

Area of
Focus #1**IRS Implementation and Enforcement of Withholding on Certain Payments to Foreign Persons Is Burdensome, Error-Ridden, and Fails to Protect the Rights of Affected Taxpayers****TAXPAYER RIGHTS IMPACTED¹**

- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

The National Taxpayer Advocate has previously raised a number of concerns regarding implementation of the Foreign Account Tax Compliance Act (FATCA) and related offshore enforcement measures.² Taxpayers have been increasingly burdened by the foundational shift from a service/compliance-based to an enforcement-based regime that has been steadily occurring in this area. The National Taxpayer Advocate is troubled that, without statistically valid evidence or analytical justification, the IRS has adopted a coercive approach to international taxpayers, reflecting an assumption that all such taxpayers are suspect of fraudulent activity.

Specifically, the National Taxpayer Advocate is concerned that:

- The IRS's processes for reviewing and validating Chapter 3 and Chapter 4 refund requests have unnecessarily burdened taxpayers;³
- The IRS's unsuccessful systemic matching program has caused particular hardships for international students; and
- The IRS's enforcement-oriented approach to international taxpayers creates problems for taxpayers, representatives, and other stakeholders, and wastes precious IRS resources.

The IRS's Processes for Reviewing and Validating Chapter 3 and Chapter 4 Refund Requests Have Unnecessarily Burdened Taxpayers

With the advent of the FATCA reporting and withholding requirements, the IRS became preoccupied with potentially fraudulent activity on the part of taxpayers and withholding agents in the context of both Chapter 3 and Chapter 4 requests for refunds. TAS analysis, however, indicates that the vast majority of taxpayers requesting a refund of tax shown as withheld on a Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, by filing a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, actually appear to be substantially more compliant than a comparable portion of the overall U.S.

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that was adopted by the IRS are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 National Taxpayer Advocate 2015 Annual Report to Congress 346-52; National Taxpayer Advocate 2013 Annual Report to Congress 238-48. FATCA was passed by the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

3 Under IRC §§ 1441-1443 (Chapter 3), the IRS imposes withholding on payments made to non-resident aliens and foreign corporations and allows credits and refunds of the amounts to which these taxpayers are entitled. Likewise, IRC §§ 1471-1474 (Chapter 4) mandates withholding under FATCA on payments to foreign financial institutions (FFIs) or similar institutions in specified circumstances and refers taxpayers to Chapter 3 for rules governing the credit or refund of those withheld amounts.

taxpayer population.⁴ Nevertheless, the IRS has frozen Chapter 3 and Chapter 4 refunds for up to one year or longer, while attempting to match the documentation provided by taxpayers with the documentation provided by withholding agents.⁵ Specifically, the IRS adopted a program under which it compared each of 18 fields on Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, filed electronically by the withholding agent with those fields on the Form 1042-S furnished as part of the taxpayer's paper return.⁶ Any discrepancy, no matter how small, was grounds for rejection of the refund claim.⁷

This verification process, however, was ill-conceived and the applied technology inadequate. The technology flaws were exacerbated by the fact that non-residents are required to file Forms 1040NR on paper.⁸ As a result, international taxpayers have been subjected to onerous and unnecessary burdens.

As of March 2016, Form 1040NR returns with refund claims based on Form 1042-S withholding for the calendar year (CY) 2014, which generally were due by April 15, 2015, were treated by the IRS as follows:⁹

- 17,004 refund claims initially frozen, with those refunds eventually released to taxpayers after an average delay of 26 weeks;
- Another 27,670 refund claims in freeze status with an average delay of 33 weeks and counting; and
- An additional 15,257 refund claims disallowed after first having been frozen for an average period of 36 weeks.¹⁰

Even the refunds that ultimately have been allowed were long delayed and caused significant burden to taxpayers. This approach has not only been costly for taxpayers, but for the IRS, which has

4 TAS bases this determination on the fact that Form 1040NR taxpayers claiming Form 1042-S refunds have a lower percentage of high-scoring Discriminant Index Function (DIF) returns in comparison to filers overall — see particularly Total Positive Income (TPI) Class 72, which encompassed most taxpayers in this group. Data drawn Mar. 25, 2016 for tax year (TY) 2014 from IRS Compliance Data Warehouse (CDW), Individual Return Transaction File (IRTF) and Individual Master File (IMF). High-scoring DIF returns were defined as those with a DIF value that exceeded 80 percent of DIF scores in the general population for a particular TPI class. TAS calculated a cutoff point for DIF scores at the 80th percentile for each TPI class for TY 2014, and derived the percentage of Form 1040NR taxpayers claiming Form 1042-S refunds in each TPI class that exceeded the DIF cutoff point. Overall, only approximately three percent of Form 1040NR taxpayers claiming Form 1042-S refunds exceeded their respective DIF cutoff points, compared to 20 percent for individual filers in the general population (especially TPI Class 72). Accordingly, Form 1040NR taxpayers claiming Form 1042-S refunds showed a lower percentage of “high-scoring” DIF returns, and thus more compliant behavior, than the overall population. We did, however, identify certain small groups of taxpayers within the overall group who appear to have considerable compliance issues (see TPI Classes 75 and 80).

5 Internal Revenue Manual (IRM) 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR (TC 810-3 -E Freeze)* (May 1, 2015).

6 IRM 21.8.1.11.14.3 (2) (Jun. 2, 2016) (see SERP: <https://serp.enterprise.irs.gov/databases/irm.dr/current/21.dr/21.8.dr/21.8.1.dr/21.8.1.11.14.3.htm>). Notes from TAS conference call with Large Business and International (LB&I) (Apr. 29, 2016) (on file in TAS archives). A few withholding agents file their Forms 1042 on paper, but the vast majority of withholding agents now do so electronically.

7 IRM 21.8.1.11.14.3 (4) (Jun. 2, 2016) (see SERP: <https://serp.enterprise.irs.gov/databases/irm.dr/current/21.dr/21.8.dr/21.8.1.dr/21.8.1.11.14.3.htm>). Notes from TAS conference call with LB&I (Apr. 29, 2016) (on file in TAS archives).

8 See National Taxpayer Advocate 2013 Annual Report to Congress 205-13.

9 Taxpayers who did not receive wages as an employee subject to U.S. income tax withholding had until June 15, 2015 to file their 2014 Form 1040NR, *U.S. Nonresident Alien Income Tax Return*. See instructions for 2014 Form 1040NR, 6, <https://www.irs.gov/pub/irs-prior/i1040nr-2014.pdf>.

10 CDW, IMF and IRTF Extract Cycle as of 201612 (Mar. 2016). This data excludes the less than 100 Form 1040NR returns accompanied by Form 1042-S refund claims that have been released but were partially disallowed.

estimated that an extension of the freezes through early 2016 would generate an interest expense of over \$4 million.¹¹

Some of these taxpayers have been subject to significant hardship on account of the refund freezes and contacted TAS in hopes of obtaining assistance in expediting and resolving their cases.¹² TAS opened an information gathering project regarding the Form 1042-S issues, and has undertaken substantial casework and advocacy in this context. The IRS, however, has moved slowly on these cases, with many operations assistance requests (OARs) remaining unworked for extended periods.¹³ TAS is developing Taxpayer Assistance Orders (TAOs) and mass OARs to address the most commonly arising Form 1042-S scenarios. The National Taxpayer Advocate will issue these orders as necessary to protect taxpayer rights and preserve the systemic integrity of the tax system.

TAS has also observed that the IRS has been disallowing claims that are not quickly verified by its systemic matching program, which is based on the use of an automated matching tool supplemented by high-level manual review. These disallowances occurred for reasons that often were beyond taxpayers' control, such as transcription errors within the IRS and poor data quality.¹⁴ The IRS's solution, however, has been to require that taxpayers experiencing a mismatch contact their withholding agents and persuade them to amend the inconsistent Form 1042-S submissions.¹⁵ These efforts were made even more difficult because the IRS Letters 5532C, *Notification of Preliminary Action Regarding Chapter 3 or Chapter 4 Withholdings Shown as Payments on Your Tax Return*, issued to affected taxpayers did not state the specific reasons for the mismatches between their Forms 1042-S and those filed by the withholding agent.¹⁶ Thus, taxpayers often found it difficult to tell what information they should ask their withholding agents to correct.

The IRS's Unsuccessful Systemic Matching Program Has Caused Particular Hardships for International Students

As an example of the problems caused by the IRS's approach to the processing of Form 1042-S refund claims, several months ago TAS became aware of tens of thousands of foreign university students whose Form 1042-S refunds were disallowed by the IRS on account of alleged mismatches in withholding information filed by the students and their colleges and universities.¹⁷ The National Taxpayer Advocate and her staff raised concerns about the matching program and the student Form 1042-S issue.¹⁸ These concerns, however, were repeatedly dismissed by the IRS officials charged with operating the program.¹⁹

11 *The National Taxpayer Advocate's 2015 Annual Report to Congress: Hearing Before the H. Subcomm. on Government Operations and the H. Comm. on Oversight and Government Reform, 114th Cong.* (2016) (statement of Nina E. Olson, National Taxpayer Advocate).

12 IRM 21.8.1.11.14.2(9), *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR (TC 810-3 -E Freeze)* (Feb. 18, 2016).

13 Notes from TAS conference calls with LB&I (Mar. 13, 2016 and Apr. 29, 2016) (on file in TAS archives).

14 Notes from TAS conference call with LB&I (Apr. 29, 2016) (on file in TAS archives).

15 See IRM 21.8.1.11.14.3, June 2, 2016 (see SERP: <https://serp.enterprise.irs.gov/databases/irm.dr/current/21.dr/21.8.dr/21.8.1.dr/21.8.1.11.14.3.htm>).

16 See IRM 21.8.1.11.14.3(5), June 2, 2016 (see SERP: <https://serp.enterprise.irs.gov/databases/irm.dr/current/21.dr/21.8.dr/21.8.1.dr/21.8.1.11.14.3.htm>).

17 TAS General Project 34152. See also SERP Alert 16A0135 (Mar. 24, 2016), revised on Apr. 7, 2016, rescinded on Apr. 26, 2016.

18 TAS General Project 34152. TAS expressed concerns about the Form 1042-S matching program to ensure there is no undue hardship on taxpayers since at least February 2015. See, e.g., FATCA Executive Steering Committee Meeting Notes (Feb. 4, 2015; June 10, 2015; Oct. 14, 2015; Mar. 2, 2016; Mar. 16, 2016; Apr. 27, 2016; May 25, 2016) (on file with TAS).

19 TAS General Project 34152. On March 2, the National Taxpayer Advocate brought forth an issue involving 1042-S matching problems to LB&I leadership. FATCA Executive Steering Committee Meeting Notes (Mar. 2 and 16, 2015) (on file with TAS).

When questioned about this specific issue, the IRS represented both to TAS, and to other parties, that the mismatches were attributable to a glitch in the third-party software used by the colleges and universities in their capacity as withholding agents.²⁰ The providers of this software contacted the IRS in an attempt to learn more about the alleged errors, to obtain assistance in identifying and repairing systemic problems, and to seek solutions for the impacted students. According to the National Association of College and University Business Officers (NACUBO) and at least one of the software providers, the IRS was extremely reluctant to communicate with the impacted parties and explain its rationale for the existing problems. “IRS officials have not reached back out to NACUBO or to two of the three institutions and one of the two software providers that furnished student tax returns to the IRS ... Repeated requests to the IRS for follow up ... go unanswered.”²¹

As stated by one of the software providers, “We are four companies that don’t usually communicate, yet we miraculously made the same mistake after doing this for many years? That is highly improbable from a software standpoint, and it is much more logical to look at their whole set of new code in the matching software.”²²

Only when congressional inquiries were received did the IRS take these student Form 1042-S problems, raised by the National Taxpayer Advocate and other stakeholders, seriously.²³ TAS understands that an investigation of the process ultimately was undertaken and a determination reached that IRS transcription errors and rigid processes were primarily responsible for the mismatches.²⁴ Finally, the IRS publicly acknowledged that its matching program was generating excessive false-positives and that the IRS was at fault, not the software companies serving the educational institutions and their students.²⁵

The IRS’s Enforcement-Oriented Approach to International Taxpayers Creates Problems for Taxpayers, Representatives, and Other Stakeholders, and Wastes Precious IRS Resources

This problem for foreign students, third-party service providers, and all foreign taxpayers filing Form 1040NR and Form 1120-F refund claims based on withholding of tax reported on Forms 1042-S, could largely have been avoided, and resources maximized, had the IRS simply used technology already developed and pre-tested in the domestic withholding context.²⁶ Likewise, the hardships to taxpayers could have been mitigated if the IRS had listened when it was originally contacted regarding the concerns of third parties. From a broader perspective, this entire chain of events, both for foreign students and

20 Notes from TAS conference call with LB&I (Mar. 13, 2016) (on file in TAS archives); Sabrina Rodriguez, *Tax Software Glitch Leaves International Students in Panic*, POLITICO PRO (Apr. 14, 2016).

21 Briefing paper, NACUBO, *Widespread Tax Problems for International Students* (Apr. 21, 2016) (on file in TAS archives); Letter from Donna Kepley, President, Arctic International LLC, to Nina E. Olson, National Taxpayer Advocate (Apr. 18, 2016) (on file with TAS).

22 Sabrina Rodriguez, *Tax Software Glitch Leaves International Students in Panic*, POLITICO PRO (Apr. 14, 2016).

23 Letter from Rep. Lloyd Doggett to John Koskinen, Comm’r, IRS (Apr. 22, 2016) (on file in TAS archives); Letter from John Koskinen, Comm’r, IRS to Rep. Lloyd Doggett (Jun. 6, 2016) (on file in TAS archives).

24 TAS General Project 34152.

25 IRS, *IRS Takes Steps to Help Students; Outlines Interim Process for Obtaining Refunds of Withholding Tax Reported on Form 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding* (June 6, 2016), <https://www.irs.gov/uac/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042s-foreign-persons-us-source-income-subject-to-withholding>.

26 The Return Integrity & Compliance Services (RICS) Integrity & Verification Operation (IVO) — a part of the Wage & Investment (W&I) Division — uses filters, rules, data mining models, and manual reviews to identify potentially false returns, usually through reported wages or withholding, to stop fraudulent refunds before the IRS issues them. See, e.g., IRM 25.25.2.1(1) (Aug. 20, 2015). See also Area of Focus: *The IRS’s Pre-Refund Wage Verification Program Continues to Incorrectly Flag and Substantially Delay Legitimate Refunds for Hundreds of Thousands of Taxpayers*, *infra*.

for all taxpayers whose withheld tax is reflected on Form 1042-S, was rooted in the IRS's increasingly enforcement-oriented culture, was perpetuated by the poorly-conceived and executed systemic matching program, and was exacerbated by the IRS's unwillingness to effectively engage with taxpayers and other stakeholders, including TAS.

The IRS has announced the intention of lifting the freezes currently placed on refunds of withholding tax reported on Form 1042-S and discontinuing its policy of instituting future freezes until it has redesigned the process for examining such claims.²⁷ The IRS should move quickly and decisively to provide this relief, and, insofar as possible, to undo the hardships that it has needlessly caused impacted taxpayers.

TAS has requested to be a part of the cross-functional team charged with future process redesign. To this point, however, the IRS has not committed to include TAS in this effort. In order for this process redesign to be successful, the IRS must abandon its enforcement-only bias against international taxpayers, become less insular in its approach, and listen to the observations and recommendations of the National Taxpayer Advocate and stakeholders who have valuable perspectives to contribute.

FOCUS FOR FISCAL YEAR 2017

In Fiscal Year 2017, TAS will continue to:

- Monitor IRS's redesign of the Form 1042-S withholding program;
- Work with the IRS to improve the policies and procedures associated with the redesigned Form 1042-S withholding program;
- Advocate for U.S. taxpayers experiencing any remaining significant hardships as a result of systemic Chapter 3 and Chapter 4 refund freezes and issue TAOs as necessary;
- Provide TAS employees working these Form 1042-S cases with enhanced training and guidance, including TAOs covering the most commonly arising situations; and
- Explore potential regulatory and legislative avenues for improving the Chapter 3 and Chapter 4 withholding regime in ways that are less intrusive, only gather the information actually needed by the IRS, and limit the burden on all impacted parties.

27 IRS, *IRS Takes Steps to Help Students; Outlines Interim Process for Obtaining Refunds of Withholding Tax Reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding* (June 6, 2016), <https://www.irs.gov/uac/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042s-foreign-persons-us-source-income-subject-to-withholding>.