



COMMISSIONER

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

June 12, 2006

The Honorable Max Baucus  
Ranking Member  
Committee on Finance  
United States Senate  
Washington DC 20510

Dear Senator Baucus:

This letter is in response to your inquiry dated May 16, 2006, on our use of foreign-source information documents. I appreciate and share your concerns that we have not taken adequate steps to use the foreign-source documents we receive. I also appreciate the suggestions you offered to use the information. I assure you that I am personally looking into this matter.

#### Background

Since the mid-seventies, we have received documents from our tax treaty partners reporting payments of foreign source income to United States persons, including individuals and business entities such as corporations, trusts, governmental entities, partnerships, and pension plans. Treaty partners generally report passive income such as interest, dividends, rents, and royalties. In 1995, we began receiving these documents on magnetic media instead of paper. Since that time, many countries migrated from paper documents to magnetic media. However, we continue to occasionally receive a limited number of paper documents from our treaty partners. In 2005, we received about 2.8 million documents on magnetic media from 20 countries.

International tax compliance is one of my priorities, and we are taking steps to ensure we have the capabilities to evaluate and identify international tax compliance risk. We want to use all the information and tools reasonably available to us to ensure all taxpayers comply with their tax responsibilities. The use of documents that report foreign source income has been a concern for us for many years. To balance the cost and benefits, we need to evaluate our compliance process and information systems capabilities to identify how we can best use foreign documents to improve our compliance programs. However, as discussed in more detail below, this will be very challenging because of deficiencies in the data.

I hope the following information addresses your specific questions.

Question 1

*Why has the IRS found it to be difficult to use this foreign source income data for compliance purposes?*

These documents suffer from a number of deficiencies. Most of the information does not contain a U.S. tax identification number (TIN.) These documents are in a foreign language and involve foreign currency, contain mismatched tax years and/or multiple tax years, are not timely received for an automated matching program, and at times, do not report a taxable event in the U.S. The documents received on magnetic media suffer from the same fundamental deficiencies as the paper documents.

The most efficient use of such a high volume of documents would be in an automated matching program. Although we do not have an automated matching program for income paid to non-individuals, we have made efforts to process the paper documents for use in an automated matching program for individuals by converting them into Forms 1099. However, the deficiencies in the documents, the need to fund competing and other priority compliance initiatives, and the lack of an adequate cost/benefit analysis have impeded the strategic and coordinated use of this information across business units.

Question 2

*Please provide a status update on the IRS's efforts to implement the recommendations in TIGTA report 2005-30-101.*

The Director, International, Large and Mid-Size Business Division, established controls within the Automatic Exchange of Information Program (AEIP) that monitor the receipt and timeliness of foreign-source income data.

We could not agree to implement a pilot program to include foreign- source income documents in the domestic Information Returns Program or develop a separate matching program. Foreign-source information documents must contain TINs or be processed through TIN perfection before they can be useful to Wage and Investment's Automated Under Reporter (AUR) process. Currently, over 90% of incoming documents do not contain any TINs. Also, our treaty partners do not always collect and provide us with data based on a calendar year. Delaying the AUR process to perfect TIN matching and to convert the data to a calendar year would extend audit cycle times and be prohibitive from a cost/benefit perspective. Nevertheless, we are using the data in other ways, as discussed in our responses below, and we will continue to look for other ways to use the data within our compliance programs.

The Associate Chief Counsel (International) (ACCI) has advised the Director, International (LMSB) that, under current treaties, we can only disclose foreign source information to people or entities involved in the assessment, collection, enforcement, or prosecution of taxes covered by the treaty. Further, these individuals or entities may use the information only for such purposes, and only for administration of a treaty-covered tax under Title 26. Thus, we cannot use information received under a tax treaty to enforce the Foreign Bank and Financial Accounts Report (FBAR) reporting obligations under Title 31. We have discussed this issue with the Department of the Treasury. With Treasury, we continue to believe that a general change in policy would produce little benefit while having significant negative consequences. We continue to explore whether a targeted provision could allow effective use of treaty exchanged information in non-tax cases without violating long-standing treaty policy or raising significant privacy concerns.

#### Questions 3 and 4

*What efforts does the IRS make to inform field agents that this foreign source information is available?*

*Describe the current process for field agents to obtain this information, including time frame*

Over the past several years, we have informed field personnel of the existence of the data during continuing professional education sessions and given the names of people to contact in International for access to the data. This traditional means of informing field agents of this data has yielded few, if any, requests for the data.

International is, therefore, looking for new ways to advise field agents of the data's availability. These efforts will include assurances that we will process requests for the data timely.

#### Question 5

*When were the paper information documents stored in Philadelphia destroyed? Why were they destroyed? Who authorized this action? Were the documents destroyed in response to the Senate Finance Committee's inquiries?*

The Philadelphia Submission Processing Center (PSPC) last received paper documents sometime during calendar year 2004. The majority of the paper documents received in 2004 was for tax year 2002 and prior and the remainder was for tax year 2003. The PSPC has not received any paper documents since that time.

The PSPC destroyed the documents received in 2004 consistent with directives specified in IRM 1.15.29, Records Control Schedule for Tax Administration Wage and Investment Records. It destroyed the Foreign Information Return Program

(FIRP) documents through the routine records management process with no special authorization provided. When it destroyed the FIRP documents, the PSPC was not aware of, and had no knowledge of, the Senate Finance Committee's inquiries.

#### Question 6

*What is the record retention period for paper and electronic documents? Was this requirement violated when the paper documents were destroyed?*

The records retention period for paper FIRP documents that the PSPC maintained is specified as follows in IRM 1.15.29-1, IRM 1.15.29, Records Control Schedule for Tax Administration Wage and Investment Records. ITEM # 85 (2) (b) 2 – Information Returns and Documents not selected for review – **Destroy January 2, following the year received.** The PSPC destroyed the paper records following the IRM directives.

We have not added the magnetic and electronic documents to the retention schedule. We will not destroy this data until we have an approved retention schedule. Thus, this information is available either on a database or on the original media.

#### Question 7

*Where are the new paper information documents being sent to and where are they stored?*

With the Organization for Economic Cooperation and Development (OECD), we have discouraged our treaty partners from exchanging paper documents for some time. Thus, Trinidad and Tobago is the last country to send paper documents to PSPC, and PSPC last received paper FIRP documents from Trinidad and Tobago in calendar year 2004. Switzerland, however, is providing paper documents it receives monthly at our office in Paris where we are holding them. U.S. recipients of Swiss income file these documents, which are claims for over withheld Swiss tax. The form requires a U.S social security number. We receive 3,000 to 5,000 paper documents in Paris every year. Approximately 20% of these documents relate to individuals claiming refunds. Businesses, charities, pension funds, and other non-individual entities file the others. Last year, the Paris office began a manual review of these documents and sent them to an SB/SE compliance function.

The SB/SE International office received paper copies of these Swiss refund claims. It selected a sample for field audits and is pursuing Examination issues like the reporting of all Swiss source income, the amount of foreign tax credit claimed, and the exchange rate used. We do not yet have the results of these audits, but early indications are that these audits are productive.

Question 8

*Why did Modernization and Information Technology Service (MITS) stop processing the data?*

We stopped uploading the incoming foreign information while we worked to resolve issues concerning the identification of the appropriate business owner of the data. After receiving your letter, the Corporate Data Systems Management Division in MITS agreed to resume uploading the data until we can resolve the business ownership issue.

Question 9:

What plans do you have to begin processing the electronic data again, including, but not limited to, extracting, sorting, matching and analyzing data and making it available to the field? This response should include server capacity and privacy issues. Provide specific action items, timeframes and milestones.

As stated in Question 2 above, LMSB is exploring what capabilities and requirements they will need to use this information. When they complete their analysis, they will work with the MITS organization to define system requirements.

Question 10:

How much would it cost to design and implement an electronic system that would make the foreign source data easily accessible for matching, analyzing and auditing? How long would it take to bring the system on-line?

We will not have this information until LMSB and MITS define system requirements as discussed in question 9.

Question 11 and 12

*How much tax do you estimate goes unpaid because of unreported foreign income?*

*How much unpaid tax in question 11 do you estimate would be collected if the IRS utilized the foreign source income data as a part of its Automated Underreporter Program?*

We have no studies that estimate the amount of unreported foreign income. Nor can we estimate the impact of using the foreign income data in AUR. However, most of the foreign income data we receive is from our treaty partners, which generally are not countries where we would expect taxpayers to conduct business for the purpose of avoiding U.S. tax.

Question #13

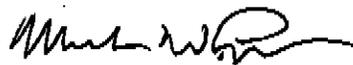
*Please provide the Research Plan for the ongoing IRS project to test the value of the documents being received.*

The SB/SE Research office has agreed to test the usefulness of FIRP data from Canada because Canada provides the largest volume of FIRP documents. The LMSB Division receives Canada's information in electronic OECD standard format. Because the OECD format is not compatible with IRS systems, Research will convert data to a usable format and run TINs received against master file to identify potential nonfilers. When we identify valid TINs, we will do a preliminary match of FIRP income to types of income reported on U.S. tax returns. We will stratify results, and the next step will be to identify returns for examination.

For records with missing or invalid TINs, SB/SE is working with Accounts Management to determine the resources needed for TIN perfection through the use of IRS's Auto-TIN program. When we complete the estimate of resource needs, we will request funding.

Your letter has provided an opportunity to view these documents in a different context and to rethink some of the traditional ways we have attempted to use this information. We are committed to evaluating the use of foreign-source income documents and determining their appropriate use in our compliance activities. We will continue to keep your committee updated as we make progress in this area. I am also writing to Senator Grassley. If you have questions or would like to schedule a meeting, please contact me or call Floyd Williams, National Director, Legislative Affairs, at (202) 622-4725.

Sincerely,



Mark W. Everson