Erroneous Refunds May Be Issued Without a Program to (b)(7)(E)

July 2002

Reference Number: 2002-30-114

TDP 15-71

INSPECTION GENERAL FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 2, 2002

MEMORANDUM FOR	R COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION Scott 3. Wilson
FROM:	(for) Pamela J. Gardiner Deputy Inspector General for Audit
SUBJECT:	Final Report - Erroneous Refunds May Be Issued Without a Program to (Audit # 200130024)
issuance of refunds to objective of this review (b)(7)(E) (b)(7)(E) to withhold taxes on " Effectively connected or business in the Un	the results of our review of the Internal Revenue Service's (IRS) of (b)(7)(E) The was to determine the overall effect of (b)(7)(E) with the IRS' records of (b)(7)(E). The Internal Revenue Code (I.R.C.) § 1446¹ requires partnerships effectively connected income" allocable² to foreign partners. income is taxable income connected with the conduct of a trade ited States (U.S.). Tax is withheld on each foreign partner's ne effectively connected income.
Administration titled,	w-up to a report issued by the Treasury Inspector General for Tax Stronger Actions Are Needed to Ensure Partnerships Withhold and in Taxes on Certain Income of Foreign Partners. The report e IRS (0)(7)(E)
¹ LR.C. §1446 (1989).	locable income, regardless of whether distributions were made during the partnership's

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³ Reference Number 2001-30-084, dated June 2001.

In summary, (b)(7)(E)
(b)(7)(E) Individual foreign partners file U.S.
Nonresident Alien Income Tax Returns (Form 1040NR). For Tax Year 1999, there were
6,438 Forms 1040NR (6)(7)(E)
For an additional 2,299 returns, (5)(7)(E)
We reviewed 100 of these returns, (b)(7)(E) and in
34 cases (b)(7)(E)
(b)(7)(E)
These represent potential compliance problems that need to
be resolved. In 38 of the remaining 66 cases, the partnership incorrectly identified the
taxpaver on the withholding form.

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

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

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

Attachment

Erroneous Refunds May Be Issued Without a Program to (b)(7)(E)

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The Tax Reform Act (TRA) of 1986¹ added § 1446 to the Internal Revenue Code (I.R.C.).² This law requires partnerships to withhold taxes on "effectively connected income" allocable³ to foreign partners. Effectively connected income is taxable income connected with the conduct of a trade or business in the United States (U.S.). Tax is withheld on each foreign partner's distributive share of the effectively connected income.

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

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

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responding to that report, the IRS requested additional time to assess, given its limited resources, whether a systemic program (DXT)(E)

(b)(7)(E)

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

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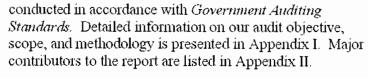
¹ Pub. L. No. 99-514, 100 Stat. 2085.

² LR.C. §1446 (1989).

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

⁴ Reference Number 2001-30-084, dated June 2001.

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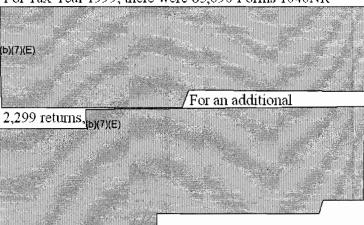




The IRS has records of withholding documents filed by partnerships (6)(7)(E)

partners report the withholding on the Foreign Partner's Information Statement of Section 1446 Withholding Tax (Form 8805). Certain publicly traded partnerships⁵ report withholding on distributions to foreign partners on the Foreign Person's U.S. Source Income Subject to Withholding (Form 1042-S), although they may optionally withhold and file using the Form 8805. Individual foreign partners show the withholding as payments on their U.S. Nonresident Alien Income Tax Returns (Form 1040NR), and must attach copies of Forms 8805 and Forms 1042-S to the returns.

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



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

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⁵ A publicly traded partnership is any partnership whose interests are regularly traded on an established securities market.

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8,737 Teutilis, 2007
(b)(7)(E) We reviewed them in coordination with an
analyst from the IRS' Partnership, Trust, and International
Section of the SB/SE Division's Customer Account
Services function. (b)(7)(E)
but the remainder had either Forms 8805 or
Forms 1042-S attached.
In 34 of the 100 cases, (DXT)(E)
(b)(7)(E)
These represent potential compliance problems that
need to be resolved.

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

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

In responding to the prior report, the IRS requested additional time to assess, given its limited resources, whether a systemic program (D)(7)(E)

Without such a program, the IRS risks issuing refunds that may not be substantiated.

Erroneous Refunds May Be Issued Without a Program to (5)(7)(E)

Recommendations

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

- Contact the partnerships or the taxpayers for the 34 unresolved cases and determine whether compliance actions are needed.
- 2. If a compliance gap is identified, develop a system that (b)(7)(E)
- 3. Use our methodology as an interim measure to (b)(7)(E)
- 4. For Forms 1040NR (b)(7)(E)
- 5. Develop educational materials to help ensure partnerships file all required withholding documents and include the correct TINs for the individual taxpayers.

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

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Appendix I

Detailed Objective, Scope, and Methodology

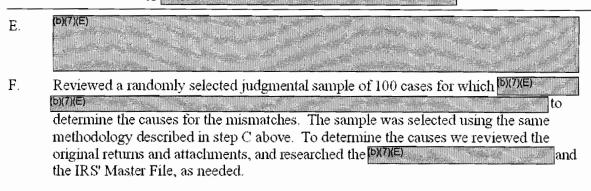
Our ob b)(7)(E) (b)(7)(E)	with the Internal Revenue Service's (IRS) records of (b)(7)(E)
Specifi	ically, we performed the following audit work:
Α.	Obtained an extract from the Mid-West Automated Compliance System (MACS) ¹ of (b)(7)(E)
B.	Obtained data for TY 1999 from DX(7)(E)
	Validated the data obtained by selecting a judgmental sample of 293 records from our (b)(7)(E) and then comparing the records to the IRS' Master File. The sample was chosen by randomly selecting records on pages printed from the above comparisons. There were 6,438 Forms 1040NR (b)(7)(E) and 2,299 Forms 1040NR (b)(7)(E) on the Forms 1040NR (b)(7)(E) (b)(7)(E)
D.	Compared the data from (b)(7)(E) to determine whether (b)(7)(E) (b)(7)(E)

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

² We limited our testing to Form 1040NR because that return has a specific line for IR.C. § 1446 withholding.

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Erroneous Refunds May Be Issued Without a Program to (5)(7)(E)

Appendix II

Major Contributors to This Report

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

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Customer Account Services, Small Business/Self-Employed Division S:CAS
Deputy Chief Financial Officer, Department of the Treasury
Audit Liaison: Commissioner, Small Business/Self-Employed Division S

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Appendix IV

Determination of Data Mismatch Causes From Review of 100 Cases

Explanation	No. Cases
Cases where taxpayer's claim was traceable to partnership withholding	
documents	
Taxpayer Identification Number (TIN) problems:	
TIN shown as name, not number, on database	20
Found on database under different TIN	18
Internal Revenue Service (IRS) data transcription (input) error	8
Resolved per partnership's transmittal document data (b)(7)(E)	
(b)(7)(E)	6
Different year shown on Forms 8805	5
Taxpayer error	3
Original transmittal document attached to taxpayer's return - not processed	
IRS adjusted credit	
Partnership error - deposit slips used, not individual Forms 8805 (b)(3):26 U.S.C. 6103	
Found on previous database under correct TIN	
Cases where taxpayer's claim was not traceable to partnership withholding documents	
Employee Identification Number on taxpayer's Form 8805 found on transmittal	
database table (b)(7)(E)	30
Cannot determine	4
Total	100

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