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TAX COMPLIANCE

Challenges in Ensuring Offshore Tax Compliance

Statement of Michael Brostek
Director
Strategic Issues

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Highlights

Highlights of GAO-07-823T, a testimony before the Committee on Finance, U.S. Senate

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TAX COMPLIANCE

Challenges in Ensuring Offshore Tax Compliance

Why GAO Did This Study

Offshore tax evasion is difficult for the Internal Revenue Service (IRS) to address. IRS examines tax returns to deal with offshore evasion that has occurred. IRS's Qualified Intermediary (QI) program seeks to foster improved tax withholding and reporting.

GAO was asked to testify on two topics. First, GAO was asked to provide information on (1) the length of, and assessments from, IRS's examination of tax returns with offshore activity and (2) the impact of the 3-year statute of limitations on offshore cases. Second, for the QI program, GAO was asked to address (1) program features intended to improve withholding and reporting, and (2) whether weaknesses exist in the U.S. withholding system for U.S. source income and QI external reviews and IRS's use of program data. GAO relied on prior work for the first topic. For the QI program, GAO used the latest data that were available and corroborated by IRS.

What GAO Recommends

A report GAO released today suggests that Congress make an exception to the 3-year civil statute of limitations period for taxpayers involved in offshore financial activity. GAO will consider recommendations for the QI program in a forthcoming report.

www.gao.gov/cgi-bin/getrpt?GAO-07-823T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Examinations involving offshore tax evasion take much more time to develop and complete than other examinations—a median of 500 more days for cases from fiscal years 2002 to 2005, but their resulting median assessment is almost three times larger than for all other examinations. Nevertheless, because they take more staff time, offshore examinations yielded tax assessments per hour of staff time that were about one-half of that for all other examinations. Because of the 3-year statute of limitations, the time needed to complete an offshore examination means that IRS sometimes prematurely ends offshore examinations or decides not to open an examination, despite evidence of likely noncompliance. Congress has granted a statute change or exception when enforcement challenges similar to those found in offshore cases have arisen in the past.

QIs are foreign financial institutions that contract with IRS to withhold and report U.S. source income paid offshore to foreign customers. The QI program provides IRS some assurance that QIs are properly withholding and reporting tax on U.S. source income paid offshore. QIs (1) are more likely to have a direct working relationship with customers who claim reduced tax rates under tax treaties, (2) accept responsibilities for ensuring customers are in fact eligible for treaty benefits, and (3) agree to have independent parties review a sample of accounts and report to IRS.

However, a low percentage of U.S. source income flows through QIs. For tax year 2003, about 12.5 percent of U.S. source income flowed through QIs. About 87.5 percent flowed through U.S. withholding agents, which provide somewhat less assurance of proper withholding and reporting than do QIs. In addition, U.S. persons may be able to evade taxes by masquerading as foreign corporations.

The contractually required independent reviews of QIs' accounts do not require auditors to follow up on indications of illegal acts, as would reviews under U.S. *Government Auditing Standards*. While IRS obtains considerable data from withholding agents, it does not make effective use of the data to ensure proper withholding and reporting has been done.

U.S. Source Income Flowing through QIs and to Foreign Corporations, 2003

Dollars in billions

Total U.S. source income	Amount and percentage flowing through QIs: Amount	Amount and percentage flowing through QIs: Percentage	Amount and percentage flowing to foreign corporations: Amount	Amount and percentage flowing to foreign corporations: Percentage
$293.3	$36.6	12.5	$200.5	68.4

Source: GAO analysis of IRS data.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss two topics related to offshore tax evasion: the impact of the 3-year civil statute of limitations on Internal Revenue Service (IRS) offshore enforcement efforts, and the Qualified Intermediary (QI) program. IRS's success in identifying and pursuing all tax evasion is of critical importance. When some taxpayers do not pay their fair share of taxes, honest taxpayers are left with higher tax bills and may find reason to doubt their own willingness to stay compliant. Offshore tax evasion is especially difficult to identify because of the layers of obfuscation that can come with doing business in overseas locations beyond the effective reach of the U.S. government. Doing business outside of the country is, of course, perfectly legal, but hiding income or assets in offshore locations in order to evade taxes is not. Generally, to address offshore tax evasion, IRS examines tax returns with offshore activity to deal with noncompliance once it has occurred. IRS has also initiated the QI program to improve upon the prior system of withholding and reporting of U.S. source income that flows offshore. QIs are foreign financial institutions, such as banks, trusts, and partnerships, that contract with IRS to withhold and report U.S. source income paid offshore to individuals who are not U.S. persons and do not live in the United States (nonresident aliens).

My remarks regarding IRS's offshore compliance activity will focus on (1) IRS's examination of tax returns with offshore activity and how those examinations differ from nonoffshore examinations in their length and in the assessments they ultimately yield and (2) the implications of the 3-year statute of limitations on offshore examinations. Regarding the QI program, I will address (1) features of the QI program intended to improve withholding and reporting, (2) whether weaknesses exist in the U.S. withholding system that complicate identifying beneficial owners[1] of U.S. source income, and (3) whether weaknesses exist in QI external reviews and IRS's use of program data. My statement today is drawn, in part, from our report on offshore tax evasion being publicly released today.[2] The portion of this statement addressing the QI program is based on the

[1] The beneficial owner is the true owner of the income, corporation, partnership, trust or asset, who receives or has the right to receive the proceeds or advantages of ownership. For the rest of this statement, we will use the term "owner."

[2] GAO, *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion Examinations*, GAO-07-237 (Washington, D.C.: Mar. 30, 2007).

preliminary results of new work. We describe the methodology for our QI program review later in this statement. The offshore report and our QI program review were prepared in accordance with generally accepted government auditing standards.

Let me begin by highlighting two major points about IRS's examination of returns with offshore activity:

- IRS examinations involving offshore tax evasion take longer than other examinations but also yield higher assessments. In conducting offshore examinations, IRS faces inherent difficulty in identifying and obtaining information from foreign sources, often dilatory and uncooperative tactics on the part of taxpayers and their representatives, and technical complexity. Our analysis of IRS examination data from fiscal years 2002 through 2005 showed that offshore cases—measured from when the return was filed to when the examination closed—took a median of about 500 more calendar days overall to close than nonoffshore cases and required nearly four times as many staff hours to examine, on average. These examinations had a median assessment that was nearly three times larger than all nonoffshore examinations but given the greater staff time taken per case, yielded about one half as much in tax assessments per hour of examination time.
- Offshore examinations are subject to the same 3-year statute of limitations on assessments as other types of cases. IRS officials told us that the need to complete an examination and make an assessment no later than 3 years after the return was filed sometimes means that IRS closes an examination before some work is complete and sometimes chooses not to open an examination at all, despite evidence of likely noncompliance. Changes to the statute in the past provide precedent for a longer statute for offshore cases, but any change would likely have both advantages and disadvantages. In a separate report being released today, we suggest that Congress lengthen the statute of limitations for cases involving offshore activity.

I would also like to make three major points about the QI program:

- The QI program contains features that give IRS some assurance that QIs are more likely to properly withhold and report tax on U.S. source income paid offshore than other withholding agents. First, because QIs are in overseas locations, they are more likely to have a direct working relationship with nonresident aliens or other persons who may claim exemptions or treaty benefits. Second, QIs accept enhanced responsibilities for ensuring customers are in fact eligible for treaty benefits and exemptions. Third, and importantly, QIs agree to contract with independent third parties to review the information contained in a sample of accounts, determine whether the appropriate amount of tax was withheld, and submit a report of the information to IRS.

- Although QIs provide enhanced assurance that treaty benefits are properly provided, the vast majority of U.S. source funds do not flow through QIs, and some U.S. taxpayers may inappropriately receive treaty benefits and exemptions as owners of foreign corporations. For tax year 2003, about 88 percent of U.S. source income flowed through U.S. withholding agents, which provide somewhat less assurance of proper withholding and reporting than do QIs.[3] In addition, under current U.S. tax law and regulations, corporations are taxpayers and the owners of their assets and income, regardless of the residency of the underlying corporate owners. By establishing an offshore corporation, a U.S. person(s) may escape identification and required reporting. In 2003, at least 68 percent of U.S. source income was received by foreign corporations. Since the identity of corporate owners is not reported to IRS, U.S. persons may be able to evade taxes.
- QI external reviews give IRS greater assurance that QIs perform their responsibilities properly, but these reviews do not require auditors to follow up on indications of fraud or illegal acts; and IRS does not make effective use of withholding data. Under U.S. *Government Auditing Standards*,[4] auditors performing external reviews like those done for the QIs must follow up on indications of fraud or illegal acts that could affect the matters they are reviewing. Further, data that IRS needs to effectively administer the QI program and ensure that withholding agents perform their duties properly are not readily available and in some instances no longer exist.

Additional Time Needed to Complete Offshore Tax Evasion Examinations

Examinations involving offshore tax evasion take much more time to develop and complete than examinations of other types of returns, but when offshore examinations are completed, the resulting median assessment is almost three times larger than for all other types of examinations. However, because of the 3-year statute, the additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open an examination at all, despite evidence of likely noncompliance.

[3] A withholding agent is responsible for withholding tax on payments of U.S. source income and depositing such tax into the U.S. Treasury.

[4] GAO, *Government Auditing Standards, January 2007 Revision*, GAO-07-162G (Washington, D.C.: January 2007).

Some offshore examinations exhibit enforcement problems, such as technical complexity, which are similar to those where Congress has granted a statute change or exception in the past. In a separate report being publicly released today, we suggest that Congress lengthen the statute of limitations for cases involving offshore activity.

IRS generally uses the term "offshore" to mean a country or jurisdiction that offers financial secrecy laws in an effort to attract investment from outside its borders.[5] IRS examinations, both offshore and nonoffshore, are generally of one of three types—correspondence, office, or field. The most complex examinations are done through revenue agent field visits to taxpayer locations, that is, field examinations. Most offshore examinations from 2002 through 2005 were of this type. Generally, unless a taxpayer's tax return involves fraud or a substantial understatement of income, or unless the taxpayer agrees to an extension, the statute of limitations for IRS to assess additional taxes is 3 years from when IRS receives the taxpayer's tax return. Taking an examination past the statute of limitations date may result in disciplinary action against the responsible revenue agent and his or her manager.

Offshore Tax Evasion Takes Longer to Find but Offshore Examinations Yield Larger Assessments Than Other Types of Cases

Comparing offshore and nonoffshore examinations, IRS examination data from fiscal years 2002 through 2005 showed that it takes IRS longer both to develop a potential offshore examination case after a return is filed and to conduct the examination itself. The median of offshore case total cycle time—the time that elapses between a return being filed and IRS's closing of the examination of that return—was almost 500 calendar days longer than for nonoffshore cases, a 126 percent difference. Offshore examinations also required significantly more direct examination time,[6] with an average of 46 hours spent directly on offshore examinations and 12 hours on nonoffshore examinations. IRS officials told us that the longer time needed to complete offshore examinations is because of the inherent difficulty in identifying and obtaining information from foreign sources,

[5] IRS officials noted that although many enforcement problems occur in certain foreign jurisdictions that are characterized by strict financial privacy regimes, the term "offshore" broadly includes the activities of U.S. taxpayers in all foreign transactions.

[6] Direct examination time does not include time spent waiting for a taxpayer's response to a request for information or other such time spent between specific tasks related to the examination.

often dilatory and uncooperative tactics on the part of taxpayers and their representatives, and technical complexity.

About half of all offshore examinations resulted in a recommended assessment of additional taxes due compared to approximately 70 percent of nonoffshore examinations. While fewer offshore examinations resulted in assessments, the median assessment of all types of offshore examinations was nearly three times larger than for nonoffshore examinations. Although assessments were larger, the greater number of hours of direct examination time meant that assessment dollars per hour of offshore direct examination time were about half that of nonoffshore examinations—$1,084 per hour from offshore examinations and $2,156 from nonoffshore examinations.

IRS created guidance for continuing offshore examinations past the 3-year point. Subject to management approval, agents can carry on the examination past the 3-year point based on their judgment that, given additional time, they will ultimately prove that the examination met one of the criteria necessary for IRS to make an assessment after the 3-year statute date has passed.

All of the examinations allowed to extend past the statute date under this guidance represent a gamble on the part of IRS that the examination will ultimately meet one of the exceptions to the statute and an assessment will be allowed under the law. IRS records show that 1,942 offshore examinations were taken past the 3-year statute period from fiscal years 2002 through 2005. IRS ultimately made assessments on 63 percent of these examinations and these assessments were significantly higher than assessments from all other types of examinations, with a median assessment of about $17,500 versus about $5,800 from offshore examinations that were closed within the 3-year statute of limitations. The median assessment for all nonoffshore examinations that went past the statute date was about $4,900 versus about $2,900 from all nonoffshore examinations closed within 3 years. IRS databases do not allow systematic analysis of the approximately 700 offshore examinations that did not result in an assessment, so we do not know if these were accurate returns or if the agent discovered tax evasion but it did not rise to the level of fraud or substantial understatement of income.

IRS Does Not Pursue Some Apparent Offshore Tax Evasion Because of the 3-Year Statute of Limitations

Revenue agents and managers told us that because IRS has only 3 years from the time the taxpayer files a tax return, and offshore cases take longer than nonoffshore cases to identify and develop, some case files are not opened for examination because insufficient time remains under the statute to make the examination worthwhile. They added that, in order to avoid violating the statute, they will often choose case files to examine with more time remaining under the 3-year statute of limitations over case files that have less time remaining and with more likely or more substantial possible assessments. Similarly, IRS revenue agents and managers sometimes close cases without examining all issues rather than risk taking the examination past the statute period, losing revenue, and facing disciplinary action.

Congress has lengthened or made exceptions to the statute in the past. For example, Congress changed the statute in 2004 to provide IRS with an additional year to make assessments in the case of unreported listed transactions.[7] Since many offshore schemes exhibited enforcement problems similar to those of unreported listed transactions, it follows that a similar statute extension could be granted for certain offshore transactions.

IRS officials and individuals from the tax practitioner and policy communities told us of both advantages and disadvantages of an exception to the statute for taxpayers involved in offshore financial activity. For example, an advantage was increased flexibility for IRS to direct enforcement resources to egregious cases. A disadvantage was lack of closure for taxpayers. In our report discussed earlier, we suggest that Congress make an exception to the 3-year civil statute of limitations assessment period for cases involving offshore activity. In e-mail comments on a draft of our report, IRS expressed agreement that a longer statute makes sense and should enhance compliance.

[7] Listed transactions are the same as, or substantially similar to, a transaction specifically identified by IRS as a tax avoidance transaction. For a transaction to be a listed transaction, IRS must issue a notice, regulation, or other form of published guidance informing taxpayers of the details of the transaction. IRS listed 31 such transactions as of January 2007.

QI Program Provides Some Assurance That Tax Is Properly Withheld and Reported but Limitations Exist

For tax year 2003, withholding agents reported that individuals and businesses residing abroad received about $293 billion in income from U.S. sources. The QI program provides IRS some assurance that tax is properly withheld and reported to IRS. However, a low percentage of U.S source income flows through QIs. In addition, although QIs are subject to external reviews, the auditors conducting these reviews are not required to follow up on indications of fraud or illegal acts. Further, IRS does not make effective use of the data it receives from withholding agents to ensure that withholding agents perform their duties properly.

To address our objectives for the QI program, we reviewed various IRS documents and interviewed IRS and Department of the Treasury (Treasury) officials and private practitioners involved in the development and implementation of the QI program. We also reviewed various studies and reports on foreign investment and banking practices. A GAO investigator created a shell corporation and opened a bank account for that corporation to test the due diligence exercised by withholding agents. We also analyzed IRS data on U.S. source income that flowed overseas for tax years 2002 and 2003. The qualified intermediary data were reported by withholding agents and edited by IRS, and do not include an unknown amount of activity that was unreported. We determined that these data were sufficiently reliable for the purposes of describing the qualified intermediary program by (1) performing electronic testing for obvious errors in accuracy and completeness and (2) interviewing agency officials knowledgeable about the data, specifically about how the data were edited. We reviewed the auditing requirements contained in the QI agreement and other standards, such as the U.S. *Government Auditing Standards*[8] and the international standard on agreed-upon procedures (AUP) and visited IRS's Philadelphia Campus, which is responsible for processing the information returns submitted by QIs.

Background

Money is mobile and once it has moved offshore, the U.S. government generally does not have the authority to require foreign governments or foreign financial institutions to help IRS collect tax on income generated from that money. In 1913, the United States enacted its first legislation establishing that U.S. persons and nonresident aliens were subject to withholding at source before the investment income leaves U.S. jurisdiction. Subsequent legislation made withholding applicable to

[8] GAO-07-162G.

dividends and certain kinds of bond income earned by nonresident aliens, foreign corporations, foreign partnerships and foreign trusts and estates. The Internal Revenue Service issued a comprehensive set of withholding regulations for nonresident aliens in 1956. These regulations have been changed over the years to reflect statutory changes or perceived abuses by taxpayers.

To attract foreign investment, the tax rules were further adapted to exclude several types of nonresident alien capital income from U.S. taxation, such as capital gains from the sale of personal property, interest income from bank deposits and "portfolio interest," which includes U.S. and corporate debt obligations. The latter exemption helps finance the U.S. national debt by offering a U.S. tax free rate of return for foreigners willing to invest in U.S. bonds.

Most of the U.S. source income flowing offshore likely is paid to nonresident aliens but some may be paid to U.S. persons. The income may be paid directly to nonresident aliens located offshore, for example when a company pays dividends to a foreign stockholder, or may flow through one or more U.S. or foreign financial intermediaries, such as banks or brokerage firms. Whether this income paid to nonresident aliens is subject to U.S. tax and, if so, how much depends on a number of factors, including the type of income and whether the recipient is a resident of a country with which the United States has negotiated a lower tax rate. If U.S. source income is subject to U.S. tax, the payor of that income has to report information about the recipient and the type and amount of income to IRS, and in some cases would be required under U.S. law to withhold the taxes due from the recipient. Any entity required to perform these withholding and reporting duties is known as a "withholding agent." The difference in taxation, withholding, and reporting for nonresident aliens and U.S. persons can motivate some U.S. individuals or businesses to seek to appear to be nonresident aliens.

Among the types of U.S. source investment income paid to nonresident aliens, some is exempt from U.S. tax and some is taxable. Payors must report this income to IRS and withhold where appropriate. For example, some types of income paid to nonresident aliens, such as bank deposits and portfolio interest[9] are exempt from taxation by U.S. statute. Payors of this income do not have to withhold tax on this income but are required to report certain information to IRS about the amounts of income paid and to whom. Other types of investment income paid to nonresident aliens, such as the gross proceeds on the sale of personal property, such as securities in a U.S. corporation, are also exempt from U.S. tax but financial intermediaries are neither required to withhold taxes on the income nor report information on the payment of the income to IRS. Some U.S. investment income, such as dividends, is subject to a statutory tax rate of 30 percent.[10] Payors of this income generally are to withhold the 30 percent tax if the recipients do not reside in a nation that has negotiated a treaty with a lower tax rate or cannot show they are in fact residents in the treaty country. The payors also have to report to IRS certain information covering the amount of income paid and to whom. About $5 billion of this capital income was withheld for tax year 2003, implying that about $83 billion of this income was exempt from tax or was taxed at lower tax treaty rates (known as treaty benefits).

IRS established the QI program in 2000. Under the QI program, foreign financial institutions sign a contract with IRS to withhold and report U.S. source income paid offshore. The QI program, and the larger withholding regime, is rooted in the 1980s when Congress expressed concerns about tax evasion by U.S. persons using foreign accounts, treaty benefits claimed by those who were ineligible, and the effect of tax havens and secrecy jurisdictions on the U.S. tax system. With these considerations in mind, and a general view that the old regulations were simply not being followed, IRS began a long, consultative process of developing new rules to balance a number of objectives, including a system to routinely report income and withhold the proper amounts, dispense treaty benefits, meet the U.S. obligation to exchange information with foreign tax authorities and encourage foreign investment in the United States.

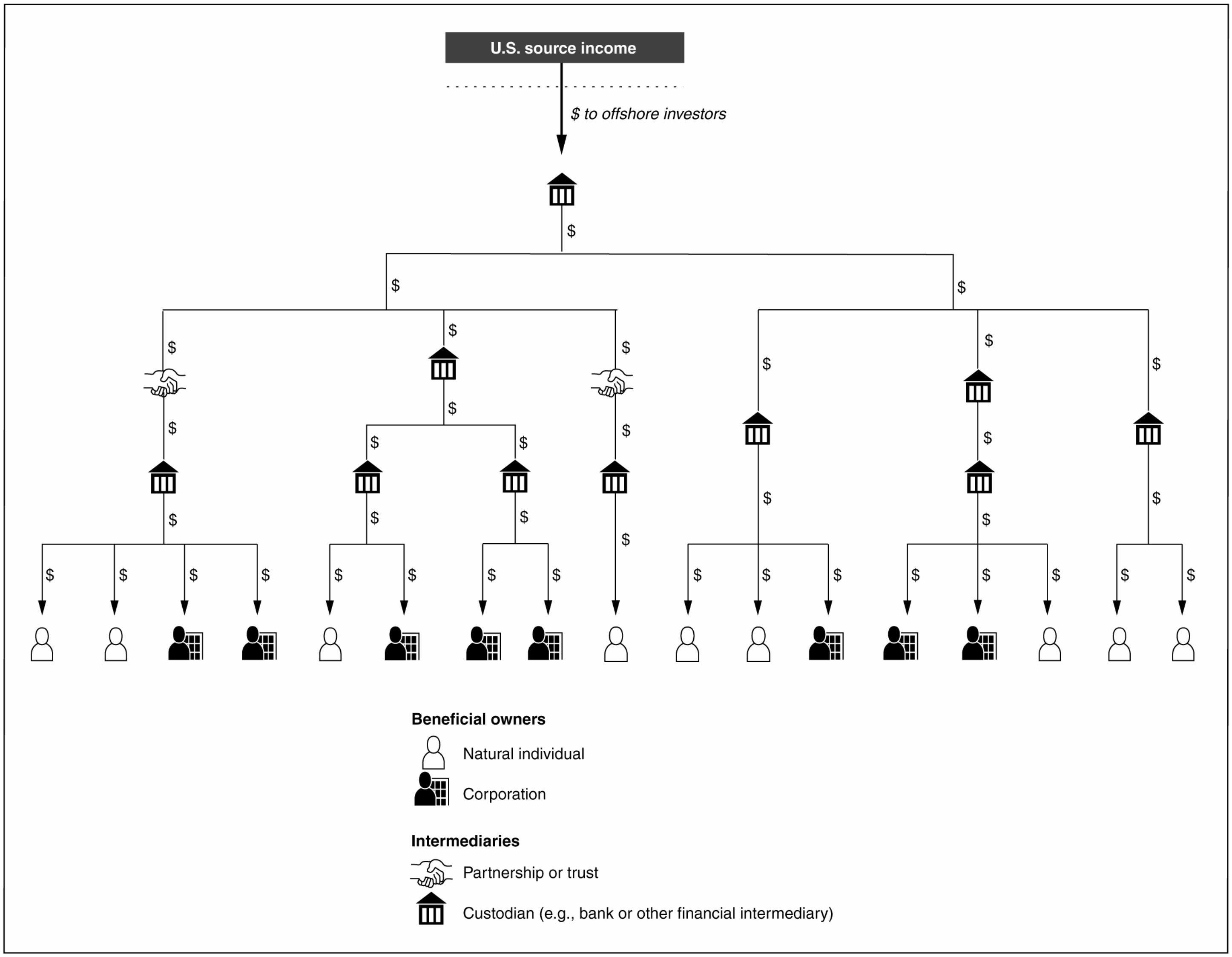
Chains of payments are routine in modern global finance, and the QI system of reporting is designed to reflect this normal course of business.

[9] Interest includes interest paid by U.S. obligors general, interest paid on real property mortgages, interest paid to controlling foreign corporations, interest paid by foreign corporations, interest on tax-free covenant bonds, deposit interest, and Original Issue Discount (OID) which is the profit earned by purchasing a bond at a price less than its face value.

[10] Dividends include those paid by U.S. corporations, dividends qualifying for reduced withholding under a tax treaty, and dividends paid by foreign corporations.

For example, a small local bank in a foreign country may handle the accounts of several owners of U.S. investments. The bank may aggregate the funds of each of these individual investors into an omnibus account that it, in turn, invests in a regional bank. The regional bank may handle a number of omnibus accounts that it, in turn, aggregates and invests in some U.S. securities. The return on these securities will flow out of the United States and reverse this chain of transactions until each of the original investors gets their pro rata share of profit. See figure 1 for examples of tiered financial flows.

Figure 1: Tiered Financial Flows



Source: GAO analysis of IRS data.

Although QIs generally agree to be withholding agents for their customers, QIs may opt out of primary withholding and reporting responsibilities for designated accounts—including those owned by U.S. persons, ceding those responsibilities and liabilities to financial institutions upstream in that chain of payments. Eventually, the responsibilities and liabilities associated with these accounts may fall to the last payor within the United States (and therefore within the jurisdiction of IRS). Even though this income may be paid to account holders in QIs or nonqualified intermediaries (NQI), the reporting and withholding might be executed by U.S. institutions.[11]

The United States maintains a network of bilateral treaties designed to set out clear tax rules applying to trade and investment between the United States and each nation in order to promote the greatest economic benefit to the United States and its taxpayers. Each treaty is intended to eliminate double taxation of taxpayers conducting economic activity in the United States and another nation by allocating taxing rights between the two countries, establishing a mechanism for dealing with disputes between the two taxing authorities, providing exchange of information between the two taxing authorities, and reducing withholding taxes. Reductions of withholding taxes are negotiated with each treaty partner individually and the benefits are reciprocal—so U.S. residents may benefit from a reduced tax rate for investing abroad, just as foreign investors may be for investing in the United States. As of January 2007, 54 tax treaties were signed, including for all members of the Organization of Economic Cooperation and Development (OECD).

The QI Program Provides Some Additional Assurance That Tax Is Properly Withheld and Reported

Compared to U.S withholding agents, IRS has additional assurance that QIs are properly withholding the correct amount of tax on U.S. source income sent offshore. QIs accept several responsibilities that help ensure that their customers qualify for treaty benefits.

First, because QIs are in overseas locations, they are more likely to have personal contact with nonresident aliens or other persons who may claim exemptions or treaty benefits than would U.S. withholding agents. This direct relationship may increase the likelihood that the QI will collect adequate ownership information and be able to accurately judge whether its customers are who they claim to be.

Second, QIs accept enhanced responsibilities for providing assurance that customers are in fact eligible for treaty benefits and exemptions. All

[11] An NQI is any intermediary that is not a U.S. person and not a qualified intermediary who is a party to a withholding agreement with the IRS. It can also refer to a qualified intermediary that is not acting in its capacity as a qualified intermediary with respect to a payment. See Treasury Regulations 1.1441-1(c)(14).

withholding agents are expected to follow the same basic steps when determining whether to withhold taxes on payments of U.S. source income made to nonresident alien customers. The withholding agents must determine the residency of the owner of the income and the kind and amount of U.S. source income, which governs the customers' eligibility for no (if the type of income is exempt from U.S. tax) or reduced taxation (if a lower taxation rate has been set in a treaty). However, under their contract, QIs must obtain acceptable account opening documentation regarding the customer's identity. When determining whether a customer qualifies for treaty benefits, the kinds of documents QIs may use are approved by IRS based upon the local jurisdiction "know your customer" (KYC) rules. When customers wish to claim treaty benefits, they must also submit an IRS Form W-8BEN, known as a withholding certificate, or other acceptable documentation. On the withholding certificate the customer provides various identifying information and completes applicable certifications, including that the customer is a resident of a country qualifying for treaty benefits and that any limitations on benefits (LOB) provisions in the treaty are met.[12] Because QIs agree to follow specified account opening procedures in all cases, regardless of whether a QI performs withholding itself or it passes the responsibility to another withholding agent, there is enhanced assurance that the residency and nationality of the account holder has been accurately determined and thus correct withholding decisions will be made.

Third, and importantly, QIs agree to contract with independent third parties to review the information contained in a sample of accounts, determine whether the appropriate amount of tax was withheld, and submit a report of the information to IRS. These reviews are discussed in greater detail later in this statement. In contrast, U.S. withholding agents generally have not yet been subject to external reviews for this purpose. IRS officials believe that those U.S. withholding agents that participated in IRS's 2004 Voluntary Compliance Program[13] were effectively subject to

[12] The LOB provisions seek to prevent nonresidents of the two treaty countries from taking advantage of the preferential tax treatment in the favorable tax treaty by forming a conduit entity in the treaty country but then funneling the profits back (to the United States or another non-treaty country). Accordingly, the LOB provisions contained in many tax treaties between the United States and other countries disallow the availability of treaty benefits to recipients that do not maintain significant contacts with the treaty jurisdiction in question.

[13] The Voluntary Compliance Program, announced in Rev. Proc. 2004-59, was a program in which IRS invited U.S. withholding agents to disclose and resolve issues arising from the implementation of the final withholding regulations.

external review because under the program they had to provide IRS essentially the same information that IRS would have reviewed in an audit. IRS is preparing to audit all of the U.S. withholding agents that did not participate in the Voluntary Compliance Program. However, because U.S. withholding agents generally rely on identity documentation from downstream intermediaries, even when U.S. withholding agents have been audited by IRS, there is less assurance that nonresident aliens actually qualified for the benefits.

Although account opening and withholding procedures for QIs may give IRS greater assurance that treaty benefits are properly provided by QIs than by U.S. withholding agents, QIs provide IRS less information to use in targeting its enforcement efforts than do U.S. withholding agents. One of the principal incentives for foreign financial institutions to become QIs is their ability to retain the anonymity of their customer list. QIs report customer income and withholding information to IRS in the aggregate for groups of similar recipients receiving similar benefits. This is known as "pooled reporting." NQIs also can pool results when reporting to upstream withholding agents, but nevertheless, must identify all of the individual customers for which they have provided treaty benefits.[14] Although pooling restricts the information available to IRS on individuals receiving treaty benefits, to the extent that QIs do a better job of ensuring treaty benefits are properly applied up front, IRS has less need for after-the-fact enforcement. The accuracy of the pooled reporting by QIs is also subject to the external reviews of QIs' contractual performance.

QIs Account for a Small Portion of U.S. Source Income and Individuals May Inappropriately Receive Treaty Benefits as Owners of Corporations

Although the QI program provides IRS some assurance that treaty benefits are being properly applied, a low percentage of U.S. source income flows through QIs and U.S. taxpayers may inappropriately receive treaty benefits and exemptions as owners of foreign corporations.

[14] Income owned by U.S. taxpayers held offshore may not be pooled and must be reported to IRS individually, either by the QI or the last U.S. payer in a chain of payments.

The Majority of U.S. Source Income Flows Outside the QI System

As shown in table 1, for tax year 2003, 87.5 percent of U.S. source income reported to IRS was reported by U.S. withholding agents, not QIs.[15] Thus, the overwhelming portion of this income flowed through channels that provide somewhat less assurance of proper withholding and reporting than exists under the QI program. More than 90 percent of the U.S. source income QIs paid their customers for tax year 2003, or nearly $34 billion, flowed through QIs that each handled $4 million or more of U.S. source income. These QIs and the income they handled were subject to external review (as discussed later in this statement, smaller QIs can obtain a waiver from external reviews). Overall, QIs withheld taxes from U.S. source income at more than twice the rate of U.S. withholding agents, 3.7 percent versus 1.5 percent.

Table 1: Income and Withholding Flows by Type of Intermediary for Tax Year 2003

Dollars in billions

	U.S. withholding agents					QIs				
Amount of U.S. source income reported by withholding agent	**Number of returns**	**Total gross income**	**Total tax withheld**	**Withholding rate (percentage)**	**Percentage total income**	**Number of returns**	**Total gross income**	**Total tax withheld**	**Withholding rate (percentage)**	**Percentage total income**
$4 million or more	5,503	$223.3	$2.4	1.1	76.1	716	$33.8	$1.1	3.2	11.5
Less than $4 million and equal or greater than $1 million	8,553	16.9	0.5	3.2	5.8	805	1.7	0.1	8.6	0.6
Less than $1 million	1,977,001	16.5	1.0	5.9	5.6	40,648	1.2	0.1	10.6	0.4
Subtotals	**1,991,057**	**$256.7**	**$3.9**	**1.5**	**87.5**	**42,169**	**$36.6**	**$1.4**	**3.7**	**12.5**

Source: GAO analysis of IRS data.

Note: Numbers may not total because of rounding.

The jurisdiction of recipients of U.S. source income is a major determinant of the applicable withholding rate and the degree of cooperation IRS may expect from foreign governments in enforcing U.S. tax administration. Bilateral tax treaties are one means of reducing withholding taxes that

[15] Tax year 2003 is the most recent year for which reliable data is available.

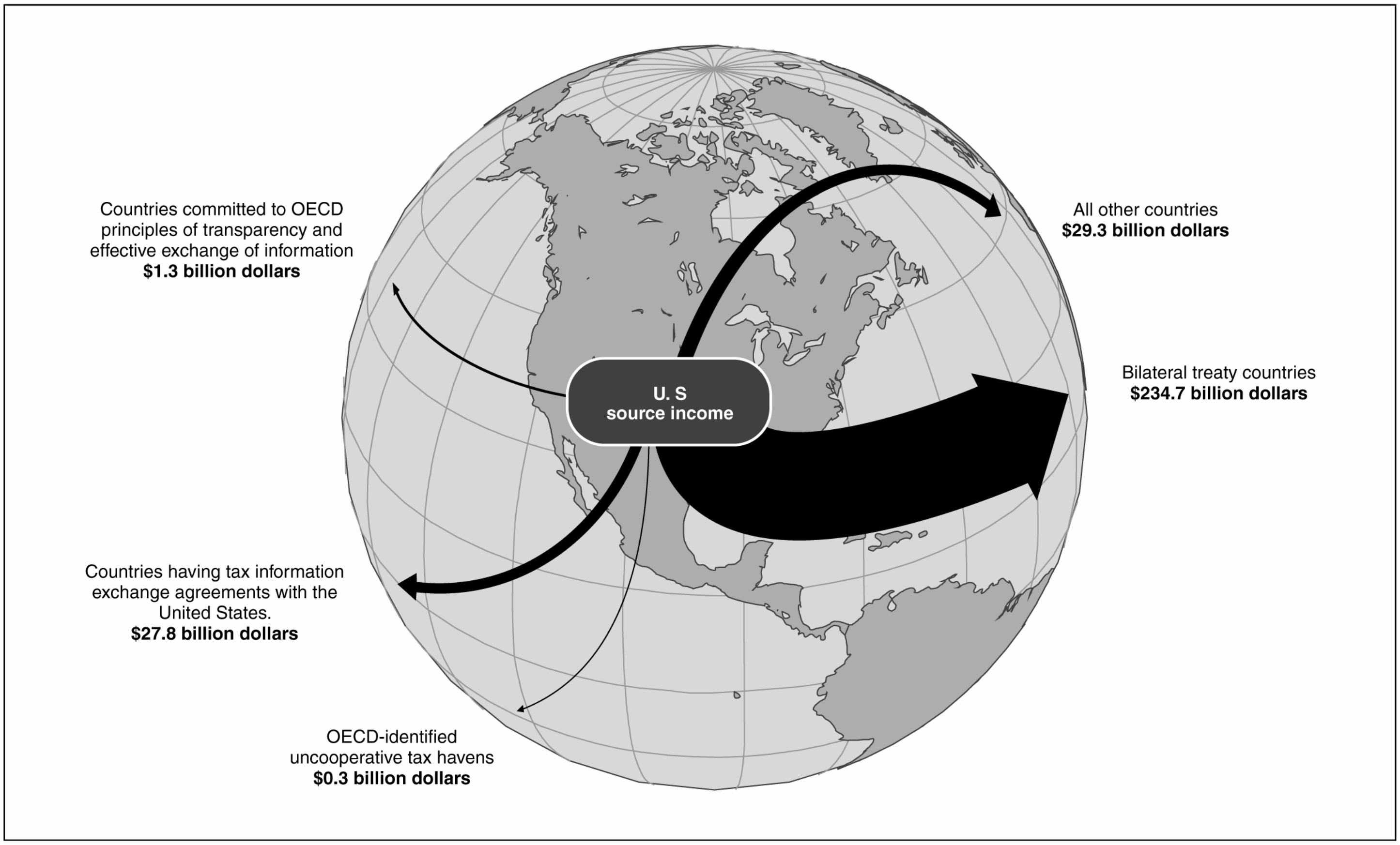
treaty partners may impose on their residents. In general, a treaty provides enhanced assurance that both nations' tax rules will be properly applied. When a treaty does not exist, tax administration can be furthered by agreements to exchange information. As of November 2006, 15 nations had Tax Information Exchange Agreements (TIEA) with the United States.[16] To countervail harmful tax practices, the OECD encourages countries to develop and practice administrative transparency and effective exchange of tax information in their local tax administrations. A number of countries have made formal commitments to work toward these principles. However, because of their continued unwillingness to agree to these two principles, five countries are on the OECD's list of "uncooperative tax havens."[17] Finally, 165 other jurisdictions receive U.S. source income but do not fall into any of these categories.

Although the vast majority of U.S. source income flows outside the QI system, the preponderance flows through countries with which the United States has tax treaties, as shown in figure 2.

[16] Since we performed our analysis, according to the Department of the Treasury, the number of countries with TIEAs reached a total of 22. Although, Mexico has a TIEA, it also has a tax treaty with the U.S. and has been reported as such in the following figure and table.

[17] The Marshall Islands is one of the 15 nations with TIEA agreements in force. However, it is classified by OECD as an "uncooperative tax haven" and has been reported as such in the following figure and table.

Figure 2: U.S. Source Income Flowing Offshore by Type of Jurisdiction, Tax Year 2003



Sources: GAO analysis of IRS data, and PhotoDisc (image).

As shown in table 2, for tax year 2003 about 80 percent of U.S. source income flowed through treaty countries with 88 percent of that flowing through U.S. withholding agents. The data indicate that persons in the treaty countries received the preponderance of U.S. source income and the lowest withholding rates, because of a combination of reduced withholding rates negotiated by treaty and residents receiving certain kinds of income that are exempt by statute. About $28 billion flowed through TIEA countries, and recipients received significant withholding tax reductions–without mutually beneficial treaties. Persons in jurisdictions committed to OECD's principles, that is, "committed jurisdictions," and OECD-identified "uncooperative tax havens" accounted for relatively little U.S. source income. Withholding agents in other and undisclosed countries not falling into any of these categories received about $29 billion in U.S. source income for tax year 2003, and dispensed about $8 billion in withholding tax reductions that year.

Table 2: U.S. Withholding Agents' and QIs' Withholding Rates by Jurisdiction, Tax Year 2003

Dollars in billions

	U.S. withholding agents			QIs		
	Gross income	Withholding	Withholding rate (percentage)	Gross income	Withholding	Withholding rate (percentage)
Treaty countries	$212.7	$2.9	1.3	$22.0	$0.9	4.0
TIEA countries	24.9	0.7	2.7	3.0	0.1	2.3
OECD committed jurisdictions	1.2	0.1	5.4	[a]	[a]	2.6
OECD uncooperative tax havens	0.2	[a]	9.3	[a]	[a]	6.9
Other countries	9.9	0.2	1.6	0.3	[a]	1.2
Undisclosed	7.8	0.1	1.4	11.3	0.4	3.5
Not Listed	[a]	[a]	24.2	0.1	[a]	2.1
Unidentified	7.5	[a]	1.1	11.1	0.4	3.5
Unknown	0.3	[a]	8.6	0.1	[a]	12.1
All countries	**$256.7**	**$3.9**	**1.5**	**$36.6**	**$1.4**	**3.7**

Source: GAO analysis of IRS data.

Notes:

Treaty countries: Australia, Austria, Bangladesh, Barbados, Belgium, Canada, China, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Trinidad & Tobago, Tunisia, Turkey, Ukraine, United Kingdom, and Venezuela.

TIEA countries: Antigua and Barbuda, Aruba, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Dominica, Grenada, Guernsey, Isle of Man, Jersey, St. Lucia, U.S. Virgin Islands.

OECD committed jurisdictions: Anguilla, Bahrain, Belize, Cook Islands, Gibraltar, Malta, Mauritius, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, American Samoa, San Marino, Seychelles, St. Kitts & Nevis, St. Vincent & Grenadines, Turks and Caicos, and Vanuatu.

OECD uncooperative tax havens: Andorra, Liberia, Liechtenstein, Marshall Islands, and Monaco.

Due to rounding, the amount of gross income shown in this table differs slightly from the amount of gross income shown in fig. 2.

[a]Rounded down to less than $0.1 billion.

A close look at the data points to some potential problems with the withholding and reporting activities for tax year 2003. Both U.S. withholding agents and QIs reported transactions in unknown or unidentified jurisdictions. For example, for tax year 2003, $19 billion of income was reported ($7.8 billion through U.S. withholding agents and $11.3 billion through QIs), on which $500 million was withheld ($100 million through withholding agents and $400 million through QIs) from undisclosed countries. In a separate analysis, we calculated that $5 billion of treaty benefits and exemptions were given that were not associated with any particular country. And other data analysis indicates that both U.S. withholding agents and QIs reported transactions with "unknown recipients" across all jurisdictions. For tax year 2003, U.S. withholding agents and QIs reported a combined $7 billion of U.S. source income paid to offshore unknown recipients, from which $233 million was withheld at a rate of 3.4 percent. The transactions with unknown or unidentified jurisdictions and with unknown recipients indicate a significantly reduced rate of withholding without proper documentation or reporting to IRS, since eligibility for a reduced rate of withholding must be determined by the claimants' documented residency and type of investment.

Foreign Corporations May Provide U.S. Taxpayers a Mechanism for Evading Taxation

U.S. tax law enables the owners of offshore corporations to shield their identities from IRS scrutiny, thereby providing U.S. persons a mechanism to exploit for sheltering their income from U.S. taxation. Under U.S. tax law, corporations, including foreign corporations, are treated as the taxpayers and the owner of their income. Because the owners of the corporation are not known to IRS, individuals are able to hide behind the corporate structure. In contrast to tax law, U.S. securities regulation, and some foreign money laundering and banking guidelines treat shareholders as the owners. Even if withholding agents learn the identities of the owners of foreign corporations while carrying out their due diligence responsibilities, they do not have a responsibility to report that information to IRS. However, if it provides them with actual knowledge or reason to know that the claim for reduced withholding in the withholding certificate or other documentation is unreliable for purposes of establishing residency, new supporting documentation must be obtained.

Bilateral treaties may reduce or eliminate U.S. taxes on income that would otherwise be taxable to nonresident alien recipients, including foreign corporations, but generally not for U.S. persons. Similarly, the U.S. tax exemption for foreign recipients of portfolio interest, created to encourage foreign investors to purchase U.S. government and corporate debt, eliminates their tax on this type of income. The exemption is not available to U.S. persons, or to persons who own 10 percent or more of the debtor corporation or partnership as well as certain other restrictions.

Withholding agents generally may accept a withholding certificate at face value, and so may grant treaty benefits or a portfolio interest exemption to a foreign corporation that is owned by a U.S. person or persons. IRS regulations permit withholding agents (domestic and QIs) to accept documentation declaring corporations' ownership of income at face value, unless they have "a reason to know" that the documentation is invalid.[18] Consequently, it may be possible for U.S. persons to establish a corporation offshore, submit a withholding certificate to the withholding agent(s) and receive a reduced rate of withholding. In these situations where the foreign corporation is owned by a U.S. person or persons, it is incumbent upon the owners to report their corporate ownership and any income appropriately taxable to them on their own U.S. tax returns. There is no independent third-party reporting of that income to IRS. Generally, compliance in reporting income to IRS is poor when there is not third party reporting to IRS.

Foreign corporations received at least $200 billion, or 68 percent, of the $293 billion in total U.S. source income for tax year 2003 (see table 3). From this income, almost $3 billion was withheld (an effective withholding rate of 1.4 percent) representing more than $57 billion of treaty benefits and exemptions. About half of all foreign corporate investment in the United States that year was in debt instruments which are paid U.S. tax free to qualified investors. The preponderance of tax withheld from corporations was derived from dividends.

Table 3: Foreign Corporate U.S. Source Income, Withholding, and Benefits, Tax Year 2003

Dollars in billions

Type of income	Gross income	Tax withheld	Withholding rate (percentage)	Benefits
Interest[a]	$96.3	$0.2	0.22	$28.7
Dividends[b]	42.4	1.9	4.56	10.8
Miscellaneous[c]	61.8	0.7	1.14	17.8
Total income	**$200.5**	**$2.8**	**1.42**	**$57.3**

Source: GAO analysis of IRS data.

[a]Interest includes interest paid by U.S. obligors general, interest paid on real property mortgages, interest paid to controlling foreign corporations, interest paid by foreign corporations, interest on tax-free covenant bonds, deposit interest, and Original Issue Discount.

[18] As discussed earlier, however, under their contract with IRS, QIs are implicitly expected to use KYC documentation when judging whether a customer's withholding certificate is valid.

[b]Dividends include those paid by U.S. corporations, dividends qualifying for reduced withholding under a tax treaty, and dividends paid by foreign corporations.

[c]Miscellaneous income includes royalties, pensions, compensation for personal services, REIT distributions, notional principal contracts and other income.

To test the level of due diligence exercised by withholding agents, a GAO investigator using an assumed identity created a shell corporation and then sought to establish an overseas bank account for that corporation. Our investigator approached a European QI to open an account. The QI required our investigator to provide documentation sufficient to establish his identity as an officer of the corporation and documentation showing the source of the funds to be invested. Further, a representative from the QI contacted the investigator and questioned him in detail to ensure compliance with KYC standards and requested to meet with him in person. The investigator discontinued the effort and did not open an account with the QI. Our investigator also contacted an NQI in the Caribbean to open an account. The NQI requested that the investigator provide documentation of his identity and a letter explaining the purpose of the corporation. In addition, the NQI contacted a U.S. bank where the investigator had an account and requested a letter of reference. The NQI opened an account for our investigator. We did not then make an investment to earn U.S. source income in part because of the relatively large minimum investments required by QI and NQI firms we contacted. Thus, we were able to open a solely owned foreign corporation that was not actually an active business but do not know whether a QI or NQI intermediary would then have questioned a withholding certificate had we made an investment and claimed treaty benefits.

QI External Reviews and IRS Use of Program Data

Because QIs agree to have external auditors perform oversight of their compliance with required procedures, IRS has greater assurance that taxes are properly withheld and treaty benefits are properly dispensed by QIs than by U.S. withholding agents. However, within their limited scope, QIs' auditors are not responsible for following up on possible indications of fraud or illegal acts that could have an impact on the matters being tested as they would under U.S. *Government Auditing Standards*.[19] In addition, IRS obtains considerable data from withholding agents but does not make

[19] GAO-07-162G.

effective use of the data to ensure that withholding agents perform their duties properly.

External Reviews

In designing the QI program, IRS, Treasury, and intermediaries and their representatives had the objective of achieving an appropriate balance to obtain appropriate assurance that QIs meet their obligations without imposing such a burden that intermediaries would not participate in the program. As discussed earlier, IRS generally does not have the legal authority to audit a foreign financial intermediary, but IRS requires specific periodic procedures to be performed by external auditors to determine whether QIs are documenting customers' identities and accurately withholding and reporting to IRS. The QI agreement requires each QI to engage and pay for an external auditor to perform "agreed upon procedures" (AUP) and submit a report of factual findings to the IRS's QI program office for the second and fifth years of the agreement. The QI selects the external auditor, but IRS must approve it after considering the external auditor's qualifications and any potential independence impairments.

IRS selected AUPs as the type of engagement to monitor QI compliance because of their flexible and scalable attributes. AUPs differ from a full audit in both scope of work and the nature of the auditor's conclusions. As shown in table 4, in performing a full audit, an auditor gathers sufficient, appropriate evidence to provide assurance regarding the subject matter in the form of conclusions drawn or opinions expressed, for example, whether the audited entity is in material compliance with requirements overall. Under AUPs the external auditor performs specific work defined by the party requesting the work, in this case, IRS. In general, such work would be specific but less extensive, and less expensive, than the amount of work an auditor would do to provide assurance on the subject matter in the form of conclusions or an opinion. Thus, withholding agents would likely be more willing to participate in the QI program with a required AUP review than a full audit, which they would have to pay for under the program requirements. AUPs can provide an effective mechanism for oversight when the oversight needs relate to specific procedures.

Table 4: Comparison of Key Features of Audits and Agreed-Upon Procedures

Audit	AUPs[a]
Auditor gathers sufficient, appropriate evidence to provide assurance, draw conclusions or express an opinion on the subject matter.	Auditor performs specific procedures and provides the requestor with a report of factual findings based on the procedures performed.
Auditor determines nature and extent of procedures necessary to provide assurance.	Party or parties requesting the report determine and agree to the procedures performed by the auditor.
Report distribution usually not limited.	Report distribution limited to party or parties requesting the report.

Source: GAO analysis of audit and AUP characteristics as defined by U.S. *Government Auditing Standards* and International Auditing and Assurance Standards Board standards.

[a]These are attributes of AUPs performed under international accounting standards.

IRS developed a three-phase AUP process to focus on key performance factors to address specific concerns while minimizing compliance costs. In phase 1 procedures, the external auditor is required to examine all or a statistically valid sample of accounts with their associated documentation and compile information on whether the QI followed withholding requirements and the requirements of the QI agreement. IRS reviews the data from phase 1 AUPs and determines whether significant concerns exist about the QI's performance. If concerns exist, IRS may request that additional procedures be performed. For example, additional procedures may be requested if the external auditor identified potential problems while performing phase 1 procedures. IRS defines the work to be done in a phase 2 review based on the specific concerns surfaced by the phase 1 report. Phase 3 is necessary only if IRS still has significant concerns after reviewing the phase 2 audit report. In phase 3, IRS communicates directly with the QI management and may request a face-to-face meeting in order to obtain better information and resolve concerns about the QI's performance. IRS cited high rates of documentation failure, underreporting of U.S. source income and under-withholding as the three most common reasons for phase 3 AUPs.

Data from the 2002 audit cycle shows that IRS required phase 2 procedures for about 18 percent of the AUPs performed. IRS moved to phase 3 procedures for 35 QIs, which is around 3 percent of the 2002 AUPs performed. Of the QIs that had phase 3 reviews, IRS met face-to-face with 13 and was ultimately satisfied that all but 2 were in compliance with their QI agreements. The remaining 2 were asked to leave the QI program.

Since the QI program's inception in 2000, there have been 1,245 terminations of QI agreements. Of the 1,245 terminations, 696 were the result of mergers or consolidations among QIs and not related to noncompliance with the QI agreements. Aside from the 2 terminations mentioned above, the remaining 549 terminations were of QIs that failed to file either an AUP report of factual findings or requests for an AUP waiver by the established deadline.

IRS grants waivers of the AUP requirement if the QI meets certain criteria. A QI may be eligible for a waiver if it can demonstrate that it received not more than $1 million in total U.S. source income for that year. In order to be granted a waiver, the QI must file a timely request that includes extensive data on the types and amounts of U.S. source income received by the QI. Among items required with the waiver request are a reconciliation of U.S. source income reported to the QI and U.S. source income reported by the QI to IRS; the number of QI account holders; and certifications that the QI was in compliance with the QI agreement. IRS evaluates the data provided with the waiver request to determine if AUPs are necessary despite the relatively small amount of U.S. source income, and will deny the waiver request if the data provided raises significant concerns about the QI's compliance with the agreement. About 3,400 QIs (around 65 percent of the QIs at that time) were approved for audit waivers in 2005. The largest 5 percent of the QIs accounted for about 90 percent of the withholding based on data from the 2002 audit cycle.

One notable difference between the AUPs used for the QI program and AUPs that would be done under U.S. *Government Auditing Standards* is that the QI contract is silent on whether external auditors have to perform additional procedures if information indicating that fraud or illegal acts that could materially affect the results of the AUP review come to their attention. Absent specific provisions in the contract, the auditors perform the QI AUPs in accordance with the International Standard on Related Services (ISRS) 4400.[20] Our U.S. *Government Auditing Standards*, known as the Yellow Book, are more stringent on this topic than the ISRS standards.

[20] The International Auditing and Assurance Standards Board (IAASB) is an independent body that establishes and provides guidance on auditing, assurance and other related services, including ISRSs, for its member organizations. Member organizations agree to comply with IAASB standards.

Yellow Book standards state that auditors should be alert to situations or transactions that could indicate fraud, illegal acts, or violations of provisions of contracts. If the auditor identifies a situation or transaction that could materially affect the results of the engagement the auditor is to extend procedures to determine if the fraud, illegal acts, or violations of provisions of contracts are likely to have occurred and, if so, determine their effect on the results of the engagement. The auditor's report would include information on whether indications of fraud or illegal acts were encountered and, if so, what the auditors found. Therefore the report would provide IRS with the information necessary to pursue the indications of fraud or illegal acts through phase 2 procedures.

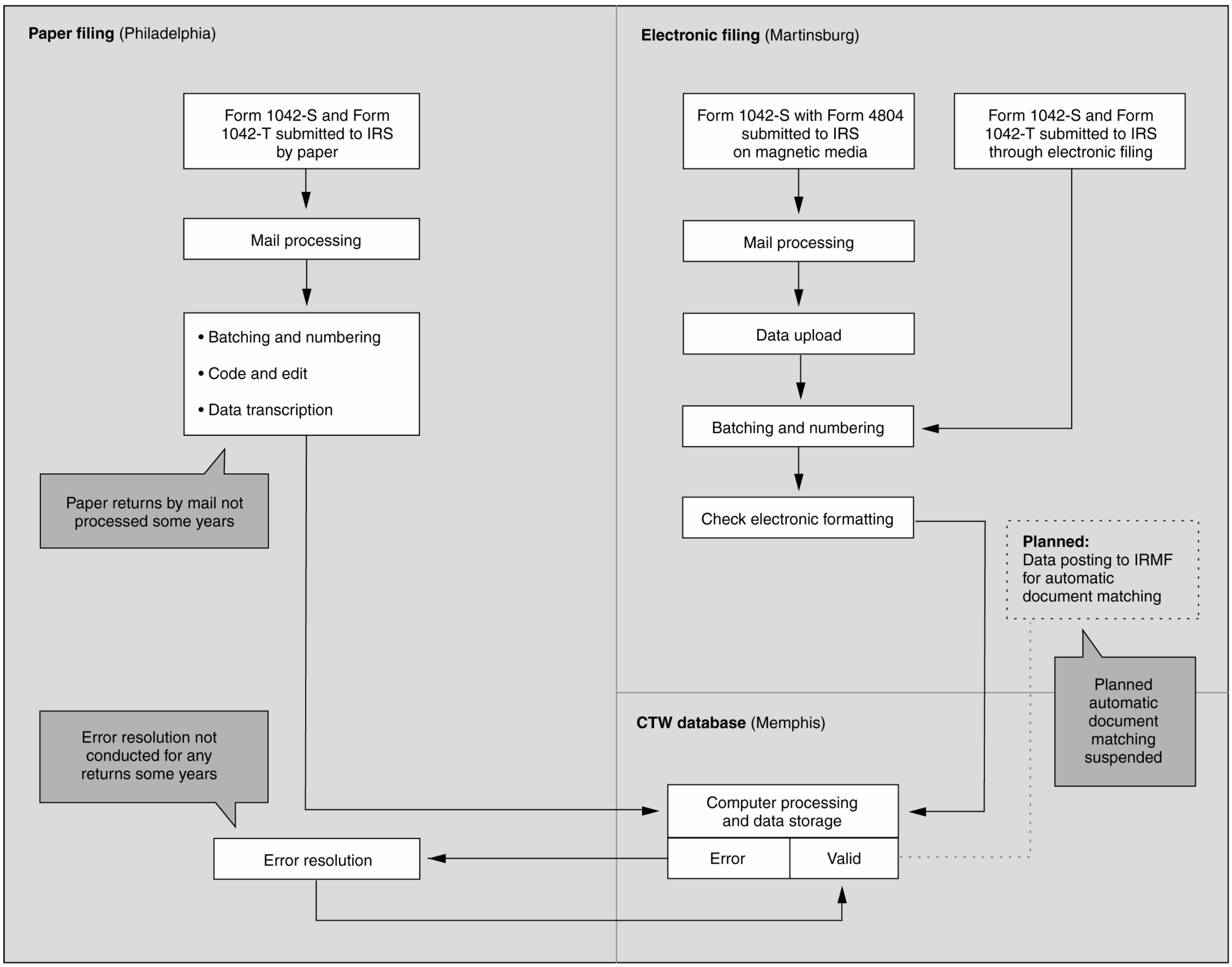
IRS Does Not Make Full Use of Available Data to Ensure Compliance with Withholding and Reporting Requirements

Data that IRS needs to effectively administer the QI program are not readily available for use and in some instances no longer exist. Consequently, IRS has difficulty ensuring that refunds claimed by withholding agents are accurate and is less able to effectively target its enforcement efforts.

All withholding agents, whether QIs or not, are to report withholding information on their annual withholding tax returns (Forms 1042) and information returns (Forms 1042-S). Forms 1042 are filed on paper. Forms 1042-S may be filed electronically or on paper. The law requires withholding agents filing more than 250 returns to file electronically; consequently, most U.S. financial institutions file the information returns electronically, while most QIs file on paper. When returns are paper filed, IRS personnel must transcribe information from the paper returns into an electronic database in order to efficiently and effectively make use of the data. Data on both paper and electronically filed returns must also be reviewed for errors.

Data from Forms 1042 have been routinely transcribed and checked for errors. However, since the inception of the QI program, IRS has not consistently entered information from the paper Forms 1042-S into an electronic database. In years when data were not transcribed, the unprocessed paper 1042-S forms were stored at the Philadelphia Service Center in Philadelphia and then destroyed a year after receipt in accordance with record retention procedures. Additionally, for certain tax years, the electronically filed Forms 1042-S did not go through computerized error resolution routines. For tax year 2005 IRS's Large and Midsize Business Division transferred $800,000 in funding to the service center to fund transcribing paper Forms 1042-S and performing error resolution for all Forms 1042-S. IRS officials anticipate funding 2006 transcription and error resolution although as of March 2007, this had not yet occurred. Figure 3 shows the dual processing procedures IRS uses for receiving, checking and validating the Form 1042-S data it receives.

Figure 3: IRS Processing of Paper and Electronic 1042-S Forms



Source: GAO analysis of IRS information.

Notes: The forms are Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding; Form 1042-T, Annual Summary and Transmittal of Forms 1042-S; and Form 4804, Transmittal of Information Returns Reported Magnetically.

CTW is Chapter Three Withholding; IRMF is Information Returns Master File.

Because the Form 1042-S data have not been routinely transcribed and corrected, IRS lacks an automated process to use the Form 1042-S information return data to detect underreporting on the Form 1042 or to verify refunds claimed. Forms 1042 are due in March and the withholding agents might report owing IRS more if they under-withheld the amount of tax their customers' owed, or might claim a refund if they over-withheld. After performing simple consistency and math checks on the Forms 1042, IRS accepts the returns as filed and either bills withholding agents that did not include full payment or refunds amounts to those whose Forms 1042 indicates they over-withheld taxes due.

Because the Forms 1042-S information returns have not been routinely transcribed, IRS has not been able to automatically match the information return documents to the annual tax return data, which is one of IRS's most efficient and effective tools to ensure compliance. IRS had planned to perform such automatic document matching, but IRS suspended the plans for matching the Form 1042-S and Form 1042 data since funding has not been available to routinely transcribe Form 1042-S data. Therefore, when Forms 1042-S had been electronically filed or transcribed, IRS has only been able verify the accuracy of Forms 1042 by individually retrieving the 1042-S data stored in the Chapter Three Withholding (CTW) database, a time-consuming and seldom used process. When Forms 1042-S were not transcribed, IRS was only able to verify Forms 1042 by manually retrieving and reviewing the paper 1042-S. Further, for years when transcription did not occur, if a QI filed an amended return after the paper Forms 1042-S were destroyed, IRS could not even perform a manual verification and had to take the amended return claiming a refund at face value provided other processing criteria were met. IRS has no information to determine whether or how often such erroneous or fraudulent refunds might occur.

Properly transcribed and corrected 1042-S data would have other uses as well. For instance, IRS officials said that such data could be used to check whether the AUP information submitted by QI withholding agents is reliable. For U.S. withholding agents, Form 1042-S information might be used to determine whether to perform audits. Several other units within IRS, as well as Treasury, the Joint Committee on Taxation and congressional tax-writing committees also could use these data to research and evaluate tax policy and administration issues and to identify possibly desirable legislative changes. We are considering recommendations in a forthcoming report on the QI program regarding IRS's data management.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you or other members of the committee may have at this time.

Contact and Acknowledgments

For further information regarding this testimony, please contact Michael Brostek, Director, Strategic Issues, at (202) 512-9110 or brostekm@gao.gov. Contacts for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Jonda Van Pelt, Assistant Director; Jeffrey Arkin; Susan Baker; Perry Datwyler; Amy Friedheim; Evan Gilman; Shirley Jones; David L. Lewis; Donna Miller; John Mingus; Danielle Novak; Jasminee Persaud; Ellen Rominger; John Saylor; Jeffrey Schmerling; Joan Vogel; and Elwood White.

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