TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Improvement Is Needed in Compliance Efforts to Identify Unsupported Claims for Foreign Tax Credits

September 26, 2017

Reference Number: 2017-30-084

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

Highlights

Final Report issued on September 26, 2017

Highlights of Reference Number: 2017-30-084 to the Internal Revenue Service Commissioners for the Large Business and International and the Wage and Investment Divisions.

IMPACT ON TAXPAYERS

The United States taxes corporations on their worldwide income. The Foreign Tax Credit (FTC) is intended to eliminate 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 generated. The FTC can significantly affect the amount of income taxes paid by corporations on U.S. tax returns.

WHY TIGTA DID THE AUDIT

The FTC is the largest tax credit taken by corporations. For tax periods 2013 through 2015, approximately $298.9 billion in the FTCs were claimed. Our overall objective was 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 processed corporate tax returns that allowed taxpayers to claim the FTC without the required supporting documentation, resulting in potentially erroneous FTCs for tax periods 2013 through 2015. TIGTA found that 9.2 percent of the corporations filing paper returns received the FTC without the supporting documentation, and that 2.6 percent received an incorrect FTC amount or an FTC they did not request. In addition, some tax returns under examination were not referred to international examination specialists as required. In many cases, IRS examiners were not inputting key information into the Issue Management System; discrepancies existed in the FTC amount recorded by the taxpayer and the amount recorded in IRS computer systems; and the Large Business and International Division did not sufficiently monitor or track FTC examination results. The IRS should know the results of FTC examinations to more accurately determine what role they should play in the new Large Business and International Division's compliance strategy.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) ensure that supporting documentation is attached for all corporate FTC claims; 2) validate the FTCs reported on all tax returns in the Form 1120, *U.S. Corporation Income Tax Return*, series; 3) clarify Internal Revenue Manual requirements to send taxpayer notices for inaccurate FTC claims; 4) ensure that tax returns with an FTC in the Examination function inventory are referred to international examiners as required; 5) ensure the accuracy and completeness of key case data entered into the Issue Management System; 6) develop Functional Specification Packages to determine the amount of the FTC limitation and account for mixed-component consolidated tax returns; and 7) improve the measurement of the compliance results and productivity of the examinations of FTC issues.

In response to our report, IRS management agreed with six of our recommendations, and partially agreed with one. The IRS plans to take corrective actions to address the weaknesses identified.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 26, 2017

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvement Is Needed in Compliance Efforts to Identify Unsupported Claims for Foreign Tax Credits (Audit # 201630027)

This report presents the results of our review to determine whether Internal Revenue Service controls ensure that the Foreign Tax Credit is accurately claimed on a tax return when foreign government taxes are used to offset Federal taxes. This audit is included in the Treasury Inspector General for Tax Administration's Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of the Impact of the Global Economy on Tax Administration.

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

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

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Abbreviations

BRTF	Business Return Transaction File
FTC	Foreign Tax Credit
IMS	Issue Management System
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business and International
MeF	Modernized Electronic Filing
MSC	Missing Schedule Code
SAIN	Standard Audit Index Number
SRS	Specialist Referral System
TIGTA	Treasury Inspector General for Tax Administration
TPNC	Taxpayer Notice Code
UIL	Uniform Issue List
W&I	Wage and Investment

Background

U.S. corporations are taxed on their worldwide income. However, the Foreign Tax Credit (FTC) allows U.S. corporations to credit the foreign taxes paid, accrued, or deemed paid against their U.S. income tax, dollar for dollar, subject to FTC limitations. FTC limitations prevent taxpayers from using foreign taxes paid in a country with a higher tax rate to offset their tax liabilities on U.S. source income. The IRS has determined that the FTC is the largest tax credit claimed by U.S. corporations.[1]

The FTC is the largest tax credit claimed by U.S. corporations. For tax periods 2013 through 2015, at least 18,264 corporations claimed the FTCs of $298.9 billion.

The FTC is intended to eliminate potential double taxation on the foreign income of U.S. corporations. Double taxation occurs when the same item of income is taxed twice; by the United States, as the country of residence, and by the foreign country, where the income was generated. The principal purposes of the FTC were to keep U.S. corporations competitive with foreign companies that pay lower tax rates and to protect U.S. tax revenue from being lost to foreign subsidiaries. The FTC applies both to U.S. corporations with foreign subsidiaries as well as to the U.S. subsidiaries of foreign corporations.

The current provisions in Internal Revenue Code Section (§) 27(a) allow a nonrefundable credit, computed under Internal Revenue Code § 901, for income, war profits, and excess profit taxes paid by U.S. taxpayers, both corporate and individual, to foreign countries. Income is defined using U.S. tax principles. A foreign tax that is not a tax on income is not creditable, such as a value-added tax, property tax, or sales tax. Taxpayers can choose to take either a credit or a deduction of foreign taxes paid. The taxpayer is not allowed both a credit and a deduction on the same income in any given year for foreign taxes paid. The choice of a credit or a deduction may be made or changed within the 10-year statute of limitations.[2] However, it is almost always more beneficial for taxpayers to claim the credit.

Corporations report the FTCs on Form 1118, *Foreign Tax Credit–Corporations*, which is attached to the Form 1120, *U.S. Corporation Income Tax Return*, series of returns.[3] The Internal

[1] Statistics of Income Bulletin, Corporate Foreign Tax Credit, 2010, Fall 2014.
[2] Internal Revenue Code § 6511(d)(3) establishes a 10-year period in which to claim the FTC.
[3] The Form 1120 series of tax returns also includes Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*; Form 1120-F, *U.S. Income Tax Return for Foreign Corporation*; Form 1120-FSC, *U.S. Income Tax Return of a Foreign Sales Corporation*; Form 1120-L, *U.S. Life Insurance Company Income Tax Return*; Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return;* Form 1120-RIC, *U.S. Income Tax Return For Regulated Investment Companies*; and Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts.*

Revenue Service's (IRS) Submission Processing function is responsible for receiving, processing, and archiving tax return information. When paper-filed tax returns (hereafter simply paper tax returns) are received with an FTC, they are coded, edited, and numbered. The tax return data are then entered into the IRS computer system, validity checks are run, and errors are corrected. Data from paper tax returns are reviewed in the Code and Edit function and perfected by tax examiners in the Error Resolution System. This process is designed to ensure that the information on the paper tax return and Form 1118 is complete. Tax returns with an FTC can also be filed electronically through the Modernized Electronic Filing (MeF) system. The MeF system provides real-time processing of tax returns, improves error detection, standardizes business rules, and expedites tax return filing acknowledgements to taxpayers.

FTC statistics

Computing the FTC is very complex for U.S. corporations and can significantly affect the taxes claimed on U.S. tax returns. For tax periods 2013 through 2015, at least 18,264 corporations filed returns and reduced their U.S. income taxes by approximately $298.9 billion by claiming the FTC.[4] The FTCs will continue to reduce corporate income taxes as income from foreign sources rises. FTC regulations are complex and make tax administration more difficult. Figure 1 shows the breakdown of paper and electronically filed tax returns.[5]

Figure 1: Number of FTC Filings and Amounts

File or Source	Tax Period[6]	Forms 1120	Corporation Returns Filed	Amount of the FTC
Electronically Filed Returns	2013	5354	5336	$112,874,210,527
Electronically Filed Returns	2014	4561	4551	$ 90,670,860,728
Electronically Filed Returns	2015	5641	5636	$94,100,876,516
Electronically Filed Returns Totals		15,556	15,523	$297,645,947,722
Paper Returns	2013	1127	1116	$581,982,767
Paper Returns	2014	939	936	$356,003,705
Paper Returns	2015	692	689	$364,707,868
Paper Totals		2,758	2,741	$1,302,694,340

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Form 1120 tax return data obtained from the TIGTA Data Center Warehouse[7] through December 31, 2016.

[4] These figures include only Form 1120. The same corporations filing returns for multiple tax years are counted separately.
[5] Amounts used in our calculations and projections throughout this report were rounded.
[6] Tax period denotes the ending year of the corporations' accounting period.
[7] The Data Center Warehouse is a centralized storage and administration of files that provides IRS data and data access services to TIGTA auditors.

For Tax Year 2013, which is the latest year that specific IRS Statistics of Income data are currently available, there were 6,542 U.S. corporations that claimed an FTC, a 9 percent decrease from Tax Year 2012. Those corporations claimed more than $118 billion in the FTCs and reduced their U.S. income tax by 35.9 percent, from $329.4 billion to $211.1 billion. The credit reduced total U.S. corporate income tax reported for all corporations by 29 percent. Those corporations reported $831 billion in gross foreign source income, an increase of 4.8 percent from Tax Year 2012. The reported foreign source income was 37 percent of income subject to tax of all active U.S. corporations.

If an erroneous FTC is not identified by the Code and Edit function during processing, it can be corrected by the IRS's Large Business and International (LB&I) Division during an examination. The LB&I Division was reorganized in February 2016, and the International Business Compliance function was moved to the Cross Border Activities Practice Area. The LB&I Division is now organized by practice areas, which are groups of employees organized together to focus on one or more areas of expertise. Some examination inventory in the LB&I Division will now be selected based on the focus of issues (campaigns). The term "campaign" reflects the LB&I Division's strategic approach to address particular types of noncompliance. Campaigns will be used to identify, prioritize, and allocate resources to compliance issues within the LB&I Division's filing population. For the tax periods under review for the purposes of our audit, the International Business Compliance function was responsible for FTC management.

This review was performed with information obtained from the LB&I Division Headquarters in Washington, D.C. and the Small Business/Self-Employed Division offices and the Wage and Investment (W&I) Division Submission Processing site in Ogden, Utah, during the period December 2016 through July 2017. 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.

Results of Review

Submission Processing Weaknesses Have Improperly Allowed Foreign Tax Credits for Some Taxpayers

The IRS processed corporate tax returns that allowed taxpayers to claim the FTC without the required supporting documentation, resulting in potentially erroneous FTCs for tax periods 2013 through 2015.

Corporations that elect the benefits of the FTC under Internal Revenue Code § 901 must complete and attach Form 1118 to their income tax return to support the corporations' claim for an FTC for certain taxes paid or accrued to foreign countries or U.S. possessions. To identify taxpayers that may have erroneously received the FTC, we selected two statistically valid stratified samples (one for both electronically filed returns and paper tax returns and one for paper tax returns only) for tax periods 2013 through 2015 for which the FTC was greater than **2**.[8] We reviewed the tax returns to identify:

- The presence of Form 1118.
- Whether the FTC was claimed for amounts included in the deduction for taxes and licenses.
- Any instances in which the amount of the FTC claimed did not equal the amount of the FTC allowed.

We analyzed 76 paper (transcribed)[9] and 145 electronically filed corporate tax returns for tax periods 2013 through 2015 that required a Form 1118 be attached to support FTC claims. All electronically filed corporate tax returns in our sample had Forms 1118. However, for paper tax returns, we found that:

- In seven instances (9.2 percent), taxpayers received the FTC without the required Form 1118 attached.
- In two instances (2.6 percent), the IRS did not properly transcribe the FTC. These taxpayers received either an FTC for the incorrect amount or an FTC they did not request.

[8] See Appendix I for our detailed sampling methodology.
[9] When filing stand-alone Forms 1120-RIC and 1120-REIT or consolidated Forms 1120-PC and 1120-L, taxpayers must submit a paper tax return.

When projected to the population of paper tax returns, we estimate that 134 FTCs were allowed without the required Form 1118 and 38 FTCs were improperly transcribed.[10]

The process for perfecting paper Form 1120 series tax returns with a Form 1118 attached does not ensure that the form is present, complete, or accurate

We conducted a walkthrough in the IRS's Submission Processing function, which is part of the IRS's W&I Division, and reviewed the procedures, guidelines, and practices related to the processing of the paper Form 1120 series tax returns with an FTC amount on Line 5(a) of the Schedule J section, *Tax Computation and Payment*, of the Form 1120. We observed the following limitations to ensuring consistency and accuracy in processing paper Forms 1120 with the FTC:

- Procedures only require the Submission Processing function to correspond for a missing Form 1118 when two or more schedules are missing.
- Transcribed data from Line 5(a) of the Schedule J section of Form 1120 were not matched to the amount of the FTC claimed on Form 1118 to identify any potential errors.
- Data from Form 1118 (used to support the FTC claimed) *********2********
- No identifier is transcribed that indicates whether a Form 1118 is attached to a tax return that claims the FTC.

Internal Revenue Manual (IRM) 3.11.16.9.2, dated January 2015, instructs Code and Edit function employees to mark the tax return with Missing Schedule Code (MSC) 29 when the FTC claimed is more than **2** and Form 1118 is missing. **********2********** **********2********** *******2***** would the tax return be moved to the Error Resolution System for taxpayer correspondence to request the missing form. **********2********** **********2********** **********2********** **********2********** *******2*******. When the tax return posts to the IRS computer system, the MSC 29 systemically generates a notice (Computer Paragraph 181) to the taxpayer. We found that employees did not always follow existing IRM instructions to edit the tax return for MSC 29 and request the missing Form 1118. The analysis of our sample of various Form 1120 series paper tax returns for tax periods 2013 through 2015 indicated that none of the paper returns without a Form 1118 attached were marked with MSC 29.

Additional review of the processing phase of the tax return showed that Code and Edit function employees do not edit or review the Form 1118 if it is attached. There are no instructions in the

[10] See Appendix IV for methodology used to measure projected outcomes from sampling.

IRM informing employees as to what to do when there is more than one Form 1118 present. IRS management stated that they do look at Line 5(a) of the Schedule J section of Form 1120 to see if there is an FTC dollar amount listed there. However, there is no requirement to validate or match the amount on Line 5(a) to the amount on Form 1118. There are two different Code and Edit function procedures to generate audit codes, depending on if the FTC is greater or less than ***2***. If the FTC amount on Line 5(a) of the Schedule J section is less than ***2*** employees are instructed to edit the tax return for Audit Code 07; if it is more than ***2*** the tax return is edited for Audit Code 02. However, we found that these audit codes are not specific to the FTC and are used for many other situations. Submission Processing function management stated that if there is no dollar amount on Line 5(a) of the Schedule J section of Form 1120, then there is no dollar amount that they would check for on Form 1118. While there are some error codes that the FTC may generate, they are not specific to Form 1118. ********2********** **********2********** *********2*****. According to IRS management, Form 1118 is very complicated, but very little instruction or attention is paid to it.

**********2**********

Our ability to conduct the audit tests planned for the identified Form 1120 series tax returns was limited by data availability for certain forms in the Form 1120 series of tax returns and Form 1118. These data could be used to validate and ensure the accuracy of the FTC reported on all returns. For tax periods 2013 through 2015, there were 44,342 paper Form 1120 series tax returns for which no identification of the FTC existed on the Business Return Transaction File (BRTF).[11] **********2********** **********2********** **********2********** **********2********** **********2********** **********2********** **********2********** **********2********** **********2**********. **********2********** **********2**********. According to the Tax Year 2013 Form 1118 instructions, the estimated average time needed to complete and file this form and related schedules is approximately 147 hours. This complex form is required by the IRS to document and support the taxpayer's claim for the FTC. **********2*********

[11] BRTF programs receive business tax return data, and reformat and post returns to the Return Transaction File. These programs analyze tax return data for reports and extracts.

**********2********** appears to be a contradiction to the requirement and appears to reflect the IRS's lack of commitment to use the information to improve FTC compliance.

Corporations were not informed when IRS data systems changed the FTC amount

We analyzed BRTF files for tax periods 2013 through 2015 Forms 1120, 1120-C, and electronically filed Forms 1120-F tax returns claiming an FTC amount greater than zero. We compared the amount of the FTC claimed on the tax return to the amount allowed by IRS processing to determine whether Submission Processing function controls detect errors in FTC computations.

When we asked the Submission Processing function which of the two dollar amounts was actually given as the credit, Submission Processing function management stated that tax examiners follow the procedures in IRM 3.12.251(dated October 2015) to determine how the error condition should be resolved. The computation is systemic, *i.e.*, the "FTC Computer" field is determined by comparing the amount the taxpayer claims in the FTC to what the taxpayer has entered in the line for gross income tax. If the FTC claimed is greater than the gross income tax, IRS data systems accept the amount of gross income tax as the amount for the FTC, and a Taxpayer Notice Code (TPNC)11 (the FTC exceeded maximum allowable) is generated. If the FTC is equal to or less than the gross income tax, then the FTC amount entered by the taxpayer is allowed. W&I Division management stated that this is the only notice to taxpayers in use for the FTC and that no manual mathematical computations are performed during processing.

We requested from IRS management the volume of TPNC 11 notices sent to taxpayers for the tax periods under our review. They reported that a total of 14 TPNC 11 notices were generated or issued for tax periods 2013 through 2015. This is in contrast to the 291 tax returns identified in our analysis. It appears that there were 277[12] additional TPNC 11 notices that should have been sent to taxpayers but were not. W&I Division management stated that, although this number was accurate, the TPNC volumes were not evidence of accurate processing because employees may process the tax return correctly but use another TPNC with a similar explanation. As previously stated, there are no other notices in use for the FTC, and we found no evidence of any other TPNC that applied to the FTC. IRM 3.12.251.24.40 states that TPNC 11 is the notice to be generated under these conditions.

[12] Although TIGTA cannot confirm the 14 TPNC 11 notices reported by the IRS as sent were part of the population of 291 tax returns in our analysis, we have included them in the total in an effort to be conservative.

Recommendations

The Commissioner, W&I Division, should:

Recommendation 1: Establish controls to ensure that a Form 1118 is attached to all Form 1120 series tax returns for FTC claims when required. This would include ensuring that MSC 29 is coded on the tax return as required.

> ***Management's Response:*** The IRS agreed with this recommendation and will be changing its procedures. It will correspond with taxpayers to request missing documentation, in lieu of editing MSC 29, and use math error authority if taxpayers fail to provide Forms 1118. Electronically filed returns with this condition will continue to be rejected back to the originator for correction.

Recommendation 2: Include either an indicator for the presence of Form 1118 **2** **********2********** in order to validate the FTC reported on all tax returns in the Form 1120 series.

> ***Management's Response:*** The IRS agreed with this recommendation and will request programming that will add an indicator to the return record so the presence or absence of Form 1118 can be noted. Programming will also be requested for a corresponding error code, based on the indicator status and the presence or absence of the FTCs claimed.

Recommendation 3: Clarify IRM requirements to send taxpayer notices for inaccurate FTC claims. Determine if there is a computer processing failure that is not automatically generating a TPNC 11 when the FTC claimed is greater than the gross income tax reported.

> ***Management's Response:*** The IRS agreed with this recommendation and will review the related IRM 3.12.251 instructions to identify changes needed in the 2018 revision and request Enterprise Systems Testing of the programming for generating TNC 11.

Tax Returns Under Examination With a Foreign Tax Credit Were Not Always Referred to International Examination Specialists As Required

The Specialist Referral System (SRS) is an electronic, web-enabled referral routing system used to request international assistance on original filed tax returns with international features meeting the mandatory international referral criteria. According to guidance issued by the LB&I Division, specialists are used to examine events or transactions that require specialized skills and abilities. International examiners analyze transactions involving international features to determine whether a significant international issue needs to be examined, including cases with FTC issues. The SRS communicates the status of the acceptance or rejection of referrals and facilitates management issue tracking.

For the tax periods reviewed during this audit, IRM 4.60.6, dated March 2007, was in effect. Due to the complexity of the FTC computations, IRM 4.60.6 mandates that revenue agents submit requests for assistance from international examiners using the SRS when auditing tax returns claiming the FTC. In order to be referred, the tax returns must be in the Examination function's inventory and claim an FTC greater than ***2*** It is important 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.

We performed an analysis of Examination function records for open, closed, and nonexamined corporation tax returns for tax periods 2013 through 2015 with an FTC claimed of greater than ***2*** We matched these data to records provided to us by the IRS of tax periods 2013 through 2015 corporate tax returns referred to the SRS with an FTC identified as an issue to determine whether any of these corporation tax returns were referred to international examiners as required and whether they were accepted into the International program or rejected back to the originator. We identified that 473 corporate tax return examinations conducted by all business operating divisions having the FTCs totaling more than $19 billion were properly referred through the SRS.[13] We also identified 1,389 closed and nonexamined tax returns that were not referred to the SRS. Of those closed and nonexamined tax returns, 338 returns claiming a total FTC of almost $2 billion should have been referred per the referral criteria, 134 (39.6 percent) of which claimed more than $1 million.

In addition, we determined that the remaining 1,051 tax returns with combined FTCs of more than $17 billion would have met the referral requirements but instead were surveyed[14] by field examination support groups prior to assignment to examiners. The IRM requirement for referrals is vague as to at what point in the process the referral should be made. The LB&I Division stated that these returns were surveyed because the Assessment Statute Expiration Date was less than 18 months. However, IRM guidance sets the amount of time required for assignment to an examiner as a minimum of 12 months remaining until the Assessment Statute Expiration Date. Analysis of the examined tax returns under review determined that the average amount of time taken for full examination of corporation tax returns with the FTC is slightly more than 10 months. We further determined that 410 of the 1,051 tax returns were surveyed for having less than 18 months until the Assessment Statute Expiration Date. All of these returns had more than 12 months remaining until the Assessment Statute Expiration Date, and 410 tax returns had more than 17 months remaining. Notwithstanding the dollar amount of the FTC at stake, it appears that the LB&I Division field examination support groups are surveying cases even when there is sufficient time to conduct the examination.

[13] The following business operating divisions were included: the LB&I, Small Business/Self-Employed, and Tax Exempt and Government Entities Divisions.
[14] A surveyed case is a type of case closure.

During discussions with LB&I Division management, classifiers, and revenue agents, we questioned the ***2*** mandatory referral amount for the FTC. This threshold amount has not been revised since Calendar Year 2004. During this period, the FTCs claimed by U.S. corporations have risen from $56.6 billion to $118.3 billion (Calendar Year 2013). The majority of management and employees interviewed believe that the threshold for FTC referrals should be raised, and various suggestions to do that were put forward. Criteria such as percentage of tax liability, dollar amount of the FTC claimed, or a workable combination of other relevant criteria were proposed. More than 98 percent of the total FTC dollars for a year are claimed by the largest corporations.[15] In addition to other factors which are discussed below, the low referral threshold may be a factor in the nonreferral of FTC claims.

Clarification of referral procedures was a good first step, but additional emphasis on the referral criteria is needed

The purpose of the 2007 IRM 4.60.6 was to provide "guidance and technical information on international referral criteria and procedures applicable to referrals to all Operating Divisions." As a result of a prior TIGTA report,[16] an updated IRM 4.60.6 and related training, *Specialist Referral System, Issue Practice Groups & Technical Specialists*, were issued in December 2015.[17] This IRM update states that:

> *In the normal course of auditing tax returns, revenue agents and tax compliance officers may require the assistance of international subject matter experts. A request for international assistance may be either a formal request for the assignment of an IE [international examiner] to the case, or an informal request that simply seeks a response to a specific question. In either case, the Specialist Referral System (SRS) shall be used to request international assistance.*

The updated IRM also states that all returns meeting the mandatory referral criteria in IRM 4.60.6.2 will be referred using the SRS.

It appears that the contradictory wording in the March 2007 version of IRM 4.60.6 that was in effect during our review was a factor in the cases not being referred. It stated that, "Generally, all returns with international features that meet the mandatory criteria must be referred to international examiners." The word "generally" caused confusion and was removed from the December 2015 IRM, leaving no ambiguity. While we recognize that the effect of the revised IRM cannot yet be determined, the IRS has acknowledged that these cases should have been the subject of an international referral and that further investigation would validate our contention that referrals are not being made as required. The IRM has been clarified; however, we believe

[15] Statistics of Income Bulletin, *Corporate Foreign Tax Credit*, 2011, Winter 2016.
[16] TIGTA, Ref. No. 2015-30-052, *Improvement Is Needed in Compliance Efforts to Identify Unsupported Claims for Foreign Tax Credits* (July 2015).
[17] The training was titled *Specialist Referral System, Issue Practice Groups & Technical Specialists.*

that some employees may still not know whether their cases must be referred through the SRS for FTC issues.

In addition to the IRM revisions, more attention must be focused on generating awareness of the mandatory referral criteria, and further emphasis or clarification on examiners' compliance with this process should be included in any training material and guidance. When tax returns are not referred to an international examiner as required, the skill level needed to evaluate the FTC may not be appropriately used and FTC issues could go unexamined.

Recommendation

Recommendation 4: The Commissioner, LB&I Division, should conduct an analysis to determine the most effective dollar amount threshold for referring and classifying FTC amounts for examination and emphasize the mandatory referral criteria for FTC cases through guidance to employees and the quality review process.

> ***Management's Response:*** The IRS agreed with this recommendation and will conduct an analysis to review the criteria for referring and classifying FTC amounts for examination, and emphasize the importance of mandatory referrals through guidance to employees and the quality review process.
>
> ***Office of Audit Comment:*** Although IRS management agreed with our recommendation, they took exception to our finding that 338 returns claiming a total FTC of almost $2 billion should have been referred per the referral criteria, but were not. As we presented in the report, the IRS's own guidance requires that a request for international assistance may be either a formal request for the assignment of an international examiner to the case or an informal request that simply seeks a response to a specific question. However, it also states that, in either case, the SRS shall be used to request the assistance. In addition to reviewing the SRS for the referrals, we also looked at all electronic case information and were not able to identify any indication the cases were referred. IRS management stated that they pulled the paper case files and identified hard copy notes discussing referral activities. Evidence of a discussion concerning a possible referral does not mean that the case was referred as required. Because the guidance on referrals was not followed, there is no clear evidence that the cases in question were referred.
>
> IRS management also took exception to our assessment that cases with 12 months remaining until the Assessment Statute Expiration Date could be assigned to an examiner for audit. As mentioned in the report, the IRS's own guidance sets the amount of time required for assignment to an examiner as a minimum of 12 months remaining until the Assessment Statute Expiration Date. The average amount of time taken for full examination of corporation tax returns with the FTC is slightly more than 10 months. All 1,051 of the returns we identified had more than 12 months remaining until the

Assessment Statute Expiration Date, and 410 (39 percent) of the 1,051 tax returns had more than 17 months remaining until the Assessment Statute Expiration Date. If the IRS would like to use 18 months as the time frame, it should provide support to IRS executives and make changes to its formal guidance rather than continue to use "separate internal rules."

Examiners Are Not Always Properly Inputting Key Case Data to the Issue Management System

The LB&I Division designed the Issue Management System (IMS) to serve as a case management system for agents, specialists, international examiners, managers, and others. LB&I Division management mandated the use of the IMS in March 2006 for all LB&I Division employees working examinations.[18] According to LB&I Division officials, the purpose of the system is to help management improve strategic decisions and make informed decisions on resource allocations. Examiners are required to use the IMS to capture information from their audits, such as the type of examination issues pursued and the amounts and reasons for adjustments. The IMS is also used to create reports to deliver information to decision-makers and field examiners as well as to provide issue data and information as a way to identify the most productive tax issues for examination in the future.

According to the July 2011 IRM 4.46.1, team members are responsible for IMS input. Case managers and team coordinators are responsible for ensuring that the IMS is timely updated and accurate. The information captured is related to cases, tax return issues, and cycles (tax years under examination).

The LB&I Division has established mandatory minimum input requirements for new cases.[19] This mandatory input includes Standard Audit Index Numbers (SAIN) and Uniform Issue List (UIL) issue codes. According to the August 2015 IRM 4.25.5.2.1.4, identified issues are classified by selecting a SAIN and an UIL. The primary purpose of the SAIN is to provide a consistent numbering system for examination workpapers, and the UIL is a list of codes used to track examination issues. The SAIN is also used for time tracking. The IRM states that tracking issues using both the SAIN and the UIL number will allow the IRS to plan and allocate resources more efficiently. Consequently, at least one SAIN and one UIL number must be selected for each tax return in a case.

Examiners prepare workpapers and written records to provide support for the conclusions reached in the examiners' report. Workpapers are used to document procedures applied, tests performed, information obtained, and conclusions reached in the examination. Workpapers should appropriately document techniques used and conclusions reached and must properly document examination activities. Form 9984, *Examining Officer's Activity Record*, is used to

[18] The IMS is the LB&I Division's computerized case management system.
[19] New cases are cases started on or after March 12, 2012.

record this information and is required in the IMS. LB&I Division management requires that workpapers be legible and organized and identified by the appropriate SAIN. When examiners create an issue in the IMS, a lead sheet with the SAIN they selected for the issue is automatically generated.

We analyzed a statistically valid sample of 70 closed LB&I Division examinations for which the FTC was greater than $100,000. Of the 70 IMS records in the sample, 47 were for tax periods 2013 through 2015 corporate tax returns referred to the SRS and accepted. We found that 20 of the 47 records had been referred with the FTC identified as an issue but with no FTC SAIN or UIL recorded in the IMS. There were 33 records in our sample with an FTC SAIN included in the IMS. Of those 33 records, we identified 29 records for which prescribed procedures were not followed. Further analysis of the 70 IMS records identified the following:

- In 37 instances, the FTC SAIN and UIL were not input when examining an FTC. Missing or erroneous data in IMS electronic workpapers may reduce opportunities to improve how the IRS selects returns for issue-focused examinations.
- In 66 instances, the lead sheet was incomplete or missing. Completing the lead sheet allows for documentation of audit procedures.
- In 54 instances, Form 9984 was missing or incomplete. Form 9984 must be filled out to provide a complete and concise case history and is used to support examination actions taken on a case.
- In 63 instances, the conclusion was missing from the lead sheet. Workpapers should properly document the conclusions reached.

In a related audit performed by TIGTA, we determined that the LB&I Division does not generally know the results of its compliance efforts by issue.[20] The inability to generate accurate compliance results by issue is due in part to an overly broad UIL, systemic limitations, human error, and a lack of emphasis by management to address those errors. For example, revenue agents do not always use the codes accurately when inputting issues into the IMS, so reports used in monitoring or decisionmaking can be unreliable.

Recommendation

Recommendation 5: The Commissioner, LB&I Division, should implement controls to improve the accuracy and completeness of data entered into the IMS, ensure that examination procedures are being followed, and emphasize the accuracy and completeness of data in the quality review process.

[20] TIGTA, Ref. No. 2016-30-089, *The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit From Reliable Information on Compliance Results* (Sept. 2016).

Management's Response: The IRS agreed with this recommendation and stated that the LB&I Division can improve the accuracy and completeness of data it enters into the IMS, the LB&I Division's primary case management system. The IRS asserts that it already places heavy emphasis on the accuracy and completeness of data in the IMS and agrees to continue this practice. In addition, programming changes have been made to the IMS application to encourage and facilitate more accurate data input by IMS users, and LB&I Division managers have received training on the importance of accurate use of codes to categorize issues in the IMS. The IRS also stated that the review of IMS data for accuracy is a managerial commitment in the performance management process, and that Quality Review and Analysis staff review input into the IMS application on every case.

The Accounts of Some Taxpayers Have Erroneous Data Related to the Foreign Tax Credit

As previously stated, our analysis of BRTF files for tax periods 2013 through 2015 Forms 1120 and 1120-C and electronically filed Form 1120-F tax returns showed a large dollar difference in the amount of the FTC claimed by the taxpayers and the amount of the FTC allowed and recorded in the IRS data system.

The Government Accountability Office's *Standards for Internal Control in the Federal Government*[21] states that quality information is appropriate, current, complete, and accurate. We found instances in which the IRS data system improperly determined the FTC amount to be zero. The IRS explained that the records we identified were mixed-component tax returns.[22] Taxpayers that file consolidated returns and include at least one subsidiary that is either a Life Insurance Company (Form 1120-L) or a Property and Casualty Insurance Company (Form 1120-PC) are instructed to leave Lines 1 through 29 (income and deductions) blank on their Form 1120. These "mixed-component tax returns" can create an IRS processing exception. In this situation, the IRS data system uses the blank in Line 3 to reduce the FTC amount to zero. This computation is systemic, *i.e.*, the "FTC Computer" field is determined to be zero when income on the return (Line 3) is blank. This exception processing requires fully allowed FTCs to be coded into the Integrated Data Retrieval System as zero.[23] IRS data collection recognizes only the zero amount as the computed FTC even though the FTC claimed amount has been fully allowed. We sent the IRS five cases for which the FTC amount was reduced to zero. In two of the five cases, there is a potential discrepancy between the MeF system and paper processing.

[21] Government Accountability Office, GAO-14-704G, *Standards for Internal Control in the Federal Government* (Sept. 2014).
[22] A mixed-component tax return is a consolidated return for which the subsidiaries compute tax in different ways, *i.e.*, Form 1120-L and Form 1120-PC are combined with a Form 1120. A combination of Form 1120 and Form 1120-L or 1120-PC may be processed as either the parent or subsidiary tax return.
[23] The Integrated Data Retrieval System is the IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

IRS management stated that the MeF system does not generate an amount for total statutory credits when Line 3 of Form 1120 is zero. The MeF system should be following paper processing procedures and limit the total statutory credits to zero when Form 1120, Schedule J, Line 2 is zero. As a result, the accounts of the affected taxpayers may be inaccurate. Taxpayers have the right for their accounts to be correct. The IRS has stated that it is looking into whether a change is required to fix the problem.

According to W&I Division management, the MeF system does not perform a schema (database) validation or request the implementation of business rules to math verify the FTC. Furthermore, we found no evidence that the FTC limitation is calculated and applied correctly at any time during processing. **********2********** **********2********** This would be an added processing control to detect errors in FTC computations.[24]

Recommendation

Recommendation 6: The Commissioner, W&I Division, should evaluate the Functional Specification Packages to identify programming changes needed to calculate the amount of the FTC limitation and account for mixed-component returns. **********2********** **********2**********

> ***Management's Response:*** The IRS partially agreed with this recommendation. It will evaluate the Functional Specification Package and Code and Edit function rules and, in coordination with IRS compliance functions, will determine if changes can be made that will improve its ability to identify and select for treatment mixed-component returns claiming the FTC.
>
> ***Office of Audit Comment:*** The IRS's corrective action to evaluate the Functional Specification Package and Code and Edit function rules to improve its ability to identify and select for treatment mixed-component returns claiming the FTC is a positive step. **********2********** it should allow for a calculation of the FTC limitation on all tax returns when making these improvements.

[24] Functional Specification Packages contain information about the logic and data within a given program. They contain the functional requirements for programs developed by the IRS using a structured methodology.

Results of the Internal Revenue Service's Foreign Tax Credit Compliance Efforts Cannot Be Determined Without Sufficient Tracking and Monitoring of Examinations With Foreign Tax Credit Issues

LB&I Division management does not specifically track or monitor FTC examination results or outcomes. LB&I Division management stated that there are data reported to provide certain results (the International Briefing Book), but this report does not provide sufficient statistics to measure the impact of the IRS's FTC compliance efforts, *e.g.*, examination adjustments and taxes ultimately assessed. In the related TIGTA audit, we determined that the LB&I Division generally does not know the results of its compliance efforts by issue and that this lack of information is due in part to an overly broad UIL and a lack of emphasis on the part of management to ensure that issues are logged appropriately into the IMS.[25] The IRS has stated that it is implementing a campaign approach to address its highest risk compliance issues. In response to the prior TIGTA report, LB&I Division management agreed to provide "compliance results by issue from the Issue Based Management Information System for use by the practice areas in the development of campaigns." Therefore, the IRS should be measuring the results of its examinations of FTC issues, including the amounts of the examination adjustments and the taxes ultimately assessed.

The U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* requires management to track major agency achievements and compare them to established plans, goals, and objectives. Managers also need to compare actual performance to planned or expected results throughout the organization and analyze significant differences. Internal controls should generally be designed to ensure that ongoing monitoring occurs in the course of normal operations; is performed continually and is ingrained in the agency's operations; and includes regular management and supervisory activities, comparisons, reconciliations, and other actions people take in performing their duties. In the IRS's "Future State" plan, a core set of guiding principles was established as the foundation for where the LB&I Division wants to be in the future. These include:

- Utilizing data analytics and examiner feedback to select better work with intended compliance outcomes.
- Driving continual collection and analysis of data and feedback to enhance the ability to focus, plan, and execute work and promote innovation and feedback-based improvement.

The LB&I Division intends to use data and analysis, combined with input from its experienced examiners and their leaders, to determine the selection of better work (building campaigns).

[25] TIGTA, Ref. No. 2016-30-089, *The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit From Reliable Information on Compliance Results* (Sept. 2016).

Without accurate tracking and monitoring of the FTC work they are currently engaged in, the potential to do this in the future may be diminished.

Recommendation

Recommendation 7: The Commissioner, LB&I Division, should improve the measurement of the compliance results of the examinations of FTC issues. This should include, but not be limited to, the amount of the examination adjustments and the taxes ultimately assessed.

> ***Management's Response:*** The IRS agreed with this recommendation and will improve monitoring and measuring of FTC results, especially with regard to examination adjustments. The IRS also agreed that there would be some benefit to tracking taxes ultimately assessed on FTC issues. However, the IRS stated that it has limited resources available, and it believes the relatively limited benefits of assessment information make this a lower priority compared to other competing priorities. The IRS stated that it cannot commit to the submission or completion of a work request to track taxes assessed for FTC issues at this time.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was 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. To accomplish our objective, we:

I. Determined whether the IRS is properly processing Forms 1118, *Foreign Tax Credit–Corporations*, after receipt of the tax return.

A. Obtained and reviewed the appropriate IRM sections to determine what controls are in place to properly process Form 1118.

B. Identified the process used to ensure the accuracy of Form 1118 during processing by performing a walkthrough of the Ogden, Utah, Submission Processing Site, including the Code and Edit, Error Resolution, and Data Transcription functions.

C. Interviewed representatives of the Code and Edit, Error Resolution, Data Transcription, and Electronic Tax Administration functions to determine what oversight they provide and the procedures they use to ensure that Form 1118 is accurately processed.

D. Reviewed Form 1118 electronic filing documentation to determine what checks are included to ensure that the FTC claimed is accurate. We also identified any relevant reject codes to see what errors the IRS is identifying before the tax return is accepted.

E. Reviewed the Functional Specifications Packages[1] to determine if IRS computer programming included computations for the FTC limitation and identified other types of errors that can be made on the FTC calculation.[2]

F. Obtained data on Forms 1120, *U.S. Corporation Income Tax Return*, and Forms 1120-C, *U.S. Income Tax Return for Cooperative Associations*, from the BRTF at TIGTA's Data Center Warehouse for which taxpayers claimed the FTC on Line 5a of the Schedule J section of Forms 1120 and 1120-C for the tax periods 2013, 2014, and 2015.[3] In addition, we identified, from the BRTF, those taxpayers with an amount on Form 1120, Line 17, *Taxes and Licenses*, and those taxpayers with an

[1] Functional Specification Packages contain information about the logic and data within a given program. They contain the functional requirements for programs developed by the IRS using a structured methodology.
[2] Documentation of the IRS's computer programming.
[3] Returns filed with an accounting period ending from January 2013 through December 2015.

amount on Form 1120-C, Line 15, *Taxes and Licenses*, that filed Form 1118 for the same time period.

1. Using the data identified in Step I.F., identified tax returns for which the FTC claimed did not equal the amount allowed by the computer to verify the computer programming on calculating the FTC limitations.
2. Using the data identified in Step I.F., matched the Form 1118 data to the Forms 1120 and 1120-C data on Line 5(a) of the Schedule J section.
3. Using the data identified in Step I.F.1., identified Forms 1120 and 1120-C with an FTC of **2** or more and selected two statistically valid samples to ensure that Form 1118 was filed with the tax return as required. In order to project measured outcomes from any identified exceptions, we used a 95 percent confidence level, 4 percent expected error rate, and ±3 percent precision rate for this sample.
4. Using the data identified in Step I.F.1., identified Forms 1120 and 1120-C with an FTC of less than **2**
5. Using the data identified in Step I.F., identified Forms 1120 and 1120-C for which the taxpayer claimed the FTC and also claimed a deduction on Form 1120, Line 17, *Taxes and Licenses*, and Form 1120-C, Line 15, *Taxes and Licenses*, to determine if it appeared the taxpayer claimed both the credit and the deduction for the same foreign taxes.

G. Identified the remaining Form 1120 series tax returns[4] that have a corresponding Form 1118 but do not have a corresponding Form 1118 from the match performed in Step I.F.

1. Reviewed one statistically valid sample of records from Step F.3. of the Form 1120 series tax returns with a corresponding Form 1118 to determine the accuracy of the transcription of the FTC by matching the amount on Form 1120 to the amount on Form 1118, and verified that the taxpayer did not claim both an FTC deduction and credit. For the exceptions identified from our review, we employed a contract statistician to project the results to the total population.

II. Determined what examination controls the IRS has in place to identify and validate questionable amounts of the FTCs claimed on Forms 1120, and determined whether the IRS verifies that the FTC limitation is calculated and applied correctly.

[4] The Form 1120 series of tax returns includes Form 1120; Form 1120-C; Form 1120-F, *U.S. Income Tax Return for Foreign Corporation*; Form 1120-FSC, *U.S. Income Tax Return of a Foreign Sales Corporation*; Form 1120-L, *U.S. Life Insurance Company Income Tax Return*; Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return;* Form 1120-RIC, *U.S. Income Tax Return For Regulated Investment Companies*; and Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts.*

A. Obtained and reviewed the IRM to determine what controls are in place to identify and select tax returns claiming questionable FTCs for examination.

B. Interviewed Examination function management from the Small Business/ Self-Employed Division and the LB&I Division to determine:

   1. How they identify and select for audit tax returns claiming questionable FTCs.

   2. Whether they are using available international tax information in their audits.

   3. Examination management's opinion on Form 1118 taxpayer compliance.

C. Interviewed LB&I Division management to determine if there are any IMS[5] or other system reports that show FTC SAIN codes (No. 604-01) or FTC UIL codes (No. 9413) as an examination issue or as a method of tracking.

D. Obtained and analyzed records from the Audit Information Management System[6] files at TIGTA's Data Center Warehouse to identify all examination cases closed during Fiscal Years[7] 2013, 2014, 2015, and 2016. We matched this information to the BRTF to identify all the examined Forms 1120 that claimed the FTC.

E. Analyzed the matched data in Step II.D. to identify any examination results related specifically to the FTC.

F. Used the information obtained in Step II.D. to identify examined tax returns claiming the FTC by business operating division.

G. Used the data matched in Step II.D. to identify all claimed FTCs greater than ***2*** We matched these data to the SRS to determine if any Forms 1118 claiming an FTC greater than ***2*** were referred to international examiners as required.

H. Used the results of the matches in Steps II.D. and II.E. to determine if the IRS is identifying instances in which the incorrect FTC is reported and whether the incorrect amount is being referred to and addressed by the Examination function.

I. Used the results from II.H. and selected a statistically valid sample of those tax returns to determine whether FTC examination procedures were being followed. In order to project a measured outcome from any identified exceptions, we used a 95 percent confidence level, 5 percent expected error rate, and ±5 percent precision rate for this sample. Results of review was limited to observations of exceptions and were not projected.

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[5] The IMS is the LB&I Division's computerized case management system.
[6] The Audit Information Management System is a computer system used by Examination functions to control returns, input assessments/adjustments to the Master File, and provide management reports.
[7] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

Data validation methodology

During this review, we relied on Form 1120, Form 1120-C and Form 1120-F return data extracted from the BRTF for tax periods ending in 2013, 2014, and 2015 that were extracted by an auditor from TIGTA's Data Center Warehouse. Additionally, we relied on Form 1120 and Form 1120-F return data extracted from the BRTF for tax periods ending in 2013, 2014, and 2015 that were provided by TIGTA's Office of Investigations' Strategic Data Services. We further relied on data extracted from the Audit Information Management System for examination records matching Form 1120, Form 1120-C, and Form 1120-F returns for tax periods ending in 2013, 2014, and 2015. To assess the reliability of computer-processed data, TIGTA auditors and programmers within Strategic Data Services validated the data extract files, while we ensured that each data extract contained the specific data elements we requested and that the data elements were accurate. We reviewed samples of more than 100 randomly selected records and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System and on the Form 1120, Form 1120-C, and Form 1120-F. As a result of our testing, we determined the data used in our review were 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 that the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for processing the FTC in the Submission Processing and Examination functions. We evaluated these controls by interviewing IRS management and field employees as well as evaluating tax return data, Examination function database files, and information tax returns.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Deputy Commissioner, Large Business and International Division
Deputy Commissioner, Wage and Investment Division
Director, Cross Border Activities, Large Business and International Division
Director, Office of Audit Coordination

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; $70,504,288[1] million for 134 tax returns claiming the FTC that did not have the required documentation (see page 4).

Methodology Used to Measure the Reported Benefit:

Action Taken	Results
Obtained Forms 1120, 1120-C, and 1120-F (electronic and paper)[2] with an FTC filed for tax periods 201301 - 201512	18,314
Extracted paper Forms 1120, 1120-C, and 1120-F with an FTC greater than **2** (the sample population)	1,454
Sample size of the population of 1,454 paper tax returns using: • 70 tax returns – 95 percent confidence level, ± 5 percent error rate, and ± 5 percent precision • 20 tax returns – 95 percent confidence level, ± 4 percent error rate, and ± 3 percent precision	76 total records sampled • 56[3] • 20
Sample results – exceptions (an FTC received with no Form 1118)[4]	• 7
Results projected to our population of 1,454 tax returns using 95 percent confidence level	• 134
Average exception dollars per tax return in the population	• $48,490[5]
Potential protected revenue (average dollars per tax return in the population times the number of tax returns in the population) = ($48,490*1,454)	• $70,504,288

[1] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between $3,685,231 and $186,678,384.
[2] Form 1120, *U.S. Corporation Income Tax Return*; Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*; Form 1120-F, *U.S. Income Tax Return for Foreign Corporation*.
[3] There were two samples. The first sample included 70 paper tax returns. It contained one duplicate from the second sample, which was removed. We requested 69 returns, and only received and reviewed 56.
[4] Form 1118, *Foreign Tax Credit–Corporations.*
[5] Rounded from $48,489.8815.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $33,710[6] for 38 tax returns that received the FTC due to transcription errors (see page 4).

Methodology Used to Measure the Reported Benefit:

Action Taken	Results
Obtained Forms 1120, 1120-C, and 1120-F (electronic and paper) with an FTC filed for tax periods 201301 - 201512	18,314
Extracted paper Forms 1120, 1120-C, and 1120-F with an FTC of greater than **2** (sample population)	1,454
Sample size of the population of 1,454 paper tax returns using: • 70 tax returns – 95 percent confidence level, ± 5 percent error rate, and ± 5 percent precision • 20 tax returns – 95 percent confidence level, ± 4 percent error rate, and ± 3 percent precision	76 total records sampled • 56 • 20
Sample results – exceptions (taxpayer received an FTC due to transcription errors)	• 2
Results projected to our population of 1,454 using 95 percent confidence level	• 38
Average exception dollars per tax return in the population	• $23[7]
Potential protected revenue (average dollars per tax return in the population times the number of tax returns in the population) = ($23*1,454)	• $33,710

[6] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between $1,762 and $79,554.
[7] Rounded from $23.1842.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

COMMISSIONER
LARGE BUSINESS AND
INTERNATIONAL DIVISION

September 12, 2017

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT
MICHAEL E. McKENNEY

FROM: Douglas W. O'Donnell
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report # 2016-30-027, Improvement is Needed in Compliance Efforts to Identify Unsupported Claims for Foreign Tax Credits (FTC)

Thank you for the opportunity to respond to the report entitled "Improvement Is Needed In Compliance Efforts to Identify Unsupported Claims for Foreign Tax Credits *(TIGTA Audit 2016-30-027)*."

The report comes at a time when the IRS is developing new processes and initiatives intended to bring about substantive, long term improvements in taxpayer compliance. These include changes to how the IRS selects and staffs cases - including cases with foreign tax credits (FTCs) - and assigns work for their examination.

We agree with many of the report's recommendations for improving identification of unsupported claims for FTCs. It is important to note that the scope of this report is limited to a review of the IRS' processing of corporate returns with FTCs and certain controls for examining FTCs and does not cover the broader IRS program and strategy for ensuring compliance with the corporate FTCs. We feel it is important to clarify facts related to the report and to point out steps the IRS is already taking to address concerns underlying the report's recommendations.

Paper-filed returns: The report identifies several issues associated with processing of paper-filed returns claiming the FTC. We note that from 2013 through 2015, the total FTC claimed on paper-filed returns accounted for less than one-half of one percent of the overall FTC claimed by corporations. While correcting processing issues on paper-filed returns would provide limited compliance benefits, the impact of such corrections would be small in proportion to FTC claimed by all taxpayers. The IRS needs to balance improvements to paper-filed return processing with broader initiatives to administer corporate foreign tax credits across the entire population, including the more significant electronic filing population.

International specialist referrals: The IRS acknowledges the importance of bringing appropriate expertise to bear on all cases. Under our new approach, traditional referrals

of FTC cases from one group of agents to another via the Specialist Referral System (SRS) will no longer be necessary, as appropriate specialists will be part of planned examination staffing from case inception. The IRS expects a gradual and substantial diminution in future need for separate specialist referrals for corporate work assigned under this new initiative.

- Use of SRS for Referrals: TIGTA contends the IRS failed to make required referrals in hundreds of cases covering roughly $2 billion in claimed FTCs. In its review of the cases in question, the IRS determined referrals were in fact made for the vast majority-though not all used SRS. The IRS can identify only 70 cases, representing less than $200 million, in which it appears no referrals were made. Nevertheless, the IRS agrees to reassess the ***2*** threshold criteria for making referrals to international specialists. It also agrees to continue to emphasize appropriate referral criteria in employee guidance, and to use its quality review process to monitor and enforce compliance with referral procedures.

- Time limits for making referrals: The report suggests that $17 billion of FTCs on roughly 1,000 returns were not referred as required because IRS used incorrect time limit criteria in its decision not to examine these returns. TIGTA stated that these returns had sufficient time (12 months) on the statute, the period in which the IRS can assess taxes, to allow for an examination and referral. The IRS does not agree with these findings, and continues to believe appropriate time limits were applied. Instead of the 12 months discussed above, IRS used 18 months as the criteria for determining whether a return had sufficient time on the statute to be examined. This criteria is based on separate internal rules requiring IRS to be "current" on examinations and that allow adequate time for independent administrative review.

Compliance results: The IRS disagrees with TIGTA's assertion that the agency is largely unaware of the results of its compliance efforts on FTC issues. We do agree the IRS should continue to improve monitoring and measuring of FTC results, especially regarding examination adjustments.

There are two attachments included herewith. Attachment I provides details on our corrective actions responding to TIGTA's specific recommendations. Attachment II notes we are unable to confirm the two Outcome Measures recommended by TIGTA in Appendix IV of the report.

If you have any questions, please contact me or members of your staff may contact John E. Hinding, Director, Cross Border Activities Compliance Practice Area at (202) 317-8686.

Attachments (2)

Attachment I

RECOMMENDATION 1:

The Commissioner, Wage and Investment Division, should: Establish controls to ensure that a Form 1118 is attached to all Form 1120 series tax returns for FTC claims when required. This would include ensuring that MSC 29 is coded on the tax return as required.

CORRECTIVE ACTIONS:

We agree and are changing our procedures. We will correspond with taxpayers to request missing documentation, in lieu of editing Missing Schedule Code 29, and use math error authority if taxpayers fail to provide Forms 1118, Foreign Tax Credit - Corporations. Electronically-filed returns with this condition will continue to be rejected back to the originator for correction.

IMPLEMENTATION DATE:

October 15, 2017

RESPONSIBLE OFFICIAL(S):

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

The Commissioner, Wage and Investment Division, should: Include either an indicator for the presence of Form 1118 **********2********** in order to validate the FTC reported on all tax returns in the Form 1120 series.

CORRECTIVE ACTIONS:

We agree with this recommendation and will request programming that will add an indicator to the return record so the presence or absence of Form 1118 can be noted. Programming will also be requested for a corresponding error code, based on the indicator status and the presence or absence of FTCs claimed.

IMPLEMENTATION DATE:

Programming changes are subject to limited resources, budgetary constraints, and competing priorities; consequently, we cannot provide an implementation date at this time.

RESPONSIBLE OFFICIAL(S):

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor this corrective action as part of our internal management system of controls.

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RECOMMENDATION 3:

The Commissioner, Wage and Investment Division, should: Clarify IRM requirements to send taxpayer notices for inaccurate FTC claims. Determine if there is a computer processing failure that is not automatically generating a TPNC 11 when the FTC claimed is greater than the gross income tax reported.

CORRECTIVE ACTIONS:

We agree with the recommendation. We will review the related Internal Revenue Manual 3.12.251 instructions to identify changes needed in the 2018 revision and request Enterprise Systems Testing of the programming for generating Taxpayer Notice Code 011.

IMPLEMENTATION DATE:

January 15, 2018

RESPONSIBLE OFFICIAL(S):

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:

The Commissioner, Large Business and International Division, should: Conduct an analysis to determine the most effective dollar amount threshold for referring and classifying FTC amounts for examination and emphasize the mandatory referral criteria for FTC cases through guidance to employees and the quality review process.

CORRECTIVE ACTIONS:

The IRS agrees to conduct an analysis to review the criteria for referring and classifying FTC amounts for examination, and to emphasize the importance of mandatory referrals through guidance to employees and the quality review process.

IMPLEMENTATION DATE:

March 31, 2018

RESPONSIBLE OFFICIAL(S):

Director, Cross Border Activities, LB&I, and
Director, Program and Business Solutions (PBS), LB&I

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 5:

The Commissioner, Large Business and International Division should: Implement controls to improve the accuracy and completeness of data entered into IMS, ensure that examination procedures are being followed, and emphasize the accuracy and completeness of data in the quality review process.

CORRECTIVE ACTIONS:

We agree that LB&I can improve the accuracy and completeness of data it enters into the Issue Management System (IMS), LB&I's primary case management system. LB&I has traditionally placed heavy emphasis on the accuracy and completeness of data in IMS. We agree to continue this practice. Programming changes have been made to the IMS application to encourage and facilitate more accurate data input by IMS users. LB&I managers have received training on the importance of accurate use of codes to categorize issues in IMS. Review of IMS data for accuracy is a managerial commitment in the performance management process; in addition, Quality Review & Analysis (QRA) staff review input into the IMS application on every case.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

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RECOMMENDATION 6:

The Commissioner, Wage and Investment Division should: Evaluate the Functional Specification Packages to identify programming changes needed to calculate the amount of the FTC limitation and account for mixed component returns. ***2**** **********2**********.

CORRECTIVE ACTIONS:

We partially agree. We will evaluate the Functional Specification Package and Code and Edit Rules and, in coordination with IRS Compliance functions, will determine if changes can be made that will improve their ability to identify and select for treatment mixed component returns claiming the FTC.

IMPLEMENTATION DATE:

March 15, 2018

RESPONSIBLE OFFICIAL(S):

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 7:

The Commissioner, Large Business and International Division should: Improve the measurement of the compliance results of the examinations of FTC issues. This should include, but not be limited to, the amount of the examination adjustments and the taxes ultimately assessed.

CORRECTIVE ACTIONS:

The IRS agrees that it should improve monitoring and measuring of FTC results, especially with regard to examination adjustments. The IRS also agrees that there would be some benefit to tracking taxes ultimately assessed on FTC issues. However, the IRS has limited resources available: the relatively limited benefits of assessment information make this of lower priority compared to other competing priorities. The IRS cannot commit to the submission or completion of a work request to track taxes assessed for FTC issues at this time.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

Attachment II

1. Type and Value of Outcome Measure:

Potential: $70.5 million for 134 tax returns claiming FTCs that did not have the required documentation.

We cannot confirm this projected Outcome Measure. The increased revenue amount of $70.5 million is based on credits claimed on tax returns for which Form 1118 was missing. The absence of the form does not necessarily prove that the claim for the credits was erroneous. Only an examination of the returns can conclusively establish whether or not the claimed amount was erroneous.

2. Type and Value of Outcome Measure:

Revenue Protection – Potential: $33,710 for 38 tax returns that received the FTC due to transcription errors.

We cannot confirm this projected Outcome Measure.The increased revenue of $33,710 is based on transcription errors. Errors in which the amount of FTC is inflated may result in lost revenue. Errors transcribing another credit as FTC, however, do not necessarily represent lost revenue without evidence that the taxpayer is not eligible for the other credit.