researched the Internal Revenue Manual, Treasury Inspector General for Tax Administration audit reports, and U.S. Government Accountability Office audit reports.
 - B. Interviewed responsible IRS management personnel.
- II. Determined what controls are in place to ensure wage, withholding, and refund information on Forms 1040NR is accurate.
 - A. Obtained access to and analyzed the IRS Form 1042-S database (also referred to as Chapter Three Withholding or CTW) to determine its usability in matching wage and withholding information submitted from employers to tax return information claimed by taxpayers on their Form 1040NR returns.
 - B. Obtained an IRS IMF computer extract of all TY 2007 and TY 2008 Forms 1040NR from the Treasury Inspector General for Tax Administration Information Services staff. We validated the accuracy and completeness of the data received by comparing 30 records to IRS IMF data for each tax year.
 - C. Selected a judgmental sample² of 296 TY 2007 and TY 2008 Forms 1040NR.

¹ *Validation of Returns With Individual Taxpayer Identification Numbers at the Fraud Detection Centers* (Audit Number 200940031).

² We used a judgmental sample to determine if processing controls were in place to detect potentially inaccurate tax withholding and refund amounts claimed on Forms 1040NR. A judgmental sample was also used because the results would not need to be projected over the entire population. This judgmental sample included only Forms 1040NR filed with ITINs and focused on certain dollar amounts, certain issuers of Forms 1042-S, returns filed from certain foreign countries, and certain tax return preparers. The judgmental sample was selected from a combined population of 635,158 TY 2007 and 598,023 TY 2008 Forms 1040NR.



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- D. Reviewed the judgmental sample to identify any questionable claims or refunds. We considered the following in identifying these returns:
1. Forms 1042-S that contain information that appears to be fabricated, incomplete, or questionable.
 2. Forms 1042-S in which a TIN (SSN or ITIN) is not present or appears to be invalid.
 3. Forms 1042-S that contain withholding amounts that appear unreasonable or inaccurate.
 4. Wage and withholding amounts claimed on the Forms 1040NR that do not match the amounts provided on the Forms 1042-S.
- E. Requested that the IRS determine the legitimacy of the information contained in the questionable Forms 1042-S and Forms 1099 identified in Step II.D by asking the employer to validate the information provided.
- III. Determined whether the proper amounts of wages, withholding, and refunds are claimed by taxpayers on Forms 1040NR.
- A. Selected a statistical sample³ of Forms 1040NR from the TY 2008 IRS IMF computer extract obtained in Step II.B.
- B. Reviewed the statistical sample to determine if any of the returns appeared to be fraudulent. We included the following tests:
1. Matched the total withholding amounts claimed on the return to the amounts claimed on the individual Forms 1042-S and noted any discrepancies.
 2. Matched the Form 1042-S information attached to the Forms 1040NR to IRS IMF data and the Form 1042-S database.
 3. Verified that the TIN (SSN or ITIN) on the Form 1040NR belongs to the taxpayer.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems

³ After we determined control weaknesses existed that could allow improper tax withholding and refunds to be claimed, we selected a statistical sample to help quantify the extent of the problem over the entire Form 1040NR population. The statistical sample size was selected using a 95 percent confidence level, a ± 5 percent precision, and a 50 percent expected error rate. We selected a sample of 420 TY 2008 Forms 1040NR from a population of 598,023.



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for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices related to the identification of erroneous claims for refunds claimed in Forms 1040NR.



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Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

Kyle R. Andersen, Director

Larry Madsen, Audit Manager

Roy E. Thompson, Lead Auditor

John B. Mansfield, Senior Auditor

Michele S. Jahn, Auditor

Richard Hillelson, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner

Office of the Commissioner – Attn: Chief of Staff C

Commissioner, Large and Mid-Size Business Division SE:LM

Commissioner, Wage and Investment Division SE:W

Deputy Commissioner (International) United States Competent Authority, Large and Mid-Size Business Division SE:LM:IN

Director, International Compliance Strategy and Policy, Large and Mid-Size Business Division SE:LM:IN

Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP

Chief Counsel CC

National Taxpayer Advocate TA

Director, Office of Legislative Affairs CL:LA

Director, Office of Program Evaluation and Risk Analysis RAS:O

Office of Internal Control OS:CFO:CPIC:IC

Audit Liaisons:

Commissioner, Large and Mid-Size Business Division SE:LM

Chief, Program Evaluation and Improvement, Wage and Investment Division

SE:W:S:PRA:PEI



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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These outcome measures are based on specific cases identified through our judgmental samples and are not projected to the overall population of Forms 1040NR. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Actual; \$2,369,524 in questionable refunds on 40 taxpayer returns (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained an extract of 635,158 TY 2007 and 598,023 TY 2008 U.S. Nonresident Alien Income Tax Returns (Forms 1040NR) from the IRS IMF. We reviewed a judgmental sample of 296 Forms 1040NR from the TY 2007 and TY 2008 returns. From our judgmental sample, we identified 40 questionable refunds totaling \$2,369,524. *****2(f)*****

Type and Value of Outcome Measure:

- Revenue Protection – Actual; \$428,151 in questionable refunds on 22 taxpayer returns (see page 9).

Methodology Used to Measure the Reported Benefit:

From the judgmental sample previously described, we identified 22 returns where citizens from ***2(f)***received \$428,151 in refunds from withholding on gambling winnings they were not entitled to receive.

Type and Value of Outcome Measure:

- Revenue Protection – Actual; \$3,462,677 in questionable refunds on 84 taxpayer returns (see page 10).



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Methodology Used to Measure the Reported Benefit:

Prior to starting this review, we identified two questionable Forms 1040NR returns in which the withholding amounts on the supporting Forms 1042-S appeared suspicious. In the judgmental sample referred to previously, *****2(f)*****



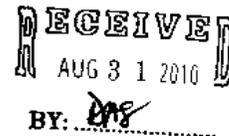
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Appendix V

Management's Response to the Draft Report

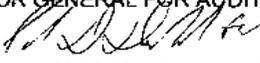


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



August 30, 2010

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Heather C. Maloy 
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report – Improvements are Needed to Verify
Refunds to Nonresident Aliens Before the Refunds Are Sent Out
of the United States (Audit # 201040036)

Thank you for sharing the subject draft report for our review and comments. The Large and Mid-Size Business (LMSB) and Wage and Investment (W&I) Divisions agree that improvements are needed to verify refunds to nonresident aliens before the refunds are sent out of the United States. Your review of a statistically valid sample of Forms 1040NR (U.S. Nonresident Alien Income Tax Returns) from tax year 2008 indicated that there was not a significant percentage of Form 1040NR returns with questionable or fraudulent refund claims. Although no widespread problems were identified, your judgmental sample of Form 1040NR tax returns from tax years 2007 and 2008 did identify some significant control weaknesses in the processing of refunds claimed on Forms 1040NR. As your report indicates, your audit findings and recommendations were based on the judgmental sample.

Your report acknowledges the improvements we have already made in the processing of Forms 1040NR, which are part of our continuing efforts to ensure that the issues with erroneous and fraudulent Forms 1040NR refund claims are not widespread. Your report includes several of the IRS actions taken to correct processing control weaknesses. Some of these corrective actions have already been completed and others are in progress. One of the most important actions is the legislative change that allowed the IRS 180 days instead of 45 days to process these types of refunds. The IRS now has more time to examine nonresident alien claims and ensure they are entitled to the refunds before they are issued. We are also implementing new procedures for reviewing and processing these refund claims, including the development of a new database, new document matching, and improved administration of penalty provisions. Finally, we are creating a new unit at the Austin Service Center Campus to specialize in this type of work. Our action plan for addressing your recommendations is attached.



*Improvements Are Needed to Verify
Refunds to Nonresident Aliens Before the Refunds
Are Sent Out of the United States*

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We have reviewed the outcome measures included in Appendix IV, which are based on the judgmental sample. We are in the process of taking the appropriate actions regarding the tax returns identified in your sample. We note that the results identified for some of the taxpayers will be dependent upon receipt of advice from the office of IRS Chief Counsel regarding the proper sourcing of the income in question.

If you have any questions, please contact me, or a member of your staff may contact Michael Danilack, Deputy Commissioner, International, LMSB, at (202) 435-5000.

Attachment



Improvements Are Needed to Verify Refunds to Nonresident Aliens Before the Refunds Are Sent Out of the United States

Attachment

RECOMMENDATION 1:

The Commissioner, Large and Mid-Size Business Division should ensure that plans, developed during the course of our audit to address the control weaknesses discussed in this report, are implemented including:

- *****2(f)*****

Establish Large and Mid-Size Business International Campus Compliance Units at the Austin IRS Campus to conduct examinations of questionable Form 1040NR refunds.
Work with the Office of Servicewide Penalty & Interest to begin assessing penalties for Form 1042-S late filing, inaccurate filing, and erroneous paper filing (filing 250 or more Forms 1042-S on paper) of Forms 1042-S.

CORRECTIVE ACTIONS:

The actions that are described above are in process.

IMPLEMENTATION DATE:

March 31, 2011

RESPONSIBLE OFFICIAL(S):

Director, International Compliance Strategy and Policy

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, International Compliance Strategy and Policy will review the progress on the above actions on a monthly basis beginning on September 3, 2010, with a final implementation by March 31, 2011.

RECOMMENDATION 2:

The Commissioner, Wage and Investment Division, should develop controls *****2(f)*****

CORRECTIVE ACTIONS:

We agree with your recommendation. Based on our analysis of cases provided by the Treasury Inspector General for Tax Administration, a Unified Work Request (UWR) will be submitted by January 15, 2011, to add a document identification number as an additional validation criteria.

Since the requested action will be subject to funding and resource prioritization by Modernization and Information Technology Services (MITS), submission of the UWR will complete the corrective action.

IMPLEMENTATION DATE:

January 15, 2011

RESPONSIBLE OFFICIAL(S):

Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN:



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The IRS will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3:

The Commissioner, Large and Mid-Size Business Division, should determine whether it would be feasible to require payers issuing multiple Forms 1042-S to issue a single summary Form 1042-S at the end of the calendar year to simplify reporting for the U.S. business and third-party payer and decrease taxpayer burden.

CORRECTIVE ACTIONS:

A team with members from LMSB International, Chief Counsel, and other appropriate functions will be formed to consider the feasibility of requiring payers issuing multiple Forms 1042-S to issue a single summary Form 1042-S. The team will issue a report that outlines either the actions needed to implement this requirement, or the reasons why it is not feasible and alternative actions to minimize the risks to the government and minimize taxpayer burden. The Deputy Commissioner for International, LMSB will be briefed on the results.

IMPLEMENTATION DATE:

June 30, 2011

RESPONSIBLE OFFICIAL(S):

Director, International Compliance Strategy and Policy

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, International Compliance Strategy and Policy will review the progress on the above actions on a monthly basis beginning on September 3, 2010, with a final decision by June 30, 2011.

RECOMMENDATION 4:

The Commissioner, Large and Mid-Size Business Division, should use the Foreign Country Codes on Form 1040NR to systemically verify the amounts on Form 1040NR, where possible, to ensure that the correct rate of tax has been applied according to the applicable tax treaty.

CORRECTIVE ACTIONS:

As part of the E-trak withholding database, an automated internal consistency check of issued Forms 1042-S is being instituted. Country codes will be used. In addition, income codes, exemption codes, withholding percent, and potentially other fields from the Form 1042-S will be used.

IMPLEMENTATION DATE:

March 31, 2011

RESPONSIBLE OFFICIAL(S):

Director, International Compliance Strategy and Policy

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, International Compliance Strategy and Policy will review the progress on the above actions on a monthly basis beginning on October 3, 2010, with final implementation by March 31, 2011.

RECOMMENDATION 5:

The Commissioner, Large and Mid-Size Business Division, should screen additional *****2(f)*****



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CORRECTIVE ACTIONS:

*****7*****

IMPLEMENTATION DATE:

March 31, 2011

RESPONSIBLE OFFICIAL(S)

Director, International Compliance Strategy and Policy

CORRECTIVE ACTION(S) MONITORING PLAN

The Director, International Compliance Strategy and Policy will review the progress on the above actions on a monthly basis beginning on October 3, 2010, with a final resolution by March 31, 2011.

RECOMMENDATION 6:

The Commissioner, Large and Mid-Size Business Division, should work with the Tax Forms and Publications function to Clarify instructions on what constitutes U.S. source income in *U.S. Tax Guide for Aliens* (Publication 519) and *Withholding of Tax on Nonresident Aliens and Foreign Entities* (Publication 515) with regard to income from multi-level marketing companies.

CORRECTIVE ACTIONS:

Director, International Compliance Strategy and Policy staff will work with Tax Forms and Publications to clarify instructions in Publications 519 and 515. The IRS Chief Counsel will review and approve the revisions.

IMPLEMENTATION DATE:

December 31, 2011

RESPONSIBLE OFFICIAL(S)

Director, International Compliance Strategy and Policy

CORRECTIVE ACTION(S) MONITORING PLAN

The Director, International Compliance Strategy and Policy will review the progress on the above actions on a monthly basis beginning on October 3, 2010. Revisions to Publications 519 and 515 are expected to be completed by December 31, 2011.