Program Improvements Are Needed to Encourage Taxpayer Compliance in Reporting Foreign Sourced Income

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

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MEMORANDUM FOR COMMISSIONER LANGDON, LARGE AND MID-SIZE BUSINESS DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Program Improvements Are Needed to Encourage Taxpayer Compliance in Reporting Foreign Sourced Income

This report presents the results of our review of taxpayer compliance in reporting foreign sourced income. In summary, the Internal Revenue Service (IRS) has (b)(7)(E) [redacted] The IRS did not adequately address previously reported recommendations, which included reviewing operations to measure the overall effect of foreign sourced income on compliance efforts, and (b)(7)(E) [redacted] Additionally, much of the information the IRS receives on foreign sourced income is (b)(7)(E) [redacted]

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TDP 15-71 [redacted]

Management's response was due on February 26, 2001. As of February 28, 2001, management had not responded to the draft report.

Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

Table of Contents

Program Improvements Are Needed to Encourage Taxpayer Compliance in Reporting Foreign Sourced Income

Executive Summary

One of the Internal Revenue Service's (IRS) strategic goals is to provide top quality service to all taxpayers. This means that the IRS strives to apply the law with integrity and fairness so that those taxpayers who do not comply are not allowed to place a burden on those who do comply. To help determine whether it is reaching this goal, the IRS is developing compliance measures. One measure is "reporting" compliance, which is the percentage of tax liability reported on filed returns.

The Large and Mid-Size Business (LMSB) Division has identified business globalization as a strategic impact area. United States (U.S.) residents[1] make significant foreign investments, and these residents are taxed on their worldwide income. Investments abroad have been growing in recent years, increasing from $1.3 trillion in 1995 to $2.6 trillion in 1999. To assist in identifying income paid to U.S. residents, the IRS has a Routine Exchange of Information Program (REIP), under which it routinely exchanges information with 20 countries. As part of this program, the IRS receives paper documents and magnetic tapes listing foreign sourced income paid to U.S. residents. In reporting years 1996 through 1998, foreign countries reported at least $261 billion in income received by U.S. residents.

An IRS Inspection Service (now Treasury Inspector General for Tax Administration) report titled, *Review of the Internal Revenue Service's Efforts to Ensure Compliance of Taxpayers Receiving Foreign Sourced Income* (Reference Number 072208, dated April 2, 1997), noted that the IRS did not (b)(7)(E) [redacted] The overall objective of our review was to follow up on the previously identified conditions and determine whether the actions taken in response to the prior audit report have corrected the problems or whether the risks still exist.

Results

The IRS needs to apply the tax law with fairness to all. (b)(7)(E) [redacted] The IRS needs to improve its program

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[1] We use the term "resident" to include U.S. citizens and resident aliens. Resident aliens are generally taxed in the same way as U.S. citizens.

to address the reporting compliance of taxpayers receiving billions of dollars in foreign sourced income.

Although management has taken some actions to address the recommendations in the prior audit report, the IRS is in no better position today to (b)(7)(E) [redacted]

(b)(7)(E) [redacted] This is significant because limited sample tests by both the International function and the Office of Audit indicated potential non-compliance in reporting foreign sourced income.

Recommendations from the Prior Audit Report Have Not Been Fully Addressed

The IRS has not taken actions to address the prior audit report's most significant recommendations. The recommended actions included reviewing operations to measure the REIP's overall effect on compliance, and (b)(7)(E) [redacted] The IRS needs these processes if it is to have an effective program to verify compliance levels involving the reporting of billions of dollars in foreign sourced income.

(b)(7)(E) [redacted]

The IRS receives foreign sourced income information documents in both paper and magnetic formats. However, (b)(7)(E) [redacted] Specifically, no more than 2 percent ($0.6 billion in paper documents of a total of $26.4 billion in paper and magnetic documents for 1998) of the foreign sourced income reported (b)(7)(E) [redacted]

[2] The U.S. has entered into bilateral income tax conventions, commonly called tax treaties, with foreign governments. Tax treaties address the problems of double taxation which result when two countries assert taxing jurisdiction over the same persons or transactions.

(b)(7)(E) [redacted]

(b)(7)(E) [redacted]

(b)(7)(E) [redacted] However, no information is available on the results obtained from the use of those documents. (b)(7)(E) [redacted]

Summary of Recommendations

The LMSB Division needs to implement the previously identified recommendations and establish a formal program with goals, objectives, processes and measures to improve the use of the REIP for compliance. In addition, the U.S. Competent Authority,[4] who is responsible for establishing and monitoring Tax Information Exchange Agreements and pursuing increased global coordination, should identify the highest risk foreign sourced income documents and coordinate with tax treaty partners (b)(7)(E) [redacted]

Management's Response: Management's response was due on February 26, 2001. As of February 28, 2001, management had not responded to the draft report.

[4] This individual is the Director of International, reporting to the Commissioner, LMSB Division.

Objective and Scope

The overall objective of our review was to follow up on the previously identified conditions and determine whether the actions taken in response to the prior audit report have corrected the problems or whether the risks still exist.

An Internal Revenue Service (IRS) Inspection Service (now Treasury Inspector General for Tax Administration) report titled, *Review of the Internal Revenue Service's Efforts to Ensure Compliance of Taxpayers Receiving Foreign Sourced Income* (Reference Number 072208, dated April 2, 1997), noted that the IRS did not (b)(7)(E) [redacted] The overall objective of our review was to follow up on the previously identified conditions and determine whether the actions taken in response to the prior audit report have corrected the problems or whether the risks still exist.

To accomplish our objective, we:

- Determined the status of corrective actions and evaluated the adequacy of those that have been completed.
- Assessed the validity of magnetic data received and evaluated the usefulness and timeliness of exchange of information documents.
- Assessed the IRS' plans to effectively process the magnetically filed information documents.

We conducted our audit at the Office of the Director, International, between April and December 2000. The audit was conducted in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

One of the IRS' strategic goals is to provide top quality service to all taxpayers. This means that the IRS strives to apply the law with integrity and fairness so that those taxpayers who do not comply are not allowed to place a burden on those who do comply. To help determine whether it is reaching this goal, the IRS is developing compliance measures. One measure is "reporting" compliance, which is the percentage of tax liability reported on filed returns.

The LMSB Division has recognized the challenge that the expansion of the global economy presents to tax administration.

The Large and Mid-Size Business (LMSB) Division has identified business globalization as a strategic impact area. United States (U.S.) residents[1] make significant foreign investments, and these residents are taxed on their worldwide income. Investments abroad have been growing in recent years, increasing from $1.3 trillion in 1995 to $2.6 trillion in 1999. To assist in identifying income paid to U.S. residents, the IRS has the REIP, under which it routinely exchanges information with 20 countries. As part of this program, the IRS receives paper documents and magnetic tapes listing foreign sourced income paid to U.S. residents. In reporting years 1996 through 1998, foreign countries reported at least $261 billion in income received by U.S. residents.

Results

The IRS needs to improve its program to address the reporting compliance of taxpayers receiving billions of dollars in foreign sourced income.

The IRS needs to apply the tax law with fairness to all. (b)(7)(E) [redacted] The IRS

[1] We use the term "resident" to include U.S. citizens and resident aliens. Resident aliens are generally taxed in the same way as U.S. citizens.

needs to improve its program to address the reporting compliance of taxpayers receiving billions of dollars in foreign sourced income.

Although management has taken some actions to address the recommendations in the prior audit report, the IRS is in no better position today to (b)(7)(E) [redacted]

(b)(7)(E) [redacted] This is significant because both the International function and the Office of Audit identified potential reporting non-compliance in limited sample tests

Recommendations from the Prior Audit Report Have Not Been Fully Addressed

The General Accounting Office's *Standards for Internal Control in the Federal Government* require that monitoring of internal control include policies and procedures for ensuring that the findings of audits and other reviews are promptly resolved. Among other things, managers are to complete, within established time frames, all actions that correct or otherwise resolve the matters brought to their attention.

The IRS has taken actions to correct some of the prior audit report's findings. These actions include clarifying the Internal Revenue Manual's (IRM) procedures for

[2] The U.S. has entered into bilateral income tax conventions, commonly called tax treaties, with foreign governments. Tax treaties address the problems of double taxation which result when two countries assert taxing jurisdiction over the same persons or transactions.

processing paper REIP data. Revised publications and instructions for tax forms concerning foreign sourced income now emphasize the reporting of that income. Additionally, management augmented the IRM's instructions and enhanced training for tax examiners who audit the foreign sourced income tax issue.

The IRS has not taken actions to address the prior audit report's most significant recommendations.

However, management has not taken actions to completely address the two most significant prior recommendations. These issues concern reviewing operations to measure the overall effect of the REIP on compliance efforts, and (b)(7)(E) [redacted]

Reviewing operations to measure the overall effect of the REIP on compliance efforts

The prior report recommended that the IRS conduct a review to measure the role the REIP should play in relation to overall compliance efforts. The primary action taken in response to this recommendation was a study undertaken by the District Office Research and Analysis (DORA) section of the International function.

The IRS' actions do not provide a baseline to measure the effect of the REIP on compliance efforts.

The DORA report provided analyses on volumes, types of income and recipients. The report made recommendations for improving tax identification number systems and designing a compliance strategy. However, the International function indicated that these recommendations have not been acted upon and the results of the report have not been shared with any responsible officials. Consequently, the DORA report does not provide a baseline to measure the effect of the REIP on compliance efforts.

As envisioned in the prior recommendation, the review of the REIP's compliance efforts should focus on how to develop systems to evaluate the impact of the REIP activities to assign resources, target enforcement efforts, and make better use of information and technology. The IRS has not effectively addressed these concerns because management has not placed sufficient priority on the program. For example, IRS management has not

(b)(7)(E) [redacted]

established any goals or objectives for the program. As a result, the IRS does not have an effective program to measure the proportional emphasis the REIP should have on overall compliance efforts.

(b)(7)(E) [redacted]

The key recommendation in the prior audit report was for the IRS to (b)(7)(E) [redacted]

The International function has created a database of magnetically transmitted foreign data for review purposes. (b)(7)(E) [redacted] The Tax Systems Modernization (TSM) program initially contained funding for the system. But the TSM program no longer exists, and the system has still not been developed because no alternate funding is available.

Recommendation

1. The Commissioner, LMSB Division, should take actions to ensure the prior recommendations are implemented. Establishing a formal program with goals, objectives, processes and measures could help ensure that sufficient management attention is devoted to improving the use of the REIP for compliance.

   Management's Response: Management's response was due on February 26, 2001. As of

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[3] The AUR matches information reported for both domestic and foreign sources to individuals' tax returns.

February 28, 2001, management had not responded to the draft report.

(b)(7)(E) [redacted]

Only a small percentage of the documents the IRS receives (b)(7)(E) [redacted]

The IRS receives foreign sourced information documents in both paper and magnetic formats. However, (b)(7)(E) [redacted] For example, according to the DORA report, for data processed in 1997, the IRS received 36,675 paper documents reporting $111 billion in foreign sourced income. (b)(7)(E) [redacted]

The DORA study reported similar usability limitations with magnetic data for 1996 and 1997. Our analysis of all 1998 magnetic data files confirmed the DORA study's results. For 1998, the IRS received 627,050 magnetic documents reporting $25.8 billion. However, only 212,949 documents, reporting $3.5 billion, (b)(7)(E) [redacted]

In 1998, the IRS processed $0.6 billion in paper documents.[5] It received additional paper documents that were not usable, but it has no records of the number and

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[4] (b)(7)(E) [redacted]

[5] The numbers reported can fluctuate greatly from year to year. One reason is that the reporting countries can report up to 3 years' information at one time. For example, of the $111 billion reported on paper documents in 1997, $101 billion was from one country, [redacted] (b)(7)(E)

dollar amounts of the unusable documents. This means that for 1998, no more than 2 percent ($0.6 billion in paper documents of a total of $26.4 billion in paper and magnetic documents) of the foreign sourced income reported (b)(7)(E) [redacted] (b)(7)(E) [redacted] This large volume of data is not usable because the IRS and tax treaty partners exchange information only on a cooperative basis within the limitations of foreign bank secrecy laws.[6]

The LMSB Division's strategic assessment summary states that the IRS needs to address global issues by using tax treaty provisions to identify, address, and resolve complex international issues. The tax treaty partners need to work together to address and resolve common issues, minimizing double taxation and ensuring consistency through sharing of knowledge and experience.

(b)(7)(E) [redacted]

(b)(7)(E) [redacted] This is significant because both the International function and the Office of Audit identified potential non-compliance in reporting foreign sourced income in limited sample tests. The prior audit report commented that the dollars involved in cases with discrepancies in reporting foreign sourced income could be 18 percent higher than the average case reporting only domestic income. A limited International function study of 1997 information supplied by Germany indicated nearly a 25 percent rate of potential under-

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[6] The Organization for Economic Cooperation and Development (OECD) consists of 29 countries and provides governments a setting in which to discuss, develop and perfect economic and social policy. Representatives of these governments compare experiences, seek answers to common problems and work to coordinate domestic and international policies. The OECD's April 2000 report titled, *Improving Access to Bank Information for Tax Purposes*, stated that member countries should permit access to bank information for tax purposes, but should also support the broader role that bank secrecy plays in protecting the confidentiality of financial information.

reporting. Our analysis of German information for a sample of 65 taxpayers' 1998 returns showed $1,781,742 in potential underreporting in 17 (26 percent) of the cases. Taxpayer contact would be necessary to verify whether all income was, in fact, reported.

Recommendation

2. The U.S. Competent Authority,[7] who is responsible for establishing and monitoring Tax Information Exchange Agreements and pursuing increased global coordination, should identify the highest risk foreign source income documents. The U.S. Competent Authority should then use these documents to coordinate with tax treaty partners (b)(7)(E) [redacted] Processes should then be developed to verify these taxpayers' reporting compliance.

(b)(7)(E) [redacted]

The IRS needs to increase efforts to employ usable foreign sourced income information in its compliance programs.

As previously stated, (b)(7)(E) [redacted] While paper documents were included in the program for 1997 and 1998, no information is available on the results obtained from the use of those documents.

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[7] This individual is the Director of International, reporting to the Commissioner, LMSB Division.

In 1992, the OECD developed a standardized format for tax treaty partners to submit magnetic data.[8] (b)(7)(E) [redacted]

Our analysis of the 1998 magnetic data showed that about 163,000 of the documents, reporting approximately $452 million, were for individual taxpayers (b)(7)(E) [redacted][9] Likewise, usable information reported on corporations could be used in other compliance programs, such as during the examination of returns.

The *Standards for Internal Control in the Federal Government* state that internal control should provide reasonable assurance that the objectives of an agency are being achieved. These encompass the effectiveness and efficiency of operations, including the use of the entity's resources, and compliance with applicable laws and regulations. One of the strategic initiatives in the LMSB Division's Strategic and Program Plan is to build a tax administration to effectively deal with globalization to address specific areas of non-compliance. (b)(7)(E) [redacted]

Recommendation

3. The LMSB Division's Director of Business Systems Planning, who is responsible for articulating business needs and filling gaps in processes, (b)(7)(E) [redacted] and develop procedures to

[8] The OECD developed this non-binding format for magnetic information exchange under its Model Tax Convention.
[9] Timing is a consideration in that the information would have to be received within defined processing cycles to be included in the AUR.

use data for businesses in other compliance programs.

Conclusion

The IRS needs to develop programs to determine compliance levels in reporting foreign sourced income and encourage improved data reporting through tax treaty partners.

The IRS has recognized the challenge that the expansion of the global economy presents to tax administration, and has developed strategies to address it. To help effectively meet that challenge, the IRS needs to make a number of improvements to its compliance program for foreign sourced income. Specifically, the IRS needs to ensure that the previously identified recommendations are implemented, and establish a formal program with goals, objectives, processes and measures to improve the use of the REIP for compliance. The IRS also needs to identify the highest risk foreign sourced income documents, and develop methods to employ usable data in its matching and other compliance programs.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the audit was to follow up on the previously identified conditions and determine whether the actions taken in response to the prior audit report[1] have corrected the problems or whether the risks still exist. To accomplish our objective, we:

I. Determined the status of corrective actions from the prior audit report and evaluated the adequacy of those that have been completed.

   A. Discussed the status of any corrective actions to the recommendations from the prior audit findings with officials designated as responsible for the actions.

   B. Determined the cause for actions that had been cancelled or delayed.

   C. Evaluated the adequacy of actions that had been completed.

   D. Evaluated the Internal Revenue Service's (IRS) overall program for exchange of information with foreign governments, including the timeliness of the information exchange. Determined whether laws, regulations and treaties had been changed since the prior audit.

   E. Assessed the IRS' plans to effectively process the magnetically filed foreign information.

   F. Evaluated the extent to which the International function used information exchange data to evaluate taxpayer compliance.

   G. Determined the extent to which the International function encouraged the IRS to develop a system to monitor voluntary compliance of taxpayers who earn foreign sourced income.

II. Determined the extent of the information reported to the IRS on foreign sourced income and whether it was sufficient and accurate enough to be useful in compliance efforts, and determined the adequacy of the IRS' efforts to ensure taxpayer compliance.

   A. Evaluated the overall goals, objectives, measures and results of the IRS' Routine Exchange of Information Program.

[1] *Review of the Internal Revenue Service's Efforts to Ensure Compliance of Taxpayers Receiving Foreign Sourced Income* (Reference Number 072208, dated April 2, 1997)

B. Obtained statistical information, for both paper and electronic media, on foreign sourced income data submitted to ascertain the number of taxpayers, number of information returns, and amount of income involved in the program.

C. Analyzed foreign sourced income magnetic media data files from the International function to determine total population, treaty countries, and statistical information. Stratified the data by country and recipient type (individual or business), and validated the data by ensuring it contained the proper fields and formats as prescribed in data documentation issued by the Organization for Economic Cooperation and Development.

D. Computed the percentages of taxpayers for whom Taxpayer Identification Numbers (TIN) were and were not provided. Used this information to determine whether the information the IRS receives was complete enough for use in compliance efforts.

E. Ascertained the steps necessary to perfect information documents received without TINs to determine the feasibility of the IRS devoting resources to perfect the data for use in compliance efforts.

F. Analyzed a judgmental sample of 65 cases of 200 taxpayers whose foreign sourced income exceeded $5,000 for the latest data year (1998) for Germany. Researched the IRS' computer files to determine how feasible it was to ascertain that foreign sourced income, tax withheld, and foreign tax credits are accurately reported on proper forms and schedules. Obtained original returns to clarify unclear or incomplete information.

G. Evaluated what use the IRS could make of the data from all sources (both paper and magnetic media) to help ensure the compliance of taxpayers receiving foreign sourced income.

Appendix II

Major Contributors to This Report

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Appendix III

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