TAX COMPLIANCE

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

GAO Accountability·Integrity·Reliability

Highlights

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

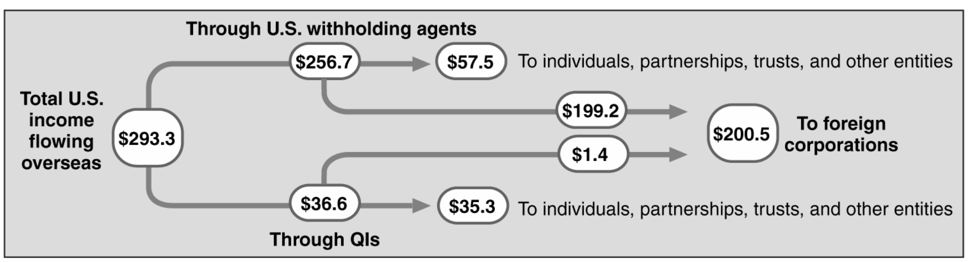
What GAO Found

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 disbursal of tax benefits. IRS could require electronic filing by QIs whenever possible.