Treasury Inspector General for Tax Administration
Office of Audit

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

Issued on September 27, 2013

Highlights

Highlights of Report 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' United States (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 Exclusion*. 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.

In their response to the report, IRS officials agreed with the recommendations and plan to take corrective actions.

READ THE FULL REPORT

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

http://www.treas.gov/tigta/auditreports/2013reports/201330112fr.pdf.

E-mail Address: TIGTACommunications@tigta.treas.gov *Phone Number: 202-622-6500*
Website: http://www.treasury.gov/tigta