



Treasury Inspector General for Tax Administration Office of Audit

IMPROVEMENTS ARE NEEDED TO REDUCE ERRONEOUS FOREIGN EARNED INCOME EXCLUSION CLAIMS

Issued on August 16, 2010

Highlights

Highlights of Report Number: 2010-40-091 to the Internal Revenue Service Commissioner for the Large and Mid-Size Business Division and the Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

Taxpayers excluded \$19.2 billion in foreign earned income on Tax Year 2008 tax returns. Our review identified 23,334 Tax Year 2008 tax returns with erroneous foreign earned income tax exclusions totaling \$675 million with an estimated revenue loss totaling \$90 million. Over five years, TIGTA estimates erroneous claims could result in total revenue losses of \$450 million.

WHY TIGTA DID THE AUDIT

This audit was initiated to assess the IRS's process to ensure the accuracy of foreign earned income tax exclusions. If an individual is a United States (U.S.) citizen or resident alien, his or her worldwide income generally is subject to U.S. income tax, regardless of where the individual lives. The individual is subject to the same income tax filing requirements that apply to U.S. citizens or resident aliens living in the U.S. However, if an individual meets certain requirements while living abroad, the individual may exclude up to \$91,500 of foreign earned income (Tax Year 2010).

WHAT TIGTA FOUND

Using information on the completed Foreign Earned Income (Form 2555), TIGTA reviewed 231,277 Tax Year 2008 tax returns with claims for foreign earned income tax exclusions and identified that some individuals incorrectly calculated the exclusion or did not qualify for the exclusion.

- 17,787 (eight percent) individuals overstated their foreign earned income exclusion by \$410 million.
- 5,547 (two percent) tax returns with \$265 million in exclusions had incomplete information or inaccuracies on the Forms 2555.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Large and Mid-Size Business Division, review the tax returns of those individuals TIGTA identified as incorrectly claiming the foreign earned income exclusion; establish a unit to address taxpayers identified as erroneously claiming the foreign earned income exclusion; and assess whether compliance project criteria can be used to identify erroneous claims during tax return processing.

In addition, TIGTA recommended that the Commissioner, Wage and Investment Division, include programming to forward tax returns (both electronically filed and paper) to the Error Resolution System for correction for individuals who incorrectly compute their foreign earned income exclusion.

IRS management agreed with four of the seven recommendations. Management stated that substantial barriers prevent the implementation of the remaining three recommendations at this time. TIGTA is concerned that the lack of corrective action will allow continued revenue loss as noted in our report.

READ THE FULL REPORT

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

<http://www.treas.gov/tigta/auditreports/2010reports/201040091fr.pdf>.