Erroneous Refunds May Be Issued Without a Program to \[\text{[Redacted]}\]

July 2002

Reference Number: 2002-30-114
July 2, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: (for) Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Report - Erroneous Refunds May Be Issued Without a Program to [REDACTED] (Audit # 200130024)

This report presents the results of our review of the Internal Revenue Service's (IRS) issuance of refunds to [REDACTED]. The objective of this review was to determine the overall effect of [REDACTED] with the IRS' records of [REDACTED]. The Internal Revenue Code (I.R.C.) § 1446 requires partnerships to withhold taxes on "effectively connected income" allocable to foreign partners. Effectively connected income is taxable income connected with the conduct of a trade or business in the United States (U.S.). Tax is withheld on each foreign partner's distributive share of the effectively connected income.

This audit was a follow-up to a report issued by the Treasury Inspector General for Tax Administration titled, Stronger Actions Are Needed to Ensure Partnerships Withhold and Pay Millions of Dollars in Taxes on Certain Income of Foreign Partners. The report recommended that the IRS [REDACTED]

2 The provision applies to allocable income, regardless of whether distributions were made during the partnership's tax year.
In summary, Individual foreign partners file U.S. Nonresident Alien Income Tax Returns (Form 1040NR). For Tax Year 1999, there were 6,438 Forms 1040NR.

For an additional 2,299 returns,

We reviewed 100 of these returns and in 34 cases These represent potential compliance problems that need to be resolved. In 38 of the remaining 66 cases, the partnership incorrectly identified the taxpayer on the withholding form.

Management's Response: Management's response was due on June 27, 2002. As of July 1, 2002, management had not responded to the draft report.

The Treasury Inspector General for Tax Administration has designated this report as Limited Official Use (LOU) pursuant to Treasury Directive TD P-71-10, Chapter III, Section 2, “Limited Official Use Information and Other Legends” of the Department of Treasury Security Manual. Because this document has been designated LOU, it may only be made available to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Unit within the Treasury Inspector General for Tax Administration's Office of Chief Counsel.

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.

Attachment
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Background

The Tax Reform Act (TRA) of 1986\(^1\) added § 1446 to the Internal Revenue Code (I.R.C.).\(^2\) This law requires partnerships to withhold taxes on "effectively connected income" allocable\(^3\) to foreign partners. Effectively connected income is taxable income connected with the conduct of a trade or business in the United States (U.S.). Tax is withheld on each foreign partner's distributive share of the effectively connected income.

One of the Internal Revenue Service's (IRS) major strategies is to deal effectively with the global economy. Additionally, the IRS includes revenue protection through minimizing tax-filing fraud as one of its management challenges. These are both important issues when considering the number of U.S. partnerships with foreign partners increased from about 22,000 in 1995 to over 30,000 in 1999 (more than 36 percent).

In June 2001, the Treasury Inspector General for Tax Administration issued a report titled, *Stronger Actions Are Needed to Ensure Partnerships Withhold and Pay Millions of Dollars in Taxes on Certain Income of Foreign Partners.*\(^4\) The report included a recommendation to...

In responding to that report, the IRS requested additional time to assess, given its limited resources, whether a systemic program...

We performed the audit between March and December 2001, using data obtained from the Small Business/Self-Employed (SB/SE) Division's Compliance and Customer Account Services functions' computer files. The audit was

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\(^3\) The provision applies to allocable income, regardless of whether distributions were made during the partnership's tax year.

conducted in accordance with Government Auditing Standards. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS has records of withholding documents filed by partnerships6. Partnerships that withhold taxes from their foreign partners report the withholding on the Foreign Partner’s Information Statement of Section 1446 Withholding Tax (Form 8805). Certain publicly traded partnerships7 report withholding on distributions to foreign partners on the Foreign Person’s U.S. Source Income Subject to Withholding (Form 1042-S), although they may optionally withhold and file using the Form 8805. Individual foreign partners show the withholding as payments on their U.S. Nonresident Alien Income Tax Returns (Form 1040NR), and must attach copies of Forms 8805 and Forms 1042-S to the returns.

For Tax Year 1999, there were 85,690 Forms 1040NR

During a meeting to discuss our draft report, IRS management asked us to review a sample of the cases to determine the reasons for the apparent mismatch condition. We randomly selected a judgmental sample of 100 of the

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6 A publicly traded partnership is any partnership whose interests are regularly traded on an established securities market.
8,737 returns. We reviewed them in coordination with an analyst from the IRS’ Partnership, Trust, and International Section of the SB/SE Division’s Customer Account Services function, but the remainder had either Forms 8805 or Forms 1042-S attached.

In 34 of the 100 cases, These represent potential compliance problems that need to be resolved.

In the remaining 66 cases, there were several reasons for the discrepancies in the data match. A majority of those – 38 cases (58 percent) – were due to Taxpayer Identification Number (TIN) problems, in which the partnership incorrectly identified the taxpayer on the Form 8805. Transcription errors (8 cases) and showing the incorrect year on the withholding form (5 cases) were the next most identified mismatch reasons. Appendix IV provides a complete listing of the causes.

The Office of Management and Budget’s Circular A-123, Management Accountability and Control, requires that management controls provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use, and misappropriation. The General Accounting Office’s Standards for Internal Control in the Federal Government state that internal controls should provide reasonable assurance regarding prevention of or prompt detection of unauthorized acquisition, use, or disposition of an agency’s assets.

In responding to the prior report, the IRS requested additional time to assess, given its limited resources, whether a systemic program Without such a program, the IRS risks issuing refunds that may not be substantiated.
Recommendations

The Chief, Partnership, Trust, and International Section of the SB/SE Division's Customer Account Services function, partnering with the SB/SE Division's Compliance function, should:

1. Contact the partnerships or the taxpayers for the 34 unresolved cases and determine whether compliance actions are needed.

2. If a compliance gap is identified, develop a system that

3. Use our methodology as an interim measure to

4. For Forms 1040NR

5. Develop educational materials to help ensure partnerships file all required withholding documents and include the correct TINs for the individual taxpayers.

Management's Response: Management's response was due on June 27, 2002. As of July 1, 2002, management had not responded to the draft report.
Detailed Objective, Scope, and Methodology

Our objective was to determine the overall effect of [Redacted] with the Internal Revenue Service's (IRS) records of [Redacted].

Specifically, we performed the following audit work:

A. Obtained an extract from the Mid-West Automated Compliance System (MACS)\(^1\) of [Redacted].

B. Obtained data for TY 1999 from [Redacted].

C. Validated the data obtained by selecting a judgmental sample of 293 records from our [Redacted] and then comparing the records to the IRS' Master File. The sample was chosen by randomly selecting records on pages printed from the above comparisons. There were 6,438 Forms 1040NR [Redacted] and 2,299 Forms 1040NR [Redacted] on the Forms 1040NR [Redacted].

D. Compared the data from [Redacted] to determine whether [Redacted].

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\(^1\) The MACS is a computer system that contains a combination of the transcribed return transaction files and selected entity information from the Master File. The Master File is the IRS' main computer system that stores various types of taxpayer account information. It includes individual, business, and employee plans and exempt organizations data.

\(^2\) We limited our testing to Form 1040NR because that return has a specific line for I.R.C. $ 1446 withholding.
E. 

F. Reviewed a randomly selected judgmental sample of 100 cases for which to determine the causes for the mismatches. The sample was selected using the same methodology described in step C above. To determine the causes we reviewed the original returns and attachments, and researched the and the IRS' Master File, as needed.
Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Philip Shropshire, Director
Richard Hayes, Audit Manager
Pillai Sittampalam, Senior Auditor
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Report Distribution List

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Deputy Chief Financial Officer, Department of the Treasury
Audit Liaison: Commissioner, Small Business/Self-Employed Division  S
### Determination of Data Mismatch Causes From Review of 100 Cases

<table>
<thead>
<tr>
<th>Explanation</th>
<th>No. Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cases where taxpayer’s claim was traceable to partnership withholding documents</strong></td>
<td></td>
</tr>
<tr>
<td>Taxpayer Identification Number (TIN) problems:</td>
<td></td>
</tr>
<tr>
<td>TIN shown as name, not number, on database</td>
<td>20</td>
</tr>
<tr>
<td>Found on database under different TIN</td>
<td>18</td>
</tr>
<tr>
<td>Internal Revenue Service (IRS) data transcription (input) error</td>
<td>8</td>
</tr>
<tr>
<td>Resolved per partnership’s transmittal document data</td>
<td></td>
</tr>
<tr>
<td>Different year shown on Forms 8805</td>
<td>6</td>
</tr>
<tr>
<td>Taxpayer error</td>
<td>5</td>
</tr>
<tr>
<td>IRS adjusted credit</td>
<td>3</td>
</tr>
<tr>
<td>Partnership error - deposit slips used, not individual Forms 8805</td>
<td></td>
</tr>
<tr>
<td>Found on previous database under correct TIN</td>
<td></td>
</tr>
<tr>
<td><strong>Cases where taxpayer’s claim was not traceable to partnership withholding documents</strong></td>
<td></td>
</tr>
<tr>
<td>Employee Identification Number on taxpayer’s Form 8805 found on transmittal database table</td>
<td>30</td>
</tr>
<tr>
<td>Cannot determine</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100</td>
</tr>
</tbody>
</table>

1. Partnerships file the Annual Return for Partnership Withholding Tax (Section 1446) (Form 8804) to report total liability and as a transmittal for the Form 8805 for each foreign partner.