# Closing the Flow Through Entities Tax Gap

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## Highlights

- ***Maximize taxpayer compliance by more accurately recognizing non-compliers,  and low or high risk taxpayers***
- ***Maximize collections by more accurately prioritizing collections based on the historic and current risk associated with an individual taxpayer***
- ***Minimize the burden on taxpayers by developing individualized taxpayer assistance, compliance programs and communications***
- ***Improve the cost effectiveness of the tax/revenue department  by employing automated  taxpayer identity and relationship information***
- ***Maximize responsiveness to the taxpayer by improving the speed, quality and accuracy of the service interactions with taxpayers by recognizing their names, their identities and their network (s)***
- ***Build on existing investments to optimize investment in skills and infrastructure***
- ***Protect tax payer privacy by anonymizing their personally identifiable information***
- ***Use proven IBM technologies and techniques to implement***

### Strategic Issues

Today's tax agencies typically lose 15 percent or more of total revenues to tax evasion and other types of non-compliance –known as the 'tax gap.' At a time when tax evasion techniques have grown more sophisticated, this includes agencies challenged with tax-payer compliance associated with flow through entities. Flow through entities also go by other names such as pass through entities.

### Flow Through Entities

Individuals can earn income from a variety of pass through entities that conduct business in a State , Province and other government geography. This could include for example;  Estates, a "Corporation" to include a C Corporation, S Corporation, Limited Partnership, Limited Liability Partnership (LLP), Limited Liability Company (LLC), Professional Limited Company (PLLC), Real Estate Investment Trust (REIT), Regulated Investment Company (RIC), Real Estate Mortgage Investment Conduit (REMIC), Financial Asset Securitization Investment Trust (FASIT), or similar entities created with limited liability for the partners, members, or shareholders.

The payees of payments (other than income effectively connected with a

U.S. trade or business) made to a foreign flow-through entity are the owners or beneficiaries of the flow-through entity. Income that is, or is deemed to be, effectively connected with the conduct of a U.S. trade or business of a flow-through entity, is treated as paid to the entity. All of the following are flow-through entities:

- A foreign partnership (other than a withholding foreign partnership and partnerships claiming treaty benefits as entities that are not fiscally transparent)
- A foreign simple or foreign grantor trust (other than a withholding foreign trust), and foreign simple and foreign grantor trusts claiming benefits as entities that are not fiscally transparent
- An entity receiving income for which treaty benefits are claimed by an interest holder in the entity and the entity is considered fiscally transparent

In many states these entities are subject to one or more of the following state income tax laws such as; individual income tax, property tax, business taxes, payroll taxes. A pass-through entity files form X to report the pass-through entity's items of income, adjustments, gains, losses, and other required information. These items are passed through the entity to be taxed to the partners, shareholders, members or beneficiaries (referred collectively hereafter as "member"). Each member is then required to file the applicable state income tax return and pay any tax due on the member's distributable or pro-rata share of the pass-through entity's items for the tax year.

**Tax Gap Scenarios**

Generally, you treat a payee as a flow-through entity if it provides you with a form IRS W-8IMY on which it claims such status. You may also be required to treat the entity as a flow-through entity under the IRS presumption rules.

You must determine whether the owners or beneficiaries of a flow-through entity are US or foreign persons, how much of the payment relates to each owner or beneficiary, and, if the owner or beneficiary is foreign, whether a reduced rate of NRA withholding applies. You make these determinations based on the documentation and other information (contained in a withholding statement) that is associated with the flow-through entity's form W-8IMY. If you do not have all of the information that is required to reliably associate a payment with a specific payee, you must apply the IRS presumption rules.

A non withholding foreign partnership has three partners: a nonresident alien individual; a foreign corporation, and a US citizen. You make a payment of US source interest to the partnership. It gives you a form W-8IMY with which it associates forms W-8BEN from the nonresident alien and the foreign corporation and a form W-9 from the US citizen. The partnership also gives you a complete withholding statement that enables you to associate a portion of the interest payment to each partner.

You must treat all three partners as the payees of the interest payment as if the payment were made directly to them. Report the payment to the nonresident alien and the foreign corporation on forms 1042-S. Report the payment to the US citizen on form 1099-INT.

**Why Now?**

Today's intensifying tax agency challenges mandate a fresh approach to managing tax compliance and fraud information.

- Multiplication of fraud types, frequency, complexity and interconnectedness of people and organizations
- Fraud is increasingly asymmetrical
- Explosion in complexity of fraud identification
- Frequency of transaction/interactions
- Transparency is clouding
- Regulatory pressures are increasing
- Intensifying budget and tax revenue pressures
- Customer centric approach

Current Approaches have become obsolete.

- SSN and/or EIN are no longer reliable as the sole means of identification and linkage to other taxpayers

- Information is compartmentalized – lack of full integration is obscuring visibility
- Query state limits ability to address complexity of fraud - you need to know the right question to ask
- Untimely – fraud identified ex-post facto.
- Inaccurate – broad scale false positives and false negatives
- Out of context – lack of decision support/guidance once fraud is identified

**More Effective Taxpayer Compliance**

IBM Tax Compliance Intelligence is a powerful, sophisticated solution that can be configured to meet a given agency's particular compliance needs. It helps improve the compliance process in the following ways:

- Segment tax payers to detect who may be a higher risk to focus appropriate attention and resources where the taxpayer of interest suggests such attention
- Automate the real time alerting and insight into identities and/or providing enterprise discovery and insight tool (operations/execution message)
- Detect and determine if tax payers are properly registered – eliminate duplicate registrations by up to 50%
- Automate previously manual steps to detect, verify taxpayer names, identities and relationships
- Provide full attribution with a complete history of a tax payer and never throw away data about them
- Real time updates, and self correcting to provide a current and a more accurate view
- Auditors require tools to know how noncompliance occurs and at the same time protect the privacy of tax payers.
- Improve tax/revenue department performance and effectiveness by using fact based taxpayer identity and relationship information for deep insight into who you are dealing with

*Recognizes multi-cultural name variations*

- Kate, Cait, Catherine, Katherine, Kat
- Multiple name variations: name order, multiple titles, name variants, multiple prefixes, phonetic transpositions of nicknames

*Recognizes identities*

- Provides the ability to identify who people, and organizations are

*Recognizes relationships*

- Identities what relationships exist between a tax payer, and obvious, non-obvious people and organizations

**Privacy Protection**

Information about tax payers is needed to successfully follow up on leads and process cases by the tax agency. The Information is usually provided by a tax payer themselves and does not itself represent privacy issue. Difficulty arises if elements of information are combined in ways that reveal more about a person's private life than intended. Different countries take different approaches to privacy. Many countries have legislated privacy into their tax systems. Sometimes privacy protections are an inhibitor to good tax compliance and service. Tax payers may be willing to allow privacy information to be shared if asked and to their benefit if they provide consent.

IBM Tax Compliance Intelligence provides tax agencies:

- Ability to share identity and relationship information with third parties without disclosing the identity of the person to whom the information relates
- Support tax agency services delivery model oriented around integrated service and tax payer consent and choice

**Proven Methods, Tools and Techniques**

IBM has invested significant resources in Tax Compliance Intelligence to bring together a range of tools and techniques all specifically designed to enhance the implementation of integrated tax case and risk management solutions for tax agencies.

## A solid foundation: World class technologies from IBM

IBM is one of the largest providers of solutions to government agencies around the world. The IBM Tax Compliance Intelligence is built upon:

- IBM Global Name Recognition: recognizes names across multiple cultural variations
- IBM Identity Resolution: identities ‘who is who’
- IBM Relationship Resolution: identifies ‘who knows who’ by detecting relationships across multiple degrees of separation
- IBM Anonymous Resolution: allows multiple organizations to share identity and relationship data anonymously that never exposes the identity of an individual

## For more information

To learn more about these solutions, please visit: **ibm.com/db2/eas** or contact your IBM sales representative.

*Sources: US Treasury, Internal Revenue Service (IRS)*

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IBM (United States of America)
Entity Analytic Solutions
6600 Bermuda Rd, Suite A
Las Vegas, Nevada
United States of America, 89119

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