



*Improvements Are Needed to
Reduce Erroneous Foreign
Earned Income Exclusion Claims*

August 16, 2010

Reference Number: 2010-40-091

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

2(f) = Risk Circumvention of Agency Regulation or Statute (whichever is applicable)

Phone Number | 202-622-6500

Email Address | inquiries@tigta.treas.gov

Web Site | <http://www.tigta.gov>



HIGHLIGHTS

IMPROVEMENTS ARE NEEDED TO REDUCE ERRONEOUS FOREIGN EARNED INCOME EXCLUSION CLAIMS

Highlights

Final Report issued on August 16, 2010

Highlights of Reference 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 5 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' 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 (8 percent) individuals overstated their foreign earned income exclusion by \$410 million.
- 5,547 (2 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.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 16, 2010

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips

Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Improvements Are Needed to Reduce Erroneous
Foreign Earned Income Exclusion Claims (Audit # 200940043)

This report presents the results of our review to assess the Internal Revenue Service's process to ensure the accuracy of foreign earned income tax exclusions. This audit is included in our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenges of Erroneous and Improper Payments and Credits and Implementing Tax Law Changes.

Management's complete response to the draft report is included in Appendix VII.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



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Abbreviations

<i>e-file(d); e-filing</i>	Electronically file(d); electronic filing
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
LMSB Division	Large and Mid-Size Business Division
U.S.	United States



Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims

Background

If an individual is a United States (U.S.) citizen or resident alien,¹ the individual's 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 qualify to treat up to \$91,500 of foreign earned income² (Tax Year 2010), not including the housing exclusion and housing deduction, as not taxable by the U.S. This is called the foreign earned income exclusion.

In Calendar Year 2010, U.S. taxpayers living abroad can exclude up to \$91,500 of foreign earned income, not including the housing exclusion and housing deduction, from taxable income.

Internal Revenue Code (I.R.C.) Section (§) 911(d)(1)(A) outlines qualifications that must be met for U.S. citizens or resident aliens to claim the foreign earned income exclusion. To qualify for the foreign earned income exclusion, the taxpayer must have foreign earned income and the taxpayer's tax home must be in a foreign country.³ To claim the exclusion, the taxpayer is required to attach a completed Foreign Earned Income (Form 2555)⁴ to his or her U.S. Individual Income Tax Return (Form 1040). The tax returns, whether paper or electronically filed (*e-filed*), are considered International tax returns and are all processed at the Austin Submission Processing Site.⁵ Figure 1 shows the number of tax returns filed with a Form 2555 during Processing Years⁶ 2007 through 2009 and the total foreign earned income that was excluded.

¹ A resident alien is someone who is not a U.S. citizen who meets either the green card test of holding an immigrant visa or the physical presence test of being in the U.S. for at least 31 days during the current calendar year and 183 days during the 3 years that includes the current calendar year and the 2 preceding years.

² Earned income includes all the taxable income and wages you get from working.

³ A tax home is the area of a person's main place of business, employment, or post of duty, regardless of where the person maintains his or her family home.

⁴ See Appendix VI for an example of a Form 2555.

⁵ The Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

⁶ A processing year is the calendar year in which the tax return was processed by the Internal Revenue Service.



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Figure 1: Total Returns and Exclusion Amounts

Processing Year	Number of Tax Returns	Total Amount of Exclusion
2007	271,926	\$15.3 billion
2008	291,724	\$17.3 billion
2009	317,778	\$19.2 billion
Totals	881,428	\$51.8 billion

Source: Our analysis of Forms 1040 and 2555.

Approximately 73 percent (646,423 of 881,428) of the tax returns claiming the foreign earned income exclusion are filed on paper; the remaining tax returns are *e-filed*. Figure 2 provides totals by filing type of tax return for Processing Years 2007 through 2009.

Figure 2: Type of Tax Return Filed

Source	Processing Year			Total
	2007	2008	2009	
<i>E-filed</i>	60,384	76,761	97,860	235,005
Paper	211,542	214,963	219,918	646,423

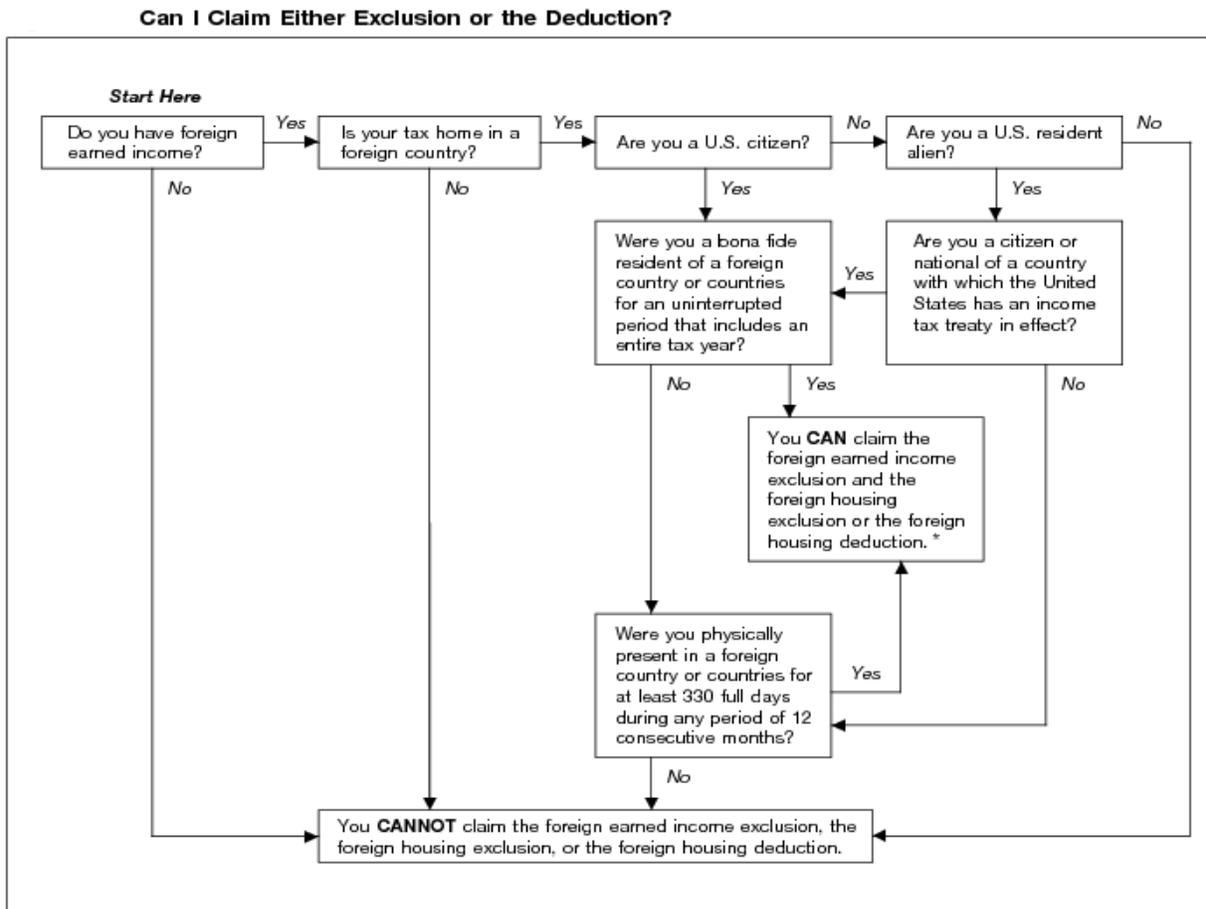
Source: Our analysis of Forms 1040 and 2555.

Figure 3 is an excerpt from the *Tax Guide for U.S. Citizens and Resident Aliens Abroad* (Publication 54) to assist individuals in determining whether they are eligible to claim the foreign earned income exclusion.



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Figure 3: Excerpt From Internal Revenue Service (IRS) Publication 54



* Foreign housing exclusion applies only to employees. Foreign housing deduction applies only to the self-employed.

Source: IRS Publication 54.

The IRS launched a new initiative to focus on international tax issues

Earlier in Calendar Year 2009, the President expressed an urgent need to increase focus on international tax administration. In response, the Large and Mid-Size Business (LMSB) Division launched a new initiative in October 2009 called “Large Business and International Expansion.” The IRS noted that this new initiative will significantly increase the IRS’ focus on international tax administration. The IRS determined that much more attention needed to be placed on the increasing levels of compliance risk among global entities, such as multinational corporations, high-wealth individuals, and U.S. citizens living outside the U.S.

The new initiative will ultimately integrate all of the IRS’ offshore and international compliance units under one organization, to be centralized in the LMSB Division. The IRS submitted a request for \$121 million and 781 positions to support the President’s priority of focusing on



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international tax administration. This will provide the IRS with the tools necessary to reduce international tax evasion and abuse. The LMSB Division established a team to oversee the transition of the IRS' international programs.

This review was performed at the IRS National Headquarters and the LMSB Division's International organization in Washington, D.C., and at the Wage and Investment Division's Austin Submission Processing Site in Austin, Texas, during the period October 2009 through May 2010. 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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Results of Review

***Improvements Are Needed to Reduce Erroneous Foreign Earned
Income Tax Exclusion Claims***

The IRS has developed processes in an attempt to identify erroneous foreign earned income tax exclusions. These include:

- ***Filters for e-filed tax returns with Forms 2555.*** Prior to IRS acceptance, *e-filed* tax returns go through 22 validity checks⁷ relating to the Forms 2555. These validity checks ensure, among other things, the completeness of the Forms 2555 (i.e., that entries are included in all required fields). For Tax Year 2008, the IRS rejected 14,531 tax returns as a result of errors with the Forms 2555.
- ***Processes to review paper-filed tax returns with Forms 2555.*** Paper-filed tax returns are perfected by tax examiners in the Code and Edit function. Similar to the *e-file* filters, this process is designed to ensure the information on the paper tax return and Form 2555 is complete. Depending on the nature of the errors identified, the IRS may correspond with the taxpayer. For example, the IRS may send notices to the taxpayers advising that their foreign earned income exclusion claims were disallowed because they did not qualify as a bona fide resident of a foreign country or meet the physical presence test. For Tax Year 2008, the IRS sent 2,376 notices to taxpayers regarding errors on the Forms 2555.
- ***Compliance Projects to identify high-risk filers for examination selection.*** To identify potential cases of noncompliance, the IRS selects for review a specific group of workers within a certain industry that have a high potential for noncompliance with requirements for claiming the exclusion. *****2(f)*****

Currently, the IRS has initiated 5 compliance projects that have identified more than 9,631 taxpayers who may have incorrectly claimed almost \$107 million in foreign earned income exclusions.

Despite the above efforts, our review of the 231,277 Tax Year 2008 tax returns⁸ with claims for foreign earned income tax exclusions identified 23,334 (10 percent) tax returns with erroneous foreign earned income tax exclusions totaling \$675 million with an estimated revenue loss

⁷ See Appendix V for a description of the specific validity checks performed for *e-filed* tax returns relating to the Forms 2555.

⁸ This represents the number of Tax Year 2008 tax returns processed as of August 2009.



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totaling \$90 million. Over 5 years, the estimated revenue loss could total more than \$450 million. Information on the Forms 2555 identified individuals who incorrectly calculated the exclusion or did not qualify for the exclusion. Specifically:

- 17,787 (8 percent) individuals overstated their foreign earned income exclusion by \$410 million.
- 5,547 (2 percent) tax returns with \$265 million in exclusions had incomplete information or inaccuracies on the Forms 2555.

*****2(f)*****

In addition, based on our review of travel information for a statistically valid sample of 150 Tax Year 2008 tax returns with a foreign earned income exclusion claim, we estimate that potentially 13,877 individuals claiming the exclusion may not have met the physical presence requirement. Travel information showed that not all taxpayers were in a foreign country for at least 330 full days during a period of 12 consecutive months including all or part of the filing tax year. Management advised us that some of these erroneous claims may be the result of transcription errors - IRS employees incorrectly entering date field information from paper tax returns into IRS computers. However, our statistically valid sample identified that the dates were correctly entered for 97 percent of the 150 tax returns we selected in our sample.

*****2(f)*****

*****2(f)*****

I.R.C. § 911(d)(1)(A) and § 911(d)(2) require individuals to have foreign earned income and a tax home in a foreign country to qualify for the foreign earned income tax exclusion. Although both foreign earned income and foreign residency (via either the bona fide residency or physical presence test) is needed to claim the exclusion, *****2(f)*****

We reviewed a statistically valid sample of 150 Tax Year 2008 tax returns with claims for the foreign earned income exclusion to determine if the individuals met foreign earnings requirements. Our review identified:



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- 108 individuals that had no Form W-2 attached to the tax return. As a result, we were unable to perform any additional work to confirm earnings.
- 42 individuals that had earnings reported to the IRS from a U.S. company. We contacted these companies to confirm that these were foreign earnings and that the individuals lived outside the U.S. As of April 21, 2010, we received 17 responses, and our results showed that 13 (76 percent) of the 17 individuals did have foreign earned income while living an entire tax year in a foreign country. The other four responses were inconsistent with the IRS data. For example, *****1*****

*****.

In addition, we reviewed the statistically valid sample of 150 accounts to determine if the individuals met the physical presence test (330 calendar days in a foreign country). Our review identified that 82 individuals were bona fide residents of a foreign country. A bona fide resident is an individual that lives in a foreign country or countries for an uninterrupted period that includes an entire tax year. An entire tax year is from January 1 through December 31 for taxpayers who file their tax returns on a calendar year basis. For these individuals, we accepted the individual's identification on their tax return that they were a bona fide residence of a foreign country.

For the remaining 68 individuals, we requested data from the U.S. Department of Homeland Security that details time periods of the individuals leaving and entering the U.S. Our review of this data identified 9 (13 percent) of the 68 individuals did not meet the physical presence requirements and therefore did not qualify for the exclusion they claimed. The number of days short of the 330 calendar day requirement averaged 109 calendar days (the range was from 10 to 287 calendar days short of the requirement). We determined the number of days in a foreign country by subtracting the number of calendar days in the U.S. from the number of calendar days in the year.

Based on the results of our sample review of 150 individuals, we estimate that 13,877⁹ of the individuals claiming the exclusion in Tax Year 2008 may not have met the physical presence requirement. *****2(f)*****

***** . While the foreign earned income is not a tax credit, individuals can exclude earned income amounts (\$91,500 for Tax Year 2010) that are considerably larger than *****2(f)*****
*****—the Health Coverage Tax Credit (\$6,900) and the First-Time Homebuyer Credit (\$8,000).

⁹ The 13,877 is an estimate based on our sample review of 150 individuals $9/150 = 6$ percent \times 231,277 Tax Year 2008 tax returns.



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Individuals are not accurately computing the foreign earned income exclusion

Our review of 231,277 Tax Year 2008 tax returns with a foreign earned income exclusion claimed identified 17,787 (8 percent) individuals incorrectly computed the foreign earned income exclusion, overstating their exclusion by \$410 million. These included:

- 11,953 individuals that excluded an amount which exceeded the total of their foreign earned income, housing costs, and/or allowances (meals and lodging) by \$254 million.

*Example:*¹⁰ Taxpayer A showed only an entry of \$87,000 on line 42 (Foreign Earned Income Exclusion) of Form 2555 and a zero housing exclusion but incorrectly entered \$105,000 on line 45 of Form 2555, which was carried forward to line 21 of Form 1040, resulting in a overstated Foreign Earned Income Exclusion of \$18,000.

- 5,834 individuals that did not accurately transfer the amounts of the foreign earned income exclusion from the Forms 2555 to the appropriate line on the Forms 1040. The amounts reflected on the Forms 1040 exceeded the foreign earned income exclusion on the Forms 2555 by \$156 million.

Example: Taxpayer B reported a total Foreign Earned Income Exclusion of \$85,000 on Form 2555 but entered the exclusion as \$139,000 on line 21 of Form 1040, possibly resulting in an overstated Foreign Earned Income Exclusion of \$54,000.

*****2(f)*****

Information provided on Forms 2555 showed individuals did not qualify for the foreign earned income exclusion

Our review of the 231,277 Tax Year 2008 tax returns with foreign earned income tax exclusions identified 5,547 (2 percent) tax returns with \$265 million in exclusions for which the information provided on the Forms 2555 showed that the individuals did not qualify for an exclusion. For example:

- 3,843 taxpayers indicating bona fide foreign residency listed overseas time periods that did not meet the bona fide resident requirement. Bona fide residency requires an individual to be a resident of a foreign country or countries for an uninterrupted period that includes an entire tax year. An entire tax year is from January 1 through December 31 for taxpayers who file their tax returns on a calendar year basis. To qualify as a bona fide resident, taxpayers must show the IRS that they resided overseas for an uninterrupted

¹⁰ All examples in italics are hypothetical.



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period that included at least one entire tax year with part of the time period being in the tax year they are currently filing.

Example: Taxpayer C claimed a total Foreign Earned Income Exclusion of \$86,000 on Form 2555 but reported being overseas for only 9 months (August 2008–April 2009) instead of the entire Tax Year 2008 as required to qualify as a bona fide resident.

- 1,704 individuals listed time periods for residing in a foreign country that did not meet the physical presence test for Tax Year 2008. Physical presence requires an individual to be physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months, providing that the period includes all or part of the filing tax year.

Example: Taxpayer D claimed a total Foreign Earned Income Exclusion of \$84,000 on Form 2555 but reported being overseas for only 2 months (December 2008 – January 2009) instead of the 330 full days in foreign countries required to meet the physical presence test.

*****2(f)*****

Recommendations

Recommendation 1: The Commissioner, LMSB Division, and the Commissioner, Wage and Investment Division, should *****2(f)*****

Management's Response: IRS management disagreed with this recommendation. Because of substantial barriers to implementing this recommendation, IRS management does not plan to take action at this time. There are two barriers. *****2(f)*****

Office of Audit Comment: We acknowledge that *****2(f)*****



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*****2(f)*****

Recommendation 2: *****2(f)*****

Management's Response: IRS management disagreed with this recommendation. IRS management does not plan to take action on this recommendation at this time, as the recommendation is closely related to Recommendation 1.

Office of Audit Comment: See the Office of Audit Comment related to management's response to Recommendation 1.

Recommendation 3: The Commissioner, LMSB Division, should ensure the 23,334 individuals who the Treasury Inspector General for Tax Administration identified as incorrectly claiming the foreign earned income exclusion were entitled to the exclusion. Review of these tax returns could be inventory for those employees acquired for the IRS' new "Large Business and International Expansion" Initiative.

Management's Response: IRS management agreed with this recommendation. They reviewed the data presented in our report and believe that some of the identified errors were made by taxpayers in filling out the Form 2555. Other errors could be due to IRS errors in transcribing data provided on paper returns. Based on their review of the data, 5 filters were used to identify the 23,334 returns reported as having errors. Another filter, not mentioned in the report, led to the identification of another 7,724 possible errors. IRS management plans to do a statistically valid review of the taxpayers identified by each of the filters to determine the cause of the errors. Based on that review, IRS management will determine the appropriate treatments, which will be dependent on the cause of the errors. These treatments could include examinations, soft letters, and/or changes in the IRS process.

Recommendation 4: The Commissioner, Wage and Investment Division, should include programming to forward tax returns (both e-filed and paper) to the Error Resolution System for correction if the individual incorrectly computes the foreign earned income.

Management's Response: IRS management agreed with this recommendation and will submit a Unified Work Request by January 15, 2011, to forward tax returns (both e-filed and paper) to the Error Resolution System for correction if the taxpayer incorrectly computes the foreign earned income. Form 2555 and Foreign Earned Income



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Exclusion (Form 2555-EZ) are not processed by the Modernized e-File system at this time; however, the implementation plan has these forms scheduled for processing in Release 7 with a target deployment date of January 2012. A Unified Work Request will be submitted to include this recommendation in the scope of Release 7. Because the requested action will be subject to funding and resource prioritization by the Modernized and Information Technology Services organization, submission of the Unified Work Request will complete the corrective action.

Recommendation 5: The Commissioner, Wage and Investment Division, should include programming to forward tax returns (both *e-filed* and paper) to the Error Resolution System for correction for individuals who do not qualify as bona fide residents or do not appear to meet the physical presence test based on incomplete or inaccurate date information on Forms 2555.

Management's Response: IRS management agreed with this recommendation. Existing procedures ensure that paper returns that include Forms 2555 and 2555-EZ are reviewed by the Code and Edit function in Submission Processing. If the exclusion is disallowed, the Error Resolution System performs a second review. If the exclusion is still disallowed after the second review, the IRS notifies the taxpayer of that determination.

The Internal Revenue Service Identifies Noncompliant Individuals Through Its Compliance Initiatives

The IRS has developed a number of successful compliance initiatives to identify individuals erroneously claiming the foreign earned income exclusion. Figure 4 identifies the number of noncompliant taxpayers identified compared with the number of examinations initiated.

Figure 4: Tax Returns Identified From Compliance Projects

Fiscal Year	Tax Returns Identified	Tax Returns Examined	Tax Assessed
2007	2,036	1,785	\$12,695,223
2008	1,770	1,149	\$24,770,637
2009	1,770	1,277	\$13,355,094

Source: LMSB Division analysis of five compliance projects.

Since Fiscal Year 2004, the IRS has started 5 compliance initiatives that identified more than 9,631 taxpayers who have incorrectly claimed almost \$107 million in foreign earned income exclusions. For these projects, the IRS is currently examining 914 tax returns, and 176 examinations were closed as of March 2010 with assessed amounts of \$630,597. The criteria the IRS uses to identify noncompliant taxpayers as part of its compliance initiatives results in a high rate of examined returns that are assessed additional tax (rather than being closed with no change



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to the tax return). Of the 4,211 examinations initiated in the last 3 processing years, 3,476 (83 percent) resulted in an assessment. Figure 5 provides a list and a brief description of the five compliance projects.

Figure 5: List of Five Compliance Initiatives

2(f)	*****2(f)*****

Source: LMSB Division analysis of five compliance initiatives.

IRS has indicated that resources are not sufficient to adequately address noncompliant individuals identified via compliance initiatives. Currently, tax compliance officers and revenue



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agents review cases that are considered international tax returns. In Processing Year 2009, the IRS received more than 1.4 million international tax returns, of which 317,778 included the foreign income exclusion. However, as we previously detailed, the IRS submitted a request for \$121 million and 781 positions to support the Presidential priority of focusing on international tax administration. This will provide the IRS with the tools necessary to reduce international tax evasion and abuse.

The IRS recognizes the need for additional resources as well as the complexity of international tax issues, which necessitates the use of technically trained employees to review international tax returns for compliance with tax laws. To address these issues, the IRS has proposed establishing an International Campus Compliance Unit in the Austin Campus¹¹ in Austin, Texas. The goal of this new unit would be to identify and resolve the incorrect tax returns during processing. The IRS initially planned to implement the International Campus Compliance Unit in March 2010. However, this initiative has been delayed and the new implementation date is scheduled for September 30, 2010.

Recommendations

Recommendation 6: The Commissioner, LMSB Division, should establish the International Campus Compliance Unit to address those taxpayers identified by compliance initiatives as erroneously claiming the foreign earned income exclusion.

Management's Response: IRS management agreed with this recommendation. The Director, Internal Compliance Strategy and Policy, will ensure that the actions to establish the International Campus Compliance Unit that are in process will be completed by September 30, 2010.

Recommendation 7: The Commissioner, LMSB Division, should assess whether compliance project criteria can be used to forward tax returns (both *e-filed* and paper) to the Error Resolution System for correction at the time the filed tax returns are processed. For example, information is provided on the tax returns as to the foreign country where individuals are residing. The IRS could use this information to identify individuals living in Antarctica who are erroneously claiming the foreign earned income exclusion and forward those tax returns to the Error Resolution System.

Management's Response: IRS management disagreed with this recommendation. Because of a substantial barrier to implementing this recommendation, IRS management does not plan to take action at this time. The compliance projects that the IRS conducts to identify individuals incorrectly claiming the foreign earned income exclusion relate to examinations of filed tax returns. The examinations involve complex international

¹¹ 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.



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compliance issues that are largely dependent on the facts and circumstances of each case. As such, the compliance criteria used to select returns for examination do not convert to objective criteria like those used to identify returns with either filing or math error adjustments.

Office of Audit Comment: Taking no action will result in the IRS expending significant resources on examinations or allowing improper claims because the IRS has indicated that resources are not sufficient to adequately address noncompliant individuals identified via compliance initiatives.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the IRS' process to ensure the accuracy of foreign earned income¹ tax exclusions. To accomplish our objective, we:

- I. Identified the steps taken by the IRS to verify the accuracy of foreign earned income tax exclusions at the time a tax return is processed.
 - A. Participated in a walkthrough at the Austin Submission Processing Site² and determined efforts taken to verify the accuracy of foreign earned income tax exclusions.
 - B. Held discussions with representatives from the Code and Edit function³ and Error Resolution function and identified any steps taken in an attempt to verify the accuracy of foreign earned income tax exclusions.
 - C. Reviewed *e-file* documentation and identified specific items validated prior to tax return processing when an individual claims the foreign earned income exclusion.
- II. Identified the steps taken by the IRS to identify tax returns with questionable foreign earned income tax exclusions subsequent to tax return processing.
 - A. Interviewed IRS personnel and identified any steps taken to identify questionable foreign earned income tax exclusions.
 - B. Reviewed management information reports that outlined post-processing efforts and results.
- III. Determined if taxpayers accurately claimed the foreign earned income exclusion.
 - A. Selected a statistically valid sample of 150 tax returns filed in Tax Year 2008 from an IRS Individual Return Transaction File⁴ extract of 231,277 tax returns claiming the foreign earned income exclusion and assessed the actions taken by the IRS to validate the foreign earned income tax exclusion. To validate the extract, we matched our

¹ Earned income includes all the taxable income and wages you get from working.

² The Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

³ The Code and Edit function is responsible for reviewing all documents submitted with tax returns. Tax examiners review the tax returns to ensure they are correct, complete, valid, and in the correct order for input to IRS computer systems. They also review any attachments to the tax returns to determine if any additional actions are required.

⁴ The Return Transaction File contains all edited, transcribed, and error-corrected data from the U.S. Individual Income Tax Returns (Form 1040 series) and related forms for the current processing year and 2 prior years.



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sample to the data captured on the Individual Return Transaction File and the data that posted to the Individual Master File.

We used attribute sampling to calculate the minimum sample size (n),⁵ which we rounded to 150:

$$n = (Z^2 p(1-p))/(A^2)$$

Z = Confidence Level: 90 percent (expressed as 1.65 standard deviation)

p = Expected Rate of Occurrence: 5 percent

A = Precision Rate: ± 3 percent

The test population was the 231,277 records from the Individual Return Transaction File and the method used was selected to permit projections to the test population as needed.

1. For *e-filed* tax returns, we identified specific validations performed for Foreign Earned Income (Form 2555) to ensure that *e-filed* tax returns were properly rejected.
 2. For paper tax returns, we determined if *e-filed* reject conditions have a corresponding Error Resolution System code for processing paper tax returns.
 3. Identified individuals not eligible to claim the foreign earned income exclusion and estimated potential lost revenue. We projected our sample results to the total population of tax returns claiming the foreign earned income exclusion to determine the total potential revenue loss.
 4. Matched our statistically valid sample of 150 taxpayers (from Step III.A.1.) to State Department passport files to identify taxpayers not listed on the passport file and determined if they were eligible for the exclusions.
- B. Queried the Individual Return Transaction File extract and identified 11,953 accounts where the foreign earned income exclusion exceeded the totals shown on the Form 2555 and the incorrect amount was carried forward to the Form 1040. (Totaled line 36 – Housing + line 42 - foreign earned income exclusion and the sum did not equal line 45 on Form 2555 and line 45 is carried forward to line 21 on Form 1040).
- C. Queried the Individual Return Transaction File extract and identified 5,834 accounts where the amount of the foreign earned income exclusion reported on the Form 1040 exceeded the amount reported on Form 2555.

⁵ The formula $n = (Z^2 p(1-p))/(A^2)$ is from *Sawyer's Internal Auditing – The Practice of Modern Internal Auditing*, 4th Edition, pp. 462-464.



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- D. Queried the Individual Return Transaction File extract using the bona fide date fields and identified 3,843 accounts where the bona fide dates did not to qualify for the exclusion.
- E. Queried the Individual Return Transaction File extract using the physical presence dates and identified 1,704 accounts where the physical presence dates were 10 months or less (310 calendar days) not qualifying for the exclusion.
- F. Reviewed a judgmental sample of 50 tax returns filed in Tax Year 2008 from a population of 5,322 individual tax returns in the 2008 tax year with no earned income reported and determined that taxpayers were eligible to claim the exclusion. We used judgmental sampling because our time resources were limited.
- G. Reviewed a judgmental sample of 50 tax returns filed in Tax Year 2008 from a population of 12,616 individual tax returns in the 2008 tax year where the taxpayer is identified as being in the U.S. for more than 36 calendar days and determined whether they met the physical presence test. We used judgmental sampling because our time resources were limited.
 - 1. Checked foreign earned income exclusion taxpayers to the State Department passport file to determine whether the individuals could be living overseas.
 - 2. Performed Integrated Data Retrieval System⁶ research to determine whether taxpayers with physical presence declaration qualified after returning (waiver possible) to the U.S.
 - 3. Identified individuals not eligible to claim the foreign earned income exclusion and estimated potential lost revenue. We projected our sample results to the total population of tax returns claiming the foreign earned income exclusion to determine the total potential revenue loss.
- H. Determined if IRS processes identified individuals claiming foreign earned income exclusions using income from U.S. Government employment.
 - 1. Matched Tax Year 2008 foreign earned income exclusion taxpayers to the Individual Return Transaction File and determined whether any of the taxpayers were U.S. Government employees.
 - 2. Performed Integrated Data Retrieval System research and identified sources of income that would qualify for the exclusion.

⁶ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims

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: Austin Submission Processing Site processing controls. Our analyses found that those processing controls were not working effectively to identify and correct tax returns when captured tax return information did not support the exclusion for the foreign earned income deduction. We evaluated these controls by interviewing management and reviewing procedures and reviewing samples of tax returns.



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Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
Russell P. Martin, Director
Edward Gorman, Audit Manager
Kathleen A. Hughes, Senior Auditor
Lawrence R. Smith, Senior Auditor
LaToya R. Penn, Auditor
Marcus D. Sloan, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner (International) United States Competent Authority, Large and Mid-Size
Business Division SE:LM:IN
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, International Compliance and Strategy and Policy, Large and Mid-Size Business
Division SE:LM:IN
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
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 Liaisons:
 Commissioner, Large and Mid-Size Business Division SE:LM
 Chief, Program Evaluation and Improvement, Wage and Investment Division
 SE:W:S:PRA:PEI



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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:

- Revenue Protection – Potential; \$231 million over 5 years. This estimate is based on 17,787 individuals overstating their foreign earned income exclusion by \$410 million in Tax Year 2008 (see page 5).

Methodology Used to Measure the Reported Benefit:

We identified 17,787 tax returns with foreign earned income exclusion where the individuals incorrectly computed the foreign earned income exclusion, overstating their exclusion by \$410 million. These included:

- 11,953 individuals who excluded an amount which exceeded the total of their foreign earned income, housing costs, and/or allowances (meals and lodging) by \$254 million.
- 5,834 individuals who did not accurately transfer the amounts of the foreign earned income exclusion from the Foreign Earned Income (Form 2555) to the appropriate line on the U.S. Individual Income Tax Returns (Form 1040). The amounts reflected on the Forms 1040 exceeded the foreign earned income exclusion by \$156 million.

*****2(f)*****

*****.

To compute the loss of revenue, we:

- Recomputed the taxpayers' Adjusted Gross Incomes¹ (\$1.1 billion) by adding the overstatement amounts for each of the 17,787 returns that resulted in a loss of revenue of \$46.1 million.

¹ Adjusted Gross Income (Form 1040 line 37) is the total income (line 22) minus the allowable adjustments (lines 23-35).



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- Recomputed the new taxable income (\$862 million) by subtracting the itemized or standard deductions and the exemption allowances from the Adjusted Gross Income.
- Applied the 2008 tax rates per filing status to the new taxable income to obtain the new tentative tax figures.
- Computed lost revenues by subtracting the taxpayers’ total tax figures from the new total tax figures.
- Calculated the loss of revenue total of \$231 million over 5 years by multiplying the annual loss of \$46.1 x 5 years.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$219 million over 5 years. This estimate is based on 5,547 individuals who did not qualify for exclusions totaling \$265 million in Tax Year 2008 based on information on their Forms 2555 (see page 5).

Methodology Used to Measure the Reported Benefit:

We identified 5,547 tax returns with \$265 million in foreign earned income tax exclusions for which the information provided on the Forms 2555 showed that the individuals did not qualify for the exclusion. These included:

- 3,843 individuals who listed a bona fide residency time period for residing in a foreign country that did not meet the bona fide residency or physical presence test requirements. To meet the bona fide residency test, the taxpayer must show the IRS that they have been a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year. An entire tax year is from January 1 through December 31 for taxpayers who file their tax returns on a calendar year basis. To meet the physical presence requires an individual to reside in a foreign country or countries for at least 330 full days during any period of 12 consecutive months, providing that the period includes all or part of the filing tax year.
- 1,704 individuals listed a time period for residing in a foreign country that did not meet the physical presence requirement. Physical presence requires an individual to reside in a foreign country or countries for at least 330 full days during any period of 12 consecutive months, providing that the period includes all or part of the filing tax year.

*****2(f)*****

To compute the loss of revenue, we:



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- Recomputed the taxpayers' Adjusted Gross Income (\$559 million) by adding the foreign earned income exclusion for each of the 5,547 returns that resulted in a loss of revenue of \$43.9 million.
- Recomputed the new taxable income (\$485 million) by subtracting the itemized or standard deductions and the exemption allowances.
- Applied the 2008 tax rates per filing status to the new taxable income to obtain the new tentative tax figures.
- Computed lost revenues by subtracting the taxpayers' total tax figures from the new total tax figures.
- Calculated the loss of revenue total of \$219 million over 5 years by multiplying the annual loss of \$43.8 x 5 years.



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Appendix V

Descriptions of Electronic Filing Error Reject Codes

Electronic return transmissions go through a series of filters that perform various format and validity checks to produce an electronic file for further computer processing. The filters can generate the following 22 reject codes for tax returns claiming the Foreign Earned Income Exclusion.

0452 – Social Security Number on Foreign Earned Income (Form 2555) must equal Primary Social Security Number or Secondary Social Security Number of U.S. Individual Income Tax Return (Form 1040).

0453 – Total Foreign Earned Income cannot exceed **\$87,600 for 2008 individual income tax returns**.

0454 – Earned Income Credit cannot be significant if Form 2555 is present.

0455 – Foreign Earned Income Exclusion cannot exceed Foreign Earned Income.

0456 – Housing/Foreign Earned Income Exclusion must equal Form 2555.

0457 – Housing/Foreign Earned Income Exclusion Amount must equal the maximum of Housing and Foreign Earned Income Exclusions from Forms 2555.

0458 – Other Adjustments on Form 1040 must equal Form 2555.

0459 – If Other Adjustments on Form 1040 equal Form 2555, then Other Adjustment Amount must equal Total Housing Deduction from Form 2555.

0460 – Bona Fide Residence end date shows the last day of the tax year, and the start date must equal either the first day of the same tax year or be prior to the current tax year.

0461 – Form 2555 – Statement to Authorities – Yes and Required to Pay Income Tax – No, both cannot be significant.

0462 – Form 2555 – If No Travel Statement is present, then the Country Name, Arrival Date, Departure Date, Full Days in Country, Number of Days in U.S. on Business, and Income Earned in the U.S. on Business cannot be present.

0463 – Form 2555 – Taxpayer Foreign Street Address, Taxpayer Foreign City, and Taxpayer Foreign Country must be present and contain a valid country code.

0464 – If Separate Foreign Residence is present, then foreign address must be properly completed and show the number of days lived at that address.



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0465 – Housing Exclusion cannot be greater than Employer-Provided Amounts.

0466 – Total Housing and Foreign Earned Income Exclusions must equal the total of Housing Exclusion plus Foreign Earned Income Exclusion.

0467 – If Bona Fide Residence is significant, then the dates must be shown.

0468 – If Physical Present is significant, then the dates must be shown.

0469 – Tax Home Test must have an entry if the answer is “yes.”

0470 – Only one box (Yes or No) can be marked for the following:

- Bona Fide Residence
- Physically Present
- Revoked Exclusions

0471 – Form 2555 – Part II or Part III must be present, but not both.

0472 – Form 2555/2555EZ – Must be processed at the Austin Submission Processing Center.

0473 – Form 2555 – If Allocable Deductions are significant, then the Allocable Deductions Computation must equal a specified format.



Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims

Appendix VI

Foreign Earned Income – Form 2555

Form **2555** Foreign Earned Income OMB No. 1545-0074
 Department of the Treasury Internal Revenue Service
 ▶ See separate instructions. ▶ Attach to Form 1040.
2008 Attachment Sequence No. 34
 For Use by U.S. Citizens and Resident Aliens Only

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 ▶ _____
 b Employer's foreign address ▶ _____
 5 Employer is (check ▶) a A foreign entity b A U.S. company c Self
 any that apply: d A foreign affiliate of a U.S. company e Other (specify) ▶ _____
 6a If, after 1981, you filed Form 2555 or Form 2555-EZ, enter the last year you filed the form. ▶ _____
 b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ▶ and go to line 7.
 c Have you ever revoked either of the exclusions? Yes No
 d 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? See **Second foreign household** on page 3 of the instructions. Yes No
 b 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 page 2 of the 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? Yes No
 b 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? See instructions Yes No
 b Are you required to pay income tax to the country where you claim bona fide residence? See instructions Yes No
If you answered "Yes" to 13a and "No" to 13b, you do not qualify as a bona fide resident. Do not complete the rest of this part.
 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.

(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. ▶ _____
 b Enter the type of visa under which you entered the foreign country. ▶ _____
 c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation Yes No
 d Did you maintain a home in the United States while living abroad? Yes No
 e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶ _____

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 11900P Form 2555 (2008)



Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims

Form 2555 (2008)

Page **2**

Part III Taxpayers Qualifying Under Physical Presence Test (see page 2 of the 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 2008 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 2008, no matter when you performed the service.

		Amount (in U.S. dollars)
2008 Foreign Earned Income		
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	22a	
b Family 22b	22b	
c Education 22c	22c	
d Home leave 22d	22d	
e Quarters 22e	22e	
f For any other purpose. List type and amount. <input type="text"/>	22f	
g Add lines 22a through 22f 22g	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	24	
25 Total amount of meals and lodging included on line 24 that is excludable (see instructions) 25	25	
26 Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your 2008 foreign earned income. <input type="text"/>	26	

Form **2555** (2008)



Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims

Form 2555 (2008)

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 2008 tax year (see instructions)	31	days	
32 Multiply \$38.30 by the number of days on line 31. If 366 is entered on line 31, enter \$14,016.00 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	\$87,600	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 2008 tax year (see the instructions for line 31).	38	days	
39 • If line 38 and the number of days in your 2008 tax year (usually 366) are the same, enter "1.000." • Otherwise, divide line 38 by the number of days in your 2008 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 2007 housing deduction because of the 2007 limit, use the worksheet on page 4 of the instructions to figure the amount to enter on line 49. Otherwise, go to line 50.			
49 Housing deduction carryover from 2007 (from worksheet on page 4 of 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 (2008)



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Appendix VII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D. C. 20224

RECEIVED
JUL 15 2010

BY: *AR*

JUL -9 2010

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT

FROM: Heather C. Maloy *Heather C. Maloy*
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report – Improvements Are Needed to Reduce
Erroneous Foreign Earned Income Exclusion Claims (Audit
200940043)

Thank you for sharing the subject draft report for our review and comments. In general, the Large and Mid-Size Business (LMSB) and Wage and Investment (W&I) divisions agree that improvements are needed to reduce erroneous foreign earned income exclusion claims. As your report indicates, the LMSB Division established the new "Large Business and International Expansion" initiative in October 2009 in response to the President's increased focus on international tax administration. This initiative will help us to improve international tax compliance significantly, including compliance with the foreign earned income exclusion. The approved budget and increased staffing will more effectively allow us to continue to address and increase our efforts on international issues, evasion, and abusive transactions.

Your report acknowledges our efforts to improve our processes for identifying and correcting erroneous foreign earned income exclusion claims. However, your report did not reference recent improvements to the instructions for the Form 2555, Foreign Earned Income, which take effect for Tax Year 2009. Our goal is to increase taxpayer understanding of the information required on the form. This should result in more accurate and complete answers to the questions regarding both the physical presence test and the bona fide resident test. We request that your report reference these efforts as well.

We generally agree that improvements are needed to reduce erroneous foreign earned income exclusion claims and we have set forth herein our action plan for addressing a number of your specific recommendations. On the other hand, where we could not agree with a specific recommendation because of a substantial barrier, we have included an explanation and would be happy to talk with you further about the problem.

If you have any questions, please contact Michael Danilack, LMSB Deputy Commissioner, International, at (202) 435-5000.

Attachment



Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims

Attachment

RECOMMENDATION 1:

The Commissioner, Large and Mid-Size Business Division, and the Commissioner, Wage and Investment Division

*****2(f)*****

CORRECTIVE ACTIONS:

Because of substantial barriers to implementing this recommendation, we plan not to take action at this time.

REASON FOR NO ACTION:

There are two barriers to taking action on this recommendation.

*****2(f)*****

*****2(f)*****

IMPLEMENTATION DATE:

N/A



*Improvements Are Needed to Reduce
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RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 2:

*****2(f)*****

CORRECTIVE ACTIONS:

We plan to take no action on this recommendation at this time, as the recommendation is closely related to Recommendation 1.

REASON FOR NO ACTION:

This recommendation is closely related to Recommendation 1 and our reason for not taking action is the same as described above.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 3:

The Commissioner, Large and Mid-Size Business Division, should ensure the 23,334 individuals who TIGTA identified as incorrectly claiming the foreign earned income exclusion were entitled to the exclusion. Review of these tax returns could be inventory for those employees acquired for the IRS' new "Large Business and International Expansion" Initiative.



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CORRECTIVE ACTIONS:

We have reviewed the data presented in the TIGTA report and the detailed spreadsheets that were provided, and we believe that some of the identified errors were made by taxpayers in filling out the Form 2555. Other errors could be due to IRS errors in transcribing data provided on paper returns. Based on our review of the data, five filters were used to identify the 23,334 returns reported as having errors. Another filter, not mentioned in the report, led to the identification of another 7,724 possible errors. We plan to do a statistically valid review of the taxpayers identified by each of the filters to determine the cause of the errors. Based on that review, we will determine the appropriate treatments, which will be dependent on the cause of the errors. These treatments could include examinations, soft letters, and/or changes in IRS processes.

IMPLEMENTATION DATE:

December 31, 2010

RESPONSIBLE OFFICIAL(S):

Director, International Compliance Strategy and Policy

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, International Compliance Strategy and Policy will review the progress on the statistically valid review of the taxpayers identified by TIGTA on a monthly basis beginning on August 31, 2010 with a final report that includes recommendations for appropriate treatments by December 31, 2010.

RECOMMENDATION 4:

The Commissioner, Wage and Investment Division, should include programming to forward tax returns (both *e-filed* and paper) to the Error Resolution System for correction if the individual incorrectly computed foreign earned income.

CORRECTIVE ACTIONS:

We agree with the recommendation and will submit a Unified Work Request (UWR) by January 15, 2011, to forward tax returns, (both e-filed and paper) to the Error Resolution System for correction if the taxpayer incorrectly computes the foreign earned income. Forms 2555 and 2555-EZ are not processed by the Modernized e-File (MeF) system at this time; however, the implementation plan has those forms scheduled for processing in Release 7 with a target deployment date of January 2012. A UWR will be submitted to include this recommendation in the scope of Release 7. Since the requested actions will be subject to funding and resource prioritization by the Modernization and



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Information Technology Services (MITS), submission of the UWR will complete the corrective action.

IMPLEMENTATION DATE:

January 15, 2011.

RESPONSIBLE OFFICIAL(S):

Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Wage and Investment Division will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 5:

The Commissioner, Wage and Investment Division, should include programming to forward tax returns (both *e-filed* and paper) to the Error Resolution System for correction for individuals that do not qualify as bona fide residents or do not appear to meet physical presence test based on incomplete or inaccurate date information on Forms 2555.

CORRECTIVE ACTIONS:

We agree with this recommendation. Existing procedures ensure that paper returns that include Forms 2555 and 2555-EZ are reviewed by the Code and Edit function in Submission Processing. The review includes a check of the dates used to determine if the taxpayers meet both the bona fide residency and physical presence requirements. If the date information is not sufficient for the exclusion, the exclusion is marked out and not transcribed. This causes the return to be forwarded to the Error Resolution System (ERS) for a second review. If the exclusion is disallowed by ERS a notice is sent to the taxpayer.

A UWR will be submitted to implement the recommendation for e-filed returns. Validation of the beginning and ending dates on the Forms 2555 and 2555-EZ for the bona fide residency and physical presence tests will be performed. New error codes will be created to identify for correction those returns failing validation.

Forms 2555 and 2555-EZ are not processed by the Modernized e-File (MeF) system at this time; however, the implementation plan has those forms scheduled for processing in Release 7 with a target deployment date of January 2012. A UWR will be submitted to include this recommendation in the scope of Release 7. Since the requested actions will be subject to funding and resource prioritization by the Modernization and



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Information Technology Services (MITS), submission of the UWR will complete the corrective action.

IMPLEMENTATION DATE:

January, 15, 2011

RESPONSIBLE OFFICIAL(S)

Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN

The Wage and Investment Division will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 6:

The Commissioner, Large and Mid-Size Business Division, should establish the Campus Compliance Unit to address those taxpayers identified by compliance initiatives as erroneously claiming the foreign earned income exclusion.

CORRECTIVE ACTIONS:

The Director, International Compliance Strategy and Policy, will ensure that the actions to establish the International Campus Compliance Unit that are in process will be completed by September 30, 2010. The purpose of the unit is to address a number of International compliance issues related to U.S. citizens, residents and nonresident aliens with a U.S. filing requirement. The issue regarding erroneously claimed foreign earned income exclusion will be considered as we continue to identify and prioritize the workload for this new unit.

IMPLEMENTATION DATE:

September 30, 2010

RESPONSIBLE OFFICIAL(S)

Director, International Compliance Strategy and Policy

CORRECTIVE ACTION(S) MONITORING PLAN

The Director, International Compliance Strategy and Policy, will review the status of this project on a weekly basis beginning with the week ending July 16, 2010, with a final report upon full establishment of the operation.



*Improvements Are Needed to Reduce
Erroneous Foreign Earned Income Exclusion Claims*

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RECOMMENDATION 7:

The Commissioner, Large and Mid-Size Business Division, should assess whether compliance project criteria can be used to forward tax returns (both *e-filed* and paper) to the Error Resolution System for correction at the time the filed tax returns are processed. For example, information is provided on the tax return as to the foreign country where individuals are residing. The IRS could use this information to identify individuals living in Antarctica who are erroneously claiming the foreign earned income exclusion and forward those tax returns to the Error Resolution System.

CORRECTIVE ACTIONS:

Because of a substantial barrier to implementing this recommendation, we plan to take no action at this time.

REASON FOR NO ACTION:

The compliance projects that the IRS conducts to identify individuals incorrectly claiming the Foreign Earned Income Exclusion constitute examinations of filed tax returns. This is a complex international compliance issue that is largely dependent on the facts and circumstances of each case. None of the subjective criteria evaluated under these compliance projects can be properly reduced to simple, objective criteria that could give rise to a filing error or math error adjustment. Rather, disallowance of the exclusion in these cases must be predicated on a careful review of the facts and circumstances.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A