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

July 16, 2015

Reference Number: 2015-30-052

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 = Risk Circumvention of Agency Regulation or Statute

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

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

Highlights

Final Report issued on July 16, 2015

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

IMPACT ON TAXPAYERS

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

WHY TIGTA DID THE AUDIT

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

WHAT TIGTA FOUND

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

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

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

WHAT TIGTA RECOMMENDED

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

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

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 16, 2015

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

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 # 201330050)

This report presents the results of our review to determine whether Internal Revenue Service (IRS) controls ensure that the Foreign Tax Credit (FTC) 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 2015 Annual Audit Plan and addresses the major management challenge of Globalization.

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

Copies of this report are also being sent to the IRS 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).

Table of Contents

Abbreviations

FTC	Foreign Tax Credit
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
MeF	Modernized Electronic Filing
SRS	Specialist Referral System
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number

Background

The United States generally taxes U.S. citizens and resident aliens[1] on their worldwide income. Foreign persons are taxed on their U.S. source income or the portion of their income that, by definition, is considered to be connected with a U.S. source. The Foreign Tax Credit (FTC) is intended to reduce the double taxation burden that would otherwise arise when foreign source income is taxed by both the United States and the foreign country from which the income is derived. In most cases, a taxpayer must meet the following four tests in order for any foreign taxes paid to qualify for the FTC:

- The tax must be imposed on the taxpayer.
- The taxpayer must have paid or accrued the tax.
- The tax must be a legal and actual foreign tax liability.
- The tax must be an income tax (or a tax in lieu of an income tax).

Current provisions in Internal Revenue Code (I.R.C.) Section (§) 27(a) allow for a nonrefundable credit, computed under I.R.C. § 901, for income, war profits, and excess profit taxes paid by U.S. taxpayers, both individual and corporate, to foreign countries. I.R.C. §§ 901(b) and 906 allow the credit to be claimed by U.S. citizens, resident aliens, as well as nonresident aliens carrying on a trade or business within the United States. A taxpayer can choose to take either a credit or a deduction of the foreign taxes paid. However, the taxpayer cannot take both the credit and the deduction for the foreign taxes paid on the same foreign source income in any given year. The choice of a credit or a deduction may be made or changed within the 10-year statute of limitations. However, in most situations, it is more beneficial for taxpayers to select the credit.

The FTC is designed to allow a dollar-for-dollar tax credit, offsetting the foreign taxes paid against the taxpayer's U.S. tax liability on the foreign source income that was subjected to double taxation. The FTC does not allow a credit for foreign taxes to be used against the tax on U.S. source income.

The FTC is based on three principles:

- The same income should not be taxed more than once.
- The country in which the income is earned has the primary right to tax that income.
- The taxpayer's country of residence has a secondary or residual right to tax the income earned in a foreign country.

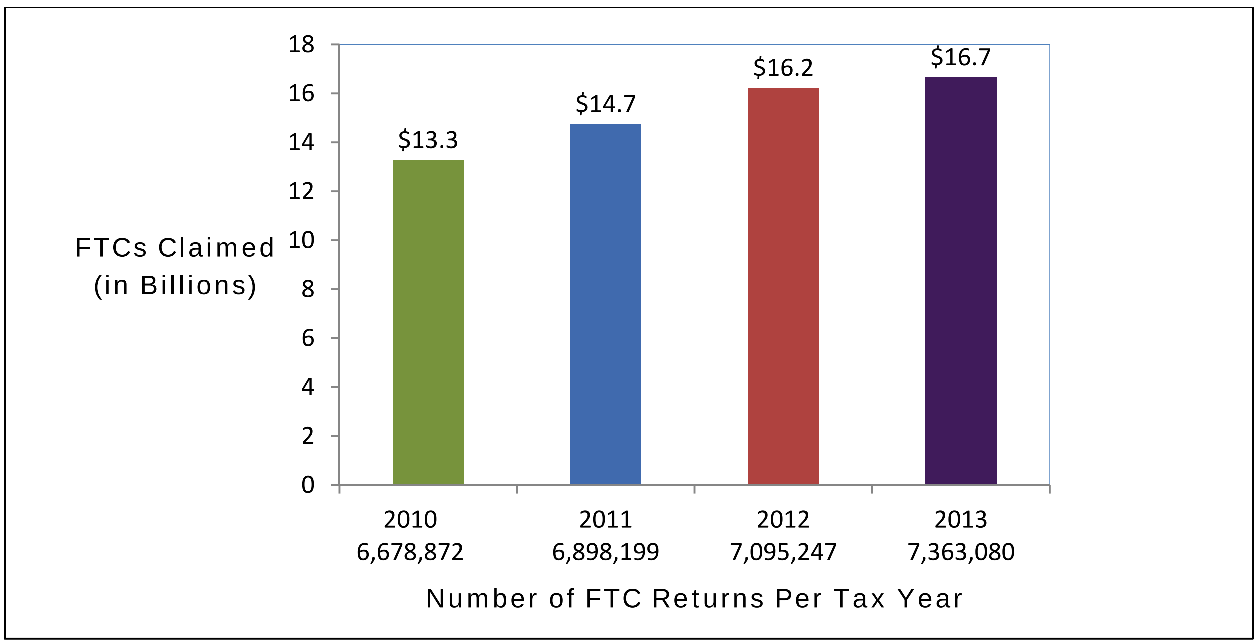
[1] See Appendix VI for a glossary of terms.

The Internal Revenue Service's (IRS) Submission Processing function is responsible for receiving, processing, and archiving tax return information. When 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 the paper-filed tax returns are reviewed and perfected by tax examiners in the Code and Edit function. This process is designed to ensure that the information on the paper tax return and Form 1116, *Foreign Tax Credit*, 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 acknowledgements to taxpayers.

FTC statistics

Computing the FTC can add to the difficulty of completing a tax return for taxpayers living in a foreign country or having foreign source income. In addition, this credit can significantly affect the taxes claimed on U.S. tax returns. In Tax Year 2013,[2] nearly 7.4 million individual tax returns were filed claiming approximately $16.7 billion in FTCs. Figure 1 shows the increasing trend in FTC claims for Tax Years 2010 through 2013.

Figure 1: Individual Tax Returns Claiming the FTC for Tax Years 2010 Through 2013



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of FTC information from the Individual Master File.

[2] Through November 26, 2014.

This review was performed at the Large Business and International Division Headquarters in Washington, D.C., and offices in Philadelphia, Pennsylvania, and Austin, Texas; the Wage and Investment Division Submission Processing Site in Austin, Texas; and the Small Business/Self-Employed Division Campus Compliance Operations and offices in Philadelphia, Pennsylvania, during the period August 2013 through January 2015. 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

The Internal Revenue Service Improperly Allowed Foreign Tax Credits for Some Taxpayers

The IRS does not have adequate controls and processes in place to identify erroneous FTC claims. The IRS processed tax returns that allowed individual taxpayers to claim the FTC without the required supporting documentation. We identified 65,499 tax returns that did not have the required documentation, resulting in approximately $94.9 million in potentially erroneous FTCs.[3] Figure 2 shows the breakdown of the exception tax returns identified and the amount of erroneously allowed FTCs for Tax Years 2010 through 2012.

Figure 2: Number of Individual Tax Returns and FTCs Erroneously Claimed

	Paper-Filed Tax Returns	Electronically Filed Tax Returns	Totals
Number of Individual Tax Returns Without a Form 1116 Attached As Required	19,027	46,472	65,499
Amount of FTCs Erroneously Allowed (in Millions)	$33.8	$61.1	$94.9

Source: TIGTA analysis of the Individual Return Transaction File information for Tax Years 2010 through 2012.

Taxpayers are required to attach a completed Form 1116 to their Form 1040, *U.S. Individual Tax Return*, or Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, when claiming an FTC of more than $300 ($600 if married filing a joint return).[4] The Form 1116 and its instructions are used by taxpayers to determine and support the amount of the FTC they can claim.[5] Our analysis of more than 2.1 million paper and electronically filed individual tax returns, for Tax Years 2010 through 2012 that required a Form 1116 be attached to support more than $42.6 billion in FTC

[3] All amounts used in our calculations and projections throughout this report were rounded.
[4] Treasury Regulations § 1.905-2 establishes the requirement for individual taxpayers to use Form 1116. I.R.C. § 904(j) exempts taxpayers from certain FTC limitations under the law when the credits claimed are less than $300 ($600 in the case of a joint return). The $300 rule would apply to taxpayers filing Forms 1040 or Forms 1040NR with filing statuses of Single, Married Filing Separately, or Head of Household. Hereafter in the report, we will refer to them as "single" taxpayers.
[5] See Appendix V for an example of the Form 1116.

claims, identified 70,305 tax returns that appeared to have claimed $249.9 million in FTCs that the IRS allowed without the required Form 1116 being attached.

Electronically filed tax returns with erroneously allowed FTCs

We determined that taxpayers filing 46,472 electronic returns erroneously received approximately $61.1 million in FTCs without an attached Form 1116 as required. ******2*****
***********************************2***********************************
************************************2************************************
************************************2************************************
************************************2*********************************
************************************2************************************
************************************2************************************
************************************2************************************
************************************2************************************
************************************2************************************
************************************2***********************************
************************************2************************************
************************************2************************************
************************2***********.

Paper-filed tax returns with erroneously allowed FTCs

In addition, we determined that taxpayers filing 19,027 paper returns[6] erroneously received approximately $33.8 million[7] in FTCs without an attached Form 1116 as required. From the 23,833 paper-filed tax returns,[8] we selected and reviewed a statistically valid sample[9] of 203 returns for Tax Years 2010 through 2012 for which the FTC was greater than $300 (filing single) or $600 (married filing joint) and the taxpayers filed a Form 1040 or 1040NR without attaching a Form 1116. From our sample, we found that taxpayers filed:

- 162 paper tax returns that claimed $287,929 in FTCs, but did not have a Form 1116 attached as required. Based on our sample results, we project that taxpayers received approximately $33.8 million in erroneous FTCs from 19,027 paper tax returns with missing Forms 1116.
- 41 paper tax returns that initially appeared to have improperly claimed the FTC on their Form 1040 or Form 1040NR without an attached Form 1116. Upon further review, we discovered that 32 of these taxpayers filed a Form 1116 with their tax returns. Although the

[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 17,732 and 20,323.
[7] 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 $12,835,085 and $54,671,382.
[8] Of the 70,305 tax returns identified from the IRS data as claiming the FTC without an attached Form 1116 as required, 46,472 were electronically filed and 23,833 were paper filed.
[9] See Appendix I for our detailed sampling methodology.

IRS did not properly transcribe the Form 1116 on these returns, these taxpayers received the FTCs they claimed. The remaining nine taxpayers did not claim the FTC or file a Form 1116 but received the FTC. This occurred because of errors made when entering taxpayer data into the IRS computer system. The majority of the transcription errors was due to IRS data transcribers entering data from a different credit (such as the Child Care Credit) and generally would not have any tax effect unless the mistranscribed credit was subject to a phase-out and the taxpayer erroneously claimed the full amount.[10] When projected to the population, we estimate that data transcribers did not properly transcribe the Form 1116 or entered inaccurate data on 4,806 taxpayer accounts[11] for Tax Years 2010 through 2012.

Internal Revenue Manual (IRM) 3.11.3.14.5.1 currently instructs Code and Edit function employees to request the Form 1116 from all taxpayers when the FTC claimed is more than $600. However, there are no instructions in the IRM to contact single taxpayers claiming more than $300 in FTCs who did not file Form 1116.[12] This may have been the reason that Code and Edit function employees did not correspond with some taxpayers when the Form 1116 was missing. During discussions with IRS management, they indicated that the lack of instructions to request the Form 1116 when a single taxpayer claims more than $300 in FTCs was an unintentional oversight, and we have since verified that the IRM has been corrected. However, we found that employees did not always follow existing IRM instructions to request the Form 1116 when married filing joint taxpayers claimed more than $600 in FTCs and the Form 1116 was not attached to their return. Furthermore, the IRS stated it would review training material and guidance to determine if further emphasis or clarification on the processing of FTCs is needed.

We believe that limitations of the quality review process may have also contributed to taxpayers erroneously receiving the FTC. According to the IRM, the purpose of a quality review process is to monitor, measure, and improve the quality of work throughout the Submission Processing function. Based on the number of exceptions we identified, it would appear the quality review process is not identifying erroneous FTC claims. According to IRS management, the sample size for quality review would be five documents per tax examiner per week. They believe that it is possible the documents in question were not part of any reviewed sample. Due to the complexity of the FTC computations and potential revenue impact, the quality review process should verify that IRS employees are ensuring that taxpayers claiming the FTC are actually entitled to the credit and that it is being input and computed accurately.

---

[10] ***1*************************************
******************1**.

[11] 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 3,510 and 6,101.

[12] We estimate this population to be approximately 26 percent of total tax returns required to file a Form 1116.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Establish controls to ensure that a Form 1116 is attached to Forms 1040 or Forms 1040NR for taxpayer FTC claims when required.

> **Management's Response:** The IRS agreed with this recommendation. The IRS requested programming changes on February 27, 2015, to systemically identify returns filed without a required Form 1116. However, the IRS disagreed with our potential outcome measure that $94.9 million in FTCs were claimed on 65,499 tax returns without the required documentation. While the IRS acknowledged that Forms 1116 claiming the FTCs were missing, the IRS stated that the forms absence does not mean that the credits were erroneous. Accordingly, only an examination of the returns can determine whether the claimed FTCs were erroneous. In addition, the IRS claimed that some of these missing Forms 1116 were transcription errors and that the Forms 1116 were attached to the filed returns.
>
> **Office of Audit Comment:** Taxpayers are required to attach a completed Form 1116 to their Form 1040 or Form 1040NR when claiming an FTC of more than $300 ($600 if married filing a joint return). The 19,027 paper tax returns in addition to the 46,427 electronic tax returns did not have a Form 1116 attached as required and taxpayers claimed $94.9 million in FTCs. The IRS accepted these returns as filed and erroneously allowed taxpayers the FTCs without the required documentation. We agree that only an examination would ultimately determine the validity of the FTC claims. That is the reason we qualified our outcome projections as "potential." However, it should be noted that the IRS did not provide any statistics as to the percentage of returns submitted by taxpayers claiming FTCs without the required documentation that are ultimately found to be valid. In addition, during our analysis of paper filed returns claiming FTCs, we found the transcription errors mentioned in the IRS's response, brought them to the IRS's attention, and had already removed them from our monetary outcome measure projections prior to issuance of the draft report.

Recommendation 2: Ensure any training materials and additional guidance related to FTCs are updated to match the revisions to IRM 3.11. Management should also periodically review worked cases to determine employee compliance with the updated FTC guidance.

> **Management's Response:** The IRS agreed with this recommendation. The IRS will update procedural guidance and training materials to ensure conformity with IRM 3.11.3, *Returns and Documents Analysis, Individual Income Tax Returns*. The IRS will address employee compliance with the updated guidance as part of the existing quality review process. However, the IRS disagreed with our potential outcome measure that 4,806 taxpayer accounts had transcription errors involving the FTC. The IRS stated that these transcription errors included data from different credits (such as the Child Care

Credit) that were input on the wrong line. As such, these would not be a loss of revenue and any associated potential revenue loss should be excluded from the report.

Office of Audit Comment: The 4,806 tax returns had transcription errors involving the FTC. These errors were made when IRS employees entered taxpayer data incorrectly into the IRS computer system. While the majority of the transcription errors were due to IRS data transcribers entering data from a different credit, we agree that these errors generally would not have any tax effect unless the mistranscribed credit was subject to a phase-out and the taxpayer erroneously claimed the full amount. However, we did not claim in this report any monetary outcome measure (*e.g.*, revenue loss) associated with the data transcription errors on these returns.

Some Taxpayers May Have Erroneously Claimed the Foreign Tax Credit

As previously described, the general rule is that taxpayers are required to file Form 1116 if they are claiming an FTC. An exception exists and no Form 1116 is required for taxpayers claiming an FTC if **all** of the following conditions are satisfied:

- All of their foreign source gross income was "passive category income" (which includes most interest and dividends).
- All of the income and any foreign taxes paid on it were reported to them on a "qualified payee statement," *e.g.*, third-party information return documents. Qualified payee statements include:[13]
  - Form 1099-INT, *Interest Income*
  - Form 1099-DIV, *Dividends and Distributions*
  - Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*
  - Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*
  - Schedule K-1 (Form 1065-B), *Partner's Share of Income (Loss) From an Electing Large Partnership*
  - Schedule K-1 (Form 1120S), *Shareholders Share of Income, Deductions, Credits, etc.*
- Their total creditable foreign taxes are not more than $300 ($600 if married filing a joint return).

[13] See I.R.C. §§ 904(j) and 6724(d) for definitions of "qualified payee statement." Forms 1099-INT and 1099-DIV are required to be provided to each person who had reportable amounts of interest or dividends of more than $10. These information returns are also required if there were any foreign taxes withheld on interest, dividends, and other distributions of stock. In addition, the issuers of these documents are required to provide copies to the IRS.

Between Tax Years 2010 and 2012, approximately 12 million tax returns claiming FTCs were filed that satisfied the third-party information return documentation exception and no Form 1116 was required. However, during this same three-year period, we found 188,102 tax returns for which taxpayers potentially received approximately $40 million in FTCs that were not supported by third-party information return documents as required. These taxpayers did not meet the exception previously described and, therefore, were required to file Form 1116 but failed to do so. The IRS did not take any action to address the failure to file this required form and the full FTC was allowed. Having either a third-party information return or a completed Form 1116 provides the IRS some substantiation of the claimed FTC. Figure 3 shows the number and amount of FTCs claimed that were unsubstantiated by third-party information return documents.

Figure 3: FTCs Unsubstantiated by Third-Party Information Return Documents

Type of Exception	Number of Tax Returns	Total of Amount of FTCs Claimed
No match to any third-party information return documents.	102,721	$22,782,956
Matched a third-party information return document, but the amount of the FTC claimed on the tax return was more than the amount reported on the document.	85,381	$17,209,249
TOTALS	**188,102**	**$39,992,205**

Source: TIGTA data analysis of the Individual Return Transaction File and the Information Return Master File information for Tax Years 2010 through 2012.

If the IRS chooses to address this noncompliance, it would face several challenges. Earlier in this report, we recommended that the IRS ensure the Form 1116 is attached to the tax return if required. However, in this case, the law provides an exemption from filing Form 1116 if a third-party information return has been filed with the IRS. Because the IRS does not receive these specific third-party information returns until after tax returns are required to be filed, IRS systems cannot identify these types of errors during processing. *********2***************
********************************2***************************************
***************2********************.

The IRS's Automated Underreporter Program performs an analysis of information return processing documents and matches them to tax returns to determine if taxpayers are reporting the proper wages, interest, dividends, property taxes, and other entries on their tax returns. The Automated Underreporter Program has used soft notices to supplement its other compliance activities by providing coverage to a segment of the taxpayer population that generally is not reached by traditional enforcement means. In response to a TIGTA report related to the use of soft notices,[14] the IRS stated that "limited resources prevent the examination of all questionable returns, so decisions are made regarding the balancing of appropriate coverage with the work perceived to have the greatest potential for change." The use of soft notices in these instances would provide the IRS with a compliance alternative that is a less expensive way to expand its coverage in the FTC area. In addition, the use of soft notices would be a beneficial self-correction method for taxpayers and an efficient means to educate them about the potentially erroneous FTC claims on their tax returns.

Some taxpayers claimed both an FTC and a deduction for foreign taxes paid on the same foreign source income

The FTC is intended to reduce double taxation that would occur when foreign source income is taxed by both the United States and the foreign country in which the income is earned. Taxpayers choosing to report foreign taxes paid may claim either a credit or a deduction, but not both. Taxpayers may attach a Schedule A, *Itemized Deductions,* to their Form 1040 or 1040NR to reduce the amount of taxable income and therefore reduce the tax they owe. Taxpayers can choose to claim their foreign taxes paid on Line 8 of the Schedule A as "other taxes." The other taxes include deductible taxes other than State taxes or property taxes. Figure 4 shows an excerpt from Schedule A of where the deduction for foreign taxes paid is claimed.

Figure 4: Excerpt from Line 8 on Schedule A

Taxes You Paid	5 State and local **(check only one box):** a ☐ Income taxes, or b ☐ General sales taxes	5		
	6 Real estate taxes (see instructions)	6		
	7 Personal property taxes	7		
	8 Other taxes. List type and amount ▶	8		

Source: IRS.gov website.

Taxpayer instructions for Line 8 on the Schedule A state, *"You may want to take a credit for the foreign tax instead of a deduction. See the instructions for Form 1040, line 47, for details."* The Schedule A deduction for foreign taxes paid will only reduce taxable income, whereas, the FTC claimed on Line 47 on the Form 1040 (Line 45 on the Form 1040NR) will reduce the amount of total taxes. Regardless of what the taxpayer decides, the taxes paid on the same foreign source income should only be claimed once on the tax return.

We identified tax returns for Tax Years 2010 through 2012 in which the taxpayer filed a Schedule A claiming an amount as a deduction on Line 8 and matched these to tax returns in which the same amount was claimed as a credit on Line 47 on Form 1040 (Line 45 on Form

[14] TIGTA, Ref. No. 2011-30-091, *Using Soft Notices to Address Reporting Discrepancies Has Merit, but Cost and Benefit Questions Remain* (Sept. 2011).

1040NR). Figure 5 shows an excerpt from Forms 1040 and 1040NR of where the FTC is claimed.

Figure 5: Excerpt of Line 47 on Form 1040 and Line 45 on Form 1040NR for Tax Year 2012

Form 1040:

47	Foreign tax credit. Attach Form 1116 if required	47	

Form 1040NR:

45	Foreign tax credit. Attach Form 1116 if required	45	

Source: IRS.gov website.

Our analysis of more than 3.1 million paper and electronically filed individual tax returns for Tax Years 2010 through 2012 that had an amount claimed on both Line 47 of the Form 1040 (Line 45 of the Form 1040NR) and Line 8 on the Schedule A identified 16,058 tax returns for which taxpayers reported an FTC in the same amount as they reported as a deduction for "other taxes." Paid tax preparers prepared 9,804 (61 percent) of these returns, and 817 taxpayers claimed the same amounts for the FTC and the deduction for foreign taxes paid for multiple years. As a result, approximately $2.9 million in FTCs or Schedule A deductions may have erroneously been allowed for these tax returns. Figure 6 shows the number of taxpayers and amounts claimed for both the deduction and the credit for Tax Years 2010 through 2012.

Figure 6: FTCs Claimed As Both a Credit and a Deduction on the Same Foreign Source Income

Tax Year	Tax Returns	Line 8 on Schedule A	FTC Claimed	FTC Allowed[15]
2010	5,718	$881,728	$881,825[16]	$839,017
2011	5,078	$1,084,361	$1,084,361	$1,038,320
2012	5,262	$1,058,990	$1,058,990	$984,153
Totals	**16,058**	**$3,025,079**	**$3,025,176**	**$2,861,490**

Source: TIGTA analysis of the Individual Return Transaction File information for Tax Years 2010 through 2012.

---

[15] These are all cases in which the FTC reported on Line 8 of the Schedule A is the same amount as the FTC claimed on the Form 1040 or Form 1040NR. However, the reason there is a difference in our table between Line 8 of the Schedule A amounts and the FTC allowed amounts is the result of a decrease in taxes that are actually owed, *e.g.*, resulting from the IRS's use of its math error authority.

[16] ***1***
1.

*************************************2*************************************
*************************************2*************************************
*************************************2************************************
*************************************2************************************
*************************************2***********************************
*************************************2*************************************
*************************************2************************************
*************************************2********************************.

Recommendation

The Commissioner, Large Business and International Division, should:

Recommendation 3: Develop a compliance strategy to address the risks identified with the FTC, including the issues of taxpayers receiving both the credit and the deduction for the same foreign tax payments, and taxpayers claiming the FTC without the proper third-party information return documentation.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will develop a strategy that identifies returns that appear to have both credits and deductions along with other FTC compliance issues, and devise a risk-based examination strategy to address these issues. However, the IRS disagreed with our potential outcome measure that $40 million in FTCs were claimed on 188,102 tax returns when third-party information documents indicated the taxpayer did not pay any foreign taxes or the amount of the foreign taxes paid was less than the amount of the FTC claimed.
>
> ***Office of Audit Comment:*** If the IRS develops a sufficient compliance strategy, it should address the improper claims on which we based the potential outcome.

The Majority of Tax Returns With Improperly Allowed Foreign Tax Credits Were Prepared by Paid Tax Preparers

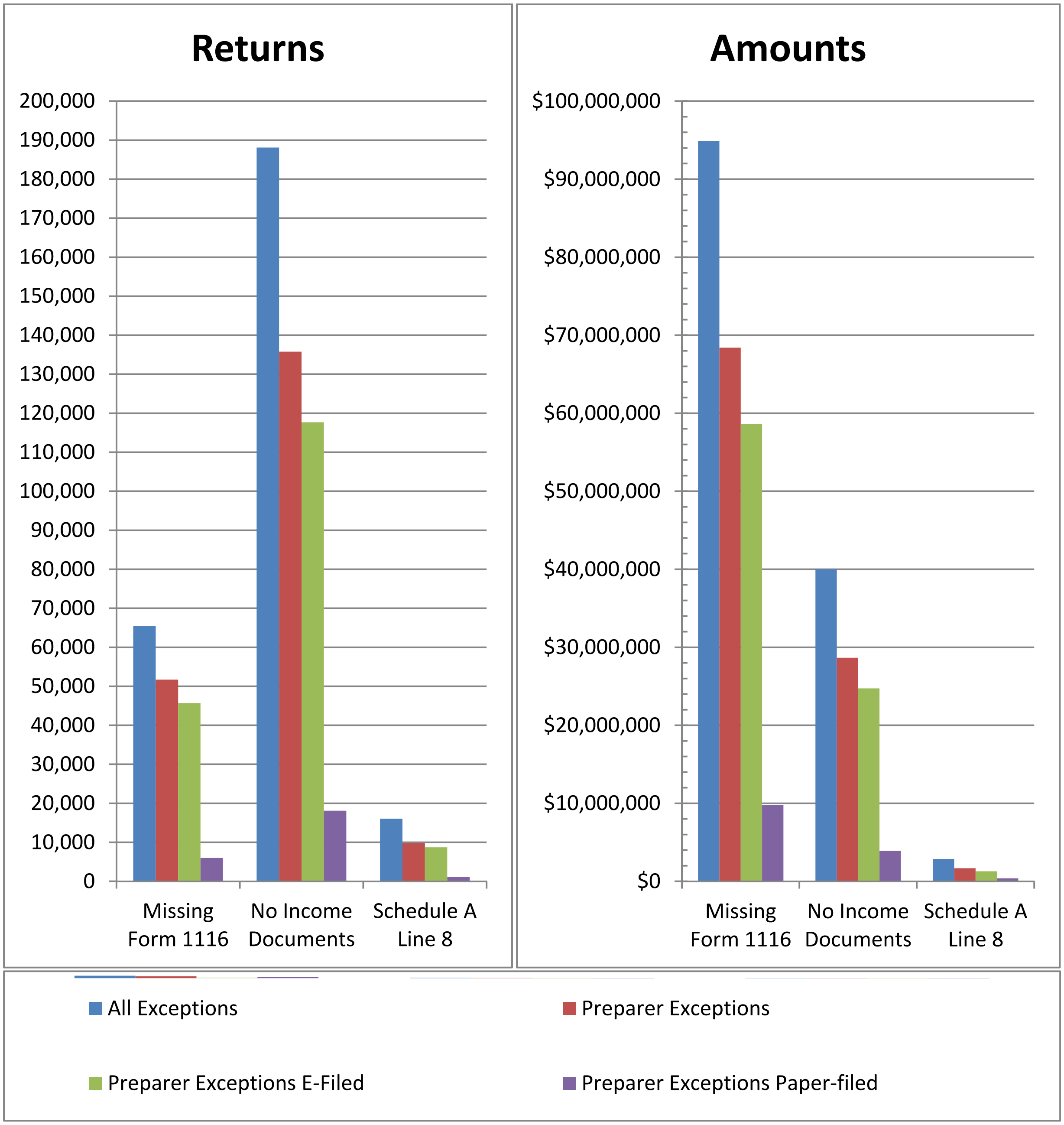
Our analysis of the 269,659 tax returns with approximately $138 million in improperly allowed FTCs (resulting from missing Forms 1116) for paper and electronically filed individual tax returns for Tax Years 2010 through 2012 determined that 197,263 (73 percent) of these returns with exceptions totaling approximately $98.2 million were prepared by paid tax preparers. Of the 197,263 returns, 172,087 (87 percent) were electronically filed with approximately $84.6 million in FTCs. Paid tax preparer involvement was identified in each of the following exception categories:

- *65,499 tax returns claiming approximately $94.9 million in FTCs that the IRS improperly allowed without the required Form 1116. Of these, 51,693 returns with more than $68 million in FTC exceptions were identified as prepared by paid tax preparers.*[17] *In this category, 45,702 returns totaling more than $58.6 million in FTC exception amounts were electronically filed by the identified tax preparers.*
- *16,058 tax returns with approximately $2.9 million in FTCs and Schedule A deductions in which taxpayers reported the same FTC amount as they reported as a deduction for "other taxes." Of these, 9,804 returns with more than $1.6 million in FTCs and Schedule A deductions were identified as prepared by paid tax preparers. In this category, 8,719 returns totaling $1.3 million in FTC and Schedule A exception amounts were electronically filed by the identified tax preparers.*
- *188,102 tax returns for which taxpayers received approximately $40 million in FTCs that were not supported by third-party information return documents as required. Of these, 135,766 returns with more than $28.6 million in FTC exceptions were identified as prepared by paid tax preparers. In this category, 117,666 returns totaling more than $24.7 million in FTC exception amounts were electronically filed by the identified tax preparers.*

Figure 7 summarizes the FTC exceptions by the total number of tax returns and the total amount of the exceptions prepared by the paid tax preparers.

[17] Included in the 51,693 FTC exception returns identified as prepared by paid tax preparers are 5,991 returns projected by our statistical sample to have no Form 1116 attached.

Figure 7: FTC Exception Returns and Amounts Prepared by Paid Tax Preparers



Source: TIGTA data analysis of the Individual Return Transaction File and the Information Return Master File information for Tax Years 2010 through 2012.

We also identified a population of paid tax preparers who had an FTC exception on more than 50 percent of the tax returns they prepared and electronically filed. Figure 8 shows paid tax preparers who electronically filed 10 or more FTC exception returns and their exception rates during Tax Years 2010 through 2012.

Figure 8: Statistics for the Top 97 FTC Exception Paid Tax Preparers

	Number Range of FTC Exception Returns			
	Less Than 500 Returns	**500 – 999 Returns**	**Greater Than 999 Returns**	**Total**
NUMBER OF PAID TAX PREPARERS	79	11	7	97
TOTAL NUMBER OF FTC RETURNS PREPARED BY THESE PAID PREPARERS	9,294	8,253	9,788	27,335
TOTAL NUMBER OF FTC EXCEPTION RETURNS PREPARED BY THESE PAID PREPARERS	9,165	8,224	9,725	27,114
PERCENTAGE OF TOTAL FTC EXCEPTION RETURNS TO TOTAL FTC RETURNS PREPARED	98.6%	99.7%	99.4%	99.2%
TOTAL FTC AMOUNT CLAIMED ON RETURNS PREPARED BY THESE PAID PREPARERS	$10,784,137	$10,476,989	$11,765,766	$33,026,892
TOTAL FTC AMOUNT ERRONEOUSLY CLAIMED ON RETURNS PREPARED BY THESE PAID PREPARERS	$10,754,905	$10,475,247	$11,761,989	$32,992,141
PERCENTAGE OF TOTAL ERRONEOUS FTC CLAIM AMOUNTS TO THE TOTAL FTC AMOUNTS CLAIMED ON RETURNS PREPARED	99.7%	99.9%	99.9%	99.9%

Source: TIGTA analysis of the IRS's Individual Return Transaction File information for Tax Years 2010 through 2012.

Our analysis of improperly received FTCs and paid tax preparers' involvement in this process shows this is an area that requires more emphasis by the IRS. Interviews with IRS management indicated that there are no controls in place to monitor or track assessments made on FTC cases, and processing oversight has been limited. This limited our ability to evaluate the IRS's FTC examination efforts.

The IRS cannot address the challenges of monitoring taxpayer and paid preparer compliance when claiming the FTC without capturing and maintaining key FTC statistics. The lack of a compliance focus on the FTC has diminished the IRS's capacity to ensure that the FTC is accurately claimed on tax returns when foreign government taxes are used to offset Federal income taxes.

Recommendations

The Commissioner, Large Business and International Division, should:

Recommendation 4: Identify and track key FTC statistics related to taxpayer FTC claims and any FTC-related assessments.

> **Management's Response:** The IRS partially agreed with this recommendation. In June 2014, the IRS implemented a system for using Uniform Issue List codes to assist in identifying potential noncompliance and trends involving international issues, including the FTC. The IRS stated that further enhancements to gather statistics are not possible due to current budget and resource restrictions.

Recommendation 5: Improve education, outreach, and enforcement activities to correct the paid tax preparer issues identified in this report related to the FTC.

> **Management's Response:** The IRS agreed with this recommendation. The IRS will continue its education and outreach efforts to the return preparer community to maximize efficiency and reach the broadest audience. The IRS will continue to make presentations or participate in panel discussions at practitioner meetings and conferences sponsored by various professional practitioner organizations such as the American Bar Association, California Society of Enrolled Agents, *etc*. The FTC is also being considered as a suggestion for a topic at the 2016 National Tax Forums. Furthermore, the IRS will use enforcement activities of the Return Preparer Program to address egregious noncompliance.

Tax Returns Under Examination With a Foreign Tax Credit Are Not Being Referred to International Examination Specialists As Required

Due to the complexity of the FTC computations, IRM 4.60.6 mandates that revenue agents and tax compliance officers submit requests for assistance from international examination specialists using the Specialist Referral System (SRS) when auditing tax returns claiming an FTC. In order to be referred, the tax returns must be in the Examination function inventory and have claimed an FTC greater than $25,000. It is important that tax returns open for examination with international issues are reviewed by an international specialist with the requisite knowledge to determine whether a significant international issue exists that needs to be examined.

A referral can be generated online which will automatically notify the appropriate international examination specialist's manager by e-mail of the request. If the referral is accepted, the international examiner can either work the international issue or provide a consultation and have the domestic examiner add the international issue to his or her examination. If the referral is rejected, the tax return is returned to the domestic examiner to continue on with his or her examination. The reasons for rejecting the referral might include insufficient time to complete, lack of staffing, lack of substantial issues, *etc*.

We analyzed Examination function records for Fiscal Years 2011 through 2014 for Tax Years 2010 through 2012 individual tax returns with FTCs greater than $25,000 and found that only 196 Examination function cases meeting these criteria were referred as required. In discussions with IRS management, they acknowledged that there were additional Examination function cases that potentially should have been referred through the SRS during this time period, but were not. Figure 9 shows the characteristics of the cases that were referred, as well as the cases that were not referred for Fiscal Years 2011 through 2014.

Figure 9: Analysis of SRS Referrals and Nonreferrals for Tax Returns Reporting FTCs Greater Than $25,000

SRS STATUS	EXAMINATION RECORDS	UNIQUE TAX RETURNS[18]	TOTAL FTC AMOUNT CLAIMED
NOT REFERRED	1,163	1,161	$ 412,517,519
REFERRED - Assigned	89	88	$ 305,021,609
REFERRED - Rejected	107	101	$ 87,086,420
Total	***1,359***	***1,350***	***$ 804,625,548***

Source: TIGTA analysis of the Individual Return Transaction File information for Tax Years 2010 through 2012 and the Audit Information Management System and SRS information for Fiscal Years 2011 through 2014.

The purpose of IRM 4.60.6 is to provide "guidance and technical information on international referral criteria and procedures applicable to referrals to all Operating Divisions." IRM 4.60.6.2 states, "Generally, all returns with international features meet the mandatory referral criteria and must be referred to an international examiner." In discussions with IRS management, they believed that because the word "generally" is used in the referral instructions, it allows discretion as to whether or not a request for an international examination specialist is entered into the SRS. However, additional specific instructions follow the word "generally" in the IRM. These instructions are contradictory and include "mandatory" and "generally" under IRM 4.60 in the section entitled, *Mandatory Referral Criteria*. Figure 10 shows an excerpt of the contradictory referral instructions contained in the IRM.

[18] A tax return may have more than one examination record, each with different assessment amounts and disposal codes. We identified the number of distinct tax returns in the examination records we analyzed.

Figure 10: IRM Excerpt of the SRS Instructions

4.60.6.2 (03-01-2007)
Mandatory Referral Criteria

(1) Generally, all returns with international features meet the mandatory referral criteria and must be referred to an international examiner.

(2) A preliminary review of returns with international features will be made to determine if the case should be referred.

(3) International features include but are not limited to the following:

a. Schedules and attachments of any of the following forms to the tax return:

Form	Form Title	Referral Criteria
926	Return by a U.S. Transferer of Property to a Foreign Corporation	All
1116	Foreign Tax Credit (Individual, Estate or Trust)	FTC > than $25,000

Source: IRM 4.60.6.2 (Mar. 1, 2007).

By contrast, the SRS User Guide is not ambiguous in its instructions. The mandatory referral specifications in the User Guide state that if the return has a Form 1116 attached with an FTC greater than $25,000, the user is required to submit a request for an international examination specialist through the SRS. Applying these more specific mandatory criteria, we identified an additional 2,143 cases with FTCs from the Small Business/Self-Employed and the Wage and Investment Divisions' Campus Examination functions and the Large Business and International Division's International Compliance functions that were not referred through the SRS during Fiscal Years 2011 through 2014. When we discussed these cases with IRS management, they stated that Campus Examination function cases are generally limited to single issues (such as the Earned Income Tax Credit) and would not be referred through the SRS even with an FTC. They also said that the International Compliance function cases would not be referred for any FTC issues because these employees are specifically trained to work FTC cases.

Due to the ambiguity of the FTC referral criteria and the limited number of referrals, we believe that some employees may not know whether their cases should be referred through the SRS for FTC issues. When tax returns are not referred to an international examination specialist as required, the skill level needed to evaluate the FTC is not being appropriately used. The SRS is intended to ensure that specialists who can best evaluate whether the FTC is valid have an opportunity to review the tax return. Due to its complexity and a lack of third-party information reporting, there is a risk of some taxpayers claiming an incorrect FTC amount. Additional scrutiny of an international examination specialist is necessary for the IRS to determine the accuracy of the FTC.

Recommendation

The Commissioner, Large Business and International Division, should:

Recommendation 6: Revise IRM 4.60.6.2 and the SRS User Guide to clearly define the referral criteria that will be followed to ensure that tax returns in the Examination function inventory with FTCs are referred as required.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will ensure that the language in the IRM and the SRS User Guide is consistent to provide clarity for FTC referral requirements.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether IRS controls ensure that the FTC[1] is accurately claimed on a tax return when foreign government taxes are used to offset Federal taxes. To accomplish this objective, we:

I. Determined whether the IRS is properly processing Forms 1116, *Foreign Tax Credit*, after receipt of the tax return.

   A. Obtained and reviewed the appropriate IRMs to determine what controls are in place to process the Form 1116.

   B. Identified the process used to ensure the accuracy of the Form 1116 during processing by performing a walkthrough of the Submission Processing Site including the Code and Edit, Error Resolution, and Data Transcription functions in Austin, Texas.

   C. Interviewed representatives of the Code and Edit, Error Resolution, Data Transcription, and Electronic Tax Administration functions to determine what oversight they provide and procedures they use to ensure that the Form 1116 is accurately processed.

   D. Reviewed the Form 1116 Electronic Filing System business rules to determine what checks are included to ensure that the FTC claimed is accurate. We also identified the relevant reject codes to see what errors the IRS is identifying before the tax return is accepted.

   E. Obtained from TIGTA's Data Center Warehouse Forms 1040, *U.S. Individual Tax Return*, and Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, data from the Individual Return Transaction File in which taxpayers claimed the FTC on Line 47 of the Form 1040 or in which taxpayers claimed the FTC on Line 45 of the Form 1040NR for Tax Years 2010, 2011, and 2012. In addition, we identified from the Individual Return Transaction File those taxpayers who also filed a Form 1040, Schedule A, *Itemized Deductions*, with an amount on Line 8 and those taxpayers who filed a Form 1116 for the same time period. We performed the following steps:

      1. Using the data identified in Step I.E., matched the Forms 1116 data to the Forms 1040 and Forms 1040NR data.

[1] See Appendix VI for a glossary of terms.

2. Using the data identified in Step I.E.1., identified Forms 1040 and Forms 1040NR with an FTC of more than $300 for taxpayers filing single and more than $600 for taxpayers filing jointly and ensured that the Form 1116 was filed with the tax return as required.

   a. Identified 70,305 tax returns that claimed an FTC without supporting documentation that included 23,833 paper-filed tax returns. We selected a statistically valid sample of 203 of the paper-filed tax returns to validate the Form 1116 was missing. Our sampling criteria included:

      Population = 23,833

      Confidence Level = 95 percent

      Estimated Error Rate = 5 percent

      Precision = ± 3 percent

   b. Projected the results of the statistical sample to the population. The accuracy of our projection was reviewed by TIGTA's contract statistician.

3. Using the data identified in Step I.E., identified Forms 1040 and Forms 1040NR in which the taxpayer claimed the FTC and also claimed a deduction on Line 8 of the Schedule A to determine if the taxpayer claimed both the credit and the deduction for the same foreign taxes paid.

4. Using the data identified in Step I.E., identified Forms 1040 and Forms 1040NR with an FTC of less than $300 for single taxpayers and less than $600 for married taxpayers filing jointly with no Form 1116 attached.

   a. Matched the Taxpayer Identification Number (TIN) and tax years identified from Step I.E.4. to the Information Return Master File for the following forms:

      - Form 1099-INT, *Interest Income*, with amount in Box 6.
      - Form 1099-DIV, *Dividends and Distributions*, with amount in Box 6.
      - Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, with amount in Box 14 Coded "B."

   b. Using the documents extracted in Step I.E.4.a., matched the TIN to the primary taxpayer for all returns with a single filing status in which an FTC of $300 or less was allowed. We also matched the TIN of both the primary and secondary taxpayers for all returns with a joint filing status in which an FTC of $600 or less was allowed.

c. Using a $99 tolerance, identified the tax returns that had a difference between the amount of the FTC allowed and the FTC reported on the documents identified in Step I.E.4.a. We also identified the tax returns that had an FTC allowed greater than $99 and none of the previously mentioned documents were available.

d. Matched the TINs of the 269,659 exception tax returns to the Individual Return Transaction File for Tax Years 2010, 2011, and 2012 to identify whether they were prepared by a paid tax preparer. We also identified the total population of returns these preparers had prepared with an FTC and performed an analysis to identify the paid tax preparers who had more than 50 percent of the tax returns they prepared with an FTC that was an exception.

II. Determined what examination processes the IRS has to identify and validate questionable amounts of FTCs claimed on Forms 1040 or Forms 1040NR.

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

B. Obtained and analyzed Audit Information Management System data at TIGTA's Data Center Warehouse to identify all examination cases closed during Fiscal Years 2011, 2012, 2013, and 2014. We matched this information to the Individual Return Transaction File to identify all examined Forms 1040 and Forms 1040NR that claimed the FTC.

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

D. Using the data matched in Step II.B., identified all FTCs claimed greater than $25,000. We matched these data against SRS data to determine if any Forms 1116 claiming an FTC of more than $25,000 were referred to international examiners through the SRS as required.

E. If there were large numbers of tax returns with a Form 1116 claiming more than $25,000 not referred to international examiners, interviewed Examination function management from the Large Business and International and Small Business/Self-Employed Divisions to determine why these cases were not being referred.

F. Interviewed Examination function management from the Small Business/Self-Employed and Large Business and International Divisions to determine:

1. How they identified and selected for audit tax returns claiming questionable FTCs.

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

3. Examination function management's opinion on Form 1116 taxpayer compliance.

Data validation methodology

During this review, we relied on Tax Years 2010, 2011, and 2012 Forms 1040 and Forms 1040NR data extracted from the Individual Return Transaction File for Processing Years 2011, 2012, and 2013 that were extracted by an auditor from TIGTA's Data Center Warehouse. Additionally, we relied on Tax Years 2010, 2011, and 2012 Form 1099-INT, Form 1099-DIV, and Schedule K-1 (Form 1041) data extracted from the Information Return Master File for Processing Years 2011, 2012, and 2013 that were provided by the TIGTA Office of Investigations' Strategic Data Services. 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. For example, we reviewed a judgmental sample of 30 cases 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 Forms 1040 and Forms 1040NR. 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

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Bryce Kisler, Acting Assistant Inspector General for Audit, (Compliance and Enforcement Operations)
Tina Parmer, Acting Director
Nancy VanHouten, Acting Audit Manager
John Chiappino, Lead Auditor
Jeff Jones, Senior Auditor
Kim McMenamin, Senior Audit Evaluator

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Large Business and International Division SE:L
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, International Individual Compliance, Large Business and International Division SE:LB:IN
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Audit Coordination OS:PPAC:AC
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:

- Commissioner, Large Business and International Division SE:LB
- Commissioner, Small Business/Self-Employed Division SE:S
- Commissioner, Wage and Investment Division SE:W

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:

- Increased Revenue – Potential; $94.9 million for 65,499 tax returns claiming FTCs that did not have the required documentation (see page 4).

Methodology Used to Measure the Reported Benefit:

We analyzed more than 2.1 million paper and electronically filed Forms 1040, *U.S. Individual Tax Return*, and Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, for Tax Years 2010 through 2012 that required a Form 1116, *Foreign Tax Credit*, be attached to support more than $42.6 billion in FTC claims. We identified 65,499 tax returns that did not have the required documentation and taxpayers that received approximately $94.9 million in potentially erroneous FTCs.

- Taxpayers filing 46,472 electronic returns erroneously received approximately $61.1 million in FTCs without an attached Form 1116 as required.
- Based on our sample results, taxpayers filing 19,027 paper returns erroneously received $33.8 million in FTCs without an attached Form 1116 as required.

Figure 1: Number of Individual Tax Returns and FTCs Erroneously Claimed

Action Taken	Results
Total tax returns with FTCs for Tax Years 2010, 2011, and 2012 that required a Form 1116 be attached.	2,134,679
Total tax returns (electronic and paper) with FTCs greater than $300 for single taxpayers ($600 for joint filers) filing a return with no Form 1116 attached.	70,305
Total paper tax returns with FTCs greater than $300 for single taxpayers ($600 for joint filers) filing a return with no Form 1116 attached.	23,833
Sample size of the population of 23,833 paper tax returns using 95 percent confidence level, 5 percent estimated error rate, and ± 3 percent precision.	203
Sample results.	162 paper tax returns that claimed $287,929 in FTCs that did not have the required documentation. 41 paper tax returns and related taxpayer accounts that had FTC transcription errors.
Projecting the results to our population of 23,833 using 95 percent confidence rate.	19,027 paper tax returns[1] with approximately $33.8 million[2] in erroneous FTCs without an attached Form 1116 as required. 4,806 paper tax returns[3] with transcription errors involving the FTC.

Source: TIGTA analysis of the Individual Return Transaction File information for Tax Years 2010 through 2012.

[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 17,732 and 20,323.
[2] 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 $12,835,085 and $54,671,382.
[3] 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 3,510 and 6,101.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 4,806 taxpayer accounts with transcription errors involving the FTC (see page 4).

Methodology Used to Measure the Reported Benefit:

The detailed information on these cases is included in the previously discussed Figure 1.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $40 million in erroneous FTCs on 188,102 tax returns when third-party information documents indicated the taxpayer did not pay any foreign taxes or the amount of the foreign taxes paid was less than the amount of the FTC claimed (see page 8).

Methodology Used to Measure the Reported Benefit:

Between Tax Years 2010 and 2012, approximately 12 million tax returns claiming FTCs were filed that satisfied the third-party information return documentation exception, and no Form 1116 was required. However, during this same three-year period, we found 188,102 tax returns for which taxpayers potentially received approximately $40 million in FTCs that were not supported by third-party information return documents as required.

Figure 2: FTCs Unsubstantiated by Third-Party Information Return Documents

Action Taken	**Results**	
	Tax Returns	**FTC Amount**
Identified tax returns in which the FTC reported was less than or equal to $300 for single filers ($600 for joint filers) for three tax years.	Tax Year 2010 - 3,949,754 Tax Year 2011 - 4,071,934 Tax Year 2012 - 4,188,737	
Using the third-party information return documents, we matched them by TIN to the primary taxpayer (and the secondary taxpayer, if a joint return was filed).	Tax Year 2010 - 3,726,166 Tax Year 2011 - 3,840,251 Tax Year 2012 - 3,940,833	
Nonmatches for which the difference between the amount claimed by the taxpayer and the total amount supported by third-party information return documents was at least $99.	85,381	$17,209,249
Nonmatches for which no supporting documents from third-party information return document data were found and the FTC amount claimed by the taxpayer was at least $99.	102,721	$22,782,956
Total	188,102	$39,992,205

Source: TIGTA data analysis of the Individual Return Transaction File and the Information Return Master File information for Tax Years 2010 through 2012.

Appendix V

Form 1116, Foreign Tax Credit

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

► **Attach to Form 1040, 1040NR, 1041, or 990-T.**

► **Information about Form 1116 and its separate instructions is at *www.irs.gov/form1116*.**

OMB No. 1545-0121

2013

Attachment Sequence No. **19**

Name | **Identifying number** as shown on page 1 of your tax return

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** in the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

a ☐ Passive category income **c** ☐ Section 901(j) income **e** ☐ Lump-sum distributions

b ☐ General category income **d** ☐ Certain income re-sourced by treaty

f Resident of (name of country) ►

Note: *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession.*

Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

		Foreign Country or U.S. Possession			Total
		A	B	C	(Add cols. A, B, and C.)
g	**Enter the name of the foreign country or U.S. possession** ►				
1a	Gross income from sources within country shown above and of the type checked above (see instructions):				1a
b	Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is $250,000 or more, and you used an alternative basis to determine its source (see instructions) ► ☐				
Deductions and losses (Caution: *See instructions*):					
2	Expenses **definitely related** to the income on line 1a (attach statement)				
3	Pro rata share of other deductions **not definitely related:**				
a	Certain itemized deductions or standard deduction (see instructions)				
b	Other deductions (attach statement)				
c	Add lines 3a and 3b				
d	Gross foreign source income (see instructions)				
e	Gross income from all sources (see instructions)				
f	Divide line 3d by line 3e (see instructions)				
g	Multiply line 3c by line 3f				
4	Pro rata share of interest expense (see instructions):				
a	Home mortgage interest (use the Worksheet for Home Mortgage Interest in the instructions)				
b	Other interest expense				
5	Losses from foreign sources				
6	Add lines 2, 3g, 4a, 4b, and 5				6
7	Subtract line 6 from line 1a. Enter the result here and on line 15, page 2 ►				7

Part II Foreign Taxes Paid or Accrued (see instructions)

Country	Credit is claimed for taxes (you must check one) (h) ☐ Paid (i) ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			(n) Other foreign taxes paid or accrued	Taxes withheld at source on:			(r) Other foreign taxes paid or accrued	(s) Total foreign taxes paid or accrued (add cols. (o) through (r))
	(j) Date paid or accrued	(k) Dividends	(l) Rents and royalties	(m) Interest		(o) Dividends	(p) Rents and royalties	(q) Interest		
A										
B										
C										

8 **Add lines A through C, column (s). Enter the total here and on line 9, page 2** ► 8

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11440U Form **1116** (2013)

Form 1116 (2013) Page **2**

Part III Figuring the Credit

9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I	9	
10	Carryback or carryover (attach detailed computation)	10	
11	Add lines 9 and 10	11	
12	Reduction in foreign taxes (see instructions)	12	( )
13	Taxes reclassified under high tax kickout (see instructions)	13	
14	Combine lines 11, 12, and 13. This is the total amount of foreign taxes available for credit	14	
15	Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see instructions)	15	
16	Adjustments to line 15 (see instructions)	16	
17	Combine the amounts on lines 15 and 16. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 18 through 22. However, if you are filing more than one Form 1116, you must complete line 20.)	17	
18	**Individuals:** Enter the amount from Form 1040, line 41, or Form 1040NR, line 39. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	18	
	Caution: *If you figured your tax using the lower rates on qualified dividends or capital gains, see instructions.*		
19	Divide line 17 by line 18. If line 17 is more than line 18, enter "1"	19	
20	**Individuals:** Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 42. **Estates and trusts:** Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37	20	
	Caution: *If you are completing line 20 for separate category e (lump-sum distributions), see instructions.*		
21	Multiply line 20 by line 19 (maximum amount of credit)	21	
22	Enter the smaller of line 14 or line 21. If this is the only Form 1116 you are filing, skip lines 23 through 27 and enter this amount on line 28. Otherwise, complete the appropriate line in Part IV (see instructions) ▶	22	

Part IV Summary of Credits From Separate Parts III (see instructions)

23	Credit for taxes on passive category income	23	
24	Credit for taxes on general category income	24	
25	Credit for taxes on certain income re-sourced by treaty	25	
26	Credit for taxes on lump-sum distributions	26	
27	Add lines 23 through 26	27	
28	Enter the smaller of line 20 or line 27	28	
29	Reduction of credit for international boycott operations. See instructions for line 12	29	
30	Subtract line 29 from line 28. This is your **foreign tax credit**. Enter here and on Form 1040, line 47; Form 1040NR, line 45; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶	30	

Form **1116** (2013)

Source: IRS.gov website.

Appendix VI

Glossary of Terms

Term	Definition
Audit Information Management System	An IRS computer system used by Examination functions to control returns, input assessments/adjustments to the Master File, and provide management reports.
Automated Underreporter Program	The Automated Underreporter Program matches items reported on an individual's income tax return to information supplied to the IRS from outside sources (such as from employers, banks, and credit unions) to determine if the taxpayer's tax return reflected the correct amounts.
Business Rule	As it relates to this report, a business rule is programming criteria for IRS electronic filing systems that cause a return to be rejected from processing.
Code and Edit Function	IRS function that manually screens returns to properly identify items that require input to the IRS computer system.
Data Center Warehouse	A centralized storage and administration of files that provides IRS data and data access services to TIGTA auditors.
Data Transcriber	An IRS employee who enters information from tax returns into the IRS computer system.
Double Taxation	The levying of tax by two or more jurisdictions on the same declared income. This is often mitigated by tax treaties between countries.

Term	Definition
Electronic Filing System	The IRS Electronic Filing System is a process by which tax returns are submitted to the IRS by way of data communications and processed electronically through front-end edits. Tax return data are transmitted in the form of electronic records to a designated Submission Processing function.
Electronic Tax Administration	Provides oversight of all electronic filing activities. Its purpose is to revolutionize how taxpayers transact and communicate with the IRS.
Error Resolution	An IRS system that provides for the correction of errors associated with input submissions.
Fiscal Year	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.
Foreign Source Income	Foreign source income is income derived from sources outside of the United States.
Foreign Tax Credit	The FTC intends to reduce the double taxation burden that would otherwise arise when foreign source income is taxed by both the United States and the foreign country from which the income is derived.
Foreign Tax Deduction	A taxpayer can choose each year to take the amount of any qualified foreign source income tax paid or accrued during the tax year as an itemized deduction on Schedule A, *Itemized Deductions*.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Return Transaction File	Data transcribed from initial input of the original individual income tax returns during return processing.

Term	Definition
Information Return Master File	An IRS database that contains third-party information return documents for taxpayers, such as Form W-2, *Wage and Tax Statement*, Form SSA-1099, *Social Security Benefit Statement, etc.*
Information Return Processing	IRS program used to validate tax return information using information returns such as Forms W-2.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Internal Revenue Code	The Federal Statutory Law enacted as Title 26 of the U.S. Code is organized according to topic and covers all relevant rules pertaining to gift, estate, payroll, and excise taxes. The IRS is its implementing agency.
Internal Revenue Manual	The primary official source of instructions to staff relating to the organization, administration, and operation of the IRS.
International Examination Specialist	Specialists are used on cases to examine events or transactions that require specialized skills and abilities.
Master File	An IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Math Error Authority	I.R.C. Section 6213(b) authorizes the IRS to make a summary assessment of tax due for which that addition is the result of a mathematical or clerical error on the return.

Term	Definition
Modernized Electronic Filing System	The MeF System is an Internet-based electronic filing platform. It provides a single method for filing business and individual tax returns, forms, and schedules via the Internet. The system provides real-time processing of tax returns, improves error detection, standardizes business rules, and expedites tax return acknowledgements to taxpayers.
Nonresident Alien	An individual who is not a U.S. citizen or U.S. national who has not passed the green card test or the substantial presence test.
Primary Taxpayer	The individual who is filing the tax return.
Resident Alien	An individual who is not a U.S. citizen who meets either the "green card" test of holding an immigrant visa or the physical presence of being in the United States for at least 31 days during the current calendar year and a total of 183 days during the three-year period that includes the current year and the two preceding years.
Revenue Agent	An employee in the Examination function who conducts face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes, *e.g.*, excise tax returns.
Secondary Taxpayer	The spouse of the primary taxpayer filing the tax return.
Specialist Referral System	The SRS automates the referral request process and must be used for referrals, questions, and requests for assistance from specialist groups.
Tax Compliance Officer	An IRS employee in the Examination function who primarily conducts examinations of individual taxpayers through interviews at IRS field offices.
Tax Examiner	An IRS employee who processes tax returns, establishes and edits tax account records, and determines proper tax liabilities.

Term	Definition
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
Taxpayer Identification Number	A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the TIN is an Employer Identification Number, a Social Security Number, or an Individual Taxpayer Identification Number.

Appendix VII

Management's Response to the Draft Report

LARGE BUSINESS AND INTERNATIONAL DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

June 10, 2015

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Heather C. Maloy
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report – Improvement Is Needed In Compliance Efforts to Identify Unsupported Claims for Foreign Tax Credits (Audit No. 201330050)

Thank you for the opportunity to review and comment on the subject draft report. The Foreign Tax Credit (FTC) is intended to reduce the double taxation burden that would otherwise arise when foreign source income is taxed by both the United States and the foreign country from which the income is derived. A taxpayer is afforded an opportunity to choose either a credit or a deduction of the foreign taxes paid. However, a taxpayer may not take the credit and the deduction for the foreign taxes paid on the same foreign source income in any given year.

We appreciate your recommendations and are always seeking ways to improve our programs. As shown by the figures in the report, the IRS properly and effectively addresses the overwhelming majority of returns claiming the FTC. In light of the significant decrease in enforcement resources, the IRS has to make strategic and risk-based decisions in devising our examination plan, to ensure that our limited compliance resources are allocated to focus on areas with the highest levels of noncompliance. The FTC is included in our risk-based decisions for allocating resources. This approach allows us to maximize our coverage in the most egregious tax filing issues while achieving balanced overall coverage.

We agree with the recommendations in your report with one exception. We can only partially agree with Recommendation 4 that IRS should identify and track key FTC statistics of taxpayer FTC claims and related assessments. While we implemented the use of Uniform Issue List (UIL) codes in June 2014, to assist in identifying potential noncompliance and trends involving international issues including FTC, further enhancements are not possible due to current budget and resource restrictions.

We do not agree with the proposed outcome measures in this report, which you reached by totaling up the total amount of credits claimed on tax returns for which a Form 1116, *Foreign Tax Credit* was not submitted by the taxpayer. The absence of the form does not support the assumption that the claim for the credit was erroneous. Only an examination of the returns can conclusively establish whether the claimed amount was erroneous. Please see Attachment II for further details.

Attached are our comments to your recommendations. If you have any questions, please contact me or members of your staff may contact David W. Horton, Director, International Individual Compliance, at 630-493-5937.

Attachments (2)

Attachment I

RECOMMENDATION 1:

The Commissioner, Wage and Investment, should establish controls to ensure that a Form 1116 is attached to Forms 1040 or Forms 1040NR for taxpayer FTC claims when required.

CORRECTIVE ACTIONS:

The IRS agrees with this recommendation and, on February 27, 2015, requested the requisite programming changes to systemically identify returns filed without a required Form 1116, *Foreign Tax Credit*. However, because programming is dependent on limited resources and the prioritization of the requested changes against other needs, we cannot guarantee that the programming changes will be implemented and do not commit to further corrective actions beyond those already taken.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 2:

The Commissioner, Wage and Investment, should ensure any training materials and additional guidance related to FTCs is updated to match the revisions to IRM 3.11. Management should also periodically review worked cases to determine employee compliance with the updated FTC guidance.

CORRECTIVE ACTIONS:

The IRS will update procedural guidance and training materials to ensure conformity with Internal Revenue Manual (IRM) 3.11.3, *Returns and Documents Analysis, Individual Income Tax Returns*. The IRS will address employee compliance with the updated guidance as part of the existing quality review process.

2

IMPLEMENTATION DATE:

January 15, 2016

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 control system.

RECOMMENDATION 3:

The Commissioner, Large Business and International Division should develop a compliance strategy to address the risks identified with the FTC, including the issues of taxpayers receiving both the credit and the deduction for the same foreign tax payments, and taxpayers claiming the FTC without the proper third-party information return documentation.

CORRECTIVE ACTIONS:

The IRS agrees with this recommendation. We will develop a strategy that identifies returns that appear to have both credits and deductions along with other FTC compliance issues, and devise a risk-based examination strategy to address these issues.

IMPLEMENTATION DATE:

December 31, 2015

RESPONSIBLE OFFICIAL(S):

Director, International Individual Compliance, Large Business and International Division

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 4:

The Commissioner, Large Business and International Division should identify and track key FTC statistics related to taxpayer FTC claims and any FTC related assessments.

CORRECTIVE ACTIONS:

The IRS partially agrees with this recommendation. As of June 2014, IRS implemented a system for using UIL codes to assist in identifying potential noncompliance and trends involving international issues including FTC. Further enhancements to gather statistics are not possible due to current budget and resource restrictions.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 5:

The Commissioner, Large Business and International Division should improve education, outreach and enforcement activities to correct the paid tax preparer issues identified in this report related to the FTC.

CORRECTIVE ACTIONS:

IRS agrees with this recommendation, and we will continue our education and outreach efforts to the return preparer community to maximize efficiency and reach the broadest audience. IRS will continue to make presentations or participate in panel discussions at practitioner meetings and conferences sponsored by various professional practitioner organizations such as the American Bar Association, California Society of Enrolled Agents, etc. IIC is also considering suggesting FTC as a topic for the 2016 National Tax Forums.

Enforcement activities include the Return Preparer Program (RPP) to address egregious noncompliance. The number of RPP projects we are able to work at one time is limited. Decisions to initiate projects include evaluation of the degree of noncompliance as well as available resources.

IMPLEMENTATION DATE:

June 30, 2016

RESPONSIBLE OFFICIAL(S):

Director, International Individual Compliance, Large Business and International Division

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 6:

The Commissioner, Large Business and International Division should revise IRM 4.60.6.2 and the SRS User Guide to clearly define the referral criteria that will be followed to ensure that tax returns in the Examination function inventory with FTCs are referred as required.

CORRECTIVE ACTIONS:

The IRS agrees with this recommendation and we will ensure the language in the IRM and SRS Guide is consistent to provide clarity for FTC referral requirements.

IMPLEMENTATION DATE:

October 31, 2015

RESPONSIBLE OFFICIAL(S):

Director, International Business Compliance, Large Business and International Division

CORRECTIVE ACTION(S) MONITORING PLAN:

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

Attachment II

OUTCOME MEASURES:

1. Increased Revenue – Potential; $94.9 million for 65,499 tax returns claiming FTCs that did not have the required documentation.

IRS does not agree with the projected Outcome Measure of $94.9 million dollars for Increased Revenue. The TIGTA's analysis identified the amount of credits claimed on tax returns for which Form 1116, *Foreign Tax Credit,* was missing; however, the absence of the form does not support the assumption that the claim for the credits was erroneous. Only an examination of the returns can conclusively establish whether the claimed amount was erroneous.

The 19,027 paper returns without a Form 1116 attached included returns with Form 1116 not transcribed. The five transcription errors shared with SP included three returns with valid FTC claims in which Form 1116 was attached and not transcribed. Three of the five errors for missing Form 1116 were due to an IRM error. As stated above, the absence of Form 1116 is only an indicator of a potentially erroneous claim. Please consider this information in the calculations on the report.

***2.* Reliability of Information - Potential; 4,806 taxpayer accounts with transcription errors involving the FTC.**

The IRS does not agree that potentially 4,806 accounts have transcription errors involving FTC. The 41 returns with transcription errors causing erroneous FTC included errors transcribing FTC in place of another allowable credit (for example, Childcare Credit on line 48 inadvertently transcribed as FTC on line 47). This is not a loss of revenue. The ten transcription errors shared with SP included two of these types of errors and both had been corrected in ERS before the returns posted. Please exclude the associated potential revenue loss from the report.

3. Increased Revenue – Potential; $40 million in erroneous FTCs on 188,102 tax returns when third-party information documents indicated the taxpayer did not pay any foreign taxes or the amount of the foreign taxes paid was less than the amount of the FTC claimed.

The IRS does not agree with this outcome measure. In the discussion draft report, TIGTA recommended issuing soft notices to the same population of taxpayers identified in this outcome measure. After addressing the discussion draft recommendation related to this item, the recommendation was not included in this draft report, but the corresponding outcome measure was not changed.