

December 2007

# TAX COMPLIANCE

## Qualified Intermediary Program Provides Some Assurance That Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved





Highlights of [GAO-08-99](#), a report to the Committee on Finance, U.S. Senate

## Why GAO Did This Study

U.S. source income flows to recipients offshore through foreign financial institutions and U.S. withholding agents. The Internal Revenue Service (IRS) established the Qualified Intermediary (QI) program to improve tax withholding and reporting on such income. QIs are foreign financial institutions that contract with IRS to withhold and report U.S. tax.

GAO was asked to (1) describe program features, (2) assess whether weaknesses exist in the U.S. withholding system for U.S. source income, and (3) identify any weaknesses in QI external reviews and IRS's use of program data. GAO interviewed agency officials and private practitioners and reviewed the latest IRS data on U.S. source income flowing offshore.

## What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue (1) measure U.S. withholding agents' reliance on self-certification documentation and use that data in its compliance efforts, (2) determine why withholding agents report billions flowing to undisclosed jurisdictions and unidentified recipients, (3) enhance external reviews to include reporting of indications of fraud or illegal acts, and (4) require electronic filing in QI contracts whenever possible.

Although IRS generally agreed with GAO's recommendations, its planned actions are not fully consistent with our recommendations.

To view the full product, including the scope and methodology, click on [GAO-08-99](#). For more information, contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov)

## TAX COMPLIANCE

### Qualified Intermediary Program Provides Some Assurance That Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved

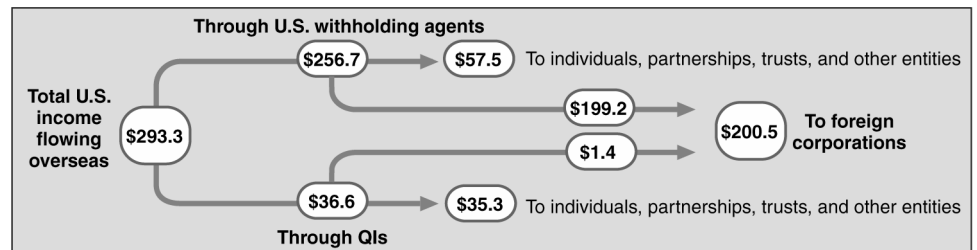
#### What GAO Found

The QI program provides IRS some assurance that tax on U.S. source income sent offshore is properly withheld and reported. For example, QIs, located overseas, are more likely to have a direct working relationship with customers who claim tax benefits, such as reduced withholding, and agree to have independent parties review a sample of accounts and report to IRS.

However, a low percentage of U.S. source income sent offshore flows through QIs. For tax year 2003, about 12.5 percent of the \$293 billion in U.S. income flowed through QIs, as shown below. The rest or about 87.5 percent flowed through U.S. withholding agents. While QIs are required to verify account owners' identities, U.S. withholding agents can accept owners' self-certification of their identity at face value. IRS does not measure the extent to which withholding agents rely on self-certification and use this data in its compliance efforts. In addition, U.S. persons may evade taxes by masquerading as foreign corporations. In 2003, 68.4 percent of U.S. income flowed through foreign corporations whose ownership is not reported to IRS.

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

Dollars in billions



Source: GAO analysis of IRS data.

Note: Numbers do not add to totals due to rounding.

GAO's analyses showed that U.S. withholding agents and QIs reported billions of dollars in funds flowing to undisclosed jurisdictions and unknown recipients in 2003. Lacking proper identification, U.S. withholding agents and QIs should withhold taxes at the 30 percent rate. GAO found that withholding on these accounts was much lower than 30 percent.

The contractually required independent reviews of QIs' accounts help provide assurance that taxes are properly withheld. However, the external auditors are not required to follow up on indications of fraud or illegal acts, as would reviews under U.S. Government Auditing Standards. As a result, IRS has less information on whether QIs are adequately preventing fraud or illegal acts. Further, while IRS obtains considerable data from information returns, it does not effectively use it to ensure proper withholding and reporting. IRS has not consistently entered data from paper information returns into a database and matched the data to tax returns to identify inappropriate disbursement of tax benefits. IRS could require electronic filing by QIs whenever possible.

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## Abbreviations

AUP	Agreed-Upon Procedure
CTW	Chapter Three Withholding
GAGAS	Generally Accepted Government Auditing Standards
IAASB	International Auditing and Assurance Standards Board
IRMF	Information Returns Master File
IRS	Internal Revenue Service
ISRS	International Standards on Related Services
LMSB	Large and Mid-sized Business
NQI	Non-Qualified Intermediary
NRA	Nonresident Alien
OECD	Organisation for Economic Co-operation and Development
OID	Original Issue Discount
QI	Qualified Intermediary
SOI	Statistics of Income
TIEA	Tax Information Exchange Agreement
Treasury	Department of the Treasury
VCP	Voluntary Compliance Program

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United States Government Accountability Office  
Washington, DC 20548

December 19, 2007

The Honorable Max Baucus  
Chairman  
The Honorable Charles E. Grassley  
Ranking Member  
Committee on Finance  
United States Senate

In tax year 2003, the most recent data available at the time of our analysis, individuals and businesses residing abroad, known as nonresident aliens (NRA), received \$293.3 billion in income from U.S. sources. Certain types of income sent to NRAs, such as certain interest from U.S. and corporate debt, are exempt from taxation by U.S. statute. Other types of income, such as the gross proceeds on the sale of equities, are neither reported nor withheld. Yet some income, such as dividends, is subject to a statutory tax rate of 30 percent, which may be reduced if the recipient resides in a country that has negotiated a lower rate through a tax treaty (known as treaty benefits). About \$5 billion of this income was withheld for tax in 2003. If the full 30 percent rate had been applied to the entire \$293.3 billion, about \$88 billion would have been withheld implying about \$83 billion worth of treaty benefits and exemptions. The income and benefits may have been sent directly to beneficial owners<sup>1</sup> located offshore or may have flowed through one or more foreign financial intermediaries, such as banks or brokerage firms.

The Internal Revenue Service (IRS) initiated the Qualified Intermediary (QI) program in 2000 to improve on the prior system of withholding and reporting of U.S. source income sent offshore. The QI program, and the larger withholding regime, are rooted in congressional concerns about tax evasion by U.S. persons using foreign accounts, treaty benefits claimed by those who are ineligible, and the effect of tax havens and secrecy jurisdictions on the U.S. tax system. With these considerations in mind, IRS began a long, consultative process of developing new rules to balance a number of objectives, including a system to routinely report income and

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<sup>1</sup>The beneficial owner is the true owner of the income, corporation, partnership, trust, or transaction who receives or has the right to receive the proceeds or advantages of ownership. For the rest of this report, we will use the term "owner."

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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. We were requested by the Committee on Finance to (1) describe features of the QI program intended to improve withholding and reporting, (2) assess whether weaknesses exist in the U.S. withholding system that complicate identifying owners of U.S. source income, and (3) determine whether weaknesses exist in QI external reviews and IRS's use of program data. This report builds on our testimony given May 3, 2007.<sup>2</sup>

To meet our objectives, we obtained information from several sources. We reviewed various IRS documents, such as regulations and industry directives, and interviewed IRS officials, 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. We analyzed IRS data on U.S. source income that flowed overseas for tax years 2002 and 2003, the most recent data available at the time of our analysis. The QI 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<sup>3</sup> and the international standard on agreed-upon procedures (AUP), and visited IRS's Philadelphia Campus, which was responsible for processing the information returns submitted by QIs during our review.<sup>4</sup> We conducted our review from January 2006 through October 2007 in accordance with generally accepted government auditing standards.

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<sup>2</sup>GAO, *Tax Compliance: Challenges in Ensuring Offshore Tax Compliance*, [GAO-07-823T](#) (Washington, D.C.: May 3, 2007).

<sup>3</sup>GAO, *Government Auditing Standards, July 2007 Revision*, [GAO-07-731G](#) (Washington, D.C.: July 2007).

<sup>4</sup>Responsibility for processing QI information returns was transferred to IRS's Ogden Campus in January 2007.

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## Results in Brief

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 sent offshore than other withholding agents. First, because QIs are in overseas locations, they are more likely to have a direct working relationship with NRAs or other persons who may claim exemptions or treaty benefits as the owners of the income. Second, QIs accept enhanced responsibilities for ensuring customers are in fact eligible for treaty benefits and exemptions, for example by obtaining acceptable account opening documentation. 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 tax benefits are properly provided, the vast majority of U.S. source funds are not reported or withheld by QIs, and some U.S. taxpayers may inappropriately receive treaty benefits and exemptions as owners of foreign corporations. In tax year 2003, the most recent year that data are available, about 88 percent of U.S. source income was reported and withheld by U.S. withholding agents, who provide somewhat less assurance of proper withholding and reporting than do QIs.<sup>5</sup> One situation in which U.S. withholding agents provide less assurance of proper withholding is when they accept self-certified identity documents from Non-Qualified Intermediaries (NQI) representing indirect account holders—those not directly holding an account with the U.S. withholding agent.<sup>6</sup> Unlike QIs, who verify the identity of all account holders through documentation, NQIs can accept account holders' self-certification of their identity. Although IRS has the information to do so, IRS has not determined how much of the income and associated withholding flowing through U.S. withholding agents comes from QIs versus NQIs because that information has not been regularly processed or corrected. Using this information may help IRS in its compliance efforts such as assessing the Treasury's exposure to unaudited documentation and exposure to tax benefits flowing to unaudited accounts.

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<sup>5</sup>A withholding agent is responsible for withholding tax on payments of U.S. source income and depositing such tax with Treasury.

<sup>6</sup>An indirect account holder is any person who receives amounts from a U.S. withholding agent but does not have a direct account relationship with the U.S. withholding agent. Indirect account holders can be NQIs, flow-through entities, or U.S. branches of a foreign bank or insurance company subject to U.S. or state regulatory supervision.

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U.S. withholding agents and QIs reported billions of dollars in funds flowing to undisclosed jurisdictions and unknown recipients in 2003. In general, lacking proper identification of a customer, including their residence, U.S. withholding agents and QIs should withhold taxes at the 30 percent rate. Withholding on these accounts was less than 4 percent.<sup>7</sup> Finally, under current U.S. tax law and regulations, corporations are taxpayers and the owners of their assets and income, regardless of the nationality and residency of the underlying owners of the corporation. Therefore, regardless of what type of institution serves as the withholding agent, by establishing an offshore corporation, a U.S. person(s) may escape identification and required reporting. In 2003, 68.4 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.

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. Although external reviews are an important attribute of the QI program, these reviews do not require auditors to report indications of fraud or illegal acts that could materially affect the results of these reviews and IRS does not make effective use of withholding data. Under U.S. Government Auditing Standards, auditors performing external reviews like those done for the QIs must follow up on indications of fraud or illegal acts that could have a material effect on the matters they are reviewing and report actual fraud or illegal acts detected. IRS officials identified several reasons for not requiring the external auditors to pursue evidence of fraud or illegal acts. For example, QIs are located in about 70 countries and each country has its own definition and interpretation of fraud. Also, in some countries identifying possible fraud can lead to significant adverse consequences for the audited entity, such as closing the business until the possible fraud is investigated. Consequently, in applying the fraud or illegal acts provisions to QI contracts IRS would need to take certain mitigating steps, such as defining fraud or illegal acts for purposes of the contracts or excluding the provision to report potential fraud. In addition, IRS does not make effective use of withholding data. IRS obtains considerable data from overseas withholding agents, but citing limited funding IRS has not consistently entered information from paper information returns into an

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<sup>7</sup>The effective withholding rate of less than 4 percent may be the result of income that is eligible for a lower treaty rate or a statutory exemption from withholding, or both.



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electronic database and matched the data to tax returns to identify, for example, possible erroneous refund claims. Because QIs sign contracts with IRS, the contract offers a vehicle for IRS to require electronic filing even when QIs' filing volumes fall below statutory levels triggering electronic filing requirements.

We recommend that the Commissioner of Internal Revenue (1) measure U.S. withholding agents' reliance on self-certified documentation and use that data in its compliance efforts, (2) determine why some funds are reported to flow to unknown jurisdictions and to unidentified recipients and take appropriate steps to recover withholding taxes that should have been paid and to better ensure that U.S. taxes are withheld when account owners do not properly identify themselves, (3) work to enhance external reviews by requiring the external auditor to report any indications of fraud or illegal acts encountered while performing AUPs that could significantly affect the results of the review, and (4) require electronic filing of forms in QI contracts whenever possible, thereby reducing the need to manually process data reported from abroad.

In commenting on a draft of this report, the acting Commissioner of Internal Revenue generally agreed with our recommendations to further improve the QI program but in several cases her detailed comments are not fully consistent with our recommendations. Regarding our recommendation to measure U.S. withholding agents' reliance on self-certified documentation, IRS agreed it would be beneficial to determine the compliance effect of U.S. withholding agents' use of self-certified documentation. However, IRS's detailed comments focused on examining the accuracy of self-certified documents rather than systematically measuring U.S. withholding agents' exposure to unverified documentation to determine how large or small a challenge this documentation is to the integrity of the U.S. withholding system. Although better understanding the accuracy of self-certified documents is laudable, we believe a systematic measurement of agents' reliance on such documents, which can be made with information IRS already receives, would both assist IRS in targeting enforcement efforts and inform policymakers' judgments about the current reporting regime. The acting Commissioner agreed to determine why withholding agents reported billions of dollars of tax benefits to unknown jurisdictions and unidentified recipients, and proposed to develop a methodology to determine the extent of this underwithholding. Regarding AUP's coverage of indications of fraud or illegal acts, IRS states overall agreement that QIs should provide any information indicating fraud or illegal acts. But IRS said it would be extremely complex and complicated to define fraud and illegal acts in at

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least 70 countries. In addition, IRS pointed to certain current QI requirements that provide IRS with some information on fraud and illegal acts. However, as discussed in our draft report, we believe IRS could draw on existing auditing standards to establish a consistent definition of fraud and illegal acts for the purposes of the QI program. In addition, the provisions to which IRS refers rely in part on self-reporting by the QI and in part focus on “know your customer” rule violations alone. However, self-reporting by the QI is not equivalent to judgments by the auditors about whether there are indications that fraud or illegal acts have occurred. And the universe of potential fraud or illegal acts extends beyond potential violations of know your customer rules. Therefore we reaffirm our recommendation. Finally, IRS agreed that while there are benefits to electronic filing of tax Forms 1042 and 1042-S, IRS said such a requirement would be a burden for QIs that file only a few (3 or fewer) forms. IRS said it has implemented a procedure to include an application to electronically file for all QIs applying for or renewing participation in the program. If IRS were to require all QIs to electronically file, we believe any burdens filers of few forms would face could be addressed by offering them a waiver opportunity similar to waivers that are available to all institutions that are currently required to file electronically (those that file more than 250 returns). Requiring electronic filing whenever possible would reduce IRS’s costs and improve the timeliness and accuracy of data for program oversight.

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## Background

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### History, Purpose, and Determinants of Withholding

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 in the U.S. from that money. In 1913, the United States enacted its first legislation establishing that U.S. persons and NRAs were subject to withholding at source before the investment income leaves U.S. jurisdiction. Subsequent legislation made withholding applicable to dividends and certain kinds of bond income earned by NRAs, foreign corporations, foreign partnerships, and foreign trusts and estates. IRS issued a comprehensive set of withholding regulations for NRAs 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 NRA capital income from U.S. taxation, such as

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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.

Among the types of U.S. source investment income sent to NRAs, some are exempt from U.S. tax and some are taxable. Payors must report this income to IRS, withhold where appropriate, and deposit such tax with Treasury. Any entity required to perform these withholding and reporting duties is known as a “withholding agent.” For example, some types of income sent to NRAs, such as bank deposits and portfolio interest,<sup>8</sup> 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 sent and to whom. Other types of investment income sent to NRAs, such as the gross proceeds on the sale of personal property (e.g., 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.<sup>9</sup> 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 sent and to whom. About \$5 billion of this capital income was withheld for tax year 2003. Had the full 30 percent rate been applied to the entire \$293.3 billion, about \$88 billion would have been withheld, implying that about \$83 billion of this income was exempt from tax or was taxed at lower tax treaty rates.

Chains of payments are routine in modern global finance, and the QI system of reporting is designed to reflect this normal course of business. For example, a small local bank in a foreign country may handle the

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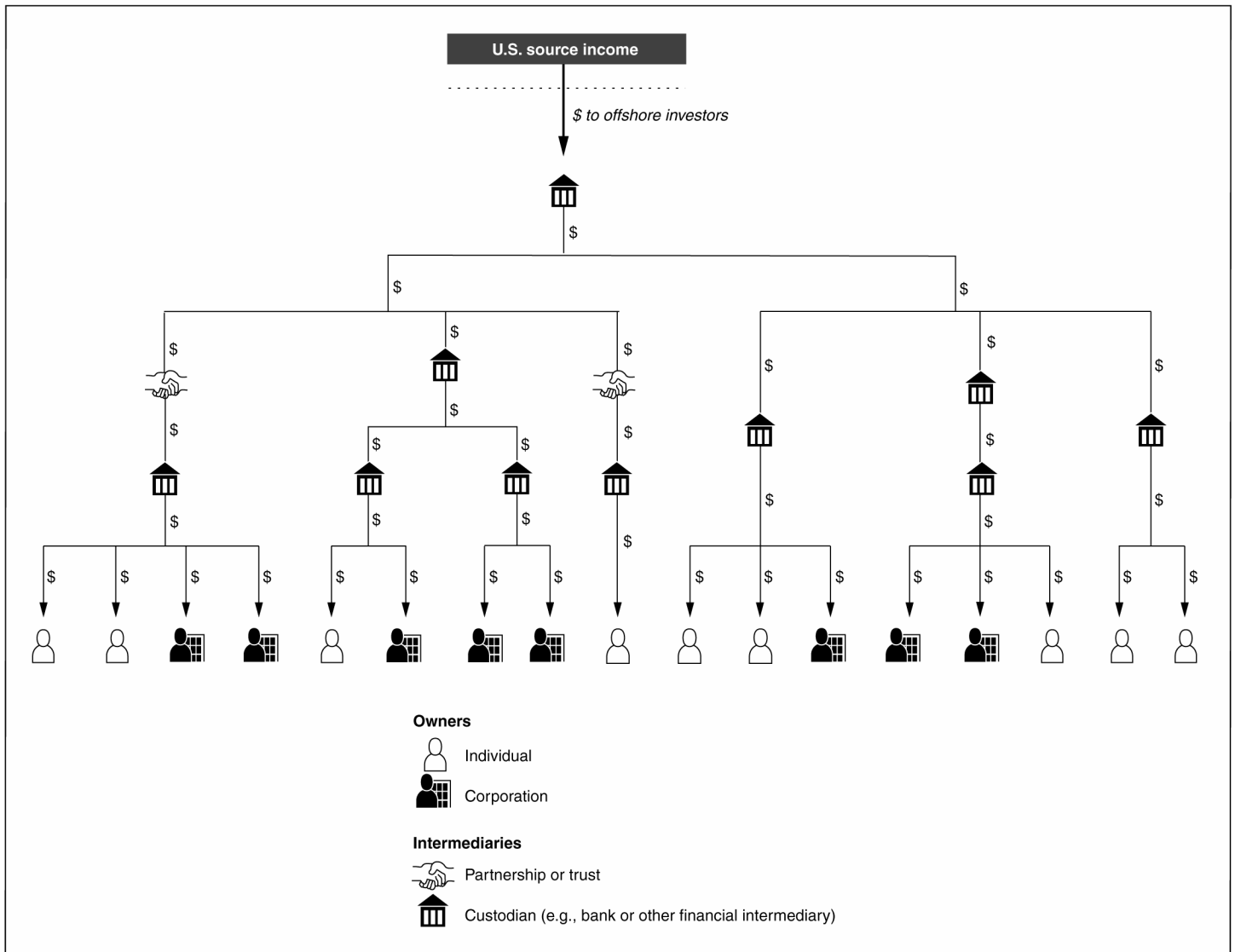
<sup>8</sup>Interest includes interest paid by U.S. obligors general, interest paid on real property mortgages, interest paid to controlling foreign corporations, interest paid by foreign corporations, interest on tax-free covenant bonds, deposit interest, and Original Issue Discount (OID), which is the profit earned by purchasing a bond at a price less than its face value.

<sup>9</sup>Dividends include those paid by U.S. corporations, dividends qualifying for reduced withholding under a tax treaty, and dividends paid by foreign corporations.

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accounts of several owners of U.S. investments. The bank may aggregate the funds of each of these individual investors into an omnibus account which it, in turn, invests in a regional bank. The regional bank may handle a number of omnibus accounts which 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.

## Multiple Objectives of the Withholding and Reporting System

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 sent offshore. The new regulations, which the QI program was intended to help administer, were designed 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

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exchange information with foreign tax authorities, and encourage foreign investment in the United States.

Under the QI program, foreign financial institutions voluntarily sign an agreement to withhold and report the appropriate amount of tax on the U.S. source income they send to their offshore customers. This entails determining the kind and amount of their clients' U.S. source income, determining whether clients are eligible for benefits (which is determined by the client's national residency), and then calculating, withholding, and reporting appropriate amounts to IRS. When customers wish to claim treaty benefits or exemptions, they must also submit to a QI or other withholding agent 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 or exemptions and that any limitations on benefits provisions in the treaty are met.<sup>10</sup> To determine whether a client is eligible for treaty benefits and exemptions, the QIs accept documentation declaring clients' residency, most often a self-certified Form W-8BEN, and verify that with other documents accepted as part of their account-opening procedures, such as passports or national health cards, in accordance with the "know your customer" rules already established by the jurisdiction in which they are located.

If there is insufficient documentation to adequately determine the treaty status of an account owner, the QI, a nonqualified intermediary, or a U.S. financial institution must use the presumption rules<sup>11</sup> and apply backup withholding. Backup withholding is regulated separately, reported separately, and processed separately from routine NRA income and withholding. Furthermore, U.S. persons generally are taxed on their

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<sup>10</sup>The limitations on benefits 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 nontreaty country). Accordingly, the limitations on benefits 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.

<sup>11</sup>The presumption rules require that an account owner without acceptable documentation may not be eligible for U.S. tax benefits. Therefore, U.S. source income must be withheld at the 30 percent statutory rate.

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worldwide income. Their income and assets are withheld and reported separately and individually.

One of the principal incentives for foreign financial institutions to become QIs is their ability to retain the anonymity of their client list. QIs may report customer income and withholding information for a group of similar recipients receiving similar benefits, known as “pooled reporting.” NQIs, on the other hand, must reveal the identity of their clients to upstream withholding agents through acceptable documentation in order for their customers to receive treaty benefits as well as interest and capital gains exemptions. Income owned by U.S. taxpayers held offshore may not be pooled and must be reported to IRS individually, either by the QI, NQI, or the last U.S. payor in a chain of payments. Payors of U.S. source income to U.S. taxpayers are not required to withhold from this income, but they must report the income on IRS Form 1099. U.S. taxpayers must report all of their current income on their income tax returns, including U.S. source and foreign source income, as well as ownership of foreign bank accounts and significant ownership in foreign corporations.<sup>12</sup> 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 the 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).

Most of the U.S. source income flowing offshore likely is sent to NRAs but some may be sent to U.S. persons. The income may be sent directly to NRAs 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. Since U.S. persons generally are taxed on their worldwide income, while NRAs are taxed only on certain U.S. source income, the difference in taxation, withholding, and reporting for NRAs and U.S. persons may motivate some U.S. individuals or businesses to seek to appear to be NRAs.

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<sup>12</sup>Under the Bank Secrecy Act, a U.S. person must file a Report of Foreign Bank and Financial Accounts if (1) the person has financial interest in, signature authority, or other authority over one or more accounts in a foreign country and (2) the aggregate value of the accounts exceeds \$10,000 at any time during the calendar year.

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## QI Program Provides Some 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. Because QIs are in overseas locations, they are more likely to have personal contact with NRAs 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 account ownership information and be able to accurately judge whether its customers are who they claim to be.

Under the contract signed with IRS, QIs accept enhanced responsibilities for providing assurance that customers are in fact eligible for treaty benefits and exemptions. All 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 NRA 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 taxation (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, such as a valid driving license, regarding the customer's identity. When determining whether a customer qualifies for treaty benefits, the kinds of documents QIs may use are based upon the local jurisdiction's "know your customer" rules. Because QIs agree to follow specified account-opening procedures, 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. Further, when QIs do not actually perform withholding, the QIs adherence to the account-opening procedures gives greater assurance of proper customer identification than NQIs, who follow account-opening procedures of unknown rigor.

Furthermore, and importantly, QIs agree to contract with independent external auditors 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 report. 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



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IRS's 2004 Voluntary Compliance Program<sup>13</sup> were effectively subject to 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 NRAs 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 because of their pooled reporting. NQIs also can pool results when reporting to upstream withholding agents but, as discussed earlier, must identify all of the individual customers for which they have provided treaty benefits.<sup>14</sup> 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.

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## Weaknesses in the Withholding System Complicate the Identification of the Owner

The overwhelming portion of U.S. source income flows through U.S. withholding agents who may accept self-certifications of identity from indirect account owners that are forwarded by either QIs or NQIs. A high percentage of U.S. source income flows through U.S. withholding agents, but IRS has not determined how much of the income, or the associated withholding, to U.S. withholding agents flows through QIs versus NQIs. While QIs verify the self-certifications with other original account-opening documentation, and those accounts are reviewed externally, NQIs provide somewhat less assurance of proper withholding and reporting than exists under the QI program. On the other hand, most U.S. source income flows to treaty countries that have some working relationship with IRS.

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<sup>13</sup>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.

<sup>14</sup>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. payor in a chain of payments.

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However, establishing a foreign corporation provides a legal mechanism for shielding the identity of the owner of income.

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### The Majority of U.S. Source Income Flows through U.S. Withholding Agents

Although the QI program provides IRS some assurance that tax benefits are being properly applied, a low percentage of U.S. source income flows through QIs. As shown in table 1, for tax year 2003, about 88 percent of U.S. source income reported to IRS was reported by U.S. withholding agents, not QIs.<sup>15</sup> 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 sent 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 report, smaller QIs can obtain a waiver from external reviews). Overall, QIs withheld taxes from U.S. source gross income at more than twice the rate of U.S. withholding agents, 3.7 percent versus 1.5 percent.

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<sup>15</sup>Tax year 2003 is the most recent year for which reliable data are available.

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

Dollars in billions

Amount of U.S. source income reported by withholding agent	U.S. withholding agents					QIs				
	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%
<b>Totals</b>	<b>1,991,057</b>	<b>\$256.7</b>	<b>\$3.9</b>	<b>1.5%</b>	<b>87.5%</b>	<b>42,169</b>	<b>\$36.6</b>	<b>\$1.4</b>	<b>3.7%</b>	<b>12.5%</b>

Source: GAO analysis of IRS data.

Note: Numbers do not add due to rounding.

Even though a high percentage of U.S. source income flows through U.S. withholding agents, IRS has not determined how much of the income, or the associated withholding, to U.S. withholding agents flows through to QIs versus NQIs. Indirectly owned account identity information received from NQIs is a particular weakness because, unlike QIs who contractually agree to verify W-8BEN information with know your customer information, NQIs may accept W-8BENs at face value and forward them to U.S. withholding agents.<sup>16</sup> Therefore, indirect accounts expose the withholding agent and reporting activity to a greater potential for incorrect granting of tax exemptions or treaty benefits due to misinformation or fraud. In 2003, two Large and Mid-sized Business (LMSB) Industry Directives giving guidelines for withholding agent audits were published, which did not address the differences in reporting for direct and indirect account owners. IRS could, but has not yet, analyzed the amount of funds flowing through U.S. withholding agents that flow to QIs versus NQIs

<sup>16</sup>An indirect account holder is any person who receives amounts from a U.S. withholding agent but does not have a direct account relationship with the U.S. withholding agent. Indirect account holders can be nonqualified intermediaries, flow-through entities, or U.S. branches of a foreign bank or insurance company subject to U.S. or state regulatory supervision.

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using information already reported on the Form 1042-S. The 1042-S includes two federal tax identification numbers—one for the payee and one for the payor—and IRS knows which identification numbers are assigned to QIs. Because the Form 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. Doing so may help IRS in assessing the Treasury’s exposure to unaudited documentation and exposure to tax benefits flowing to unaudited accounts. Additionally, this information might help policymakers decide whether documentation requirements should be modified for unaudited accounts or whether other changes should be made to improve the likelihood that tax benefits are properly determined.

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### Most U.S. Source Income Flows to Treaty Countries or Jurisdictions That Have Some Working Relationship with IRS

The jurisdiction of recipients is a major determinant of the applicable withholding rate. The U.S. maintains a network of bilateral tax treaties designed to set out clear tax rules applying to trade and investment between the two nations in order to promote the greatest economic benefit to the United States and its taxpayers. Treaties are intended to eliminate double taxation of taxpayers conducting economic activity in the two jurisdictions by allocating taxing rights between the two countries, establish a mechanism for dealing with disputes between the two taxing authorities, provide for exchange of tax information between the two tax authorities, and reduce withholding tax. Reductions in withholding tax 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, as foreign investors may be for investing in the United States. As of January 2007, there were 54 tax treaties in force, including all members of the Organization of Economic Cooperation and Development (OECD).

In addition to treaty countries, the U.S. has other kinds of relationships with nontreaty countries. For example, the U.S. has signed numerous Tax Information Exchange Agreements (TIEA) with countries with which the U.S. does not have full reciprocal tax rate reduction treaties. TIEAs have less scale and scope than a tax treaty. Furthermore, a number of other countries have made formal commitments to the OECD to work toward the goals of tax administrative transparency and effective exchange of tax information with other countries’ tax authorities in order to countervail harmful tax practices. Having agreed to these principles, these countries are no longer considered to be “tax havens.” However, because of their continued unwillingness to agree to even these two principles, three countries remain on the OECD’s list of “uncooperative tax havens.”

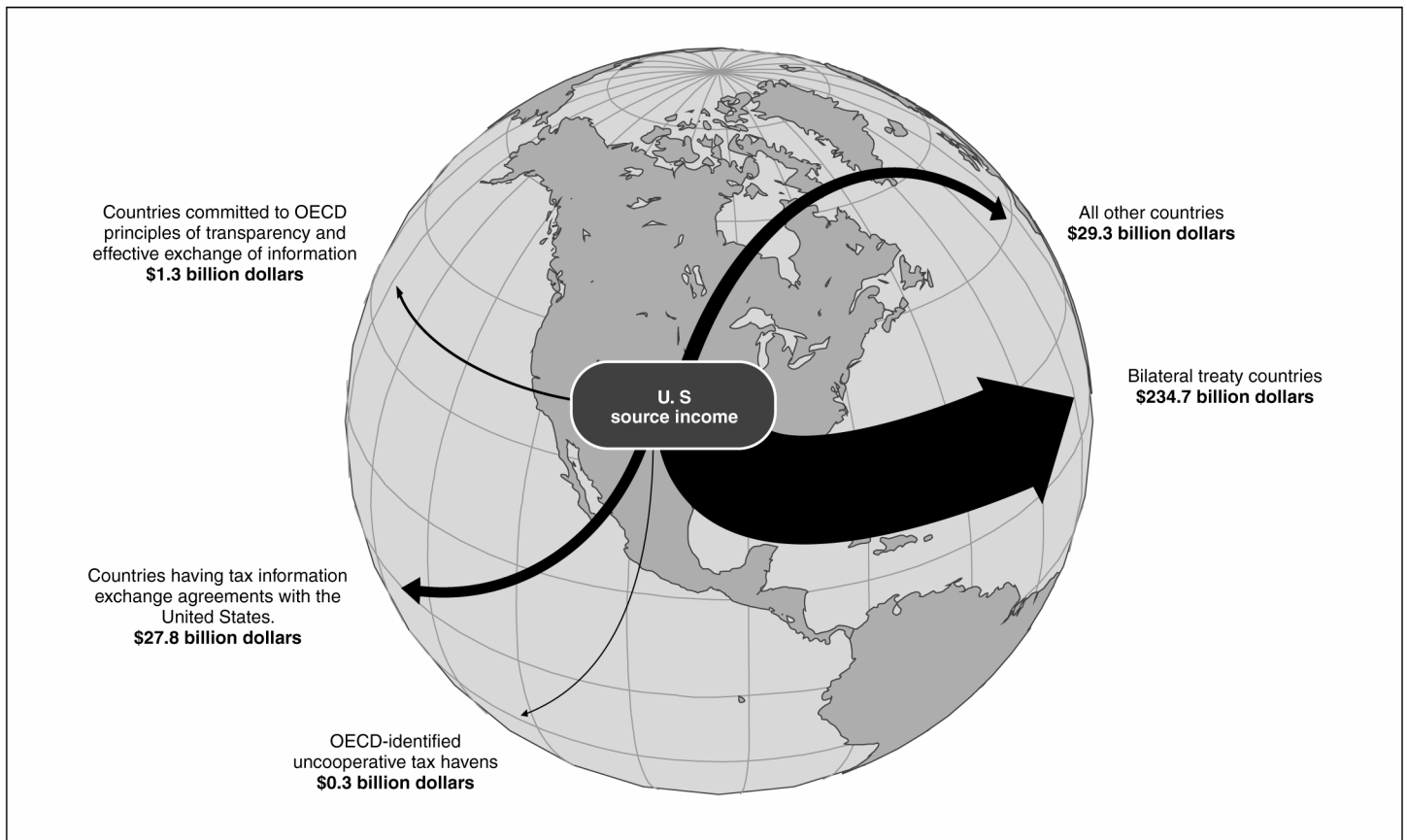
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Although the vast majority of U.S. source income flows outside the QI system, the preponderance flows through countries with which the United States has tax treaties, as shown in figure 2. For tax year 2003, about 80 percent of U.S. source income flowed 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.<sup>17</sup> 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.

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<sup>17</sup>Recipients resident in TIEA countries may have received withholding tax reductions if the type of income earned is exempt from withholding by statute.

**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, 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. These withholding agents 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%	<sup>a</sup>	<sup>a</sup>	2.6%
OECD uncooperative tax havens	\$0.2	<sup>a</sup>	9.3%	<sup>a</sup>	<sup>a</sup>	6.9%
Other countries	\$9.9	\$0.2	1.6%	\$0.3	<sup>a</sup>	1.2%
Undisclosed	\$7.8	\$0.1	1.4%	\$11.3	\$0.4	3.5%
Not listed	<sup>a</sup>	<sup>a</sup>	24.2%	\$0.1	<sup>a</sup>	2.1%
Unidentified	\$7.5	<sup>a</sup>	1.1%	\$11.1	\$0.4	3.5%
Unknown	\$0.3	<sup>a</sup>	8.6%	\$0.1	<sup>a</sup>	12.1%
All countries	\$256.7	\$3.9	1.5%	\$36.6	\$1.4	3.7%

Source: GAO analysis of IRS data.

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 and 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, and U.S. Virgin Islands.

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

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

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

<sup>a</sup>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 undisclosed jurisdictions or with unknown recipients within various countries. These transactions may reflect billions of dollars of reduced tax withholding without proper documentation or reporting to IRS, since eligibility for a reduced rate of withholding must be determined by the claimants' documented nationality, residency, and type of investment.

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Regarding transactions with undisclosed jurisdictions, 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 U.S. withholding agents and \$400 million through QIs) from undisclosed countries. The \$500 million withheld represents a 2.7 percent withholding rate on this income. Since withholding at the 30 percent rate would have yielded about \$5.7 billion in withheld taxes on the \$19 billion in total income, the withholding agents may have erroneously underwithheld as much as \$5.2 billion.

IRS officials did not have information to explain why withholding was only \$500 million on these transactions. Officials said that some of the money flowing to unknown or unidentified jurisdictions could be a by-product of QIs' ability to pool accounts when reporting. For example, if recipients from two nations with the same treaty rates for the same type of income were in a QI reporting pool, the QI would not identify the differing jurisdictions. However, IRS officials did not have information to show to what extent this may have accounted for the QIs' reporting of income flowing to unknown or unidentified jurisdictions. Nor did they have information that would explain why U.S. withholding agents reported money flowing to unknown or unidentified jurisdictions at a reduced withholding rate.

Regarding U.S. withholding agents and QIs' reported transactions with "unknown recipients" within various countries for tax year 2003, U.S. withholding agents and QIs reported a combined \$7 billion of U.S. source income sent to offshore unknown recipients, from which about \$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 nationality, residency, and type of investment. If the 30 percent withholding rate should have been applied to all of the funds flowing to unknown recipients, about \$2.1 billion should have been withheld, or about \$1.9 billion more than what was withheld.<sup>18</sup>

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<sup>18</sup>Some of the transactions may have been reported both with undisclosed jurisdictions and unknown recipients. Therefore, the potential amounts underwithheld should not be added together.



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IRS officials were also unable to explain why our data showed money flowing to unknown recipients and at low withholding rates. They suggested that the unknown recipients might result, in part, from discovery during external audits that the identities of some QI customers were not adequately documented. The QIs would pay the appropriate withholding at the 30 percent rate and issue a 1042-S for “unknown recipient” to prevent the customer from claiming a refund for monies that had not been withheld. Such corrected information on the amount withheld may not have been incorporated into the Statistics of Income (SOI) data base. In addition, IRS officials noted that the Form 1042-S is not clear about how to report tax payments for customers who are not adequately documented. IRS did not have any data or firm information to explain why U.S. withholding agents and QIs reported that \$7 billion of U.S. source income was sent to unknown recipients in tax year 2003.

Two approaches could help IRS determine whether and to what extent this reduced withholding on funds flowing to undisclosed jurisdictions and unknown recipients was proper. First, IRS could analyze data it collects to identify withholding agents who report withholding rates below 30 percent on funds flowing to these types of recipients. IRS officials said they have not done so in the past because the data are not routinely processed and any errors corrected. However, processing and error correction has occurred in several years, including most recently for tax year 2005. Second, using this information IRS could request enhanced external reviews of those QIs that report such withholding and could use the information both as a factor for selecting which U.S. withholding agents it will audit and to focus audit efforts on such reduced withholding. To the extent the enhanced external review of QIs or IRS audits of U.S. withholding agents reveal improper withholding, IRS then could take the appropriate steps to recover withholding taxes that should have been paid and to better ensure that U.S. taxes are withheld when account owners do not properly identify themselves.

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### Establishing a Foreign Corporation Provides a Mechanism for Shielding the Identity of the Owner

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 current U.S. tax law, corporations, including foreign corporations, are treated as the taxpayers and the owners of their assets and 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

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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 NRA 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, persons who own 10 percent or more of the debtor corporation or partnership, or persons failing to meet certain other restrictions.

Withholding agents, regardless of the type of institution, 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.<sup>19</sup> 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 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 no third party reporting to IRS.

Although no one knows the extent to which U.S. persons hide behind domestic and foreign corporations to escape tax on U.S. source income, a recent case shows that this can happen and substantial sums can be

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<sup>19</sup>As discussed earlier, however, under their contract with IRS, QIs are implicitly expected to use know your customer documentation when judging whether a customer's withholding certificate is valid.

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invested. This example occurred before the advent of the QI program, but illustrates how corporations can be misused. In summary:

In April 2007, a federal grand jury indicted an adult entertainment mogul for income tax evasion. The government's complaint alleges that this U.S. person, a resident of Nevada, produced, marketed, sold and distributed videotapes and DVDs through a business incorporated in Oklahoma and operating in California. He also formed a Nevada company to perform marketing, purchasing, and promotional activities on behalf of the Oklahoma/California company. Using nominee shareholders to conceal his ownership, the U.S. person also established an international business corporation in the Cayman Islands which was the named owner of a bank account in Bermuda and a brokerage account in California. The indictment alleges that the U.S. person had about \$15 million transferred from the Bermuda bank account to the California brokerage account, which earned interest income that the U.S. person neither reported, nor for which he paid income taxes. In total, the U.S. government alleges that this U.S. person used a web of U.S. and offshore companies, bank accounts, and brokerage accounts to obscure his ownership, overstate business and personal expenses, and underreport more than \$18 million of his true taxable income for the years 2002-2003.

Foreign corporations received at least \$200 billion, or 68.4 percent, of the \$293.3 billion in total U.S. source income for tax year 2003 (see table 3). From this income, almost \$3 billion was withheld (a 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 <sup>a</sup>	\$96.3	\$0.2	0.22%	\$28.7
Dividends <sup>b</sup>	\$42.4	\$1.9	4.56%	\$10.8
Miscellaneous <sup>c</sup>	\$61.8	\$0.7	1.14%	\$17.8
<b>Total income</b>	<b>\$200.5</b>	<b>\$2.8</b>	<b>1.42%</b>	<b>\$57.3</b>

Source: GAO analysis of IRS data.

<sup>a</sup>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.

<sup>b</sup>Dividends include those paid by U.S. corporations, dividends qualifying for reduced withholding under a tax treaty, and dividends paid by foreign corporations.

<sup>c</sup>Miscellaneous income includes royalties, pensions, compensation for personal services, REIT distributions, notional principal contracts, and other income.

## 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 or NQIs. However, within their limited scope, auditors of QIs are not responsible for following up on possible indications of fraud or illegal acts that could have a material impact on the matters being tested or reporting actual fraud and illegal acts detected, as they would under U.S. Government Auditing Standards.<sup>20</sup> In addition, IRS obtains considerable data from withholding agents but does not make effective use of these 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 reasonable assurance that QIs meet their obligations without imposing such a burden that intermediaries would not participate in the program. 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

<sup>20</sup>GAO-07-731G.

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 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, on 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 <sup>a</sup>
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.

<sup>a</sup>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

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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 raised 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 underwithholding 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 involved 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,

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and will deny the waiver request if the data provided raise 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.

Under current AUPs, the external auditors are required to report whether, based on information from the QI or its own information, the QI is in material violation of, or is under investigation for violation of "know your customer" rules applicable to the QI. However, 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,<sup>21</sup> which does not require auditor follow-up on indications of fraud or illegal acts.

U.S. Government Auditing Standards<sup>22</sup> are more stringent on this topic than the ISRS standards. These 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.

As discussed previously, IRS defines the work to be done in a phase 2 review based on the specific concerns surfaced by the phase 1 report, which is done under the international standards. However, IRS may not have complete information for its decisions about phase 2 procedures, to

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<sup>21</sup>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.

<sup>22</sup>These standards are commonly known as the Yellow Book.

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the extent that AUP reports do not include information about situations or transactions that could indicate fraud, illegal acts, or violations of provisions of contracts that auditors encountered during the engagement.

During the course of our work, IRS officials told us there were several reasons for not requiring external auditors to pursue evidence of fraud or illegal acts in the same manner as required by the U.S. Government Auditing Standards. First, QIs are located in about 70 countries and each country has its own definition and interpretation of fraud. Second, the negotiations involved in establishing the QI program resulted in focused procedures for discrete tasks and specifically excluded procedures involving the exercise of professional judgment. Third, in some countries identifying possible fraud can lead to significant adverse consequences for the audited entity, such as closing the business until the possible fraud is investigated.<sup>23</sup>

Due to the above reasons, the requirements of the U.S. Government Auditing Standards may be challenging to implement across international jurisdictions. However, the objectives can be met through a modified approach. IRS could draw on existing auditing standards to establish a consistent definition of fraud and illegal acts for the purposes of the QI program. For example, U.S. auditing standards define fraud as an intentional act involving the use of deception to obtain an unjust or illegal advantage. The external auditors could be required to report any indications of fraud or illegal acts that could significantly affect the results of the review and that could be readily identified by a qualified auditor in the course of performing normal AUP procedures. IRS then could review the indications of fraud or illegal acts and specify what procedures the auditors should follow in phase 2 to investigate the possible fraud or illegal acts. Finally, if there are situations in which the consequences of adding a requirement on indications of fraud or illegal acts to the QI contract could result in outcomes IRS officials judge to be inappropriate, the provision could be excluded from that contract.

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<sup>23</sup>IRS officials also said that the AUPs already include some steps requiring auditors to alert IRS to possible “know your customer” violations and IRS can ask for additional information during phases 2 and 3 if IRS suspects fraud or illegal acts on the basis of phase 1 results. However, the universe of possible fraud or illegal acts is broader than “know your customer” violations. Further, the on-site auditor is likely to have information beyond that which is currently required to be reported to IRS.



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## 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.<sup>24</sup> 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 Forms 1042-S 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.<sup>25</sup> IRS officials anticipate funding 2006 transcription and error resolution although as of October 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.

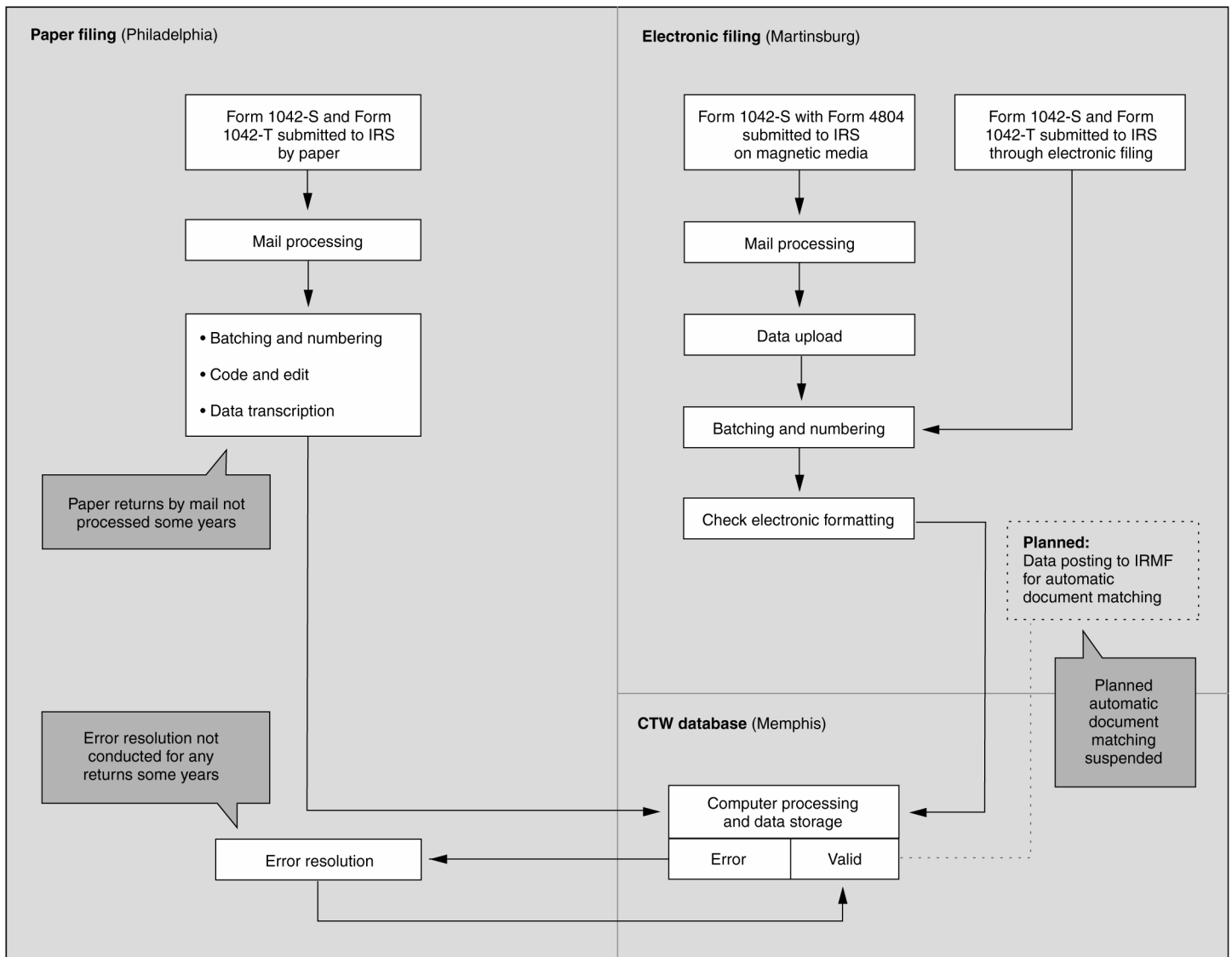
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<sup>24</sup>The 250-or-more electronic filing requirement applies separately to each type of form filed.

<sup>25</sup>In addition to the \$800,000 in transcription and error resolution costs, IRS also incurs an opportunity cost because those resources could be reallocated to revenue producing activities. It is difficult to precisely estimate this opportunity cost without knowing how the resources would be reallocated, but IRS generally estimates that it returns \$4 to the Treasury for every \$1 increase in its budget.

IRS officials told us that LMSB would begin routinely funding transcription and error resolution in the future.

**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.

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As of January 1, 2007, the processing of paper returns was transferred to IRS's campus in Ogden, Utah.

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 underwithheld the amount of tax their customers' owed, or might claim a refund if they overwithheld. 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 overwithheld taxes due.

Because the Form 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 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 to 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.<sup>26</sup>

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

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<sup>26</sup>Data in the CTW system are retained for a period of 3 years as provided by regulation.

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research and evaluate tax policy and administration issues and to identify possibly desirable legislative changes.

IRS's QI program could have the data it needs to review AUP information if it were to require QIs to file electronically. Because withholding agents filing fewer than 250 returns are by law exempted from filing electronically, with the pooling of accounts offered under the QI regime most QIs end up filing paper returns as they have fewer than 250 returns. IRS officials said the statute would need to be changed to require QIs with fewer than 250 returns to file electronically. However, the QI contract states that the agreement may be amended by IRS if it determines that the amendment is needed for the sound administration of the internal revenue laws or regulations. Therefore, IRS could require QIs to file electronically as part of the QI contractual process and avoid the problems plaguing the processing of paper returns.

Other obstacles identified during our work also appear to be surmountable. For example, QIs would incur additional costs to purchase the software to prepare the forms or engage electronic transmittal services, but the basic software can be obtained for less than \$200. Although electronic transmittals sent from certain countries' internet service providers may be blocked by IRS's computer system firewall protections, an IRS official suggested that QIs facing this challenge could utilize the services of their third-party auditors to transmit the data electronically. The third-party auditors often are part of large, multinational auditing firms. Another concern is that in the short term IRS may experience an increased electronic filing error rate as QIs file electronically for the first time and go through a learning curve regarding IRS's data formatting conventions. However, similar problems occurred when the QI program began and were addressed through taxpayer education. For those QIs for whom filing electronically would be an undue hardship, IRS could establish a process for granting waivers similar to the current procedures available for QIs already required to file electronically because they file more than 250 returns annually. Additionally, NQIs falling under the 250-or-more requirement and QIs not choosing not to assume primary withholding responsibilities could still file paper returns, but the smaller number of paper filers might then enable IRS to completely process the paper Forms 1042-S at a reduced cost. Regardless, to the extent QIs contractually agree to electronically file, IRS would have more information to use to manage the program and deter noncompliance and would incur less cost to enter any remaining paper returns into electronic databases.

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## Conclusions

Whether tax is owed on U.S. source income flowing to foreign recipients depends on accurately identifying those recipients. The QI program's features provide some assurance that financial intermediaries in other nations accurately identify recipients of U.S. source income and thereby correctly determine and withhold the proper amount of U.S. tax.

However, because the vast majority of U.S. source income flowing to foreign recipients flows through U.S. withholding agents rather than QIs, their ability to accurately identify foreign recipients also is critical to the correct determination of U.S. tax liability. When dealing with indirect account holders, U.S. withholding agents may rely on the self-certified identity information (W-8 BENs) forwarded by QIs and NQIs for their customers, and NQIs may not have rigorous processes for identifying their account holders. Accordingly, the correct determination of U.S. tax liability may be at risk. IRS receives information on Forms 1042-S that could be used to determine what portion of U.S. withholding agents' accounts are with, and U.S. source income goes to, NQIs and QIs, but it has not done the analysis. Doing so may help IRS in assessing the Treasury's exposure to unaudited documentation and exposure to tax benefits flowing to unaudited accounts. This information might help policymakers decide whether documentation requirements should be modified for unaudited accounts or whether other changes should be made to improve the likelihood that tax benefits are properly determined. In addition, if certain NQIs account for a large portion of U.S. withholding agents' accounts, IRS might be able to take steps to encourage them to join the QI program, and if certain countries are the source of a large portion of the accounts Treasury might focus efforts on improving applicable tax treaties or information exchange agreements.

IRS Form 1042-S data on the flow of U.S. source income to foreign recipients in unidentified jurisdictions or to unknown recipients suggest 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 as well as with unknown recipients across all jurisdictions. In general, lacking proper identification of a customer, including the customer's residence, U.S. withholding agents and QIs should withhold at the 30 percent rate. Yet withholding on the money flowing to undisclosed jurisdictions and to unidentified recipients was 2.7 and 3.4 percent, respectively. If the 30 percent withholding rate should have been applied to all or a significant portion of the funds flowing to unknown jurisdictions or to unknown recipients, several billion dollars more in taxes should have been withheld. Although IRS officials suggested some scenarios exist where a specific jurisdiction might not be identified in reporting to IRS or where a QI might purposely use the term unknown

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recipient when reporting to IRS, they had no data to show that the funds flowing to undisclosed jurisdictions or unknown recipients were properly taxed.

Although account-opening and withholding procedures for QIs may give IRS greater assurance that treaty benefits are properly provided, the effectiveness of those procedures is not assessed until the external auditors review a sample of accounts as required by the AUPs. However, the QI contract does not require the auditors to report indications of fraud or illegal acts that could materially affect the results of the AUP review. Under U.S. Government Auditing Standards, additional follow-up work is required in such cases. In the QI environment, this objective could be met through a requirement for auditors to report to the QI program office that they found indications of fraud or illegal acts, which the program office would consider in determining whether and to what extent phase 2 procedures should be conducted.

Furthermore, to better administer all withholding and reporting activities (by QIs and U.S. withholding agents) IRS needs reliable 1042-S data. However, Form 1042-S data have not been completely processed every year. IRS officials point to a lack of available funding. In those years, the identity, jurisdiction, and income and withholding data generated by withholding and reporting agents are inadequate for use by IRS, Treasury, or Congress. These data would be available if IRS required QIs to file electronically as part of their contractual agreement and completed its processing. Although QIs might incur some additional expense, IRS would have readier access to more complete data as well as saving the resources currently devoted to perfecting and entering data reported on paper forms. Because such a requirement could be part of contracts with QIs, if in certain cases electronic filing is not feasible, the contract could exclude this provision.

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## Recommendations

We recommend that the Commissioner of Internal Revenue Service do the following:

- Measure U.S. withholding agents' reliance on self-certified documentation and use that data in IRS compliance efforts.
- Determine why U.S. withholding agents and QIs report billions of dollars in funds flowing to unknown jurisdictions and to unidentified recipients. Based on this determination, IRS should take appropriate steps to recover any withholding taxes that should have been paid and

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to better ensure that U.S. taxes are withheld when account owners do not properly identify themselves.

- Work to enhance AUPs by requiring the external auditor to report any indications of fraud or illegal acts that could significantly affect the results of the review. Under current AUPs, the external auditor is required to report whether, based on information from the QI or its own information, the QI is in material violation of, or is under investigation for violation of “know your customer” rules applicable to the QI. IRS should direct the head of the QI program office to expand this reporting requirement in the QI contractual agreement to require the external auditor to report any indications of fraud or illegal acts encountered while performing AUPs that could significantly affect the results of the review. This would give the QI program office the information necessary to pursue any indications of significant fraud or illegal acts identified during the AUP review through additional targeted procedures in phase 2 of the AUPs.
- Require electronic filing of forms in QI contracts whenever possible, thereby reducing the need to manually process data reported from abroad. Further, IRS should invest the funds necessary to perfect these data.

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## Agency Comments and Our Evaluation

The Acting Commissioner of Internal Revenue provided comments on a draft of this report in a December 7, 2007, letter, which is reprinted in appendix II. The Acting Commissioner generally agreed with our recommendations to improve the QI program, but in several cases her detailed comments are not fully consistent with our recommendations.

IRS agreed it would be beneficial to investigate both the use of U.S. withholding agents’ reliance on self-certified identity documents and why withholding agents reported billions of dollars in tax benefits flowing to unknown jurisdictions and unidentified recipients. However, for the first recommendation, IRS’s detailed comments focused on examining the accuracy of the self-certified documents, rather than systematically measuring U.S. withholding agents’ exposure to unverified documentation to determine how large or small a challenge this documentation is to the integrity of the U.S. withholding system. Although better understanding the accuracy of self-certified documents is laudable, we believe a systematic measurement of agents’ reliance on such documents, which can be made with information IRS already receives, would both assist IRS in targeting enforcement efforts and inform policymakers’ judgments

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about the current reporting regime. For the second recommendation, the Acting Commissioner agreed to determine why withholding agents reported billions of dollars of tax benefits to unknown jurisdictions and unidentified recipients, and proposed to develop a methodology to determine the extent of this underwithholding.

Regarding the third recommendation covering indications of fraud or illegal acts, although IRS agrees that QIs should provide information indicating fraud or illegal acts, it also states concern about defining fraud and illegal acts and requiring auditors to report such information when dealing with at least 70 countries, 60 of which are non-English-speaking. In addition, IRS pointed to certain current QI requirements that provide IRS with some information on fraud and illegal acts. However, as discussed in our draft report, we believe IRS could draw on existing auditing standards to establish a consistent definition of fraud and illegal acts for the purposes of the QI program. In addition, the provisions to which IRS refers rely in part on self-reporting by the QI and in part focus on “know your customer” rule violations alone. However, self-reporting by the QI is not equivalent to judgments by the auditors about whether fraud or illegal acts have occurred. And the universe of potential fraud or illegal acts extends beyond potential violations of “know your customer” rules. Therefore we reaffirm our recommendation.

Finally, IRS agreed that there are benefits to electronic filing of tax Forms 1042 and 1042-S, but said such a requirement would be a burden for QIs that file only a few (3 or fewer) forms. IRS said it has implemented a procedure to include an application to electronically file for all QIs applying for or renewing participation in the program. If IRS were to require all QIs to electronically file, we believe any burdens filers of few forms would face could be addressed by offering them a waiver opportunity similar to waivers that are available to all institutions that are currently required to file electronically (those that file more than 250 returns). Requiring electronic filing whenever possible would reduce IRS’s costs and improve the timeliness and accuracy of data for program oversight. We have added language regarding the opportunity for seeking a waiver to the report based on IRS’s comment.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the issue date. At that time, we will send copies of this report to appropriate congressional committees and the Acting Commissioner of Internal Revenue. We also will make copies available to others upon request. In



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addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions concerning this report, please contact me at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

A handwritten signature in black ink that reads "Michael Brostek". The signature is written in a cursive style with a large initial "M".

Michael Brostek  
Director, Tax Issues  
Strategic Issues Team

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# Appendix I: Objectives, Scope, and Methodology

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The objectives of this report are to (1) describe features of the Qualified Intermediary (QI) program intended to improve withholding and reporting, (2) assess whether weaknesses exist in the U.S. withholding system that complicate identifying beneficial owners of U.S. source income, and (3) determine whether weaknesses exist in QI external reviews and the Internal Revenue Service's (IRS) use of program data.

To address our objectives, we reviewed various IRS documents and interviewed IRS officials in the QI program office and U.S. withholding program audit staff, Large and Mid-sized Business (LMSB) International, and IRS Counsel, as well as Department of the Treasury (Treasury) officials in the Office of Tax Policy and FinCEN. Furthermore, we spoke with private practitioners involved in the development and implementation of the QI program. We reviewed various studies and reports on foreign investment and banking practices. We reviewed the auditing requirements contained in the QI agreement and other standards, such as the U.S. Government Auditing Standards and the international standards on agreed-upon procedures (AUP) and visited IRS's Philadelphia Campus, which was responsible during our review for processing information returns submitted by some QIs.

Withholding data used in this report were reported by withholding agents and edited by IRS. During the 2002-2003 period, paper withholding information returns were processed at IRS's Philadelphia Campus and electronic returns and information returns were processed in Martinsburg, West Virginia. IRS's Statistics of Income (SOI) staff collected this information, made several adjustments and additions to the data described below, and performed several quality control checks to the data. As a result, these were the most recent data available.

Because payments may have flowed through tiers of intermediaries before reaching the owner of the income, SOI stratified payment information by the type of withholding agent. It then became possible to subtract payments made from one intermediary to another, eliminating possible double or multiple counting of one payment. Furthermore, withholding instructions issued under the new 2001 regulations required withholding agents to report U.S. source income and withholding information to IRS in whole dollar figures. However, not all agents followed these instructions, instead reporting income and tax figures in dollars and cents. This resulted in an error factor of 100 for some reported payments. In order to correct these errors, SOI compared income and tax totals for certain withholding agents with information from prior years for reasonableness, identifying 25

agents whose information required adjustment by a factor of 100. The IRS database was modified accordingly.

We determined that these data were sufficiently reliable for the purposes of describing the QI 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 analyzed IRS data on U.S. source income that flowed overseas for tax years 2002 and 2003. The data do not include an unknown amount of activity that was unreported. In order to calculate tax benefits by type of recipient, by destination of account, and by income type, we multiplied the gross U.S. source income sent offshore by 30 percent, required by IRC Section 1441, and then subtracted the income actually withheld, and presumed to be sent to the Treasury. To measure the withholding rates by type of recipient, by destination of account, and by income type, we divided the actual monies withheld, and presumed to be paid to the Treasury, by the gross U.S. source income sent offshore.

IRS AUP guidance requires third-party reviewers to sample QI accounts. IRS provides guidance on the sample size using a standard statistical formula and a decision rule. We reviewed the sampling methodology used in the AUPs and found that it was adequate to identify problems with the accounts.

# Appendix II: Comments from the Internal Revenue Service



COMMISSIONER

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

December 7, 2007

Mr. Michael Brostek  
Director, Tax Issues  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. Brostek:

Thank you for providing your draft report entitled "*Tax Compliance: Qualified Intermediary Program Provides Some Assurance that Taxes on Foreign Investors Are Withheld and Reported but Can Be Improved*" (GAO-08-99) for our review and comments before the final report is issued. I am pleased the GAO recognizes that the Qualified Intermediary (QI) Program provides the Internal Revenue Service (IRS) some assurance that tax on U.S. source income sent offshore is properly withheld and reported. I generally agree with your recommendations to further improve the QI Program, and I have enclosed a detailed response to address your audit recommendations.

The QI Program started in 2000 when about \$1.9 billion was withheld for tax on U.S. sourced income moving offshore. About \$5 billion was withheld in 2003. This amount represents a 250 percent increase since the program was implemented. The QI Program is a significant reason for this improved compliance.

To increase voluntary compliance by U.S. withholding agents, we conducted a Voluntary Compliance (VC) Program from 2004 to 2006. This was an initiative on the amount of tax reported, tax withholding, and reporting obligations that applied to withholding agents in connection with payments to foreign persons. Approximately 500 entities participated in the VC Program. This resulted in a significant reporting of income and additional withholding tax.

We also implemented the Broker Initiative Project in which we are examining forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, filed by U.S. clearing brokers. These "dual purpose" examinations are assessing the withholding and information reporting compliance of the withholding agent as well as the tax compliance of U.S. beneficial owners of U.S. brokerage accounts held in the name of nominee entities domiciled in secrecy jurisdictions.

In addition, we implemented the U.S. Withholding Agent (USWA) Program this year. The USWA Program Team was convened to follow up with the VC Program

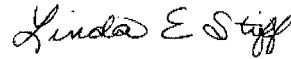
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participants, examine forms 1042, and participate in outreach activities at professional conferences such as tax forums.

We believe that the combined impact of the QI, VC, and USWA programs and the Broker Initiative Project will further improve compliance efforts to ensure the proper amount of tax is withheld on U.S. source income moving offshore.

I appreciate the time the GAO Team spent reviewing our QI Program and its recommendations for improvement. If you have any questions or need any additional information to clarify our comments and/or response to the audit recommendations, please contact Walter L. Harris, Director, Financial Services Industry, at (212) 298-2048.

Sincerely,



Linda E. Stiff  
Acting Commissioner

Enclosure

Enclosure

The GAO recommends that the IRS Commissioner:

**RECOMMENDATION 1:**

Measure U.S. withholding agents' reliance on self-certified documentation and use that data in IRS' compliance efforts.

**RESPONSE:**

We agree it would be beneficial to determine the compliance effect of U.S. withholding agents' self-certified documentation. We will study the feasibility for a process to measure the accuracy of the self-certified documentation.

In early 2007, we formed a separate USWA Program. The manager and some team members were formerly with the QI Program. Some of the objectives of the USWA Program are to follow up with the participants of the VC Program, examine forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and participate in outreach events such as tax forums.

The USWA Program is currently examining forms 1042. During these examinations, we have reviewed some forms W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Withholding, and have observed some deficiencies. However, we did not view them as significant in relation to the whole program. Therefore, we will continue to review self-certified documentation from withholding agents during examinations of the forms 1042 and 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. In addition, we will gather information and provide guidance on self-certified documentation through our VCP follow up and outreach activities. We post our findings on our Website and use the information on subsequent examinations. We also communicate our findings at outreach activities to change withholding agents' reliance on accepting forms W-8BEN at face value.

We also implemented the Broker Initiative Project in which we are examining forms 1042 filed by U.S. clearing brokers. These "dual purpose" examinations are assessing the withholding and information reporting compliance of the withholding agent as well as the tax compliance of U.S. beneficial owners of U.S. brokerage accounts held in the name of nominee entities domiciled in secrecy jurisdictions. This project is currently in the pilot phase. As it continues, we expect improved compliance by withholding agents and U.S. beneficial owners of brokerage accounts.

**RECOMMENDATION 2:**

Determine why U.S. withholding agents and QIs report billions of dollars in funds flowing to unknown jurisdictions and to unidentified recipients. Based on this determination,

IRS should take appropriate steps to recover any withholding taxes that should have been paid and to better ensure that U.S. taxes are withheld when account owners do not properly identify themselves.

**Response:**

We agree that further investigation into the extent and reasons why withholding agents report undisclosed jurisdictions and unidentified recipients may be necessary. We will investigate the extent of the underwithholding and take appropriate actions to recover any withholding taxes that should have been paid if our investigation confirms any underwithholding. We anticipate that our investigation into this matter will require development of a methodology or process to determine the extent of the underwithholding, cross-functional coordination, and agreements on information sharing.

During Form 1042 examinations and QI audit reviews, the USWA and QI programs routinely review and question withholding agents and QIs about forms 1042-S that show undisclosed jurisdiction and unidentified recipients. A number of forms 1042-S included a complete address with country in the address box (2003 Form 1042-S, box 13), but the country code was left blank (2003 Form 1042-S, box 16). We have observed some forms 1042-S with incorrect country codes. For example, the address box may show an address in London, England, but the country code entered was ENG or GB. The correct code should only be UK. We inform the withholding agents about the errors and request they file amended forms 1042-S with the correct country codes.

Statistics of Income (SOI) prepared a special report for GAO on U.S. source capital income data, including data from forms 1042 and 1042-S for 2002-2003. Since there are some systemic issues associated with processing, matching, and reconciling the form contents, we believe that the reported unidentified and undisclosed transactions may be somewhat less than what is reported in the SOI report. To illustrate, if the country code was blank, no attempts were made to cross-reference it to another field such as address. Therefore, it would be categorized as unidentified or undisclosed.

**RECOMMENDATION 3:**

Work to enhance agreed-upon procedures (AUPs) by requiring the external auditor to report any indications of fraud or illegal acts that could significantly affect the results of the review. IRS should direct the head of the QI Program office to expand this reporting requirement in the QI contractual agreement to require the external auditor to report any indications of fraud or illegal acts encountered while performing AUPs that could significantly affect the results of the review. This would give the QI Program office the information necessary to pursue any indications of significant fraud or illegal acts identified during the AUP review through additional targeted procedures in phase 2 of the AUPs.

**Response:**

We agree QIs should provide any information indicating fraud or illegal acts. However, an attempt to define fraud and illegal acts in at least 70 countries (60 non-English speaking) would be extremely complex and complicated. Current AUPs include two sections that provide some guidance or indications addressing fraud or illegal acts. One section requires the external auditor to obtain a letter from the QI stating it is in material violation or under investigation for violation of know-your-customer (KYC) rules. This section also requires the external auditor to state if they are aware of any violation or investigations of KYC rules by the QI. Another section of the AUP requires the QIs to report on U.S. accounts removed to avoid an AUP. In addition, indications of fraud or illegal activities are addressed during the Phase 2 review, when we contact the external auditor, and during the Phase 3 review, when we meet with the QI.

Therefore, current AUPs and the QI Program include opportunities for QIs to report indications of fraud or illegal acts. We are concerned that GAO's suggestion to require the reporting and pursuing of indications of fraud or illegal acts may have repercussions on our broader relationship (economic, political, and cultural) with various countries, and we have to carefully consider those consequences.

**RECOMMENDATION 4:**

Require electronic filing of forms in QI contracts whenever possible, thereby reducing the need to manually process data reported from abroad. Further, IRS should invest the funds necessary to perfect these data.

**Response:**

We agree with the benefits of electronic filing and perfecting the data. However, we recognize the burden issues with some QIs who only file a few (three or less) forms 1042-S.

The QI Program has implemented the procedure to include Form 4419, Application for Filing Information Returns Electronically, to all QI applications and renewals. The majority of QIs receiving this form file electronically. In addition, we have continued to fund the transcription of Form 1042-S and error resolution for fiscal year 2008 and plan to use 1042-S data for compliance purposes (e.g., assembling databases for analysis and testing). We expect continued funding in the future beyond current levels.



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# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

Michael Brostek, (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov)

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## Acknowledgments

In addition to the contact person named above, Jonda Van Pelt, Assistant Director; Susan Baker; Amy Friedheim; Evan Gilman; Shirley Jones; Donna Miller; John Saylor; Joan Vogel; and Elwood White made key contributions to this report.

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