Treasury Inspector General
for Tax Administration
Office of Audit

IMPROVEMENT IS NEEDED IN COMPLIANCE EFFORTS TO IDENTIFY UNSUPPORTED CLAIMS FOR FOREIGN TAX CREDITS

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Highlights

Highlights of Report Number: 2015-30-052 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

IMPACT ON TAXPAYERS

The United States generally taxes U.S. citizens and resident aliens on their worldwide income and foreign persons on their U.S. source income. The Foreign Tax Credit (FTC) is intended to reduce the double taxation burden that would otherwise occur when foreign source income is taxed by both the United States and the foreign country from which the income is derived. The FTC can significantly affect the amount of taxes paid by individuals on U.S. tax returns. In Tax Year 2013, taxpayers claimed more than $16.7 billion in FTCs.

WHY TIGTA DID THE AUDIT

Due to its complexity and a lack of third-party reporting information, there is a risk of some taxpayers claiming an incorrect FTC amount. This audit was initiated to determine whether IRS controls ensure that the FTC is accurately claimed on a tax return when foreign government taxes are used to offset Federal taxes.

WHAT TIGTA FOUND

The IRS does not have sufficient controls and processes in place to identify erroneous FTC claims. TIGTA's analysis of paper and electronically filed individual tax returns for Tax Years 2010 through 2012 identified that the IRS potentially:

- Allowed $94.9 million in FTCs on 65,499 tax returns improperly.
- Allowed taxpayers to file 16,058 tax returns that claimed nearly $2.9 million in FTCs as a deduction, as well as a credit on the same foreign taxes paid.
- Allowed nearly $40 million in erroneous FTCs on 188,102 tax returns when third-party information return documents did not support the FTCs claimed.
- Incorrectly transcribed the FTC on 4,806 taxpayer accounts.

Further analysis of those tax returns with improperly allowed FTCs determined that 197,263 (73 percent) were prepared by paid tax preparers, with exceptions totaling approximately $98.2 million. In addition, the IRS did not refer 1,161 Examination cases that potentially met mandatory FTC referral criteria to international examination specialists. The IRS also does not monitor or track assessments made on FTC cases.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) establish controls to ensure that the Form 1116, *Foreign Tax Credit*, is attached when required; 2) ensure that any training materials and additional guidance related to FTCs are updated, and that employees comply with the updated guidance; 3) develop a compliance strategy to address the risks identified with taxpayer FTC issues; 4) capture and maintain key FTC statistics; 5) improve education, outreach, and enforcement activities to correct the paid preparer issues related to the FTC; and 6) revise the Internal Revenue Manual and the Specialist Referral System User Guide to clearly define the referral criteria that will be followed to ensure that tax returns in the Examination function inventory with FTCs are referred as required.

IRS officials agreed with five of TIGTA's recommendations and have taken or plan to take corrective actions. In addition, the IRS partially agreed with the remaining recommendation to identify and track key FTC statistics. The IRS has implemented a system to assist in identifying potential noncompliance and trends involving international issues, including the FTC. However, further enhancements to gather statistics are not possible due to current budget and resource restrictions.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

http://www.treas.gov/tigta/auditreports/2015reports/201530052fr.pdf.