

GAO

Report to the Chairman,
Committee on Finance,
U.S. Senate

May 1993

TAX
ADMINISTRATION

IRS Activities to
Increase Compliance
of Overseas Taxpayers





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-251491

May 18, 1993

The Honorable Daniel P. Moynihan
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

This letter responds to the February 10, 1992, request of your predecessor as Chairman of the Committee on Finance, Senator Lloyd Bentsen, that we review what actions the Internal Revenue Service (IRS) has taken since 1986 to improve the tax compliance of American taxpayers living overseas. We previously testified on this matter in 1985 and issued a report in 1986 addressing IRS' collections procedures for taxpayers living overseas.¹ In that testimony, we estimated that 61 percent of U.S. taxpayers living in seven foreign cities were nonfilers.

Results in Brief

Since 1986, IRS has taken several steps to encourage voluntary compliance by taxpayers overseas, including reducing taxpayer burden, increasing taxpayer education, and continuing its enforcement efforts. In spite of these efforts, IRS still cannot measure the full extent of overseas noncompliance because it has limited information about Americans living overseas. No reliable data exist on the number of Americans living overseas, and federal agencies, such as the State Department and the Social Security Administration, restrict IRS access to agency data that might help IRS identify overseas Americans. IRS' information returns program—which matches information from employers, financial institutions, and other third parties with individual tax returns—has a limited impact on the identification of overseas nonfilers because the majority of foreign documents IRS receives do not correspond to the IRS tax year or lack a taxpayer identification number. IRS' access to the State Department's passport application data, mandated by the Tax Reform Act of 1986, has not significantly improved IRS' ability to identify nonfilers.

In three overseas enforcement initiatives that we studied, IRS did not collect significant additional federal tax revenues. IRS was unable to contact many nonfilers identified in each of these initiatives, and those nonfilers who were contacted reported little or no U.S. tax liability. Among

¹United States Citizens Living in Foreign Countries and Not Filing Federal Income Tax Returns, statement by Johnny Finch, GAO before the U.S. House, Committee on Government Operations, Subcommittee on Commerce, Consumer and Monetary Affairs (May 8, 1985); and Tax Administration: IRS Can Improve Its Collection Procedures for Taxpayers Living Overseas (GAO/GGD-87-14, Dec. 12, 1986). See also Foreign Source Income: Problems of Tax Return Nonfiling and Income Underreporting by Americans Living or Investing Abroad, House Government Operations Committee (Aug. 8, 1986).

the possible reasons for this were that nonfilers had incomes below the minimum level required for filing a U.S. tax return, or their U.S. tax liability was negligible after the foreign earned income exclusion and the foreign tax credit were taken into account. The revenue costs related to the exclusion of income earned abroad were estimated to be \$7.9 billion for fiscal years 1992 through 1996.

IRS plans to continue its efforts to educate taxpayers overseas about filing requirements and to consider additional options for simplifying filing and reducing the burden of filing from overseas locations. In addition, IRS has begun several projects to develop better information about Americans living overseas. These projects may ultimately allow IRS to better target its enforcement activities.

Background

The United States requires its citizens and resident aliens, regardless of where they reside, to file U.S. tax returns and pay taxes on their worldwide income. By contrast, the citizens of most other countries are not taxed by their country of citizenship if they reside in a foreign country. In 1991, the minimum income level necessitating a tax return was \$5,550 for a single individual.

Despite the U.S. filing requirement, many individuals eliminate or reduce their U.S. tax liability by taking advantage of two provisions in the Internal Revenue Code—the foreign income exclusion and the foreign tax credit. First, U.S. citizens and resident aliens may qualify to exclude up to \$70,000 of their foreign earned income under section 911 of the Code.² This section also allows for the exclusion of certain foreign housing costs for tax purposes.³ To qualify for the exclusions, individuals must meet one of two residency tests⁴ and attach IRS Form 2555 with a timely filed tax return. In 1987, the most recent year for which comprehensive data were available, 171,191 individuals filed a Form 2555 with their returns. These individuals reported a total foreign net income of \$8.2 billion and claimed foreign

²Amounts paid by the U.S. government to its employees are not considered foreign earned income and may not be excluded under section 911.

³The housing cost amount is equal to the qualified housing expenses of an individual for the tax year less a base amount. The base amount is 16 percent of the salary of a U.S. employee for the Step 1 Grade GS-14, figured on a daily basis, multiplied by the number of days during the year that the taxpayer meets either of the residency tests. For 1991, the base amount for a full year was \$8,055.

⁴The exclusion is available to U.S. citizens and certain resident aliens whose tax home is in a foreign country and who are either (1) bona fide residents of a foreign country for an uninterrupted period that includes a complete tax year or (2) physically present in one or more foreign countries for at least 330 full days during any 12 consecutive months.

earned income and foreign housing exclusions of \$6.5 billion. Appendix I provides more information on these taxpayers. According to an IRS internal report, 180,087 Forms 2555 were filed in 1990, but this report did not indicate the amount of income reported or the exclusion taken. Appendix II shows the number of Forms 2555 received for tax year 1990 by country or countries of origin. In 1991, the Joint Committee on Taxation estimated the revenue costs related to the exclusion of income earned abroad by U.S. citizens to be \$7.9 billion for fiscal years 1992 through 1996.

Second, persons who pay income tax to a foreign government may qualify for a foreign tax credit under section 901 of the Code. To claim this credit, taxpayers file IRS Form 1116 with their tax returns. The foreign tax credit can also be claimed by taxpayers living in the United States for taxes paid to foreign countries on income earned from foreign sources. In 1987, over 561,000 taxpayers claimed foreign tax credits of about \$1 billion. IRS could not tell us how many persons taking foreign tax credits lived in foreign countries and how many lived in the United States.

The Office of the Assistant Commissioner (International)—AC (International)—is responsible for all international tax matters. To support its mission, AC (International) maintains 13 revenue service representatives (RSRs) and 5 assistant RSRs at 13 foreign posts of duty. AC (International)'s Taxpayer Service Division also has year-round staff members at 2 foreign posts and 18 seasonal staff who work at 10 of the remaining 11 posts during tax season.

Objectives, Scope, and Methodology

Our specific objectives were to review IRS activities regarding current tax filing rules for overseas taxpayers, and to report what IRS has done since 1986 to improve the tax compliance rate of these taxpayers. To fulfill these objectives, among other things we interviewed officials from IRS and other involved agencies and reviewed GAO and Committee reports and various IRS records.

We did our review between February and October 1992 in accordance with generally accepted government auditing standards. A detailed discussion of our objectives, scope, and methodology appears in appendix III.

IRS Efforts to Address Nonfiling Have Been Multifaceted

Since 1986, IRS has taken several steps to bring current nonfilers back into the system and keep filers from becoming nonfilers. Some efforts have been in direct response to GAO and congressional recommendations, while others have been undertaken at IRS' own initiative. The efforts can be

grouped into three general categories: reduction of taxpayer filing burden, taxpayer education, and improvement of enforcement capabilities.

Making Overseas Filing Easier

According to IRS officials, the burden associated with filing from overseas discourages some people from filing, especially those who ultimately would not owe any tax because of the income exclusion and the tax credit. The complexity of specialized tax forms is a barrier to filing from overseas. An IRS/American Institute of Certified Public Accountants (AICPA) survey of tax practitioners conducted in 1989 found that individuals who were unfamiliar with the complexities of the foreign income and housing exclusion and the foreign tax credit could not file returns without the assistance of a tax practitioner. Such assistance can be very expensive in some foreign countries. IRS officials reported costs of \$900 to get a Form 1040EZ prepared in Indonesia and as much as \$1,500 for an individual in Canada to file a return claiming the foreign income exclusion and the foreign tax credit.

Beginning in tax year 1992, many overseas filers will be able to file a simplified Form 2555 for electing the foreign income exclusion. IRS' goal in simplifying Form 2555 was to make it easier for those persons who were least likely to owe any U.S. taxes—persons who make less than \$70,000 in foreign earned income—to file their returns. IRS estimates it will take about half as long to complete the Form 2555EZ as the standard Form 2555. IRS believes that at least one-third of current filers of the standard Form 2555 will be able to use the Form 2555EZ.⁵ IRS will include both the Form 2555EZ and the Form 2555 in its overseas forms package in 1992, along with a notice announcing the new form.

IRS plans to carefully monitor the implementation of the Form 2555EZ. It plans to analyze the number of Forms 2555EZ filed and determine how many people could have used the Form 2555EZ but used the Form 2555 instead. IRS expects to use this analysis to determine if it can expand the population of filers of the Form 2555EZ without compromising the simplicity of the new form.

IRS has also taken several steps to improve access to tax forms overseas, which has been cited as another barrier to filing. Each year, IRS mails about 700,000 tax packages and forms to overseas taxpayers who filed in the previous year—including those located at U.S. Army and Fleet Post

⁵To use the Form 2555EZ, a taxpayer must have less than \$70,000 in foreign earned wage or salary income. Persons who are self-employed and those who claim business or moving expenses cannot use the Form 2555EZ. Also, users of the Form 2555EZ cannot claim the foreign housing exclusion.

Office addresses—as well as about 100,000 forms and schedules for specialized uses. In 1987, about 39 percent of these packages were classified as undeliverable due to inaccurate or incomplete addresses. In response, IRS revised its automated system for recording and updating addresses and changed its overseas mailing procedures. Instead of mailing packages directly through U.S. mail, IRS now uses a contractor to ship pouches of mail to each country, which then sends the mail through its local mail service. As a result of these efforts, IRS reduced the undeliverable rate to 4 percent in 1991. In addition, IRS used response cards completed by recipients of 1991 tax packages to determine that average delivery time fell to about 8 days in 1991, down from the 1987 average of 34 days. IRS also automated its system for supplying tax forms to State Department posts, which serve as distribution points for IRS forms during filing season. To address the problem of getting forms to persons who cannot come to the posts to pick them up, IRS is expanding its network for distribution. In 1992, American schools and chambers of commerce in five countries served as distribution points for tax forms. For 1993, IRS is pursuing an agreement with an international travel and credit services company to make tax forms available at its many locations worldwide.

Educating Taxpayers About Their Requirements to File

IRS efforts to educate taxpayers overseas are intended to reach those nonfilers who either are completely unaware of the requirement to file or are under the mistaken impression that the foreign earned income exclusion exempts them from filing if they earn less than \$70,000. IRS developed several publications and advertisements that explain the filing requirements applicable to Americans living overseas. IRS has used its own distribution networks and State Department resources to disseminate this information both to persons already overseas and those moving overseas for the first time. In addition, beginning in early 1993, all U.S. passports will include a statement about filing requirements.⁶

Other IRS efforts use a variety of methods to target specific groups of Americans living overseas. For example, IRS held “town meetings” in Toronto and London that allowed taxpayers to discuss overseas filing issues with IRS. IRS has recently developed a variety of educational initiatives targeting persons who have just moved or are planning to move to Kuwait, in an attempt to prevent these taxpayers from becoming nonfilers. IRS plans to monitor the results of this project. In addition, IRS,

⁶The required statement is “All United States citizens working and residing overseas are required to file and report on their worldwide income. See IRS Publication 54 for an explanation of filing requirements and benefits.”

with the help of the State Department, continues to present its taxpayer assistance programs during its overseas tours held each year during tax season. In 1992, AC (International) Taxpayer Service Division scheduled visits by IRS representatives in 143 cities abroad.

Improving Overseas Enforcement

Since 1986, IRS has adopted several enforcement recommendations made by GAO and the House Government Operations Committee. In our 1985 testimony, we identified weaknesses in IRS collections procedures for overseas cases, finding that collections personnel closed cases by accepting inaccurate explanations of filing and tax requirements from nonfilers. For example, one IRS official told us personnel closed cases if taxpayers claimed to be exempt from filing because their foreign earned income was below \$70,000, without the taxpayers being informed that they had to file to claim the exclusion. To address this, IRS developed a training course for collections personnel at its Philadelphia Service Center, which handles all overseas collections cases. Collections personnel now use detailed flowcharts that instruct them how to handle each taxpayer's situation. IRS also revised the tax delinquency notices sent to overseas nonfilers and underreporters to include an explanation of overseas filing requirements.

IRS adopted our recommendation that it arrange access to the records in the Department of Defense's (DOD) Defense Manpower Data Center (DMDC) database to obtain addresses that could be used for collections purposes. DMDC maintains records on active and retired DOD civilian and military personnel and reservists, as well as virtually all active and retired federal government personnel.⁷ IRS submits certain collections cases on identified nonfilers to DMDC, which matches these cases against its database. When a match is made, DMDC provides IRS with a record including name, address, and other data IRS can use in its enforcement efforts. Although the original agreement provided for a quarterly match against only the DOD portion of the database, it has been expanded to a monthly match against the entire DMDC database. IRS does not maintain separate data on the collections cases for which it obtains DMDC information, so it cannot assess the revenue impact of this program. However, one official told us that IRS has been happy with the results of this match.

The Tax Reform Act of 1986 incorporated the Committee's recommendation that the State Department collect taxpayer identification

⁷DMDC does not include persons in the U.S. intelligence community.

numbers⁸ on passport applications and provide this information to IRS. The State Department sent the first records to IRS in May 1988. IRS paid most of the costs of setting up the system and pays State a flat fee per record for the records it maintains. In one 6-month period in 1991, IRS received data on almost 2.2 million passport applicants, about 3 percent of which came from overseas posts.

IRS Does Not Know the Extent of the Nonfiling Problem Overseas

In spite of its efforts to improve overseas compliance, IRS does not have the data to fully measure the extent of overseas noncompliance. No reliable data exist on the number and identities of Americans living overseas. IRS is restricted from access to databases maintained by other federal agencies, such as the State Department, that may help it identify Americans living overseas. IRS' document-matching system for identifying domestic nonfilers with information provided by employers and other payors is of limited usefulness in identifying overseas nonfilers. Access to passport application data has had a limited impact on IRS' ability to identify nonfilers.

Number of Americans Who Reside Overseas Is Unknown

The State Department estimated that 2.2 million Americans lived overseas in 1989, excluding U.S. military personnel, Americans working for the U.S. government, and their dependents.⁹ However, State Department officials told us the reliability of State's estimates varies by post. In some locations, State Department officials use records maintained by the foreign government to estimate the number of Americans living in the country or post territory. In other locations, where State Department personnel question the accuracy of the foreign government's records, officials rely more on State's own records and personal knowledge of the area to develop an estimate of the American population that would be less precise than if the foreign government's records were available. According to the State Department, one of the problems in estimating the number of Americans in a particular country is that the host country may not list some of them as Americans, and the American embassy may not know of them.

⁸For federal income tax purposes, the Social Security number is the taxpayer identification number for individuals.

⁹In 1988, the number of DOD military and civilian personnel and other U.S. government employees overseas was estimated to be about 1 million.

Federal Agencies Restrict IRS' Access to Databases

IRS officials believe that federal agencies maintain data that could be used to identify and locate Americans living overseas, but these agencies cite the Privacy Act in refusing to grant IRS access to this information. For example, the State Department has denied IRS requests for general access to its lists of Americans who register at U.S. embassies and consulates contending that disclosure would violate the Privacy Act. The content of State Department lists varies by post, but all lists include name, date, and place of birth of Americans who voluntarily register at these posts; lists include some local addresses as well. In addition to Privacy Act concerns, State is also concerned that disclosing this information to IRS would discourage persons from registering with the posts. The State Department encourages persons to register their whereabouts with the posts so it can carry out its mission to protect Americans while they are in foreign countries. The Social Security Administration also cites the Privacy Act in restricting the data that it provides to IRS.

IRS' Document-Matching Program Receives Unusable Foreign Data

IRS' Information Returns Program (IRP) matches information from employers, financial institutions, and other third parties with individual tax returns to identify nonfilers and underreporters. IRS generally receives few, if any, documents related to persons living overseas. Unless individuals work for the federal government or for a U.S. company, IRS will not receive third-party wage and salary information on them. Therefore, IRS does not receive such wage and salary information on independent contractors, employees of foreign corporations, and retired persons with income from foreign sources—groups the 1989 IRS/AICPA survey indicated were among those thought to be noncompliant. If an individual no longer has any investments in the United States, IRS may receive no IRP documents on that individual at all.

One mechanism that generates IRP information on persons living overseas also has shortcomings. IRS currently receives information records from 18 of its 39 treaty partners through its exchange of information program. Although this information is intended to provide data on U.S. persons receiving income from sources outside the United States, much of the data cannot be used. For example, in 1990, 11 percent of the almost 532,000 documents IRS received could not be entered into the IRP system for such reasons as the tax year data did not correspond to the IRS tax year, or sources of income were reported that were not included in IRP. Of the remaining 89 percent of documents, 81 percent did not have a taxpayer identification number. Although IRS used an automated program to try to identify the appropriate taxpayer identification number associated with

each record, one official estimated it was successful in less than 10 percent of these cases.

Passport Information Is of Limited Usefulness

According to IRS officials, passport application data provided by the State Department have not significantly enhanced IRS' capability to identify or locate overseas nonfilers. Officials cited several problems with the use of the data. For example, the address listed on the application is not always a good indicator of where an individual lives. At least some persons who live overseas apply for a passport while in the United States; this is particularly true of persons who apply for a passport before moving overseas. Conversely, some tourists who lose their passports will apply from overseas. In addition, IRS receives records with missing and erroneous Social Security numbers because the State Department is not required to verify the Social Security numbers reported on applications. Currently, IRS enters the passport information into the IRP system and uses it along with other information returns to identify nonfilers. A passport record alone will not result in the identification of a nonfiler; the automated IRP system will identify a potential nonfiler only if at least one other IRP record indicates a potential tax liability of at least \$50. Officials acknowledged that a better system is needed for IRS to work with the passport information and are contemplating several alternatives.

IRS Efforts to Date Have Resulted in Minimal Revenues

We found that in three studies where IRS successfully identified a number of nonfilers living overseas, enforcement actions taken against them did not result in significant additional revenue. Because of the limited data available to IRS on overseas nonfilers, IRS may not be able to predict the potential revenue impact of undertaking enforcement actions against them. Many persons living overseas do not owe U.S. taxes because of the foreign income and housing exclusion and the foreign tax credit. As a result, IRS' enforcement efforts to date have identified many taxpayers who are required to file but do not owe U.S. taxes. These efforts have also found many persons overseas who do not meet the minimum filing requirements. Enforcement actions on Americans living overseas have been further complicated by poor address information.

Various studies by IRS illustrate the problems encountered in overseas enforcement. Beginning in 1990, AC (International) participated in the 1988 Taxpayer Compliance Measurement Program (TCMP) study of nonfilers. The study involved 437 taxpayers thought by IRS to be overseas nonfilers in tax year 1988. IRS could not locate or contact more than half of this group

(261 taxpayers). Of the remaining 176 taxpayers, 50 did not meet the minimum income level for filing, 39 were not required to file for other reasons, 36 were shown to have actually filed a return, and 20 were transferred to domestic locations. Only 14 of the nonfilers filed returns as a result of being contacted. Of these, only one taxpayer owed U.S. taxes totaling \$9,595. For the remaining 17 cases, IRS used available information to estimate returns, but they could not tell us what, if any, tax liability was associated with these returns. Officials qualified the results of this study because the Persian Gulf war prevented them from traveling abroad to do the necessary work. However, according to one official, working cases in the field would have allowed IRS to contact more taxpayers, but this might not have resulted in very much additional revenue.

Another study, completed in 1987, found that many Social Security beneficiaries did not owe taxes to the United States. As with the RCMP study, IRS was unable to locate or secure a response from many (44 percent) of the potential nonfilers identified. Of those responding, only 8 of 140 provided delinquent returns with a total tax liability of \$2,126. About two-thirds of respondents were not required to file because they had insufficient income.

IRS also did a study in Perth, Australia, that similarly found that many nonfilers did not owe taxes. The IRS post in Sydney, Australia, identified 114 citizens living in Perth and determined that 62 of them were nonfilers. Of the 62, 23 did not meet the minimum requirement to file, and IRS did not or could not contact 14. As of September 1992, 21 nonfilers filed returns and IRS was awaiting returns from 4 others. Only 3 of the 21 owed tax to IRS, totaling \$5,345.

IRS Plans for Dealing With Overseas Nonfilers Focus on Better Data, Further Simplification

In spite of some of the problems it has encountered, IRS plans several new efforts to increase overseas compliance. Many of these focus on improving the information available to IRS on overseas Americans. They include developing better data, improving IRS' internal systems, and continuing efforts to get data from a variety of external sources, including other federal agencies that do not currently allow IRS access to certain information. IRS officials also continue to consider additional options to simplify filing.

IRS plans to make better use of its internal systems to develop data on persons living overseas. AC (International) officials recently requested data from IRS' national computing center on persons who currently file from

overseas locations. Officials believe that by learning more about the population of persons who file, they can develop information that may help them better define the population of nonfilers. IRS expects to use this information in a variety of ways to better direct its education, simplification, assistance, and enforcement programs. IRS is also working on several initiatives directed at improving the usability of records received from tax treaty countries under the exchange of information programs. These efforts include the development of a standardized reporting format to be used by all countries, transmission of computer records instead of paper documents, and working with individual countries in improving the data submitted.

IRS is also analyzing external sources of data on Americans living overseas. It recently received data from a private credit bureau that officials hope will provide names, addresses, and Social Security numbers of some Americans who live in Canada. IRS will also continue to work with other agencies, such as the State Department, to gain access to additional agency data.

In addition to developing better data on overseas Americans, IRS is exploring options to further reduce the burden of filing from overseas locations. Officials recognize that although the creation of the Form 2555EZ will reduce the filing burden for some taxpayers, others will continue to be discouraged from filing by complicated forms and high preparers' fees. In particular, many persons earning more than \$70,000 will still have to file the complicated Form 1116 for taking the foreign tax credit. Legislation has been introduced to simplify claiming the foreign tax credit by waiving the requirement to file Form 1116 for persons who claim foreign tax credits below an established threshold, but this will primarily benefit domestic taxpayers with foreign investments.

IRS officials have contemplated several other alternatives to further simplify filing. They include creating a simplified Form 1116 for taking the foreign tax credit, creating a specialized Form 1040 for overseas filers, and eliminating the filing requirement altogether for persons who can provide evidence—either on a specialized return or with some other documentation—that they have no U.S. tax liability. However, each of these options is complicated by the differences from country to country as to what income is taxed and what is not. Therefore, it may be very difficult to design a single, standardized form or method for establishing a taxpayer's U.S. liability if a foreign tax credit is involved. Further, one official told us it would be more difficult to audit taxpayers if the existing

filing requirement were eliminated for persons who provide evidence of having no U.S. tax liability and that such a change might result in a taxpayer paying no tax to either country on certain categories of income.

Better data may aid IRS in determining the direction of its simplification efforts. For example, one official said that on the basis of preliminary data showing that a significant number of persons who take the foreign tax credit do not itemize, IRS may explore the possibility of creating a simplified Form 1116 for persons taking the standard deduction. In other cases, however, IRS does not yet have the statistical data it needs to estimate the potential number of persons who might benefit from proposed changes and therefore cannot weigh the benefits against the costs.

Conclusions

IRS has implemented several initiatives to encourage voluntary compliance by Americans living overseas. In spite of these efforts, IRS still lacks the data it needs to determine the full extent of nonfiling. IRS efforts to simplify filing and educate taxpayers about the filing requirements appear to be positive steps to encourage persons to file. Although the enforcement efforts we studied resulted in minimal revenues, IRS' plans to develop more information on the population of overseas Americans may allow it to better target its enforcement activities.

Agency Comments

IRS generally agreed with our findings, and the full text of its comments appears in appendix IV.

IRS noted that the three IRS enforcement efforts described in our report involved only a very small number of overseas nonfilers. It cautioned that the results of these efforts cannot be used to project noncompliance levels for overseas American taxpayers.

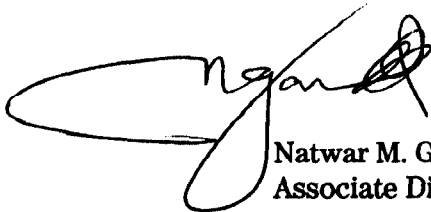
IRS cited several efforts that it believes will be successful and that we did not mention in our draft report. These efforts include working with tax practitioners to determine how to bring noncompliant taxpayers into the system; revising applicable publications; working with multinational companies with an emphasis on U.S. citizen tax responsibilities; holding special compliance seminars; and doing a special mailing to 2,400 U.S. firms with U.S. citizen employees overseas. Many of these efforts were still being developed at the time our field work was concluded.

We made several changes to the report on the basis of the State Department's comments. In addition, the State Department expressed concern about the cost and appropriateness of providing data from domestic passport applications to IRS since IRS' focus is on Americans living overseas. However, as we mentioned earlier, at least some persons who live overseas apply for passports while they are in the United States. Therefore, while we recognize the State Department's concern, we did not evaluate this issue in detail during the course of our audit work and do not take a position on it in the report. The full text of the State Department's comments appears in appendix V.

We are sending copies of this report to various congressional committees, the Secretary of the Treasury, the Commissioner of the Internal Revenue Service, the Director of the Office of Management and Budget, and other interested parties. Copies will be made available to others upon request.

The major contributors to this report are listed in appendix VI. If you have any questions, please contact me at (202) 272-7904.

Sincerely yours,



Natwar M. Gandhi
Associate Director, Tax Policy and
Administration Issues

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Abbreviations

AC	Assistant Commissioner
AICPA	American Institute of Certified Public Accountants
DMDDC	Defense Manpower Data Center
DOD	Department of Defense
IRP	Information Returns Program
IRS	Internal Revenue Service
RSR	revenue service representative
TCMP	Taxpayer Compliance Measurement Program

All Returns With Form 2555, 1983 and 1987

Table I.1: 1983 Returns With Form 2555

Dollars in thousands

Size of adjusted gross income	Number of returns	Total gross foreign earned income	Foreign earned income exclusion	Foreign housing exclusion
All returns	159,194	\$7,185,955	\$5,707,052	\$314,767
Under \$10,000	95,046	3,348,823	3,149,663	98,807
\$10,000 under \$25,000	31,013	1,245,644	1,058,736	49,103
\$25,000 under \$50,000	20,155	1,121,717	801,784	73,843
\$50,000 under \$100,000	9,234	836,775	459,480	55,799
\$100,000 under \$200,000	3,056	450,675	194,928	25,438
\$200,000 under \$500,000	631	149,739	37,961	11,276
\$500,000 under \$1,000,000	32	22,142	2,595	388 ^a
\$1,000,000 or more	27	10,440	1,905	113 ^a

Note 1: In 1983, qualifying taxpayers could exclude up to \$80,000 of their foreign earned income from U.S. income tax.

Note 2: Figures are estimates based on samples.

^aEstimate should be used with caution because of the small number of sample returns on which it is based.

Sources: "Foreign Income and Taxes Reported on U.S. Individual Tax Returns, 1983: An Overview," and "Individual Foreign Earned Income and Tax Credit, 1987," Statistics of Income, IRS.

**Appendix I
All Returns With Form 2555, 1983 and 1987**

Table I.2: 1987 Returns With Form 2555

Dollars in thousands

Size of adjusted gross income	Number of returns	Total gross foreign earned income	Foreign earned income exclusion	Foreign housing exclusion
All returns, total	171,191	\$8,190,229	\$5,982,454	\$467,896
Under \$10,000	92,656 ^a	3,026,702	2,910,722	55,197
\$10,000 under \$25,000	32,587	1,088,383	959,576	46,719
\$25,000 under \$50,000	20,644	1,181,219	853,073	74,595
\$50,000 under \$100,000	15,483	1,253,374	708,209	120,481
\$100,000 under \$200,000	6,766	902,082	366,947	105,446
\$200,000 under \$500,000	2,564	557,384	153,369	56,623
\$500,000 under \$1,000,000	367	126,054	22,883	6,954
\$1,000,000 or more	125	55,030	7,676	1,881

Note 1: In 1987, qualifying taxpayers could exclude up to \$70,000 of their foreign earned income from U.S. income tax.

Note 2: Figures are estimates based on samples.

^aIncludes returns with adjusted gross deficit.

Sources: "Foreign Income and Taxes Reported on U.S. Individual Tax Returns, 1983: An Overview," and "Individual Foreign Earned Income and Tax Credit, 1987," Statistics of Income, IRS.

1990 Forms 2555, by Location

Country or post of duty	Number of forms 2555 filed
Germany	23,643
United Kingdom ^a and Ireland	18,011
Canada	17,191
Japan	14,419
Italy and Eastern Mediterranean ^b	10,713
Miscellaneous countries	10,267
Saudi Arabia	9,790
France ^c	6,999
Indonesia, Malaysia, and Singapore	5,410
Hong Kong	4,917
Australia	4,260
Switzerland	4,177
Egypt and Gulf states ^d	4,024
Korea and Okinawa	3,955
Belgium	3,448
Taiwan	3,334
Western Caribbean ^e	3,310
Mexico	2,983
Spain, Portugal, Gibraltar, and Liberia	2,821
Belize, Costa Rica, and Honduras	2,790
Brazil	2,467
Philippines	2,324
Bangladesh, India, and Thailand	2,253
Kenya, Nigeria, Zaire, and Zimbabwe	2,237
Netherlands	2,204
Denmark, Norway, and Sweden	2,204
Argentina, Chile, Paraguay, Peru, and Uruguay	2,142
Eastern Caribbean ^f and Venezuela	2,056
Unidentified countries	1,628
Austria	1,152
Canal Zone, Panama	822
South Africa	807
New Zealand, Nauru, and Vanuatu	724
Cayman Islands and Turks and Caicos	430

(continued)

Appendix II
1990 Forms 2555, by Location

Country or post of duty	Number of forms 2555 filed
Army Post Office/Fleet Post Office	146
1040NR (Nonresident alien)	24
Forms 1040, 1040A, and 1040EZ without 2555	5
Total	180,087

*The United Kingdom consists of England, Wales, Scotland, and Northern Ireland. Also included in this post are Guernsey, Jersey, the Channel Islands, and the Isle of Man.

†Includes Vatican City, Cyprus, Greece, Israel, and Turkey.

‡Includes Liechtenstein, Luxembourg, and Monaco.

§Includes Bahrain, Kuwait, Oman, United Arab Emirates, and Qatar.

¶Includes Bahamas, Bermuda, Cocos Island, Dominican Republic, Haiti, Jamaica, and other West Indies.

‡Includes Antigua, Barbados, British Virgin Islands, Dominica, Guadeloupe, Montserrat, Netherlands Antilles, St. Kitts, St. Lucia, St. Vincent, and Trinidad and Tobago.

Source: District Office 98 filings with Form 2555, tax year 1990; AC (International).

Objectives, Scope, and Methodology

In accordance with Senator Bentsen's request, our objectives were to update our previous work on IRS' efforts concerning nonfiling by overseas taxpayers. Specifically, we were asked to

- review IRS activities regarding current tax filing rules applicable to overseas taxpayers, and
- report what actions IRS has taken since 1986 to improve the tax compliance rate of these taxpayers.

To address the current tax filing requirements, we consulted the Internal Revenue Code and reviewed the requirements contained in IRS publications. We surveyed literature on overseas taxpayers that provided experts' explanations of the requirements and advice to businesses on how to comply with the requirements. The literature we reviewed included both professional journal articles and publications of major accounting firms.

To address the various actions taken by IRS since 1986 to improve compliance, we reviewed the recommendations and observations of prior GAO and Committee reports. We interviewed officials from several major components of AC (International) in Washington, DC, to gain an understanding of their activities. These components are responsible for taxpayer service, collections, examinations, international programs, tax treaties, legal issues, criminal investigations, and various special projects. To address the implementation of specific recommendations, we interviewed officials from IRS' Philadelphia Service Center, which is responsible for processing all returns from citizens living overseas. We also interviewed individuals from the Statistics of Income Division, which produces economic, financial, and tax statistics; officials from the Office of the Assistant Commissioner (Collection), which is responsible for the TCMP nonfilers study; and officials from the Office of Associate Chief Counsel. We also interviewed officials of the Office of the Assistant Commissioner (Information Systems Management), which is responsible for IRS' interface with the DMDC database.

We documented IRS efforts to educate taxpayers on their filing requirements, reduce taxpayer burden, and improve enforcement. We obtained IRS studies designed to determine the extent of overseas nonfiling and assess the impact of possible enforcement actions. To document agency objectives related to improved compliance, we obtained IRS' strategic business plan and AC (International)'s annual business plan for fiscal year 1992.

Where possible, we obtained data on results of specific IRS programs and projects. However, because the impact of certain recent IRS initiatives will not be known for at least another filing season, evaluation of these efforts was not possible during the course of our review. These include educational efforts targeted to certain professional groups and countries, a simplified foreign earned income exclusion form, plans for improved forms delivery, and expanded matching of IRS records with those of a DOD database.

Although we addressed certain problems associated with current enforcement tools and their causes, we did not do a comprehensive evaluation of the costs and benefits of possible further enforcement tools.

To identify information on overseas Americans available from other sources and to develop information on specific initiatives, we interviewed officials from various agencies. To identify databases and information sources that could be potentially useful to IRS enforcement efforts, we interviewed officials of the State Department, Social Security Administration, the Department of Veterans Affairs, the U.S. Postal Service, and DOD's DMDC. To obtain information on activity by the State Department to collect Social Security numbers from passport applications and provide them to IRS, we interviewed State Department officials responsible for passport services.

To discuss issues related to a 1990 article and survey on the overseas nonfiling problem, we interviewed representatives of the AICPA. We also obtained the results of an AICPA survey of overseas tax practitioners that was undertaken with IRS.

Comments From the Internal Revenue Service



COMMISSIONER

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

FEB 22 1993

Mr. Johnny C. Finch
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

We appreciate the opportunity to review your draft report entitled "IRS Activities to Increase Compliance of Overseas Taxpayers."

Generally, we agree with the Report's findings concerning IRS efforts to increase compliance by overseas taxpayers. Our detailed comments on the Report are enclosed.

Best regards.

Sincerely,

A handwritten signature in cursive script, appearing to read "Michael P. Dolan".

Michael P. Dolan
Acting Commissioner

Enclosure

**Appendix IV
Comments From the Internal Revenue
Service**

**IRS COMMENTS ON FINDINGS CONTAINED
IN GAO DRAFT REPORT ENTITLED
"IRS ACTIVITIES TO INCREASE COMPLIANCE
OF OVERSEAS TAXPAYERS"**

The Report notes that in three IRS overseas enforcement studies, the IRS did not collect significant additional federal revenues. These studies, conducted by the Assistant Commissioner (International), involved only a very small number of overseas nonfilers and cannot be used to project noncompliance levels for overseas American taxpayers. However, overall, these early studies gave us insight into the types of issues and fact patterns that we need to look at to determine levels of noncompliance.

Our current approach, using the Compliance 2000 strategy, is to devote resources to:

- Educate, inform and assist the taxpayer population. Examples include our worldwide Taxpayer Service tax assistance, including our special project in Kuwait to educate taxpayers who are new to international issues. These efforts include working with tax practitioners to determine how to bring noncompliant taxpayers back into the system, revision of applicable publications, and extensive work with multi-national companies with emphasis on U.S. citizen tax responsibilities.
- Advocate simpler and more equitable tax rules as determined from listening to the general public and the tax practitioner community at our town meetings;
- Redesign and simplify forms and notices, like the new Form 2555EZ, concerning the foreign income exclusion, modify regulations, such as recommending changes to the regulations for Internal Revenue Code Section 911 (Citizens or Residents of the U.S. Living Abroad), and modify procedures for responding to noncompliant taxpayers;
- Make available Publication 953 (International Tax Information for Business) to the various embassies, consulates and IRS posts located abroad. This publication addresses issues of interest to international business filers and provides them with information concerning Foreign Controlled Corporations (FCCs), Controlled Foreign Corporations (CFCs), Foreign Sales Corporations (FSCs), Foreign Investment In Real Property Tax Act (FIRPTA), and Excise Taxes.;
- Work with our treaty partners to improve the administration of the tax laws: nine foreign countries now use standardized magnetic media to transmit return

**Appendix IV
Comments From the Internal Revenue
Service**

information which can be used in our information document matching program; and

- Correct unintentional noncompliance through efforts of our overseas Revenue Service Representatives to get nonfilers back into the system. These efforts include special "open house" compliance seminars, increased promotion of tax responsibilities, development and placement of new "tax awareness" posters, a special mailing to 2400 U.S. firms with U.S. citizen employees overseas, and the development and issuance of an informational flyer to be included in selected Embassy mailings.

The Service has had success with a Compliance 2000 prototype involving noncompliant taxpayers in Puerto Rico. We identified a market segment of noncompliant taxpayers who failed to pay self-employment taxes. This project has yielded 4,591 closed cases, with deficiencies and penalties assessed totalling over \$15 million, through January of 1993. In addition, we have received \$2.5 million in voluntary remittances with returns. We anticipate future success with other Compliance 2000 projects.

Page 15 of the draft, in discussing information received from our foreign treaty partners through the Routine Exchange of Information program, states that "...this information is intended to provide IRP-type data on U.S. persons overseas...." This statement is incorrect. The Routine Exchange of Information program is designed to provide information on U.S. persons receiving income from sources outside the United States whether they are residing in the United States or overseas.

Clarified on p. 9.

Comments From the Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



United States Department of State
Chief Financial Officer
Washington, D.C. 20520-7427

FEB 17 1993

Dear Mr. Finch:

Thank you for the opportunity to comment on your draft report, "TAX ADMINISTRATION: IRS Activities to Increase Compliance of Overseas Taxpayers" (GAO Job Code 268547). Comments are enclosed.

If you have any questions on this issue, please call James L. Ward, Acting, CA, on 647-9577.

Sincerely,

A handwritten signature in cursive script, appearing to read "Roger R. Gamble".

Roger R. Gamble, Acting

Enclosure:
As stated.

cc:
Mr. Oyola

Mr. Johnny C. Finch,
Assistant Comptroller General,
General Government Division,
U.S. General Accounting Office,
441 G Street, N.W.,
Washington, D. C. 20548

Appendix V
Comments From the Department of State



United States Department of State

Washington, D.C. 20520

MEMORANDUM

February 9, 1993

TO: GAO Liaison Officer - Eileen L. Gower
FROM: CA - James L. Ward, Acting
SUBJECT: GAO Draft Report on IRS Activities to Increase the
Compliance of Overseas Taxpayers, GAO Job Code 268547
REF: Memo from FMP - Roger R. Gamble, Acting dated
February 2, 1993

Per your request, written comments on the above subject report from CA/PPT and CA/OCS are attached.

Attachments:
As stated.

Appendix V
Comments From the Department of State



United States Department of State

Washington, D.C. 20520

February 9, 1993

MEMORANDUM

TO: CA - James L. Ward, Acting

FROM: CA/PPT - Wayne Griffith, Acting *WJ/GR*

SUBJECT: GAO Report on IRS Attempts to Increase Overseas Tax Compliance

REF: February 2 Memo from Gamble to Ward,
re: GAO Draft Report on IRS Activities to Increase the Compliance of Overseas Taxpayers, GAO Code 268547

My staff and I have read the subject GAO Report. We have the following comments concerning items listed in the report and a major issue which was addressed to GAO which did not appear in the report.

Items Appearing in the Report:

Page 12

Second sentence may lead the reader to believe that State sends passport applications to IRS. We recommend changing to read: "In one six month period, IRS received data on 2.2 million passport applicants, about 3 percent of which came from overseas posts."

Page 13

Although it is an OCS issue, PPT/PS agrees with OCS that the IRS should not be given the names and addresses of Amcits registered at overseas posts because the mission of OCS to encourage the registration of Amcits with posts could be adversely impacted if the Amcits were aware that data regarding their whereabouts would be reported to IRS. This human safety objective of OCS is paramount to the fiscal objectives of the IRS.

Now on page 7.

See comment 1.

Now on page 8.

See comment 2.

Now on page 9.

See comment 3.

Page 16

The first sentence indicates that the State Department does not verify social security numbers reported on passport applications. Although the sentence is factually correct, it may lead the reader to believe erroneously that State is negligent in not verifying the numbers. Rather, when accepting passport applications, our agents/employees and a printed statement on the application itself advise the applicant that a social security number is required for the IRS. In the executing an application, our agents may take a social security from a driver's license and write it on the application as evidence of identity provided by the applicant. They may even compare that number to the one provided by the applicant in the social security number field. However, it has never been our practice to verify the social security number provided by the applicant against a social security card or an SSN database. This has been and continues to be our general policy and practice. IRS knows this and agreed that the accuracy of the social security number provided by a passport applicant would be an issue between the applicant and the IRS.

We recommend that the sentence be changed to read:

"In addition, IRS receives records with missing and erroneous Social Security numbers because the State Department, in agreement with the IRS, does not verify the Social Security numbers reported on applications."

Issue Which Does Not Appear in Report

Although Passport Services captures and forwards data on millions of domestic and overseas passport applicants to IRS each year, IRS informs us that it is focusing its efforts on overseas applications only. In our discussion, we have been told by IRS that it wants the data on the more than three million domestic applicants anyway because it is useful in comparing mailing addresses with those stated on tax returns. The IRS is using that data only as secondary information when the address on a tax return is not factual.

See comment 4.

Appendix V
Comments From the Department of State

When it was suggested that the domestic data was not being used as had been originally intended by the Congress (to identify overseas non-filers), IRS stated that it wanted the data anyway.

PPT/PS has the following concerns about continuing to pass data on domestic applicants to IRS:

- The data is not being used as was intended by the Congress;
- IRS is maintaining this data as a secondary source of addresses of domestic taxpayers or potential domestic non-filers when the addresses on tax returns are erroneous or not current;
- There may be a privacy issue involved here as to whether or not PPT should continue forwarding data on passport applicants if IRS is going to use it only to build a database for comparing domestic addresses.
- There is a fiscal concern as to whether it is cost effective for IRS to continue to pay PPT to capture data on domestic applicants if it is not going to use the data to identify overseas non-filers. (PPT suggested that we suspend the capture and transfer of data on domestic applicants to save taxpayer dollars until IRS could make the overseas program work. IRS insisted that the data was 'good to have' and wanted to continue with the transfer as mandated by the law.)

Passport Services informed GAO of its concerns during the GAO review of the subject. Nevertheless, the issue did not appear in the report. We suggest that in its response, the Department may want to remind GAO of its concerns.

Appendix V
Comments From the Department of State

Drafted by: PPT/PS - Richard P. McClellan/akl
2/9/93 DOC# 2385G

Clearance: CA:MHarty^M
CA:JLWard, Acting



United States Department of State

Washington, D.C. 20520

February 9, 1993

UNCLASSIFIED
MEMORANDUM

TO: CA: Mr. James L. Ward
THRU: CA/OCS: Mr. David L. Hobbs *DLH*
FROM: CA/OCS/CCS: Carmen A. DiPlacido *CA*
SUBJECT: GAO Draft Report on IRS Activities
to Increase the Compliance of Overseas
Taxpayers, GAO Job Code 268547
REF: FMP's Memorandum of February 2, 1993

Attached for your review are our suggested changes to the GAO Report on IRS Activities to Increase the Compliance of Overseas Taxpayers. The attachment has been prepared in the format requested by FMP. The Wang document number is WWCCSAF 515.

Attachment:

Suggested changes

**Appendix V
Comments From the Department of State**

GAO Draft Report on IRS Activities to
Increase the Compliance of Overseas
Taxpayers, GAO Job Code 268547

Now on page 1.
See comment 1.

Page 2 8th line, insert after the word "Department"
the following: "and Social Security
Administration"

Now on page 6.
See comment 1.

Page 9 Penultimate line, insert after the word
"present" the following: "with the
assistance of the Department of State"

Now on page 7.
See comment 1.

Page 13 Insert at the end of the first paragraph
after sentence ending with the word
"population" the following: "One of the
problems in estimating the number of
Americans in a particular country is that
some are dual nationals and would not be
listed as a foreign nationals by the host
government and may not be known to the
American Embassy."

Now on page 8.
See comment 5.

Page 14 4th line, insert after the sentence ending
with the word "countries" the following:
"The State Department is extremely willing
and continues to assist IRS in education and
informing Americans about tax compliance."

The following are GAO's comments on the Department of State's letter dated February 17, 1993.

GAO Comments

1. Change made.
2. This is consistent with what the report says.
3. We revised the text to indicate that the State Department is not required to verify Social Security numbers.
4. We have addressed this comment in the report body.
5. The body of the report already discusses the State Department helping IRS with taxpayer education and tax compliance.

Major Contributors to This Report

**General Government
Division, Washington,
D.C.**

**Jose R. Oyola, Assistant Director
Lawrence M. Korb, Assignment Manager**

**Philadelphia Regional
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