

GAO

Report to the Chairman, Subcommittee
on Select Revenue Measures,
Committee on Ways and Means,
House of Representatives

April 2010

TAX COMPLIANCE

IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden



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Highlights of [GAO-10-429](#), a report to the Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

Every year, the U.S. receives millions of legal visits by foreign individuals. Nonresident aliens—who are neither U.S. citizens nor residents—may be required to file a federal tax return if they earn U.S.-source income, and their noncompliance can contribute to the tax gap. As with U.S. citizens and residents, the Internal Revenue Service (IRS) is responsible for ensuring that nonresident aliens fulfill their tax obligations. GAO was asked to (1) identify what data are available on nonresident alien tax filing and compliance, (2) provide information on guidance IRS provides to nonresident aliens and third parties on tax requirements and any challenges associated with filing, and (3) assess actions IRS takes to enforce nonresident alien tax compliance. To meet its objectives, GAO examined IRS and other federal agency documentation, reviewed tax filing and other data, and interviewed IRS officials and other third parties.

What GAO Recommends

GAO suggests that Congress consider raising the exemption threshold for income paid by a foreign employer and eliminating the certificate of compliance, or sailing permit, requirement. GAO also recommends that IRS determine if creating an automated program to identify improper filing of Form 1040 by nonresident aliens would be a cost-effective means of improving compliance. In commenting on a draft of this report, IRS agreed with our recommendation.

[View GAO-10-429 or key components.](#) For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

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IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden

What GAO Found

For tax year 2007, nonresident alien individuals filed about 634,000 Forms 1040NR, the U.S. Nonresident Alien Income Tax Return. IRS has not developed estimates for the extent of nonresident alien tax noncompliance because it often lacks information to distinguish between nonresident aliens and other filers, and examinations can be costly and difficult since many nonresident aliens would depart the country before IRS could examine their returns.

IRS's outreach and education efforts have focused on presenting information on nonresident tax issues to a variety of audiences and making information available on its Web site and in its publications. Nevertheless, some nonresidents, their employers, and paid preparers may not be aware of nonresident alien tax rules, according to representatives of groups that work with employers and nonresidents to assist them in fulfilling their tax obligations. Other filing challenges exist. For example, individuals filing Forms 1040NR cannot file electronically. Also, nonresidents in the U.S. for less than 90 days who earn over \$3,000 in compensation for services paid for by a foreign employer will likely have to file Form 1040NR, even if they owe no tax. The \$3,000 exemption threshold, enacted by Congress in 1936 to lessen the tax compliance burden on nonresident aliens and never adjusted for inflation or other purposes, likely results in a greater proportion of nonresident aliens having a filing requirement today than in 1936.

IRS has expanded its nonresident alien enforcement efforts over the past decade. However, IRS does not have a program to automatically identify nonresident aliens who improperly file Form 1040 instead of Form 1040NR, which can result in lost tax revenue when these taxpayers take unallowed deductions. IRS may be able to use taxpayer information to identify this type of noncompliance systematically. Finally, some nonresidents must file a certificate of compliance, referred to as a sailing permit, before departing the U.S. to ensure that tax obligations have been satisfied. The requirement is difficult to enforce and few nonresidents fulfill it, potentially leading to broader noncompliance if individuals assume the lack of enforcement extends to other tax rules.

Nonresident Alien Filing Statistics, Tax Years 2003 through 2007

Form 1040NR filers	2003	2004	2005	2006	2007
Number of filers (in thousands)	627	638	648	636	634
Total income reported (dollars in billions)	\$7.8	\$9.3	\$11.2	\$13.4	\$12.8
Total tax liability reported (dollars in billions)	\$1.5	\$1.8	\$2.1	\$2.5	\$2.5

Source: IRS.

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United States Government Accountability Office
Washington, DC 20548

April 14, 2010

The Honorable Richard E. Neal
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

Every year, the U.S. receives millions of legal visits by foreign individuals, some of whom have U.S.-source income or are engaged in a U.S. trade or business. Individuals who are neither U.S. citizens nor residents are known as nonresident aliens for tax purposes and may be required to file federal tax returns to report their U.S.-source income.¹ Nonresident aliens' failure to comply with their tax requirements can contribute to the tax gap—the difference between taxes paid on time and what should have been paid. The Internal Revenue Service (IRS) last estimated a gross tax gap of \$345 billion for tax year 2001. IRS estimated that it would eventually collect, through various enforcement efforts, about \$55 billion of the gross tax gap, leaving a net tax gap of \$290 billion. As it is for U.S. citizens and residents, IRS is responsible for helping nonresident aliens to understand their tax obligations and ensuring compliance with such obligations.

In response to your request, this report provides information on nonresident alien tax obligations and compliance. Specifically, this report (1) identifies what data are available on nonresident alien tax filing and compliance, (2) provides information on guidance IRS provides to nonresident aliens and associated third parties on tax and filing requirements and any burdens and challenges associated with filing, and (3) assesses actions IRS takes to enforce nonresident alien tax compliance.

To provide data on nonresident alien tax filing and compliance, we obtained and reviewed IRS data from nonresident alien income tax returns (Form 1040NR) filed for tax years 2003 to 2007, the 5 most recent years for which data were available. We compared the Form 1040NR data to

¹Nonresidents with U.S.-source income may also owe state income taxes; however, we focus only on federal taxes in this report.

published data on other individual taxpayers from IRS's Statistics of Income program. We also interviewed IRS research and compliance officials. To provide information on guidance IRS provides to nonresident aliens and associated third parties on tax and filing requirements and associated burdens and challenges, we reviewed IRS tax forms, guidance, and outreach materials. We also interviewed IRS officials responsible for conducting outreach efforts and representatives from groups that work with employers and nonresidents to assist them in fulfilling their tax obligations, such as paid tax return preparers, accounting and law firms, and university business officers. To assess actions that IRS takes to enforce nonresident alien tax compliance, we used IRS's goal in its 2009-2013 strategic plan of increasing resource allocation to priority areas as criteria. We reviewed data from IRS's enforcement programs, reviewed related documentation, and interviewed IRS enforcement officials to determine whether resources were increased for nonresident alien compliance efforts and what results IRS had achieved.

We conducted this performance audit from July 2009 through April 2010 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. For more information on our scope and methodology, see appendix I.

Background

For federal tax purposes, non-U.S. citizens are categorized as either resident or nonresident aliens and are subject to different tax and filing requirements. Generally, a nonresident alien is an individual who (1) does not possess a permanent resident card, known as a green card, or (2) has not established a substantial presence in the U.S., which is generally determined by the number of days an individual spends in the U.S. over a 3-year period, though other considerations apply.² Resident aliens are

²Generally, aliens are resident aliens if they are present in the U.S. on 183 days or more in a calendar year. Individuals are also considered to have met the substantial presence test if they are present in the U.S. on at least 31 days during the current year and 183 days during the 3-year period that includes the current year and the 2 years immediately before that. When calculating the 183 day figure, individuals are to count all the days they were present in the current year, one-third of the days they were present in the immediately preceding year before the current year, and one-sixth of the days they were present in the second preceding year before the current year. I.R.C. § 7701(b)(3).

generally subject to the same federal tax requirements as U.S. citizens, which include paying U.S. taxes on worldwide income and filing an individual tax return (Form 1040). On the other hand, nonresident aliens generally pay U.S. taxes only on income derived from U.S. sources and may be required to report income on the nonresident alien individual tax return (Form 1040NR).³ Nonresident aliens cannot take some credits and deductions available to residents and citizens. However, nonresidents may qualify for reduced tax rates or exemptions as a result of tax treaties between the U.S. and their countries of residence.⁴

Generally, the tax rate nonresident aliens are to pay varies by both the types of income earned and the individuals' countries of residence. Nonresident aliens earning income effectively connected to a U.S. trade or business, such as employee wages, are generally taxed at the same graduated rates as U.S. citizens and residents, though some tax treaties offer certain exemptions on this type of income. The U.S.'s tax treaty with China, for example, exempts from taxation certain income earned from the performance of personal services if the nonresident alien is in the country for no more than 183 days.⁵ Income not effectively connected to U.S. trade or business, such as certain types of investment income, is generally taxed at 30 percent. However, nonresidents with income such as interest payments on deposits with a U.S. bank, or who are covered by a tax treaty may qualify for income exemptions or lower tax treaty rates. For example, residents of Mexico earning dividends from U.S. companies may qualify for a 10 percent or lower tax rate on this income instead of the flat 30 percent rate.

Nonresidents with income effectively connected to a U.S. trade or business are generally required to file Form 1040NR even if they owe no taxes because of a tax treaty or deductions. Conversely, nonresident aliens not engaged in a U.S. trade or business and whose tax liability was

³Foreign individuals can have a U.S. tax liability without entering the U.S., for example if they have certain types of U.S.-source investment income.

⁴The U.S. had 59 income tax treaties as of 2009. Under these bilateral agreements, residents of treaty countries are generally exempted from taxation or taxed at reduced rates on certain types of income they receive from U.S. sources, such as income from personal services, capital gains, royalties, and pensions or annuities.

⁵Personal services can be those services performed independently by professional persons, such as doctors and lawyers, or dependently by employees for an employer.

satisfied by the withholding of tax at the source do not have to file.⁶ A filing exemption also holds for nonresidents meeting certain other criteria, such as the following.

- Nonresidents whose only U.S.-source income is wages in an amount less than the personal exemption amount—\$3,650 for tax year 2009—do not have to file if they have no other need to file, such as to claim tax treaty benefits or a refund.⁷
- Income of \$3,000 or less paid by foreign employers for personal services performed in the U.S. is not considered to be from U.S. sources for nonresidents in the country for 90 days or less.⁸ An individual with only this type of U.S.-source income would not need to file a return. This \$3,000 threshold has not changed since its inception in 1936 and would equate to over \$46,000 in 2009 dollars if adjusted for inflation.

Table 1 lists examples of nonresident aliens earning U.S.-source income and the potential tax treatment in each scenario.

⁶Treas. Reg. § 1-6012-1(b)(2). Examples of income from U.S. sources but not effectively connected to U.S. trade or business include some interest earnings, dividends, rents, premiums, and annuities.

⁷IRS Notice 2005-77 (2005-46 IRB, Nov. 14, 2005).

⁸I.R.C. § 861(a)(3). The same exception applies when determining whether a nonresident alien is engaged in a trade or business within the United States. I.R.C. § 864(b)(1).

Table 1: Examples of Nonresident Aliens Earning U.S.-Source Income

Nonresident alien	Example of income earned and potential tax treatment
Income effectively connected to a U.S. trade or business	
Foreign visitor on nonimmigrant work visa	An individual earns wages while employed by a U.S. entity. The income is generally taxed at the same graduated rates as for U.S. citizens and residents.
Foreign short-term business traveler to U.S.	Employee of a foreign corporation travels to U.S. for a conference, meetings, or other business matters and earns more than \$3,000 in wage income during work days spent in the U.S. The wages are taxed at graduated rates unless exempted via tax treaty.
Foreign athlete or entertainer performing or competing in U.S.	Foreign athletes' and entertainers' income is taxable in the same manner as income derived by other nonresident aliens: income for performances within the U.S. is taxed at graduated rates on a net basis, and income such as royalties is subject to a 30 percent withholding tax. Tax treaties generally provide special exemptions for specific amounts of income earned for these performances.
Foreign student in U.S. on scholarship	Students in certain visa classes are nonresident aliens for at least the first 5 years spent in the U.S. Scholarship income may be excludable if the student is a degree candidate and uses the funds to pay tuition or other course-related expenses.
Employee of foreign government or international organization	Generally considered a nonresident regardless of the number of days spent in the U.S. Salaries from foreign governments and certain international organizations may be exempt from U.S. taxes.
Income not effectively connected to a U.S. trade or business	
Foreign investor in U.S. companies	An individual realizes a capital gain from trading stocks or securities through a U.S. broker. The income is generally tax exempt. Dividend income that is not effectively connected to a U.S. trade or business is taxed at a flat 30 percent or lower treaty rate.
Foreign investor with U.S. bank deposits	An individual receives interest from bank deposits with a U.S. financial institution. The interest income is from U.S. sources but is generally tax exempt.

Source: GAO analysis.

Note: Examples have been simplified for the purposes of illustration; exceptions may apply.

As with U.S. citizens and residents, nonresidents must have a taxpayer identification number in order to file a tax return. Foreign individuals authorized to work in the U.S., such as individuals traveling on a nonimmigrant temporary worker visa, must apply for a Social Security number (SSN). Individuals who do not qualify for a SSN but have a valid filing requirement under the Internal Revenue Code may apply to IRS for an individual tax identification number (ITIN). For example, certain short-term foreign business visitors earning wages from foreign employers while in the U.S. and foreign investors would generally apply for an ITIN.

Tax law also requires that both resident and nonresident aliens obtain a certificate of compliance, known as a sailing permit, to ensure that their outstanding U.S. tax obligations have been satisfied prior to departing the

country.⁹ First enacted in 1921, the requirement stipulates that most aliens permitted to work in the U.S. must visit an IRS office 2 weeks to 30 days prior to departing the country, provide documentation to support any claims of taxable income and prior tax payments made, and complete either a Form 1040-C (U.S. Departing Alien Income Tax Return) or Form 2063 (U.S. Departing Alien Income Tax Statement). An alien is to file Form 1040-C to report all income received or expected to be received during the tax year and generally is to pay any outstanding U.S. tax liability at the time the form is filed. Form 2063 is to be filed when the departing alien has no taxable income for the tax year or when tax collection will not be hindered by the alien's departure from the country. Certain frequent travelers between the U.S. and Mexico or Canada, alien students and exchange visitors, and visitors for business admitted on a class B-1 or B-1/B-2 visa with no taxable income and in the country for no more than 90 days are generally exempted from the sailing permit requirement.

Finally, entities making income payments to nonresidents are required to withhold taxes at either graduated or fixed rates, depending on the type of income earned, except when the payee can verify the individuals are entitled to an exemption. For example, a nonresident alien earning wages from a U.S. employer would generally be subject to graduated withholding in a manner similar to that of U.S. citizens and residents. On the other hand, a financial institution disbursing U.S.-source investment income to a foreign-based individual would generally withhold at a fixed 30 percent rate, unless the entity could verify that the nonresident was entitled to a reduced treaty rate. In both of these examples, the employer and financial institution are required to report income payments and withholding to IRS on information returns, such as Form W-2 (Wage and Tax Statement) or Form 1042-S (Foreign Person's U.S.-source Income Subject to Withholding). In certain circumstances with nonresident alien athletes and entertainers, IRS enters into arrangements that set withholding rates for income earned from specific events, often at less than the 30 percent otherwise required. These arrangements, called Central Withholding Agreements, specify the amount and timing of U.S. tax payments and take into account expenses associated with the income earnings.

⁹I.R.C. § 6851(d); Treas. Reg. § 1.6851-2.

Several Hundred Thousand Individuals File Form 1040NR and It Would Be Difficult to Measure Nonresident Alien Tax Noncompliance

According to IRS data, nonresident alien individuals filed about 634,000 Forms 1040NR for tax year 2007, a small number compared to the 143 million Forms 1040 other individual taxpayers filed for that year.¹⁰ These nonresident filers reported \$12.8 billion in income, resulting in a \$2.5 billion tax liability.¹¹ The number of Form 1040NR filers varied little from 2003 to 2007, the latest years for which data were available. However, total income and total tax liability reported increased during this period, as shown in table 2. Total income and tax liability reported on Form 1040NR increased by 64 percent and 71 percent, respectively, compared to increases in reported income (40 percent) and tax liability (48 percent) reported on Form 1040 from tax year 2003 to tax year 2007.¹² The \$5 billion increase in total income reported on Forms 1040NR for this period is largely due to increases among higher earners, since the total income that nonresidents with \$100,000 or more in income reported on Form 1040NR increased from \$3.8 billion to \$8.1 billion (111 percent).

Table 2: Nonresident Alien Filing Statistics, Tax Years 2003 through 2007

Form 1040NR filers	2003	2004	2005	2006	2007
Number of filers (in thousands)	627	638	648	636	634
Total income reported (dollars in billions)	\$7.8	\$9.3	\$11.2	\$13.4	\$12.8
Total tax liability reported (dollars in billions)	\$1.5	\$1.8	\$2.1	\$2.5	\$2.5

Source: IRS.

Form 1040NR filing data do not represent the full population of nonresident alien taxpayers, however. Certain foreign investors earning U.S.-source investment income with sufficient taxes withheld at the source, for example, are not required to file Form 1040NR. Also, nonresidents married to U.S. citizens or residents can choose to be treated as residents and jointly file Form 1040 with their spouses.¹³ Other

¹⁰Although Form 1040NR is filed by both individual taxpayers and on the behalf of nonresident alien estates or trusts, Form 1040NR data in this report only include figures for individual nonresident alien taxpayers.

¹¹The \$12.8 billion in income excludes about \$1.9 billion in income fully exempt from taxation due to tax treaties. Also excluded are tax-exempt interest; qualified dividends; and nontaxable individual retirement account distributions, pensions, and annuities on effectively connected income. Total income includes \$1.0 billion in negative income so that positive income reported in 2007 was \$13.9 billion (totals do not equal due to rounding).

¹²Total Forms 1040 filed increased 10 percent during the period.

¹³Nonresidents married to other nonresidents generally cannot jointly file a tax return.

nonresident aliens may incorrectly file Form 1040, meaning their tax return information is not reflected in the Form 1040NR data.

IRS data also allow for comparison of nonresident alien filing characteristics to those of U.S. citizen and resident filers, as shown in table 3.

Table 3: Comparison of Selected Filing Statistics from Forms 1040NR and 1040, Tax Year 2007

Filing statistic	Percentage of filed forms	
	Form 1040NR	Form 1040 ^a
Forms with no tax liability	53	25
Forms reporting tax balance due	8	20
Forms reporting a refund due	67	77
Forms prepared by a paid preparer	64	56

Source: GAO analysis of IRS data.

^aFigures for Form 1040 are estimates.

As shown in table 3, 53 percent of Form 1040NR filers reported no tax liability for tax year 2007, in contrast to an estimated 25 percent of Form 1040 filers. Some nonresidents qualify for tax treaty income exemptions which may contribute to the higher proportion of Form 1040NR filers with no tax liability.¹⁴ Requiring a nonresident with no tax liability to file a U.S. return creates some burden on the taxpayer, yet there are reasons why it may be beneficial. For example, for individuals filing exclusively to claim a treaty exemption, IRS may use that information to review and potentially dispute claims. Additionally, some nonresidents may not know if they have a tax liability until they go through the process of preparing a tax return.¹⁵

Also as shown in table 3, a smaller percentage of Forms 1040NR than Forms 1040 reported a tax balance or refund due for tax year 2007. These differences could be due to various factors, such as some nonresidents having no tax liability as a result of tax treaties. Also, a greater proportion

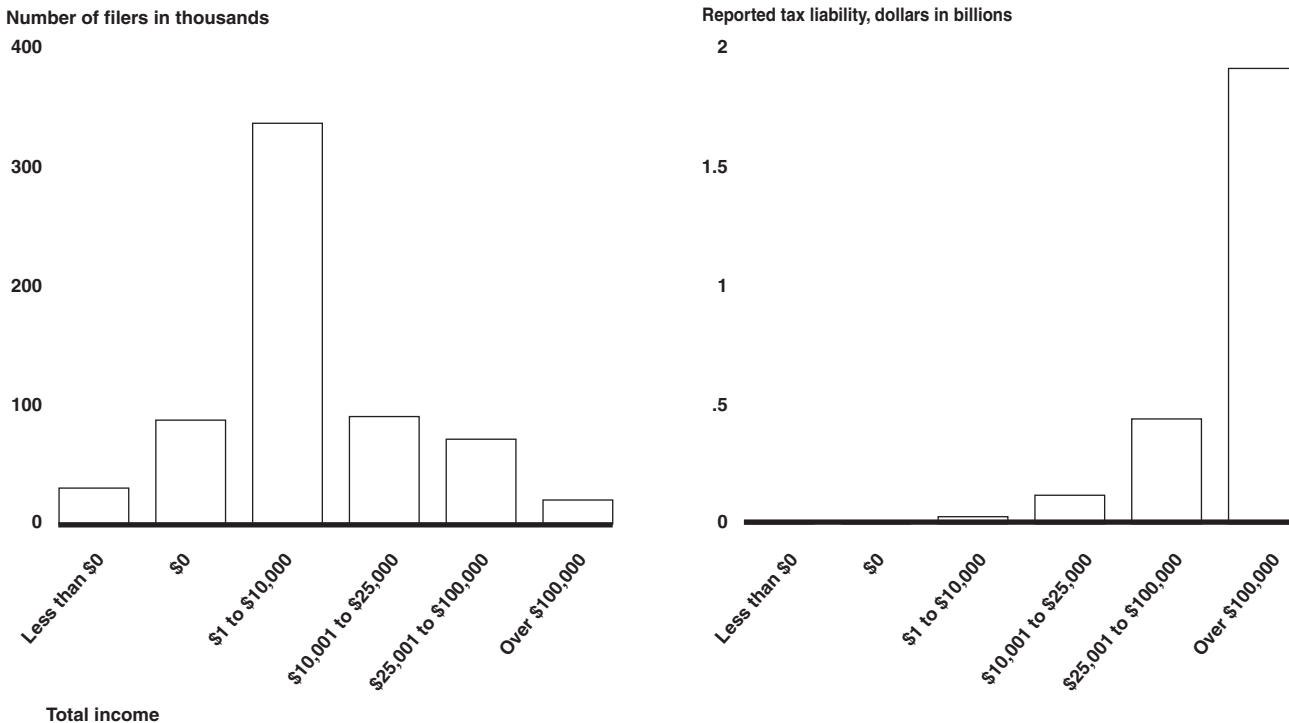
¹⁴IRS data show that about 60,000 Form 1040NR filers (9 percent of all Forms 1040NR filed) reported treaty exempt effectively connected income and no tax liability for tax year 2007, with little variation over the preceding 4 years.

¹⁵In 2007, 187,000 Form 1040NR filers reported no tax liability and filed a return to obtain a tax refund from IRS.

of Forms 1040NR than Forms 1040 were prepared by a paid tax return preparer, a disparity which may be due to several factors, such as the complexity of nonresident tax law and that some employers with employees traveling internationally may hire tax professionals to assist in preparing employees' returns.

Figure 1 below shows that a small proportion of filers accounted for the majority of reported tax liability. For example, about 20,000 filers (3 percent of all Form 1040NR filers) reported over \$100,000 in total income, yet this population contributed 76 percent (\$1.9 billion of \$2.5 billion) of reported tax liability reported for tax year 2007. Conversely, 72 percent of nonresidents reported \$10,000 or less in income, with these returns accounting for 1 percent of all reported tax liability (\$29 million out of \$2.5 billion). One reason why most nonresidents reported low income amounts might be that some are in the country for only part of the tax year.

Figure 1: Number and Total Reported Tax Liability of 1040NR Filers by Income Bracket, Tax Year 2007



Source: GAO analysis of IRS data.

Note: Form 1040NR filers could have reported less than \$0 dollars in total income if they had losses, such as capital or business losses, that exceeded their income.

IRS Lacks Comprehensive Data on Nonresident Alien Tax Compliance and Obtaining Data Would Be Challenging

IRS has not developed estimates for three types of nonresident alien tax noncompliance: (1) failing to file a tax return, known as nonfiling, (2) underreporting income on filed returns, and (3) filing Form 1040 instead of Form 1040NR.¹⁶ IRS has developed an estimate of overall individual taxpayer nonfiling by comparing general population information from the U.S. Census Bureau's Current Population Survey to individual income tax filing data, and matching data taxpayers report on tax returns to that which third parties report on information returns, such as wage and tax statements from employers.¹⁷ However, according to IRS research officials, it is not possible for IRS to parse out the nonresident portion of its nonfiling estimate because the agency lacks the information necessary to distinguish between nonresident alien and other nonfilers. Also, census data exclude many short-term nonresident visitors.

IRS has excluded Form 1040NR returns from its studies of individual taxpayer underreporting, which it uses to estimate the tax gap.¹⁸ Those studies rely partially on face-to-face examinations with individual taxpayers. Sampling Form 1040NR filers in these studies would have been costly and difficult since many nonresident aliens would have departed the country by the time IRS examined the returns, according to IRS research officials. Given limited agency resources, IRS has focused its compliance measurement efforts on types of taxpayers that may represent greater compliance risks. Total lost tax revenues associated with nonresident noncompliance, for example, may be modest when compared with underreporting for other areas, such as individual income tax, employment taxes, or entities such as S corporations.¹⁹

¹⁶Another type of individual income tax noncompliance is underpayment of one's reported tax liability.

¹⁷IRS's most recent estimate of the nonfiling tax gap for individual taxpayers was \$25 billion for tax year 2001.

¹⁸IRS completed a study, through its National Research Program (NRP), for tax year 2001 using a sample of about 46,000 Form 1040 returns. IRS has begun to study individual taxpayer reporting compliance on an ongoing basis and expects to have an updated compliance estimate by 2013.

¹⁹S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders, who are to report these items on their personal tax returns.

Additionally, IRS has not estimated the extent to which nonresidents improperly file Form 1040 instead of Form 1040NR.²⁰ This is partly because sampling and examining Form 1040 filers to identify nonresidents would be time-consuming and costly, given the large number of Form 1040 filers and the likelihood that nonresidents will have already departed the country.

Generating a rough estimate of the number of nonresident aliens who may have a filing requirement using data from other federal agencies would be challenging. The Department of Homeland Security (DHS) reported admitting 9.7 million visitors for purposes other than pleasure to the U.S. in 2007, while the Department of State reported issuing 6.4 million nonimmigrant visas in the same year. Yet neither figure serves as a reliable proxy for the number of nonresident aliens entering the country for employment or business purposes, much less incurring a filing obligation. DHS's data reflect the number of entries into the U.S. rather than the number of individuals, thus overcounting individuals making multiple trips to the U.S. State data reflect the number of visas issued, but some were issued for strictly leisure purposes, some visa recipients never enter the U.S., and others may enter the U.S. and stay for a period of time sufficient to establish tax residency. Even with an estimate of the number of nonresident aliens entering the U.S. each year, it would be difficult to further determine the number incurring a tax liability. Some individuals may not earn sufficient income to prompt a filing requirement and others may be noncompliant with the filing requirement but not owe U.S. taxes because of tax treaty benefits.

²⁰Nonresident aliens who file Form 1040 instead of Form 1040NR may take deductions and claim credits to which they are not entitled. However, by filing Form 1040 instead of Form 1040NR, these individuals may forgo tax treaty benefits they are entitled to claim.

IRS Has Recently Expanded Nonresident Outreach and Education Efforts, but Nonresidents Still Face Challenges in Fulfilling Their Tax Obligations

IRS's outreach efforts have focused on presenting information on nonresident tax issues to a variety of audiences. In 2009, IRS began conducting seminars and workshops for tax practitioners on nonresident alien tax issues and Form 1040NR at its Nationwide Tax Forums. IRS also conducted two phone forums in 2008 on federal tax withholding, for nonresident alien athletes and entertainers, and Central Withholding Agreements.²¹

IRS has also presented annually to groups such as the American Payroll Association and National Association of College and University Business Officers and has presented periodically to the American Bar Association, Tax Executives Institute, and local attorney and certified public accountant groups. Regarding nonresident aliens, these presentations covered a wide array of topics, including tax residency rules, income sourcing rules, tax treaty issues, descriptions of which forms to file, and guidance on withholding on payments to foreign individuals. Additionally, IRS employees at foreign posts are available to provide guidance to nonresidents, although these posts generally are staffed by few employees, making outreach difficult.

IRS has held preliminary discussions with the Department of State and the U.S. Citizenship and Immigration Service about having links to information on IRS's Web site on nonresident alien tax requirements included on sections of those agencies' Web sites that cover visa applications and requirements. IRS and the Department of State have discussed incorporating tax information within visa application materials. However, according to an IRS official involved with this effort, State was not inclined to produce this material because of the cost involved and because the agency did not want to be perceived as providing guidance on tax matters.

According to IRS compliance officials, IRS does not engage in outreach to tax software providers on nonresident alien tax issues, primarily because Form 1040NR currently cannot be filed electronically, as discussed later. Software providers could conceivably insert a question in their Form 1040 preparation programs inquiring if the user is a citizen, resident, or nonresident alien.

²¹IRS holds phone forums for tax practitioners, attorneys, payroll professionals, and industry partners with the goal of facilitating the filing of accurate tax returns.

According to IRS officials, IRS is assessing the feasibility and cost-effectiveness of setting up a toll-free number that individuals can call from outside of the U.S. to receive tax assistance. Currently IRS tax assistance toll-free numbers cannot be called from outside of the U.S. IRS also produces various publications containing information relevant to nonresident aliens and includes information on nonresident alien tax issues on its Web site.²²

Nonresident Aliens Face Challenges in Fulfilling Their Tax Obligations

According to representatives from groups that work with employers and nonresidents to assist them in fulfilling their tax obligations, nonresident aliens face challenges in fulfilling their tax filing obligations. For example and despite IRS's outreach and education efforts, some nonresidents and their employers may not be aware of the nonresident alien tax rules. Although nonresidents earning wages from U.S. employers would likely know that they had taxes withheld from their wages, they may not know they also have to file a tax return or which return to file. Likewise, foreign individuals in the U.S. for short-term business trips may be unaware that they have a filing requirement given that comparable requirements may not exist in their countries of residence. For example, in Canada, nonresidents generally do not have to file a tax return if they owe no Canadian tax. Also, some paid tax return preparers may not be familiar with nonresident alien tax rules. Representatives from groups we spoke with thought that unlicensed preparers in particular might not be familiar with the nonresident alien tax rules.

Likewise, aspects of nonresident alien taxation, such as tax residency rules, determining whether income is effectively connected to a U.S. trade or business or is U.S.- or foreign-source, and applying tax treaty provisions, can be difficult for nonresidents to understand. For example, it can be challenging to answer the basic question of whether or not a foreign person is a nonresident or resident alien. Beyond the green card and substantial presence tests, noncitizen taxpayers or their practitioners need to consider various scenarios in making residency determinations. For example, individuals who would otherwise be treated as residents can

²²These publications include Publication 513, *Tax Information for Visitors to the United States*; Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*; Publication 519, *U.S. Tax Guide for Aliens*; Publication 901, *U.S. Tax Treaties*; and Publication 1915, *Understanding Your IRS Individual Taxpayer Identification Number*.

file as nonresidents if they have a closer connection to a foreign country.²³ It is also possible to be both a nonresident alien and resident alien in the same tax year and different rules apply for the part of the year an individual is a nonresident alien and the part of the year the individual is a resident alien. Although no single rule may be difficult to apply, that numerous rules need to be considered can make the residency determination a difficult and time consuming one, according to representatives from groups that work with employers and nonresidents to assist them in fulfilling their tax obligations.

The inability for nonresidents to file Form 1040NR electronically is another challenge the groups we interviewed mentioned. Currently, IRS does not allow for electronic filing of Form 1040NR because it contains fields that cannot easily be transcribed into an electronic format. IRS redesigned Form 1040NR for tax year 2009, in part to address this problem. However, it does not plan to accommodate electronic filing of the form until at least 2014.²⁴

Another set of challenges that groups we interviewed identified concerned obtaining ITINs, as discussed below.

- ITIN applicants need to submit large amounts of documentation to IRS, some of which must be certified by going to a U.S. embassy, which can be time-consuming.
- Some applicants need to prove that they cannot obtain a SSN before they can be assigned an ITIN and some nonresidents apply for a SSN just to get the rejection letter so they can then apply for an ITIN.
- Some nonresidents unable to obtain an ITIN prior to departing the country may end up not filing a return, even if owed a refund. Whether or not they persist in the process to obtain an ITIN may depend on whether or not the individuals anticipate subsequent U.S. taxable activities.

²³Nonresident aliens in the U.S. for less than 183 days during the year are considered to have a closer connection to a foreign country if they maintain a tax home in that country during the tax year and have maintained more significant contacts with the foreign country than with the U.S. A tax home is the general area of an individual's main place of business or employment, regardless of the location of the individual's family home.

²⁴However, since ITIN applications cannot be filed electronically, nonresidents filing Form 1040NR in conjunction with an ITIN application would not be able to file Form 1040NR electronically for that year.

Finally, some groups noted it is a burden for nonresidents paid by foreign employers who take short business trips to the U.S. to file the required Form 1040NR.²⁵ As previously discussed, personal service income of \$3,000 or less paid to a nonresident by a foreign employer is not considered to be from U.S. sources for individuals in the U.S. 90 days or less who have no other compensation for services within the U.S. Congress established this threshold in 1936 to permit foreign residents to visit the U.S. for business purposes without being subject to taxes on the compensation they earn while in the U.S. In discussing this exemption, the Senate noted that the lack of a threshold had created ill will disproportionate to the small amount of revenue raised by taxing foreign residents making short business trips to the U.S.²⁶

Because the \$3,000 threshold has not increased since 1936, it is likely that a greater proportion of nonresident aliens have a filing requirement today than when the threshold was established. For example, in 1936, \$3,000 was 559 percent of the U.S. per capita personal income amount of \$537. In 2008, \$3,000 represented 8 percent of the U.S. per capita personal income amount of \$39,751. Likewise, a nonresident would need to earn an annual salary of \$12,133 to exceed the \$3,000 threshold during a 90-day period, assuming the individual had no other U.S.-source income.²⁷ A salary of \$12,133 in 1936 is equivalent to \$187,938 in 2008 dollars. A nonresident earning \$187,938 in 2008 would need to be in the U.S. for only 5 days for business purposes to trigger a filing requirement, if the individual earned no other U.S.-source income.²⁸ This increased reach of the filing requirement is underscored by the advance of economic globalization and increase in business travel since the threshold was established.

Some groups we spoke with suggested raising the \$3,000 threshold to reduce the burden of filing tax returns on nonresidents who make short business trips to the U.S. and are paid by foreign employers. In evaluating

²⁵A foreign employer is defined as a nonresident individual, foreign partnership, or foreign corporation or an office or place of business maintained in a foreign country or U.S. possession by a U.S. corporation, a U.S. partnership, or an individual who is a U.S. citizen or resident. Foreign governments are not considered to be foreign employers.

²⁶S. Rep. No. 74-2156, at 22 (1936).

²⁷This calculation assumes that the individual works 5 days a week every week of the year.

²⁸In this scenario, the individual's U.S.-source income would exceed both the \$3,000 threshold for income paid by a foreign employer and the personal exemption equivalent threshold of \$3,500 for 2008.

whether to increase the threshold, either by the level of inflation since 1936 or another amount, various issues warrant consideration. For example, although the current filing requirement may be applicable to a broader population of nonresident aliens than in 1936, many nonresidents who are required to file may ultimately owe reduced or no taxes because of the tax treaties the U.S. has adopted. According to DHS data, at least 78 percent of admissions to the U.S. in fiscal year 2007 were of individuals residing in countries with which the U.S. has tax treaties. Also, raising the exemption amount could negatively affect U.S. residents if they do not receive reciprocal exemptions on income otherwise subject to tax in countries with which the U.S. has tax treaties.

Raising the threshold amount could result in lost tax revenue. For example, IRS calculated that Form 1040NR filers who had income from personal services in an amount of \$40,000 or less reported \$222.1 million in tax liability for tax year 2007. This amount represented about 9 percent of the total tax liability reported on Form 1040NR for that year. If the threshold had been set at \$40,000 for tax year 2007, which is slightly less than the value of \$3,000 in 1936 dollars inflated to 2007 dollars, the \$222.1 million could have been exempt and not paid. However, it is not likely that all of that amount would have been exempt because some of the nonresidents with personal services income of \$40,000 or less could have been paid by a U.S. employer or could have been in the U.S. for more than 90 days, and therefore would not have been entitled to the exemption. Also, some of that tax amount may be attributed to other types of income.

Although increasing the exemption threshold would likely result in reduced tax revenue, it would also likely result in reduced burden and cost savings for some nonresidents and IRS. Some taxpayers would no longer bear the burden or cost of obtaining an ITIN and filing a return. IRS would likely realize cost savings from having to process fewer ITIN applications and Forms 1040NR.

IRS Has Increased Nonresident Alien Tax Enforcement but May Be Able to Identify Additional Noncompliant Taxpayers

IRS has expanded its enforcement efforts over the past decade. In 2001, IRS had two examiners who covered nonresident alien compliance issues. Currently, IRS's Large and Mid-sized Business division's International Compliance Strategy and Policy group (LMSB International) has 261 examiners dedicated to international compliance issues, including nonresident alien tax compliance.²⁹ LMSB International plans to hire an additional 202 examiners during fiscal year 2010.

LMSB International has generally conducted face-to-face examinations of nonresident aliens through special projects that focus on particular types of taxpayers. For example, LMSB International has examined individuals employed by foreign embassies or consulates and international organizations in the U.S. Although U.S.-source income paid to nonresident employees of foreign governments and international organizations may be exempt from federal income tax, the exemption depends on the tax treaty or consular convention between the U.S. and the relevant foreign governments or other U.S. tax laws. Also, employees of foreign governments and international organizations are generally considered nonresidents regardless of how long they are in the U.S. LMSB International found that some individuals were claiming income exemptions to which they were not entitled or filed Form 1040 instead of Form 1040NR.³⁰ For this project, IRS first contacted potentially noncompliant individuals and allowed them to voluntarily correct any noncompliance. IRS assessed \$32.0 million in taxes for 4,540 taxpayers who voluntarily settled with IRS from fiscal year 2007 through the end of January 2010, for an average of \$7,049 per settlement. IRS then examined 3,720 taxpayers who did not voluntarily settle with IRS, assessing \$21.8 million in taxes, for an average of \$5,851 per examination. LMSB International is continuing these examinations.

Building face-to-face examination cases for nonresidents is resource intensive. For example, preparing for and conducting the examinations of employees of foreign embassies and consulates and international organizations took up nearly all of LMSB International's resources that were dedicated to nonresident alien enforcement. LMSB International

²⁹ Areas for which the LMSB International group is responsible include nonresident aliens, U.S. citizens and residents living abroad, and entities that are required to report income and withhold taxes on payments to foreign individuals.

³⁰ IRS found that some U.S. citizens and residents employed by foreign governments were also improperly claiming income exemptions.

used State Department visa information to identify the nonresidents it contacted and examined. However, it is difficult and time consuming for IRS to use visa information to identify corresponding tax returns because visas do not include SSNs or ITINs, which are the unique identifiers included on tax returns that IRS uses to build examination cases.

LMSB International is planning on using examiners it expects to hire in fiscal year 2010 to conduct additional enforcement actions against nonresidents that would be less time consuming and complex than face-to-face examinations. For example, IRS may examine potentially noncompliant nonresidents through correspondence, according to an LMSB International official. Likewise, through its Automated Underreporter program (AUR), IRS has begun to match information taxpayers report on Forms 1040NR to information third parties report to IRS to identify nonresident alien taxpayers who may have underreported their income. IRS previously concluded, through a test, that matching income items from Form 1040NR, such as wages, was not a prudent use of resources. IRS found that many of the tax returns it studied claimed tax treaty benefits, which can be time consuming to verify and can require expertise to evaluate that IRS AUR staff generally did not possess. However, given that LMSB International is planning to hire additional staff, it may be able to examine nonresident alien taxpayers whom it identifies as potentially noncompliant through AUR, according to the official.

IRS has a broad program to identify taxpayers who failed to file a required tax return, including those who should have filed Form 1040NR. The program only identifies whether individuals may have failed to file a tax return and cannot easily identify which form they should have filed (i.e., Form 1040 versus Form 1040NR). IRS may be able to identify during an examination that a nonfiler should have filed Form 1040NR.

IRS May Be Able to Systematically Identify Nonresidents Who Improperly File Form 1040

IRS does not have a program to automatically identify taxpayers who may have improperly filed Form 1040 instead of Form 1040NR. According to an LMSB International official familiar with examinations of nonresidents, IRS has found that some nonresidents improperly file Form 1040 instead of Form 1040NR. The official told us that nonresidents filing the wrong tax return presents a greater compliance risk than nonresidents failing to file a tax return altogether because withholding is required for most nonresidents earning U.S.-source income regardless of whether they file a tax return. Also, other nonresidents who do not file and for whom taxes are not withheld, such as those working for foreign employers, may not

have tax liabilities because of tax treaty benefits. On the other hand, nonresidents who file Form 1040 instead of Form 1040NR may claim credits or take deductions to which they are not entitled, which may lead to reduced tax revenue.

IRS may be able to systematically identify nonresidents who improperly file Form 1040 instead of 1040NR. As previously discussed, nonresidents must obtain an ITIN to file a tax return if they do not meet the requirements to obtain a SSN. IRS can identify Forms 1040 filed using ITINs. IRS can also identify Forms 1040 filed jointly by married individuals that included both an ITIN and a SSN, as nonresidents married to U.S. citizens or residents can choose to be treated as residents and file Form 1040 jointly with their spouses. IRS may also be able to use information from ITIN applications (Form W-7) to further refine the identification of taxpayers who may have filed the wrong tax return because ITIN applicants indicate if they are resident or nonresident aliens, or a spouse or dependent of either, on that form.

LMSB International officials told us that IRS may be able to effectively use such a filtering process in its enforcement efforts. As previously discussed, LMSB International is planning on initiating additional enforcement actions against nonresidents that would be less time consuming and complex than the face-to-face examinations it has traditionally conducted. The officials told us that if IRS were able to identify nonresidents who may have improperly filed Form 1040 instead of Form 1040NR, IRS could examine some of those individuals through correspondence, for example those who took large deductions that would not be allowed when filing Form 1040NR. Likewise, IRS could review Forms 1040 filed jointly by a married couple where one filer used an ITIN to ensure that the return included the couple's worldwide income, and not just their U.S.-source income, as is required by U.S. tax law. The officials told us that it would be worthwhile to test the identification process to determine the size of the potential examination inventory and the cost-effectiveness of working on these examination cases.

IRS Has Expanded Enforcement for Reporting and Withholding on Payments to Foreign Individuals

In 2008, LMSB designated reporting and withholding on U.S. income paid to foreign individuals as a high-priority issue.³¹ U.S. persons or entities who make payments of certain types of U.S.-source income to nonresidents generally must withhold tax at a rate of 30 percent on such payments, unless there are applicable tax treaty provisions allowing for a reduced rate. Such payments are generally subject to reporting on Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) and Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding). The person or entity making these payments—generally referred to as a U.S. withholding agent—is responsible for the withholding and reporting. IRS's focus for this issue is on the compliance of U.S. withholding agents with regard to these reporting and withholding responsibilities.

The impetus behind designating U.S.-source income reporting and withholding as a priority issue was two-fold, according to an LMSB International official. First, in September 2008, the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs issued a report on actions foreign individuals take to avoid payment of taxes on U.S. stock dividends.³² The report brought attention to the problem of withholding agents not reporting and withholding proper amounts of tax. Second, IRS historically had not taken actions to enforce compliance with the requirements for reporting and withholding on payments to nonresidents.

The U.S.-source income reporting and withholding initiative is made up of three components, according to LMSB International officials.

- First, IRS is attempting to address intermediary (e.g., hedge funds' and other financial institutions') marketing of aggressive tax positions, such as through instruments like total return swaps, which may allow

³¹Reporting and withholding on fixed, determinable, annual, periodical (FDAP) U.S.-source income was designated as a LMSB Tier One, or top, issue. FDAP income is any income other than gains from the sale of personal or real property or items of income excluded from gross income, such as tax-exempt municipal bond interest. LMSB adopted its issue tiering strategy in 2006 to ensure that high-risk compliance issues are properly addressed and treated consistently across the division. According to LMSB, using issue tiers provides a consistent framework for identifying, prioritizing, and addressing significant compliance risks in a nationally coordinated manner.

³²Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, United States Senate, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends* (Washington, D.C., September 2008).

taxpayers to avoid taxation on income that would otherwise be taxed at 30 percent.³³

- Second, IRS has begun to match filed Forms 1042-S to Forms 1040 or 1040NR to determine if taxpayers are underreporting income.
- Third, IRS has initiated a number of compliance projects. LMSB International has started a marketing campaign within IRS to increase focus on withholding agent compliance by, for example, encouraging examiners to look for taxpayers with foreign addresses when reviewing businesses' payroll information. LMSB International has also begun testing whether it can identify entities that filed Forms 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) or 5472 (Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) but failed to report payments to nonresidents on Form 1042-S. IRS found for a test group of 10 corporations, 9 failed to report some payments. However, it was unclear if these payments were exempt because of tax treaties and as such appropriate to exclude from reporting. IRS is continuing this test.

IRS uses Central Withholding Agreements to minimize tax compliance risk for athletes and entertainers, who often are high earners relative to other nonresident aliens. As shown in table 4, the number of agreements and amounts withheld has increased over the past 3 fiscal years, although the average amounts withheld have fluctuated.

Table 4: Central Withholding Agreements, Fiscal Years 2007 through 2009

	2007	2008	2009
Number of agreements	507	655	944
Total withholding deposits (dollars in millions)	\$53.7	\$59.2	\$70.9
Average withholding deposit per agreement	\$106,009	\$90,363	\$75,066

Source: IRS.

³³ An example of a total return swap is an arrangement where one party agrees to pay an amount equal to any appreciation in the price of a stock plus the amount of any stock dividends paid during the term of the swap, while the other party agrees to pay any depreciation in the stock price plus certain fees, which usually include an interest component. The end result is that the swap provides the first party with virtually all of the economic benefits and burdens of holding stock without taking physical possession of the shares.

Few Nonresidents Obtain Sailing Permits and IRS Does Not Enforce the Sailing Permit Requirement

The number of sailing permits filed annually has decreased substantially over past decades. As we reported in 1988, the number of Form 1040-C sailing permits filed dropped from about 176,000 in calendar year 1960 to 1,245 in fiscal year 1986.³⁴ According to an LMSB International official, about 1,000 Forms 1040-C were filed for tax year 2006. Likewise, neither IRS nor the U.S. Customs and Immigration Service have enforced the sailing permit requirement for departing aliens for decades, according to LMSB International officials. These officials told us that IRS cannot realistically enforce the sailing permit requirement given the volume of foreign individuals who depart the U.S. daily. Enforcing the requirement would be particularly burdensome, as IRS would have to check all aliens for sailing permits even though the requirement is only applicable to some. For example, only a portion of foreign individuals enter the U.S. for business purposes. According to DHS data, about 74 percent of visitor admissions were for pleasure rather than for business or other purposes in fiscal year 2007.

That few individuals file sailing permits and IRS does not enforce the filing requirement may not represent a significant compliance risk. Tax withholding is generally required on payments of U.S.-source income to nonresident aliens.³⁵ Such withholding reduces the chance that nonresidents will depart the country without paying taxes owed. Furthermore, although foreign employers may not withhold U.S. taxes on U.S.-source income payments made to nonresidents, those individuals may not have substantial tax liabilities because of tax treaties. As previously discussed, at least 78 percent of admissions to the U.S. in fiscal year 2007 were of individuals residing in countries with which the U.S. had a tax treaty.

On the other hand, there may be a downside to having a requirement that is not enforced. Nonresidents who recognize that IRS does not enforce the sailing permit requirement may assume that IRS will not enforce other requirements, which could lead to broader noncompliance. Representatives from groups that work with employers and nonresidents to assist them in fulfilling their tax obligations told us that they were aware that IRS has not enforced the sailing permit requirement in decades. Also, according to an LMSB International official, the existence of a

³⁴GAO, *Tax Administration: Opportunities Exist for Improving IRS' Administration of Alien Taxpayer Programs*, GAO/GGD-88-54 (Washington, D.C.: Apr. 11, 1988).

³⁵I.R.C. § 1441.

requirement could even negatively affect overall tax compliance in that some foreign individuals who file the Form 1040-C version of the sailing permit may not realize that they have to file a tax return after the year's end and pay any additional tax that was not paid in conjunction with filing Form 1040-C. Finally, although few aliens file sailing permits, IRS incurs at least some cost to process filed permits and maintain guidance concerning the requirement.

Conclusions

Much has changed since Congress developed the tax rules for nonresident aliens. The world economy is increasingly interconnected and the number of aliens entering the U.S. for business purposes has increased accordingly. Congress passed legislation in 1936 to lessen the tax compliance burden for nonresidents paid by foreign employers in the U.S. for short periods of time. However, inflation has eroded the effect of the dollar threshold Congress established and nonresidents increasingly may have to file tax returns if they are in the U.S. for business for only a few days.

Another requirement that has been effectively eroded by the increase in travel to the U.S and other tax laws is the requirement that aliens obtain certificates of compliance, otherwise known as sailing permits. For nonresidents working for U.S. employers, withholding has supplanted sailing permits as the primary way to minimize compliance risk. Nonresidents working for foreign employers may not have substantial tax liabilities because of tax treaty benefits. Further, few nonresidents obtain sailing permits. IRS does not enforce the requirement, and it likely could not effectively enforce the requirement given the volume of foreign individuals departing the country daily. A lack of enforcement may also lead taxpayers to conclude that IRS does not enforce other filing requirements. Taken together, these conditions call into question whether the sailing permit requirement is still necessary to ensure compliance.

Despite an increased focus on nonresident alien tax enforcement, IRS may be missing an opportunity to identify more potentially noncompliant taxpayers because it does not systematically identify nonresidents filing the incorrect type of tax return. If IRS were able to identify taxpayers who should have filed Form 1040NR instead of Form 1040 by using information reported on tax returns or ITIN applications, it may be able to cost-effectively address this form of noncompliance for some taxpayers. Without further study, IRS cannot know if this type of enforcement action would be cost-effective.

Matters for Congressional Consideration

Given the increasing extent of business travel to the U.S. and the eroding effect of inflation, Congress should consider raising the amount of U.S. income paid by a foreign employer that is exempt from tax for nonresidents who meet the other conditions of the exemption. Also, given the difficulty of enforcing the requirement for aliens to obtain certificates of compliance—sailing permits—before departing the country and the existence of withholding requirements and tax treaties, Congress should consider eliminating the sailing permit requirement.

Recommendation for Executive Action

We recommend that the Commissioner of Internal Revenue determine if creating an automated program to identify nonresident aliens who may have improperly filed Form 1040 instead of Form 1040NR by using ITIN information would be a cost-effective means to improve compliance.

Agency Comments and Our Evaluation

In a March 31, 2010, letter responding to a draft of this report, IRS's Deputy Commissioner for Services and Enforcement stated that IRS agreed to study the feasibility of an automated system to identify nonresident aliens who improperly file Form 1040 instead of Form 1040NR, including whether information from ITIN applications can be effectively analyzed with such an automated system. The letter also stated that IRS would continue to look for ways to improve nonresident alien tax compliance through enforcement and outreach. For the full text of IRS's comments, see appendix II.

As we agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this report. At that time, we will send copies of the report to the Commissioner of Internal Revenue and other interested parties. This report will also be available at no charge on GAO's Web site at

<http://www.gao.gov>. If you or your staff have any questions about this report, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.

Sincerely yours,

A handwritten signature in black ink that reads "Michael Brostek". The signature is written in a cursive style with a large initial "M".

Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

To provide data on nonresident alien tax filing, we obtained and reviewed statistics from the Internal Revenue Service's (IRS) compliance data warehouse (CDW) on Form 1040NR, the U.S. Nonresident Alien Income Tax Return, for tax year 2003 to tax year 2007, the last 5 years for which complete filing data were available. To provide context on these statistics, we reviewed published data on other individual taxpayers from IRS's Statistics of Income program, which draws from a widely used database composed of a sample of unexamined income tax returns. We determined that the estimates provided had sampling errors of less than 1 percent. We then assessed these two data sources for reliability purposes. To do this, we interviewed IRS research officials, conducted logic testing, and compared certain CDW data elements received by IRS to publicly available data on Form 1040NR filings. On the basis of our assessment, we determined that both sources used were sufficiently reliable for the purposes of our review. To identify the availability of compliance data, we reviewed IRS documentation on the National Research Program and interviewed IRS research and compliance officials. We also examined documentation on tax treaties, visa issuance data from the Department of State, and the number of annual admissions of foreign visitors from the Department of Homeland Security (DHS), in order to provide context as to the potential number of nonresident aliens with a filing requirement or incurring a tax liability each year.

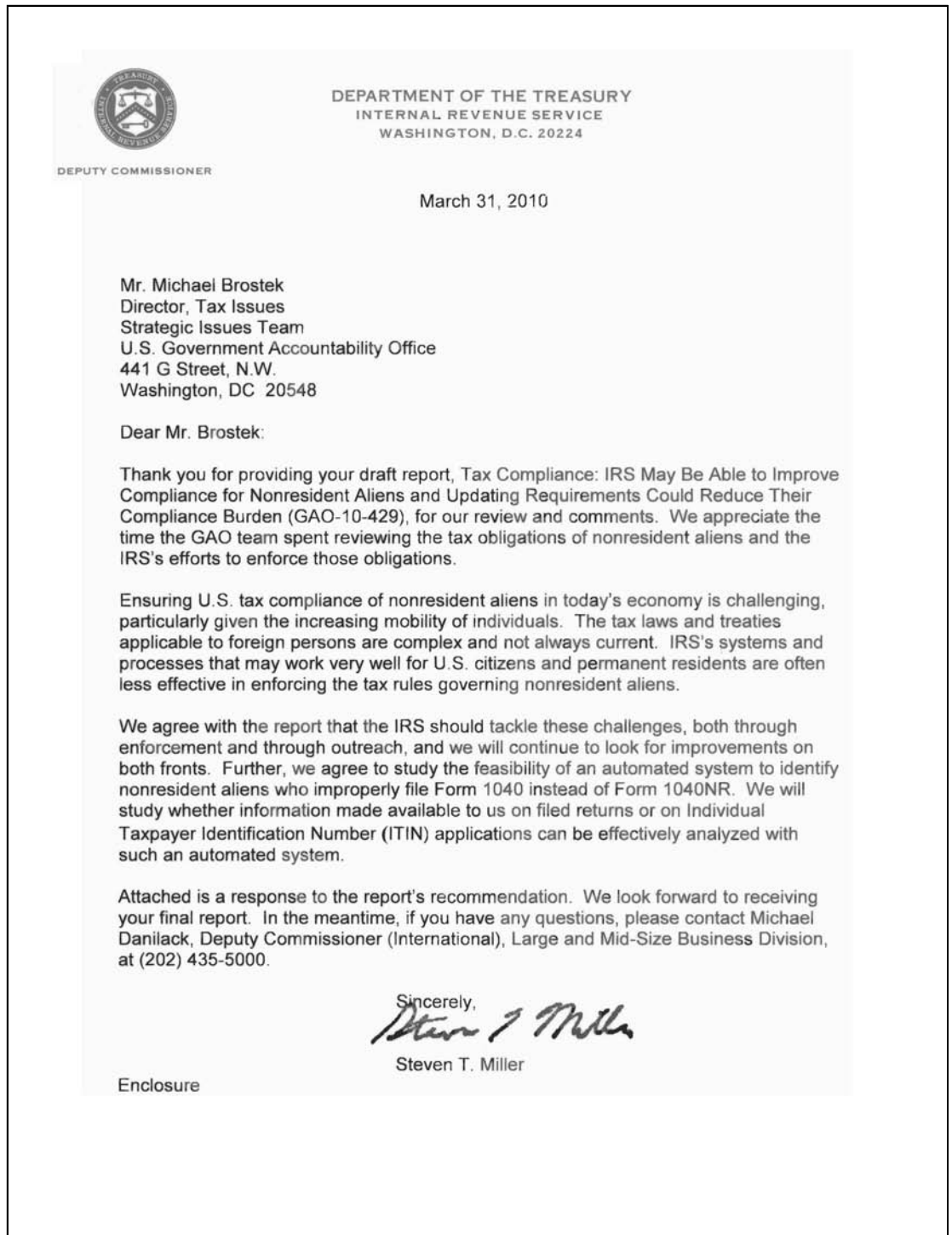
To provide information on guidance IRS provides to nonresident aliens and associated third parties on tax and filing requirements and any burdens and challenges associated with filing, we reviewed IRS tax forms, guidance, and outreach materials. We also interviewed IRS officials responsible for conducting outreach efforts and groups that work with employers and nonresidents to assist them in fulfilling their tax obligations. More specifically, we conducted group interviews with members of the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, and the National Association of College and University Business Officers, and spoke with staff from accounting and law firms that have nonresident aliens or their employers as clients.

To assess actions that IRS takes to enforce nonresident alien tax compliance, we used IRS's goal in its 2009-2013 strategic plan of increasing resource allocation to priority areas as criteria. We reviewed data from IRS's enforcement programs and interviewed IRS enforcement officials to determine whether resources were increased for nonresident alien compliance efforts and what results IRS had achieved. Specifically, we reviewed IRS data on examinations and Central Withholding Agreements

and various IRS tax forms, and interviewed IRS officials to discuss potential opportunities to expand enforcement efforts. We then assessed these IRS sources for reliability by reviewing IRS documentation and interviewing agency officials and determined that these sources were sufficiently reliable for the purposes of our review.

We conducted this performance audit from July 2009 through April 2010 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Internal Revenue Service



Attachment

RECOMMENDATION:

GAO recommends that the IRS determine if creating an automated program to identify improper filing of Form 1040 by nonresident aliens would be a cost-effective means of improving compliance.

COMMENTS:

We will study the feasibility of establishing an automated program to identify improper filing of Form 1040 by nonresident aliens to determine whether it would be a cost-effective means to improve nonresident alien compliance. Further, we will determine whether such an automated system can be effectively used to analyze information made available to us on filed returns or on Individual Taxpayer Identification Number (ITIN) applications.

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Joanna Stamatiades, Assistant Director; Jeff Arkin; Amy Bowser; Karen O'Connor; Amy Radovich; Cynthia Saunders; and John Zombro made key contributions to this report.

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