



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

September 27, 2013

Reference Number: 2013-30-112

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

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HIGHLIGHTS

THE REFERRAL PROCESS FOR EXAMINATIONS OF TAX RETURNS CLAIMING THE FOREIGN EARNED INCOME EXCLUSION NEEDS TO BE IMPROVED

Highlights

**Final Report issued on
September 27, 2013**

Highlights of Reference Number: 2013-30-112 to the Internal Revenue Service Commissioner for the Large Business and International Division.

IMPACT ON TAXPAYERS

To alleviate double taxation of taxpayers earning foreign income while residing overseas, Internal Revenue Code Section 911(a) provides for the Foreign Earned Income Exclusion (FEIE) and the Foreign Housing Exclusion/Deduction. For Tax Year 2012, the FEIE allowed taxpayers to exclude foreign earned income of up to \$95,100. Qualifying taxpayers living and working in a foreign country may also claim a limited exclusion or deduction for the amount of their housing expenses. These benefits can significantly reduce or eliminate taxpayers' U.S. income tax liabilities regardless of whether they paid any foreign income taxes.

WHY TIGTA DID THE AUDIT

Because of the large dollar amount of this exclusion, it has a significant impact on an individual's tax return. It is important for the IRS to ensure that taxpayers are properly qualified for and accurately claiming this exclusion. The overall objective of the review was to provide an overview of tax returns claiming the FEIE and the Foreign Housing Exclusion/Deduction.

WHAT TIGTA FOUND

Of approximately 140 million Tax Year 2009 individual income tax returns filed during Processing Years 2010 and 2011, 372,119 (0.27 percent) tax returns included a Form 2555/2555-EZ, *Foreign Earned Income/Foreign Earned Income Inclusion*. The

exclusions, credits, and deductions claimed were as follows:

- \$23.3 billion in the FEIE.
- \$5 billion in Foreign Tax Credits.
- \$2.7 billion in Foreign Housing Exclusions.
- \$102.6 million in Foreign Housing Deductions.

From a statistical sample of 150 tax returns from a population of 331,405 Tax Year 2009 individual income tax returns claiming the FEIE and/or the Foreign Housing Exclusion/Deduction filed during Processing Year 2010, TIGTA estimated that U.S. taxpayers living and working in foreign countries who claimed the FEIE reduced their Federal income taxes by \$562 million. Taxpayers claiming the Foreign Housing Exclusion/Deduction reduced their Federal income taxes by an additional \$174 million for Tax Year 2009.

In addition, during Fiscal Years 2009 through 2011, 2,851 (99 percent) of the 2,876 individual income tax returns examined where a Form 2555/2555-EZ was present were not referred to an international examiner as required by IRS procedures. TIGTA estimated that improving the audit referral process could result in approximately \$2.7 million in additional tax assessments, or \$13.5 million over five years. Moreover, 1,583 examinations that were not required by the IRS to be referred might warrant referral to international examiners. Referral of these tax returns could potentially result in approximately \$1.5 million in additional tax assessments, or \$7.5 million over five years.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS ensure that: 1) domestic examiners and their managers are aware of the international referral criteria and a cross reference to those criteria is incorporated into the Campus Reporting Compliance section of the Internal Revenue Manual and 2) the international referral criteria process is evaluated to determine if it should be expanded to include the Wage and Investment Division.

IRS officials agreed with the recommendations and plan to take corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 27, 2013

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL
DIVISION

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Referral Process for Examinations of Tax
Returns Claiming the Foreign Earned Income Exclusion Needs to Be
Improved (Audit # 201130050)

This report presents the results of our review to provide an overview of tax returns claiming the Foreign Earned Income Exclusion and the Foreign Housing Exclusion/Deduction. This audit is included in our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Globalization.

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

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



*The Referral Process for Examinations of Tax Returns Claiming
the Foreign Earned Income Exclusion Needs to Be Improved*

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Abbreviations

| | |
|------|---------------------------------|
| FEIE | Foreign Earned Income Exclusion |
| IRS | Internal Revenue Service |
| U.S. | United States |



*The Referral Process for Examinations of Tax Returns Claiming
the Foreign Earned Income Exclusion Needs to Be Improved*

Background

1. **The General Rules.** To qualify for the Foreign Earned Income Exclusion, a U.S. citizen or resident alien must have a tax home in a foreign country and income received for working in a foreign country (foreign earned income). The taxpayer must also meet either the bona fide residence test or the physical presence test.
2. **The Exclusion Amount.** The Foreign Earned Income Exclusion is adjusted annually for inflation. For Tax Year 2012, the maximum exclusion is \$95,100 per qualifying person.
3. **Claiming the Exclusion.** The Foreign Earned Income Exclusion and the Foreign Housing Exclusion/Deduction are claimed by using Form 2555, Foreign Earned Income, or, if only claiming the Foreign Earned Income Exclusion, by using Form 2555-EZ, Foreign Earned Income Exclusion.
4. **Taking Other Credits or Deductions.** Once the Foreign Earned Income Exclusion is chosen, a foreign tax credit or deduction for taxes cannot be claimed on the excluded income. If a foreign tax credit or tax deduction is taken on any of the excluded income, the Foreign Earned Income Exclusion may be considered revoked.

United States (U.S.) citizens and resident aliens¹ are taxed on their worldwide income, whether the individual lives inside or outside of the United States. Some U.S. citizens may also pay taxes—on the same income subject to U.S. Federal income tax—to the foreign country in which they reside and work.

Internal Revenue Code Section 911(a) provides that at the election of a qualified individual there shall be excluded from the gross income of such individual, and exempt from taxation under this subtitle, for any taxable year 1) the foreign earned income of such individual and 2) the housing cost amount of such individual.

The Foreign Earned Income Exclusion (FEIE) allows U.S. taxpayers residing in a foreign country² to exclude a specific amount of foreign earned income from their U.S. taxable income,³ thus reducing their overall income tax liability. To qualify for the FEIE, the U.S. citizen or resident alien's tax home must be in a foreign country, and the U.S. citizen or resident alien must be a bona fide resident⁴ of a foreign country or present in a foreign country for at least 330 days over a 12-month period.

¹ See Appendix VII for a glossary of terms.

² The term "foreign country" does not include Antarctica or U.S. possessions such as Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands, and Johnston Island. It also does not include international waters or the airspace above them.

³ Income earned from working abroad as an employee of the U.S. Government does not qualify for the FEIE.

⁴ The bona fide residence test is generally satisfied if the individual has established and maintained a residence in a foreign country for an uninterrupted period that includes an entire taxable year. An individual would not be considered a resident if a statement was submitted to the tax authorities of the foreign country indicating nonresidency and the foreign country did not subject the individual to foreign income taxation.



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The FEIE is computed by taxpayers on the Form 2555, *Foreign Earned Income*,⁵ or Form 2555-EZ, *Foreign Earned Income Exclusion*, and filed with their annual Forms 1040, *U.S. Individual Income Tax Return*. Figure 1 shows a section of Form 2555 for Tax Year 2012, which shows the maximum FEIE amount of \$95,100.

Figure 1: Line 37 of the Form 2555 for Tax Year 2012

| Part VII Taxpayers Claiming the Foreign Earned Income Exclusion | |
|--|---|
| 37 | Maximum foreign earned income exclusion 37 \$95,100.00 |

Source: IRS.gov, Line 37 of Form 2555 for Tax Year 2012.

If both the taxpayer and his or her spouse worked abroad in Tax Year 2012 and each met all the qualifications, each could choose the FEIE and together exclude as much as \$190,200 of foreign earned income from their U.S. taxable income.

The FEIE provides qualified taxpayers the benefit of reduced U.S. taxes, and in some case the elimination of U.S. income taxes, whenever there is foreign earned income, regardless of whether the taxpayers paid any foreign income taxes or not. Some foreign countries have no income tax and U.S. taxpayers who reside in those countries do not pay taxes to a foreign tax authority. Because this exclusion is allowed regardless of taxes owed, it benefits taxpayers by reducing or eliminating their U.S. income tax liabilities regardless of whether they paid any foreign income taxes.

Taxpayers living and working in a foreign country may also be able to claim an exclusion or a deduction for their housing expenses if their tax home is in a foreign country and they qualify for the Foreign Housing Exclusion/Deduction under either the bona fide residence test or the physical presence test.

- The Foreign Housing Exclusion applies only to amounts considered paid for with employer-provided funds (wages).
- The Foreign Housing Deduction applies only to amounts paid for with self-employment earnings.

The housing amount is the taxpayer's housing expenses (rent, repairs, utilities, *etc.*) for the year that exceeds a base housing amount. The computation of the base housing amount is tied to the maximum FEIE. The housing amount is 16 percent of the FEIE amount (computed on a daily basis) multiplied by the number of days in the qualifying period that falls within the tax year. Taxpayers use Form 2555 to determine the amount of the exclusion or deduction.

Additionally, taxpayers who pay or accrue foreign taxes to a foreign country on foreign-sourced income may be able to take either a credit or an itemized deduction for those taxes. Taken as a

⁵ See Appendix V for an example of the Form 2555.



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deduction on Schedule A, *Itemized Deductions*, of the Form 1040, foreign income taxes reduce the U.S. taxable income. Taken as a credit on Form 1116, *Foreign Tax Credit*, foreign income taxes reduce the U.S. tax liability. Certain U.S. taxpayers may qualify for a Foreign Tax Credit and the FEIE. However, if a Foreign Tax Credit or tax deduction is also claimed for any of the foreign taxes paid on the excluded income, the FEIE may be considered revoked.

Figure 2 compares the tax consequences for Tax Year 2012 for a U.S. taxpayer living and working in a foreign country (one with and one without an income tax) to a taxpayer residing and working in the United States.⁶

Figure 2: Comparison of Income Taxes for Taxpayers Living and Working in the United States, the Cayman Islands, and the United Kingdom⁷

| Country Where U.S. Taxpayer Resides and Earns Income Country's Highest Tax Rate | United States 35% | Cayman Islands 0% | United Kingdom 50% |
|--|----------------------|----------------------|-----------------------|
| Earned income of \$104,850 qualifying for the FEIE | | | |
| Earned Income | \$104,850 | \$104,850 | \$104,850 |
| Less: Standard deduction \$5,950 and one exemption \$3,800 | (\$9,750) | (\$9,750) | (\$9,750) |
| Less: FEIE | N/A | (\$95,100) | (\$95,100) |
| U.S. Taxable Income | \$95,100 | \$0 | \$0 |
| Total U.S. Income Tax | \$20,096 | \$0 | \$0 |
| Foreign Income Tax | \$0 | \$0 | \$25,552 |
| Total Worldwide Income Tax | \$20,096 | \$0 | \$25,552 |
| Effective Worldwide Income Tax Rate ⁸ | 19% | 0% | 24% |

⁶ In Tax Year 2012, both the United States and the United Kingdom had graduated income tax rates with a top income tax rate of 35 percent and 50 percent respectively, while the Cayman Islands had no income tax.

⁷ The tax calculations are hypothetical examples for demonstration purposes only.

⁸ Effective worldwide income tax rate is computed by dividing total worldwide income tax by the earned wages of \$104,850 for each example.



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| Country Where U.S. Taxpayer Resides and Earns Income | United States | Cayman Islands | United Kingdom |
|---|----------------------|-----------------------|-----------------------|
| Country's Highest Tax Rate | 35% | 0% | 50% |
| Earned income of \$104,850 without the FEIE but with the U.S. Foreign Tax Credit | | | |
| Taxable Income (after claiming standard deduction and one exemption) | \$95,100 | \$95,100 | \$95,100 |
| U.S. Income Tax | \$20,096 | \$20,096 | \$20,096 |
| Less: U.S. Foreign Tax Credit | (\$0) | (\$0) | (\$20,096) |
| Total U.S. Income Tax | \$20,096 | \$20,096 | \$0 |
| Foreign Income Tax | \$0 | \$0 | \$25,552 |
| Total Worldwide Income Tax | \$20,096 | \$20,096 | \$25,552 |
| Effective Worldwide Income Tax Rate | 19% | 19% | 24% |

Source: Our analysis of the FEIE tax effect for hypothetical U.S. taxpayers living and working in the United States, the Cayman Islands, and the United Kingdom. N/A = Not Applicable.

This review was performed at the Internal Revenue Service (IRS) Large Business and International Division⁹ Headquarters in Washington, D.C., and the IRS Campus in Austin, Texas, during the period August 2011 through March 2013. 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.

⁹ The Large Business and International Division is responsible for large business and international compliance, including both international business and individual compliance.



*The Referral Process for Examinations of Tax Returns Claiming
the Foreign Earned Income Exclusion Needs to Be Improved*

Results of Review

A Small Percentage of Taxpayers Elected the Foreign Earned Income Exclusion

Of the approximately 140 million Tax Year 2009 individual income tax returns filed during Processing Years 2010 and 2011, 372,119 (0.27 percent) tax returns included a Form 2555/2555-EZ. These tax returns claimed approximately \$23.3 billion in the FEIE and an average FEIE of about \$63,342¹⁰ per tax return.¹¹ Of the 372,119 tax returns:

- \$50.5 billion in wages were reported, of which \$36.6 billion in wages were reported as earned while living and working in a foreign country.
- \$5 billion in Foreign Tax Credits were claimed. Taxpayers living and working in a foreign country may also be eligible to claim the Foreign Tax Credit for foreign taxes paid on foreign income *not covered by* the FEIE. This includes foreign earned income (wages) as well as foreign passive income (interest and dividends).
- \$4.3 billion in Federal income taxes were reported on 175,972 tax returns. As a result of the FEIE and other credits and deductions, 196,147 tax returns reported no Federal income taxes.
- \$2.7 billion in Foreign Housing Exclusions were claimed, and \$102.6 million in Foreign Housing Deductions were taken.

Figure 3 provides a breakdown by Adjusted Gross Income for the 372,119 Tax Year 2009 individual income tax returns with Forms 2555/2555-EZ.

¹⁰ The maximum FEIE exclusion for Tax Year 2009 was \$91,400.

¹¹ Only 367,712 of the 372,119 Tax Year 2009 individual income tax returns with an attached Form 2555/2555-EZ claimed the FEIE. The averaged FEIE amount was calculated using the actual total FEIE amount claimed, not the rounded amount used in this report.



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Figure 3: Breakdown of Adjusted Gross Income for Tax Year 2009 Individual Income Tax Returns With Forms 2555/2555-EZ¹²

| Adjusted Gross Income | |
|------------------------|---|
| \$0 to \$100,000 | 298,358 (80 percent) reported less than \$100,000 in Adjusted Gross Income, averaging \$58,742 in the FEIE per tax return. As a result of the FEIE and other credits and deductions, 188,241 (63 percent) tax returns reported no U.S. Federal income taxes. |
| \$100,001 to \$500,000 | 61,552 (17 percent) reported Adjusted Gross Income from \$100,001 to \$500,000, averaging about \$80,693 in the FEIE per tax return. As a result of the FEIE and other credits and deductions, 6,933 (11 percent) tax returns reported no U.S. Federal income taxes. |
| Greater Than \$500,000 | 12,209 (3 percent) reported Adjusted Gross Income greater than \$500,000, averaging about \$88,213 in the FEIE per tax return. As a result of the FEIE and other credits and deductions, 973 (8 percent) tax returns reported no U.S. Federal income taxes. |

Source: Our analysis of the Individual Return Transaction File for Processing Years 2010 and 2011 for Tax Year 2009 individual income tax returns with Forms 2555/2555-EZ attached.

In addition to the analysis in Figure 3, we selected a statistical sample of 150 tax returns¹³ from a population of 331,405 Tax Year 2009 individual income tax returns with a Form 2555/2555-EZ to identify taxpayers who claimed the FEIE and those who also claimed the Foreign Housing Exclusion/Deduction.

Based on our sample, U.S. taxpayers living and working in foreign countries who claimed the FEIE reduced their Federal income taxes for Tax Year 2009 by \$254,393 or by \$562 million when projected to the sampled population.¹⁴ This results in an average reduction of Federal income taxes of about \$1,696 per tax return.

Foreign Housing Exclusion/Deduction

On 26 (17 percent) of the 150 tax returns sampled, taxpayers also claimed the Foreign Housing Exclusion/Deduction. The amount of their credits/deductions totaled \$520,342, which reduced their Federal income taxes by \$78,822. Applying the results of our sample to the population, we

¹² See Appendix VI for specifics on the 372,119 tax returns.

¹³ We selected a total sample of 150 Tax Year 2009 tax returns with either a Form 2555 or a Form 2555-EZ attached. However, one taxpayer attached a Form 2555 to the tax return but did not claim the FEIE. This population of individual income tax returns with an attached Form 2555/2555-EZ from which we selected our sample included only Tax Year 2009 returns processed during Processing Year 2010 from taxpayers whose tax year ended on December 31.

¹⁴ We are 95 percent confident that the range is between \$210 and \$914 million.



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estimate that taxpayers claiming the Foreign Housing Exclusion/Deduction reduced their Federal income taxes by an additional \$174 million for Tax Year 2009.¹⁵ This results in an average of about \$525 per tax return.

Foreign Tax Credit

On 36 (24 percent) of the 150 tax returns sampled, taxpayers also claimed Foreign Tax Credits. The Foreign Tax Credit is claimed when taxpayers paid or accrued foreign taxes to a foreign country on foreign-sourced income. For the 36 tax returns, foreign taxes were paid on earned income, *i.e.*, wages, totaling \$1,592,841 and passive income, *i.e.*, investments, totaling \$10,157. The total Foreign Tax Credits claimed was \$1,602,998, or an average of \$44,528.

Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Are Not Appropriately Referred to International Examiners

During Fiscal Years 2009 through 2011, domestic examiners¹⁶ did not appropriately refer 2,851 (99 percent) of 2,876 individual tax returns with a Form 2555/2555-EZ¹⁷ that had been selected for examination to international examiners.¹⁸ Additionally, 1,583 individual tax returns with a Form 2555/2555-EZ that are not required to be referred due to current IRS policy might warrant referral to international examiners.

While the IRS examines some tax returns for issues specific to the Forms 2555/2555-EZ, tax returns (with Forms 2555/2555-EZ attached) are selected and examined for other tax issues not relating to the FEIE. When this happens, domestic examiners are generally required to refer any tax return under examination with an attached Form 2555/2555-EZ¹⁹ to an international examiner through the Specialist Referral System. Internal guidelines specifically state:²⁰

(1) Generally, all returns with international features meet the mandatory referral criteria and must be referred to an international examiner.

¹⁵ We are 95 percent confident that the range is between \$64 and \$265 million.

¹⁶ Examiners who are assigned examinations associated with domestic (U.S.) issues.

¹⁷ Of the 2,851 individual tax returns, 44 were examined by the Large Business and International Division and 2,807 were examined by the Small Business/Self-Employed Division.

¹⁸ We analyzed IRS data and found that during Fiscal Years 2009 through 2011, the IRS closed 7,355 tax return examinations where a Form 2555/2555-EZ was present. Of the 7,355 tax return examinations, 4,479 were removed from the sample because they did not meet the referral criteria. Of the 4,479: 2,757 were examined as part of a specific international compliance initiative, 139 were investor tax returns held in suspense status until the primary partnership tax returns were closed and the flow-through adjustments were made, and 1,583 were examined by the Wage and Investment Division and due to current IRS policy were not required to be referred. The remaining 2,876 tax returns met the criteria to be referred to an international specialist.

¹⁹ Form 2555 is used to compute the FEIE and the Foreign Housing Exclusion/Deduction, and Form 2555-EZ is used only to compute the FEIE.

²⁰ Internal Revenue Manual 4.60.6.2 (Mar. 1, 2007).



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- (2) A preliminary review of returns with international features will be made to determine if the case should be referred.
- (3) International features include but are not limited to the following:
- a. Schedules and attachments of any of the following forms to the tax return:

| <i>Form</i> | <i>Form Title</i> | <i>Referral Criteria</i> |
|---------------|---|--------------------------|
| 2555, 2555-EZ | <i>Foreign Earned Income; Foreign Earned Income Exclusion</i> | <i>All</i> |

When asked why employees did not follow the procedures and refer individual tax returns involving the FEIE to international examiners, IRS officials responded as follows:

- **Large Business and International Division:** Officials stated that some of these tax returns were training returns and that the referral requirement was overlooked. For the other tax returns, specific information related to them could not be secured due to the recent domestic reorganization, which placed many of the cases in a different industry from which they were originally aligned. As a result, officials were unable to comment on why these cases were not referred as required.
- **Small Business/Self-Employed Division:** Officials stated that their Campus Reporting Compliance function employees are subject to the international referral criteria. However, they have determined that the Campus Reporting Compliance Internal Revenue Manual contains no cross-reference to the international referral criteria to instruct tax examiners to refer tax returns meeting the international referral criteria.
- **Wage and Investment Division:** Officials stated that their Campus Reporting Compliance function employees are not subject to the referral process when the tax return has a Form 2555/2555-EZ attached because current internal guidelines do not include the Wage and Investment Division.

The referral policy ensures that tax returns open for examination with international issues are reviewed by an international examiner with the requisite knowledge to determine whether a significant international issue exists that needs to be examined. Once a referral request is submitted, an international manager reviews the request and either declines it or accepts it and assigns the referral to an international examiner to work.

If the referral is accepted, the international examiner can either work the international issue or provide a consultation and have the domestic examiner add the international issue to his or her examination. If the referral is declined, the tax return is returned to the domestic examiner to continue with the examination without the international issue. Fourteen (56 percent) of the 25 individual tax returns with a Form 2555/2555-EZ referred to international examiners in Fiscal



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Years 2009 through 2011 were accepted. Of the 14 accepted tax returns, international examiners directly examined six returns and provided consultations on the remaining eight returns.

Examination of tax returns filed with Forms 2555/2555-EZ show a high rate of noncompliance

IRS examination results show that 77 percent of tax returns that were examined as part of the Forms 2555/2555-EZ compliance initiatives conducted during Fiscal Years 2009 through 2011 had adjustments resulting in approximately \$21 million in additional tax. When the domestic examiner closes a tax return examination case without making the required referral to the international examiner, potential international noncompliance may not be identified.

From Fiscal Years 2009 through 2011, the IRS examined 3,244 tax returns from approximately 1.1 million tax returns filed with an attached Form 2555/2555-EZ during Tax Years 2008 through 2010. These tax returns were selected as part of an IRS Compliance Initiative Program that focused specifically on Forms 2555/2555-EZ. Figure 4 provides a synopsis of the FEIE examination results for the compliance initiatives for Fiscal Years 2009 through 2011.

Figure 4: FEIE Examination Results (Fiscal Years 2009 Through 2011)

| Fiscal Year | 2009 | 2010 | 2011 | Totals | Average |
|--|-------------|-------------|-------------|---------------|----------------|
| Tax Returns Examined for FEIE Issues | 1,555 | 841 | 848 | 3,244 | |
| Recommended Examination Assessments Resulting From FEIE Issues (in Millions) | \$10.95 | \$5.32 | \$4.87 | \$21.14 | |
| Examiner Time (Hours) | 12,428 | 9,183 | 7,071 | 28,682 | |
| Dollars Per Hour | \$881 | \$579 | \$689 | | \$737 |
| Dollars Per Return ²¹ | \$7,041 | \$6,325 | \$5,743 | | \$6,516 |
| Hours Per Return | 8 | 11 | 8 | | 9 |
| No-Change Rate | 31% | 15% | 18% | | 23% |

Source: Our analysis of the Individual Return Transaction File for Processing Years 2008 through 2010 and the Audit Information Management System for tax return examinations closed in Fiscal Years 2009 through 2011.

We estimate that the risk of examiners not referring tax returns to international examiners for 410 tax returns on the Specialist Referral System is approximately \$2.7 million in annual tax assessments, or about \$13.5 million over five years. Additionally, examinations by the Wage and Investment Division that were not required to be referred due to current IRS policy might

²¹ The *Dollars Per Return* amounts were calculated using the actual *Recommended Examination Assessments Resulting From FEIE Issues* amounts, not the corresponding rounded amounts in the table.



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warrant referral to international examiners. If these 228 tax returns are referred, this could potentially result in approximately \$1.5 million in additional annual tax assessments, or about \$7.5 million over five years.²²

Recommendations

We recommended that the Commissioner, Large Business and International Division:

Recommendation 1: Coordinate with the Commissioner, Small Business/Self-Employed Division, to ensure that domestic examiners and their managers are aware of the international referral criteria of Internal Revenue Manual 4.60.6.2 and that a cross-reference to these criteria is incorporated into the Campus Reporting Compliance section of the Internal Revenue Manual.

Management's Response: The IRS agreed with this recommendation. The Small Business/Self-Employed Division Field Examination Policy function is in the process of making improvements to the examination lead sheets. Lead Sheet 110, *Audit Plan*, has been revised to include a hyperlink to the mandatory referral criteria to assist examiners in making the determination. Representatives from the Large Business and International Division and the Small Business/Self-Employed Division's Campus Reporting Compliance function will meet to evaluate the international referral criteria process and determine if it should be expanded to the Campus Reporting Compliance function.

However, the IRS disagreed with the outcome measures presented in this report and stated that without reviewing the actual physical case files reviewed by the Treasury Inspector General for Tax Administration, the IRS cannot conclude that all of the cases should have been referred to the international examiners. IRS management stated that while Internal Revenue Manual 4.60.6.2, Mandatory Referral Criteria, exists so that income tax returns open for examination with international issues can be inspected by an international specialist to ascertain if significant issues exist, the language refers to "generally" and a "preliminary review of returns with international features will be made to determine if the case should be referred." This language provides the examiner and manager the flexibility to make an appropriate business decision on when a referral is warranted. In addition, the IRS stated that our outcome measure calculation may not be accurate because it assumes that all tax returns referred to an international specialist would have similar results as tax returns audited under the IRS's Compliance Initiative Program.

Office of Audit Comment: While Internal Revenue Manual 4.60.6.2 does provide for a preliminary review of returns with international features, it also states that all returns with international features must be referred to an international examiner (the chart in section 4.60.6.2(3) specifically states that international features include all tax returns

²² See Appendix IV for a detailed explanation of these calculations.



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with a Form 2555/2555-EZ). Therefore, if a tax return is open for examination and includes the Form 2555/2555-EZ, it needs to be referred to an international specialist to determine whether a significant international issue exists. If the IRS has now decided to no longer require mandatory referrals of all returns with a Form 2555/2555-EZ, it will need to update this Internal Revenue Manual section to clearly explain that.

In addition, we obtained a computer extract to identify the tax returns with a Form 2555/2555-EZ that needed to be referred to an international examiner but did not review actual tax return cases. We then used the actual results of Form 2555/2555-EZ audits from the Compliance Initiative Program to calculate our outcome measures. While it is true that referrals of tax returns with the Form 2555/2555-EZ may have different audit results if worked through the specialist referral process rather than the Compliance Initiative Program, neither we nor the IRS knows what that difference would be. The Compliance Initiative Program results provide a good indication of likely audit results for the Form 2555/2555-EZ. As such, we believe the outcome measure projections accurately reflect the potential impact of our recommendations.

Recommendation 2: Coordinate with the Commissioner, Wage and Investment Division, to evaluate the international referral criteria process and determine if it should be expanded to the Wage and Investment Division.

Management's Response: The IRS agreed with this recommendation. Representatives from the Large Business and International Division and the Wage and Investment Division's Reporting Compliance function will meet to evaluate the international referral criteria process and determine if it should be expanded to the Wage and Investment Division.



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the Foreign Earned Income Exclusion Needs to Be Improved*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to provide an overview of tax returns claiming the FEIE¹ and the Foreign Housing Exclusion/Deduction. To accomplish our objective, we:

- I. Determined how the IRS provides compliance oversight of the FEIE and the Foreign Housing Exclusion/Deduction and their effect on tax administration.
 - A. Evaluated the Compliance Initiative Program Charters and selection criteria.
 - B. Evaluated the referral process of Forms 1040, *U.S. Individual Income Tax Return*, with a Form 2555/2555-EZ, *Foreign Earned Income/Foreign Earned Income Exclusion*, attached to international examiners through the Specialist Referral System.
 - C. Evaluated the workload results for tax compliance officer and tax examiner units working FEIE issues by comparing FEIE examination results with non-FEIE examination results.
- II. Determined the viability of the FEIE and the Foreign Housing Exclusion/Deduction in today's globalized economy.
 - A. Selected a statistically valid random variable sample of 150 tax returns from a population of 331,405 Tax Year 2009 individual income tax returns with an attached Form 2555/2555-EZ using an estimated standard deviation of \$5,338.² A random variable sample was selected to permit us to project an estimate of the amount of tax revenue. The sample results indicated an average dollar error rate of about \$1,696 or approximately \$562 million for the FEIE and about \$525 or approximately \$174 million for the Foreign Housing Exclusion/Deduction for a combined average dollar error rate of about \$2,221 or approximately \$736 million. We are 95 percent confident that the range is between \$210 and \$914 million for the FEIE and between \$64 and \$265 million for the Foreign Housing Exclusion/Deduction. The Treasury Inspector General for Tax Administration's contract statistician assisted with and reviewed our sampling plan and projections.
 - B. Determined the filing characteristics of individual income tax returns with a Form 2555/2555-EZ attached by analyzing the Individual Return Transaction File.

¹ See Appendix VII for a glossary of terms.

² This population of individual income tax returns with an attached Form 2555/2555-EZ included only Tax Year 2009 returns processed during Processing Year 2010 from taxpayers whose tax year ended on December 31.



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- C. Determined the potential tax burden in Tax Year 2012 of a single U.S. taxpayer making \$104,850 in earned income living and working in the United States (U.S. comparison), the Cayman Islands (no income tax country), and the United Kingdom (high income tax country).

Data validation methodology

Computer-processed data from the Individual Return Transaction File for Processing Years 2009 through 2011 maintained on the Treasury Inspector General for Tax Administration's Data Center Warehouse were compared and reconciled to data published in the Calendar Year 2010 and 2011 IRS Databooks and determined to be sufficiently reliable. Computer-processed data from the Audit Information Management System for Fiscal Years 2008 through 2011 maintained on the Data Center Warehouse were compared and reconciled to the IRS's Table 37 Examination Program Monitoring and determined to be sufficiently reliable.

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 the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for filing, referring, and examining tax returns with the FEIE. We evaluated these controls by reviewing source materials, interviewing management, analyzing and matching IRS data systems, reviewing examination case files, and reviewing taxpayer accounts.



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Appendix II

Major Contributors to This Report

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Kevin Nielsen, Auditor



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Appendix III

Report Distribution List

Acting Commissioner
Office of the Commissioner – Attn: Chief of Staff C
Office of the Deputy Commissioner for Services and Enforcement SE
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner (International) United States Competent Authority, Large Business and
International Division SE:LB:IN
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, International Individual Compliance, Large Business and International Division
SE:LB:IN
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Large Business and International Division SE:LB



Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$2.7 million in additional tax assessments for 410 tax returns as a result of improving referrals to international examiners for tax return examinations where Form 2555/2555-EZ, *Foreign Earned Income/Foreign Earned Income Exclusion*, is present, or \$13.5 million for 2,050 tax returns over five years (see page 8).

Methodology Used to Measure the Reported Benefit:

We found that 2,851 individual tax returns¹ with a Form 2555/2555-EZ from Fiscal Years² 2009 through 2011 were not properly referred to international examiners on the Specialist Referral System. To calculate the potential additional revenue that could have resulted from these missed referrals, we used the following calculation.

We divided the number of tax return referrals not made between Fiscal Years 2009 through 2011 by three to determine the average annualized referrals not made. As a result, on average, 950 tax returns (2,851 divided by three) requiring a referral were not made each year.

We then calculated the international examiner rejection rate. Of the 25 tax returns referred to international examiners from Fiscal Years 2009 through 2011, 14 tax returns³ were accepted. Therefore, international examiners have a 56 percent average acceptance rate (14 divided 25), or a 44 percent⁴ rejection rate. As a result, approximately 418 (950 times 44 percent) of the tax return referrals, if they were made, may be rejected, or 532 (950 less 418) of the referrals may be accepted.

Because not all tax returns examined result in a tax assessment, we calculated the international examiner no-change rate. Of the 3,244 tax returns filed with an attached Form 2555/2555-EZ

¹ Of the 2,851 individual tax returns, 44 were examined by the Large Business and International Division and 2,807 were examined by the Small Business/Self-Employed Division.

² See Appendix VII for a glossary of terms.

³ Of the 14 accepted tax returns, international examiners directly examined six returns and provided consultations on the remaining eight returns.

⁴ For the 44 percent rejection rate, 11 out of the 25 referred tax returns were rejected. *****1*****
*****1*****



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

examined by international examiners from Fiscal Years 2009 through 2011 as part of an IRS Compliance Initiative Program, 760 tax returns were closed as a no-change, or an average no-change rate of 23 percent (760 divided by 3,244). As a result, 122 cases (532 referrals accepted times 23 percent), if referred, may result in no change to the tax liability, or 410 referrals may result in additional assessments.

We then calculated the average dollars per return. The 3,244 examined tax returns with an attached Form 2555/2555-EZ had total assessments of \$21,137,491, or an average assessment of \$6,516 (\$21,137,491 divided by 3,244).⁵ As a result, approximately \$2.7 million (410 times \$6,516) in potential assessments were not made because domestic examiners did not refer these tax returns with an attached Form 2555/2555-EZ as required. We project that improving the Form 2555/2555-EZ referral process would increase revenue by approximately \$2.7 million a year, or about \$13.5 million over five years. However, the value of the outcome measure does not include amounts (revenue) that would partially offset this benefit as a result of directing examination resources away from other types of returns in order to pursue these referred ones.

Figure 1: Projections for Tax Return Referrals Not Made to International Examiners

| Description | Amount |
|---|-------------|
| Tax Return Referrals Not Made in Fiscal Years 2009 Through 2011 | 2,851 |
| Divided by: Number of Years in Analysis | 3 |
| Annualized Tax Return Referrals Not Made | 950 |
| Less: Tax Return Referrals That Could Be Expected to Be Rejected by International (44 percent Referral Rejection Rate × 950 Annualized Referrals Not Made) | (418) |
| Tax Return Referrals That Could Be Expected to Be Accepted by International | 532 |
| Less: Expected No-Change Tax Return Examinations (23 percent Average No-Change Rate × 532 Accepted Referrals) | (122) |
| Expected Tax Return Referrals With Assessments | 410 |
| Multiplied by: Average Dollars per Tax Return | \$6,516 |
| Expected Annual Increased Revenue (Rounded) | \$2,700,000 |

Source: Calculations based on Compliance Initiative Program audit results and to determine the dollar impact due to tax return referrals not being made to international examiners.

⁵ This calculation assumes that the tax returns referred will have similar results as the IRS's Compliance Initiative Program that focuses on Forms 2555/2555-EZ. However, the tax returns referred may not have similar results.



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$1.5 million in additional tax assessments for 228 tax returns as a result of expanding the referral requirement to the Wage and Investment Division for tax return examinations where a Form 2555/2555-EZ is present, or about \$7.5 million for 1,140 tax returns over five years (see page 8).

Methodology Used to Measure the Reported Benefit:

We identified 1,583 individual tax returns with a Form 2555/2555-EZ from Fiscal Years 2009 through 2011 that were not subject to the referral process because current IRS guidelines do not include the Wage and Investment Division. This referral process should be reconsidered to include the Wage and Investment Division. To calculate the potential additional revenue that could have resulted from these tax return referrals, we used the following calculation.

We divided the number of tax return referrals not made by the Wage and Investment Division between Fiscal Years 2009 through 2011 by three to determine the average annualized referrals not made. As a result, on average, 528 (1,583 divided by three) tax return referrals were not made each year.

We then calculated the international examiner rejection rate. Of the 25 tax returns referred to international examiners from Fiscal Years 2009 through 2011, 14 tax returns⁶ were accepted. Therefore, international examiners have a 56 percent average acceptance rate (14 divided 25), or a 44 percent⁷ rejection rate. As a result, approximately 232 (528 times 44 percent) of the tax return referrals, if they were made, may have been rejected, or 296 (528 less 232) referrals may have been accepted.

Because not all tax returns examined result in a tax assessment, we calculated the international examiner no-change rate. Of the 3,244 tax returns filed with an attached Form 2555/2555-EZ examined by international examiners from Fiscal Years 2009 through 2011 as part of an IRS Compliance Initiative Program, 760 returns were closed as a no-change, or an average no-change rate of 23 percent (760 divided by 3,244). As a result, 68 cases (296 referrals accepted times 23 percent), if referred, may result in no change to the tax liability, or 228 referrals may result in additional assessments.

We then calculated the average dollars per return. The 3,244 examined tax returns with an attached Form 2555/2555-EZ had total assessments of \$21,137,491, or an average assessment of

⁶ Of the 14 accepted tax returns, international examiners directly examined six returns and provided consultations on the remaining eight returns.

⁷ For the 44 percent rejection rate, 11 out of the 25 referred tax returns were rejected. *****1*****
*****1*****



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

about \$6,516 (\$21,137,491 divided by 3,244).⁸ As a result, approximately \$1.5 million (228 times \$6,516) in assessments were not made because the Wage and Investment Division policy did not require these tax returns to be referred to international examiners. If these tax returns were referred, we project that the Form 2555/2555-EZ referral process would increase revenue by approximately \$1.5 million a year, or \$7.5 million over five years. However, the value of the outcome measure does not include amounts (revenue) that would partially offset this benefit as a result of directing examination resources away from other types of tax returns in order to pursue these referred ones.

Figure 2: Projections for International Examiner Referral Requirement If Expanded to the Wage and Investment Division

| Description | Amount |
|---|-------------|
| Tax Return Referrals Not Made in Fiscal Years 2009 Through 2011 | 1,583 |
| Divided by: Number of Years in Analysis | 3 |
| Annualized Tax Return Referrals Not Made | 528 |
| Less: Tax Return Referrals That Could Be Expected to Be Rejected by International (44 percent Referral Rejection Rate × 528 Annualized Referrals Not Made) | (232) |
| Tax Return Referrals That Could Be Expected to Be Accepted by International | 296 |
| Less: Expected No-Change Tax Return Examinations (23 percent Average No-Change Rate × 296 Accepted Referrals) | (68) |
| Expected Tax Return Referrals With Assessments | 228 |
| Multiplied by: Average Dollars per Tax Return | \$6,516 |
| Expected Annual Increased Revenue (Rounded) | \$1,500,000 |

Source: Calculations based on Compliance Initiative Program audit results and to determine the dollar impact due to tax return referrals not being made to international examiners.

⁸ This calculation assumes that the tax returns referred will have similar results as the IRS's Compliance Initiative Program that focuses on Forms 2555/2555-EZ. However, the tax returns referred may not have similar results.



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

Appendix V

Form 2555, Foreign Earned Income

Form 2555 Foreign Earned Income 2012 Attachment Sequence No. 34

Name shown on Form 1040 Your social security number

Part I General Information

1 Your foreign address (including country) 2 Your occupation 3 Employer's name 4a Employer's U.S. address 4b Employer's foreign address 5 Employer is (check) a A foreign entity b A U.S. company c Self d A foreign affiliate of a U.S. company e Other (specify) 6a If you previously filed Form 2555 or Form 2555-EZ, enter the last year you filed the form. 6b If you did not previously file Form 2555 or 2555-EZ to claim either of the exclusions, check here and go to line 7. 6c Have you ever revoked either of the exclusions? 6d If you answered "Yes," enter the type of exclusion and the tax year for which the revocation was effective. 7 Of what country are you a citizen/national? 8a Did you maintain a separate foreign residence for your family because of adverse living conditions at your tax home? 8b If "Yes," enter city and country of the separate foreign residence. Also, enter the number of days during your tax year that you maintained a second household at that address. 9 List your tax home(s) during your tax year and date(s) established.

Next, complete either Part II or Part III. If an item does not apply, enter "NA." If you do not give the information asked for, any exclusion or deduction you claim may be disallowed.

Part II Taxpayers Qualifying Under Bona Fide Residence Test (see instructions)

10 Date bona fide residence began and ended 11 Kind of living quarters in foreign country a Purchased house b Rented house or apartment c Rented room d Quarters furnished by employer 12a Did any of your family live with you abroad during any part of the tax year? 12b If "Yes," who and for what period? 13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you are not a resident of that country? 13b Are you required to pay income tax to the country where you claim bona fide residence? 14 If you were present in the United States or its possessions during the tax year, complete columns (a)-(d) below. Do not include the income from column (d) in Part IV, but report it on Form 1040.

Table with 8 columns: (a) Date arrived in U.S., (b) Date left U.S., (c) Number of days in U.S. on business, (d) Income earned in U.S. on business (attach computation), (a) Date arrived in U.S., (b) Date left U.S., (c) Number of days in U.S. on business, (d) Income earned in U.S. on business (attach computation)

15a List any contractual terms or other conditions relating to the length of your employment abroad. 15b Enter the type of visa under which you entered the foreign country. 15c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation. 15d Did you maintain a home in the United States while living abroad? 15e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you.



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

Part III Taxpayers Qualifying Under Physical Presence Test (see instructions)

- 16 The physical presence test is based on the 12-month period from through
- 17 Enter your principal country of employment during your tax year.
- 18 If you traveled abroad during the 12-month period entered on line 16, complete columns (a)–(f) below. Exclude travel between foreign countries that did not involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter “Physically present in a foreign country or countries for the entire 12-month period.” **Do not** include the income from column (f) below in Part IV, but report it on Form 1040.

| (a) Name of country (including U.S.) | (b) Date arrived | (c) Date left | (d) Full days present in country | (e) Number of days in U.S. on business | (f) Income earned in U.S. on business (attach computation) |
|--------------------------------------|------------------|---------------|----------------------------------|--|--|
| | | | | | |
| | | | | | |
| | | | | | |

Part IV All Taxpayers

Note: Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2012 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions. **Do not** include income from line 14, column (d), or line 18, column (f). Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.

If you are a cash basis taxpayer, report on Form 1040 all income you received in 2012, no matter when you performed the service.

| 2012 Foreign Earned Income | | Amount (in U.S. dollars) | |
|----------------------------|---|--------------------------|--|
| 19 | Total wages, salaries, bonuses, commissions, etc. | 19 | |
| 20 | Allowable share of income for personal services performed (see instructions): | | |
| a | In a business (including farming) or profession | 20a | |
| b | In a partnership. List partnership's name and address and type of income. <input type="text"/> | 20b | |
| 21 | Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined): | | |
| a | Home (lodging) | 21a | |
| b | Meals | 21b | |
| c | Car | 21c | |
| d | Other property or facilities. List type and amount. <input type="text"/> | 21d | |
| 22 | Allowances, reimbursements, or expenses paid on your behalf for services you performed: | | |
| a | Cost of living and overseas differential | 22a | |
| b | Family | 22b | |
| c | Education | 22c | |
| d | Home leave | 22d | |
| e | Quarters | 22e | |
| f | For any other purpose. List type and amount. <input type="text"/> | 22f | |
| g | Add lines 22a through 22f | 22g | |
| 23 | Other foreign earned income. List type and amount. <input type="text"/> | 23 | |
| 24 | Add lines 19 through 21d, line 22g, and line 23 | 24 | |
| 25 | Total amount of meals and lodging included on line 24 that is excludable (see instructions) | 25 | |
| 26 | Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your 2012 foreign earned income <input type="text"/> | 26 | |



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

Form 2555 (2012)

Page 3

Part V All Taxpayers

| | | | | |
|----|--|----|--|--|
| 27 | Enter the amount from line 26 | 27 | | |
| | Are you claiming the housing exclusion or housing deduction? | | | |
| | <input type="checkbox"/> Yes. Complete Part VI. | | | |
| | <input type="checkbox"/> No. Go to Part VII. | | | |

Part VI Taxpayers Claiming the Housing Exclusion and/or Deduction

| | | | | |
|-----|--|-----|--|------|
| 28 | Qualified housing expenses for the tax year (see instructions) | 28 | | |
| 29a | Enter location where housing expenses incurred (see instructions) ▶ | | | |
| b | Enter limit on housing expenses (see instructions) | 29b | | |
| 30 | Enter the smaller of line 28 or line 29b | 30 | | |
| 31 | Number of days in your qualifying period that fall within your 2012 tax year (see instructions) | 31 | | days |
| 32 | Multiply \$41.57 by the number of days on line 31. If 366 is entered on line 31, enter \$15,216.00 here | 32 | | |
| 33 | Subtract line 32 from line 30. If the result is zero or less, do not complete the rest of this part or any of Part IX | 33 | | |
| 34 | Enter employer-provided amounts (see instructions) | 34 | | |
| 35 | Divide line 34 by line 27. Enter the result as a decimal (rounded to at least three places), but do not enter more than "1.000" | 35 | | × . |
| 36 | Housing exclusion. Multiply line 33 by line 35. Enter the result but do not enter more than the amount on line 34. Also, complete Part VIII | 36 | | |

Note: The housing deduction is figured in Part IX. If you choose to claim the foreign earned income exclusion, complete Parts VII and VIII before Part IX.

Part VII Taxpayers Claiming the Foreign Earned Income Exclusion

| | | | | |
|----|---|----|----------|------|
| 37 | Maximum foreign earned income exclusion | 37 | \$95,100 | 00 |
| 38 | • If you completed Part VI, enter the number from line 31. • All others, enter the number of days in your qualifying period that fall within your 2012 tax year (see the instructions for line 31). | 38 | | days |
| 39 | • If line 38 and the number of days in your 2012 tax year (usually 366) are the same, enter "1.000." • Otherwise, divide line 38 by the number of days in your 2012 tax year and enter the result as a decimal (rounded to at least three places). | 39 | | × . |
| 40 | Multiply line 37 by line 39 | 40 | | |
| 41 | Subtract line 36 from line 27 | 41 | | |
| 42 | Foreign earned income exclusion. Enter the smaller of line 40 or line 41. Also, complete Part VIII ▶ | 42 | | |

Part VIII Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both

| | | | | |
|----|---|----|--|--|
| 43 | Add lines 36 and 42 | 43 | | |
| 44 | Deductions allowed in figuring your adjusted gross income (Form 1040, line 37) that are allocable to the excluded income. See instructions and attach computation | 44 | | |
| 45 | Subtract line 44 from line 43. Enter the result here and in parentheses on Form 1040, line 21. Next to the amount enter "Form 2555." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 | 45 | | |

Part IX Taxpayers Claiming the Housing Deduction—Complete this part only if (a) line 33 is more than line 36 and (b) line 27 is more than line 43.

| | | | | |
|----|---|----|--|--|
| 46 | Subtract line 36 from line 33 | 46 | | |
| 47 | Subtract line 43 from line 27 | 47 | | |
| 48 | Enter the smaller of line 46 or line 47 | 48 | | |
| | Note: If line 47 is more than line 48 and you could not deduct all of your 2011 housing deduction because of the 2011 limit, use the housing deduction carryover worksheet in the instructions to figure the amount to enter on line 49. Otherwise, go to line 50. | | | |
| 49 | Housing deduction carryover from 2011 (from housing deduction carryover worksheet in the instructions) | 49 | | |
| 50 | Housing deduction. Add lines 48 and 49. Enter the total here and on Form 1040 to the left of line 36. Next to the amount on Form 1040, enter "Form 2555." Add it to the total adjustments reported on that line | 50 | | |

Form 2555 (2012)

Source: IRS.gov, Form 2555 for Tax Year 2012.



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

Appendix VI

Characteristics of Tax Year 2009 Individual Income Tax Returns Filed With a Form 2555/2555-EZ

| | Adjusted Gross Income Levels | | | Population |
|---|------------------------------|------------------------|----------------|---------------------|
| | \$0 to \$100,000 | \$100,001 to \$500,000 | >\$500,000 | Totals and Averages |
| Number of Tax Returns Population¹ | 298,358 | 61,552 | 12,209 | 372,119 |
| Total Income | \$3.7 billion | \$13.2 billion | \$17.1 billion | \$34.0 billion |
| Average Total Income ² | \$12,548 | \$214,388 | \$1,401,708 | \$91,511 |
| Total Taxable Income | \$3.0 billion | \$11.1 billion | \$16.0 billion | \$30.0 billion |
| Number of Tax Returns | 107,117 | 61,472 | 12,206 | 180,795 |
| Average Taxable Income | \$27,886 | \$180,579 | \$1,312,726 | \$166,546 |
| Total Tax | \$0.6 billion | \$1.6 billion | \$2.1 billion | \$4.3 billion |
| Number of Tax Returns | 110,117 | 54,619 | 11,236 | 175,972 |
| Average Total Tax | \$5,524 | \$28,950 | \$188,164 | \$24,457 |
| Total FEIE | \$17.3 billion | \$4.9 billion | \$1.1 billion | \$23.3 billion |
| Number of Tax Returns | 294,775 | 60,927 | 12,010 | 367,712 |
| Average FEIE | \$58,742 | \$80,693 | \$88,213 | \$63,342 |
| Total Foreign Tax Credit | \$0.2 billion | \$1.7 billion | \$3.1 billion | \$5.0 billion |
| Number of Tax Returns | 37,803 | 43,384 | 11,605 | 92,792 |
| Average Foreign Tax Credit | \$5,419 | \$38,803 | \$265,707 | \$53,580 |
| Total Foreign Housing Exclusion | \$0.4 billion | \$1.9 billion | \$0.3 billion | \$2.7 billion |
| Number of Tax Returns | 27,364 | 27,601 | 7,683 | 62,648 |
| Average Foreign Housing Exclusion | \$15,776 | \$69,735 | \$41,376 | \$42,689 |
| Total Foreign Housing Deduction | \$40.1 million | \$23.4 million | \$39.1 million | \$102.6 million |
| Number of Tax Returns | 2,675 | 1,127 | 846 | 4,648 |
| Average Foreign Housing Deduction | \$14,994 | \$20,771 | \$46,200 | \$22,075 |

Source: Our analysis of the Individual Return Transaction File for Processing Years 2010 and 2011 for Tax Year 2009 individual income tax returns with Forms 2555/2555-EZ attached.

¹ The 372,119 Tax Year 2009 individual income tax returns with an attached Form 2555/2555-EZ were filed during Processing Years 2010 and 2011. Those tax returns include taxpayers that claimed the FEIE and/or the Foreign Housing Exclusion/Deduction. Some taxpayers claimed the FEIE but not the Foreign Housing Exclusion/Deduction. Others claimed only the Foreign Housing Exclusion/Deduction. Still others claimed both.

² All averages in this table were calculated using the actual dollar amounts, not the rounded amounts reported in the table.



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

Appendix VII

Glossary of Terms

| Term | Definition |
|--|--|
| Adjusted Gross Income | As defined by Section 62 of the Internal Revenue Code, in the case of an individual, means gross income minus deductions allowed by this chapter. |
| Audit Information Management System | A computer system used by the IRS Examination functions to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data. |
| Calendar Year | A 12-consecutive-month period ending on December 31. |
| Double Taxation | The levying of tax by two or more jurisdictions on the same declared income. This is often mitigated by tax treaties between countries. |
| Examination No-Change | An examination that does not necessitate the issuance of an audit report other than a no-change report, such as a tax return where there were no adjustments or changes in tax liability for the return, including tax, penalties, or refundable credits. |
| Fiscal Year | A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30. |
| Foreign Earned Income Exclusion | Allows taxpayers to exclude some or all of their income, up to \$95,100 for Tax Year 2012 (\$190,200 for married taxpayers filing jointly), earned in a foreign country during a period in which their "tax home" is in a foreign country and they meet other qualifications (either the bona fide residence test or the physical presence test). This exclusion is provided under Section 911 of the Internal Revenue Code. |
| Foreign Tax Credit | An individual may qualify to claim a foreign tax credit if the tax is imposed on a paid or accrued income tax to a foreign country or U.S. possession. |
| Individual Return Transaction File | Data transcribed from initial input of the original individual income tax returns during return processing. |



The Referral Process for Examinations of Tax Returns Claiming the Foreign Earned Income Exclusion Needs to Be Improved

| Term | Definition |
|-----------------------------------|---|
| Internal Revenue Manual | Contains the policies, procedures, instructions, guidelines, and delegations of authority which direct the operation for all divisions and functions of the IRS. Topics include tax administration, personnel and office management, and others. |
| Processing Year | The year in which tax returns and other tax data are processed. |
| Resident Alien | An individual who is not a U.S. citizen who meets either the “green card” test of holding an immigrant visa or the physical presence of being in the United States for at least 31 days during the current calendar year and a total of 183 days during the three-year period that includes the current year and the two preceding years. |
| Specialist Referral System | The Specialist Referral System automates the referral request process and must be used for referrals, questions, and requests for assistance from specialist groups. |
| Tax Year | The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year. |
| Taxable Income | As defined by Section 63 of the Internal Revenue Code means gross income minus deductions allowed by this chapter. |
| Total Income | Total Income is synonymous with the term gross income which as defined by Section 61 of the Internal Revenue Code means all income from whatever source derived including, but not limited to, compensation for services, gross income derived from business, gains derived from dealings in property, and interest. It also factors in business losses, capital losses, farm losses, <i>etc.</i> |



*The Referral Process for Examinations of Tax Returns Claiming
the Foreign Earned Income Exclusion Needs to Be Improved*

Appendix VIII

Management's Response to the Draft Report



LARGE BUSINESS AND
INTERNATIONAL DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

August 20, 2013

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Paul D. DeNard 
Acting Commissioner, Large Business and International Division

SUBJECT: Draft Report #201130050, The Referral Process for
Examinations of Tax Returns Claiming the Foreign Earned
Income Exclusion Needs to Be Improved

Thank you for sharing the subject draft report for our review and comments. The LB&I Division agrees that improvements are needed to the referral process for examinations of tax returns claiming the Foreign Earned Income and/or Foreign Housing exclusions to help ensure compliance with existing international referral procedures.

We agree with the two audit recommendations in your report. We will incorporate them in our current review of our international referral program and will coordinate with the Small Business/Self Employed (SB/SE) and Wage and Investment (W&I) Divisions to address the recommendations.

As indicated in the TIGTA report, the Foreign Earned Income Exclusion (FEIE) allows U.S. taxpayers residing in a foreign country to exclude a specific amount of qualifying foreign earned income from their U.S. taxable income, thus reducing their overall U.S. income tax liability. To qualify for the FEIE, the U.S. citizen or resident alien must be a bona fide resident of a foreign country or present in a foreign country for at least 330 days over a 12-month period.

While Internal Revenue Manual (IRM) 4.60.6.2, *Mandatory Referral Criteria*, exists so that income tax returns open for examination with international issues can be inspected by an international specialist to ascertain if significant international issues exist, the language refers to "generally" and a "preliminary review of returns with international features will be made to determine if the case should be referred." This language provides the examiner and manager the flexibility to make an appropriate business decision on when a referral is warranted. Without reviewing the actual physical case files reviewed by your office, we cannot conclude that all of the cases reviewed "should have been referred to international."



*The Referral Process for Examinations of Tax Returns Claiming
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Also, as your report notes, the measurable benefits described in Appendix IV of the report may not be accurate. The report projects that approximately \$2.7 million in potential assessments (410 times \$6,516) were not made because domestic examiners did not refer tax returns with an attached Form 2555/2555-EZ. This calculation assumes that all tax returns referred to international would have similar results as the returns audited under the IRS's Compliance Initiative Program that focuses on Forms 2555/2555-EZ. Since the returns selected under the Compliance Initiative Program were pre-screened for a high potential for adjustments, projecting the results of such program examinations to all other tax returns with Forms 2555/2555-EZ may not be accurate. Using the results of the examined tax returns in the Compliance Initiative Program to project \$2.7 million in potential assessments may overstate the potential tax assessments. Similarly, assuming the same no-change and average adjustment rates as the Compliance Initiative results also may lead to inaccuracy.

Attached is a detailed response outlining the corrective actions the IRS will take to address your recommendations. If you have any questions, please contact David W. Horton, Director, International Individual Compliance, at (630) 493-5937.

Attachment



*The Referral Process for Examinations of Tax Returns Claiming
the Foreign Earned Income Exclusion Needs to Be Improved*

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Attachment

The Commissioner, Large Business and International (LB&I) Division should:

RECOMMENDATION 1:

Coordinate with the Commissioner, Small Business/Self-Employed (SB/SE) Division to ensure that domestic examiners and their managers are aware of the international referral criteria of Internal Revenue Manual 4.60.6.2 and that a cross reference to these criteria is incorporated into the Campus Reporting Compliance section of the Internal Revenue Manual.

CORRECTIVE ACTIONS:

1. SB/SE Field Exam Policy is in the process of making improvements to the exam lead sheets. Lead Sheet 110, Audit Plan, has been revised to include a hyperlink to the mandatory referral criteria to assist examiners in making the determination.
2. Representatives from LB&I: International and SB/SE, Campus Reporting Compliance, will meet to evaluate the international referral criteria process and determine if it should be expanded to Campus Reporting Compliance.

IMPLEMENTATION DATE:

1. June 30, 2014
2. August 31, 2014

RESPONSIBLE OFFICIAL(S):

1. Director, Exam Policy, SB/SE Division (SE:S:E:EP)
2. Director, International Individual Compliance (SE:LB:IN:IIC)
Director, Campus Reporting Compliance, SB/SE Division (SE:S:CCS:CRC)

CORRECTIVE ACTION(S) MONITORING PLAN:

The Internal Control Coordinator will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.



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RECOMMENDATION 2:

Coordinate with the Commissioner, Wage and Investment (W&I) Division to evaluate the international referral criteria process and determine if it should be expanded to the Wage and Investment Division.

CORRECTIVE ACTIONS:

Representatives from LB&I: International and W&I, Reporting Compliance, will meet to evaluate the international referral criteria process and determine if it should be expanded to the Wage and Investment Division.

IMPLEMENTATION DATE:

Estimated completion: August 31, 2014

RESPONSIBLE OFFICIAL(S):

Director, International Individual Compliance (SE:LB:IN:IIC)
Director, Reporting Compliance (SE:W:CP:RC)

CORRECTIVE ACTION(S) MONITORING PLAN:

The Internal Control Coordinator will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.