



*Additional Controls Are Needed to Help
Ensure That Nonresident Alien Individual
Property Owners Comply With Tax Laws*

August 23, 2017

Reference Number: 2017-30-048

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HIGHLIGHTS

ADDITIONAL CONTROLS ARE NEEDED TO HELP ENSURE THAT NONRESIDENT ALIEN INDIVIDUAL PROPERTY OWNERS COMPLY WITH TAX LAWS

Highlights

Final Report issued on August 23, 2017

Highlights of Reference Number: 2017-30-048 to the Internal Revenue Service Commissioners for the Large Business and International Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

Nonresident alien individuals who own and derive rental income from U.S. residential real property (hereafter referred to as U.S. property) can reduce their tax liability by electing to treat rental income generated by those properties as effectively connected to a U.S. trade or business. Nonresident aliens who make this election can reduce their rental income by offsetting rental income with expenses pertaining to the rental activity. The IRS does not ensure that these taxpayers properly make the election before allowing these tax advantages. As a result, taxpayers who fail to comply with the laws receive the same tax benefit as those who do.

WHY TIGTA DID THE AUDIT

It is estimated that nonresident alien individuals' investment in U.S. property increased from \$34.8 billion during the 12-month period ending March 2013 to \$43.5 billion during the 12-month period ending March 2016. This audit was initiated to evaluate the IRS's efforts in identifying and addressing nonresident alien individuals who should be paying tax on rental income of U.S. property.

WHAT TIGTA FOUND

The IRS can improve controls to ensure that nonresident aliens are properly reporting rental income from U.S. property. TIGTA reviewed a random sample of 149 nonresident aliens who rented their U.S. property in Tax Year 2013. TIGTA found that 102 (68 percent) of them reduced their gross rental income when

reporting their rental activity without complying with the statutory requirement of applying for this tax benefit by submitting an election statement. The IRS needs to improve compliance checks for ensuring that election statements are made. As a result, \$1.78 million in gross rental income should have been subject to 30 percent tax withholding of \$533,000 (\$56.2 million in withholding when projected to the population).

The IRS also needs to improve tools for identifying nonresident aliens who are not reporting rental income from U.S. property they own. From our sample drawn from foreign property owners in five counties, TIGTA identified foreign property owners who appeared to have failed to report and pay tax on rental income they earned (at least 28 of 214 foreign property owners in our sample). When these exceptions are projected over the population reviewed in five selected areas, there is potentially \$60.9 million in unreported rental income.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS:

- Revise Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, for nonresident aliens to make an election under Internal Revenue Code Section 871(d) and revise processing procedures to ensure that the IRS records the election.
- Verify withholding credits claimed on Form 1040NR against information in the Foreign Investment in Real Property Tax Act Database and research the nonresident alien's Master File account to determine if the U.S. property was rented and depreciated and, if so, verify calculation of the property's cost basis used in a sale.
- Develop a compliance initiative addressing foreign property owners who do not report rental income generated by real property they own in the United States.

IRS management agreed with our recommendations regarding the revision to the 1040NR and the initiation of a compliance initiative but disagreed with our recommendation concerning Foreign Investment in Real Property Tax Act verification.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 23, 2017

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Controls Are Needed to Help Ensure
That Nonresident Alien Individual Property Owners Comply With Tax
Laws (Audit # 201530026)

This report presents the results of our review to evaluate the Internal Revenue Service's efforts in identifying and addressing nonresident alien individuals who should be paying tax on rental income of United States residential real property. This audit is included in our Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of Impact of Global Economy on Tax Administration.

Management's complete response to the draft report is included as Appendix V. Copies of this report are also being sent to the Director, Office of Audit Coordination, for appropriate distribution within the Internal Revenue Service.

If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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*Additional Controls Are Needed to Help Ensure That Nonresident
Alien Individual Property Owners Comply With Tax Laws*

Abbreviations

FIRPTA	Foreign Investment in Real Property Tax Act
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration
U.S.	United States



Additional Controls Are Needed to Help Ensure That Nonresident Alien Individual Property Owners Comply With Tax Laws

Background

An alien is an individual who is not a United States (U.S.) citizen or U.S. national. The Internal Revenue Code (I.R.C.)¹ generally provides that an alien individual is a resident of the United States with respect to any calendar year for purposes of the I.R.C. (except with respect to estate and gift taxes under Subtitle B) if the individual is a lawful permanent resident of the United States at any time during such calendar year² and satisfies the “substantial presence” test.³ A nonresident alien is an individual who is not a U.S. citizen or a resident alien. Nonresident aliens are subject to U.S. income tax on any U.S. source income, which includes rental income from U.S. residential real property (hereafter referred to as U.S. property). A nonresident alien’s U.S. taxable income is divided into the following two categories:

- Income that is effectively connected to a trade or business in the United States.
- Income that is **not** effectively connected to a trade or business in the United States.

Income that is effectively connected to a U.S. trade or business, after allowable deductions, is taxed at the graduated rates applicable to U.S. citizens and resident aliens, while income that is not effectively connected to a U.S. trade or business is subject to tax at a flat rate of 30 percent that is withheld at the source. Nonresident aliens who own U.S. property that generates rental payments are subject to the flat 30 percent withholding tax on the gross rent **unless** the nonresident alien makes an election to treat the rental income as effectively connected to a U.S. trade or business.⁴ Nonresident aliens who make this election can reduce their rental income by offsetting rental income with expenses pertaining to the rental activity. To make the election, nonresident aliens must:

¹ I.R.C. § 7701(b)(1).

² A lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws. Resident status is deemed to continue unless it is rescinded or administratively or judicially determined to have been abandoned. See Treas. Reg. § 301.7701(b)-1(b).

³ An alien individual satisfies the “substantial present” test if he or she has been present in the United States on at least 31 days in the current year and at least 183 days during a three-year period that includes the current year and two preceding years. Each day of presence in the current year is counted as a full day, each day of presence in the first preceding year is counted as one-third of a day, and each day of presence in the second preceding year is counted as one-sixth of a day. See I.R.C. § 7701(b)(1)(A)(ii), (b)(3); Treas. Reg. § 301.7701(b)-1(c)(1).

⁴ I.R.C. § 871(d).



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- Annually file Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, and a Schedule E, *Supplemental Income and Loss*, to report rental income and expenses effectively connected to a U.S. trade or business.⁵
- Provide Form W-8ECI, *Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States*, to the withholding agent (e.g., renters, lessees, or property managers).⁶ Form W-8ECI informs the withholding agent that the income is effectively connected with a U.S. trade or business and is exempt from the 30 percent withholding tax.⁷

If an election is **not** made, the nonresident alien should provide Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, to the withholding agent.⁸ Form W-8BEN informs the withholding agent that the rental payments it makes are subject to a 30 percent withholding tax.⁹

The National Association of Realtors¹⁰ estimates that resident and nonresident aliens purchased approximately 214,885 homes in the United States with a total value of approximately \$102.6 billion¹¹ in the 12-month period ending in March 2016.¹² Nonresident aliens accounted for approximately \$43.5 billion (42 percent) of the U.S. property purchases, while purchases totaling \$59.1 billion (58 percent) were made by resident aliens. Figure 1 shows the estimated dollar value and percentage of nonresident aliens' U.S. property purchases over the past three years.

⁵ Effective in Tax Year 2016, nonresident aliens can file Form 1040NR electronically. A tax year is a 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁶ A withholding agent is any person, U.S. or foreign, who has control, receipt, custody, disposal, or payment of U.S. income subject to Chapter 3 withholding. A withholding agent may be an individual, corporation, partnership, trust, association, nominee (under I.R.C. § 1446), or any other entity. Chapter 3 provides the legal guidelines on the withholding of tax on nonresident aliens and foreign corporations.

⁷ I.R.C. § 1441(c).

⁸ These taxpayers generally have three years from the original filing date to amend their tax return and submit the election statement.

⁹ I.R.C. § 1441(a). Also, if a Form W-8BEN is issued and the tax withholding is made and paid to the IRS by the withholding agent, the foreign property owner is not required to file a Form 1040NR tax return. However, a foreign property owner must file a Form 1040NR to claim a refund from the tax withholding if applicable.

¹⁰ National Association of Realtors, Research Department, *2016 Profile of International Activity in U.S. Residential Real Estate* p. 5 (June 2016).

¹¹ National Association of Realtors data suggest that nonresident aliens who purchase U.S. property tend to be high-wealth individuals paying on average nearly \$477,000 for a house, compared to the overall U.S. average house price of about \$361,000 in Calendar Year 2015.

¹² A resident alien is a permanent resident of the country in which he or she resides but does not have citizenship. A resident alien needs to either have a current green card or have had one in the previous calendar year.



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Figure 1: Profile of U.S. Home Buying Activity of International Clients for the 12-Month Periods Ending in March 2013 Through March 2016

Period Ending March	Type of International Purchasers		Total International Purchases	Percentage of Nonresident Alien Purchases	Total International Purchases
	Nonresident Alien	Resident Alien			
2016	\$43.5 billion	\$59.1 billion	\$102.6 billion	42 percent	214,885
2015	\$54.4 billion	\$49.4 billion	\$103.8 billion	52 percent	208,947
2014	\$45.5 billion	\$46.7 billion	\$92.2 billion	49 percent	Not Reported
2013	\$34.8 billion	\$33.4 billion	\$68.2 billion	51 percent	Not Reported

Source: National Association of Realtors reports for the 12-month periods ending in March 2013 through March 2016

Nonresident alien purchases of U.S. properties have increased since March 2013, and a significant percentage of these properties are used to generate rental income. With this increase comes the likelihood that noncompliance with the tax laws and regulations is a proportionately higher dollar value. Tax noncompliance increases the gross Tax Gap, which is the difference between what taxpayers owe and what they pay voluntarily. The Internal Revenue Service (IRS) released an estimate of the average annual gross Tax Gap for Tax Years 2008 through 2010 in April 2016. The report estimated the gross annual Tax Gap for this period to be \$458 billion.¹³ The international component of the Tax Gap, which is the amount of taxes owed but not paid by a U.S. or nonresident person whose cross-border income is subject to U.S. taxation, is estimated (by non-IRS sources) to be \$100 billion.¹⁴ The extent of tax noncompliance (both failure to file tax returns and underreporting of tax) by nonresident aliens is unknown; however, in this audit we have identified areas of potential noncompliance that the IRS should address.

This review was performed at the Wage and Investment Division's Submission Processing function in Austin, Texas, with additional information obtained from the Large Business and International Division's Withholding and International Individual Compliance Practice. This audit was conducted during the period November 2015 through October 2016. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate

¹³ IRS, *Tax Gap Estimates for Tax Years 2008–2010* (April 2016). The Tax Gap is comprised of the nonfiling gap, the underreporting gap, and the underpayment (or remittance) gap. The gross Tax Gap is calculated without subtracting amounts collected from IRS enforcement efforts. The average annual net Tax Gap is \$406 billion and represents the difference between what taxpayers owe and what they pay less amounts collected through IRS enforcement efforts.

¹⁴ Staff of Senate Permanent Subcomm. on Investigations, 110th Cong., Rep. on Tax Haven Banks and U.S. Tax Compliance.



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evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. 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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Results of Review

Gross rental income from U.S. property owned by a nonresident alien and not effectively connected with a U.S. trade or business is subject to a flat 30 percent tax.¹⁵ Owners of U.S. property who derive rental income from property that is effectively connected with a U.S. trade or business can reduce their rental income with ordinary and necessary deductions related to the rental activity, which often results in lower effective tax rates. Due to the difficulties in determining what constitutes a U.S. trade or business and to encourage the filing of tax returns by nonresident alien owners of U.S. property, Congress provided an election that allows a nonresident alien to treat income from U.S. property as effectively connected with the conduct of a trade or business in the United States.

Controls to Ensure Proper Reporting of Rental Income by Nonresident Aliens Owning U.S. Property Can Be Improved

While the election to have U.S. property rental income treated as effectively connected with the conduct of a trade or business in the United States eliminates the withholding requirements on the gross rental income, the election also changes the calculation of taxable income. To illustrate, if a nonresident alien received \$36,000 of gross rental income from U.S. property during the calendar year, the gross rental income is subject to a 30 percent tax of \$10,800. In contrast, the ability to claim expenses related to the rental property prior to applying graduated tax rates can result in substantial savings to a foreign property owner.¹⁶ If this same taxpayer makes an election to treat the income generated from U.S. property as effectively connected to a U.S. trade or business, the gross rental income amount of \$36,000 can be reduced by mortgage interest, depreciation, management fees, taxes, insurance expenses, *etc.* The nonresident alien's income tax is then calculated using net rental income at the graduated tax rates. In addition, a taxpayer who claims the election and has a net rental loss may be able to deduct up to \$25,000 from adjusted gross income if they are actively participating or apply those losses against passive income or carry remaining losses forward to offset gains generated by a complete disposition to an unrelated party in the future.¹⁷

¹⁵ Mere ownership of U.S. property, combined with passive receipt of rental income and payments of incidental expenses for the collection of the rental income, is insufficient to rise to the level of a U.S. trade or business.

¹⁶ This is due in large part to claiming depreciation expense, which is a noncash expense.

¹⁷ I.R.C. § 469. The entire \$25,000 offset is not eligible for taxpayers who file married filing separately or exceed a certain income threshold.



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Treasury Regulations provide specific requirements when making this election

I.R.C. § 871(d)(1) allows nonresident aliens to treat rental income from U.S. property as income effectively connected to a U.S. trade or business. Treasury Regulations govern the manner in which the election should be made:

An election made under this section without the consent of the Commissioner shall be made for a taxable year by filing with the income tax return required under section 6012 and the regulations thereunder for such taxable year a statement to the effect that the election is being made. This statement shall include (a) a complete schedule of all real property, or any interest in real property, of which the taxpayer is titular or beneficial owner, which is located in the United States, (b) an indication of the extent to which the taxpayer has direct or beneficial ownership in each such item of real property, or interest in real property, (c) the location of the real property or interest therein, (d) a description of any substantial improvements on any such property, and (e) an identification of any taxable year or years in respect of which a revocation or new election under this section has previously occurred. This statement may not be filed with any return under section 6851 and the regulations thereunder.¹⁸

IRS Publication 519, *U.S. Tax Guide for Aliens*, provides additional information on this election. It states that a nonresident alien makes the election to treat income from U.S. property as effectively connected to a U.S. trade or business by attaching a written statement to his or her return, or amended return, for the first year of the election. Publication 519 instructs the nonresident alien to include the following elements when making an election:

- Statement that the election is to have the rental income considered effectively connected to a U.S. trade or business and whether the election is made under I.R.C. § 871(d) or a tax treaty.
- Complete list of all U.S. property, or any interest in U.S. property, located in the United States and the extent of ownership in the property.
- Location of the U.S. property, description of any major improvements to the property, and dates the property is owned.
- Income from the U.S. property.
- Details of any previous election or revocations of the U.S. property income election.

¹⁸ Treas. Reg. § 1.871-10, election to treat U.S. property income as effectively connected with U.S. business “statement to be filed with return.”



Additional Controls Are Needed to Help Ensure That Nonresident Alien Individual Property Owners Comply With Tax Laws

Our review shows that:

- Taxpayers are not complying with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10.
- Taxpayers who are noncompliant with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10 are allowed to deduct expenses related to the rental income.
- Form 1040NR*****2*****.
- *****2*****.

Taxpayers are not complying with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10

We selected a random stratified sample of 195 filers from 33,086 Tax Year 2013 Form 1040NR Schedule E filers who were **first-time** filers that year. We eliminated 41 of the returns from consideration because the taxpayers were reporting royalties and/or Schedule K-1 income.¹⁹ We eliminated five more returns from consideration because the information on the return was not sufficient to determine whether an election statement would be required. For the remaining 149 returns, the nonresident aliens filed and reported rental income and expenses on their Schedule E.

We found that only 47 (32 percent)²⁰ of the 149 taxpayers complied with the reporting requirements of rental income by nonresident alien individuals and included an election statement in accordance with I.R.C. § 871(d)(1) when required; only six of the election statements included all of the elements required by Treasury Regulation § 1.871-10. For 102 (68 percent) of the 149 returns in our random sample, the taxpayers did not attach an election statement as required, but they still reported their rental income as effectively connected to a U.S. trade or business. Based on stratified statistical projections, 19,098 nonresident aliens

¹⁹ Schedule K-1 income is partnership or S corporation income for each individual partner and is included on the partner's personal tax return. There are different Schedules K-1 depending on the type of business to which it relates.

²⁰ Eight of the 47 individuals who complied with the rental reporting requirements filed as dual status taxpayers in Tax Year 2013 due to residency termination. Dual status taxpayers must file both Form 1040, *U.S. Individual Income Tax Return*, and Form 1040NR during the year in which they terminated their residency. Although these taxpayers reported worldwide rental income on their Forms 1040 for the portion of the year they were residents of the United States, they are not required to do the same on their Forms 1040NR. The foreign property rental income earned on properties they own abroad is not reported on the Form 1040NR. As a result, these taxpayers were not required to attach and did not attach an election statement to either return. For the purposes of our testing, we considered them compliant.



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reported rental income as effectively connected to the conduct of a trade or business, and we estimate that 11,926²¹ (62.5 percent)²² failed to comply with the regulations in Tax Year 2013.

Schedule E instructions do not refer to an election statement

The nonresident alien individuals in our sample who failed to submit election statements may not be aware of the requirement. While Schedule E is required to be used by nonresident alien individuals to report their rental income and expenses, the form instructions do not include any mention of the requirements under I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10. The significant percentage of nonresident alien individuals not attaching election statements to their Forms 1040NR may be due to the limitation of Schedule E instructions.

Taxpayers who are noncompliant with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10 are allowed to deduct expenses related to the rental income

The 102 taxpayers in our random stratified sample who did not comply with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10 received favorable tax treatment of their rental income even though the required elections were not filed.²³ Instead of paying 30 percent of their gross rental income, they were allowed to deduct rental expenses and pay graduated rates on their net rental income. Overall, the 102 taxpayers reported approximately \$1.78 million in gross rental income, which they reduced with \$1.88 million in rental expenses.²⁴ Many of the taxpayers reported rental expenses that exceeded their gross rental income. Specifically, we determined that:

- 59 (58 percent) of the 102 taxpayers reported approximately \$682,000 in gross rental income. After rental expenses were deducted, these taxpayers reported approximately \$268,000 in net rental losses on their Schedule E. Accordingly, the 59 taxpayers paid no tax on their rental activity. In addition, the rental loss for 49 of the 59 taxpayers was reported on the front page of Forms 1040NR, and seven of these taxpayers reduced their taxable income by \$50,602. Refunds were issued to six taxpayers, totaling more than \$8,400.
- 43 (42 percent) of the 102 taxpayers reported approximately \$1.09 million in gross rental income and reported approximately \$218,000 in net rental income on Part I of their Schedule E after rental expenses were deducted.

²¹ See Appendix IV. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that this number is between 10,064 and 13,788.

²² This percentage is based on the results of the stratified random sample. As a result, it is lower than the rate of noncompliance in the sample reviewed as a whole (68 percent vs. 62.5 percent), which does not account for variations by strata.

²³ This election is not required if the taxpayer is indeed engaged in a U.S. trade or business. Based on the entries on the Schedules E in our sample and the rules regarding trade and business activity, there were no indications that the properties were part of a business that rents properties for a profit.

²⁴ Forty-nine of the 102 taxpayers reported a rental income loss.



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Because none of the 102 taxpayers complied with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10, all of their approximately \$1.78 million gross rental income should have been subject to a 30 percent tax withholding of \$534,000.²⁵ When projected over the entire population using a stratified random sample, this amount totals \$56.2 million.²⁶ This applies to only Tax Year 2013 because there would be new nonresident aliens filing Forms 1040NR with Schedule E reporting their rental income from U.S. property every tax year.

Figure 2 illustrates the tax benefits of two hypothetical taxpayers reporting their U.S. property rental income as effectively connected to a U.S. trade or business despite failing to comply with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10. Taxpayer A received \$75,000 in rental income. On Schedule E, Taxpayer A reported \$85,000 in rental expenses, resulting in a \$10,000 net loss. The loss reduces the nonresident alien individual's adjusted gross income by \$10,000, resulting in a \$1,500 tax benefit (assuming a 15 percent tax rate). Also, because the taxpayer did not comply with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10, the gross rental income (\$75,000) should have been subject to 30 percent tax (\$22,500). In total, taxpayer A received a tax benefit of \$24,000 (\$22,500 for 30 percent flat tax + \$1,500 for income tax) despite noncompliance with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10.

Taxpayer B also received \$75,000 in rental income. On Schedule E, Taxpayer B reported \$65,000 in rental expenses, resulting in a \$10,000 net rental income. Because Taxpayer B did not comply with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10, the taxpayer would have paid only \$1,500 in tax on the rental income (assuming a 15 percent tax rate). However, Taxpayer B should have paid 30 percent of the gross rental income (\$22,500) in tax. As a result, Taxpayer B received a tax benefit of \$21,000 (\$22,500 for 30 percent flat tax - \$1,500 for income tax) despite noncompliance with I.R.C. § 871(d)(1) and Treasury Regulation § 1.871-10.

²⁵ Treasury Regulation § 1.871-10(d) provides that a nonresident alien individual can make the initial election any time before the expiration of the period in § 6511(a) or by § 6511(c) for the first taxable year for which the election under this section is to apply.

²⁶ See Appendix IV. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between \$32,349,354 and \$80,122,748.



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Figure 2: Hypothetical Examples of Tax Benefits Allowed Even When an Election Statement Is Not Filed

Table with 3 columns: Schedule E, Taxpayer A, and Taxpayer B. Rows include Gross Rental Income, Deductions, Net Rental Income (Loss), Income Tax on Net Rental Income, 30 Percent Flat Tax, and Tax Benefit on Treatment of Rental Income.

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of first-time Schedule E filers.

Form 1040NR *****2*****

IRS filing requirements provide that nonresident aliens submit Forms 1040NR for processing at the Austin Campus. *****2*****

*****2*****. In addition, the timing of the election presents challenges to ensuring compliance. Specifically, the statute requires taxpayers to attach an election statement to their Form 1040NR return in the initial year of having rental income.

27 The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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If the information was captured, the Wage and Investment Division could determine whether an election was made while verifying FIRPTA withholding credits claimed by nonresident alien foreign sellers of U.S. property.³² Large Business and International Division's Withholding and International Individual Compliance Practice management recognizes the difficulty in enforcing I.R.C. § 871(d) and is considering alternatives to attaching an election statement to Form 1040NR. One alternative being discussed is to change the applicable instructions to convey that nonresident alien taxpayers would be deemed to comply if they file a Schedule E reporting their rental activity as effectively connected to a U.S. trade or business. In effect, the filing of the Schedule E will satisfy the election statement requirement. While this change makes it easier to enforce the requirement for the election, it would not capture the information required by Treasury Regulation § 1.871-10 that can assist the IRS in enforcing existing tax law such as the FIRPTA.

Recommendations

The Director, Large Business and International Division, Withholding and International Individual Compliance Practice, should:

Recommendation 1: Request that a revision be made to Form 1040NR to enable nonresident aliens to make an election under I.R.C. § 871(d) and revise processing procedures to ensure that the IRS records the election.

Management's Response: IRS management agreed with this recommendation. The IRS agrees that a revision to Form 1040NR that captures data currently sought in the election statement could improve compliance and balance taxpayer burden and efficient tax law administration. While electronic filing of Form 1040NR has begun, implementation of this recommendation is subject to the availability of limited Information Technology organization resources, and its completion cannot be reasonably assured. Accordingly, the IRS cannot provide an implementation date at this time.

Recommendation 2: Request that the Wage and Investment Division, when verifying FIRPTA withholding credits claimed on Form 1040NR filed by nonresident alien sellers against information in the FIRPTA Database, also research the nonresident alien's Master File account to determine if the U.S. property was rented and depreciated. If it was, verify calculation of the property's cost basis used in the sale.

Management's Response: IRS management disagreed with this recommendation. There is agreement that verification of a property's cost basis should ideally accompany

³² The Wage and Investment Division verifies FIRPTA withholding credits claimed on U.S. income tax returns filed by foreign sellers against information in the FIRPTA Database to ensure that Forms 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, were filed by the buyer and that the FIRPTA withholding was remitted to the IRS.



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verification of FIRPTA withholding credits claimed on a Form 1040NR. However, absent enhancements to the IRS's systems that will capture data and automatically verify cost basis, it is not feasible at this time to include a manual verification of cost basis for a potential audit when validating FIRPTA withholding.

Placing the Reporting and Withholding Burden on Renters Is Problematic

Voluntary compliance is strongest in the presence of information reporting and withholding. I.R.C. § 1441 governs the reporting and withholding requirements when nonresident aliens do not report their U.S. property rental income as effectively connected to a U.S. trade or business.³³ However, we found the following potential barriers that may be preventing voluntary compliance with reporting and withholding requirements of rental income under I.R.C. § 1441:

- The burden of determining whether I.R.C. § 1441 applies is placed on the renter of U.S. property owned by a nonresident alien. As such, the renter is responsible for filing the required forms with the IRS, withholding a portion of the rental amount, and remitting the withheld amount to the IRS.
- To determine whether I.R.C. § 1441 applies, the renter is dependent on the U.S. property owner disclosing their status as a nonresident alien who is subject to I.R.C. § 1441. If nonresident alien property owners do not communicate their status or are not truthful about their foreign status, renters will be unaware of their responsibilities as a withholding agent.³⁴ Also, nonresident aliens may not know they are subject to I.R.C. § 1441. While the nonresident alien may disclose that they are exempt from withholding, the renter must withhold 30 percent of the rent unless the renter receives an appropriate Form W-8ECI from the nonresident alien claiming exemption from withholding tax.
- Because the law designates the renter a withholding agent, renters are required to file Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, for each tax year in which rent is paid to nonresident aliens (even when the nonresident alien individual is exempt from withholding). However, the IRS places an additional burden on renters who are individuals. Instructions for Form 1042-S require the withholding

³³ Testimony of Nina E. Olson, National Taxpayer Advocate, *Committee on Ways and Means; Response to questions for the record submitted by Rep. Diane Black in connection with the Committee's January 20, 2011, hearing on Fundamental Tax Reform: Reporting compliance rates are about 99 percent on wages subject to withholding and third-party information reporting, about 96 percent on income subject to full third-party information reporting (e.g., interest and dividends) – yet less than 50 percent on income not subject to third-party information reporting.* (January 20, 2011).

³⁴ Under the law, the renter is considered a withholding agent in the absence of a management company. Management companies deal directly with renters, handling rentals, collecting rent, handling maintenance and repair issues, responding to tenant complaints, and pursuing evictions.



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agent to file using an Employer Identification Number. Accordingly, in order to comply with I.R.C. § 1441 and file Form 1042-S, the renter must request and obtain an Employer Identification Number.

- While the IRS has made an effort to educate the public regarding nonresident aliens' withholding requirements under I.R.C. § 1441 in Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*, pertinent instructions and publications may not help renters recognize and fully understand their tax withholding requirements under I.R.C. § 1441. For instance, there is no reference to the renter in Publication 515 related to tax withholding on nonresident aliens and foreign entities. As a result, the IRS has not been entirely clear in identifying the renter as a withholding agent and conveying his or her responsibilities.

In addition, while I.R.C. § 1441 suggests that the withholding agent (renter) is required to withhold from their rent payment and remit the withholding to the IRS, I.R.C. § 1461 indicates that they are liable for the withholding tax imposed on rental income. However, Publication 515 indicates joint liability between the withholding agent and the property owner, stating:

As a withholding agent, you are personally liable for any tax required to be withheld. This liability is independent of the tax liability of the foreign person to whom the payment is made. If you fail to withhold and the foreign payee fails to satisfy its U.S. tax liability, then both you and the foreign person are liable for tax, as well as interest and any applicable penalties.

Of the 154 property owners tested in the same sample previously discussed,³⁵ 139 reported domestic rental revenue.³⁶ Because the property owners reported U.S. rental income on a Schedule E, they should have provided the withholding agent (either the renter or management company) with a withholding certificate exempting withholding. The withholding agent would still be required to file Form 1042-S to report the rental payments made. Form 1042-S indicates a withholding exemption by entering exemption code '01' (Effectively Connected Income Exemption) in box 6 (Exemption Code). However, we researched the IRS Information Returns Master File and determined that only five (3.6 percent) of the 139 property owners in our sample

³⁵ For the purposes of this test, we considered the five taxpayers who were dropped from the Schedule E test because we could not determine whether they were first-time filers. Regardless of whether they were first-time Schedule E filers or not, the tenants should have submitted a Form 1042-S reporting the rent they paid to the nonresident alien individuals.

³⁶ Fifteen nonresident alien individuals tested did not report income, were reporting on rental income earned on property they own abroad, or did not provide enough information to determine whether a Form 1042-S was required. Those who used Schedule E to report on property abroad were designated dual status residents who were considered resident aliens for part of the year and nonresident aliens for the remainder of the year. The income reported on the Schedule E represents income earned on foreign property during the period of time they were considered resident aliens. Four additional property owners were tested because a Form 1042-S would be required regardless of whether an election statement was required in Tax Year 2013 if the nonresident alien is reporting on rental income earned on U.S. property they own.



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had rental income supported by a corresponding Form 1042-S.³⁷ We also determined that 83 of the 134 property owners reported management fees on their respective Schedule E indicating that they may have employed a management company handling their rental property. As such, 134 property owners had rental income for which the renter and/or management company did not file a Form 1042-S and the IRS did not receive support from a corresponding Form 1042-S.

To complement the results of our sample, we obtained a data extract of the Form 1042-S database that included 87,495 Tax Year 2013 Form 1042-S documents reporting real property income and natural resources royalties (income code 13 in box 1 of the form). We matched all 87,495 Tax Year 2013 Forms 1042-S against all 86,463 Tax Year 2013 Forms 1040NR reporting rental income on the Schedule E. We found that only 2,585 (3 percent)³⁸ of the 86,463 returns had rental income that was supported by a corresponding Form 1042-S. In accordance with the I.R.C., the IRS can impose a failure to file an information return penalty of \$100 if withholding agents fail to file on or before the required filing date.³⁹ For the 83,878 (86,463 – 2,585) withholding agents (renters) that we determined did not file a required Form 1042-S, the IRS could have assessed nearly \$8.4 million in failure to file penalties.

The property owner’s residency status creates a reporting requirement for the renter, and most renters would not be aware of this reporting requirement unless notified by the property owner. Yet the law provides for stiff penalties when they fail to file. The tax compliance regime with respect to nonresident aliens who do not file the required election appears to be impracticable. While there is both high noncompliance by nonresident aliens for the filing of elections and a high filing and withholding noncompliance rate of renters of foreign-owned U.S. property, the compliance regime is dependent on nonresident aliens informing renters of their tax status so that renters can then remit a portion of their rent payments to the IRS. There is a lack of clear information regarding the obligations of renters in such situations, but it is not clear that providing more information to the public would affect the noncompliance. Whether renters are involved in short-term vacation rentals or long-term residential rentals, they do not appear to be an effective means to achieve higher tax compliance by nonresident aliens.

The IRS ***2*******
*******2*******

As previously noted, nonresident alien individuals are offered an election that potentially reduces their taxable rental income. The tax benefits of the election provide incentive for nonresident aliens who derive income from U.S.-owned property to file tax returns and report rental income.

³⁷ The Information Returns Master File contains information returns data.

³⁸ There were 55,768 Forms 1042-S that reported a blank or incomplete Taxpayer Identification Number. This necessitated matches using other fields on the Forms 1042-S and the corresponding Forms 1040NR reporting rental income. It should be noted that the matches are not conclusive because there are many other variations of the fields that could have been joined that would have likely resulted in additional matches.

³⁹ 26 U.S.C. § 6721 – *Failure to file correct information returns.*



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As part of this review, we attempted to assess the tax noncompliance of nonresident aliens owning real property in the U.S. Because of the significant limitations in attempting to identify nonresident alien ownership of U.S. property, we could not establish or estimate a noncompliance rate of all nonresident aliens owning U.S. property; however, we were able to identify some potential noncompliance.⁴⁰

To identify nonresident aliens who own U.S. rental properties that potentially necessitate the filing of tax returns or income reporting and withholding, we used the *2014 Profile of International Home Buying Activity*⁴¹ report from the National Association of Realtors to gauge foreign investment interest in various cities throughout the United States during Tax Year 2013. City information is compiled by the National Association of Realtors based on the number of searches by foreign residents for various cities on their website.⁴² The following 10 cities were the top U.S. cities searched on realtor.com in the 12-month period ending March 2014, per the aforementioned report.

- | | | |
|--------------------------------|-----------------------------|-------------------------------|
| 1. Los Angeles, California (*) | 5. New York, New York | 9. Chicago, Illinois |
| 2. Miami, Florida (*) | 6. Detroit, Michigan | 10. San Diego, California (*) |
| 3. Las Vegas, Nevada | 7. Houston, Texas (*) | |
| 4. Orlando, Florida (*) | 8. Fort Lauderdale, Florida | |

The asterisk (*) indicates the five cities that were also the top cities for international searches in the 2015 International Profile report. We judgmentally selected five counties in which the cities are located and requested property tax records of property owners with foreign mailing addresses in Tax Year 2013. Broward (Fort Lauderdale), Harris (Houston), Clark (Las Vegas), Los Angeles (Los Angeles) and Orange (Orlando) counties were selected for this audit. We reviewed the property tax records provided by each county to isolate property owners with foreign mailing addresses (if this was not already completed by the counties themselves). In Tax Year 2013, we identified 42,926 property owners with foreign mailing addresses in the five counties selected, as shown in Figure 4.

⁴⁰ For example, to identify nonresident alien ownership of U.S. property, we used properties with foreign addresses. While we believe this approach provides a reasonable basis to gauge foreign ownership, it does not take into consideration nonresident aliens who use U.S. addresses as their mailing address.

⁴¹ National Association of Realtors, *2014 Profile of International Home Buying Activity Purchases of U.S. Real Estate by International Clients for the Twelve Month Period Ending March 2014* p. 48 (June 2014).

⁴² Although the report provides data for foreign purchases by State, it is not currently possible for the National Association of Realtors to present data for purchases by foreigners on a city-by-city basis.



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Figure 4: Property Tax Population and Sample Information

County	Population	Sample
Broward County (Fort Lauderdale)	25,011	125
Harris County (Houston)	1,016	5
Clark County (Las Vegas)	6,073	30
Los Angeles County (Los Angeles)	3,277	16
Orange County (Orlando)	7,549	38
Total	42,926	214

Source: U.S. property tax records for property owners with foreign mailing addresses (Tax Year 2013) that were obtained from the Broward County Property Appraiser, Harris County Appraisal District, Clark County Assessor's Office, Los Angeles County Office of the Assessor, and Orange County Property Appraiser.

We selected a random stratified sample of 214 U.S. properties for which the owner had a foreign mailing address (hereafter referred to as foreign property owners).⁴³ Of the 214 cases in our sample, we excluded 29 cases that were owned by corporations, partnerships, or trusts, and 11 cases for which the U.S. property was a vacant lot. This resulted in 174 cases that were residential properties owned by individuals. We then researched these property addresses online to determine whether they had been listed for rent at any point during Tax Years 2010 through 2015. This search provided some indication as to whether the property was potentially rented by the owner identified in the Tax Year 2013 list. We conducted further research on the sample of 174 properties and property owners. We matched the property addresses in our sample against the filing addresses used on Tax Year 2013 income tax returns. We analyzed the results of this match to determine whether individuals other than the property owners were filing income tax returns from the property addresses in the sample.

Based on our analysis, we determined that 28 (13 percent) of the 214 foreign property owners appear to have rented their U.S. property and did not file a tax return for Tax Year 2013. When projected over the population from which we selected the stratified random sample, 5,634 foreign property owners may have rented their U.S. property and did not comply with reporting and filing requirements for Tax Year 2013.⁴⁴ In 28 cases, we determined that a taxpayer other than the property owner filed their Tax Year 2013 income tax return from the

⁴³ We identified these individuals as foreign property owners because the property tax invoices for these properties are mailed to a foreign address. We were unable to identify foreign property owners using a domestic mailing address. If a domestic mailing address was used by a foreign property owner, they were excluded from our analysis.

⁴⁴ See Appendix IV. The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 3,750 and 7,517.



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foreign owner's U.S. property address, indicating that the property owner may have rented out their U.S. property.⁴⁵

These 28 foreign property owners represent a portion of the potential noncompliance of the people selected in our sample who failed to report rental income.⁴⁶ These cases also suggest potential noncompliance with I.R.C. § 1441, which requires a 30 percent withholding of tax on rental payments to nonresident alien individuals unless such income is classified as being effectively connected to a U.S. trade or business.⁴⁷ Because of the limitations of the sample and the lack of IRS compliance data on this issue, a reliable estimate of the actual noncompliance rate cannot be computed. For example, while we used the characteristic of whether a return was filed using the address by someone other than the property owner and the property owner did not file a return, there could be instances in which the renter would either not be filing a return or not filing the return using the address of the rented property. Accordingly, some of the remaining 146 of 214 foreign property owners could be renting their U.S. property and not complying with reporting and filing requirements.

Ensuring compliance with third-party income reporting requirements on passive income earned by nonresident aliens can be extremely challenging, especially given the IRS's budgetary constraints and some of the other barriers described in this report. The potential unreported income in the five counties tested, using the lowest listed rental price for eight properties that were listed for rent with no reported income,⁴⁸ is \$131,880 in annual unreported rental income.⁴⁹ Since we did not have the potential rental income for all the 28 exception cases, we estimated the exception rate for each county using the estimated median rental price of a one-bedroom rental for that county. This would potentially result in unreported rent of \$60.9 million.⁵⁰ Because we

⁴⁵ We did not determine whether the 146 (of 174) property owners listed their properties for rent or whether someone other than the owner filed an income tax return from the property address.

⁴⁶ Because the population was limited to foreign property owners with a foreign address, the potential noncompliance rate of 13 percent would be higher if we were able to identify and include in our analysis the foreign property owners who use a domestic address.

⁴⁷ I.R.C. § 61(a).

⁴⁸ We could identify a rental price for only eight of the 28 properties.

⁴⁹ We calculated this total by annualizing the lowest listed rental price for each of the eight properties on Zillow, an Internet site that provides historical accounts of property changes. This gave us the least possible 12-month rental total for each of the eight properties that were listed for rent with no reported income.

⁵⁰ We cannot provide a good estimate of the confidence interval for these dollars because our estimate of the dollars associated with these exceptions was indirect (the actual rental costs for the 174 properties examined were unavailable). The dollars associated with exceptions was estimated from the estimated median monthly rental costs in the individual counties. These ranged from \$699 in Clark County to \$1,395 in Los Angeles County. We assumed the median rental cost for each exception property was equal to the estimated median rental cost for its county to estimate the total rental costs associated with exception properties in this population. With this approach, we estimate that the annual rental dollars for the population is \$60.9 million. This accuracy of this estimate is based on the assumption that the exception rental properties are similar to the median properties in each respective county.



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used the median rental price of one-bedroom rental for each county, this approach results in a more conservative estimate than what the actual potential unreported rent would be.

*****2*****
*****2*****. The IRS should explore the feasibility of obtaining property tax address lists through its information sharing partnerships with the States. The IRS recognizes the potential for noncompliance in this area but has not been proactive in addressing the issue. The Large Business and International Division’s Withholding and International Individual Compliance Practice is considering strategies to improve compliance related to nonresident alien ownership of U.S. property interests.

Recommendation

Recommendation 3: The Large Business and International Division, Withholding and International Individual Compliance Practice, should develop a compliance initiative addressing nonresident aliens who do not report rental income generated by real property they own in the United States.

Management’s Response: IRS management agreed with this recommendation and agreed that a compliance strategy to assist nonresident aliens in understanding and complying with their filing requirements related to rental income generated by U.S. real property is important. The IRS strategy will consider effective tax law enforcement, taxpayer burden, resources available, and other competing organizational priorities.

Office of Audit Comment: In their response, the IRS management commented that the outcome measure pertaining to this issue was based on an insufficient sample size and questionable valuation. However, the audit population consisted of 42,926 properties registered to foreign owners in five counties, and a stratified random sample of 214 properties were selected and reviewed. The sampling plan was designed to achieve a precision better than 6 percent using 95 percent confidence interval projections. The actual precision achieved (4.39 percent) was better than 6 percent because the exception rate (13 percent) was smaller than initially expected (25 percent). Our outcome measure is based on a projection to the population represented by the five counties we sampled from. For this type of projection, the sample size is appropriate.

The IRS also expressed concern with the accuracy of estimates from Zillow. IRS management cited two studies conducted by the Wall Street Journal and Fortune and suggested the studies reported that most Zillow estimates are accurate but many are inaccurate. We reviewed the two articles cited by the IRS; however, the studies pertain to estimates of home values. We used Zillow for median rental income prices, which are based on the monthly estimated median rent in particular geographical regions (counties).



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the IRS's efforts in identifying and addressing nonresident alien individuals who should be paying tax on rental income of U.S. residential real property (hereafter referred to as U.S. property). To accomplish our objective, we:

- I. Evaluated the IRS's education and outreach efforts related to helping nonresident alien individuals and withholding agents who are impacted by rental income on U.S. property.
 - A. Identified the IRS's educational and outreach efforts to affected taxpayers.
 - B. Assessed the adequacy of the IRS's educational and outreach materials or services provided to nonresident alien individuals and their withholding agents to ensure that the information was useful in helping them determine their filing, reporting, payment, and withholding requirements.
- II. Evaluated the policies, procedures, and training for IRS managers and employees who ensure that nonresident alien individuals and their withholding agents are properly paying and withholding tax when rental income is received from U.S. property they own.
 - A. Interviewed Large Business and International Division and Wage and Investment Division management to identify any policies, procedures, and training that have been provided to IRS personnel so they can ensure that nonresident alien individuals and their withholding agents properly pay and report income they have generated through U.S. residential real property they own.
 - B. Assessed the adequacy of the policies, procedures, and training available to IRS managers and employees related to ensuring that nonresident alien individuals and their withholding agents are properly paying or withholding taxes when required.
- III. Evaluated the IRS's compliance program to identify nonresident alien individuals and their withholding agents that are potentially noncompliant with paying or withholding tax on rental income of U.S. property.
 - A. Interviewed Large Business and International Division and Wage and Investment Division management to identify compliance initiatives in this area.



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- B. Requested copies of any studies conducted by the Large Business and International Division and Wage and Investment Division related to nonresident alien individuals or withholding agents.
 - C. Conducted walkthroughs at the IRS campus in Austin, Texas, to fully understand Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, and Schedule E, *Supplemental Income and Loss*, processing, specifically as it relates to the type of information that is transcribed and recorded.
- IV. Determined whether the IRS ensures that a trade or business election is appropriate when rental income is received on U.S. property owned by a nonresident alien individual.
- A. Identified the population of nonresident aliens who filed a Form 1040NR and claimed a Schedule E income/loss on line 18 of the return during Tax Years¹ 2010 through 2014, potentially indicating rental income/expenses. Once identified, we limited our focus to Tax Year 2013 and isolated a population of 33,086 nonresident alien taxpayers who had no records of previous Form 1040NR Schedule E filings between Tax Years 2010 and 2012 or a subsequent Form 1040NR Schedule E filing in Tax Year 2014.
 - B. Selected a statistically valid stratified random sample of taxpayers, from the population of 33,086, using the data extract results of nonresident alien individuals who appeared to have first filed a Form 1040NR with an attached Schedule E for Tax Year 2013 exclusively, based on a 95 percent confidence level, a 50 percent anticipated error rate, and a ± 7 percent precision rate.² We worked with a contracted statistician to develop the sampling methodology and ultimately project the results.
 - C. Requested copies of Tax Year 2013 Forms 1040NR for the 195 taxpayers selected and reviewed each attached Schedule E for rental income, expense items, total net rental income, and an election statement. We also used IRS data systems to verify that the taxpayer had never previously filed a Form 1040NR with an attached Schedule E.
 - D. If rental income was claimed on the Schedule E documents reviewed, we also used IRS data systems to determine whether the taxpayer had a Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, associated with their TIN/ITIN, supporting the gross rental income and any withholding claimed.
 - E. Used the results from testing to project the number of taxpayers who failed to make an election as well as the withholding tax owed as a result.

¹ A tax year is a 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

² This sampling methodology was used because TIGTA consulted with its contracted statistician. A 50 percent exception rate was utilized because TIGTA was unsure of what the exception rate would ultimately be.



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- F. Obtained a Form 1042-S extract and had the TIGTA Applied Research and Technology Group perform data analytics on the information received. The group identified all Tax Year 2013 Forms 1040NR reporting rental income on the attached Schedules E (line 3) and matched those amounts against available Forms 1042-S that would support the rental income reported. We used the results to estimate the number of Schedule E returns reporting rental income that were unsupported by a Form 1042-S withholding statement as well as possible associated penalties.
- V. Determined whether the IRS ensures that rental income received on U.S. residential real property owned by a nonresident alien individual is properly reported.
 - A. Used county property tax records containing lists of property owners with foreign mailing addresses in Tax Year 2013 and selected a statistically valid stratified random sample of taxpayers from each of the five counties judgmentally selected based on a 95 percent confidence level, a 25 percent exception rate, and a ± 7 percent precision rate. Given the size of the Tax Year 2013 property tax list for each county, we selected 125 individuals in Broward County (Ford Lauderdale), five in Harris County (Houston), 30 in Clark County (Las Vegas), 16 in Los Angeles County (Los Angeles), and 38 in Orange County (Orlando). We worked with our contracted statistician to develop the sampling methodology and made the sample selections from a total population of 42,926 property owners across five cities.
 - B. Reviewed the owners in the sample selected and dropped properties that were designated commercial real estate or owned by businesses or trusts.
 - C. Searched for remaining property owner Taxpayer Identification Numbers on IRS data systems using the names provided on the lists and then searched each property address on the Internet to determine whether it had been listed for rent during Tax Years 2010 through 2015. If the Taxpayer Identification Numbers were identified and the property was listed for rent, we looked into whether the taxpayer had filed a return reporting rental income on Form 1040NR or had rental income tax withheld on their behalf at any point during the five-year review period.
 - D. Matched property addresses from the sample selected against filing addresses in IRS systems to determine whether anyone other than the property owner filed from the address in the list of property owners with foreign mailing addresses.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the guidelines and rules related to processing Forms 1040NR. We evaluated these controls by conducting a walkthrough of the



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return processing function at the Austin Campus and reviewing a random sample of Forms 1040NR received and processed at the Austin Campus.

Data validation methodology

During this review, we relied on data extracts from the IRS's Individual Master File³ and the Return Transaction File⁴ located at TIGTA's Data Center Warehouse.⁵ We relied on data validation tests conducted by TIGTA Office of Investigations' Strategic Data Services for the accuracy of the data and compared their runs of requested data to data we pulled and used. Before relying on these data, we ensured that each file contained the specific data elements we requested. In addition, during the course of reviewing returns, we verified that most of the taxpayers matched the criteria we sought. We determined that the data were sufficiently reliable for purposes of this report.

We also relied on data obtained from Broward County (Ford Lauderdale), Harris County (Houston), Clark County (Las Vegas), Los Angeles County (Los Angeles), and Orange County (Orlando). We requested property tax lists containing property owners with foreign mailing addresses. Once we obtained these lists, we confirmed the counts with representatives at each county assessors' office when possible (Clark and Harris Counties). If representatives could not be reached to confirm these totals, we took a random sample of properties on the property lists and compared the information in the sample selected against the related property tax bill (Broward and Orange Counties). We could not, however, validate the data provided by Los Angeles County. Overall, we determined that the data were sufficiently reliable for purposes of this report.

³ The IRS database that maintains transactions or records of individual tax accounts.

⁴ A database that the IRS maintains that contains transcribed line items and their accompanying forms and schedules from the tax returns it receives.

⁵ A collection of IRS databases containing various types of taxpayer account information that is maintained by TIGTA for the purpose of analyzing data for ongoing audits and investigations.



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Alien Individual Property Owners Comply With Tax Laws*

Appendix II

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Alien Individual Property Owners Comply With Tax Laws*

Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Director, International Business Compliance, Large Business and International Division
Director, Office of Audit Coordination



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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 Congress.

Type and Value of Outcome Measure:

Increased Revenue – Potential; \$18.3 million from 5,634 nonresident alien individual property owners from five counties who are subject to a 30 percent tax on potentially unreported rental income of \$60.9 million (see page 17).

Methodology Used to Measure the Reported Benefit:

We selected a random stratified sample of 214 U.S. properties across five judgmentally selected counties where the owner had a foreign mailing address. Of those 214 properties in our sample, we excluded 29 that were owned by corporations, partnerships, or trusts. We also eliminated 11 properties that were vacant lots. This resulted in 174 properties that were residential properties owned by individuals. We then researched these property addresses online to determine whether they had been listed for rent at any point during Tax Years 2010 through 2015. The search provided some indication as to whether the property was potentially rented by the owner identified in the Tax Year 2013 list. We conducted further research on the sample of 174 properties and property owners. We matched the property addresses in our sample against the filing addresses used on Tax Year 2013 income tax returns. We analyzed the results of this match to determine whether individuals other than the property owners were filing income tax returns from the property addresses in the sample.¹

Based on our analysis, we determined that 28 (13 percent) of the 214 foreign property owners may have rented their U.S. property and failed to comply with reporting and filing requirements. Specifically, for Tax Year 2013, we identified 28 instances in which individuals appeared to be renting properties owned by individuals with foreign mailing addresses during Tax Year 2013. We broke out each of these exceptions by county and applied the January 2014 estimated median listed price for a one-bedroom rental (per Zillow) to both the sample total as well as the exceptions noted for that county. Our contracted statistician reviewed this information and projected the data over the population of property owners with foreign mailing addresses provided by each county using the Levy and Lemeshow Approach.

¹ We had no evidence to suggest that 146 (of 174) property owners may have been nonresident alien individuals who rented their U.S. properties.



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Using the 28 exceptions, we calculated the strata (county) error rate by dividing the number of exceptions per county by the tested sample total in that county for an error rate of:

- 7.20 percent (9/125) in Stratum 1 (Broward County).
- 20.00 percent (1/5) in Stratum 2 (Harris County).
- 36.67 percent (11/30) in Stratum 3 (Clark County).
- 12.50 percent (2/16) in Stratum 4 (Los Angeles County).
- 13.16 percent (5/38) in Stratum 5 (Orange County).

We then projected the number of exceptions by multiplying the calculated error rate for each county by the number of property owners with foreign mailing addresses in each list provided by the county assessor's office:

- 1,800.8 (25,011 x 7.20 percent) projected property owners with unreported rent in Stratum 1 (Broward County).
- 203.2 (1,016 x 20.00 percent) projected property owners with unreported rent in Stratum 2 (Harris County).
- 2,226.8 (6,073 x 36.67 percent) projected property owners with unreported rent in Stratum 3 (Clark County).
- 409.6 (3,277 x 12.50 percent) projected property owners with unreported rent in Stratum 4 (Los Angeles County).
- 993.3 (7,549 x 13.16 percent) projected property owners with unreported rent in Stratum 5 (Orange County).

We then calculated the average exception dollars per case by dividing the county exception dollars (the product of the number of exceptions and the median one-bedroom listed rent price) by the total number of cases reviewed per county. This resulted in average exception dollars (per case) of:

- \$907 (\$113,400/125) for Stratum 1 (Broward County).
- \$2,760 (\$13,800/5) for Stratum 2 (Harris County).
- \$3,076 (\$92,268/30) for Stratum 3 (Clark County).
- \$2,093 (\$33,480/16) for Stratum 4 (Los Angeles County).
- \$1,303 (\$49,500/38) for Stratum 5 (Orange County).



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Finally, we applied the average exception dollars per county to each list of property owners with foreign mailing addresses provided by the county assessor's office to determine the total projected unreported rent. This yielded:

- \$22,689,979 (\$907 x 25,011) potential unreported rent in Stratum 1 (Broward County).
- \$2,804,160 (\$2,760 x 1,016) potential unreported rent in Stratum 2 (Harris County).
- \$18,678,119 (\$3,076 x 6,073) potential unreported rent in Stratum 3 (Clark County).
- \$6,857,123 (\$2,093 x 3,277) potential unreported rent in Stratum 4 (Los Angeles County).
- \$9,833,566 (\$1,303 x 7,549) potential unreported rent in Stratum 5 (Orange County).²

Based on these parameters, we estimate that 5,634³ potential taxpayers failed to report or will fail to report rental income of \$60.86 million⁴ on property they own in the five judgmentally selected counties.⁵ The withholding tax required to be withheld on the potentially unreported rent of \$60,862,946 at 30 percent would be \$18,258,884.

² The actual results of the computations are slightly different due to rounding and approximations. Consequently, the calculations provided here are rounded to the closest whole number and are immaterially different from the results.

³ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 3,750 and 7,517.

⁴ We cannot provide a good estimate of the confidence interval for these dollars because our estimate of the dollars associated with these exceptions was indirect (the actual rental costs for the 214 properties examined were unavailable). The dollars associated with exceptions was estimated from the estimated median monthly rental costs in the individual counties. These ranged from \$699 in Clark County to \$1,395 in Los Angeles County. We assumed the median rental cost for each exception property was equal to the estimated median rental cost for its county to estimate the total rental costs associated with exception properties in this population. With this approach, we estimate that the annual rental dollars for the population is \$60.9 million. This accuracy of this estimate is based on the assumption that the exception rental properties are similar to the median properties in each respective county.

⁵ The actual results of the computations are slightly different due to rounding and approximations. Consequently, the calculations provided here are rounded to the closest whole number and are immaterially different from the results.



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Appendix V

Management's Response to the Draft Report



COMMISSIONER
LARGE BUSINESS AND
INTERNATIONAL DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

July 17, 2017

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT
MICHAEL E. McKENNEY

FROM:

Douglas W. O'Donnell *Douglas W. O'Donnell*
Commissioner, Large Business and International Division

SUBJECT:

Draft Audit Report # 2015-30-026, Additional Controls Are Needed to Help Ensure Nonresident Alien Individual Property Owners Comply With Tax Laws

Thank you for the opportunity to respond to the report entitled "Additional Controls are Needed to Help Ensure Nonresident Alien Individual Property Owners Comply with Tax Laws." We appreciate your acknowledgement of the challenges related to administering the tax law related to nonresident alien ownership of U.S. real property.

LB&I is currently developing compliance initiatives intended to make substantive, long-term improvements in taxpayers' compliance including those with income from rental properties. This could include developing outreach to property managers on the benefits of an election and working with state and local governments to identify property owners who are not filing returns. The onset of electronic filing of Forms 1040NR will also allow us to explore alternatives to the existing election process that improves the IRS's ability to collect the data without increasing taxpayer burden. Similar to the IRS as a whole, LB&I is challenged by uncertain funding and shrinking resources. Given on-going resource limitations, it is important that the strategies used to implement the initiatives not only increase the efficiency and effectiveness of tax law administration but also reduce taxpayer burden.

We have attached a detailed response outlining our corrective actions. We disagree with the Outcome Measures as stated in Appendix IV of this report. We reviewed the sampling methodology and projections, and believe the valuation method was questionable and the sample size was too small.

If you have any questions, please contact me, or a member of your staff may contact John V. Cardone, Director, Withholding & International Individual Compliance Practice Area at (202) 317-8830.

Attachments (2)



Additional Controls Are Needed to Help Ensure That Nonresident Alien Individual Property Owners Comply With Tax Laws

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Attachment I

RECOMMENDATION 1:

The Director of Large Business and International Division, Withholding and International Individual Compliance Practice Area, should request that a revision be made to Form 1040NR to enable nonresident aliens to make an election under I.R.C. § 871(d) and revise processing procedures to ensure the IRS records the election.

CORRECTIVE ACTIONS:

We agree with your assessment that a revision to the form 1040NR that captures data currently sought in the election could improve compliance and balance taxpayer burden and efficient tax law administration. While electronic filing of the Form 1040NR has begun, implementation of this recommendation is subject to the availability of limited Information Technology resources and its completion cannot be reasonably assured. Accordingly, we cannot provide an implementation date at this time.

IMPLEMENTATION DATE:

N/A.

RESPONSIBLE OFFICIAL(S):

Director, Withholding and International Individual Compliance Practice Area, LB&I.

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2:

The Director, Large Business and International Division, Withholding and International Individual Compliance Practice Area, should request that W&I, when verifying FIRPTA withholding credits claimed on Form 1040NR filed by nonresident alien sellers against information in the FIRPTA Database, also research the nonresident alien's Master File account to determine if the U.S. property was rented and depreciated. If it was, verify calculation of the property's cost basis used in the sale.

CORRECTIVE ACTIONS:

We agree that verification of a property's cost basis should ideally accompany verification of FIRPTA withholding credits claimed on a Form 1040NR. However, absent enhancements to IRS's systems that will capture data and automatically verify cost basis, it's not feasible at this time to include a manual verification of cost basis for a potential audit when validating FIRPTA withholding. Accordingly, we disagree with this recommendation.

IMPLEMENTATION DATE:

N/A



Additional Controls Are Needed to Help Ensure That Nonresident Alien Individual Property Owners Comply With Tax Laws

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RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 3:

The Large Business and International Division, Withholding and International Individual Compliance Practice, should develop a compliance initiative addressing nonresident aliens who do not report rental income generated by real property they own in the United States.

CORRECTIVE ACTIONS:

We agree with this recommendation. LB&I agrees that a compliance strategy to assist nonresident aliens in understanding and complying with their filing requirements related to rental income generated by U.S. real property is important. LB&I's strategy will consider effective tax law enforcement, taxpayer burden, the resources available and other competing organizational priorities.

IMPLEMENTATION DATE:

The corrective actions will be implemented by October 15, 2018.

RESPONSIBLE OFFICIAL(S):

Director, Withholding and International Individual Compliance Practice Area, LB&I.

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor this corrective action as part of our internal management control system.



Additional Controls Are Needed to Help Ensure That Nonresident Alien Individual Property Owners Comply With Tax Laws

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Attachment II

1. Type and Value of Outcome Measure:

Increased Revenue – Potential; \$18.3 million from 5,634 nonresident alien individual property owners from five counties who are subject to a 30 percent tax on potentially unreported rental income of \$60.9 million.

The Outcome Measures are based on an insufficient sample size and questionable valuation.

Sample Size: When computing estimates from a random sample, one needs to have information from at least 40 observations to compute a representative attribute estimate and somewhat more to compute a representative variable estimate. The strata sample sizes used to compute the non-compliance estimates ranged from 2 filers to 28 filers. Due to these sample size issues, it is unlikely the computed estimates accurately represent the strata value for which they were computed.

Questionable Valuation: The information from Zillow may or may not be accurate. Studies were done by both The Wall Street Journal and Fortune. They both determined that while most estimates were accurate, many were inaccurate. Since we cannot determine which Zillow estimates (Zestimates) are accurate or inaccurate, we cannot be sure of the accuracy of the estimates using the Zestimates as a component.