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# ***TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION***



## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

**June 15, 2020**

**Reference Number: 2020-30-026**

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**Redaction Legend:**

1 = Tax Return/Return Information

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

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**Phone Number / 202-622-6500**

**E-mail Address / [TIGTACommunications@tigta.treas.gov](mailto:TIGTACommunications@tigta.treas.gov)**

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## HIGHLIGHTS

### WITHHOLDING COMPLIANCE EFFORTS FOR PARTNERSHIPS WITH FOREIGN PARTNERS CAN BE IMPROVED

## Highlights

**Final Report issued on June 15, 2020**

Highlights of Reference Number: 2020-30-026  
to the Commissioner of Internal Revenue.

### IMPACT ON TAXPAYERS

Internal Revenue Code (I.R.C.) Section (§) 1446 requires partnerships to withhold taxes on "effectively connected taxable income" (ECTI) that is allocable to their foreign partners. The withholding serves as an incentive for foreign partners to file the appropriate U.S. tax return, i.e., Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*, or Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, to report income from the partnership. For Tax Year 2016, the Project 1446 database shows that partnerships reported \$12.6 billion in the ECTI allocable to their foreign partners.

### WHY TIGTA DID THE AUDIT

The overall objective of this review was to determine the effectiveness of the IRS's efforts to ensure withholding compliance of partnerships with foreign partners.

### WHAT TIGTA FOUND

A sample of 137 partnership filings found that partnerships remitted the reported I.R.C. § 1446 tax; however, TIGTA identified barriers for the IRS to use Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*, and Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*, data to ensure compliance of partnerships and foreign partners subject to the provisions of I.R.C. § 1446. TIGTA identified significant errors in the Project 1446 database which limit the IRS's ability to verify withholding credits and identify potential nonfilers accurately. For Tax Year 2016, there were 17,734 partnerships that filed Forms 8804 that had related Forms 8805 reporting nearly \$3.7 billion in withholding

credits. Of these, 2,445 Forms 8804 had discrepancies concerning the withholding amounts reported on their related Forms 8805. Specifically, the 2,445 Forms 8804 reported and paid nearly \$303 million less than was reported on their related Forms 8805. Furthermore, some partnerships with foreign partners filed 1,183 Forms 8804 reporting nearly \$450 million in income that did not have any related Forms 8805 in the Project 1446 database, and 27,038 Forms 8805 were filed reporting nearly \$907 million in income that did not contain valid Taxpayer Identification Numbers. \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*

In addition, 5,077 foreign partners did not file their income tax returns reporting their share of the ECTI. As a result, these foreign partners would potentially owe \$184 million in additional tax.

Further, Form 8805 data were erroneously uploaded multiple times on the Master File, overstating the income and withholding amounts. Although the IRS identified and fixed this issue in October 2018, the overstated records remain.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS:

- 1) strengthen controls to ensure correspondence with partnerships when there are no Forms 8805 attached to Form 8804 reporting ECTI and withholding amounts, 2) establish procedures for tax examiners to prevent duplicate or multiple Forms 8805 filed by partnerships from being entered into the Project 1446 database, and 3) establish procedures using Form 8805 data to identify underreporting and potential nonfilers.

IRS management agreed with all three recommendations and plans to take appropriate corrective actions.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**DEPARTMENT OF THE TREASURY**

**WASHINGTON, D.C. 20220**

June 15, 2020

**MEMORANDUM FOR** COMMISSIONER OF INTERNAL REVENUE

**FROM:**

Michael E. McKenney  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Withholding Compliance Efforts for Partnerships  
With Foreign Partners Can Be Improved (Audit # 201830019)

This report presents the results of our review to determine the effectiveness of the Internal Revenue Service's efforts to ensure withholding compliance of partnerships with foreign partners. This audit is part of our Fiscal Year 2020 Annual Audit Plan and addresses the major management challenge of the Impact of Global Economies.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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### ***Abbreviations***

|        |                                      |
|--------|--------------------------------------|
| ECTI   | Effectively Connected Taxable Income |
| I.R.C. | Internal Revenue Code                |
| IRMF   | Information Returns Master File      |
| IRS    | Internal Revenue Service             |
| TIN    | Taxpayer Identification Number       |
| TY     | Tax Year                             |



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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### **Background**

The Tax Reform Act of 1986 added Section (§) 1446 to the Internal Revenue Code (I.R.C.).<sup>1</sup> This law requires partnerships to withhold taxes on “effectively connected taxable income” (ECTI) paid to foreign partners.<sup>2</sup> The ECTI is taxable income connected with the conduct of a trade or business in the United States. Tax is withheld on each foreign partner’s allocable share of the ECTI. The withholding rules apply regardless of whether the partnership makes any actual partnership distributions during its tax year. A foreign partner can be a foreign corporation, foreign partnership, and any other person who is not a U.S. citizen.

The rate of withholding depends on the type of the foreign partner and the type of the ECTI earned by the partnership. Withholding is imposed at the highest tax rate of 39.6 percent for non-corporate foreign partners and at a 35 percent rate for foreign corporate partners for Tax Years (TY) 2014 through 2016.<sup>3</sup> The partnership must pay the withholding tax regardless of the amount of the foreign partners’ ultimate U.S. tax liability. While it could be that the foreign partner will actually owe no U.S. tax, the partnership must still withhold and pay over the tax to the Internal Revenue Service (IRS). In that case, the affected foreign partner would be required to file a tax return with the IRS to claim a refund.

***While it could be that the foreign partner will actually owe no U.S. tax, the partnership must still withhold and pay over the tax to the IRS. The affected foreign partner must file a tax return with the IRS to claim a refund.***

Treasury Regulation § 1.1446-3 establishes the procedures for partnership reporting obligations with respect to the tax and how to pay the withholding tax. The partnership is required to use Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*, to report the total withholding liability under I.R.C. § 1446 for the partnership’s tax year.<sup>4</sup> Form 8813, *Partnership Withholding Tax Payment Voucher (Section 1446)*, is used to remit payment of the withholding collected by the partnership.<sup>5</sup>

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<sup>1</sup> Pub. L. No. 99-514, 100 Stat. 2085.

<sup>2</sup> See Appendix VIII for a glossary of terms. I.R.C. § 1446.

<sup>3</sup> The maximum rate for non-corporate foreign partners has decreased from 39.6 percent to 37 percent, and the maximum rate for corporate foreign partners has decreased from 35 percent to 21 percent for tax years after December 31, 2017. Preferential rates, such as the capital gains rate, can apply to that type of income for a qualifying foreign partner.

<sup>4</sup> See Appendix V.

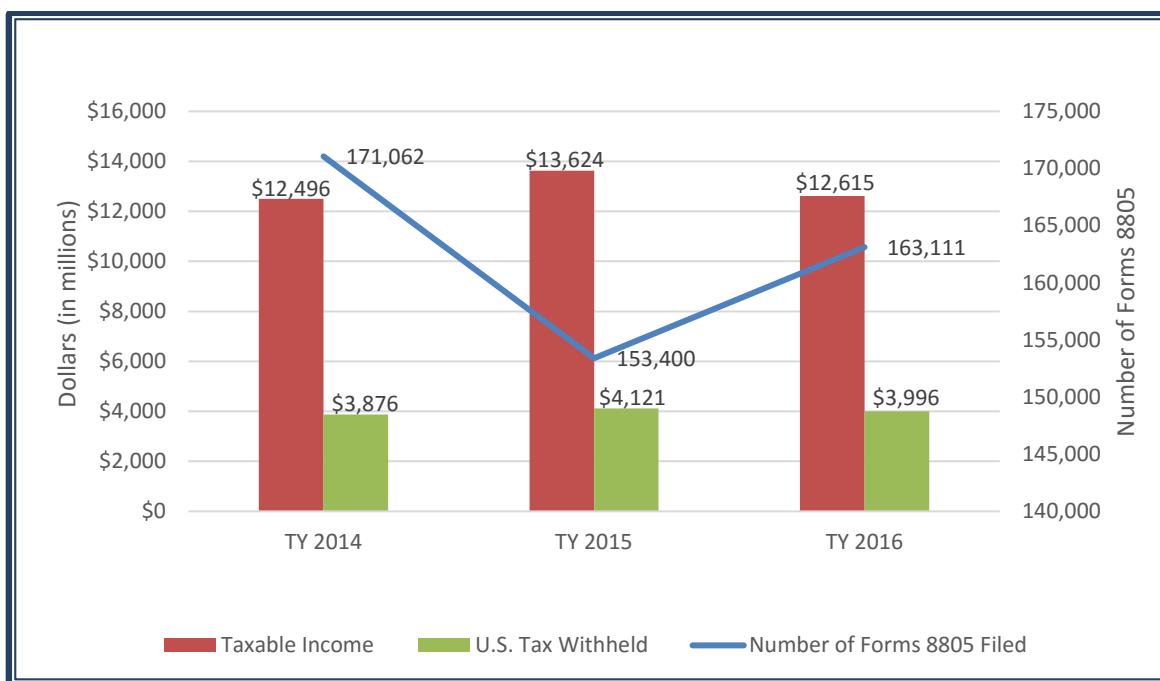
<sup>5</sup> See Appendix VII.



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The partnership is also required to file Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*, to show the amount of the ECTI and the total withholding tax credit allocable to the foreign partner for the partnership's tax year.<sup>6</sup> A separate Form 8805 is required for each partner on whose behalf the partnership paid I.R.C. § 1446 tax. Foreign partners must attach Form 8805 to their U.S. income tax return Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*, to claim a withholding tax credit for their portion of the I.R.C. § 1446 tax withheld by the partnership. In order for a foreign partner to claim a refund, a valid Taxpayer Identification Number (TIN) is required when filing the income tax return, e.g., Form 1040-NR, Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*. Figure 1 shows that the number of Forms 8805 filed in TY 2015 decreased to 153,400, but TY 2016 filings increased to 163,111.

***Figure 1: Form 8805 Filings for TYs 2014 Through 2016***



Source: Project 1446 database.

The Large Business and International Division provides oversight of I.R.C. § 1446 withholding tax matters, with an emphasis on Service-wide coordination of technical issues, compliance, and processing. The Wage and Investment Division Entity function is responsible for processing Forms 8804, 8805, and 8813, which are filed at the Ogden, Utah Campus. Form 8804 data are entered on the Master File, while Form 8805 data are entered and stored on the International

<sup>6</sup> See Appendix VI.



## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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Web Application.<sup>7</sup> The International Web Application Project 1446 database (hereafter referred to as the Project 1446 database) is not a Master File program, but Form 8805 data are uploaded to the Information Returns Master File (IRMF) monthly.

This review was performed at the Submission Processing Site in Ogden, Utah, and with information obtained from the IRS Large Business and International Division in Washington, D.C., during the period April 2018 through November 2019. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>7</sup> The International Web Application is maintained on an Enterprise Tier II SUN system.



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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### **Results of Review**

Every partnership that has the ECTI allocable to a foreign partner must file a Form 8804 with the IRS. The partnership must also send the IRS a Form 8805 for each foreign partner on whose behalf the partnership paid I.R.C. § 1446 withholding tax and provide a copy to the foreign partner. For TY 2016, the IRS received 18,929 Forms 8804 from 18,917 partnerships and also received 163,111 Forms 8805 from 17,734 of these partnerships.

\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\* While we found that partnerships timely remitted their I.R.C. § 1446 withholding tax, there are barriers to using the data to ensure compliance, and it is critical for international tax administration that the IRS take the steps to overcome these barriers. Specifically, we found that:

- Partnerships remitted the reported amount of I.R.C. § 1446 tax.
- Inaccuracies in the Project 1446 database limit its usefulness to verify withholding credit claims.
- Some foreign partners are not compliant with their tax obligations.
- Form 8805 data on the IRMF are erroneously overstated.

If the IRS does not ensure that Forms 8804 and Forms 8805 are correctly filed, then its ability to identify underreporting and potential nonfilers is diminished.

### **Partnerships Remitted the Reported Internal Revenue Code Section 1446 Tax**

Partnerships use Form 8813 to pay their I.R.C. § 1446 withholding to the IRS. Forms 8813 are to be filed on or before the 15<sup>th</sup> day of the 4<sup>th</sup>, 6<sup>th</sup>, 9<sup>th</sup>, and 12<sup>th</sup> months of the partnership's tax year. For TY 2016, the Project 1446 database documents that 17,734 partnerships filed Forms 8804 with Forms 8805 attached.<sup>8</sup> These Forms 8804 reported more than \$11.5 billion in the ECTI with nearly \$3.7 billion (32 percent) in I.R.C. § 1446 withholding tax.<sup>9</sup>

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<sup>8</sup> These 17,734 partnerships filed a total of 17,746 Forms 8804.

<sup>9</sup> The IRS Master File is the source for these amounts, while the amounts reported in Figure 1 are from the Project 1446 database.



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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We randomly sampled 137 partnerships from the population of 17,734 partnerships and reviewed their Forms 8804 reporting I.R.C. § 1446 withholding for TY 2016.<sup>10</sup> The I.R.C. § 1446 withholding for the 137 partnerships totaled almost \$15 million. We researched the Master File for each partnership's TY 2016 account to confirm that they remitted their I.R.C. § 1446 taxes to the IRS.<sup>11</sup> For all 137 partnerships, the I.R.C. § 1446 withholding payments that were remitted to the IRS reconciled with the amounts reported on their respective Form 8804.

However, while the partnerships we reviewed complied with their payment requirements, the I.R.C. § 1446 withheld amounts reported on the partnership's Form 8804 did not always match the withheld amounts reported on the Forms 8805 filed by the partnerships and provided to the foreign partners. For seven of the 137 cases, the partnership Form 8804 I.R.C. § 1446 tax did not reconcile with the total I.R.C. § 1446 tax reported on their related Forms 8805. In all seven cases, the partnerships remitted the amounts reported on their Form 8804, which was \$387,799 less than the amounts reported in the Project 1446 database. As subsequently discussed, our review of the 137 partnership filings led us to conduct additional testing of the Project 1446 database, and we determined that there are significant errors in the database that limit the IRS's ability to verify withholding credits and identify potential nonfilers accurately.

### ***Inaccuracies in the Internal Revenue Code Section 1446 Project Database Limit Its Usefulness to Verify Withholding Credit Claims***

There were 17,734 partnerships that filed Forms 8804 for TY 2016 on the Master File that had at least one related Form 8805 on the Project 1446 database. We compared the ECTI and withholding amounts reported on the Forms 8804 to related Form 8805 information tax examiners entered into the Project 1446 database. Overall, the 17,734 partnerships reported nearly \$3.7 billion in withholding. We identified 2,445 Forms 8804 with withholding amounts that did not match withholding amounts reported on their related Forms 8805. Figure 2 provided the instances in which Form 8804 data did not reconcile with Form 8805 data.

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<sup>10</sup> We selected our sample using a 90 percent confidence level, 15 percent error rate, and a 5 percent precision factor.

<sup>11</sup> Master File Tax Account Code 08 (Form 8804).



## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

**Figure 2: Withholding Reported on Form 8804 Versus  
Withholding Tax Credited on Form 8805**

| Type of Variance  | Number of Forms<br>8804 | Withholding Reported<br>on Form 8804 | Reported Withholding Tax<br>Credits on Form 8805 | Variance        |
|---|-------------------------|--------------------------------------|--|-----------------|
| Forms 8804 Withholding Less Than<br>Forms 8805 Credits    | 1,338                   | \$462,707,708                        | \$893,478,072                                    | (\$430,770,364) |
| Forms 8804 Withholding Greater Than<br>Forms 8805 Credits | 1,107                   | \$572,102,619                        | \$444,252,008                                    | \$127,850,611   |
| Net of Total Variances                                    | 2,445                   | \$1,034,810,327                      | \$1,337,730,080                                  | (\$302,919,753) |

Source: Our analysis of the Project 1446 database and the Master File.

We identified 1,338 Forms 8804 that reported nearly \$463 million in withholding credits while the related Forms 8805 reported more than \$893 million in withholding credits. This difference of more than \$430 million reflects additional withholding credits reported on the Form 8805 database than on the Forms 8804. We reviewed the discrepancies and determined that many of them appeared to be the result of:

- Duplicate or multiple Forms 8805 filed by partnerships and erroneously entered into the database.
- Transcription errors when entering dollar values.

We identified another 1,107 Forms 8804 that reported withholding credits over \$127 million greater than what was reported on their related Forms 8805. We reviewed the discrepancies and determined that many of them appeared to be the result of the number of partners stated on Form 8804 was greater than the number of related Forms 8805 in the database.<sup>12</sup>

In addition, we identified 1,183 Forms 8804 in which we did not find any related Forms 8805 in the Project 1446 database. IRS procedures do require correspondence with the partnership if there are no Forms 8805 attached to Form 8804 reporting ECTI and withholding amounts.<sup>13</sup> The 1,183 Forms 8804 reported \$449,948,542 in the ECTI and \$146,824,567 in withholding; however, because we were unable to find the related Forms 8805, the IRS cannot determine whether the foreign partners in receipt of this income filed their appropriate income tax returns.

<sup>12</sup> For example, \*\*\*\*\*1 \*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*

<sup>13</sup> Internal Revenue Manual 3.21.15.20.1.1 (Jan. 1, 2017).



## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*

From the population of 163,111 Forms 8805, we also identified 27,038 Forms 8805 that had either no TIN or an invalid TIN.<sup>14</sup> These 27,038 Form 8805 reflected \$906,850,847 of the ECTI and \$273,586,004 of withholding that foreign partners are required to report on Form 1040-NR.

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\*\*\*\*\*2\*\*\*\*\*.<sup>15</sup> These withholding certificates are only valid if they contain all the required information, including valid TINs.<sup>16</sup> Partnerships are instructed to complete Forms 8805 with a valid foreign partner's TIN.<sup>17</sup> \*\*\*\*\*2\*\*\*\*\*

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\*\*\*\*\*2\*\*\*\*\* Specifically, when

entering Form 8805 data to the Project 1446 database, Ogden Campus Entity function employees are instructed to enter the TIN that appears on Line 1b of Form 8805, and if no TIN is present on Form 8805, leave the field blank.<sup>18</sup> The 27,038 Forms 8805 included obviously erroneous TINs, *e.g.*, 999-99-9999 and 000-00-0000, and instances in which the TIN field was left blank.

### **Reconciling of the withholding taxes reported on Forms 8804 with amounts posted to the Master File**

The International Web Application at the Ogden Campus also houses the Foreign Investment in Real Property Tax Act database and is maintained by the same campus function as the Project 1446 database. We recently reported that extensive inaccuracies in the Foreign Investment in Real Property Tax Act database limit its usefulness to verify withholding credit claims accurately.<sup>19</sup>

<sup>14</sup> Examples of invalid TINs are 000-00-0000, 999-99-9999, and 000-00-0001, *etc.*

<sup>15</sup> Treas. Reg. § 1.1446-1(c)(2)(i) - Withholding tax on partners' share of the ECTI.

<sup>16</sup> Treas. Reg. § 1.1446-1(c)(2)(iv)(B) - Withholding tax on partners' share of the ECTI.

<sup>17</sup> Instructions for Forms 8804, 8805, and 8813.

<sup>18</sup> Internal Revenue Manual 3.21.25.18.2 (Jan. 1, 2015).

<sup>19</sup> Treasury Inspector General for Tax Administration, Ref. No. 2020-40-014, *Millions of Dollars in Discrepancies in Tax Withholding Required by the Foreign Investment in Real Property Tax Act Are Not Being Identified or Addressed* (Mar. 9, 2020).



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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At the Ogden Campus, Forms 8805 and 8804 are processed separately, and the information reported on Form 8805 \*\*\*\*\*2\*\*\*\*\* Forms 8804 and Forms 8805 are separated during the Code and Edit function process.<sup>20</sup> \*\*\*\*\*2\*\*\*\*\*  
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\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\* The Data Conversion function inputs Form 8804 data in the same manner as data for other income tax returns are input, such as Form 1040, *U.S. Individual Income Tax Return*. Forms 8805 are routed to the Campus Entity function where tax examiners input them to the Project 1446 database.

### ***Recommendations***

The Commissioner, Large Business and International Division, should request that Submission Processing sites:

**Recommendation 1:** Strengthen controls to ensure that the Code and Edit function corresponds with partnerships when there are no Forms 8805 attached to Form 8804 reporting ECTI and withholding amounts or in the Project 1446 database.

**Management's Response:** The IRS agreed with the recommendation. The IRS will work with the Submission Processing sites to review whether controls could be strengthened to ensure that the Code and Edit function corresponds with partnerships when there are no Forms 8805 attached to Form 8804 reporting ECTI and withholding amounts.

As part of its review, the IRS will assess what changes, if any, could be made to strengthen controls, given available resources and organizational priorities. For example, there may be updates to Code and Edit function Internal Revenue Manual procedures and training modules.

**Recommendation 2:** Establish procedures for tax examiners to prevent duplicate or multiple Forms 8805 filed by partnerships from being entered into the Project 1446 database.

**Management's Response:** The IRS agreed with this recommendation. The IRS will work with the Submission Processing sites to determine whether procedures can be established to prevent duplicate or multiple Forms 8805 from being entered into the Project 1446 database, given available technology, human resources, and organizational priorities. For any new procedures implemented, the IRS will work with the Submission Processing sites to make the necessary changes and update training modules and Internal Revenue Manual procedures, as appropriate.

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<sup>20</sup> The Code and Edit function prepares paper returns for processing by reviewing and editing the documents with specialized processing codes for input through the Integrated Submissions and Remittance Processing System.



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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### **Some Foreign Partners Are Not Compliant With Their Tax Obligations**

Withholding requirements are among the most common and effective tax compliance methods, causing foreign partners subject to withholding to have more motivation to file their U.S. income tax returns. Foreign partners engaged or considered to be engaged in a trade or business in the United States during the tax year must file an income tax return. Foreign partners that are individuals and are required to file an income tax return use Form 1040-NR. Due to high withholding rates under I.R.C. § 1446, foreign partners are more likely to file a tax return to claim a refund.<sup>21</sup> Accordingly, I.R.C. § 1446 withholding serves as an incentive for the foreign partners to file a U.S. income tax return reporting the distribution of their share of partnership income.

We obtained an extract of the Project 1446 database which included all Forms 8805 filed with the IRS from January 2015 to October 2018. We also extracted Form 1040-NR, Form 1065, *U.S. Return of Partnership Income*, and Form 1120-F data from the Treasury Inspector General for Tax Administration's Data Center Warehouse that were filed for TY 2016. We tested foreign partners' compliance with their filing and reporting requirements and found that some foreign partners are not compliant with tax obligations.

### **The ECTI reported on Forms 8805 was not reported on Forms 1040-NR, 1120-F, or 1065**

In a prior section of this report, we showed that 27,038 Forms 8805 submitted for TY 2016 did not have valid TINs, and therefore, these Forms 8805 were unable to be matched against income tax returns to test filing and reporting compliance of the recipients. These Forms 8805 reported \$906,850,847 of the ECTI and \$273,586,004 of withholding that foreign partners are required to report on Form 1040-NR. It is critical for Forms 8805 to include valid TINs so that the IRS can match this information against foreign partners' income tax returns to ensure that they are appropriately reporting their partnership ECTI, as reported earlier. The TINs are equally important to ensure proper crediting of withholding tax when partnerships report to the IRS.

The IRS Automated Underreporter Program matches information returns, such as a taxpayer's Form W-2, *Wage and Tax Statement*, against individual Form 1040 tax returns to verify the income is reported and potential discrepancies are identified. The International Web Application is not a Master File program, but Form 8805 data are uploaded to the IRMF monthly. \*2\*

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\*\*\*\*\*2\*\*\*\*\* The foreign partners' portion of the

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<sup>21</sup> There is a 39.6 percent rate for non-corporate foreign partners and a 35 percent rate for foreign corporate partners for TYs 2014 through 2016.



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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partnership ECTI is reported on Form 8805, line 9. This amount is required to be entered on their Form 1040-NR, Line 8; Form 1120-F, Section II, Line 10; and Form 1065, Line 4.

To determine whether foreign partners complied with their filing and reporting requirements, we matched the 163,111 Forms 8805 issued for TY 2016 against the TY 2016 Form 1040-NR, Form 1120-F, and Form 1065 filing data and identified 20,749 Forms 8805 that did not have a matching Form 1040-NR, 1120-F, or 1065. The 20,749 Forms 8805 reported more than \$2.7 billion in the ECTI and more than \$926 million (average of 34 percent) in tax withheld. Because there was no associated income tax form, the taxpayers who received these Forms 8805 did not report their ECTI as required. Given that there was some tax withheld on this income, we performed the following tests on the 20,749 foreign partners:

- Determined the actual rate of withholding (withholding amount/ECTI amount) for each of the 20,749 foreign partners.
- Using 35 percent, the lower of the two I.R.C. § 1446 withholding rates, as criteria, we identified those foreign partners whose withholding amount was more than 35 percent (13,960 foreign partners).<sup>22</sup> Given that the withholding was at or greater than 35 percent, these taxpayers may have sufficient withholding to cover their tax obligations even if they had filed an income tax return reporting their ECTI.
- Because the withholding rate on the remaining 6,789 foreign partners was less than 35 percent, they would potentially owe tax if they had filed income tax returns.<sup>23</sup>

For each of these 6,789 foreign partners, we calculated withholding on their ECTI at 35 percent and determined the variance between the actual amount of tax withheld and the amount that would have been withheld at 35 percent.<sup>24</sup> From the 6,789, we eliminated 1,712 cases consisting of foreign partners that either: filed a Form 1040 (and not a Form 1040-NR) or filed a Form 1065 or Form 1120-F for a non-calendar year fiscal year. As a result, 5,077 foreign partners would owe potential additional tax of \$184,114,263.

### ***Recommendation***

**Recommendation 3:** The Commissioner, Large Business and International Division, should establish procedures using Form 8805 data to identify potential nonfilers (foreign partners that do not file an income tax return) and underreporters (foreign partners that do not report their partnership ECTI on their income tax return).

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<sup>22</sup> I.R.C. § 1446 imposes withholding at the tax rate of 39.6 percent for non-corporate foreign partners and a 35 percent tax rate for foreign corporate partners; we used the 35 percent tax rate to be conservative.

<sup>23</sup> The 6,789 foreign partners include cases in which the variance was greater than \$50.

<sup>24</sup> The 35 percent withholding rate does not account for the possibility of foreign partners providing their partnership with Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, documentation that could potentially reduce the withholding tax.



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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**Management's Response:** The IRS agreed with this recommendation. The IRS will consider establishing procedures using Form 8805 data to identify potential nonfilers and underreporters. First, the IRS is evaluating the initial dataset provided by the Treasury Inspector General for Tax Administration to determine the volume of foreign partners who did not file a U.S. income tax return. Then the IRS will assess whether the foreign partners were entitled to treaty benefits and other items reducing the withholding rate to lower than 35 percent and analyze the resulting volume of noncompliance.

### **Form 8805 Data on the Information Return Master File Are Overstated**

Form 8805 data are sent to the IRMF on a monthly basis. Form 8805 records created get a time stamp which is used in the electronic file transfer script to identify which records need to move to the IRMF and which ones have already been moved to the IRMF. The time stamp helps to keep records from being duplicated.

We selected a random sample of 65 Forms 8805 issued for TY 2016 to verify the income and withholding amounts on the IRMF.<sup>25</sup> We determined that the income and withholding amounts on the IRMF were overstated due to processing errors when Form 8805 data were uploaded from the Project 1446 database. Specifically, Form 8805 data were erroneously uploaded multiple times because the time stamp control was not working as intended.

When the Form 8805 is extracted, the records are retrieved and saved to a temporary file. The file name contains a cycle number which is provided by the IRMF team. The cycle number is the week of the year. During the process, the extracted record is marked by setting an indicator in the database table and time stamped to avoid duplications. If errors occur, the time stamp is used to reverse the indicator so that the record can be re-selected. Before the Form 8805 records are merged to the Master File, the IRMF verifies that the data format and the sequence of the transferred data match what is in the record. If an error is spotted, the process will start over. After the verification is completed, the temporary file is removed.

In regards to our sample of 65 Forms 8805, 61 forms contained effectively connected income overstated by \$36,369,601 and withholding overstated by \$12,141,645.<sup>26</sup> In October 2018, the IRS identified and fixed the problem. However, the duplicate records remain as the IRMF did not update the records or replace the records. As such, IRS employees who use the IRMF need to be aware that they need to look at the latest records based on file entry date and initial cycle.

Given that the TY 2016 Form 8805 was overstated and the problem was not identified or resolved until October 2018, we believe that Form 8805 data for at least TYs 2016 to 2018 were affected, as well as other systems that rely on the IRMF.

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<sup>25</sup> We selected our sample using a 90 percent confidence level, 50 percent precision factor, and a 10 percent error rate.

<sup>26</sup> There was no Form 8805 data on the IRMF for the four other cases.



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### **Appendix I**

#### **Detailed Objective, Scope, and Methodology**

The overall objective of this audit was to determine the effectiveness of the IRS's efforts to ensure withholding compliance of partnerships with foreign partners. To accomplish our objective, we:

- I. Evaluated IRS processes and procedures to determine if income and withholdings reported on Forms 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*, are reconciled with the detailed income and withholdings reported on any associated Forms 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*.<sup>1</sup>
  - A. Reviewed Form 8804, 8805, and 8813, *Partnership Withholding Tax Payment Voucher (Section 1446)*, instructions to identify taxpayer filing requirements for preparing and submitting Forms 8804, 8805, and 8813.<sup>2</sup>
  - B. Conducted a walkthrough of the Ogden Campus to identify how Forms 8804, 8805, and 8813 submitted by partnerships are processed.
  - C. Interviewed IRS management to identify the steps taken to validate Forms 8805 in the International Web Application database.<sup>3</sup>
  - D. Interviewed IRS management to identify the steps taken to reconcile amounts reported on Forms 8804 with the detailed income and withholdings reported on Forms 8805.
- II. Assessed the effectiveness of IRS processes to ensure that income and withholdings reported on Forms 8805 are reported on Forms 8804.
  - A. Identified all TY 2016 Forms 8804 processed from the Business Return Transaction File and determined the number of foreign partners reported and the amount of income and withholdings.<sup>4</sup> We selected a statistically valid sample of 137 Forms 8804 from the population of 17,734 using a confidence level of 90 percent, 15 percent error rate, and a 5 percent precision factor.
  - B. Identified all TY 2016 Forms 8805 processed from the International Web Application database and determine the number of foreign partners and the total amount of

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<sup>1</sup> See Appendices V and VI.

<sup>2</sup> See Appendix VII.

<sup>3</sup> The International Web Application is maintained on an Enterprise Tier II SUN system.

<sup>4</sup> See Appendix VIII for a glossary of terms.



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income and withholdings. We also determined the volume of Forms 8805 received annually without valid TINs. We selected a statistically valid sample of 65 Forms 8805 from the population of 1,606 based on a confidence level of 90 percent, error rate of 50 percent, and precision factor of 10 percent.

- C. Determined whether foreign partners' numbers and dollar amounts reported on Forms 8804 (Step II.A.) are reported and agreed with the total number of Forms 8805 and the income and withholding reported on Forms 8805 (Step II.B.). We quantified the amounts which did not match.
  - D. For any variances identified in Step II.C., determined whether the IRS identified the discrepancy and took actions to notify the partnership.
- III. Determined whether IRS procedures for monitoring compliance of U.S. partnership returns with foreign partners are adequate to identify unreported income.
- A. Interviewed IRS management to identify concerns and procedures to monitor the compliance of domestic partnership with foreign partners.
  - B. Reviewed policies, procedures, management information reports, and any applicable Large Business and International Division campaign documentation or plans used to assess the compliance of partnership returns with foreign partners.
  - C. Assessed IRS actions taken to implement the revised withholding rates on ECTI distributions to foreign partners by publicly traded partnerships.
- IV. Determined the extent of the IRS's computer matching of Forms 8804 and 8805 and income tax returns (Form 1065, *U.S. Return of Partnership Income*; Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*; and Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*) to identify taxpayers with underreported income or withholding and nonfiling cases of foreign partners.
- A. Interviewed IRS management to determine the extent of computer matching of domestic partnership tax returns (Forms 1065) to information returns. Also, we assessed the IRS's strategy to ensure the effective use of the information it receives from partnerships' tax returns and withholding information documents to identify noncompliance by foreign partners.
  - B. Determined whether the IRS effectively uses information returns (Form 1065, Schedule K-1 (Form 1065), Form 8804, and Form 8805) to evaluate the withholding and filing compliance of partnerships and the filing compliance of foreign partners.
    - 1. Identified individual foreign partners that did not file a tax return.
      - a. For TY 2016, computer matched the file of Forms 8805 issued to individual foreign partners against TY 2016 Forms 1040-NR, Forms 1065, and Forms 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, data.



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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- b. Identified the Forms 8805 that did not match and quantified the ECTI and withholding amounts.
    - c. For foreign partners who did not file a tax return, calculated the withholding amount and determined whether the appropriate amounts were withheld.
  - 2. Identified individual foreign partners that did not file information returns.
    - a. Obtained and reviewed the population of Forms 1040-NR for TY 2016 and matched returns with corresponding Forms 8805.
    - b. Identified the Forms 1040-NR with no matching Form 8805 and quantified the ECTI and withholding amounts.
    - c. For Forms 1040-NR with a no matching Form 8805 with credits that exceed the IRS's tolerance limit, selected a random sample of 43 Form 1040-NR returns from the population of 4,064 to determine if foreign partners accurately and completely filed all required returns and forms with the IRS. We used a confidence level of 90 percent, a precision factor of 6 percent, and an expected error rate of 6 percent.
- C. Confirmed that the amounts claimed on foreign partners' personal income tax returns (Form 1040-NR) are verified prior to refunds being issued.

### **Data validation methodology**

During this review, we relied on data located on the Treasury Inspector General for Tax Administration's Data Center Warehouse, including Form 1040-NR and 1040-NR-EZ data extracts from the Individual Return Transaction File, and Form 8804, 1120-F, and 1065 data extracts which are all maintained on the Business Return Transaction File. Additionally, we relied on Form 8805 data provided to us by the IRS, which is maintained on the Project 1446 database. Before relying on these data, we ensured that each file contained the specific data elements we requested. During the course of reviewing the returns selected in our random sample, we verified that the information on those returns matched the information in their respective databases. We also tested a judgmentally selected sample for each of the databases and verified the amounts recorded against the IRS Master File using the Integrated Data Retrieval System. We determined that the data were sufficiently reliable for purposes of this report.

### **Reliability of information**

During the course of this audit, we determined that some of the Form 8805 information obtained from the Project 1446 database may have been erroneously transcribed by the IRS. Specifically, we noted three instances in which the ECTI and withholding amounts on Form 8805 was similar to the ECTI and withholding on Form 8804, but contained one or two additional digits seemingly input by the IRS in error. This resulted in an overstatement of more than \$439 million in the



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ECTI and an overstatement in withholding of more than \$155 million. While reviewing the Project 1446 database, we also noted that there were 27,038 records that contained invalid partner TINs. These TINs were either all zeros, all nines, or contained many zeros as the first digits.

### **Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: controls over the processing of Forms 8804 and 8805, and the processing of I.R.C. § 1446 credits claimed on the income tax returns of foreign partners. We evaluated these controls by interviewing key personnel, analyzing data from the Project 1446 database, and performing analysis of tax return data from the Individual and Business Returns Transaction Files located on the Treasury Inspector General for Tax Administration's Data Center Warehouse.



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**Appendix II**

**Major Contributors to This Report**

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Christina M. Dreyer, Director  
Timothy Greiner, Audit Manager  
Victor Taylor, Lead Auditor  
Kevin Nielsen, Senior Auditor



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**Appendix III**

**Report Distribution List**

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



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### **Appendix IV**

#### **Outcome Measures**

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

##### **Type and Value of Outcome Measure:**

- Reliability of Information – Potential; 2,445 taxpayers, *i.e.*, partnerships, who had a discrepancy between the withholding reported on their Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*, and what was reported on their related Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*. These taxpayers reported and paid \$303 million less I.R.C. Section (§) 1446 withholding tax than reported on their related Forms 8805 (see page 5).

##### **Methodology Used to Measure the Reported Benefit:**

In TY 2016, there were 17,734 partnerships that filed Forms 8804 on the Master File that had at least one related Form 8805 on the Project 1446 database.<sup>1</sup> For TY 2016, we compared Form 8804 withholding information submitted by these partnerships to related Form 8805 information entered by tax examiners into the Project 1446 database. After conducting a computer match, we identified 2,445 Forms 8804 that reported and paid \$302,919,753 less I.R.C. § 1446 withholding tax than reported on their related Forms 8805. Accordingly, the foreign partners could have used this nearly \$303 million to reduce their tax despite the partnerships not withholding and remitting the appropriate amount of I.R.C. § 1446 tax.

##### **Type and Value of Outcome Measure:**

- Reliability of Information – Potential; 1,183 Forms 8804 reporting \$450 million in income and \$147 million in withholding that did not have any related Form 8805 (see page 5).

##### **Methodology Used to Measure the Reported Benefit:**

For TY 2016, we compared Form 8804 withholding information submitted by partnerships to related Form 8805 information entered by tax examiners into the Project 1446 database. After conducting a computer match, we identified 1,183 Forms 8804 reporting \$449,948,542 in

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<sup>1</sup> See Appendix VII for a glossary of terms.



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income and \$146,824,567 million in withholding that did not have a related Form 8805 in the Project 1446 database.

### **Type and Value of Outcome Measure:**

- Reliability of Information – Potential; 27,038 foreign partner Forms 8805 that did not contain a valid TIN reported \$906.8 million of the ECTI and \$273.6 million of withholding (see page 5).

### **Methodology Used to Measure the Reported Benefit:**

For TY 2016, we compared Form 8804 withholding information submitted by partnerships to related Form 8805 information entered by tax examiners into the Project 1446 database. After conducting a computer match, we identified 27,038 Forms 8805 that were received by the IRS that did not contain a valid TIN. These 27,038 Forms 8805 reflected \$906,850,847 of the ECTI and \$273,586,004 of withholding that foreign partners are required to report on Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*. \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*

### **Type and Value of Outcome Measure:**

- Revenue Protection – Potential; \$184.1 million in additional tax that would be owed by 5,077 foreign partners (see page 9).

### **Methodology Used to Measure the Reported Benefit:**

To determine whether foreign partners complied with their filing and reporting requirements, we matched the 163,111 Forms 8805 issued for TY 2016 against the TY 2016 Form 1040-NR, Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, and Form 1065, *U.S. Return of Partnership Income*, filing data and identified Forms 8805 that did not have a matching Form 1040-NR, 1120-F, or 1065. The Forms 8805 reported more than \$2.7 billion in the ECTI and more than \$926 million (average of 34 percent) in tax withheld. Because there was no associated tax form, there is indication that the taxpayers who received these Forms 8805 did not report their ECTI as required. Given that there was some tax withheld on this income, we performed the following tests on the 20,749 foreign partners:

- Determined the actual rate of withholding (withholding amount/ECTI amount) for each of the 20,749 foreign partners.
- Using 35 percent, the lower of the two I.R.C. § 1446 withholding rates, as criteria, we identified those foreign partners whose withholding amount was more than 35 percent



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(13,960 foreign partners).<sup>2</sup> Given that the withholding was at or greater than 35 percent, we assumed these taxpayers may not owe tax even if they had filed an income tax return reporting their ECTI.

- Because the withholding rate on the remaining the 6,789 foreign partners was less than 35 percent, we assumed that they would potentially owe tax if they had filed income tax returns.<sup>3</sup>

For each of these 6,789 foreign partners, we calculated withholding on their ECTI at 35 percent and determined the variance between the actual amount of tax withheld and the amount that would have been withheld at 35 percent.<sup>4</sup> From the 6,789, we eliminated 1,712 cases consisting of foreign partners that either: filed a Form 1040, *U.S. Individual Income Tax Return*, (and not a Form 1040-NR) or filed a Form 1065 or Form 1120-F for a non-calendar year fiscal year. As a result, 5,077 foreign partners would owe potential additional tax of \$184,114,263.

**Management's Response:** The IRS disagreed with the monetary benefits of this outcome measure, acknowledging that while the forms we reviewed included some reporting discrepancies and errors that require follow up and reconciliation, it does not necessarily result in lost revenue.

**Office of Audit Comment:** The methodology used to identify and quantify the monetary benefits was appropriate and provided a reasonable estimate of the \$184 million potential tax impact. We believe the potential tax impact is both reasonable and conservative because we allowed for foreign partners filing individual income tax returns, and partnership and corporate income tax returns; accounted for taxes withheld by the respective partnerships; and applied the higher of the two § 1446 withholding tax rates. The overall risk of foreign partners owing additional tax is significant and supported by our results.

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<sup>2</sup> I.R.C. § 1446 imposes withholding at the tax rate of 39.6 percent for non-corporate foreign partners and a 35 percent rate for foreign corporate partners; we used 35 percent to be conservative.

<sup>3</sup> The 6,789 foreign partners include cases in which the variance was greater than \$50.

<sup>4</sup> The 35 percent withholding rate does not account for the possibility of foreign partners providing their partnership with Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, documentation that could potentially reduce the withholding tax.



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### Appendix V

## **Form 8804, Annual Return for Partnership Withholding Tax (Section 1446)**

| <b>Form 8804</b>   | <b>Annual Return for Partnership Withholding Tax (Section 1446)</b><br>▶ Attach Form(s) 8804-C and 8805.<br>▶ Information about Form 8804 and its instructions is at <a href="http://www.irs.gov/form8804">www.irs.gov/form8804</a> .<br>Department of the Treasury<br>Internal Revenue Service<br>For calendar year 2016 or tax year beginning , 2016, and ending , 20 | OMB No. 1545-0123<br><b>2016</b>   |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
|--|---|--|------------------|--|--|--|----|----|----|--|----|--|----|--|-----|--|---|--|----|--|--|--|-----|--|--|--|
| <small>Check this box if the partnership keeps its records and books of account outside the United States and Puerto Rico . . . . .</small> <input type="checkbox"/> |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| <b>Part I Partnership</b>  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| 1a Name of partnership   |   | b U.S. employer identification number (EIN)  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| c Number, street, and room or suite no. If a P.O. box, see instructions.   |   | <table border="1" style="width: 100%; border-collapse: collapse;"><tr><th colspan="4">For IRS Use Only</th></tr><tr><td>CC</td><td>FD</td><td>FF</td><td></td></tr><tr><td>RD</td><td></td><td>FP</td><td></td></tr><tr><td>CAF</td><td></td><td>I</td><td></td></tr><tr><td>CR</td><td></td><td></td><td></td></tr><tr><td>EDC</td><td></td><td></td><td></td></tr></table> | For IRS Use Only |  |  |  | CC | FD | FF |  | RD |  | FP |  | CAF |  | I |  | CR |  |  |  | EDC |  |  |  |
| For IRS Use Only   |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| CC   | FD  | FF   |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| RD   |   | FP   |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| CAF  |   | I  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| CR   |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| EDC  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| d City or town, state or province, country, and ZIP or foreign postal code. If a foreign address, see instructions.  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| <b>Part II Withholding Agent</b>   |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| 2a Name of withholding agent. If partnership is also the withholding agent, enter "SAME" and do not complete lines 2b, 2c, and 2d.                                   |   | b Withholding agent's U.S. EIN   |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| c Number, street, and room or suite no. If a P.O. box, see instructions.   |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| d City or town, state or province, country, and ZIP or foreign postal code.  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| <b>Part III Section 1446 Tax Liability and Payments</b>  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| 3a Enter number of foreign partners . . . . . ▶  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| b Enter number of Forms 8805 attached to this Form 8804 . . . . . ▶  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| c Enter number of Forms 8804-C attached to Forms 8805 . . . . . ▶  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| 4 Total effectively connected taxable income (ECTI) allocable to foreign partners (see instructions):  |   |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| a Total ECTI allocable to corporate partners . . . . .   | 4a  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| b Reduction to line 4a for state and local taxes under Regulations section 1.1446-6(c)(1)(iii) . . . . .   | 4b ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| c Reduction to line 4a for certified foreign partner-level items submitted using Form 8804-C . . . . .   | 4c ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| d Combine lines 4a, 4b, and 4c . . . . .   | 4d  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| e Total ECTI allocable to noncorporate partners other than on lines 4i, 4m, and 4o . . . . .   | 4e  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| f Reduction to line 4e for state and local taxes under Regulations section 1.1446-6(c)(1)(iii) . . . . .   | 4f ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| g Reduction to line 4e for certified foreign partner-level items submitted using Form 8804-C . . . . .   | 4g ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| h Combine lines 4e, 4f, and 4g . . . . .   | 4h  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| i 28% rate gain allocable to noncorporate partners . . . . .   | 4i  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| j Reduction to line 4i for state and local taxes under Regulations section 1.1446-6(c)(1)(iii) . . . . .   | 4j ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| k Reduction to line 4i for certified foreign partner-level items submitted using Form 8804-C . . . . .   | 4k ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| l Combine lines 4i, 4j, and 4k . . . . .   | 4l  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| m Unrecaptured section 1250 gain allocable to noncorporate partners . . . . .  | 4m  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| n Reduction to line 4m for state and local taxes under Regulations section 1.1446-6(c)(1)(iii) . . . . .   | 4n ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| o Reduction to line 4m for certified foreign partner-level items submitted using Form 8804-C . . . . .   | 4o ( )  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |
| p Combine lines 4m, 4n, and 4o . . . . .   | 4p  |  |                  |  |  |  |    |    |    |  |    |  |    |  |     |  |   |  |    |  |  |  |     |  |  |  |

For Paperwork Reduction Act Notice, see separate Instructions for Forms 8804, 8805, and 8813. Cat. No. 10077T Form 8804 (2016)



## Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved

Form 8804 (2016)

Page **2**

|           |  |           |   |  |   |
|-----------|--|-----------|---|--|---|
| <b>q</b>  | Adjusted net capital gain (including qualified dividend income and net section 1231 gain) allocable to noncorporate partners . . . . .   | <b>4q</b> |   |  |   |
| <b>r</b>  | Reduction to line 4q for state and local taxes under Regulations section 1.1446-6(c)(1)(iii) . . . . .   | <b>4r</b> | ( |  | ) |
| <b>s</b>  | Reduction to line 4q for certified foreign partner-level items submitted using Form 8804-C . . . . .   | <b>4s</b> | ( |  | ) |
| <b>t</b>  | Combine lines 4q, 4r, and 4s . . . . .   | <b>4t</b> |   |  |   |
| <b>5</b>  | Gross section 1446 tax liability:  |           |   |  |   |
| <b>a</b>  | Multiply line 4d by 35% (0.35) . . . . .   | <b>5a</b> |   |  |   |
| <b>b</b>  | Multiply line 4h by 39.6% (0.396) . . . . .  | <b>5b</b> |   |  |   |
| <b>c</b>  | Multiply line 4l by 28% (0.28) . . . . .   | <b>5c</b> |   |  |   |
| <b>d</b>  | Multiply line 4p by 25% (0.25) . . . . .   | <b>5d</b> |   |  |   |
| <b>e</b>  | Multiply line 4t by 20% (0.20) . . . . .   | <b>5e</b> |   |  |   |
| <b>f</b>  | Add lines 5a through 5e . . . . .  | <b>5f</b> |   |  |   |
| <b>6a</b> | Payments of section 1446 tax made by the partnership identified on line 1a during its tax year (or with a request for an extension of time to file) and amount credited from 2015 Form 8804 . . . . .  | <b>6a</b> |   |  |   |
| <b>b</b>  | Section 1446 tax paid or withheld by another partnership in which the partnership identified on line 1a was a partner during the tax year (enter only amounts reported on Form(s) 8805 and attach the Form(s) 8805 to Form 8804) . . . . .                                   | <b>6b</b> |   |  |   |
| <b>c</b>  | Section 1446 tax paid or withheld by another partnership in which the partnership identified on line 1a was a partner during the tax year (enter only amounts reported on Form(s) 1042-S and attach the Form(s) 1042-S to Form 8804) . . . . .                               | <b>6c</b> |   |  |   |
| <b>d</b>  | Section 1445(a) or 1445(e)(1) tax withheld from or paid by the partnership identified on line 1a during the tax year for a disposition of a U.S. real property interest (enter only amounts reported on Form(s) 8288-A and attach the Form(s) 8288-A to Form 8804) . . . . . | <b>6d</b> |   |  |   |
| <b>e</b>  | Section 1445(e) tax withheld from the partnership identified on line 1a during the tax year for a disposition of a U.S. real property interest (enter only amounts reported on Form(s) 1042-S and attach the Form(s) 1042-S to Form 8804) . . . . .                          | <b>6e</b> |   |  |   |
| <b>7</b>  | <b>Total payments.</b> Add lines 6a through 6e . . . . .   | <b>7</b>  |   |  |   |
| <b>8</b>  | Estimated tax penalty (see instructions). Check if Schedule A (Form 8804) is attached . . . <input type="checkbox"/>   | <b>8</b>  |   |  |   |
| <b>9</b>  | Add lines 5f and 8 . . . . .   | <b>9</b>  |   |  |   |
| <b>10</b> | <b>Balance due.</b> If line 7 is smaller than line 9, enter balance due. Attach a check or money order for the full amount payable to "United States Treasury." Write the partnership's U.S. EIN, tax year, and "Form 8804" on it . . . . .                                  | <b>10</b> |   |  |   |
| <b>11</b> | <b>Overpayment.</b> If line 7 is more than line 9, enter amount overpaid . . . . .   | <b>11</b> |   |  |   |
| <b>12</b> | Amount of line 11 you want <b>refunded to you</b> . . . . . ▶  | <b>12</b> |   |  |   |
| <b>13</b> | Amount of line 11 you want <b>credited to next year's Form 8804</b> . . . . .  | <b>13</b> |   |  |   |

|                               |   |                      |       |   |              |
|-------------------------------|---|----------------------|-------|---|--------------|
| <b>Sign Here</b>              | Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner, limited liability company member, or withholding agent) is based on all information of which preparer has any knowledge. |                      |       |   |              |
|                               | Signature of general partner, limited liability company member, or withholding agent  |                      | Title | Date  |              |
| <b>Paid Preparer Use Only</b> | Print/Type preparer's name  | Preparer's signature | Date  | Check <input type="checkbox"/> if self-employed | PTIN         |
|                               | Firm's name ▶   |                      |       |   | Firm's EIN ▶ |
|                               | Firm's address ▶  |                      |       |   | Phone no. ▶  |

Form **8804** (2016)



**Withholding Compliance Efforts for Partnerships  
With Foreign Partners Can Be Improved**

**Appendix VI**

**Form 8805, Foreign Partner's Information  
Statement of Section 1446 Withholding Tax**

|   |  |   |  |  |  |
|---|--|---|--|--|--|
| <b>Form 8805</b>  |  | <b>Foreign Partner's Information Statement<br/>of Section 1446 Withholding Tax</b>  |  | OMB No. 1545-0123  |  |
| Department of the Treasury<br>Internal Revenue Service  |  | ► Information about Form 8805 and its instructions is at <a href="http://www.irs.gov/form8805">www.irs.gov/form8805</a> . |  | <b>2016</b><br>Copy A for Internal Revenue Service<br>Attach to Form 8804. |  |
| For partnership's calendar year 2016, or tax year beginning   |  | , 2016, and ending  |  | , 20   |  |
| <b>1a</b> Foreign partner's name  |  | <b>b</b> U.S. identifying number  |  | <b>5a</b> Name of partnership  |  |
| <b>c</b> Address (if a foreign address, see instructions)   |  | <b>c</b> Address (if a foreign address, see instructions)   |  | <b>b</b> U.S. EIN  |  |
| <b>2</b> Account number assigned by partnership (if any)  |  | <b>6</b> Withholding agent's name. If partnership is also the withholding agent, enter "SAME" and do not complete line 7. |  |  |  |
| <b>3</b> Type of partner (specify—see instructions) ►   |  | <b>7</b> Withholding agent's U.S. employer identification number  |  |  |  |
| <b>4</b> Country code of partner (enter two-letter code; see instructions)  |  |   |  |  |  |
| <b>8a</b> Check if the partnership identified on line 5a owns an interest in one or more partnerships . . . . .   |  |   |  | <input type="checkbox"/>   |  |
| <b>b</b> Check if any of the partnership's effectively connected taxable income (ECTI) is exempt from U.S. tax for the partner identified on line 1a . . . . .  |  |   |  | <input type="checkbox"/>   |  |
| <b>9</b> Partnership's ECTI allocable to partner for the tax year (see instructions) . . . . .  |  | <b>9</b>  |  |  |  |
| <b>10</b> Total tax credit allowed to partner under section 1446 (see instructions). <b>Individual and corporate partners:</b><br>Claim this amount as a credit against your U.S. income tax on Form 1040NR, 1120-F, etc. . . . . |  | <b>10</b>   |  |  |  |
| <b>Schedule T—Beneficiary Information (see instructions)</b>  |  |   |  |  |  |
| <b>11a</b> Name of beneficiary  |  | <b>c</b> Address (if a foreign address, see instructions)   |  |  |  |
| <b>b</b> U.S. identifying number of beneficiary   |  |   |  |  |  |
| <b>12</b> Amount of ECTI on line 9 to be included in the beneficiary's gross income (see instructions) . . . . .  |  | <b>12</b>   |  |  |  |
| <b>13</b> Amount of tax credit on line 10 that the beneficiary is entitled to claim on its return (see instructions) . . . . .  |  | <b>13</b>   |  |  |  |

For Paperwork Reduction Act Notice, see separate Instructions for Forms 8804, 8805, and 8813. Cat. No. 10078E Form **8805** (2016)





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***Withholding Compliance Efforts for Partnerships  
With Foreign Partners Can Be Improved***

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**Appendix VIII**

***Glossary of Terms***

| Term  | Definition   |
|---|--|
| <b>Campus</b>                               | The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.  |
| <b>Effectively Connected Taxable Income</b> | The excess of the gross income of the partnership that is effectively connected under section 864(c), or treated as effectively connected with the conduct of a U.S. trade or business, over the allowable deductions that are connected to such income. |
| <b>Master File</b>                          | The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.   |
| <b>Tax Year</b>                             | The 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.                                      |
| <b>Taxpayer Identification Number</b>       | A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the TIN is either an Employer Identification Number, a Social Security Number, or an Individual TIN.                                   |



## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

### **Appendix IX**

## **Management's Response to the Draft Report**



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, DC 20224

June 1, 2020

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Douglas W. O'Donnell Digitally signed by Douglas W. O'Donnell  
Date: 2020.06.01 15:41:26 -04'00'  
Commissioner, Large Business and International (LB&I) Division

SUBJECT: Draft Audit Report # 2018-30-019, Withholding Compliance  
Efforts for Partnerships With Foreign Partners Can Be Improved

Thank you for the opportunity to review and comment on the draft report referenced above. As reflected in the report, the partnership withholding regime encompasses a variety of issues that the IRS continues to address as part of its enforcement efforts.

As part of our compliance strategy for U.S. source income paid to foreign persons, we have implemented a campaign to verify Form 1042-S credits claimed on Form 1040NR. Also, we are in the final phases of developing data integrity software for Form 1042-S that will enable withholding agents to test their data and to identify inconsistencies before submitting to the IRS. We are continuing to evaluate and modify, as appropriate, our strategic approach for U.S. source income withholding to identify and address non-compliance and improve voluntary compliance, while balancing available resources and other organizational priorities.

Additionally, we are exploring collaboration with other LB&I campaigns for referral work where U.S. partnerships with foreign partners may have non-filed withholding tax returns (Form 8804) and unpaid withholding tax liabilities (Form 8805) pursuant to I.R.C. Section 1446, the subject of this audit. Enhanced partnership and foreign partner compliance may also result from LB&I's efforts to increase partnership coverage.

The attachment provides a response outlining our corrective actions for the agreed recommendations. While the forms you reviewed included some reporting discrepancies and errors that require follow-up and reconciliation, this does not necessarily result in lost revenue. We are, therefore, unable to agree with your stated monetary benefits.

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

Attachment



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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Attachment

The Commissioner, Large Business and International Division, should request that Submission Processing:

**RECOMMENDATION 1:**

Strengthen controls to ensure the Code and Edit function corresponds with partnerships when there are no Forms 8805 attached to Form 8804 reporting ECTI and withholding amounts.

**CORRECTIVE ACTIONS:**

We will work with Submission Processing (SP) to review whether controls could be strengthened to ensure the Code and Edit function corresponds with partnerships when there are no Forms 8805 attached to Form 8804 reporting ECTI and withholding amounts.

As part of our review, we will assess what changes, if any, could be made to strengthen controls, given available resources and organizational priorities. For example, there may be updates to Code and Edit Internal Revenue Manual (IRM) procedures and training modules.

**IMPLEMENTATION DATE:**

June 15, 2021

**RESPONSIBLE OFFICIAL(S):**

Deborah Palacheck, Director, Withholding & International Individual Compliance Practice Area

**CORRECTIVE ACTION(S) MONITORING PLAN:**

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

**RECOMMENDATION 2:**

Establish procedures for tax examiners to prevent duplicate or multiple Forms 8805 filed by partnerships from being entered into the Project 1446 database.

**CORRECTIVE ACTIONS:**

We will work with SP to determine whether procedures can be established to prevent duplicate or multiple Forms 8805 from being entered into the Project 1446 database, given available technology, human resources, and organizational priorities.

For any new procedures implemented, we will work with SP to make the necessary changes and update training modules and IRM procedures, as appropriate.



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## ***Withholding Compliance Efforts for Partnerships With Foreign Partners Can Be Improved***

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**IMPLEMENTATION DATE:**

June 15, 2021

**RESPONSIBLE OFFICIAL(S):**

Deborah Palacheck, Director, Withholding & International Individual Compliance Practice Area

**CORRECTIVE ACTION(S) MONITORING PLAN:**

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

The Commissioner, Large Business and International Division:

**RECOMMENDATION 3:**

Should establish procedures using Form 8805 data to identify potential non-filers (foreign partners that do not file an income tax return) and underreporters (foreign partners that do not report their partnership ECTI on their income tax return).

**CORRECTIVE ACTIONS:**

We will consider establishing procedures using Form 8805 data to identify potential non-filers and under reporters. As a first step, we are evaluating the initial dataset provided by TIGTA to determine the volume of foreign partners who did not file a U.S. income tax return. We will then assess whether the foreign partners were entitled to treaty benefits and other items reducing the withholding rate to lower than 35% and analyze the resulting volume of noncompliance.

**IMPLEMENTATION DATE:**

June 15, 2021

**RESPONSIBLE OFFICIAL(S):**

Deborah Palacheck, Director, Withholding & International Individual Compliance Practice Area

**CORRECTIVE ACTION(S) MONITORING PLAN:**

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