

**Compliance Opportunities Exist for the
Internal Revenue Service to Use
Foreign Source Income Data**

July 2005

Reference Number: 2005-30-101

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 26, 2005

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Compliance Opportunities Exist for the
Internal Revenue Service to Use Foreign Source Income Data
(Audit # 200430002)

This report presents the results of our review of the Internal Revenue Service's (IRS) use of foreign source income data. The overall objective of this review was to determine whether compliance opportunities existed for using the foreign source income data and Reports of Foreign Bank and Financial Accounts (Form TD F 90-22.1) (referred to as FBAR)¹ received as part of the Automatic Exchange of Information Program (AEIP).²

In summary, we found that investments made abroad by United States (U.S.) residents³ have grown in recent years, nearly tripling from \$2.6 trillion in 1999 to \$7.2 trillion in 2003.⁴

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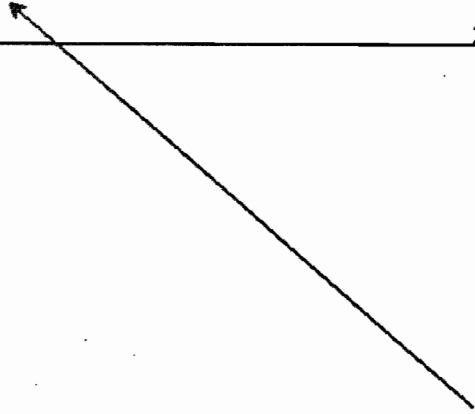
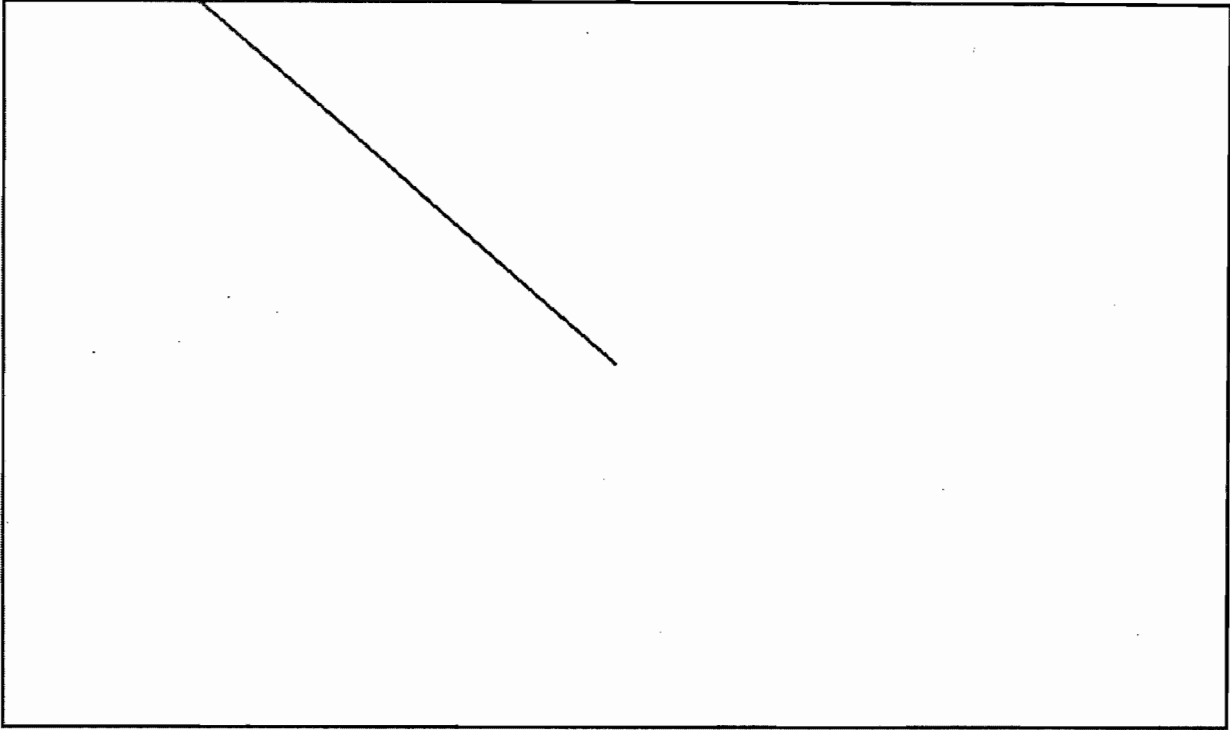
¹ An FBAR must be filed with the United States Department of the Treasury by any taxpayer who has a financial account with a value exceeding \$10,000 in a foreign country.

² The AEIP is a program through which the IRS exchanges information with approximately 20 tax treaty countries. The scope of this review was limited to electronic data. The IRS also receives hundreds of thousands of paper information documents that were not included in this review.

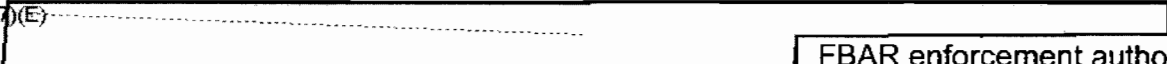
³ We use the term "resident" to include U.S. citizens and resident aliens. Resident aliens are generally taxed in the same way as U.S. citizens.

⁴ Department of Commerce – Bureau of Economic Analysis – News Release: U.S. International Investment Position at Year end 2003 (dated June 30, 2004). This news release also listed the U.S. holdings of foreign securities at \$2.5 trillion.

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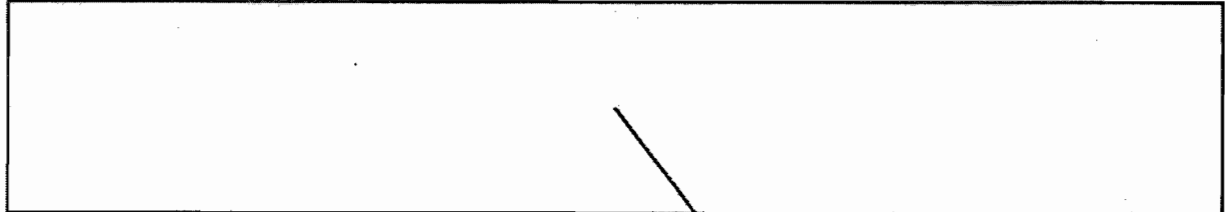
FBAR enforcement authority was delegated to the IRS by a provision of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act.⁹ Previously, the IRS could investigate FBAR filing noncompliance, but the Financial Crimes Enforcement Network maintained the responsibility of assessing FBAR penalties.



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⁹ Pub. L. No. 107-56 (2001).

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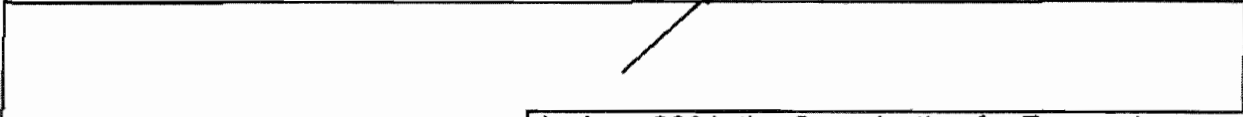
¹¹ 26 U.S.C. (2004).

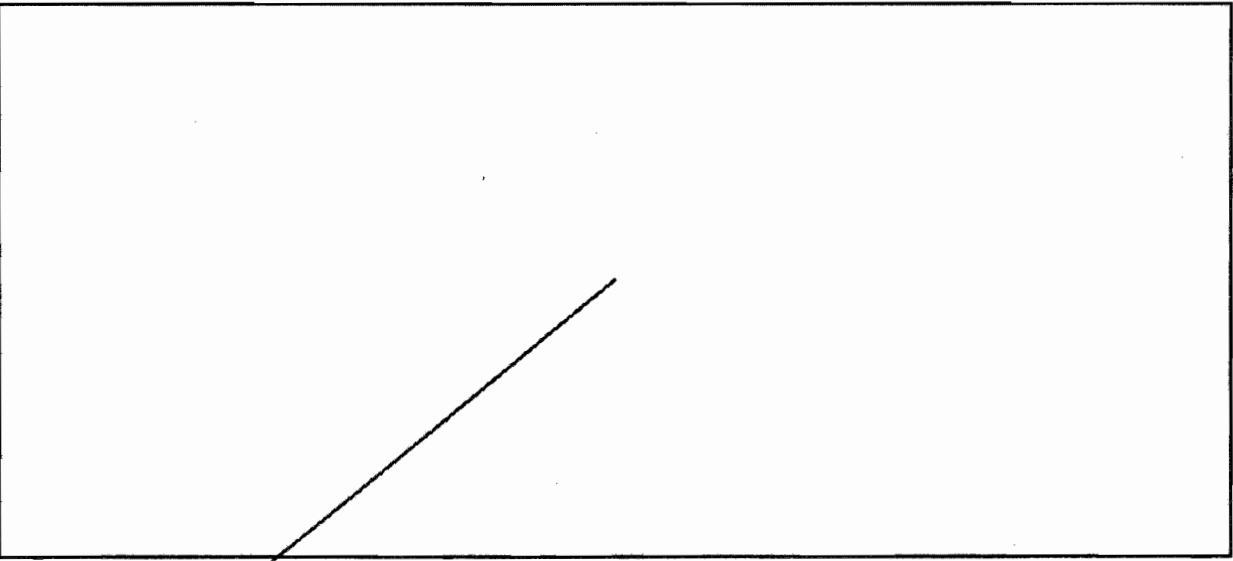
¹² 31 U.S.C. § 103 (2004).

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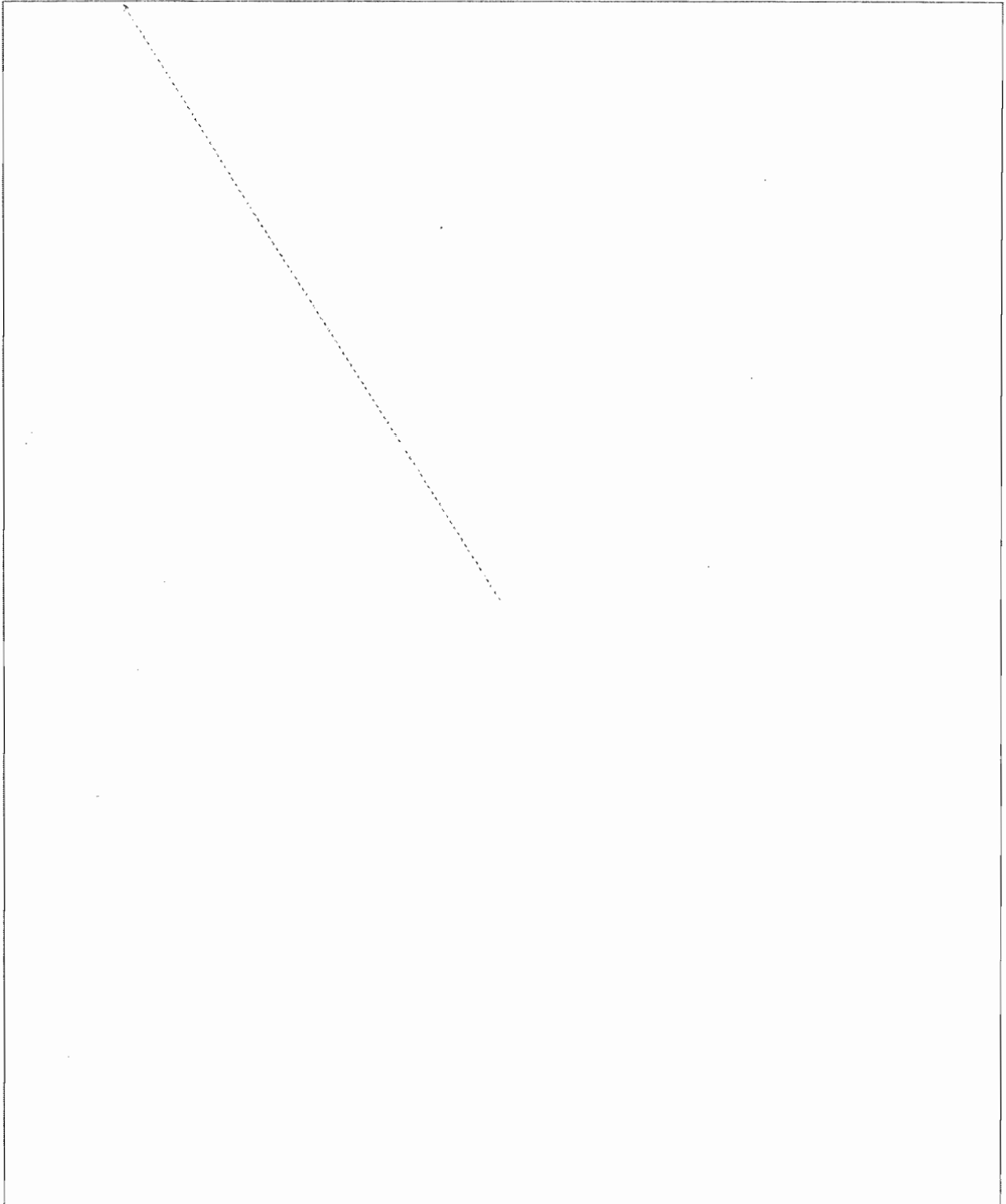
 The tax treaties restrict the use of the information exchanged to tax purposes only, covered in U.S.C. Title 26. The FBAR enforcement authority is in U.S.C. Title 31.

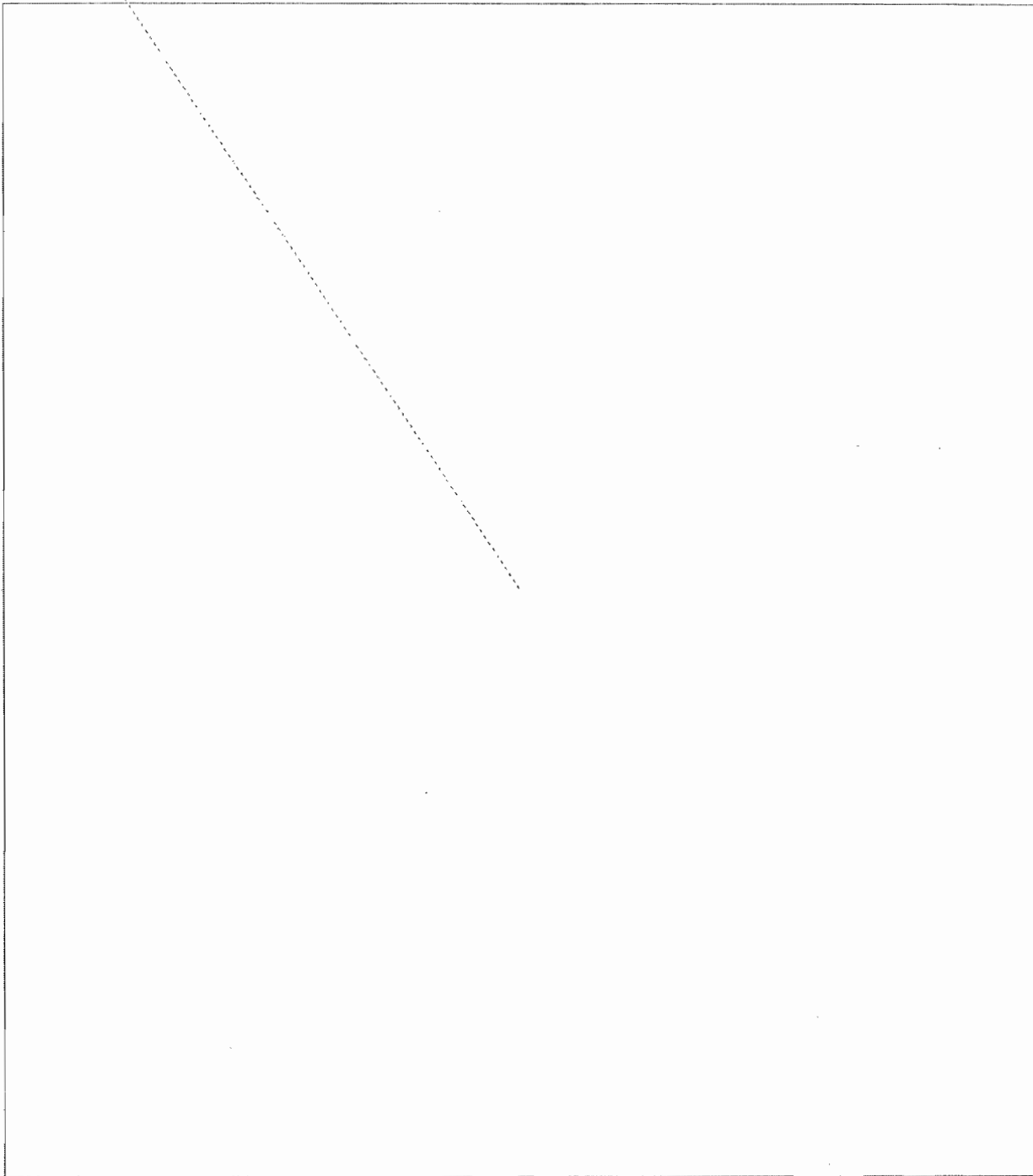
(b)(2).(b)(5).(b)(7)(E)


In June 2004, the Organization for Economic Co-Operation and Development (OECD) revised the model tax treaty. The OECD provided optional language for countries wishing to share information for nontax purposes. The revised model tax treaty provides that countries may use the information for other purposes, provided the information may be used for such purposes under the laws of both countries. While the OECD model treaty is only a model, it does signal a change in the use of tax treaty information.


(b)(2).(b)(5).(b)(7)(E)

¹³ The CBRS is an online database that contains Bank Secrecy Act (Pub. L. No. 91-508, 84 Stat. 1114 to 1124 (1970) (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C., and 31 U.S.C.)) information.





¹⁴ The AUTOTIN Program is used to validate the TINs included on information documents. It will also use a taxpayer's name and address to identify the taxpayer's TIN.

¹⁵ 31 U.S.C. § 5321(a)(5).

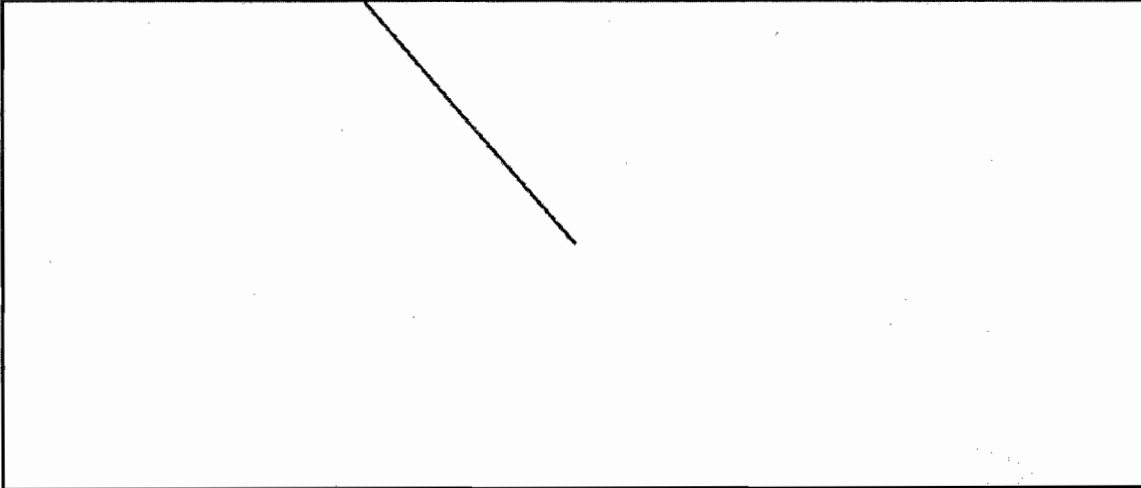
Please contact me at (202) 622-6510 if you have questions or Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at 631-654-6028.

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

(b)(2), (b)(5), (b)(7)(E)

Table of Contents

Background.....Page 1



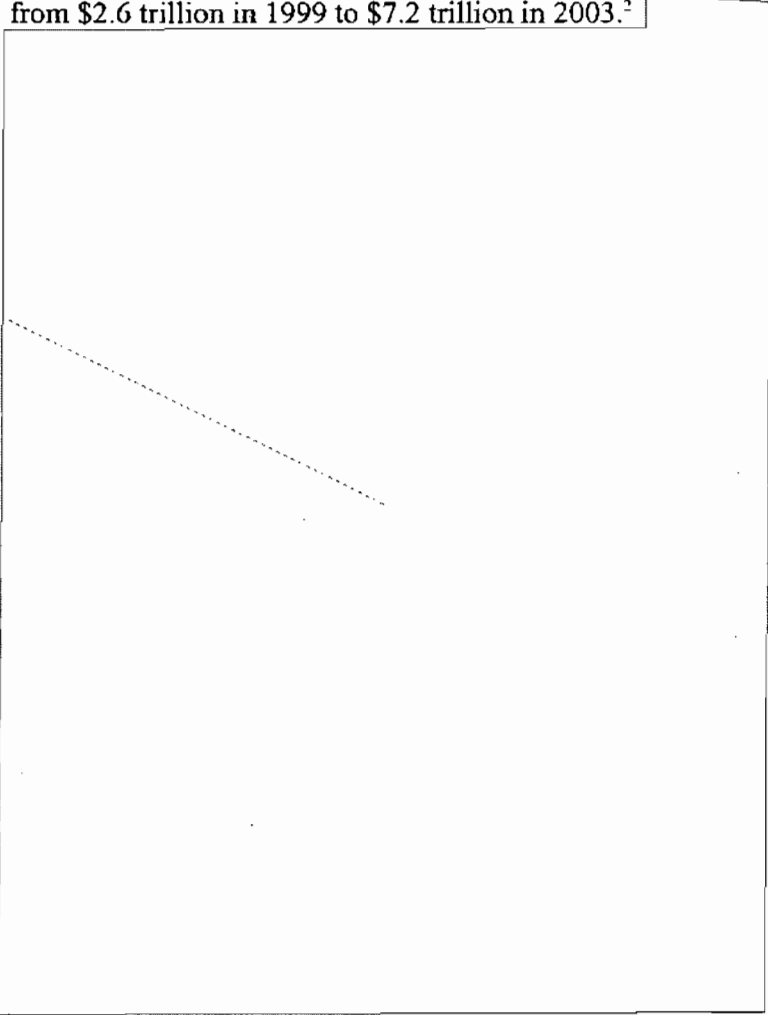
Appendix I – Detailed Objective, Scope, and MethodologyPage 18
Appendix II – Major Contributors to This ReportPage 20
Appendix III – Report Distribution List.....Page 21
Appendix IV – Outcome MeasuresPage 22
Appendix V – Management’s Response to the Draft Report.....Page 24

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

Background

United States (U.S.) residents¹ make significant foreign investments, and these residents are taxed on their worldwide income. Investments made abroad by U.S. residents have grown in recent years, nearly tripling from \$2.6 trillion in 1999 to \$7.2 trillion in 2003.²

(b)(2),(b)(7)(E)



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.

² Department of Commerce – Bureau of Economic Analysis – News Release: U.S. International Investment Position at Year end, 2003 (dated June 30, 2004). This news release also listed the U.S. holdings of foreign securities at \$2.5 trillion.

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

To complement these strategies, the IRS has an in-house source of information concerning taxpayers' foreign investments. Under the Automatic Exchange of Information Program (AEIP), the IRS exchanges information with approximately 20 tax treaty countries. As part of this Program, the IRS receives data (electronic and paper)³ listing foreign source income paid⁴ to U.S. residents and business entities.

(b)(2),(b)(5),(b)(7)(E)

Further, the Bank Secrecy Act (BSA)⁵ enacted in 1970 is one of the main Federal laws that require monitoring of financial information. A provision of the BSA that can further assist the IRS in identifying taxpayers with investments in foreign countries requires that a U.S. resident file a report with the U.S. Department of the Treasury if he or she has a financial account⁶ with a value exceeding \$10,000 in a foreign country. A taxpayer complies with this law by noting this account on his or her U.S Individual Income Tax Return (Form 1040)⁷ and by filing a Report of Foreign Bank and Financial Accounts (Form TD F 90-22.1) (referred to as FBAR). In April 2003, the IRS signed a Memorandum of Agreement with the Department of the Treasury Financial Crimes Enforcement Network (FinCEN) that delegated its enforcement authority for FBAR reporting to the IRS.

This review was performed at the Large and Mid-Size Business (LMSB) Division, Office of International, in

³ The Organization for Economic Co-Operation and Development developed the standard format for the AEIP. The scope of this review was limited to electronic data. The IRS also receives hundreds of thousands of paper information documents that were not included in this review.

(b)(2),(b)(7)(E)

⁴ Pub. L. No. 91-508, 84 Stat. 1114 to 1124 (1970) (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C., and 31 U.S.C.)

⁶ Financial interest in or a signature or other authority over a financial account in a foreign country, such as a bank, securities, or other type of financial account.

⁷ Schedule B – Interest and Ordinary Dividends, Part III, Line 7a.

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

Washington, D.C., during the period November 2003 through December 2004. The audit was performed in accordance with *Government Auditing Standards*. Our review was limited to those foreign source income documents received electronically by the IRS for Tax Years (TY) 2000 and 2001.

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We also used FBAR data received by the IRS in Calendar Years 2000 through 2003. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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As far back as 1976, the Congress⁸ urged the IRS to begin a systemic use of foreign source income documents.

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Currently, the LMSB Division International function is responsible for obtaining the foreign source income data.

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Foreign source income documents report several different types of income such as interest, dividends, rents, and royalties. The IRS received over [redacted] foreign source income documents electronically for TYs 2000 and 2001 from [redacted]

(b)(2),(b)(7)(E)

(b)(2),(b)(7)(E)

⁸ House Committee on Government Operations: Effectiveness of the IRS's Income Information Document Matching Program (dated September 23, 1976).

⁹ For both individuals and business entities.

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

For our review, we obtained all of the electronic foreign source income data the IRS received for TYs 2000 and 2001 (see Table 1). Our analysis of the data shows:

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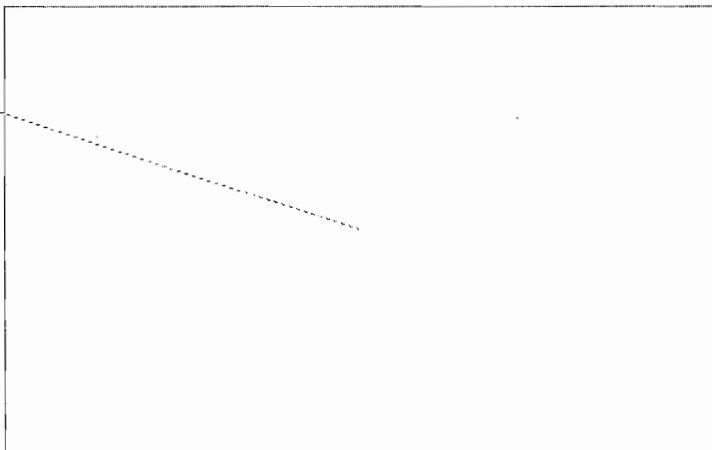


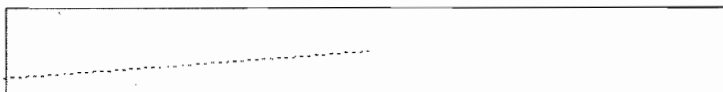
Table 1: Foreign Source Income Reported by Country for TYs 2000 and 2001

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<u>Country</u>	<u>2000 Gross Income</u>	<u>2001 Gross Income</u>

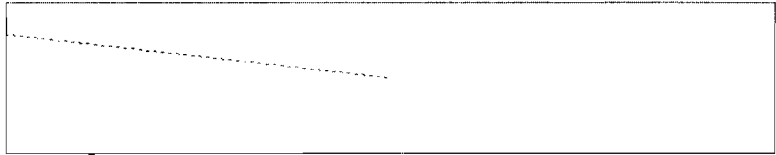
Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of the foreign source income database. (All figures are rounded.)

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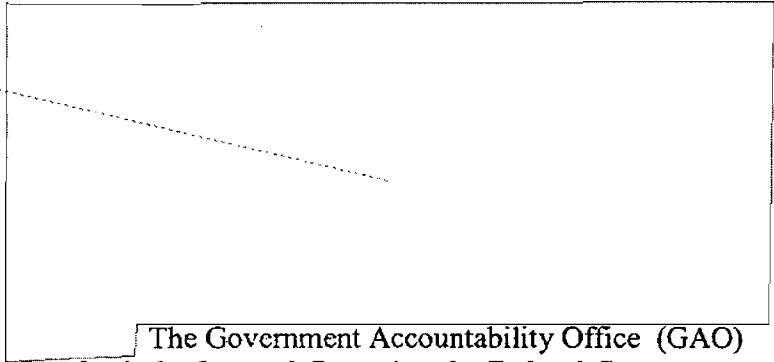


Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

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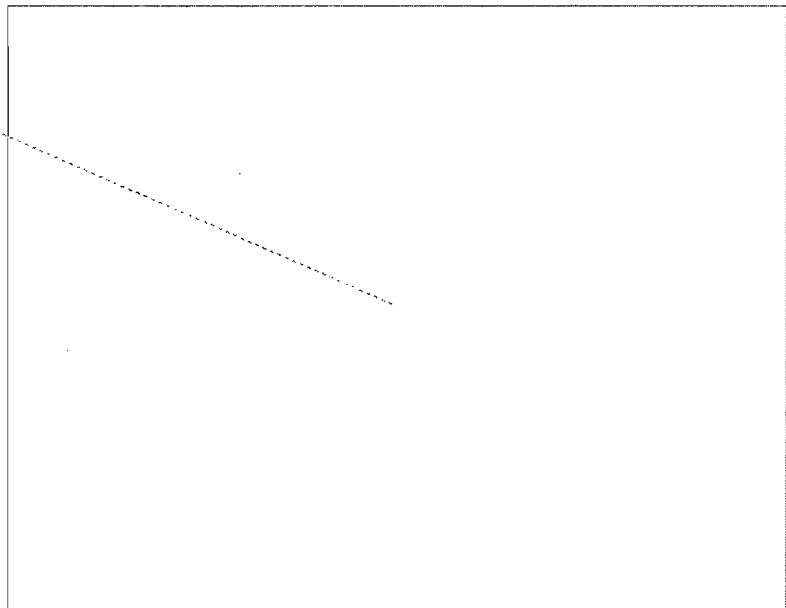
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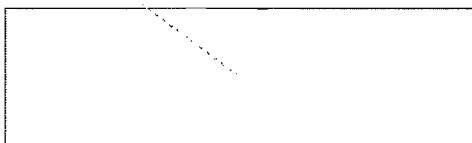
The Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government* require controls to ensure complete and accurate data.

Recommendation

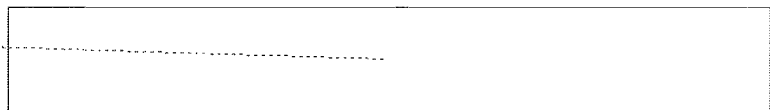
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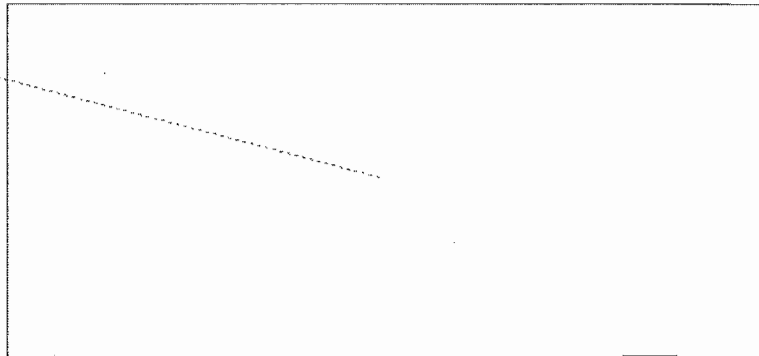


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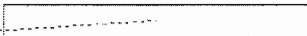


Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

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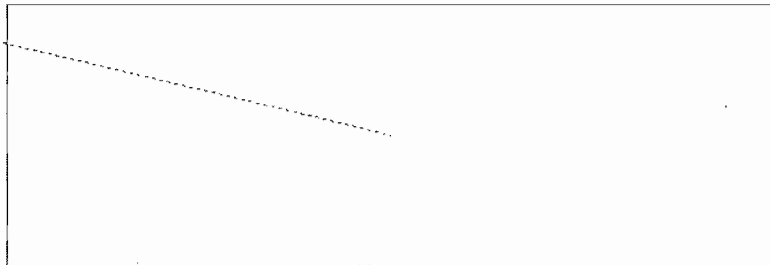


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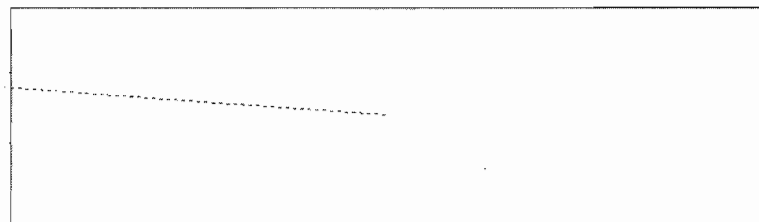
Foreign source income data 
reporting compliance of taxpayers receiving income from a foreign source

One of the principles of good tax policy is that similarly situated taxpayers are taxed similarly.¹⁴ As a testimony to this principle, the IRS Commissioner recently stated, "A vigorous enforcement program is important. Americans deserve to feel confident that when they pay their taxes, neighbors and competitors are doing the same."¹⁵

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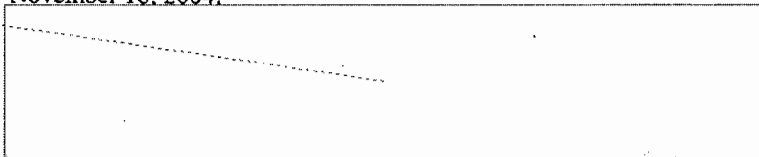
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(b)(2), (b)(7)(E)

¹⁴ Joint Commission on Taxation report JCS-18-95, pages 58 to 59.

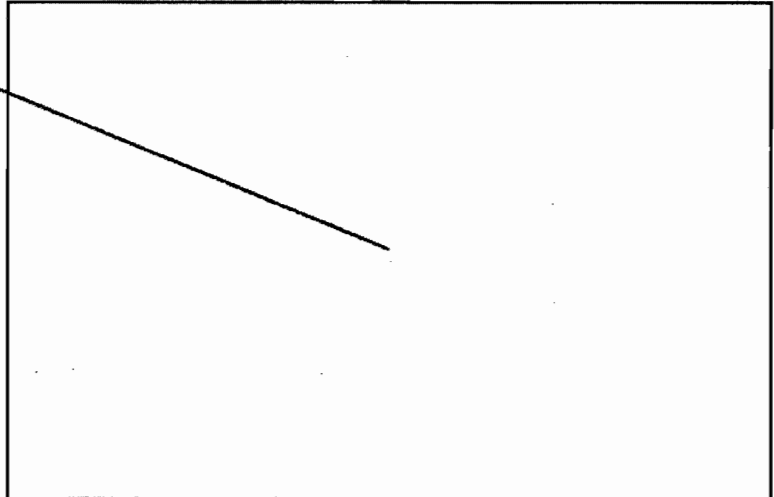
¹⁵ Prepared remarks of IRS Commissioner Mark W. Everson - November 18, 2004.



Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

to verify income (including, but not limited to, wages, interest, and dividends) on individual and business taxpayers' income tax returns.

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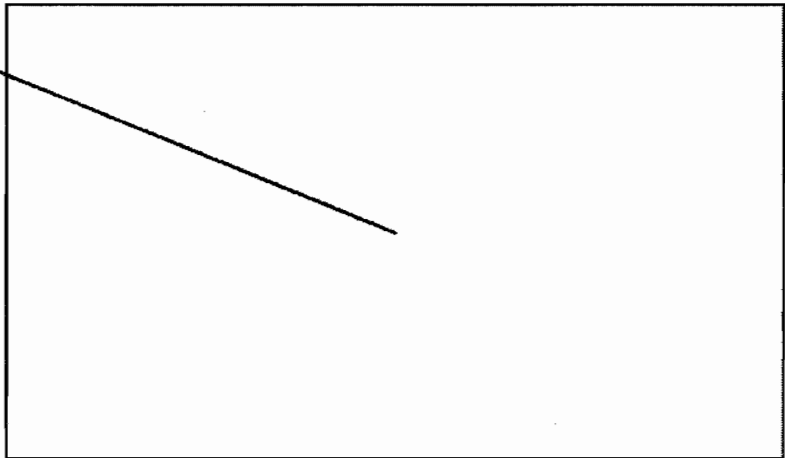
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← Using a statistically valid sample²⁰ of [redacted] foreign source income documents from the IRS' TY 2001 database, we validated and perfected the TINs²¹ for [redacted] of the documents sampled using the IRS Integrated Data Retrieval System (IDRS).²² We then determined whether the income was reported on the taxpayer's tax return. [redacted]

(b)(2),(b)(7)(E)



Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

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[Redacted]

(b)(2),(b)(7)(E)

We projected our outcomes based on the results of our sample,

See

Appendix IV for additional information.

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Foreign source income data [Redacted]
compliance with FBAR filing requirements

A provision of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act²⁵ required the Secretary of the Treasury to study methods of improving compliance with BSA reporting requirements. One method studied was delegating FBAR enforcement authority to the IRS. Accordingly, enforcement authority was delegated from the FinCEN to the IRS in April 2003. Previously, the IRS could investigate FBAR filing infractions, but the FinCEN maintained responsibility for assessing FBAR penalties. The delegation order allows the IRS to assess FBAR penalties.

A taxpayer must file an FBAR when the principal in his or her financial account in a foreign country exceeds \$10,000 at any time during the calendar year. The FBARs are posted to the Currency and Banking Retrieval System (CBRS).²⁶ The CBRS is available to FinCEN analysts, law enforcement personnel, and appropriate regulatory authorities for use, among other things, in tracking flows of money. In addition to filing an FBAR, a taxpayer must indicate his or her interest in foreign accounts on Form 1040, Schedule B, Part III. Willful failure to file an

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[Redacted]

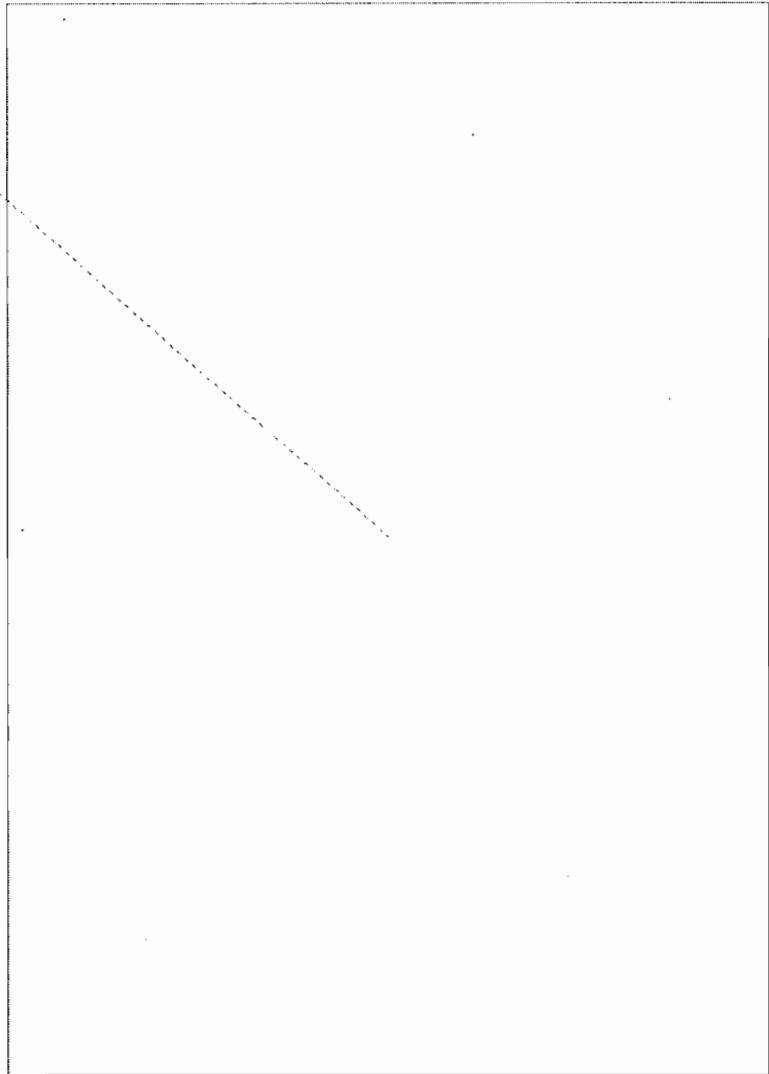
²⁵ Pub. L. No. 107-56 (2001).

²⁶ The CBRS is an online database that contains BSA information.

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

FBAR report can be punished under both civil and criminal
law.

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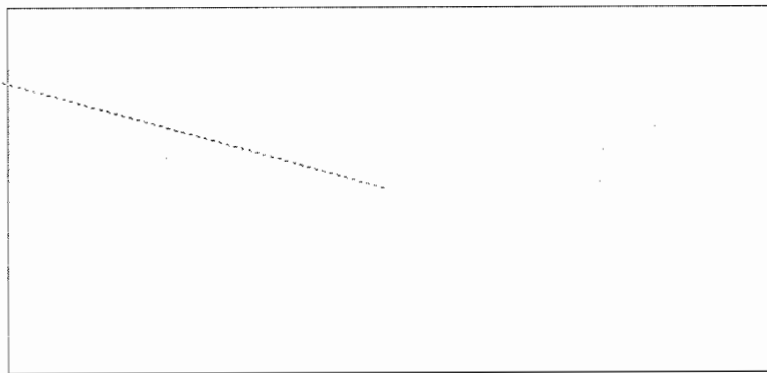
Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

Table 2: FBAR Penalties

Number of FBAR Violators	Foreign Source Interest Income	Estimated Foreign Source Income Not Reported	FBAR Penalty
23	\$519,841	\$25,992,050	\$2,300,000
12	<u>\$181,204</u>	<u>\$ 0</u>	<u>\$300,000</u>
35	\$701,045	\$25,992,050	\$2,600,000

Source: TIGTA analysis of foreign source income data and the CBRS.

(b)(2),(b)(7)(E)



Further, in October 2004, the Congress provided the IRS with another tool to enforce FBAR compliance by revising FBAR penalties in the American Jobs Creation Act of 2004.²⁸ It was enacted to amend the Internal Revenue Code (I.R.C.) of 1986, while it provides for amending the section of United States Code (U.S.C.) Title 31 that pertains to FBAR penalties by increasing the penalty amounts.²⁹

(b)(2),(b)(7)(E)

The maximum penalty for taxpayers who fail to file an FBAR and do not report the income from the foreign account can be the greater of \$100,000 or 50 percent of the balance in the account at the time of the violation. All of the taxpayers in our sample were paid a minimum of \$5,000 in foreign source interest or dividend income, which would indicate the principal on these accounts was greater than \$100,000.



²⁸ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

²⁹ 31 U.S.C § 5321(a)(5) 2004.

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

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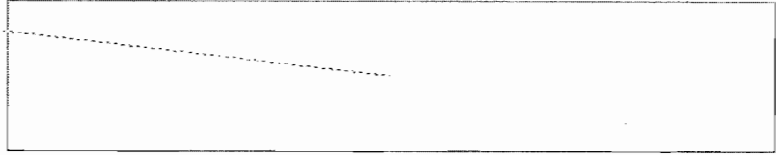


Table 3: FBAR Penalties

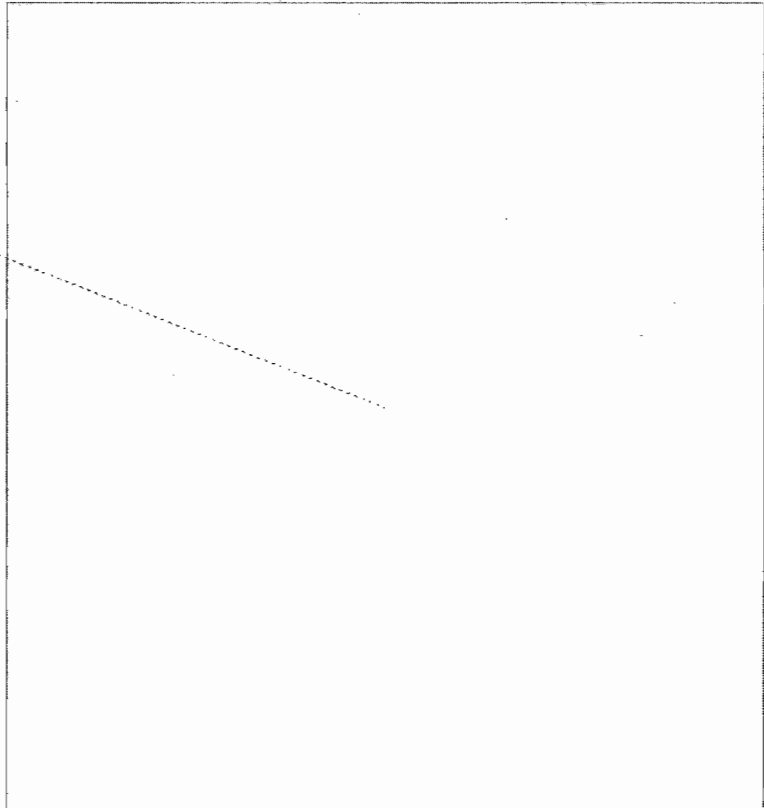
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Number of FBAR Violators	Foreign Source Interest Income	Estimated Foreign Account Principle	Estimated FBAR Penalty

Source: TIGTA analysis of foreign source income data and the CBRS.

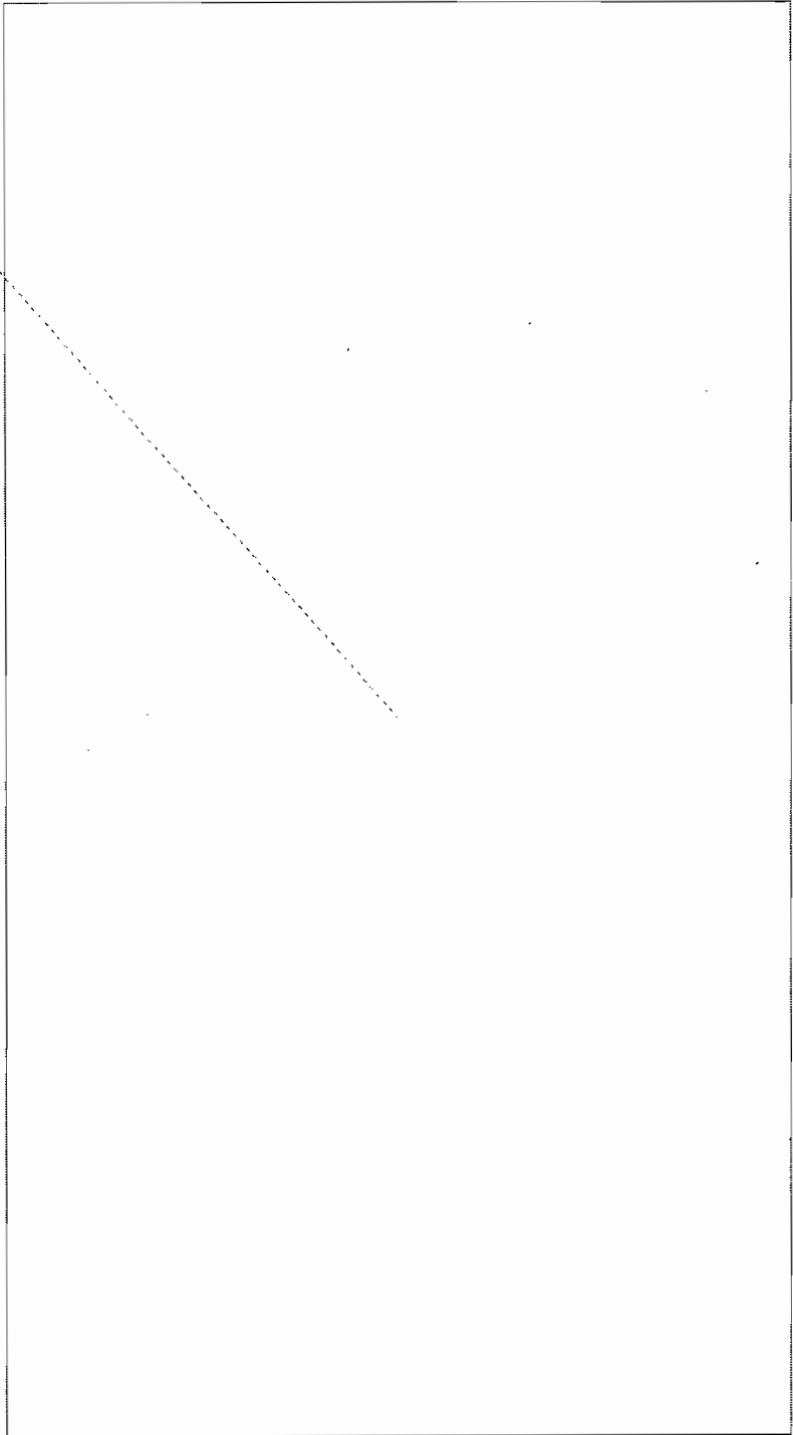
Recommendations

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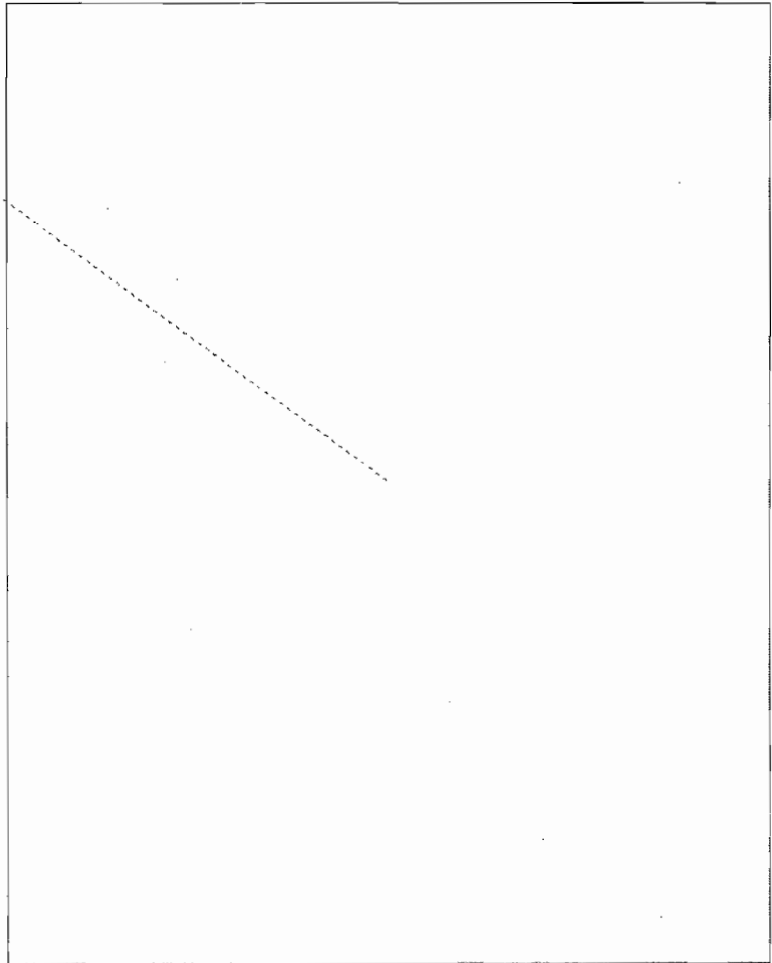
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Income Data**

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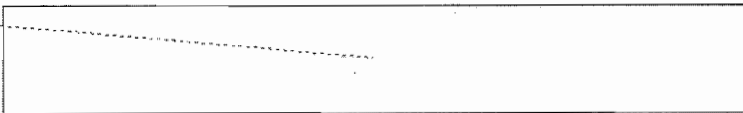
Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

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(b)(2),(b)(5),(b)(7)(E)

To ensure compliance with all applicable laws, the Deputy Director, Collection Policy, Small Business/Self-Employed Division, should:



Management's Response: IRS management agreed with this recommendation.

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Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

(b)(2),(b)(5),(b)(7)(E)

[REDACTED]

However, IRS management expressed concerns that the outcome measure calculation on FBAR penalties assumed the maximum willfulness penalty amount would be assessed on those taxpayers that also did not report the foreign source income on their respective income tax returns. They stated that calculating the penalty in this manner fundamentally misstates the penalties foregone because it assumes the person's failure to file an FBAR report was willful. Also, IRS management disagreed with our calculation of the value of the foreign account. Specifically, the IRS stated that the FBAR penalty would be calculated on the account value at June 30th following the close of the reportable year. Without proof of the actual amount on deposit on June 30th following the close of the reportable year, the penalty is limited to the lesser figure of \$25,000 or the maximum unverified amount in the account.

Office of Audit Comment: We are also concerned about the decisions regarding FBAR compliance initiatives. The I.R.C.³⁰ states that a person who willfully fails to file an FBAR, files an FBAR with a material omission or misstatement, or does not make and retain records for interests in foreign financial accounts may be assessed a penalty not to exceed the greater of the amount equal to the account balance at the time of the violation (up to \$100,000) or \$25,000.

(b)(2),(b)(7)(E)

[REDACTED]

Our premise was that the taxpayer's failure to report the income generated from the undisclosed foreign account would assist the IRS in proving that the taxpayer willfully failed to file an FBAR.

Also, the value of these accounts at the end of the reportable year significantly exceeded \$100,000, resulting in FBAR penalties of \$100,000 each. This was the best information available to us at the time of our review, and we used it as a

³⁰ 31 U.S.C. § 5321(a)(5).

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

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← starting point for our estimates. [redacted]

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[redacted]

← As previously stated in this report, [redacted]

[redacted]

foreign source income data received under the AEIP is covered under the respective tax treaty that the U.S. enters into with each country.

Most bilateral U.S. tax treaties that follow the U.S. model tax convention or that follow provisions of the Organization for Economic Co-Operation and Development (OECD) model tax convention restrict the use of the information exchanged for tax purposes. Specifically, the information obtained under a tax treaty could be used only for purposes designated under U.S.C. Title 26, I.R.C., while the FBAR filing requirements and respective penalties are covered under U.S.C. Title 31, Money and Finance.

(b)(2),(b)(5),(b)(7)(E)
)

In June 2004, the OECD revised the model tax treaty.³¹ Optional language has been included for countries desiring to share information for nontax purposes. The change provides that countries may use the information for other purposes, provided the information may be used for such purposes under the laws of both countries. In the IRS' situation, the use of tax treaty information for nontax purposes may need to be in compliance with IRS disclosure provisions.³² While the OECD model tax treaty is only a model,³³ it does signal a change in the use of tax treaty information.

A Contracting State³⁴ wishing to broaden the purposes for which it may use the information exchanged may do so by

³¹ Centre for Tax Policy and Administration, Committee on Fiscal Affairs: *Approval of Revision of Article 26 and Commentary*. June 30th 2004 (CTPA/CFA (2004)39/REV1).

³² 26 U.S.C. § 6103 (2004).

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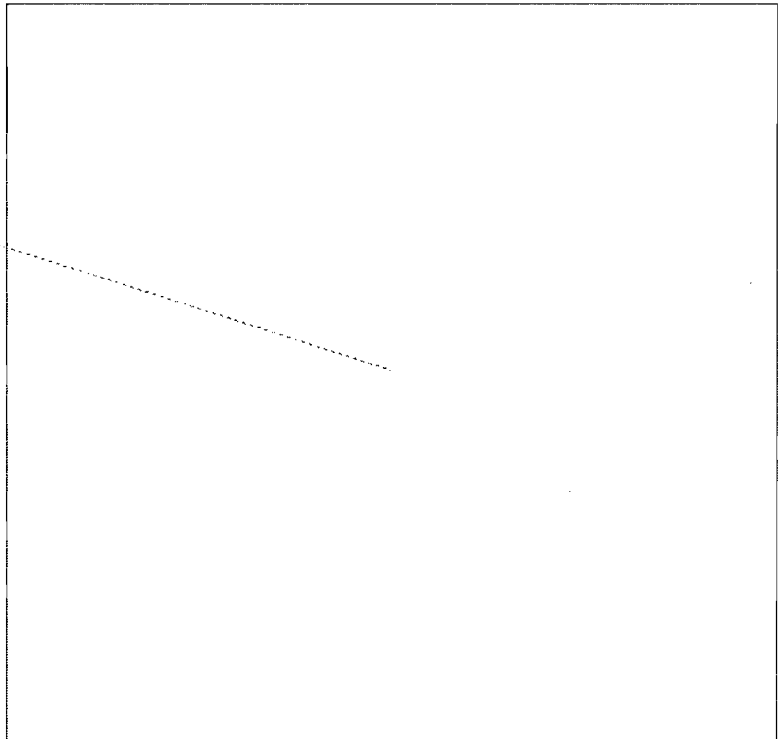
← [redacted]

³⁴ The OECD refers to a tax treaty country as a Contracting State.

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

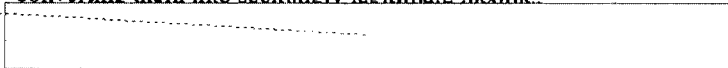
adding the following text to its treaty: "Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorizes such use."

(b)(2), (b)(5), (b)(7)(E)



(b)(2), (b)(7)(E)

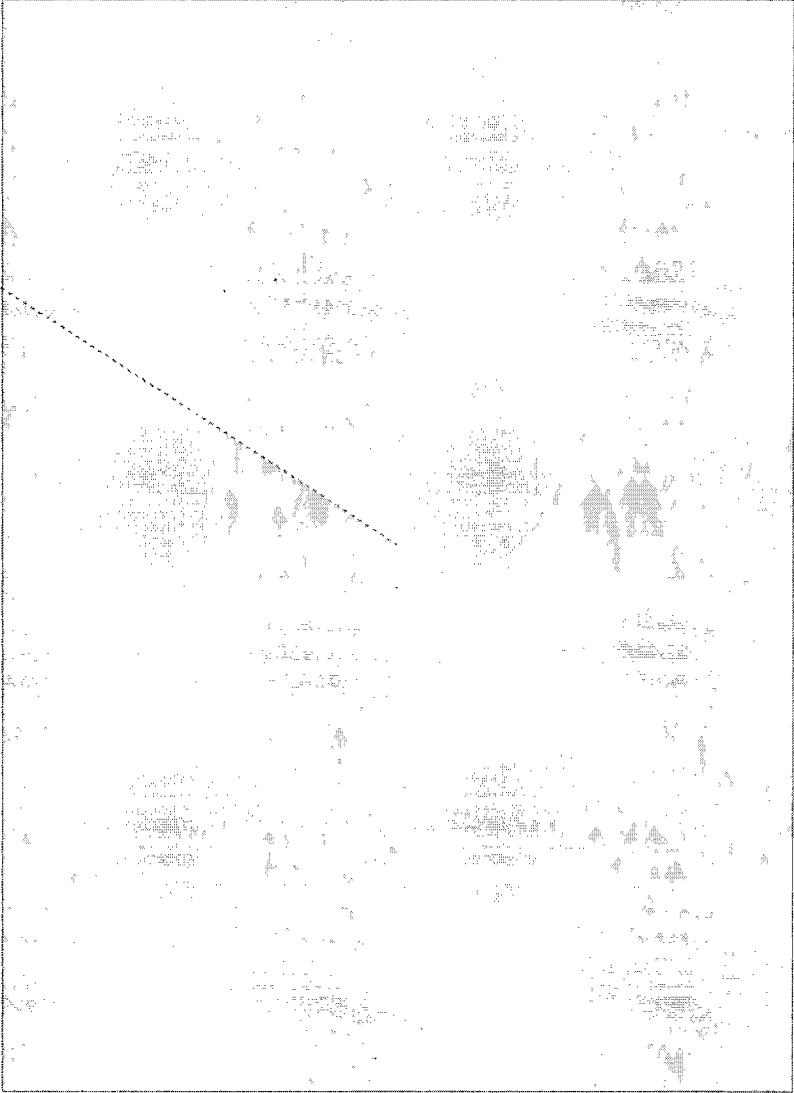
³⁵ The process whereby criminals conceal illicitly acquired funds by converting them into seemingly legitimate income.



**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

Recommendations

(b)(2), (b)(5), (b)(7)(E)



Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether compliance opportunities existed for using foreign source income data and Report of Foreign Bank and Financial Accounts (Form TD F 90-22.1) (referred to as FBAR)¹ data received as part of the Automatic Exchange of Information Program.² To accomplish our objective, we:

I. Determined the extent to which the information reported to the Internal Revenue Service (IRS) via foreign source income data was sufficient and accurate enough to be useful in compliance efforts.

A. Determined the effect of matching foreign source income data and related IRS filing data by analyzing computer files containing all of the foreign source income documents the IRS received electronically for Tax Years (TY) 2000 and 2001.³ (b)(2),(b)(7)(E)

(b)(2),(b)(7)(E) ← B. Using the TY 2001 data, selected a random statistically valid sample of [redacted] documents from a universe of [redacted] documents using a confidence level of [redacted] and a (b)(2),(b)(7)(E) (b)(2),(b)(7)(E) ← precision level of [redacted]. We obtained guidance on our sampling methodology and projections from the IRS Statistics of Income Division. (b)(2),(b)(7)(E)

C. Using the Integrated Data Retrieval System⁵ on the [redacted] documents in our sample, validated and perfected the Taxpayer Identification Numbers (TIN)⁶ [redacted] [redacted] (b)(2),(b)(7)(E) (b)(2),(b)(7)(E)

II. Determined the extent to which the information reported on FBAR documents was sufficient and accurate enough to be useful in compliance efforts.

A. Determined the effect of matching foreign source income data and related FBAR data to identify noncompliance with Bank Secrecy Act (BSA)⁷ filing requirements.

¹ An FBAR must be filed with the United States Department of the Treasury by any taxpayer who has a financial account with a value exceeding \$10,000 in a foreign country.

² This is a program through which the IRS exchanges information with approximately 20 tax treaty countries.

³ Data for TYs 2001 and 2002 were the most current at the time of our review.

(b)(2),(b)(7)(E) ← [redacted]

⁵ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

⁶ A nine-digit number assigned to taxpayers for identification purposes.

⁷ Pub. L. No. 91-508, 84 Stat. 1114 to 1124 (1970) (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C., and 31 U.S.C.) The BSA was enacted in 1970 and is one of the main Federal laws that require monitoring of financial information.

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

- (b)(2),(b)(7)(E) 1. From the foreign source income database, selected a judgmental sample of [] documents on which the recipient was an individual and received interest or
(b)(2),(b)(7)(E) dividend income of \$5,000 or more (population of []). We chose documents with
interest or dividend income of \$5,000 or greater to assure the recipients would be
subject to FBAR filing requirements, since \$5,000 in interest and dividend income
would indicate a principal balance of at least \$10,000.
- (b)(2),(b)(7)(E) 2. Matched the sample of [] documents against IRS computer files and tax returns
containing FBAR data received in TYs 2000 through 2003 to determine whether a
required FBAR was filed.

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

Appendix II

Major Contributors to This Report

Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Program)

Philip Shropshire, Director

Edmond G. Watt, Audit Manager

Michael Howard, Acting Audit Manager

Timothy F. Greiner, Senior Auditor

Frank Maletta, Auditor

Layne Powell, Information Technology Specialist

Jeffrey Williams, Information Technology Specialist

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Chief Financial Officer, Department of the Treasury
Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, International, Large and Mid-Size Business Division SE:LM:I
Director, Collection Policy, Small Business/Self-Employed Division SE:S:C:CP
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Audit Liaison: Commissioner, Large and Mid-Size Business Division SE:LM

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress. (b)(2), (b)(5), (b)(7)(E)

Type and Value of Outcome Measure:

[Redacted]

(see page 5).

(b)(2), (b)(5), (b)(7)(E)

Methodology Used to Measure the Reported Benefit:

[Redacted]

(b)(2), (b)(7)(E)
(b)(2), (b)(7)(E)

The TY 2001 foreign source income database included over [Redacted] documents. We selected a statistically valid sample of [Redacted] documents from the database.

We then converted the gross income paid from the foreign currency in which it was paid to United States (U.S.) dollars. (b)(2), (b)(7)(E)

Next we determined whether the foreign source income was reported on the taxpayers' respective U.S. Individual Income Tax Returns (Form 1040)

[Redacted]

(b)(2), (b)(5), (b)(7)(E)

¹ A nine-digit number assigned to taxpayers for identification purposes.

² The JRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

Type and Value of Outcome Measure: (b)(2),(b)(5),(b)(7)(E)

[Redacted]

Methodology Used to Measure the Reported Benefit:

The revenue protection figure is based on the premise that the IRS will find willful noncompliance (in those cases where the taxpayers did not report the foreign source income on their respective income tax returns) in failing to file required Reports of Foreign Bank and Financial Accounts (Form TD F 90-22.1) (referred to as FBAR).³ From the TY 2001 foreign source income database, we selected a judgmental sample of [Redacted] documents (cases) on which a taxpayer received income or dividend income of \$5,000 or more (population of 32,711). For the (b)(2),(b)(7)(E) [Redacted] cases, we researched the Currency and Banking Retrieval System (CBRS)⁴ for the appropriate years to determine whether an FBAR had been filed. /

[Large Redacted Block]

(b)(2),(b)(5),(b)(7)(E)

³ An FBAR must be filed with the U.S. Department of the Treasury by any taxpayer who has a financial account with a value exceeding \$10,000 in a foreign country.

⁴ The CBRS is an online database that contains Bank Secrecy Act (Pub. L. No. 91-508, 84 Stat. 1114 to 1124 (1970) (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C., and 31 U.S.C.)) information.

⁵ Under new FBAR penalty provisions, taxpayers situated similar to those in our sample could be liable for an

[Redacted]

(b)(2),(b)(5),(b)(7)(E)

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data

Appendix V

Management's Response to the Draft Report



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

RECEIVED
JUL 08 2005

July 5, 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

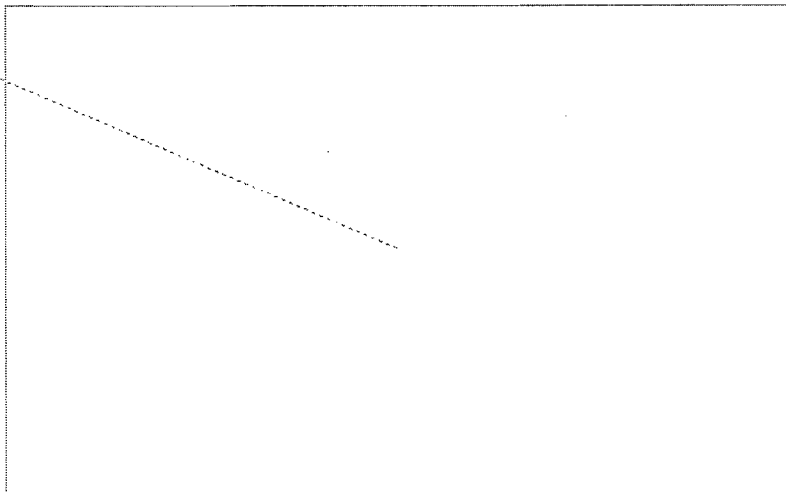
FROM: Deborah M. Nolan *Deborah M. Nolan*
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report - Compliance Opportunities Exist for the
Internal Revenue Service to Use Foreign Source Income Data
(Audit # 2004-30-002)

Thank you for the opportunity to respond to your draft audit report on our efforts to ensure compliance, including compliance with the Report of Foreign Bank and Financial Accounts (FBAR) filing requirements and enforcement of FBAR penalties, using foreign source income data.

In April 2003, the Financial Crimes Enforcement Network (FinCEN) delegated authority to the IRS to assess FBAR compliance and penalties. Since receiving this authority, the IRS has:

(b)(2),(b)(5),(b)(7)(E)



Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

2

Additionally, the IRS is currently revising the FBAR form and instructions.

(b)(2),(b)(5),(b)(7)(E)

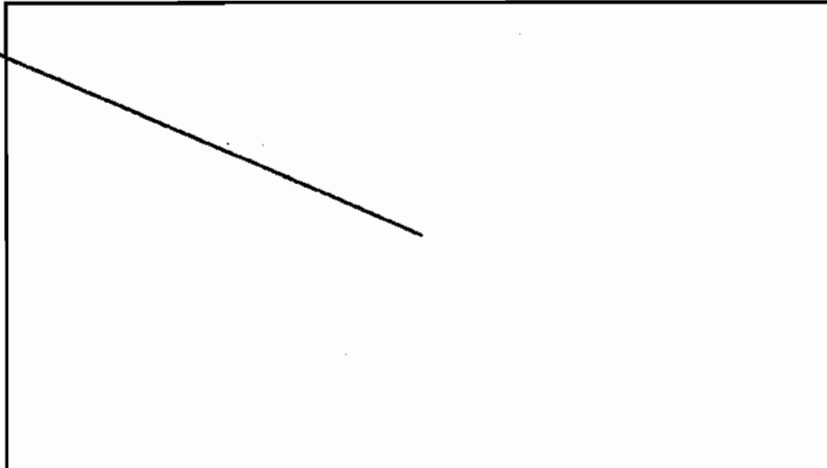
Overall, FBAR filings are increasing. [Redacted]



The Report's Factual Findings and Conclusions

Prior to receiving the draft report, we discussed with the audit team several areas of concern related to the methodology and factual findings and conclusions to be included in the report. The draft report addresses a few of our concerns, but several of our concerns remain. We will not recount each concern here, but limit our discussion to the more significant concerns with the report's factual findings and conclusions.

(b)(2),(b)(5),(b)(7)(E)

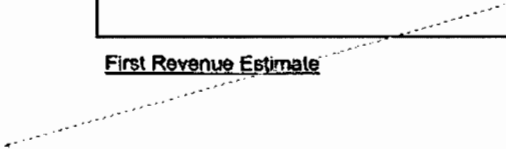


Outcome Measures

(b)(2),(b)(5),(b)(7)(E)



First Revenue Estimate



Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

3

The first revenue estimate is based on the total number of foreign information documents received by the IRS, which includes documents related to individuals, businesses, tax-exempt entities, governments, partnerships, trusts, etc. Although this total of [redacted] documents includes all entity types, the [redacted] records selected for the audit sample [redacted]

(b)(2),(b)(7)(E)

(b)(2),(b)(7)(E)

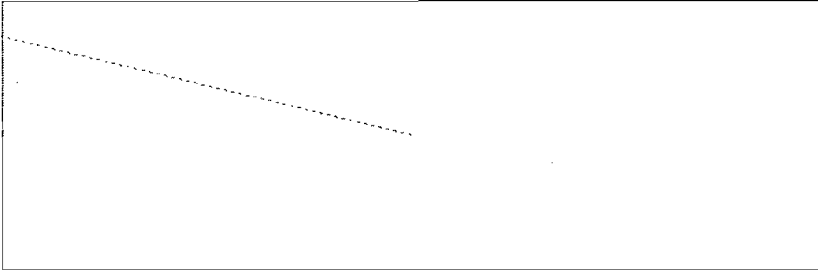
(b)(2),(b)(5),(b)(7)(E)

(b)(2),(b)(5),(b)(7)(E)

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

4

(b)(2),(b)(5),(b)(7)(E)

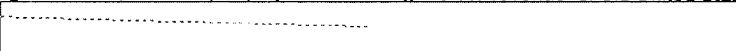


Further, although the revenue estimate in the report takes into consideration foreign taxes withheld at source, the report does not explain the effect foreign taxes paid but not withheld at source might have on the revenue estimate.

Second Revenue Estimate

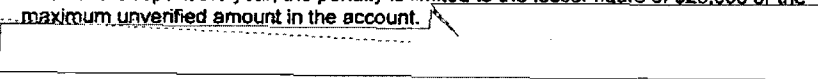
The Bank Secrecy Act requires persons to report certain financial transactions to the government; however, its purpose is not to generate revenue for the United States.

(b)(2),(b)(5),(b)(7)(E)



The second outcome measure assumes that the IRS will assess and collect the maximum willfulness penalty whenever an FBAR is not filed and the foreign source income is not reported. Calculating the outcome measure in this manner fundamentally misstates the penalties foregone because it assumes that the person's failure to file an FBAR report was willful. Further, the outcome measure uses the highest dollar value in the account for purposes of computing the penalty foregone, but the amount of the penalty is determined by the amount on deposit on June 30 following the close of the reportable year. Without proof of the actual amount on deposit on June 30 following the close of the reportable year, the penalty is limited to the lesser figure of \$25,000 or the maximum unverified amount in the account.

(b)(2),(b)(5),(b)(7)(E)



The report identified a "minimum" FBAR penalty of \$25,000. There is, however, no minimum FBAR penalty, only a maximum penalty. The maximum penalty for willful violations involving accounts with no more than \$25,000 at the time of the violation is \$25,000. The outcome measure is computed using a \$25,000 penalty for each of the [redacted] for which the report did not assume willful noncompliance. The \$25,000 penalty can only be assessed, however, in cases involving willful violations. Thus, assuming that [redacted] in the sample involved a willful violation, a more

(b)(2),(b)(5),(b)(7)(E)

(b)(2),(b)(5),(b)(7)(E)

Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data

5

accurate and sustainable computation of the penalty would have been to propose a penalty of \$25,000 per account with respect to the cases where a willful violation is assumed [redacted] times \$25,000, resulting in a [redacted] as [redacted] shown on page 9 of the report. (b)(2),(b)(5),(b)(7)(E)

The outcome measure also computed FBAR penalties for these [redacted] using the higher penalty amounts established by the American Jobs Creation Act (AJCA) for willful violations occurring after October 22, 2004 (although any reporting violations with respect to the cases in the sample would have occurred before October 23, 2004). For willful violations occurring after October 22, the maximum penalty that can be assessed for accounts with no more than \$200,000 at the time of the violation is \$100,000. Again, there is no minimum FBAR penalty, only a maximum penalty. A more accurate and sustainable computation of the penalty for willful violations occurring after October 22, 2004, assuming the same facts assumed for the earlier computation, would be to propose a \$100,000 penalty for the [redacted] in which a willful violation is assumed or [redacted] shown on pages 10 and 11 of the report. (b)(2),(b)(5),(b)(7)(E)

The AJCA establishes a new FBAR penalty of up to \$10,000 for nonwillful violations occurring after October 22, 2004 that were not due to reasonable cause. Assuming the maximum FBAR penalty was assessed for the [redacted] where it was not shown that the violations were willful, the penalty for these [redacted] (b)(2),(b)(5),(b)(7)(E)

Additionally, the Service has established a policy for mitigating factors when determining the amount of penalty to assess relating to an FBAR. In general, an agent would use the mitigating guidelines as long as the following conditions were met:

(b)(2),(b)(5),(b)(7)(E)



The use of mitigating guidelines could have reduced the total penalties substantially.

Summary of Response to Audit Recommendations

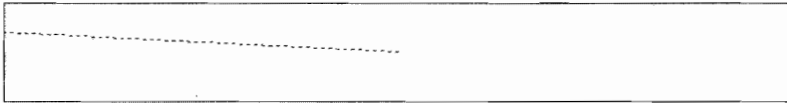
(b)(2),(b)(5),(b)(7)(E)



**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

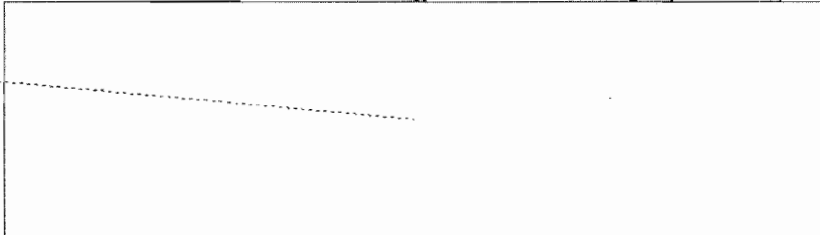
6

(b)(2),(b)(5),(b)(7)(E)



On recommendation 3, the IRS has a strategy to enforce FBAR filing requirements.

(b)(2),(b)(5),(b)(7)(E)



Attached are additional comments related to the audit recommendations and the corrective actions to address them. If you have any questions, please contact Robert H. Green at (202) 435-5000.

Attachment

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

Attachment

RECOMMENDATION 1

(b)(2),(b)(5),(b)(7)(E)

[Redacted]

CORRECTIVE ACTION(S):

(b)(2),(b)(5),(b)(7)(E)

[Redacted]

IMPLEMENTATION DATE:

July 15, 2007, for pending deliberation of recommendations 4 and 5

RESPONSIBLE OFFICIAL(S):

Director, International (LMSB)

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 2

(b)(2),(b)(5),(b)(7)(E)

[Redacted]

CORRECTIVE ACTION(S):

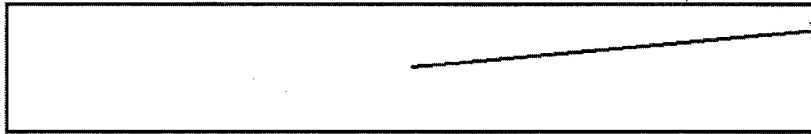
(b)(2),(b)(5),(b)(7)(E)

[Redacted]

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

2

(b)(2),(b)(5),(b)(7)(E)



IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

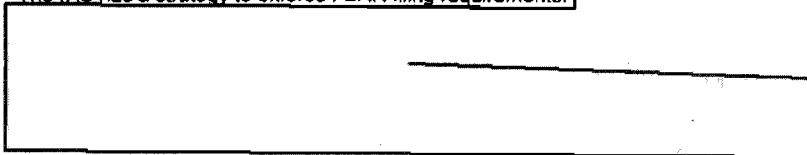
(b)(2),(b)(5),(b)(7)(E)

RECOMMENDATION 3



CORRECTIVE ACTION(S):

The IRS has a strategy to enforce FBAR filing requirements.



(b)(2),(b)(5),(b)(7)(E)

IMPLEMENTATION DATE:

July 15, 2007, pending deliberation of recommendations 4 and 5

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy (SBSE)

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

3

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 4

(b)(2),(b)(5),(b)(7)(E)

[Redacted]

CORRECTIVE ACTION(S):

(b)(2),(b)(5),(b)(7)(E)

[Redacted]

In June 2004, the OECD revised the model tax treaty Article 26, where optional language was included in the commentary for OECD member countries desiring to share information for non-tax purposes.

[Redacted]

(b)(2),(b)(5),(b)(7)(E)

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

4

(b)(2),(b)(5),(b)(7)(E)

IMPLEMENTATION DATE:

February 15, 2006, for outcome of LMSB discussions with the Office of Chief Counsel and Treasury's Office of Tax Policy

RESPONSIBLE OFFICIAL(S):

Director, International (LMSB)

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 5

(b)(2),(b)(5),(b)(7)(E)

CORRECTIVE ACTION(S):

(b)(2),(b)(5),(b)(7)(E)

IMPLEMENTATION DATE:

July 15, 2006, for outcome of LMSB discussions involving legislative changes with the Office of Chief Counsel and Treasury's Office of Tax Policy

**Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source
Income Data**

5

July 15, 2007, for implementation of possible legislative changes depending on outcome
of discussions with Chief Counsel and Treasury's Office of Tax Policy

RESPONSIBLE OFFICIAL(S):

Director, International (LMSB)

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A