
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***Continued Efforts Are Needed to Address
Billions of Dollars in Reporting and Payment
Discrepancies Relating to Tax Withheld From
Foreign Persons***

June 17, 2020

Reference Number: 2020-40-021

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.

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2 = Law Enforcement Techniques/Procedures and Guidelines for Law Enforcement Investigations or Prosecutions

7 = Information Reflecting the Bureau's Decisionmaking Process

Phone Number / 202-622-6500

E-mail Address / TIGTACommunications@tigta.treas.gov

Website / <http://www.treasury.gov/tigta>



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HIGHLIGHTS

CONTINUED EFFORTS ARE NEEDED TO ADDRESS BILLIONS OF DOLLARS IN REPORTING AND PAYMENT DISCREPANCIES RELATING TO TAX WITHHELD FROM FOREIGN PERSONS

Highlights

Final Report issued on June 17, 2020

Highlights of Reference Number: 2020-40-021 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

In most cases, foreign persons are subject to U.S. tax of 30 percent on their U.S. source income. This tax owed is generally withheld by a withholding agent. For Tax Year 2017, the IRS received 6.3 million Forms 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, from 49,618 withholding agents reporting Federal tax withheld on U.S. source income paid to foreign individuals.

WHY TIGTA DID THE AUDIT

Withholding agents are required to file Forms 1042-S to report income and withholding for each foreign person and annually file a Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, to report the cumulative amount of all taxes withheld. The overall objective of this review was to determine whether the IRS has adequate controls in place to ensure that the amounts reported as withheld on Forms 1042-S are reported on Forms 1042.

WHAT TIGTA FOUND

In response to our prior recommendations, the IRS has implemented processes to improve its identification of reporting discrepancies for Federal tax withheld on U.S. source income paid to foreign individuals. However, these processes did not identify some withholding tax discrepancies. Our review identified that IRS processes did not identify 1,919 withholding agents with reporting discrepancies totaling \$182.7 million. The IRS's filter criteria compares incomplete or inconsistent data listed on Forms 1042-S to Forms 1042. In addition, our review

identified 366 withholding agents that claimed \$506 million more in credits for tax withheld than was reported on the Forms 1042-S.

In addition, in response to our prior report, the IRS developed a systemic process to identify withholding agents that are not filing required Forms 1042-S. For example, the IRS's filter identified 1,569 withholding agents that had not filed a Form 1042-S.

Finally, our review identified 7,910 Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, which claimed withholding credits that were not supported by a Form 1042-S. These returns were not selected for IRS verification because the claim amounts were under the IRS's return selection threshold. The IRS cannot systemically verify these claims because withholding agents are not required to provide a payee Taxpayer Identification Number for all Forms 1042-S.

WHAT TIGTA RECOMMENDED

TIGTA made 12 recommendations, including that the IRS modify its filter criteria to ensure that all withholding agents that do not file Form 1042 are identified and modify procedures to ensure that the withholding credit claimed on Form 1042 matches the withholding reported on Forms 1042-S.

IRS management agreed with five recommendations and disagreed with seven recommendations. The IRS did not agree to review the Forms 1042 and 1042-S TIGTA identified with potential reporting discrepancies. The IRS also did not agree to modify *Campaign 817* filter criteria to ensure that information used is consistent or modify Error Resolution function procedures.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 17, 2020

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons (Audit # 201840022)

This report presents the results of our review to determine whether the Internal Revenue Service has adequate controls in place to ensure that amounts reported as withheld on Forms 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, are actually reported on Forms 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*. This audit is part of our Fiscal Year 2020 Annual Audit Plan and addresses the major management challenge of Improving Tax Reporting and Payment Compliance.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).



***Continued Efforts Are Needed to Address Billions of Dollars in
Reporting and Payment Discrepancies Relating to
Tax Withheld From Foreign Persons***

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Abbreviations

BRTF	Business Return Transaction File
e-file(d), e-filing	Electronically File(d), Electronic Filing
IRMF	Information Return Master File
IRS	Internal Revenue Service
LB&I	Large Business and International
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
UFI	Unique Form Identifier



Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons

Background

In most cases, foreign persons¹ are subject to U.S. tax of 30 percent² on their U.S. source income. The U.S. tax owed is generally withheld from payments made to foreign persons by a withholding agent. A withholding agent is any U.S. or foreign entity (individual, corporation, partnership, *etc.*) that takes receipt of, has control or custody of, or disposes of or makes a payment of any income to a foreign individual that is subject to withholding. Withholding agents are personally liable for any required tax that is withheld and are legally responsible for proper withholding and reporting.

Withholding agents are required to file Forms 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, to report on an individual taxpayer basis the income and withholding for each foreign person and to annually file a Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, to report the cumulative amount of all taxes withheld. For Tax Year³ 2017, the Internal Revenue Service (IRS) received 6.3 million Forms 1042-S from 49,618 withholding agents. These agents reported U.S. tax withholdings totaling more than \$528 billion.⁴ However, it should be noted that this total includes e-filed and paper Forms 1042-S where withholding agents reported Federal tax withholding over \$1 million, and the withholding is greater than the reported income. These questionable Forms 1042-S totaled over \$504 billion in withholding, which may be an indicator of a potentially fraudulent/erroneous filing. In most instances, the IRS filters correctly identified the discrepancy associated with the forms. As such, we estimate that the amount of withholding is in a range closer to \$24 billion.⁵

In addition to the specific reporting requirements, withholding agents are also responsible for periodically remitting payments of tax withheld using the Electronic Federal Tax Payment System⁶ to the U.S. Department of the Treasury. The frequency at which the withholding

¹ A foreign individual is any person that is not a U.S. person, including a nonresident alien, a foreign corporation, a foreign partnership, a foreign trust, or a foreign estate.

² A reduced rate, including exemption, may apply when there is a tax treaty between the United States and the country of residence for the foreign individual.

³ The 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.

⁴ This amount was determined by analyzing Forms 1042-S that the IRS posted to its Information Returns Masterfile. The IRS matches Forms 1042-S information in the Information Returns Master File to Form 1042 data on the Business Master File as part of its Compliance Campaigns to identify income and withholding reporting discrepancies.

⁵ The actual amount of withholding due can only be determined after the IRS matches Forms 1042-S to Forms 1042 to identify whether a discrepancy exists between amounts reported and addresses this discrepancy with the applicable withholding agents.

⁶ The Electronic Federal Tax Payment System is designed to process Federal tax deposits and other types of business and individual payments.



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payments are required to be remitted depends on the total amount of tax withheld. Figure 1 provides a general overview of these requirements.

Figure 1: Withholding Agents Deposit Requirements

Withholding Amount	Payment and Deposit Requirement
Less Than \$200	Pay by March 15 of the following calendar year.
\$200 to \$1,999	Pay 15 days after the end of the month in which the withholding was made.
\$2,000 or More	Pay three business days after the end of the quarter-monthly period, <i>i.e.</i> , 7 th , 15 th , 22 nd , or end of month, in which the withholding was made.

Source: IRS Form 1042 instructions.

The amount reported on the Form 1042 as withheld is generally equal to the total withholdings reported on Forms 1042-S, which is the amount of the tax liability, *i.e.*, amount of tax withheld to be remitted to the IRS. The IRS records the amount of the tax liability in the withholding agent's tax account. The tax liability is then offset by payments remitted by the withholding agent to the IRS during the year, any credits for amounts withheld by another withholding agent, and any payment submitted with the Form 1042. Below is a hypothetical example of how the amounts of income and withholding should reconcile between the Form 1042-S, Form 1042, and tax remitted to the IRS.

Taxpayer A is a foreign individual that receives U.S. source income. The payer of the U.S. source income, i.e., the withholding agent, is required to withhold tax from this income and remit the amount of tax withheld to the IRS. The payer is also required to issue a Form 1042-S to Taxpayer A that reports the amount of income and the amount of tax withheld. In addition, the payer must on an annual basis file Form 1042 to report all income paid and withheld from foreign individuals during the tax year and attach the supporting Forms 1042-S such as the form issued to Taxpayer A. The income and withholding on Form 1042 should agree with the income and withholding reported on the attached Forms 1042-S and the amount of tax that was remitted to the IRS by the payer.

Reporting requirements for transactions involving multiple withholding agents

In some instances, the withholding of tax from the payment of U.S. source income to foreign persons can involve multiple withholding agents. Generally, for these types of transactions, the primary withholding agent⁷ paying U.S. income to the foreign person is responsible for ensuring that the full tax is withheld as required. However, the primary withholding agent can use other

⁷ A withholding agent that has assumed responsibility for withholding on all payments.



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withholding agents, known as intermediaries,⁸ to facilitate the payment of income and withholding of tax. If an intermediary is used, the primary withholding agent must provide the intermediary with a Form 1042-S showing the amount of tax, if any, it withheld on the income paid. The Form 1042-S includes a field in which a withholding agent acting as an intermediary can then report the amounts previously withheld by another withholding agent. Figure 2 shows where this information is reported on the Form 1042-S.

Figure 2: Form 1042-S for Tax Year 2017

Form 1042-S		Foreign Person's U.S. Source Income Subject to Withholding 2017				OMB No. 1545-0096		
Department of the Treasury Internal Revenue Service		▶ Information about Form 1042-S and its separate instructions is at www.irs.gov/form1042s .				Copy A for Internal Revenue Service		
		UNIQUE FORM IDENTIFIER		AMENDED		AMENDMENT NO.		
1 Income code	2 Gross income	3 Chapter indicator. Enter "3" or "4"		13e Recipient's U.S. TIN, if any		13f Ch. 3 status code		
		3a Exemption code	4a Exemption code			13g Ch. 4 status code		
		3b Tax rate	4b Tax rate	13h Recipient's GIIN		13i Recipient's foreign tax identification number, if any		
5 Withholding allowance				13k Recipient's account number		13j LOB code		
6 Net income		7b Check if tax not deposited with IRS pursuant to escrow procedure <input type="checkbox"/>						
7a Federal tax withheld				14a Primary Withholding Agent's Name (if applicable)				
8 Tax withheld by other agents				14b Primary Withholding Agent's EIN		15 Check if pro-rata basis reporting <input type="checkbox"/>		
9 Tax paid by withholding agent				15a Intermediary or flow-through entity's EIN, if any		15b Ch. 3 status code	15c Ch. 4 status code	
10 Total withholding credit				15d Intermediary or flow-through entity's name				
11 Amount repaid to recipient				15e Intermediary or flow-through entity's GIIN				
12a Withholding agent's EIN	12b Ch. 3 status code	12c Ch. 4 status code		15f Country code		15g Foreign tax identification number, if any		
12d Withholding agent's name				15h Address (number and street)				
12e Withholding agent's Global Intermediary Identification Number (GIIN)				15i City or town, state or province, country, ZIP or foreign postal code				
12f Country code	12g Foreign taxpayer identification number, if any							
12h Address (number and street)								
12i City or town, state or province, country, ZIP or foreign postal code								

Source: Excerpt from IRS Tax Year 2017 Form 1042-S.

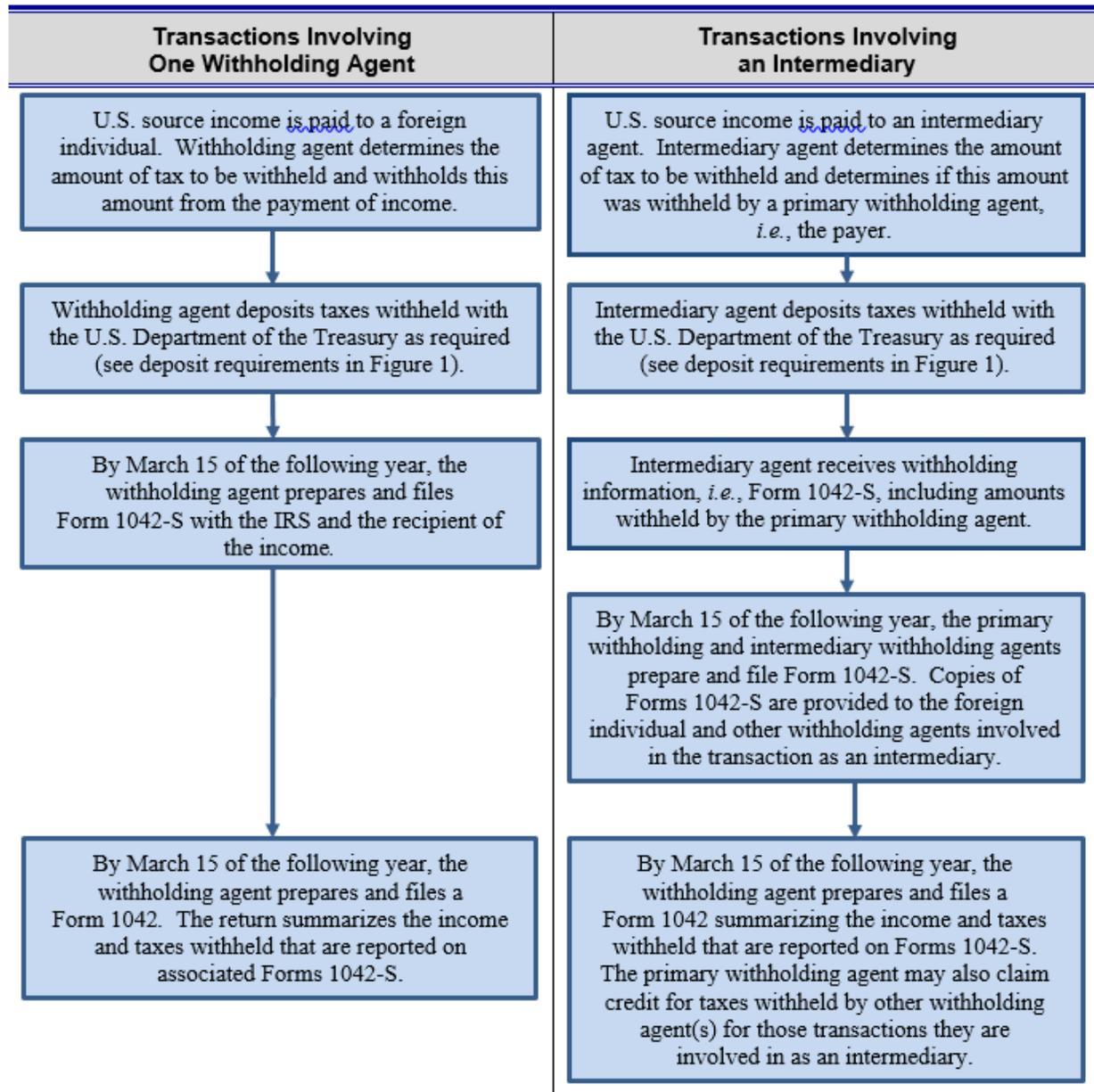
Figure 3 provides an overview of the reporting requirements for transactions that involve one withholding agent and those that involve an intermediary.

⁸ A custodian, broker, nominee, or otherwise as an agent for another person, regardless of whether that other person is the beneficial owner of the amount paid, a flow-through entity, or any intermediary.



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Figure 3: Reporting Requirements for Amounts Withheld by Withholding Agents



Source: TIGTA analysis of IRS instructions for Form 1042, Form 1042-S, and IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*, for Tax Year 2017.



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Processing of Forms 1042 and Forms 1042-S

Withholding agents must file Form 1042 via paper⁹ because the IRS does not have processes to allow for electronic filing (e-filing). When the withholding agent claims a credit for amounts withheld by others, the agent is required to attach Forms 1042-S (recipient's copy) to the Form 1042 to support the credit being claimed. IRS guidelines require tax examiners in the Submission Processing sites to verify that Forms 1042-S are attached to the Form 1042 if the credit amount is in excess of a certain dollar amount. In addition to ensuring that required Forms 1042-S are attached to the Form 1042, tax examiners transcribe information from the Form 1042 into IRS systems. The Form 1042 is also checked for accuracy (transcription errors, missing amounts in required fields, invalid Employer Identification Numbers,¹⁰ *etc.*). Tax returns for which the withholding credit does not have attached Forms 1042-S are sent to the IRS Error Resolution function. The Error Resolution function is required to correspond with the taxpayer to obtain support for the withholding credit claimed. If the taxpayer does not respond or the documentation provided does not support the credit claimed, the IRS will deny the credit.

Withholding agents are also required to submit a Form 1042-T, *Annual Summary and Transmittal of Forms 1042-S*, along with associated Forms 1042-S filed via paper. Withholding agents that report fewer than 250 Forms 1042-S can either e-file or send these to the IRS via paper. However, the IRS requires withholding agents reporting 250 or more forms to e-file their forms. Once received, the e-filed Forms 1042-S are directly loaded and the paper forms are transcribed, processed, and then loaded into the IRS's *Chapter Three Withholding Database*.¹¹ The IRS reviews Forms 1042-S to identify and correct errors in selected fields and validates the Taxpayer Identification Number (TIN)¹² of the recipient, if reported. Once perfection is completed, the Forms 1042-S are then uploaded to the IRMF and the e-Trak Non-Resident Filing System.¹³ The e-Trak Non-Resident Filing System is used to verify tax returns with claims for withholding credits associated with U.S. income paid to foreign individuals to Forms 1042-S on file with the IRS.

Verification of Form 1042-S credits claimed by individuals on Form 1040NR, U.S. Nonresident Alien Income Tax Return

Individuals who are nonresident aliens of the United States but receive income from a U.S. trade or business, including wages, commissions, interest, dividends, pensions, gambling winnings,

⁹ The Large Business and International Division submitted a request to allow Forms 1042 to be e-filed in December 2017. As of September 2018, IRS management stated that the status of the request has been delayed due to focus on tax reform work for the filing season.

¹⁰ A unique nine-digit number used to identify a taxpayer's business account.

¹¹ An online database that stores Forms 1042-S and their transmittal documents.

¹² A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the TIN is an Employer Identification Number, a Social Security Number, or an Individual TIN.

¹³ IRS database designed to allow document matching and credit verification on Forms 1042-S and Forms 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*.



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etc., report and pay taxes on that income on Form 1040NR. Nonresident aliens also file Form 1040NR to report Form 1042-S income and tax withholding as well as claim a refund of any amount overwithheld. Individuals claiming a credit for tax withheld on Form 1042-S are required to attach the Form 1042-S to their tax return. Returns with a withholding credit claim that have no attached Form 1042-S are sent to the IRS Error Resolution function for additional review. Tax examiners research the IRS IRMF to attempt to locate the Form 1042-S and verify the credit claimed. If the Form 1042-S is not found, the tax examiner will correspond with the taxpayer. If the taxpayer does not respond, the tax examiner will deny the withholding credit.

A prior TIGTA review reported that the IRS does not have an effective process to reconcile withholding reported to ensure that amounts withheld are remitted

In our September 2013 report, we determined that the IRS does not have an effective process to reconcile the withholding reported on Forms 1042 to withholding reported on Forms 1042-S. In addition, we identified that the IRS processes did not ensure that the withholding reported by withholding agents was remitted to the IRS. Our analysis of Tax Year 2011 Forms 1042-S to Forms 1042 identified discrepancies totaling almost \$747 million, of which \$543 million in withheld tax was reported on Forms 1042-S but not remitted.

We recommended that the IRS develop processes to systematically reconcile information on Forms 1042 with withholding information submitted on Forms 1042-S and ensure that withholding agents remit tax withheld, identify withholding agents that are not filing required Forms 1042-S and assess penalties as applicable, and identify and resolve Form 1042-S data quality problems. Finally, the IRS should ensure that tax examiners verify that required Forms 1042-S are attached to the Forms 1042 and support the amount of credit claimed for tax withheld by another withholding agent. The IRS agreed with all of our recommendations.

This review was performed at the Submission Processing Site in Ogden, Utah, and with information obtained from the IRS Large Business and International (LB&I) Division's¹⁴ Withholding and International Individual Compliance Practice Area in Washington, D.C., during the period December 2018 through January 2020. 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 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.

¹⁴ The LB&I Division is the functional area within the IRS responsible for ensuring that withholding agents comply with the withholding and reporting requirements.



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Results of Review

Our prior review identified that the IRS has not established a process to reconcile the amounts withheld and reported on Forms 1042-S agree with amounts reported on Forms 1042 and with the amounts remitted to the IRS by withholding agents. In response to our prior recommendations, the IRS has implemented processes to improve its identification of reporting discrepancies for Federal tax withheld on U.S. source income paid to foreign individuals. For example, the LB&I Division developed its *Campaign 817* in an effort to begin to address Forms 1042 and 1042-S noncompliance. As of August 23, 2019, the LB&I Division has developed and implemented 12 filters to systemically reconcile Forms 1042 to Forms 1042-S as well as information included in a withholding agent’s tax account to identify reporting discrepancies. For example, a filter identifies a discrepancy when a withholding agent files a Form(s) 1042-S and fails to file the associated Form 1042. Returns with discrepancies that meet the IRS’s dollar tolerance threshold are selected for compliance treatment.

The IRS is still developing the various compliance treatments that will be used to address returns identified with discrepancies.¹⁵ In addition, IRS management also noted that they are in the process of developing 12 additional filters. These filters will be used to identify *****2*****
*****2*****¹⁶ *****2*****. These filters will also identify *****2*****. However, our review identified that additional actions are needed to continue to improve processes to identify and address reporting discrepancies and to ensure that reported withheld tax is remitted to the IRS as required.

Processes Did Not Identify Some Withholding Tax Reporting Discrepancies

Our comparison of Tax Year 2017 Forms 1042-S and Forms 1042 identified 6,016 withholding agents with discrepancies totaling \$2.3 billion in tax reported on Forms 1042-S and the amount reported on Forms 1042. *Campaign 817* filters identified 4,097 of the 6,016 withholding agents with discrepancies totaling \$2.1 billion. However, due to errors in filter criteria, 1,919 withholding agents with reporting discrepancies totaling more than \$182.7 million were not being identified by the IRS’s processes. These include:

¹⁵ Appendix V describes the compliance treatment streams the IRS is developing.

¹⁶ *****2*****
*****2*****.



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Recommendations

The Commissioner, LB&I Division, should:

Recommendation 1: Review the 1,919 withholding agents we identified that did not file a Form 1042 or a Form 1042-S as required or that have a reporting discrepancy that was not identified by the *Campaign 817* criteria and take appropriate action to address the withholding agents' noncompliance with the reporting requirements.

Management's Response: The IRS disagreed with this recommendation. IRS management established tolerances for each filter applied to the Tax Year 2017 filings that did not result in the identification of every withholding agent TIGTA identified and is lowering the tolerance levels for the Tax Year 2018 filings to capture a larger population of withholding agents that failed to file Forms 1042 or 1042-S or that have a reporting discrepancy. The IRS believes resources are better expended in future cycles with these refined filters, rather than continuing to work on the earlier year returns identified by TIGTA.

Office of Audit Comment: The 1,919 withholding agents we identified had reporting discrepancies totaling more than \$182.7 million. As such, we believe that if the IRS addressed these, it could yield a significant dollar return on the use of resources in addition to improving compliance.

Recommendation 2: Modify the *Campaign 817* filter criteria to ensure that consistent information is used on Forms 1042 and Forms 1042-S to identify withholding agents that have a reporting discrepancy.

Management's Response: The IRS disagreed with this recommendation. IRS management stated that the *Campaign 817* filters already treat information consistently on Forms 1042 and Forms 1042-S.

Office of Audit Comment: We do not agree with management's assertion that the filters treat information consistently. The *Campaign 817* filters compare the reported tax withheld on Form 1042, *****2*****.
*****2*****.
We identified 1,919 withholding agents with \$182.7 million in reporting discrepancies that the *Campaign 817* filters did not identify as a result of this inconsistency.

Recommendation 3: Modify the *Campaign 817* filter criteria to ensure that all withholding agents that do not file Form 1042 are identified, *****2*****.
*****2*****.

Management's Response: The IRS agreed with this recommendation and plans to modify the *Campaign 817* filters to identify withholding agents that do not file



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Form 1042. However, the tolerance levels for this filter may not capture all of the Form 1042 nonfilers due to available resources and organizational priorities.

**Processes Do Not Ensure That Credits Claimed for Amounts Withheld
*****2***** Are Valid**

Our review of Tax Year 2017 Forms 1042 identified 366 withholding agents that claimed more than \$506 million more in credits for tax withheld *****2***** than was reported on the Forms 1042-S *****2*****. IRS processes should have identified some of these cases during return processing. These cases include:

- 269 Forms 1042 for which the credit amount claimed on the Form 1042 did not match the withholding reported *****2***** on the Forms 1042-S. IRS procedures do not require tax examiners *****2*****.
- 97 Forms 1042 with no Forms 1042-S to support the credit amount claimed, and the amount of the credit *was above the dollar tolerance for additional review*. Instructions for the Form 1042 require withholding agents that claim credits *****2***** to attach Forms 1042-S (recipient’s copy) to support the amount of the credit claimed. During processing, IRS guidelines require tax examiners to verify that Forms 1042-S are attached to the Form 1042 when the withholding credit is in excess of a certain dollar amount. Tax examiners are to correspond with the withholding agent if the required Forms 1042-S are not attached and disallow the amount of credit that is not supported through correspondence with the withholding agent.

*****2*****
*****2*****
*****2*****
*****2***** . At times, these credits can result in a withholding agent having an overpayment that generates a refund. The credit for amounts withheld *****2***** is reported on Form 1042, *****2***** . Figure 4 shows where the tax liabilities and credits for amounts withheld *****2***** are reported on Form 1042.



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Figure 4: Tax Year 2017 Form 1042 Credit for Tax Withheld by Intermediary Withholding Agents

64	Total net tax liability		
a	Adjustments to total net tax liability	64a	
b	Total net tax liability under chapter 3	64b	
c	Total net tax liability under chapter 4	64c	
d	Excise tax on specified federal procurement payments (Total payments made x 2%)	64d	
e	Total net tax liability (Add lines 64a-d)	64e	
65	Total paid by electronic funds transfer (or with a request for extension of time to file):		
a	Total paid during calendar year	65a	
b	Total paid during subsequent year	65b	
66	Enter overpayment applied as credit from 2016 Form 1042	66	
67	Credit for amounts withheld by other withholding agents:		
a	For payments other than substitute dividend payments	67a	
b	For substitute dividend payments	67b	
68	Total payments. Add lines 65 through 67	68	

Source: IRS Tax Year 2017 Form 1042.

Of the 366 withholding agents with excess credit claims, 51 agents received \$4.4 million in potentially erroneous refunds for these unsubstantiated credits. Withholding agents can claim a credit on their Form 1042 when payments of U.S. source income transactions involve ***2***
 *****2*****.

We shared the results of our analysis with the IRS on July 22, 2019. IRS management was not able to provide a reason why these withholding agents were not identified during return processing. IRS management also stated that it would be cost-prohibitive to verify the amount of credit claimed during tax processing. In addition, IRS management stated that they currently do not have a filter in place to systemically identify withholding agents that claim unsubstantiated credits for tax withheld *****2***** after Forms 1042 are processed, but they have considered implementing such ***2***.

IRS management did not provide us with any information to support their position that verifying the amount of credit claimed during tax processing would be cost-prohibitive. We disagree that it would be cost-prohibitive. In fact, as previously discussed, the IRS already has processes in place to verify Forms 1042 during tax processing. As such, management could expand these existing processes to include *****2*****.

Recommendations

The Commissioner, LB&I Division, should:

Recommendation 4: Modify Error Resolution function procedures to require tax examiners to ensure that the credit amount claimed on Form 1042 for tax withheld *****2***** matches the amount of tax withheld that is reported on Forms 1042-S *****2*****
 2.



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Management's Response: The IRS disagreed with this recommendation. IRS management believes the planned modifications to its *Campaign 817* filters will address this issue after returns have been filed. IRS management explained that current Form 1042 error resolution programming does not systemically identify differences in the amount of tax withheld *****2***** on Form 1042 and the amount(s) of tax withheld that is reported on Forms 1042-S *****2*****. Forms 1042-S are processed through a system that is not linked to the system used to process Form 1042, and there is no current systemic option available to identify these discrepancies and thereby allow the Error Resolution function tax examiners to review these returns.

Office of Audit Comment: Although *Campaign 817* filters will identify these types of discrepancies, it is not until after refunds have been paid. Alternatively, implementation of our recommendation would enable the IRS to identify reporting discrepancies *before* withholding credits are allowed and refunds are paid. At the same time tax examiners are verifying that Forms 1042-S are attached to the Form 1042, **2** *****2*****. As such, no systemic processes would be needed.

Recommendation 5: Establish processes and procedures to systemically identify and address withholding agents that file a Form 1042 for which the credit claimed for tax withheld ***2*** *****2***** is not supported by a third-party Form 1042-S, such as implementing a filter to identify these discrepancy cases.

Management's Response: The IRS agreed with this recommendation but cannot address this issue systemically at the time returns are filed. IRS management is pursuing a filter modification in *Campaign 817* to address this issue after returns have been filed.

Processes ***2***** Withholding Agents That Do Not File Required Forms 1042-S**

In response to our prior report, the IRS developed a process to systematically identify withholding agents that are not filing required Forms 1042-S. Specifically, *Campaign 817* includes filters that identify withholding agents that do not file Form 1042-S as required. As of May 13, 2019, these filters identified 1,569 noncompliant withholding agents that had not filed a Form 1042-S. However, our review of the IRS's current and planned compliance treatment streams found that, although the IRS identifies withholding agents noncompliant with Form 1042-S filing requirements, *****2*****



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these Form 1042-S nonfilers. This includes *****2*****
*****2*****. 17

When we questioned management as to why *****2***** noncompliant withholding agents, management indicated that withholding agents that failed to file Forms 1042-S *****2*****. They acknowledged there is a risk to tax administration when Forms 1042-S are not filed, *****2 and 7*****
2 and 7. As such, the IRS currently *****2***** withholding agents that fail to file a Form 1042-S.

Without Forms 1042-S, the IRS cannot determine whether a withholding agent reported all required Federal income tax withholding on Form 1042. The IRS also cannot determine whether the proper amount of tax was withheld because it does not know the applicable tax rate for the type of income paid. In addition, the IRS verifies withholding credits claimed by foreign individuals on Form 1040NR to Forms 1042-S. As such, the IRS may incorrectly deny withholding credits to which foreign individuals are entitled because the withholding agent has not filed a related Form 1042-S with the IRS.

Incorrect information prevented us from evaluating the effectiveness of the IRS’s processes to address withholding agents that do not comply with Form 1042-S e-filing requirements

Our review of Tax Year 2017 paper Forms 1042-S identified 19 withholding agents that filed 250 or more Forms 1042-S via paper instead of e-filing as required. These 19 withholding agents filed 6,811 Forms 1042-S. We also identified 232 financial institutions that filed 2,019 Forms 1042-S via paper instead of e-filing as required. Paper Forms 1042-S must be manually transcribed into the IRS’s systems before the returns can be processed, increasing the opportunity for entry errors and wasting valuable IRS resources.

Per Internal Revenue Code Section 6011 (e)(2)(A), withholding agents that file 250 or more Forms 1042-S are required to e-file these forms with the IRS. In addition, Internal Revenue Code Section 6011 (e)(4) requires all financial institutions to e-file their Forms 1042-S. We notified the IRS of our concerns on June 7, 2019. IRS management responded that they agreed that the 19 withholding agents and 232 financial institutions we identified were required to e-file their Forms 1042-S. In addition, IRS management stated that they do not have a process to identify and address withholding agents that are not compliant with Forms 1042-S e-filing requirements. IRS management stated that a filter can be implemented to identify these withholding agents when resources become available.

On January 17, 2020, IRS management stated that the information they provided in June 2019 in response to our concerns was incorrect. IRS management stated that the IRS does have a process to identify withholding agents that do not comply with the Form 1042-S e-filing requirements,

17 *****2*****.



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and this process was in place at the time we raised our concerns in June 2019. In addition, the IRS provided us with data showing that the IRS had assessed penalties totaling more than \$7.1 million for 15 of the 19 withholding agents and more than \$6.5 million for four of the 232 financial institutions we identified. However, we were unable to assess the effectiveness of the IRS's processes because this information was shared with us after we had completed our audit testing. We plan to conduct a separate review of the IRS's continued efforts to increase e-filing for business and information returns.¹⁸

Recommendations

The Commissioner, LB&I Division, should:

Recommendation 6: *****2***** withholding **2** identified as noncompliant with Form 1042-S filing requirements.

Management's Response: The IRS disagreed with this recommendation. IRS management stated that *Campaign 817* Filter 104 addresses the noncompliance of the highest risk taxpayers in the population. Tolerances in this filter have been established balancing available resources and organizational priorities and may be refined based on the data from future cycles.

Office of Audit Comment: Although *Campaign 817* Filter 104 identifies withholding agents that do not comply with the Form 1042-S reporting requirements, the IRS **2** *****2*****. Our comparison of Tax Year 2017 Forms 1042-S and Forms 1042 identified a \$2.3 billion discrepancy in the amount of tax reported on these forms. As such, we believe the risk warrants further action.

Recommendation 7: Review the 1,569 withholding agents the IRS identified that did not file Form 1042-S and take the actions necessary to address their noncompliance with the reporting requirement, including assessing failure to file penalties when appropriate.

Management's Response: The IRS disagreed with this recommendation. IRS management believes that resources are better expended in future cycles with a potentially refined filter, rather than continuing to work on the Tax Year 2017 population that we identified as not meeting the IRS's original tolerance threshold. IRS management stated that the subsequent filter run for Tax Year 2018 returns will continue to address noncompliance of Form 1042-S filings.

Office of Audit Comment: As we noted previously, our comparison of Tax Year 2017 Forms 1042-S and Forms 1042 identified a \$2.3 billion discrepancy in the amount

¹⁸ TIGTA Audit 2020-40-020, *Continued Assessment of Electronic Filing of Business and Information Returns*.



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of tax reported on these forms. We believe that further action is needed to address the 1,569 withholding agents we identified as not filing a required Form 1042-S.

Recommendation 8: Establish processes to identify and address withholding agents that do not complying with Form 1042-S e-filing requirements.

Management's Response: The IRS agreed with this recommendation and cited that it has a process in place to address the failure to comply with Form 1042-S e-filing requirements under Internal Revenue Code Section 6721. This process, as noted in TIGTA's report, has resulted in the assessment of millions of dollars of penalties.

Recommendation 9: Review the 19 withholding agents and 232 financial institutions we identified that did not comply with the Form 1042-S e-filing requirement and take the actions needed to address their noncompliance, including assessing failure to file penalties when appropriate.

Management's Response: The IRS disagreed with this recommendation. IRS management stated that it has an established process in place to address the failure to comply with Form 1042-S e-filing requirements under Internal Revenue Code Section 6721.

Office of Audit Comment: The processes that management cites are not effective given that penalties were not assessed for four of the 19 withholding agents and 228 of the 232 financial institutions we identified.

Most Returns With Unsupported Withholding Credits Are Not Addressed

Our analysis of Tax Year 2017 Forms 1040NR identified 7,980 returns for which the withholding credit claimed was not supported by a third-party Form 1042-S. The IRS has established systemic processes to identify returns and hold a portion of the refund claimed on Forms 1040NR for Federal tax withheld on their U.S. source income if the withholding credit and refund amount are above the selection dollar tolerance threshold. However, the IRS only selected for verification 70 (less than 1 percent) of the 7,980 returns we identified. The remaining 7,910 returns had claims under the IRS's return selection threshold. Thus, these 7,910 returns claimed more than \$15.5 million in withholding credits that were not verified.

The IRS uses a return selection dollar tolerance threshold in an effort to balance tax examiner inventory with available IRS resources. However, the current threshold results in the verification of less than 1 percent of the identified credit claims with discrepancies. When we discussed our concerns with IRS management regarding the high dollar tolerance, IRS management stated that they are in the process of lowering their return selection dollar tolerance threshold, which they project will result in the verification of ****2**** additional returns and address an additional *******2******* in withholding credits. We applied the IRS's lower threshold amount to the



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7,910 Forms 1040NR we identified and found that the lower threshold will not result in the verification of the majority of unsupported credits. We provided the IRS these records, and the IRS stated that it cannot support lowering the tolerance threshold further due to limited resources.

Although the IRS has established a systemic process to identify Forms 1040NR with credit claims, it is unable to systemically verify claims to third-party Forms 1042-S. This is because the IRS does not require withholding agents to provide a payee TIN for all Forms 1042-S. Our analysis of the 6.3 million Forms 1042-S filed by withholding agents for Tax Year 2017 identified 4.7 million (74 percent) forms with a missing payee TIN.

In September 2013, we reported that the lack of a valid payee TIN on Form 1042-S impedes the IRS's ability to systematically cross-check Forms 1042-S with foreign persons' tax returns to confirm income and withholding claimed on the tax return before the refunds are issued. At that time, IRS management indicated that the IRS does not require TINs on all Forms 1042-S because many foreign persons are not required to file a U.S. tax return. In addition, this would require that millions of foreign persons obtain a TIN. We noted that most foreign individuals who file a Form 1040NR are seeking a refund. As an alternative to requiring TINs on all Forms 1042-S, the IRS established processes to manually verify withholding credits claimed on Form 1040NR to copies of the Form 1042-S attached to the tax return. Returns selected are manually verified by tax examiners to Forms 1042-S data the IRS received from withholding agents. If the IRS cannot verify the credit to third-party Forms 1042-S, the credit is denied.

Recommendation

Recommendation 10: The Commissioner, LB&I Division, should further lower the dollar tolerance used to select Forms 1040NR with unsupported withholding credits for manual verification before refunds are issued.

Management's Response: The IRS agreed with this recommendation and plans to reduce the overall threshold for *Campaign 816* that addresses 1040NR refund claims by ****2**** in 2020. According to IRS management, this will bring in approximately ****2**** additional returns reviewed by the campaign totaling *****2***** in Form 1042-S credits.

Additional Improvements and Expanded Use of the Unique Form Identifier Are Needed to Resolve Continued Data Reliability Issues

Our review of the 6.3 million Tax Year 2017 Forms 1042-S identified 62,065 Forms 1042-S claiming more than \$1.4 billion in withholding that did not have a valid Unique Form Identifier



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(UFI)¹⁹ as required. In addition, we identified 23,373 amended Forms 1042-S with \$47.6 million in reported U.S. tax withholdings with valid UFIs that we were unable to associate with an original Form 1042-S. Figure 5 provides the results of our analysis of the UFIs provided on Tax Year 2017 Forms 1042-S.

Figure 5: Tax Year 2017 Forms 1042-S With Invalid UFIs

	Total Number of Forms	Number of Forms With Invalid UFIs	E-Filed Forms With Invalid UFIs	Paper Forms With Invalid UFIs
Original Forms 1042-S	6,214,391	60,930	1,208	59,722
Amended Forms 1042-S	131,337	1,135	6	1,129
Total	6,345,728	62,065	1,214	60,851

Source: TIGTA analysis of the IRMF.

In September 2013, we reported that 33,164 amended Forms 1042-S could not be associated to the original Forms 1042-S that were filed. This can result in the inaccurate identification of withholding agent reporting discrepancies and the payment of erroneous refunds to foreign individuals. We recommended that the IRS develop a process to identify and resolve Form 1042-S data quality problems. In an effort to resolve some of its data quality problems, the IRS revised the Form 1042-S for Tax Year 2017 to include a UFI. All original and amended Forms 1042-S are required to have a valid UFI. The UFI must be a unique number, cannot be the recipient U.S. or foreign TIN, must be numeric, and must be exactly 10 digits in length.

We provided our analysis to IRS management on December 3, 2018. IRS management stated that during the perfection process for e-filed returns, a Form 1042-S is rejected if the UFI is *****2*****. Of the 1,214 e-filed Forms 1042-S we identified with an invalid UFI, 1,136 *****2***** as the UFI. Because the UFI *****2*****, the IRS system did not reject the Forms 1042-S. IRS management did not provide a reason why the perfection process did not reject the remaining 78 Forms 1042-S. The remaining 60,851 Forms 1042-S we identified with an invalid or missing UFI were filed via paper. *****2*****. As such, the IRS is unable to associate all amended Forms 1042-S to the original Forms 1042-S that were filed. This increases the risk that the IRS will incorrectly identify withholding agents as having a reporting discrepancy and pay erroneous refunds to foreign individuals. Forms 1042-S with invalid UFIs will continue to be input into the IRS’s systems if the IRS does not implement additional processes to perfect and ensure that the UFIs are valid.

¹⁹ The UFI is a unique number assigned by the withholding agent that is required for all Forms 1042-S. This identifying number is used to identify which information return is being corrected or amended when multiple information documents are filed by a withholding agent.



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The Campaign 817 filter does not identify all Forms 1042-S with an invalid UFI

The IRS’s *Campaign 817* includes a filter to identify Forms 1042-S with a missing UFI and instances in which the same UFI is used on more than one original Form 1042-S. Our evaluation of this filter identified 450 withholding agents issuing 2,921 Forms 1042-S with an invalid UFI that were not identified by the IRS’s filter. The UFI field for these 2,921 Forms 1042-S *****2*****. We shared our analysis with IRS management on June 27, 2019, and IRS management agreed to update the filter criteria to capture Forms 1042-S for which the UFI is *****2*****.

Recommendations

The Commissioner, LB&I Division, should:

Recommendation 11: Establish processes to perfect *****2***** 1042-S to ensure that the forms contain a valid UFI, *i.e.*, a UFI is present and is in the valid format, before the forms are input into IRS systems.

Management’s Response: The IRS disagreed with this recommendation. IRS management stated that the IRS *****2***** Forms 1042-S to identify an invalid UFI, *****2***** *****2***** *****2***** are subject to the *Campaign 817* filters referenced in Recommendation 12.

Office of Audit Comment: Modifying the *Campaign 817* filter should improve the IRS’s ability to *****2***** Forms 1042-S that have an incorrect or invalid UFI. However, contrary to our recommendation, identification will not occur until after returns have been filed and credits paid.

Recommendation 12: Update the *Campaign 817* filter criteria to identify Forms 1042-S with a UFI *****2*****.

Management’s Response: The IRS agreed with this recommendation. IRS management stated that they have updated the *Campaign 817* filter and will apply it to the Tax Year 2018 returns that will be worked in 2020. E-filed Forms 1042-S are not accepted into the Filing Information Returns Electronically system unless there are *****2*****.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS has adequate controls in place to ensure that amounts reported as withheld on Forms 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, are actually reported on Forms 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*. To accomplish our objective, we:

- I. Determined whether the IRS has effective processes for ensuring that taxpayers file Form 1042 when U.S. tax owed is withheld from the payment made to foreign persons by a withholding agent.
 - A. Reviewed Form 1042 instructions regarding taxpayer filing requirements for preparing and submitting Form 1042.
 - B. Reviewed the Internal Revenue Manual procedures for processing Forms 1042 to identify actions the IRS takes in instances of unfiled Forms 1042 when taxes have been withheld.
 - C. Conducted a walkthrough of the Ogden Campus in Ogden, Utah, to observe the processing of Forms 1042.
 - D. Identified all Tax Year 2017 Forms 1042-S using the IRMF and matched them against the Business Returns Transaction File (BRTF)¹ Form 1042 Tax Year 2017 file to identify taxpayers that did not file a Form 1042.
 1. Quantified the number of taxpayers that did not file a Form 1042 and the amount of withholding reported on Forms 1042-S that was not reported on Form 1042.
 2. Matched the population of Forms 1042-S with no associated Form 1042 to the Business Master File.²
 3. Evaluated the IRS's process for identifying Form 1042 nonfilers, including *Campaign 817* filter criteria, and determined if the filter criteria would have identified all of the cases we identified.
 4. For discrepancies identified, provided an alert to the IRS so that it can address necessary changes to its filters.

¹ BRTF programs receive business tax return data, and reformat and post returns to the Return Transaction File.

² The IRS database that consists of Federal tax-related transactions and accounts for businesses.



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- II. Assessed the effectiveness of the IRS's process to verify the accuracy of amounts reported as withheld and to ensure that amounts withheld are paid to the IRS.
- A. Identified the IRS processes and procedures to ensure that withholdings reported on Forms 1042-S are reconciled on Form 1042.
 - B. Conducted a walkthrough of the Ogden Campus to observe the processing of Forms 1042-S.
 - C. Reviewed Internal Revenue Manual procedures and *Campaign 817* filters and met with IRS personnel to identify processing controls intended to ensure the accuracy of the tax withholdings reported on Form 1042.
 - D. Identified all Forms 1042-S from the IRMF, matched them to the related BRTF Form 1042, and created two separate populations: those that have an associated Form 1042 and those that do not. For those with an associated Form 1042, we reconciled the Forms 1042 to the related Forms 1042-S to identify discrepancies in the amount of withholding.
 - 1. From the population of Forms 1042 with associated Forms 1042-S, identified those that overreported their Form 1042 withholding claimed in comparison to the Form 1042-S information, and quantified the number of taxpayers and the amount overreported.
 - 2. From the population of Forms 1042 with associated Forms 1042-S, identified those that underreported Form 1042 withholding in comparison to the Form 1042-S information, and quantified the number of taxpayers and the amount underwithheld.
 - 3. Evaluated the IRS's current procedures for identifying discrepancies between withholding reported on Forms 1042-S and withholding reported on Forms 1042.
 - 4. Evaluated the *Campaign 817* filter(s) designed to identify those accounts for which the Forms 1042 do not reconcile to the Forms 1042-S. We used the filter criteria on cases that we identified to determine if the filter identified all of the cases that we identified.
 - 5. For discrepancies between our cases and the cases identified by using the filter criteria, provided an alert to the IRS so that it can address necessary changes to its filters.
- III. Determined whether the IRS has effective processes and procedures to identify Forms 1042 without supporting Forms 1042-S.
- A. Identified all Forms 1042 from the BRTF and matched them against IRMF Form 1042-S information to identify those Forms 1042 without an associated



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- Form 1042-S. We quantified the number of withholding agents that did not submit Forms 1042-S and the amount of withholding not reported for foreign individuals.
- B. Performed additional analysis to match payers that submitted Forms 1042-S but no Forms 1042 to payers that submitted Forms 1042 but no Forms 1042-S and identified withholding agents that may have filed under a different Employer Identification Number. This additional analysis included comparisons of withholding agent names and addresses.
 - C. Evaluated *Campaign 817* filter(s) designed to identify withholding agents that submitted Forms 1042 but did not file Forms 1042-S. We used filter criteria on cases that we identified to determine if the filters identified all of the cases that we identified.
 - D. For discrepancies between our cases and the cases identified by using the filter criteria, provided an alert to the IRS for it to address necessary changes to its filters.
- IV. Assessed the effectiveness of the IRS's process to identify withholding agents claiming unsupported credits for amounts withheld by another withholding agent.
- A. Reviewed Form 1042 instructions specifically for withholding agents claiming a credit on Line 67 of Form 1042.
 - B. Reviewed the Internal Revenue Manual for processing Forms 1042 claiming a credit on Line 67 and reviewed the *Campaign 817* filter developed by the IRS to identify these returns.
 - C. Used the BRTF to identify all Tax Year 2017 Forms 1042 claiming the credit amount withheld by another withholding agent on Line 67 of Form 1042.
 - 1. Matched the population of Forms 1042 claiming a credit on Line 67 to the Form 1042-S IRMF data.
 - 2. Created two separate populations: those that have an associated Form 1042-S and those that do not.
 - a. For Forms 1042 that did not have an associated Form 1042-S to support the credit claimed on Line 67, quantified the number of taxpayers and the amount of credit claimed that is not supported by a Form 1042-S.
 - 1. Evaluated *Campaign 817* filter(s) designed to identify taxpayers that claim a credit on Line 67 with no Forms 1042-S to support the claim. We used filter criteria to determine if the filters would identify the cases we identified.



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2. For discrepancies between our cases and the cases identified by using the filter criteria, provided an alert to the IRS so that it can address necessary changes to its filters.
 3. Matched the Forms 1042 claiming the unsupported credit to the Business Master File and determined if the credit posted to the account and refunded to the taxpayer.
- b. For Forms 1042 with an associated Form 1042-S to support the credit claimed on Line 67, identified those that claimed more credit than is supported by related Forms 1042-S. We quantified the number of taxpayers claiming excess credits and the amount of credit overclaimed.
1. Evaluated *Campaign 817* filter(s) designed to identify taxpayers that overclaim a credit on Line 67. We used filter criteria to determine if the filters would identify the cases we identified.
 2. For discrepancies between our cases and the cases identified by using the filter criteria, provided an alert to the IRS so that it can address necessary changes to its filters.
 3. Matched the forms overclaiming the credit to the Business Master File to identify credits allowed in error and determined if the erroneous credit amount was refunded.
- V. Determined whether the IRS has an effective process to identify and resolve data quality problems to avoid a tax burden on the withholding agents.
- A. Identified all Tax Year 2017 Forms 1042-S and created populations for amended forms and original forms.
 - B. From the amended population identified, matched the amended forms to the original forms using the UFI to determine if taxpayers are correctly using the UFI.
 - C. Evaluated the Form 1042-S data to determine if duplicate conditions continue to exist and determined the reason for the duplicate Forms 1042-S.
 - D. Determined whether the IRS enforces the Forms 1042-S e-filing mandate per withholding agent.
- VI. Determined whether the IRS has an effective process to identify and verify Form 1042-S withholding claims on Forms 1040NR.
- A. Identified Tax Year 2017 Forms 1040NR claiming Form 1042-S withholding.
 - B. Matched the returns against the IRMF to verify whether the Form 1042-S claims were supported by Forms 1042-S and eliminated returns identified by *Campaign 816*.



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- C. Provided the IRS our exception cases of Forms 1040NR with Form 1042-S withholding claims without IRMF support and not selected by *Campaign 816*.

Data validation methodology

During this review, we relied on data extracts obtained from the IRS's Individual Return Transaction File,³ the BRTF, the IRMF, the Individual Master File,⁴ and the Business Master File for Processing Year 2017 that were available on TIGTA's Data Center Warehouse. Before relying on the data, we selected random samples of each extract and verified that the data in the extract were the same as the data captured in the IRS's Integrated Data Retrieval System.⁵ We also performed analysis to ensure the validity and reasonableness of our data, such as ranges of dollar values, transaction dates, and tax periods. Based on the results of our testing, we believe that the data used in our review were reliable.

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: controls over the IRS's processing of Forms 1042; Forms 1042-S; and Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, and the processing of credits claimed on the income tax returns for foreign individuals. We evaluated these controls by interviewing IRS management and performing analyses of Forms 1042-S from the IRMF and individual and business return data from the Individual Return Transaction File, the BRTF, and the Business Master File on TIGTA's Data Center Warehouse.

³ Contains data transcribed from initial input of the original individual tax returns during return processing.

⁴ The IRS database that maintains transactions or records of individual tax accounts.

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



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Appendix II

Major Contributors to This Report

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)
Deann L. Baiza, Director
Sharla J. Robinson, Acting Director
Kathleen A. Hughes, Audit Manager
Ngan Tang, Audit Manager
Tracy M. Hernandez, Lead Auditor
Brieane K. Hamaoka, Auditor



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Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Commissioner, Large Business and International Division
Commissioner, Wage and Investment Division
Deputy Commissioner, Large Business and International Division
Director, Withholding and International Individual Compliance Practice Area, Large Business
and International Division
Director, Enterprise Audit Management



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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:

- Revenue Protection – Potential; 1,919 withholding agents with reporting discrepancies in comparison of their Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and their 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, totaling \$182.7 million not being identified by the IRS's processes (see page 7).

Methodology Used to Measure the Reported Benefit:

We identified the 1,597 withholding agents that filed a Form 1042-S but did not file a Form 1042 by extracting all Forms 1042-S for Tax Year 2017 from the IRMF and matching them to the BRTF to identify those that had no Form 1042. From these returns, we matched them to the IRS's filter population and identified 284 withholding agents with Forms 1042-S totaling \$40,809,758 but did not file a Form 1042 and were not identified by the IRS.

We also identified 1,449 withholding agents that overreported their withholding on Form 1042 in comparison to their Forms 1042-S by \$467,216,502. In addition, we identified 2,317 withholding agents that underreported their tax in comparison to their reporting on Forms 1042-S by \$1,584,185,904. We then matched them to the IRS's filters and identified 635 withholding agents who underreported \$116,441,137 and 347 withholding agents who overreported \$23,814,225 that the IRS did not identify.

To identify those that did not file a Form 1042-S, we used the BRTF Form 1042 returns and matched them to the IRMF data to identify those that did not file a Form 1042-S. We then matched those to the IRS filter population and found the IRS did not identify 653 withholding agents who filed Forms 1042 claiming withholding of \$1,675,736 but did not file a Form 1042-S to support the withholding on the Form 1042.

We combined the populations of withholding agents not identified by the IRS's filter for the categories above giving us a total of 1,919 withholding agents with a reporting discrepancy of \$182,740,856.



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Type and Value of Outcome Measure:

- Revenue Protection – Potential; 366 withholding agents that claimed \$506 million more in credits for tax withheld *****2***** than what was reported on the Forms 1042-S *****2***** (see page 10).

Methodology Used to Measure the Reported Benefit:

We identified all Tax Year 2017 Form 1042 returns that posted and claimed an amount on *****2*****. We matched those returns to the IRMF population of Forms 1042-S by TIN and identified those that had no Forms 1042-S to support the credits claimed. We matched those returns to the IRMF population of Forms 1042-S by TIN and identified those that either had no Forms 1042-S or those that did not fully support the credit claimed. We identified 366 withholding agents that claimed \$506,578,530 more in credits for tax withheld *****2***** than what was reported on their Forms 1042-S filed by the intermediary agent for Tax Year 2017.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 7,910 Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, claimed \$15.5 million in withholding credits that were not verified with related Forms 1042-S (see page 15).

Methodology Used to Measure the Reported Benefit:

We first identified 69,898 Forms 1040NR claiming \$407,680,006 in Form 1042-S withholding credits in the Individual Return Transaction File. We matched these Forms 1040NR to the Individual Master File to ensure that these returns posted. We then matched the returns to the Forms 1042-S data and identified 7,980 Forms 1040NR that did not have Forms 1042-S supporting the credits. We compared those to the records identified by the IRS as credits claimed with no supporting Forms 1042-S and found that 7,910 Forms 1040NR claiming \$15,590,542 in withholding credits were not identified by IRS processes.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 62,065 Forms 1042-S claiming \$1.4 billion in withholding with invalid UFIs (see page 16).

Methodology Used to Measure the Reported Benefit:

We extracted 6,345,728 Forms 1042-S from the IRMF for Tax Year 2017. We performed a data analysis and filtered the data to identify those with an invalid UFI. We identified 62,065 Forms 1042-S with an invalid UFI claiming \$1,448,180,194 in Federal withholding.



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Type and Value of Outcome Measure:

- Reliability of Information – Potential; 23,373 amended Forms 1042-S claiming \$47.6 million in Federal withholding that could not be associated with an original Form 1042-S (see page 16).

Methodology Used to Measure the Reported Benefit:

We extracted 6,345,728 Forms 1042-S from the IRMF for Tax Year 2017. From that population, we performed an analysis to identify amended Forms 1042-S and original Forms 1042-S. We limited these records to only those with a valid UFI and matched the amended forms to the original forms using the UFI and Payer TIN fields. We identified 23,373 amended Forms 1042-S claiming \$46,578,930 in Federal withholding that did not have an associated original form.



Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons

Appendix V

Campaign 817 Compliance Treatments

The LB&I Division developed its *Campaign 817* to address Forms 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and 1042-S, *Foreign Person's U.S. Source Income Subject to Noncompliance*, noncompliance. The LB&I Division is responsible for ensuring that withholding agents comply with withholding and reporting requirements. As of August 23, 2019, the LB&I Division had developed and implemented 12 filters to systemically reconcile Forms 1042 to Forms 1042-S and payment information in the withholding agents' tax accounts to identify reporting and payment discrepancies. Figure 1 shows the compliance treatment streams the IRS is developing to address returns identified by the *Campaign 817* filters.

Figure 1: Campaign 817 Compliance Treatment Streams

Treatment Stream	Explanation	Status
Correspondence by Withholding and Credit Team	The team reviews all returns selected by the <i>Campaign 817</i> filters and corresponds as necessary with the withholding agent. Depending on the discrepancy issue identified, either a soft notice is issued to educate the withholding agent of the filing requirements or a compliance notice is issued informing the withholding agent of adjustments made to their account until support for the claim is provided. The cases are then referred to a secondary treatment stream, e.g., Field Examination.	As of September 30, 2019, the IRS ****2***** *****2***** *****2***** **2**.
Form 1042-S Data Consistency Gauge	A software would be available to withholding agents and the IRS to tally and report on data accuracy errors on Forms 1042-S. The software will enable the identified errors to be corrected before submission. The IRS is working with its internal Data Solutions group and outside vendors to implement this software. Within the IRS, the software would be part of Field Examination classification and case-building tools.	The IRS ****2***** *****2***** *****2***** *****2***** **2**.



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Referrals to Qualified Intermediary Offices	The cases selected by the filters would be forwarded to the Qualified Intermediary Offices *2* *****2***** 1	As of September 30, 2019, *****2***** *****2***** *****2*****
Referrals to Classification and Field Audits	Based on the final determination by the Withholding and Credit Team, the case would be referred to classification for a possible field audit.	As of September 30, 2019, *****2***** *****2*****
Withhold Credits at the Taxpayer Level	LB&I Division management is establishing processes to deny withholding credits claimed by foreign individuals if the withholding agent has not met the filing and payment requirements.	As of September 30, 2019, *****2***** *****2***** *****2***** *****2***** *****2*****

1 *****2*****
*****2*****



Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

COMMISSIONER
LARGE BUSINESS AND INTERNATIONAL DIVISION

March 16, 2020

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT
MICHAEL E. McKENNEY

FROM: Douglas W. O'Donnell /s/ Douglas W. O'Donnell
Commissioner, Large Business and International Division

SUBJECT: TIGTA Draft Audit Report # 2018-40-022, Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons

Thank you for the opportunity to review and comment on the draft report referenced above. We appreciate your acknowledgement of the processes and improvements we've implemented to strengthen the identification of reporting discrepancies on the Forms 1042 and 1042-S. As noted in your report, in June 2019, we developed and initiated Campaign 817 to review the entire population of Form 1042 and Form 1042-S filers to systemically identify the most serious filing errors. We are reaching out directly to thousands of withholding agents to address noncompliance and errors through a variety of treatment streams. The campaign currently deploys 12 filters to systemically reconcile these forms, and we are in the process of developing 12 additional filters that will further strengthen our capabilities in this area, *****2***** by withholding agents. Also, as noted in your report, we have assessed millions of dollars in penalties for withholding agents and financial institutions that failed to comply with Form 1042-S e-filing requirements.

As part of our overall compliance strategy for U.S. source income paid to foreign persons, we also have a separate campaign aimed at verification of a Form 1042-S credit claimed on a Form 1040 NR, and have denied millions of dollars in credits that cannot be verified, as well as utilizing other treatment streams to improve voluntary compliance in this area. Also, we are currently working to develop data integrity software for the Form 1042-S that would enable withholding agents to test their data to identify inconsistencies before submission to the IRS. We will continue to evaluate and modify our strategic approach for U.S. source income withholding to identify and address noncompliance and improve voluntary compliance, while balancing available resources and other organizational priorities.

The attachment provides a response outlining our corrective actions for the agreed recommendations. While it is true that the forms you reviewed included some reporting



Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons

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discrepancies and errors that require follow-up and reconciliation, it does not necessarily follow that revenue is lost. We are, therefore, unable to agree with your stated monetary benefits. It is important to note that withholding agents are personally liable for any required tax that is withheld.

If you have any questions, please contact me, or members of your staff may contact Deborah T. Palacheck, Director, Withholding & International Individual Compliance Practice Area at (202) 317-8451.

Attachment



Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons

Attachment I

The Commissioner, LB&I Division, Should:

RECOMMENDATION 1:

Review the 1,919 withholding agents we identified that did not file a Form 1042 or a Form 1042-S as required or that have a reporting discrepancy that were not identified by the Campaign 817 criteria and take appropriate action to address the withholding agents' noncompliance with the reporting requirements.

CORRECTIVE ACTIONS:

Balancing available resource and organizational priorities, the IRS established tolerances for each filter applied to the 2017 filings that did not result in the identification of every withholding agent TIGTA identified and is lowering its tolerance levels for the 2018 filings to capture a larger population of withholding agents that failed to file Forms 1042 or 1042-S or that have a reporting discrepancy. The IRS believes resources are better expended in future cycles with these refined filters, rather than continuing to work on the earlier year returns identified by TIGTA.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 2:

Modify the Campaign 817 filter criteria to ensure that consistent information is used on Forms 1042 and Forms 1042-S to identify withholding agents that have a reporting discrepancy.

CORRECTIVE ACTIONS:

Campaign 817 filters already treat this information consistently.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A



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RECOMMENDATION 3:

Modify the Campaign 817 filter criteria to ensure that all withholding agents that do not file Form 1042 are identified, including withholding agents *****2*****
*****2*****.

CORRECTIVE ACTIONS:

LB&I will create a modification to Campaign 817 filters to identify withholding agents that do not file Form 1042. However, given available resources and organizational priorities, tolerance levels for this filter may not capture all of the Form 1042 non-filers.

IMPLEMENTATION DATE:

March 1, 2021

RESPONSIBLE OFFICIAL(S):

The Director, Withholding & Individual International Compliance Practice Area

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 4:

Modify Error Resolution function procedures to require tax examiners to ensure that the credit amount claimed on Form 1042 for tax withheld *****2***** matches the amount of tax withheld that is reported on Form 1042-S *****2*****
2.

CORRECTIVE ACTIONS:

Current Form 1042 error resolution programming does not systemically identify differences in the amount of tax withheld *****2***** on the Form 1042 and the amount(s) of tax withheld that is reported on Forms 1042-S *****2*****
*****2*****. Forms 1042-S are processed through a system that is not linked to the system used to process Form 1042 such that there is no current systemic option available to identify these discrepancies and thereby allow the error resolution tax examiners to review these returns. However, the planned modifications to our Campaign 817 filters will address this issue after returns have been filed.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A



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RECOMMENDATION 5:

Establish processes and procedures to systemically identify and address withholding agents that file a Form 1042 for which the credit claimed for tax withheld *****2*****
*****2***** is not supported by a third party Form 1042-S, such as implementing a filter to identify these discrepancy cases.

CORRECTIVE ACTIONS:

We cannot address this systemically when returns are filed. We are pursuing a filter modification in Campaign 817 to address this issue after returns have been filed.

IMPLEMENTATION DATE:

March 1, 2021

RESPONSIBLE OFFICIAL(S):

The Director, Withholding & Individual International Compliance Practice Area

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 6:

*****2***** withholding agents identified as noncompliant with Form 1042-S filing requirements.

CORRECTIVE ACTIONS:

Campaign 817 Filter 104 addresses the non-compliance of the highest risk taxpayers in this population. Tolerances in this filter have been established balancing available resources and organizational priorities and may be refined based on the data from future cycles.

IMPLEMENTATION DATE:

March 15, 2021

RESPONSIBLE OFFICIAL(S):

The Director, Withholding & Individual International Compliance Practice Area

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 7:

Review the 1,569 withholding agents the IRS identified that did not file Form 1042-S and take the actions necessary to address their noncompliance with the reporting requirement, including assessing failure to file penalties when appropriate.



Continued Efforts Are Needed to Address Billions of Dollars in Reporting and Payment Discrepancies Relating to Tax Withheld From Foreign Persons

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CORRECTIVE ACTIONS:

Given available resources and organizational priorities, we believe that resources are better expended in future cycles with a potentially refined filter, rather than continuing to work on the 2017 population that was identified by TIGTA that did not meet our original tolerance threshold. LB&I's subsequent filter run for 2018 returns will continue to address non-compliance of Form 1042-S filings.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 8:

Establish processes to identify and address withholding agents that do not complying with Form 1042-S e-filing requirements.

CORRECTIVE ACTIONS:

The IRS already has an established process in place to address the failure to comply with Form 1042-S e-filing requirements under Internal Revenue Code (IRC) Section 6721. Indeed, as noted in your report, this process has resulted in the assessment of millions of dollars of penalties.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 9:

Review the 19 withholding agents and 232 financial institutions we identified that did not comply with the Form 1042-S e-filing requirement and take the actions needed to address their noncompliance, including assessing failure to file penalties when appropriate.

CORRECTIVE ACTIONS:

The IRS has an established process in place to address the failure to comply with Form 1042-S e-filing requirements under IRC Section 6721.



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IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 10:

Further lower the dollar tolerance used to select Form 1040NR with unsupported withholding credits for manual verification before refunds are issued.

CORRECTIVE ACTIONS:

The overall threshold for Campaign 816 that addresses 1040NR refund claims will be reduced by ****2**** in 2020. This will bring in approximately 500 additional returns reviewed by the campaign totaling ****2**** in Form 1042-S credits.

IMPLEMENTATION DATE:

March 15, 2021

RESPONSIBLE OFFICIAL(S):

The Director, Withholding & Individual International Compliance Practice Area

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 11:

Establish processes *****2***** to ensure that the Forms 1042 contain a valid UFI (i.e., a UFI is present and is in the valid format) before the forms are input into IRS systems.

CORRECTIVE ACTIONS:

The IRS is unable to *****2***** Forms 1042-S to identify an invalid UFI, *****2***** , these paper returns are subject to the Campaign 817 filters referenced in Recommendation 12.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A



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CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 12:

Update the Campaign 817 filter criteria to identify Forms 1042-S with a UFI *****2*****
*****2*****.

CORRECTIVE ACTIONS:

The Campaign 817 filter has been updated and will be applied for the 2018 returns that will be worked in 2020. Electronically filed Form 1042-S are not accepted into the FIRE system unless there are *****2*****
*****2*****.

IMPLEMENTATION DATE:

March 15, 2021

RESPONSIBLE OFFICIAL(S):

The Director, Withholding & Individual International Compliance Practice Area

CORRECTIVE ACTION(S) MONITORING PLAN:

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