Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

September 2001

Reference Number: 2001-30-181

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.
MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

This report presents the results of our review of efforts taken by the Internal Revenue Service (IRS) to address the tax compliance of foreign persons. The overall objective of this review was to follow up on previously identified conditions in a prior IRS Inspection Service (now the Treasury Inspector General for Tax Administration (TIGTA)) report and determine whether the actions taken have corrected problems or whether risks still exist. We also evaluated the effect of new withholding regulations (effective January 1, 2001) for United States (U.S.) source income paid to foreign persons.

In summary, the IRS has taken substantial actions in several areas to address conditions identified in the prior report. For example, the IRS identified the need to develop an improved system to address data quality problems that were occurring in the processing of the Annual Withholding Tax Return for U.S. Source Income of Foreign Persons (Form 1042), and Foreign Person’s U.S. Source Income Subject to Withholding (Form 1042-S). The system will eventually allow computer matching of payments to

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1 Review of Nonresident Alien Information Documents (Reference Number 041403, dated January 21, 1994).
3 The report addresses the entire group of foreign person payees that include nonresident alien individuals, foreign corporations, foreign partnerships, foreign trusts, foreign estates, and any other persons that are not U.S. persons. The prior report used the term nonresident alien in lieu of the broader term foreign persons.
foreign persons with related tax returns. The IRS also developed the Individual Taxpayer Identification Number (ITIN) Program, which assigns an identifying number to foreign individuals who are not eligible for Social Security Numbers (SSN), but do have some U.S. tax-related transactions.

However, the IRS needs to take additional actions to better ensure the compliance of foreign persons. Specifically, the IRS did not completely resolve the data quality problems identified in our prior report. For example, invalid income codes were still accepted by the processing system in effect at the time of our audit. As a result:

- The IRS cannot determine the correct withholding rate since different withholding rates apply to different income types (i.e., interest, dividends, etc.).
- The IRS provides potentially inaccurate Form 1042-S data to its treaty partners under the Routine Exchange of Information Program (REIP).  
- Any Form 1042-S data currently used in examinations may not be reliable because of the existing computer processing control weaknesses.

Compliance issues with the Form 1042-S information documents affect both the payee and the payer. To address the first issue, payee compliance, an information system with a proposed completion date of March 2004 will allow computer matching of withholding reported on Form 1042-S to a foreign person’s tax return. However, at this time, there is no system with IRS-wide accessibility for examination, collection, and research purposes. Computer analysis of Form 1042-S data has not regularly occurred, and there are no specific plans for this type of analysis until the new system is implemented.

The second compliance issue concerns payers. The IRS still cannot determine whether withholding agent compliance has improved. IRS examinations of withholding agents found that most interest income was paid to foreign financial institutions serving as intermediaries for the actual account holders. Foreign financial institutions filed withholding exemption forms in their own names, and not in the names of the account holders. In some cases, interest was not reported on the Forms 1042-S and withholding exemption forms were not obtained. Consequently, the IRS cannot determine whether the account holders are foreign persons entitled to the withholding exemption for certain interest income, or U.S. persons evading taxation.

The IRS is still at risk because there is no effective system to monitor and encourage taxpayer compliance. The ITIN provision does not eliminate the compliance risks. Under the new withholding regulations, an identification number is not required when

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4 The IRS provides Form 1042-S data to foreign tax authorities.
5 The scope of this audit did not include specific tests to identify inaccurate data provided to the REIP or for examinations. Therefore, the extent of any inaccurate data that may have been provided is not known.
certain interest income is reported, so the IRS is unable to identify the recipients of the income. This prevents the IRS from systemically cross-checking Forms 1042-S with foreign persons’ tax returns before issuing refunds. In addition, the risk of U.S. persons claiming withholding exemptions they are not entitled to still exists. Finally, the Qualified Intermediary Program places the IRS at risk since compliance checks to verify foreign status will be completed by third party auditors and the identities of the actual account holders are not disclosed to the IRS.

Management’s Response: In response to our report, IRS management agreed to take corrective actions for most of the audit recommendations. However, IRS management did not agree to pursue revised regulations for identification numbers on all foreign investment income reporting documents. IRS management responded that this proposal was previously considered by the IRS and Treasury but not pursued because of the adverse effect that requiring an identification number could have on foreign investments in the United States. We have included the IRS’ response and our comments in the main body of this report where appropriate. The full text of management’s response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.
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Background

One of the major strategies of the Internal Revenue Service’s (IRS) Large and Mid-Size Business (LMSB) Division is to build a tax administration to effectively deal with globalization. This strategy includes addressing specific areas of non-compliance, promoting customer satisfaction by understanding issues from the taxpayer’s viewpoint, and enabling development of appropriate new tax legislation.

Generally, a foreign person is subject to United States (U.S) tax on U.S. source income. A foreign person can be a nonresident alien individual, a foreign corporation, a foreign partnership, a foreign trust, a foreign estate, or any other person that is not a U.S. person. Most types of U.S. source income are subject to U.S. tax of 30 percent, unless a lower rate is established by an income tax treaty. U.S. source income reported on the Foreign Person’s U.S. Source Income Subject to Withholding (Form 1042-S) has grown significantly from $79 billion in Tax Year (TY) 1990 to over $124 billion in TY 1998.

Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

The IRS issued new regulations,\(^1\) effective January 1, 2001, related to the withholding of tax and reporting of U.S. source income paid to foreign persons. These regulations represent significant changes in the way withholding taxes are collected and information is reported. Prior withholding regulations required the person (U.S. withholding agent\(^2\)) paying the income to withhold the appropriate tax amount. Under the new regulations, certain foreign intermediaries may assume responsibility for reporting and withholding the tax and for maintaining proper documentation to support reduced rates of withholding.

Generally, withholding agents are legally responsible for proper withholding and reporting. However, under the new regulations, foreign financial institutions that meet the IRS’ requirements can agree to withholding and reporting conditions normally required of U.S. withholding agents.

A 1994 IRS Inspection Service (now the Treasury Inspector General for Tax Administration) report\(^3\) identified areas where the IRS could improve payer and payee compliance with U.S. tax laws and regulations. The report identified significant weaknesses in how the IRS processes and uses Forms 1042-S to ensure compliance.

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\(^{2}\) A withholding agent is any U.S. or Foreign entity (individual, corporation, partnership, etc.) that has control, receipt, disposal, custody, or makes a payment of any income to a foreign person that is subject to withholding.

\(^{3}\) Review of Nonresident Alien Information Documents (Reference Number 041403, dated January 21, 1994).
The IRS identified foreign persons’ compliance as a material weakness for financial reporting purposes in 1994 as required under the Federal Managers’ Financial Integrity Act (FMFIA) of 1982.\(^4\) The material weakness was closed in 1998 because the IRS’ Office of the Assistant Commissioner (International)\(^5\) stated that steps to address this weakness were taken and a compliance problem no longer existed.

We performed this audit at the LMSB Division’s Office of Pre-Filing and Technical Guidance between January and May 2001. The audit was conducted in accordance with Government Auditing Standards. Detailed information on our audit objective, scope, and methodology is presented in Appendix I.

The IRS has taken significant actions in several areas to address conditions identified in the prior report. These actions included:

- Forming a task force to address the concerns identified in the 1994 audit report. The task force issued written results in 1995 outlining corrective actions taken and planned.

- Adding computer processing controls, including data validity and consistency checks,\(^6\) for TY 1994 returns processed by the IRS in 1995 to ensure higher quality information entered the system.

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\(^4\) The Federal Managers’ Financial Integrity Act of 1982, 31 U.S.C. §§ 1105, 1113, and 3512 (1994 & Supp. IV 1998) requires that all federal agencies establish processes for the evaluation and improvement of financial and internal control systems to ensure that management control objectives are met. A material weakness is a significant control deficiency of sufficient importance to be reported annually to the Office of Management and Budget.

\(^5\) Foreign persons’ withholding issues were the responsibility of the Office of the Assistant Commissioner (International) but were transferred to the LMSB Division when it was established in June 2000.

\(^6\) These checks are controls built into a computer system to identify unacceptable data.
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- Ensuring that the Form 1042-S database was provided annually to its International function. This function’s Foreign Payments Division provided assistance in obtaining Form 1042-S information in specific examination situations. The Foreign Payments Division also took steps to educate withholding agents, examiners and tax agents in foreign persons’ withholding issues.

- Developing a regulation to require a Taxpayer Identification Number (TIN) be reported on all returns filed with the IRS. This required that the IRS establish the Individual Taxpayer Identification Number (ITIN) Program to assign an identifying number to foreign individuals who are not eligible for Social Security Numbers (SSN), but do have some U.S. tax-related transactions. Foreign individuals are required to furnish either an SSN or an ITIN on tax returns filed after December 31, 1996.

- Identifying the need for a new processing system with IRS-wide accessibility. The system is currently being developed and will be implemented in phases with the first phase scheduled for completion March 2002. The first phase will address how foreign persons’ withholding documents are posted to the IRS’ Information Returns Master File (IRMF). IRMF contains data from third party sources and is used for compliance purposes. Upon completion in March 2004, the new system will allow the computer matching of payments to foreign persons with related tax returns.

- Revising the foreign withholding tax regulations extensively.

- Redesigning withholding forms including the Certificate of Foreign Status (Form W-8) and revising Publication 515, *Withholding of Tax on Nonresident Alien and Foreign Corporations* to satisfy and explain the new documentation requirements.
Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

- Developing Revenue Procedure 2001-20 that describes the Voluntary Compliance on Alien Withholding Program (VCAP), which allows certain colleges and universities to resolve issues arising from the underreporting of taxes on payments to foreign individuals.

These positive efforts have helped address some of the conditions identified in the prior report. However, the IRS needs to take additional actions to better ensure the compliance of foreign persons.

As previously stated, the IRS added computer processing controls, including data validity and consistency checks, for TY 1994 returns processed in 1995. The IRS also lowered the rate of errors allowed in the computer system when Forms 1042-S were filed magnetically. A lower acceptable error rate increases the quality of information entering the computer system because data with errors above the acceptable rate are not processed until the errors are corrected. When errors are identified, the IRS notifies the filers that the Form 1042-S data submitted need to be corrected and resubmitted.

However, the added computer processing controls did not completely resolve the data quality problems identified in the prior report. The IRS’ Statistics of Income (SOI) function identified problems with the Form 1042-S data after the processing changes took effect, including duplicate records and invalid or incorrect codes. For example, invalid income codes were still accepted by the processing system in effect at the time of our audit. Consequently, the IRS cannot determine the correct withholding rate since different withholding rates apply to different income types (i.e., interest, dividends, etc.).

Effective Processing of Foreign Person’s United States Source Income Subject to Withholding (Form 1042-S) Is Needed to Ensure the Accuracy of Data

The General Accounting Office’s (GAO) *Standards for Internal Control in the Federal Government* require that systems include controls that are designed to help ensure the completeness, accuracy, and validity of all transactions during processing.

There were two primary reasons that additional computer processing controls were not programmed. First, the International function’s requests to modify the existing system or develop a new system were initially denied because of funding shortages and other priority projects. Also, the International function anticipated having to redesign a new processing system because of the changes in the withholding regulations and waited to incorporate additional processing controls in the new system.

As a result, the IRS provides potentially inaccurate Form 1042-S data to its treaty partners under the Routine Exchange of Information Program (REIP). In addition, any Form 1042-S data currently used in examinations may not be reliable because of the existing computer processing control weaknesses. The scope of this audit did not include specific tests to identify inaccurate data provided to the REIP or for examinations. Therefore, the extent of any inaccurate data that may have been provided is not known.

**Recommendation**

1. The Submission Processing function of the Small Business/Self-Employed (SB/SE) Division’s Customer Account Services organization should ensure the accuracy of the foreign persons’ data from the new processing system. If inaccuracies in the data are identified after the new system is implemented, the causes of the inaccuracies should be identified, and system enhancements should be requested to resolve any further processing weaknesses.

**Management’s Response:** The Commissioner, LMSB Division responded that the IRS formed the Chapter Three

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8 The IRS provides Form 1042-S data to foreign tax authorities.
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Withholding (CTW) Working Group which has restructured the entire CTW Processing System. The IRS expects to implement Phase I of the new Chapter Three Withholding programs by April 1, 2002. The Submission Processing function of the SB/SE Division’s Customer Account Services will perform random data verification throughout the implementation, which will include those areas involving data input, program consistency, validity accuracy, and posting progress. In addition, the Submission Processing function submitted a placeholder Request for Information Services to address Phase II processing and to refine those areas identified as not meeting the specifications requested in Phase I. IRS has revised the Internal Revenue Manual to include the new program specifications and processes. The Submission Processing function staff will monitor the implementation of the new processing system.

The prior report recommended that the International function increase efforts to measure, examine, and enforce compliance with Form 1042-S requirements because of the significant income involved. For TYs 1995 through 1999, the recommended additional tax and penalties resulting from examinations of the Annual Withholding Tax Return for U.S. Source Income of Foreign Persons (Forms 1042) have ranged from $45 million to $189 million per year. The prior report also recommended that computer analysis and trending of Form 1042-S data be used to identify large-dollar transactions and unusual trends that may require additional actions to verify the payee income reported. At this time, computer analysis and trending of Form 1042-S data have not occurred on a regular basis and there are no specific plans for this type of analysis until the new system is implemented.

The GAO’s Standards for Internal Control in the Federal Government state that internal control should provide

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9 We obtained these statistics from the IRS’ Examination Program Monitoring Reports.
reasonable assurance that the objectives of an agency are being achieved. These encompass the effectiveness and efficiency of operations, including the use of the entity’s resources, and compliance with applicable laws and regulations.

The International function submitted two requests for the development of a system for compliance purposes. These requests were denied because of funding shortages and other priority projects.

A system with IRS-wide accessibility for examination, collection, and research purposes does not exist. The IRS cannot develop and implement strategies to accomplish business needs and objectives without an effective system to analyze and trend Form 1042-S data. This is significant because foreign persons’ income reported on Forms 1042-S has increased from over $79 billion in TY 1990 to over $124 billion in TY 1998. Yet, despite a statutory tax rate of 30 percent on foreign persons’ income, withholding amounts have decreased from approximately 2.75 percent of TY 1990 income to 1.93 percent of TY 1998 income.

Recommendation

2. The LMSB Division’s Office of the Director, International, which will be responsible for the Foreign Payments Program as of September 2001, should ensure the data from the new processing system provide useful information that will meet the IRS’ business needs and objectives. The information should be distributed to all IRS offices that would require the information to carry out their duties.

Management’s Response: The Commissioner, LMSB Division responded that the LMSB Division’s Strategy, Research and Program Planning function will receive information from the Form 1042 and Form 1042-S databases. That function will be responsible for developing objectives, examination plans, and criteria for audit selection of cases. Information will also be shared with the SB/SE Division’s planning staff and distributed to the
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The Program to Monitor the Compliance of Withholding Agents Could be Strengthened

appropriate IRS offices once the new processing system is implemented. The Foreign Payments Team will work with the Strategy, Research and Program Planning function and the SB/SE Division to ensure Form 1042 and 1042-S databases are used to develop effective return classification programs and examination plans.

The IRS still does not have an effective program to monitor payer compliance. This condition involving withholding agent compliance with laws and regulations was identified in the prior review and has not improved since 1994.

The IRS removed foreign persons’ compliance issues from its list of FMFIA material weaknesses in September 1998 after concluding that a compliance problem no longer existed in this area. Among the steps taken to reach that conclusion, the IRS examined Form 1042 returns filed by 10 of the largest withholding agents. These withholding agents were financial institutions including banks and brokerage houses.

As part of their examinations of the withholding agents, the examiners reviewed the issue of portfolio interest. Portfolio interest is interest earned on qualified investments and is tax exempt if earned by a foreign person. The examiners determined that most portfolio interest had been paid to foreign financial institutions serving as intermediaries for the beneficial account holders. A beneficial account holder is the entity (individual, corporation, etc.) that ultimately receives the interest income.

The examiners noted that foreign financial institutions furnished to the withholding agents Certificates of Foreign Status (Form W-8) in their own names, and not in the names of the beneficial account holders. The Form W-8 is used to identify the beneficial account holder as a non-U.S. person for tax purposes and may qualify the account holder for a withholding exemption for portfolio interest. The examiners also noted that income items such as portfolio interest were not reported on the Forms 1042-S and that the financial institutions did not obtain Forms W-8. The IRS
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Examiners referred to the Office of Chief Counsel the issue of whether the Forms W-8 should be in the names of the foreign financial institutions or in the names of the beneficial account holders. Chief Counsel did not issue formal guidance regarding this issue; however, the withholding regulations were subsequently rewritten.

The Internal Revenue Code\(^\text{10}\) requires a statement that the beneficial account holder is not a United States person. Without such a statement the interest is subject to a 30 percent withholding tax. The statement may be made by the beneficial account holder or by a bank or financial institution on behalf of its customers. The IRS developed Form W-8 to serve as an acceptable statement from a beneficial account holder but did not develop a similar form for financial institutions. The IRS requires portfolio interest to be reported on the Form 1042-S even if the income is exempt from withholding.

After foreign persons’ compliance was removed as a material weakness, there was a decreased emphasis on the portfolio interest issue as the IRS reevaluated the foreign persons’ compliance program including the potential effect of the new withholding regulations. In addition, requests were made for the development of a computer system that would be useful in a compliance program, but the requests were never funded.

Without proper documentation of foreign status, the IRS cannot determine whether the beneficial account holders are foreign persons entitled to the withholding exemption for portfolio interest, or U.S. persons evading taxation. A 1998 IRS internal report\(^\text{11}\) stated that the overall compliance of the financial institutions examined appeared to be good. However, the report stated that if an examining agent were to take an aggressive position in an examination situation in determining that the withholding agent lacked adequate


\(^{11}\) *Financial Institutions Withholding on Payments to Nonresident Aliens*, dated June 1, 1998, prepared by the International function’s Foreign Payments Division and Examination function’s Coordinated Examination Program.
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supporting documentation, the interest and penalties could be substantial. The report also stated, in reference to one financial institution, that:

The potential adjustment related to interest and penalties could amount to 18 percent of the portfolio interest paid. Since it is common for undocumented “portfolio interest” to be in excess of $200,000,000 per year, an interest and penalty adjustment would amount to $36,000,000.

Recommendation

3. The LMSB Division’s Office of the Director, International should increase management attention to the compliance aspects of the Program, particularly improving withholding agent compliance, in addition to the customer service aspects already being provided.

Management’s Response: The Commissioner, LMSB Division disagreed with our conclusion that the IRS still does not have an effective program to monitor payer compliance. The Commissioner, LMSB Division responded that the IRS established the Qualified Intermediary (QI) Team in the LMSB Division’s Financial Services Industry to monitor compliance issues of financial institutions with the Foreign Withholding Tax Regulations. The IRS will staff the QI Team with subject matter experts who will assist revenue agents in their examinations of Forms 1042 filed by Financial Service Industry taxpayers. The QI Team will also review reports filed by auditors of qualified intermediaries. The Foreign Payments Team will work with the QI Team to develop a Compliance Program covering U.S. withholding agents in the Financial Services Industry and qualified intermediaries under the new regulations. The Foreign Payments Team will also assist revenue agents assigned to examine returns filed by taxpayers in other industries.
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Office of Audit Comment: We concur that the LMSB Division has planned actions to address compliance issues in the future. Our conclusion, however, is based on the results of compliance efforts actually taken in recent years, not on the planned actions for the future.

The prior report recommended that the IRS improve enforcement efforts by ensuring that individuals claiming nonresident status are entitled to exemptions under the law. Critical to this effort is the use of a Tax Identification Number (TIN) to identify individual taxpayers and link all their tax-related transactions. As previously stated, the IRS established the ITIN Program to assign an identification number to foreign individuals who are not eligible for an SSN, but do have some U.S. tax-related transaction. Foreign individuals are required to furnish either an SSN or an ITIN on tax returns filed after December 31, 1996.

However, this provision does not eliminate the compliance risks. The IRS still does not have an effective program to monitor and encourage taxpayer compliance. The intent of the ITIN Program was to provide a unique identification number to foreign persons so Forms 1042-S and related tax returns could be computer matched, taxpayer compliance could be monitored, and enforcement actions could be taken if appropriate.

Under the IRS’ new withholding regulations, an identifying number is not required when portfolio interest income is reported. Also, ITINs will not be provided to the IRS under the new regulations’ QI Program. In this Program, approved foreign financial institutions establish an agreement with the IRS to maintain documentation supporting withholding exemptions, but the identities of the beneficial account holders are generally not disclosed to the withholding agent or the IRS.

The GAO’s Standards for Internal Control in the Federal Government state that internal control should provide reasonable assurance that the objectives of an agency are being achieved. These encompass the effectiveness of

Enforcement Efforts Are Needed to Encourage Taxpayer Compliance
operations, and compliance with applicable laws and regulations.

Delays in finalizing the new withholding regulations, in addition to extensive amendments to the regulations, caused delays in building a new computer processing system with matching capability. Information from the computer processing system would allow the IRS to systemically monitor taxpayer compliance and take enforcement actions if necessary.

The IRS is still at risk because the ITIN provision does not allow the IRS to identify the recipients of the income. This prevents the IRS from systemically cross-checking Forms 1042-S with the foreign persons’ tax returns before issuing refunds. In addition, the risk of U.S. persons claiming withholding exemptions they are not entitled to still exists. The QI provision places the IRS at risk because under the new withholding regulations, the QI Program does not generally disclose the names of beneficial account holders to the IRS. Compliance checks to verify foreign status are completed not by the IRS, but by third-party auditors.

**Recommendation**

4. The LMSB Division’s Office of the Director, International should consider pursuing revised regulations that require an identification number (ITIN or SSN) on all foreign investment income reporting documents.

**Management’s Response:** The Commissioner, LMSB Division responded that the IRS had previously proposed legislation to Treasury requiring backup withholding if an identification number was not provided to a withholding agent. Treasury made a policy decision not to seek legislation because of a concern that requiring a TIN would have an unnecessary adverse effect on foreign investment in U.S. marketable securities. The Foreign Payments Team will continue to identify and support efforts to promote improved taxpayer compliance.
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Office of Audit Comment: We have a continuing concern that the IRS needs a system to identify individual foreign investors.
Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the audit was to follow up on the previously identified conditions in a prior Internal Revenue Service (IRS) Inspection Service (now the Treasury Inspector General for Tax Administration) report\(^1\) and determine whether the actions taken have corrected the problems or whether risks still exist. As part of the follow-up, we evaluated the effect of new withholding regulations\(^2\) (effective January 1, 2001) for United States source income paid to foreign persons. The scope did not include test to identify inaccurate data provided to the Routine Exchange of Information Program or for examinations. To accomplish our objective, we:

I. Evaluated the status of corrective actions taken in response to the recommendations made in the prior audit report.
   A. Interviewed IRS personnel to determine the status of corrective actions.
   B. Obtained and reviewed documentation to support the status of the corrective actions for the prior report.

II. Reviewed the new withholding regulations under the Internal Revenue Code (I.R.C.)\(^3\) and determined whether the recommendations and corrective actions from the prior audit report were still applicable.

III. Reviewed procedures for processing foreign persons’ information returns and evaluated how changes in the withholding regulations would affect future processing of foreign persons’ information.
   A. Interviewed IRS personnel responsible for developing the new processing system.

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\(^1\) *Review of Nonresident Alien Information Documents* (Reference Number 041403, dated January 21, 1994).


\(^3\) I.R.C. §§ 1441-1464, 6041-6050N.
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B. Reviewed available system documentation including action plans, requests for computer support, and processing flowcharts.

IV. Evaluated the IRS’ Federal Managers’ Financial Integrity Act of 1982\(^4\) records to determine management’s justification for removing foreign persons’ information documents as a material weakness.

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for Foreign Persons, But Substantial Work Remains

Appendix II

Major Contributors to This Report

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Philip Shropshire, Director
Richard Hayes, Audit Manager
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Appendix III

Report Distribution List

Commissioner  N:C
Deputy Commissioner, Large and Mid-Size Business Division  LM
Director, International  LM:IN
Director, Pre-filing and Technical Guidance  LM:PFT
Director, Customer Account Services, Small Business/Self Employed Division  S:CAS
Deputy Chief Financial Officer, Department of Treasury
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Appendix IV

Management's Response to the Draft Report

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

September 21, 2001

RECEIVED
SEP 24, 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Larry R. Langdon
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report # 2001-30-005, Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

Thank you for the opportunity to review and comment on the subject draft report. We appreciate your comments on the substantial actions we have taken to improve the Withholding Regime for U.S. source payments to foreign persons and to address concerns identified in your 1994 Report, Review of Nonresident Alien Information Documents (Reference Number 041403).

As your draft report recognizes, the IRS has invested substantial resources since 1994 to address the shortcomings of our prior withholding tax system. Numerous IRS functions have worked together with Counsel, Treasury, and external stakeholders around the world to design and implement a new withholding regime. To ensure timely reporting of the necessary information, we now have in place:

- Detailed new withholding tax regulations
- Appropriate penalties for withholding agent noncompliance
- More sophisticated reporting forms

The design and creation of a new system to improve automated processing and IRS-wide access is well underway. Because of these efforts, we will begin receiving and processing information in the near future. These efforts have put into place what we believe will prove to be the most effective withholding tax system adopted by any major developed country, without disrupting the flow of foreign investment into the United States. While further improvements to this new regime may prove advisable over time, we respectfully disagree with those recommendations in your draft report that are based on perceived shortcomings of the prior system or apparent design problems in the new system.

We have carefully considered the findings and recommendations in your draft report and offer the following specific comments.
IDENTITY OF RECOMMENDATION/FINDING #1:

Recommendation:

The Submission Processing function of the Small Business/Self-Employed Division’s Customer Account Services organization should ensure the accuracy of the foreign person’s data from the new processing system. If inaccuracies in the data are identified after the new system is implemented, the causes of the inaccuracies should be identified, and system enhancements should be requested to resolve any further processing weaknesses.

Findings:

Effective Processing of Foreign Person’s United States Source Income Subject to Withholding (Form 1042-S) Is Needed to Ensure the Accuracy of Data

- The IRS added computer processing controls, including data validity and consistency checks, for Tax Year 1995 returns processed in 1996. However, the added computer processing controls did not completely resolve the data quality problems TIGTA identified in the prior report.

- The IRS’ Statistics of Income (SOI) function identified problems with the Form 1042-S data after the 1995 processing changes took effect, including duplicate records and invalid or incorrect codes.

- The IRS did not program additional computer processing controls.

As a result, you have found that the IRS may have provided inaccurate Form 1042-S data to its treaty partners in some cases under the Routine Exchange of Information Program (REIP). In addition, you noted that any Form 1042-S data currently used in examinations may not be reliable because of the existing computer processing control weaknesses.

ASSESSMENT OF CAUSE(S):

We believe the data quality issues identified in the draft report are due to a variety of factors, including limitations of the prior withholding tax regulations and processing programs, as well as the inadequate quality of some of the information reported by withholding agents.

Processing Programs

The domestic format of the processing program, which the Chapter Three Withholding (CTW) Program had to use in the past in the absence of any alternative, did not allow proper representation of all foreign names and addresses. Information Systems (IS)

1 The IRS provides Form 1042-S data to foreign tax authorities.
was unable to accommodate requests for an increase in the space available for the various record layout fields. In addition, programs used to prepare domestic (Form 1099) records for posting to Master File — particularly reformatting, validation, and TIN perfection programs — were not available to the CTW Program.

Data Quality Problems

IS added programming instructions in 1995 to update income, recipient, and exemption codes in use under the regulations then in effect, and to add validity and math error checks. We accomplished programming updates based on the limited funding then available. This required that we modify the existing program developed in the mid-1980s, rather than build a new program. These programming efforts helped us identify numerous errors withholding agents made when submitting records.

It is important to note that withholding agent submissions must accurately reflect the tax actually withheld by the withholding agent. For example, if a withholding agent submits a Form 1042-S that indicates improper zero percent withholding on a dividend payment, and this reflects what the withholding agent actually did, the record is correct even though the withholding agent did not withhold correctly. Apparent errors, therefore, should not always be attributed to an incorrect record submitted by the withholding agent or to the processing system.

The withholding agent must make any corrections to a record it submits. In the past, this procedure required:

- The IRS to document by hand all errors recognized by the processing system
- The withholding agent to submit a completely new file, sometimes consisting of many thousands of records with few changes, which was cumbersome

Until last year, we had no program to track receipt of files returned to the withholding agents for replacement. Thus, we had no way of readily associating the withholding agents with the files that we returned. Therefore, we could not generate notices if replacement files were not returned. Such a program is now in place and will continue to operate under the new processing system.

In many cases, the withholding agent never resubmitted a file returned by the IRS for correction. Under prior regulations, we could not assert administrative penalties for late and/or incorrect filing of magnetic media received under the CTW Program (unlike under the Domestic Program). Thus, withholding agents had no incentive to comply when we requested a replacement file. Even when resubmitted, we often received files too late to process through the system. To post to CTW, we must receive files by August 15. If submitted after that date, we either cannot process the files or must "push" the records through without any validation. In addition, because of budget constraints, we often gave processing priority to domestic programs.
Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

When we requested a replacement file from the withholding agent, we discovered that the agent did not always have the necessary information from the foreign recipient. For instance, although addresses were missing or incomplete, no correction of the record based on available information was possible. Thus, although we were aware that the information submitted in some cases was potentially incomplete or incorrect, we chose to post the available data with potential errors in a few records, rather than no data at all.

When we share the information withholding agents report to us with our treaty partners under REIP, we send a transmittal letter noting that they need to verify this information with the taxpayer. We also offer to work with the treaty partner and the withholding agent to clarify any case in which questions arise about the data.

Form 1042-S Processing

Your report notes that, in analyzing the information withholding agents reported, SOI identified substantial numbers of duplicate records. We have not had an opportunity to review SOI's methodology in detail. However, before concluding that SOI's methodology produces results that are inconsistent with those produced by Submissions Processing, we believe the systems would need to be more closely compared. For example, current Information Technology programming does not allow the creation of duplicate records within the system. We process each record as the withholding agent submits it on a file. It appears that SOI, for purposes of identifying duplicates, targets the Document Locator Number (DLN) assigned to paper documents at the Service Center. However, up through Tax Year 2000, paper Forms 1042-S had two income lines. Thus, we believe that SOI may actually be stripping out accurate information from the second line, assuming incorrectly that it is a duplicate.

CORRECTIVE ACTIONS:

We formed the CTW Working Group in 1997, when we released the original proposed Chapter 3 withholding regulations. This group includes representatives from SB/SE’s Submissions Processing function, Information Technology Services, LMSB’s International function, including the Foreign Payments Team, Chief Counsel, and the Martinsburg Computing Center. We have identified representatives from other functions who have participated as necessary.

The working group has restructured the entire CTW Processing System. The group redesigned record layouts to improve capturing of accurate name and address information, and expanded country code and treaty rate tables. Counsel developed additional and more specific income, recipient, and exemption codes. We also built complex consistency, validity, and math error matrices.

New regulations have closed the loophole regarding timely and accurate filing on magnetic media to allow us, in future processing years, to assert penalties where appropriate. An enhanced tracking system for timely receipt of replacement files will
significant efforts have been made to improve information reporting for foreign persons, but substantial work remains.

ensure return of corrected records in sufficient time to meet cycle requirements and allow posting of accurate data.

records still must reflect actions taken (or not taken) by the withholding agent. however, we will process incoming files into a relational database that will allow us to correct records on-line based on oral or written testimony from withholding agents. we will also post perfected records to the pmf, bmf, and irmf as appropriate. these records will also continue to reside on a tier ii oracle-based system to allow expanded research capability and the creation of complex queries. the relational database will greatly enhance our ability to assess compliance both on the part of withholding agents and the taxpayers.

newly trained tax examiners will accomplish all data analysis and correction in the future. we will also have enhanced ability to match 1042-s data with 1042 data.

improved documentation and enhanced compliance efforts will result in more accurate reporting of information on form 1042-s, as well as more accurate receipt of the proper amount of tax withheld at source. the withholding agent will be held responsible for collecting this data in such a way that collection of the proper amount of tax at source can be independently verified.

the new processing system is undergoing testing. we expect to implement it in time to allow withholding agents to test their own program modifications against it in december 2001 and january 2002. we expect to start processing of data prepared under the new regulations, which became effective january 1, 2001, in processing year 2002.

implementation date:

proposed: april 1, 2002

responsible officials:

commissioner, small business/self employed division (sb/se)
director, international

corrective action(s) monitoring plan:

we expect to implement the new ctv phase i programs by april 1, 2002. the submission processing function of the sb/se division's customer account services (s:cas:b:p) will perform random data verification throughout the implementation, which will include those areas involving data input, program consistency, validity accuracy, and posting progress. they will give particular attention to the program specifications surrounding the consistency, validity, and math error checks. in addition, they have submitted a placeholder request for information services (ris) to address phase ii
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processing and to refine those areas identified as not meeting the specifications requested in RIS #TSF-1-0002A01.

We have revised the Internal Revenue Manual to include the new program specifications and processes. The Submission Processing staff will monitor the implementation of the new Processing System. They will take corrective actions to resolve any problems encountered and inform all impacted areas via Submissions Processing Hot Topics, SERP, CTW Website, etc.

IDENTITY OF RECOMMENDATION/FINDING #2:

Recommendation:

The LMSB Division's Office of the Director, International, which will be responsible for the Foreign Payments Program as of September 2001, should ensure the data from the new processing system provides useful information that will meet the IRS' business needs and objectives. The information should be distributed to all IRS offices that would require the information to carry out their duties.

Finding:

Foreign Persons Data Could Be Better Used in Compliance Efforts

- Computer analysis and trending of Form 1042-S data have not occurred on a regular basis and there are no specific plans for this type of analysis until the new system is implemented.

- A system with IRS-wide accessibility for examination, collection, and research purposes does not exist.

ASSESSMENT OF CAUSE(S):

Your 1994 audit report recommended that the International function increase efforts to measure, examine, and enforce compliance with Form 1042-S requirements because of the significant income involved. Unfortunately, we had to delay our plans for developing an improved system to address data quality issues with processing of Forms 1042 and 1042-S due to funding shortages and other priority projects such as the Y2K conversion. In the interim, we directed our efforts to identifying an alternative means of measuring levels of compliance with the regulations by withholding agents and foreign persons receiving U.S. source income.

We obtained access to Forms 1042 and 1042-S databases for examination and research purposes. We reviewed information from the Form 1042 database in 1996, and selected the Form 1042 tax returns of ten large financial institutions for examination. These institutions are, by far, the largest payers of U.S. source income to foreign persons. The results of the examinations did not indicate significant noncompliance with the withholding tax regulations by taxpayers in this market.
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We also conducted compliance checks to determine if entities claiming to receive income effectively connected with a U.S. trade or business were filing tax returns. We found that each of the entities examined filed the returns.

Although we have not been able to distribute information on the Form 1042 and 1042-S databases on a regular basis, we have made examiners throughout the IRS aware of the databases at Continuing Professional Education and other training sessions. Where possible, we have provided examiners with information from the databases relating to their assigned cases. The District Office Research and Analysis Division of the International District also used the databases as part of a study of Form 1042-S and Form 1040NR filing patterns. We believe the extraction of information from the Form 1042 database for research purposes has resulted in an increase in examination assessments.

CORRECTIVE ACTIONS:

We will ensure that LMSB’s Strategy, Research & Program Planning function receives information from the Forms 1042 and Form 1042-S databases. That function will be responsible for developing objectives, examination plans, and criteria for audit selection of LMSB cases. We will also ensure that we share information with the SB/SE Division’s planning staff and distribute it to the appropriate IRS offices once we implement the new Processing System.

IMPLEMENTATION DATE:

PROPOSED: June 1, 2002

RESPONSIBLE OFFICIAL:

Director, International
Director, Strategy, Research & Program Planning

CORRECTIVE ACTION(S) MONITORING PLAN:

The Foreign Payments Team will work with the Strategy, Research & Planning function and SB/SE’s Area 15 planning staff to ensure they use Form 1042 and 1042-S databases to develop effective return classification programs and examination plans.

IDENTITY OF RECOMMENDATION/FINDING #3:

Recommendation:

The LMSB Division’s Office of the Director, International should increase management attention to the compliance aspects of the Program, particularly improving withholding agent compliance, in addition to the customer service aspects they are already providing.
Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

Findings:

The Program to Monitor the Compliance of Withholding Agents Could be Strengthened

- The IRS still does not have an effective program to monitor payer compliance.
- There was a decreased emphasis on the portfolio interest issue.

ASSESSMENT OF CAUSE(S):

Monitoring of Payer Compliance

We disagree with this finding. Although we continue to add improvements, we believe we now have an effective program to monitor payer compliance. Shortly after TIGTA issued the 1994 audit report, we formed a task force to address the concerns identified in the report and other issues that had been raised relating to withholding on payments to foreign persons. The task force recommended the establishment of an office to develop and implement IRS-wide compliance programs for withholding on payments to foreign entities. In October 1994, we established the Foreign Payments Division (now the Foreign Payments Team).

Since then, issue specialists on the Foreign Payments Team have regularly conducted training classes for IRS examiners and participated in taxpayer-sponsored seminars on withholding tax issues. Using a market segment approach, the Team developed training material and examination plans tailored to payers with similar withholding issues. For instance, in 1995 we determined that colleges and universities making payments of U.S. source income to foreign students and scholars were a significant source of noncompliance with the withholding tax regulations. The Foreign Payments Division conducted training classes for over 250 international examiners, employment tax agents, and Employee Plans and Exempt Organizations' examiners covering withholding tax issues. The examiners then addressed these issues in their examinations of over 130 colleges and universities. Issue specialists also provided similar training and on-site assistance to examiners of financial institutions, casinos, and the Shipping and Air Transportation industries. Withholding on compensation paid to nonresident alien crewmembers is the subject of a coordinated issue paper in the Shipping and Air Transportation industries.

Portfolio Interest Compliance

We disagree with this finding. We have not decreased our emphasis on portfolio interest compliance. Our efforts to ensure the accuracy of portfolio interest exemption claims were only delayed temporarily while the new withholding tax regulations were refined and in effect. Notice 98-16 extended the proposed effective date of the withholding regulations from January 1, 1999 to January 1, 2000. Notice 99-25 further extended the effective date to January 1, 2001. In Notice 98-16, the IRS stated that it would regard the 1999 calendar year as a transition period in enforcing compliance for the administration of the Withholding Tax System. Notice 99-25 added the 2000
Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

calendar year as a transition period. Notice 99-25 stated, however, that, “In enforcing compliance with the current withholding rules for calendar 1999 and 2000, the IRS will take into account the extent to which a withholding agent makes a good faith effort to transform its business practices and information systems to comply with the final regulations.”

Accordingly, when the examination teams examine the returns for tax years 1999 and 2000, they will take into account the efforts the withholding agents have taken to encourage their foreign account holders that are intermediaries to become qualified intermediaries. We believe that U.S. withholding agents have strongly encouraged members of the foreign intermediary community to become qualified intermediaries. To date, over 2,700 foreign financial institutions have applied for qualified intermediary status.

We believe the draft report’s finding may be based on the assumption that a comparable increase in tax withheld should accompany an increase in U.S. source income paid to foreign persons. However, we believe that most of the increased income paid to foreign persons constitutes interest, which generally is exempt from U.S. withholding tax, either under the portfolio interest provisions of the Internal Revenue Code or by treaty. According to SOI statistics, $95 billion of the $124 billion of income paid to foreign persons in 1998 was interest income.

CORRECTIVE ACTIONS:

Since the largest payers of U.S. source income are financial institutions served by LMSB’s Financial Services Industry, we established the Qualified Intermediary (QI) Team in this industry in August 2001 to monitor compliance issues with the Foreign Withholding Tax regulations as they apply to this industry segment. We will staff the QI Team with subject matter experts who will assist revenue agents in their examinations of Forms 1042 filed by Financial Services Industry taxpayers. The Office will also review reports filed by auditors of qualified intermediaries.

The Foreign Payments Team will work closely with the QI Team to develop a Compliance Program covering U.S. withholding agents in the Financial Services Industry and qualified intermediaries under the new regulations. The Foreign Payments Team will also assist revenue agents assigned to examine returns filed by taxpayers in other industries.

IMPLEMENTATION DATE:

PROPOSED: June 1, 2002

RESPONSIBLE OFFICIAL:

Director, International
Director, Financial Services Industry
CORRECTIVE ACTION(S) MONITORING PLAN:

The Foreign Payments Team will work with the Financial Services Industry personnel to ensure that examiners have clear guidance on how to apply the new withholding regulations, and how to approach issues that might arise during examinations of the 1999 and 2000 transition years.

IDENTITY OF RECOMMENDATION/FINDING #4:

Recommendation:

The LMSB Division's Office of the Director, International should consider pursuing revised regulations that require an identification number (ITIN or SSN) on all foreign investment income reporting documents.

Findings:

Enforcement Efforts Are Needed to Encourage Taxpayer Compliance

- The IRS still does not have an effective program to monitor and encourage taxpayer compliance.
- Under the IRS' new withholding regulations, an identifying number is not required when portfolio interest income is reported. Also, identities of account holders and ITINs will not be provided to the IRS under the new regulations' Qualified Intermediary Program.
- The IRS is still at risk because the ITIN provision does not allow the IRS to identify the recipients of the income. This prevents the IRS from systemically cross-checking Forms 1042-S with the foreign person's tax returns before issuing refunds.
- The risk of U.S. persons claiming withholding exemptions they are not entitled to still exists.

ASSESSMENT OF CAUSE(S):

Compliance Program

Although there is room for additional improvements, we do not agree with the suggestion that the IRS lacks an effective program to monitor and encourage taxpayer compliance.

Since we established the Foreign Payments Team in 1994, members of the staff have developed and assisted with a number of projects directed at monitoring compliance by foreign recipients of U.S. source income. As mentioned under the Assessment Cause Section for Recommendation #2, the examination plan for monitoring compliance by financial institutions contained a check of return filing by account holders claiming
Significant Efforts Have Been Made to Improve Information Reporting for Foreign Persons, But Substantial Work Remains

exemptions for effectively connected income. The Foreign Payments Team also worked with the Air Transportation Industry Specialist on a project dealing with filing by the foreign crewmembers of a large airline company. This is a coordinated issue in that industry as well as in the Shipping Industry. In addition, each year IRS examiners have participated in seminars sponsored by colleges and universities to instruct foreign students and scholars on their filing responsibilities.

TIN Requirement

We carefully considered imposing a TIN requirement for all types of income, but ultimately rejected it. In 1993, IRS Legislative Affairs considered a proposal that would have required backup withholding, whenever applicable, if a TIN was not provided to a withholding agent. At that time, the proposal was well received by the IRS and Treasury. However, the proposal generated substantial concern among foreign investors, who typically are not required to provide such information even to their own tax administrations. In view of the level of concern, policymakers subsequently made a decision not to seek such legislation because of a concern that requiring a TIN would have an unnecessary adverse effect on foreign investment in U.S. marketable securities. Consistent with this policy decision, the final withholding regulations that became effective on January 1, 2001, require a TIN on Form 1042-S if the withholding agent reported a reduced rate of withholding for tax treaty benefits, an exemption for effectively connected income, or exemptions for certain types of annuities. They do not require a TIN, however, when the withholding agent is reporting income from marketable securities.

QI Regime Design

The report also indicates concerns regarding aspects of the QI regime contained in the new withholding tax regulations. In particular, the report expresses concern that the identities of beneficial owner account holders will not be disclosed to the IRS, and that third-party auditors will conduct compliance checks. We believe these elements of the QI Design will prove more effective in promoting compliance than alternative approaches.

In developing the new withholding tax regulations, the IRS and Treasury considered the fact that many foreign jurisdictions prohibit financial institutions from disclosing the identity of account holders or account information. They also had to address limitations on the ability of the IRS to enforce U.S. withholding tax regulations outside the United States, given that some major jurisdictions prohibit on-site audits by tax authorities of other countries.

These considerations led to the development of the QI regime. The IRS and Treasury have worked closely with the U.S. and foreign financial communities in developing the

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2 Since this recommendation of the report addresses only payments to individuals, our response is also limited to that category of foreign persons.
QI system. The goal was to maintain the high level of foreign investment in U.S. securities, while preserving the improved compliance goals of the new withholding tax regulations. QIs are non-U.S. financial institutions that invest in U.S. securities on behalf of their account holders. The new regulations create strong incentives for QIs to enter contractual agreements with the IRS. Under these agreements, QIs are permitted to maintain the confidentiality of customers' identities and claim withholding tax relief on their behalf, in exchange for reporting information the IRS needs to enforce the new withholding regulations. While QIs generally may report payment and withholding information to the IRS on an aggregate or pooled basis, to protect the privacy of account holders, they must report any income paid to U.S. individual account holders on an individual basis, or withhold and pay U.S. tax on such amounts at the full backup withholding rate.

QIs also must agree to regular audits, to ensure their compliance with the documentation and reporting requirements of the regulations. The QI regime addresses our inability to conduct such audits in many major jurisdictions by permitting external auditors to conduct the audits. In addition to providing an audit where we would be barred from conducting one directly, this arrangement will provide much higher rate of audit coverage than our resources would permit. However, we must approve a QI's external auditor, and the auditor must be subject to laws, regulations, or rules that impose sanctions for failure to exercise its independence and to competently perform the audit. In most cases, a large accounting firm, with broader worldwide reputation concerns at stake, will perform the external audit. We believe the external auditor arrangements will, therefore, improve rather than weaken compliance, compared to what we alone would be able to accomplish.

Cross-Checking of Returns

We do not agree with the finding that the IRS is at risk because the ITIN provisions prevent cross-checking Forms 1042-S with a foreign person's tax return before issuing refunds. Since 1997, we have not processed tax returns, including returns claiming a refund, without a TIN. A taxpayer claiming a refund of over-withheld tax is required to attach copies of Form 1042-S to the return.

We would add, however, that it generally would not be possible to match Form 1042-S data against returns filed by taxpayers in non-refund cases. This is because most foreign persons who receive amounts reported on Forms 1042-S have no U.S. tax return filing obligation, since their tax is collected through withholding.

U.S. Person Claims

We do not agree that the QI regime has increased the risk of U.S. individuals claiming withholding exemptions to which they are not entitled. Our view is that the QI regime has significantly reduced this risk. As noted above, QIs must report income information for U.S. individual account holders to the IRS or withhold at the backup withholding rate.
This will give the IRS access to information it previously did not have and, in many cases, could not obtain through other means.

CORRECTIVE ACTION:

The Foreign Payments Team will continue to identify and support efforts to promote improved taxpayer compliance.

IMPLEMENTATION DATE: Not applicable.

RESPONSIBLE OFFICIAL:

Director, International

CORRECTIVE ACTION(S) MONITORING PLAN: Not applicable

We enjoyed working with your staff during the course of the audit. Our closing meeting, which gave us an opportunity to share our concerns about the discussion draft report, was very productive. We appreciate the constructive comments the audit report provided. If you have any questions, please contact Carol Dunahoo, Director, International, at (202) 874-1900.