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Report to the Chairman Committee on
Ways and Means, House of
Representatives

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TAX
ADMINISTRATION

Nonfiling Among U.S.
Citizens Abroad





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

General Government Division

B-276745

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The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review available data on the tax compliance of U.S. citizens residing in foreign countries, particularly whether they file required U.S. tax returns. The Committee was concerned that nonfiling among U.S. citizens residing abroad could result in lost tax revenue and undermine the expatriation provisions enacted in August 1996 in the Health Insurance Portability and Accountability Act (P.L. 104-191). The provisions increased the authority of the Internal Revenue Service (IRS) to tax former U.S. citizens who renounced their citizenship to avoid paying U.S. taxes.

As agreed with your office, our objectives for this report were to (1) determine whether it is possible, given available data, to estimate the prevalence and revenue impact of nonfiling among U.S. citizens residing abroad; (2) identify factors that may limit IRS' enforcement of the filing requirement or otherwise contribute to nonfiling abroad; (3) describe IRS' recent initiatives to improve the filing compliance in this population; and (4) contrast the Department of the Treasury's study on the income tax compliance of U.S. taxpayers residing abroad with our results in this study.

Background

U.S. citizens residing abroad are generally subject to the same filing requirements as citizens residing in the United States. In particular, section 6012 of the Internal Revenue Code (IRC) requires individuals to file tax returns if they meet certain gross income thresholds, regardless of whether or not they owe taxes. Individuals residing abroad must file tax returns even if they think their income is exempt from tax under the foreign earned income and housing expense exclusions. Without a return, IRS cannot verify a taxpayer's interpretation of the rules limiting eligibility for the exclusions.

Under IRC section 911, U.S. citizens or resident aliens may qualify to exclude up to \$70,000 per year of their foreign earned income through

1997,¹ and an additional amount based on their housing expenses if they meet certain foreign residency requirements. Nonfilers detected by IRS before filing voluntarily lose their eligibility for the exclusions in some circumstances. (See app. I for additional information on the exclusions and related rules affecting U.S. citizens residing abroad.)

IRS' Office of the Assistant Commissioner (International)—AC (International) is responsible for all international tax matters. To support its mission, AC (International) maintains about 13 full-time personnel at 9 foreign posts of duty. Additionally, some staff who are normally based in the United States are available for temporary tours of duty in foreign countries.

We have responded to two earlier congressional inquiries into nonfiling by U.S. citizens residing abroad. In a 1985 testimony, we noted that our analysis of filing among a limited sample of U.S. citizens in selected countries indicated a potential nonfiling problem.² As a result, Congress enacted IRC section 6039E: Information Concerning Resident Status in the Tax Reform Act of 1986. This section includes provisions requiring U.S. citizens applying for passports to provide their Social Security number (SSN), any foreign country of residence, and other information that might be prescribed by the Treasury Department. The intent of section 6039E was that IRS would use this information to identify nonfilers residing abroad.

In May 1993, we reported on IRS' relevant compliance initiatives, the lack of reliable data on U.S. citizens abroad, and IRS' limited use of passport application data as a compliance tool.³

Results in Brief

IRS has not estimated the overall prevalence of nonfiling abroad or the resulting loss of tax revenue, and the data we identified in our review were inadequate to support reliable quantified estimates. Data on the number of U.S. taxpayers residing abroad and the number of returns they file are of uncertain reliability, and the amount of taxes that nonfilers would owe if

¹The Taxpayer Relief Act of 1997 increased the limitation on the exclusion for foreign earned income from \$70,000 to \$80,000 in \$2,000 increments each year beginning in 1998, and provides that the limitation is indexed for inflation beginning in 2008.

²See U.S. Citizens Residing in Foreign Countries and Not Filing Federal Income Tax Returns testimony before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations (May 8, 1985).

³See IRS Activities to Increase Compliance of Overseas Taxpayers, a report to the Chairman of the Senate Finance Committee (GAO/GGD-93-93, May 18, 1993).

they were to file is unknown. One recent IRS initiative, however, focused on certain Mideast countries and identified enough nonfilers and additional tax revenue that IRS believes there may be benefits to looking for concentrations of nonfilers in other foreign countries.

We were able to identify several factors that may limit IRS' enforcement of the filing requirement or otherwise contribute to nonfiling abroad. Some of these factors are beyond IRS' control. First, the income of U.S. citizens residing abroad is generally not subject to U.S. tax withholding or information reporting if it is derived from foreign employers or foreign financial investments. IRS data show that tax withholding and information reporting by employers or other income providers resulted in much higher rates of tax compliance than when neither system is in place.⁴ Second, IRS generally cannot collect unpaid taxes from assets that have been transferred to a foreign country. The enforcement actions, such as liens, levies, and seizures, that IRS uses in the United States have no legal standing in most foreign countries.⁵

Some factors, however, are within IRS' control. First, although IRS obtains passport data from the State Department, it has made little use of these data; and in recent years, IRS has not attempted to penalize the large number of applicants who fail to furnish an SSN, as the law provides. Second, IRS has no systematic way of capturing a passport applicant's country of residence and occupation, which could provide demographic data on foreign concentrations of U.S. citizens and help IRS distinguish them from tourists. Third, the instructions for filing Form 1040 are potentially misleading and may cause some taxpayers residing abroad to erroneously conclude that they have no obligation to file.

IRS' recent initiatives concerning nonfiling abroad include a special project in the Middle East that was initiated as a result of events related to the Desert Storm War and a data-gathering effort to identify other potential concentrations of nonfilers residing abroad. IRS estimates that the Mideast effort contributed to a 51-percent increase in returns filed from the area and a total revenue increase of about \$76 million due to additional returns filed from Saudi Arabia from 1992 through 1995. In fiscal year 1997, IRS began to gather foreign census and other demographic information on U.S.

⁴See *Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap* (GAO/T-GGD-97-35, Jan. 9, 1997).

⁵The United States has mutual collection assistance agreements with Canada, France, Denmark, Sweden, and the Netherlands.

citizens residing abroad to identify other countries where similar compliance efforts may be beneficial.

In its May 4, 1998, report, Treasury suggested that the revenue impact of nonfiling abroad may be limited by the foreign earned income and housing expense exclusions and foreign tax credits. Treasury also cited IRS' ongoing demographic project as a means of identifying particular countries where additional compliance efforts may be warranted. The report did not recommend any additional IRS actions for improving tax compliance abroad beyond those that IRS is already planning. By contrast, our review found that certain additional IRS actions appear to be warranted.

Scope and Methodology

To explore the possibility of estimating the prevalence of nonfiling abroad, we obtained State Department and foreign government estimates of U.S. citizens abroad and IRS data on returns filed from abroad. We also obtained Social Security Administration data on the number of Social Security beneficiaries and Office of Personnel Management (OPM) data on the number of federal and military retirees residing abroad. We looked at data on the number of nonfilers abroad identified through IRS' information matching program. And, we attempted to use data IRS received from the State Department to assess the extent of filing among recent passport applicants who cited foreign addresses. The details of our scope and methodology for this objective are discussed in appendix II.

Estimating the revenue impact of nonfiling requires information on the average tax liability of nonfilers in addition to an estimate of prevalence. We identified little data bearing on the tax that nonfilers abroad would owe if they were to file. However, we did obtain the average tax owed by those who file from abroad and the taxes assessed in audits of nonfilers detected by IRS, but neither can be reliably projected to nonfilers abroad in general.

To identify the factors that may limit IRS' enforcement of the filing requirement or otherwise contribute to nonfiling abroad, we talked with responsible officials in AC (International) and the nonfiler program under AC (Collection) regarding relevant compliance information and programs and their limitations. We obtained IRS data summarizing the results of its information matching and audit programs for individual taxpayers abroad. We also reviewed relevant sections of the tax code and IRS regulations and obtained general information on the enforcement tools available to IRS

through U.S. tax treaties or administrative agreements with other nations.⁶

To describe IRS' recent initiatives to address nonfiling abroad, we talked to responsible officials in AC (International) and obtained documentation describing the initiatives they cited. We also talked to them about the status of initiatives under way when we issued our 1993 report.⁷

To contrast the Treasury study of noncompliance abroad with our study, we reviewed its report in light of the information we gathered in this review. We also contacted Treasury Department and IRS officials to clarify our understanding of the report.

We conducted our review from October 1997 through April 1998 in accordance with generally accepted government auditing standards. We requested comments from IRS, the Treasury Department, and the State Department and their oral comments are discussed at the end of this report.

Data Limitations Impede Reliable Estimation of Nonfiling Abroad

U.S. citizens, regardless of where they reside, are generally required to file income tax returns. Thus, U.S. citizens abroad who exceed certain annual income thresholds are generally required to file tax returns.⁸ Estimates of the numbers of citizens who are required to file and those who did not could possibly be made if there were reliable data on the total U.S. population residing abroad, related demographic characteristics, and the number of returns they filed. However, the data we obtained on the U.S. population residing abroad—from State Department and foreign government estimates—and the number of returns they filed are too uncertain to support such estimates.

We did obtain some information concerning nonfiling abroad from a recent IRS compliance project and IRS' information matching results. The information is not definitive, but it does indicate that there was a serious nonfiling problem in one region of the world (the Middle East) in the early 1990s and that nonfiling could be relatively prevalent abroad, compared

⁶In particular, we reviewed IRC section 911: Citizens or Residents of the United States Living Abroad, IRC section 6039E: Information Concerning Resident Status, and IRS regulation 1.911-7 on procedures for electing the foreign earned income and housing exclusions.

⁷GAO/GGD-93-93.

⁸For example, in 1997, the threshold amounts for individuals under age 65 were \$6,800 if single and \$12,200 if married and filing jointly.

with the general U.S. population, among higher income taxpayers who are covered by information reporting.

We also attempted to determine if the prevalence of nonfiling abroad could be estimated by using passport application data IRS receives from the State Department. These data were not useful, however, because many applicants did not provide an SSN on their passport applications, as required by IRC section 6039E. Generally, it is difficult for IRS to match taxpayer information against its database of filed tax returns without a valid SSN or other identification number.

Given the limitations of available data, the total revenue impact of nonfiling abroad cannot be reliably estimated. Estimating revenue impact would require reliable information concerning the number of U.S. citizens residing abroad, the number who would be required to file tax returns, the extent of nonfiling, and the amount of tax nonfilers would owe if they were to file. IRS' most recent estimate of the revenue lost to individual nonfilers residing in the United States—\$13.8 billion in 1992—illustrates the difficulty in deriving reliable estimates of the revenue losses attributable to nonfiling. According to an official in IRS' research division, (1) the estimate is limited to nonfilers residing in the United States and incorporates assumptions, necessitated by data limitations, about taxes owed by nonfilers who could not be identified or located; and (2) the statistical reliability of the estimate has not been quantified.

Limited Data on U.S. Population Abroad

The State Department estimated the total population of U.S. citizens residing abroad at about 3.1 million in 1995, excluding active military and current government personnel. This number was based on estimates derived by 221 U.S. embassies and consulates, does not include demographic breakdowns, and is not meant to be statistically reliable. The posts' estimates are intended only as rough population indicators to be used in evacuation planning.

Officials at the 18 U.S. embassies and consulates contacted during our review reported that they used various sources of information in deriving their estimates, such as data on the number of U.S. citizens renewing passports or voluntarily registering at the post or data obtained from the host country. Data limitations required the posts to use subjective judgment in deriving the estimates. For example, posts attempted to adjust their estimates to account for certain limitations in the registration data, e.g., eight posts estimated that the majority of U.S. citizens residing in their

jurisdictions were not registered. Also, some who do register may remain on file even after they leave the country.

Many foreign governments collect data on the nationality of their residents, sometimes by age group, including the number who are U.S. citizens. The foreign data are not comparable with the State Department data because of differences in how U.S. citizens are defined. For example, the estimates from many of the U.S. embassies and consulates we contacted included U.S. citizens who are dual nationals, particularly individuals who were born abroad but acquired U.S. citizenship by virtue of a parent's citizenship; while some of the foreign estimates we obtained did not count such individuals as U.S. citizens. The foreign estimates we obtained are also not comparable across countries; for example, some countries count their resident aliens based on country of birth and others based on citizenship. The latter approach would include some naturalized citizens not born in the United States.

Different countries obtain their estimates in different ways. For example, some countries rely on census counts of individuals intending to reside in the country for a certain time, while others use data on immigrants granted permanent residence status, and some countries exclude U.S. citizens in certain age categories.

Also, different estimates for the same country can vary widely, and it is not always clear who is being counted. For example, a 1991 Italian Census report noted 15,031 U.S. citizens residing in Italy while Eurostat counted 62,066 in 1993.⁹ Given the limited methodological descriptions in the reports we obtained and the translation difficulty, we could not determine exactly how the U.S. population was defined in these cases. Further, data from the Social Security Administration indicated that about 14,000 U.S. citizens resided in Italy and received U.S. Social Security benefits in 1996.

We did not contact foreign government officials about the reliability of their data on U.S. citizen populations because of resource constraints and because limitations in IRS' data on returns filed from abroad, discussed below, could limit the usefulness of country-specific data. Analysts in the U.S. Census Bureau's International Program Center told us that data from foreign censuses in developed countries are generally reliable. However, the Census officials were not specifically knowledgeable about foreign estimates of U.S. citizens residing abroad.

⁹Eurostat is a statistical organization that collects demographic statistics from the 15 countries in the European Union.

IRS classifies individual tax returns as being “international” if the return cites a foreign mailing address or includes a Form 2555 claiming the foreign earned income or housing expense exclusions. Returns reporting amounts in foreign denominations or attaching foreign earnings reports are also classified as international returns. However, these data are of uncertain reliability as an indicator of total returns filed by U.S. citizens residing abroad. IRS’ classification generally has not captured returns filed by individuals who lived abroad during the tax year but cited a domestic address on their return and did not claim the exclusions. IRS, too, has found that its computer system continued to classify some individuals as international filers even after the tax year when they returned to the United States.

The reliability of IRS’ data on returns filed from a particular country is further limited because IRS’ data do not track the filer’s country of residence in some cases.¹⁰ And IRS’ data on returns filed include, but do not distinguish from other returns, returns from permanent resident aliens of the United States who are living abroad.¹¹ These individuals are not U.S. citizens and therefore would not be included in the State Department or foreign government estimates of the U.S. population abroad.

Table 1 summarizes data available on U.S. citizens abroad and returns filed from abroad in tax year 1995 in total and for the seven countries in which State Department estimates indicated more than 100,000 U.S. citizens reside. The table illustrates the variations in available estimates of the U.S. population abroad and the lack of comparable data across countries. We note the number of tax returns filed from a particular country as “unknown” because a large percentage of the returns received from abroad are not differentiated by country in IRS’ database.

¹⁰About 43 percent of individual returns classified as being international in tax year 1995 were not classified by country in one IRS computer system (the Midwest Automated Compliance System) because they did not claim the foreign earned income or housing expense exclusion. About 33 percent of international returns for tax year 1993—the latest year for which data were available at the time of our review—were not classified by country in the other computer system used to track the number of international returns filed (the Compliance Research Information System) because they did not cite a foreign mailing address.

¹¹Permanent resident aliens are required to file U.S. tax returns on their worldwide income, generally using the same forms as U.S. citizens, regardless of where they reside. Nonresident aliens are required to file U.S. tax returns on their U.S. source income in some circumstances, via Forms 1040-NR. Forms 1040-NR are counted and tracked separately.

Table 1: Estimates of the Number of U.S. Citizens Abroad and the Number of Tax Returns Filed

Country	Estimates			Returns filed (for tax year 1995) ^b
	State Department (1995) ^a	Foreign government	Year of foreign data	
All	3,051,491	N/A	N/A	380,577
Canada	622,035 ^c	249,080	1991	^d
Germany	121,749	108,300	1994	^d
Israel	158,400	N/A	N/A	^d
Italy	147,000	62,066 ^e	1993	^d
Mexico	514,161	194,600	1990	^d
Philippines	123,000	19,529	1990	^d
United Kingdom	216,000	143,484	1991	^d

Note 1: U.S. active military and current government personnel are excluded from State Department estimates and from IRS data on returns filed. Their treatment could not be determined from available foreign data.

Note 2: N/A represents not available.

^aState Department estimates are limited to data from 221 of 247 U.S. posts abroad.

^bIRS data, excluding returns from nonresident aliens.

^cBased on 7 of 8 U.S. posts that reported data (excludes the Halifax area).

^dNumber of returns filed were unknown.

^eFrom data collected by Eurostat.

Sources: Department of State; foreign government estimates obtained from the U.S. Census Bureau International Programs Center and Eurostat; and IRS data on returns filed as obtained from the Midwest Automated Compliance System.

The above data, even if reliable, would not provide the number or proportion of actual nonfilers abroad because the number of individuals required to file is unknown. We explored whether the number of nonfilers abroad—those who are required to file but do not—might be roughly estimated by using the ratio of total individual returns filed to total U.S. population, about 0.45 in recent years,¹² as a benchmark. In particular, a ratio of returns filed from abroad to U.S. population abroad that is much smaller than 0.45 might indicate proportionately more nonfilers in the population abroad than in the general U.S. population. However, available data on the U.S. population abroad and the number of returns they file is too uncertain to allow a reliable comparison with the general population. Such an analysis would also require data on how characteristics related to

¹²This represents 118 million returns divided by an estimated U.S. population of 263 million in 1995. The ratio was also 0.45 for 1994 and 1996.

the filing requirement compare in the two populations, particularly the age and income distributions.

We identified two other sources of information that, while not definitive or indicative of the overall extent of the problem, imply that nonfiling may be a problem in certain segments of the U.S. population abroad.

- IRS estimates that its Mideast compliance project, described in more detail later in this report, was largely responsible for a 51-percent increase in returns filed by U.S. citizens residing in the region. IRS does not know whether those results reflect that nonfiling was more or less prevalent among U.S. citizens residing in Mideast countries compared with other areas of the world. The region's representativeness depends in part on how it compares with other parts of the world in terms of the number of U.S. citizens employed there by foreign corporations. Most of the nonfilers IRS identified in the Middle East worked for foreign companies, which do not participate in U.S. information reporting or tax withholding. In general, IRS has found much higher rates of noncompliance among individuals not covered by these systems.
- IRS data on nonfilers identified through its information matching program, which we did not verify, indicate that nonfiling among those who have relatively high incomes and are covered by information reporting may be more common among U.S. citizens abroad than in the U.S. population generally.¹³ IRS relies on an automated system to select the potential nonfiler cases identified in its information matching program that may warrant subsequent enforcement action. IRS' system identified 21,852 individuals classified as residing abroad who were potential nonfilers for tax year 1995 and had sufficient income reported on information returns or met other criteria that cause IRS to issue a delinquency notice. Using the same criteria, the system selected about 1.9 million individuals from the total U.S. population for the same year.

Compared with the number of returns that were filed—about 935,000 returns classified as filed from abroad in 1995 versus 118 million filed from the general population—the number of potential nonfilers abroad who were selected to receive notices was about 40-percent larger,

¹³IRS identifies potential nonfiler cases by computer matching taxpayers' returns with information returns IRS receives from employers and other income providers. Potential nonfilers are identified when the match shows income but no corresponding tax return.

proportionately, than the number identified in the general U.S. population.¹⁴

Missing SSNs Limit Usefulness of Passport Application Data

We obtained passport application data to determine if they could be matched against IRS' database of SSNs from filed tax returns to help estimate the number of U.S. citizens residing abroad who did not file tax returns. The data include an applicant's date of birth, which might be useful in identifying adults who are more likely than children to meet the filing requirement. However, many of the recent passport records IRS received from the State Department did not include SSNs and so could not be readily matched against IRS' database. As a result, we could not reliably estimate the number or proportion of passport applicants who did not file tax returns.

We analyzed 303,000 passport records that listed foreign mailing addresses and were processed by the State Department in the last half of 1995 and throughout 1996.¹⁵ About 133,000, or 44 percent of these records, did not contain SSNs and could not be readily matched.¹⁶

Of about 170,000 records that did contain SSNs, the proportion of individuals not filing returns, as either primary filers or secondary filers on a joint return, did not differ dramatically from the comparable proportion for the general U.S. population. In particular, for tax year 1994, 41 percent of the applicants did not file compared with 37 percent not filing from the general population. For tax year 1995, 35 percent of the applicants did not file compared with 36 percent in the general population. However, the large number of applications without SSNs preclude reliable estimation of the percentage of the total population of passport applicants residing abroad who did not file tax returns. (Detailed results related to the passport data analysis are provided in app. III.)

¹⁴That is, $21,852/935,348 = 0.023$, while $1,917,000/118,218,000 = 0.016$; and 0.023 is 44 percent greater than 0.016.

¹⁵According to State Department officials, passport applications citing a foreign mailing address are generally from applicants who are applying for passports at U.S. embassies and consulates in foreign countries and would include long-term residents abroad who are applying for passport renewals.

¹⁶The State Department reviewed the actual applications for a limited sample of 194 records without SSNs and found that 6, or about 3 percent, contained SSNs that were not transcribed when the State Department converted the data to magnetic media.

Revenue Impact of Nonfiling Abroad Cannot Be Estimated

The revenue impact of nonfiling abroad cannot be estimated, primarily because the prevalence of nonfiling and the income levels of the nonfilers are unknown. The impact could be relatively small or substantial, depending on the assumptions used in the analysis.

If it were assumed that the U.S. population abroad contains more children and low-income individuals than the general U.S. population, the potential number of nonfilers abroad and the resulting revenue impact may be small. Assuming that the foreign earned income and housing expense exclusions and foreign tax credit would generally eliminate much of a nonfiler's tax liability would also tend to minimize the revenue impact.

By contrast, assuming that the State Department's estimate of the U.S. population abroad is generally accurate and the population does not contain proportionately more children and low-income individuals could imply a potentially large number of nonfilers abroad. There could be a substantial revenue impact if these nonfilers have income characteristics similar to those who do file from abroad. In 1995, individuals filing from abroad, excluding military personnel and nonresident aliens, had an average income tax liability of about \$6,700 despite available exclusions and credits.

Assuming that IRS' tax assessments against nonfilers that are identified represent the amounts owed by those not identified would also suggest a relatively large potential revenue impact. IRS assessed an average tax of \$22,057 on 1,237 nonfilers residing abroad who were audited in fiscal years 1995 and 1996. It should be noted, however, that IRS generally focuses its enforcement efforts on nonfilers thought to have the highest incomes and largest unpaid tax liabilities. Further, IRS generally does not consider the effect of the foreign income exclusions or foreign tax credits in making the assessments. However, the foreign earned income and housing expense exclusions that could effectively lower overall tax liability are not necessarily extended to certain nonfilers.¹⁷

¹⁷Under IRS regulation 1.911-7, taxpayers cannot claim the exclusions unless (1) they file a Form 1040 and a Form 2555 electing to take the exclusions before IRS discovers that they have not filed these forms, and (2) they owe tax after the exclusions are considered.

Factors Limiting IRS' Enforcement of the Filing Requirement or Otherwise Contributing to Nonfiling Abroad

IRS' enforcement of the filing requirement abroad is impeded by the limited reach of U.S. law in foreign countries. In particular, IRS has no authority to require tax withholding or information reporting from foreign employers and little ability to enforce collection if a taxpayer's assets have been transferred abroad. IRS' enforcement abroad may be further hampered by its limited use of the information that is available, particularly the passport application records it receives from the State Department. Also, IRS' filing instructions for individuals may lead some U.S. citizens residing abroad to erroneously conclude that they do not need to file tax returns.

Limited Information Reporting and Tax Withholding on U.S. Citizens Abroad

Information reporting and tax withholding from employers and other income providers are the key tools available to IRS for identifying nonfilers and reducing the resulting lost revenue, but they have limited applicability to U.S. citizens residing abroad who are employed by foreign companies or derive investment income from foreign sources. IRS' tax-gap estimates indicate that those covered by information reporting and tax withholding pay a far greater share of their true tax liabilities than those who are not subject to them.¹⁸ U.S. citizens residing abroad have generally not been subject to tax withholding on income earned from foreign employers or foreign investments, and IRS receives little third-party information on such income. U.S. citizens working abroad for U.S. employers are covered by withholding and information reporting, and IRS uses this information in its matching program to identify some nonfilers abroad.¹⁹

In recent years, IRS has routinely received information on the foreign source income of U.S. citizens only from 19 of the countries with which the United States has information exchange agreements or tax treaties. Even in those countries, the information is limited to whatever is collected under a foreign country's own tax system. Most information received from foreign countries pertains to the investment income of individuals residing in the United States, while only 731 of about 302,000 foreign information documents processed for tax year 1993 pertained to the earned income of U.S. citizens employed abroad by foreign companies. IRS officials believe that foreign employers and financial institutions generally have not

¹⁸For example, IRS estimated that in tax year 1992, wage earners whose wages are subject to information reporting and tax withholding reported 99 percent of their wages to IRS, while self-employed informal suppliers, who are not covered by tax withholding and are unlikely to be covered by information reporting, reported only 19 percent of their business income.

¹⁹According to IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, U.S. employers of Americans abroad have the option of not withholding income taxes to the extent of the foreign earned income and housing expense exclusions if they have good reason to believe that an employee qualifies for the exclusions.

identified U.S. citizens who reside abroad or noted their citizenship on information returns.²⁰ Additionally, IRS has had difficulty processing and matching foreign information returns due to computer system limitations and because most foreign returns do not include the taxpayer's SSN or are received too late to be processed as part of IRS' information matching program.

IRS noted that it may receive some additional information on U.S. citizens abroad through Qualified Intermediary Agreements with foreign financial institutions beginning in tax year 2000. Qualified Intermediary Agreements, introduced by IRS regulations under IRC section 1441, generally relate to U.S. withholding by foreign financial institutions on U.S. source income paid to foreign persons; but, IRS expects the agreements will also require the foreign institutions to report certain information on U.S. citizens.

IRS Lacks Collection Authority Abroad

The mechanisms provided to IRS under U.S. law for collecting unpaid taxes, including liens, levies, and seizures, generally cannot be applied against assets that have been transferred to a foreign country. As a result, IRS generally cannot collect unpaid taxes from assets that have been transferred to a foreign country, except for the five countries that have entered into mutual collection assistance agreements as part of tax treaties with the United States—Canada, France, Denmark, Sweden, and the Netherlands. Mutual collection assistance agreements generally provide for each country to use measures available within its own legal system to collect taxes owed to its partner in the agreement. The agreement with Canada was ratified in 1995, and the others were ratified between 1939 and 1948. According to IRS documentation on the program's evolution, the 47-year hiatus between the last two agreements occurred because the Senate indicated in 1948 that it did not favor additional agreements of this type.

IRS' Limited Use of Passport Application Data

IRC section 6039E was enacted in 1986 to provide IRS with data from passport applications processed by the State Department for use in identifying individuals residing abroad who do not file tax returns. The law required passport applicants to provide their SSNs, foreign country of residence, and other information to be prescribed by Treasury, and established a penalty of \$500 for each failure to provide the required

²⁰Although IRS has received information on the foreign investments of U.S. citizens residing in the United States, IRS officials believe they have received little such information on U.S. citizens residing abroad. This is because an investor's presumed citizenship in foreign information reporting systems is likely to have been based on their mailing address.

information. However, IRS has made little use of passport application data in identifying potential nonfilers abroad, and some application records are difficult to use because they lack SSNs, as noted previously. Also, the State Department does not capture the country of residence of some passport applicants who reside abroad, and IRS has not prescribed occupation data among the items it requires from passport applicants. Passport applications contain no income information for directly identifying nonfilers, but they do contain age and occupation data, which could help IRS identify individuals who are likely to have gross incomes above the filing thresholds.

Passport data are included in IRS' matching program, but have rarely been used to identify potential nonfilers abroad. The criteria IRS used in recent years to select potential nonfilers to be contacted emphasized the total amount of income reported on information returns. One low-priority criterion applied to mismatches where IRS received passport or green-card records, but no corresponding tax return. However, only 21 of 21,852 potential nonfilers abroad selected to receive delinquency notices in 1995 were selected based on that criterion. And most of the passport records IRS received from the State Department cited U.S. rather than foreign mailing addresses.²¹ Applications that cite foreign mailing addresses are not flagged or analyzed separately in IRS' returns matching program. IRS officials said that in the future they plan to obtain passport data routinely only for those applicants who cite foreign mailing addresses. IRS expects that this will reduce the cost of obtaining the data and make it easier to use in identifying nonfilers abroad.

IRS has not attempted to penalize passport applicants in recent years for failure to provide their SSNs. As previously noted, IRS has difficulty matching records that do not contain SSNs. IRS officials believe the penalty program was dropped in 1993 because IRS had difficulty determining the SSNs of applicants who did not furnish one on the application. At that time, IRS generally did not send inquiries or penalty notices for missing SSNs unless the individual's SSN could be determined from another source. IRS officials said that it is administratively difficult to track penalty cases without taxpayers' SSNs, but there is currently no rule that requires them to obtain the applicant's SSN before inquiring about missing information. The officials said they are exploring ways of reinstating the penalty program, possibly by sending correspondence to the mailing address cited on the

²¹Only about 62,000, or less than 4 percent of the approximately 1.8 million passport records IRS received for the period of April through June 1996, contained a foreign mailing address, according to an IRS analysis of records received in that period. Similar results were obtained in an earlier IRS analysis of 1992 data.

application without attempting to determine the applicant's SSN from another source.

Passport application forms include a statement noting that an SSN must be provided if the applicant has received one, subject to a \$500 penalty. However, the State Department does not deny passports to applicants who do not provide an SSN, as it relies on other proofs of an applicant's citizenship. Whether it could do so is unclear. Denying a passport to a U.S. citizen for failure to provide an SSN could raise a constitutional issue, based on our review of relevant court cases. In particular, the Supreme Court held that the right to travel is a fundamental liberty and government restrictions on it must conform to the due process provisions of the 5th amendment.²²

IRS has not collected complete information on the country of residence and has not obtained occupation data on passport applicants residing abroad.²³ The data IRS has received has been limited to the applicant's name, mailing address, date of birth, and SSN if the applicant provided one. The applicant's country of residence is currently not required on passport applications. According to State Department and IRS officials, country of residence can be obtained in some cases from mailing addresses on passport applications, primarily when a U.S. citizen residing abroad applies for a passport renewal, or when U.S. citizens born abroad apply for passports, although applicants are not required to cite a foreign address even in these cases. Passport application forms do not contain a field for capturing the country of residence of those applying for a passport in this country and intending to live or work abroad.²⁴ Passport applications do contain a field for the applicant's occupation, but IRS has not obtained this information routinely or prescribed that applicants provide it.

According to State Department officials, the cost of capturing occupation data would include data transcription costs of about 6 cents per record and other costs to revise the computer programs used to store and retrieve the data. State Department officials also believe that the passport application form would need to be revised to capture the country of

²²Relevant Supreme Court cases are *Kent v. Dulles*, 357 U.S. 116 (1958) and *Zemel v. Rusk*, 381 U.S. 1 (1965).

²³IRS' Memorandum of Understanding with the State Department has allowed IRS to obtain hard copies of selected passport applications as requested on a case-by-case basis. The hard copies include the occupation field among other entries. Also IRS tabulated the country of residence of recent passport applicants citing foreign mailing addresses, as part of an analysis we requested.

²⁴The State Department generally will not mail passports to foreign addresses if the application is taken in this country.

residence and to provide additional instructions to the applicant. The officials said that they have not estimated the cost of modifying the relevant computer programs or revising the application form. IRS officials noted that certain IRS computer programs would also need to be modified to process the additional data, and, based on a preliminary estimate, this could require the equivalent of about 2 staff years at the GS-12/13 level and \$10,000 for related equipment and software upgrades.

IRS proposed regulations on section 6039E in 1993 that would have required applicants to provide their country of residence, address within the country of residence, occupation, and other information. The Office of Chief Counsel is working to finalize the regulations in 1998. An official in IRS' Office of Chief Counsel said that one reason the proposed regulations were not finalized earlier is that section 6039E already provides IRS with the authority to prescribe the information required from passport applicants without specifying the requirements in regulations.

In the 1960s and 1970s, U.S. citizens residing abroad and applying for passports or registering at U.S. consular posts abroad were asked to complete an IRS Form 3966: Identification of U.S. Citizen Residing Abroad. U.S. citizens were asked to voluntarily provide their foreign mailing address, occupation, date of last filed tax return, and other identifying information. When they learned that completing the form was voluntary, many citizens declined to do so. For this reason, and because some complained that the form constituted an invasion of their privacy, IRS discontinued the form in 1979.

Certain IRS Filing Instructions May Be Subject to Misinterpretation

IRS' instructions for Form 1040 and related guidance²⁵ may contribute to misinterpretation of the filing requirement among individuals who think they qualify for the foreign earned income or housing expense exclusions. The instructions state that only gross income that "is not exempt from tax" should be considered in determining whether the filing threshold is met. However, income qualifying for the foreign earned income or housing exclusions must be included in applying the threshold, as is clarified in Publication 54: Tax Guide for U.S. Citizens and Resident Aliens Abroad, even though the income is "exempt from tax" under section 911. IRS generally revises its instructions and publications annually to reflect statutory changes and to clarify potentially confusing language.

²⁵Including IRS' Publication 17: Tax Guide for Individuals.

IRS' Recent Initiatives to Address Nonfiling Abroad

IRS has initiated some actions in recent years to improve filing compliance abroad, but has not yet developed global information on the prevalence or impact of the problem or the countries where the problem may be particularly severe. In particular, IRS initiated a multiyear compliance project in 1991 aimed at U.S. citizens working in the Middle East. IRS believes that the project resulted in the recovery of a substantial amount of tax revenue, and is now attempting to gather foreign census and other demographic data that might reveal other concentrations of nonfilers abroad with tax liabilities. IRS officials cited several other recent or ongoing projects focused on compliance problems other than nonfiling among certain categories of U.S. citizens residing abroad, such as one on nonreporting of scholarship and grant income among those studying or teaching abroad and another on highly paid executives claiming tax deferrals on nonqualified foreign pension plans.

IRS estimates that the Mideast project was largely responsible for a 51-percent increase in the number of returns filed from the region—from 13,686 in 1991 to 20,647 in 1995. IRS also estimated that the increased returns filed from Saudi Arabia from 1992 through 1995 resulted in a total revenue increase of about \$76 million.²⁶ The project was initiated late in 1991 after IRS noticed that many civilians who returned to the United States during Operation Desert Storm filed tax returns for the first time in years. Also, IRS believed that the potential increase in tax revenue would justify the compliance resources expended because these countries had no income tax. U.S. taxpayers in these countries therefore could not reduce their tax liabilities by claiming foreign tax credits.

Revenue agents and other personnel from AC (International) traveled to the region to conduct informational seminars for U.S. individuals concerning their tax filing obligations and possible adverse consequences from not filing, such as losing eligibility for the foreign earned income and housing expense exclusions under Treasury Regulations section 1.911-7. The seminars were focused on companies employing a large number of U.S. citizens, which IRS identified through the financial news media and information obtained from the Department of State, the Department of Labor, and other sources.

One foreign employer of about 5,000 U.S. citizens agreed to provide IRS with information on its U.S. employees' income as requested on a case-by-case basis and also issued a letter to its U.S. employees outlining

²⁶The countries included were Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain, Qatar, and Egypt. IRS only estimated the revenue impact from Saudi Arabia, which accounted for most of the increase in returns filed.

their need to file and pay U.S. taxes. Also as part of this project, IRS mailed delinquency letters to all potential nonfilers in selected locations, including a warning that they could lose their right to claim the foreign earned income and housing exclusions if they did not file voluntarily. IRS generally sends such delinquency notices only to potential nonfilers meeting certain selection criteria based on the amount of income reported on information returns and other factors.

IRS did not know, at the time of our review, whether other geographical areas could offer compliance improvement opportunities, particularly for increased filing of required tax returns, similar to or greater than those discovered in its Mideast effort. Early in fiscal year 1997, IRS began a project to identify countries or regions where additional compliance projects similar to the Mideast project might be warranted. The project is attempting to obtain demographic data on the number, location, age stratification, and likely income levels of U.S. citizens residing abroad.

IRS' sources of information for the project include its own data on returns filed, population estimates from foreign governments, and data from the Social Security Administration and OPM on the number of Social Security beneficiaries and federal retirees residing abroad. IRS had obtained at least some foreign data from 10 countries as of December 1997, including some relatively detailed demographic information obtained directly from foreign governments. However, IRS had not obtained data from Canada, Mexico, the United Kingdom, Israel, Germany, Italy or the Phillipines—the countries where, in each case, more than 100,000 U.S. citizens resided in 1995, according to State Department estimates. IRS expects to obtain and analyze data for the countries accounting for about 80 percent of U.S. citizens abroad and to release a draft report on the results in the summer of 1998. IRS officials believe that the information will be complete and reliable enough to identify any countries where additional compliance efforts appear to be warranted.

Treasury's Report on Noncompliance Abroad

In the Health Insurance Portability and Accountability Act of 1996, Congress required Treasury to study and report on issues related to the income tax compliance of U.S. citizens and resident aliens residing abroad. In its report, Treasury discussed the current law regarding the taxation of U.S. citizens and permanent residents residing abroad and the difficulty of administering tax code provisions affecting expatriates—those who have relinquished their U.S. citizenship. The report included information on IRS' initiatives to improve compliance among U.S. taxpayers abroad and some

factors currently limiting these efforts. It also discussed the extent to which the Department of State and the Immigration and Naturalization Service collect information that could help IRS determine and improve compliance.

Treasury suggested that the revenue impact of nonfiling abroad may be limited by the foreign earned income and housing expense exclusions and foreign tax credits. While available exclusions and credits would tend to reduce the revenue impact of nonfiling abroad, we note that the impact would not necessarily be rendered insignificant. Some nonfilers lose eligibility for the exclusions, and the average tax liability of those who did file from abroad was about \$6,700 in 1995, despite available exclusions and credits. Also, the IRS studies that Treasury cited as evidence of limited impact involved a small number of taxpayers²⁷ and cannot be used to estimate the impact of nonfiling abroad because of serious data limitations, as noted in our 1993 report.²⁸

IRS' ongoing demographic study is highlighted as an initiative that will allow IRS to identify the countries where certain compliance improvement strategies may be warranted. We could not assess the effectiveness of this initiative because it was not complete at the time we performed our work.

The Treasury study cited several factors beyond IRS' control as inhibiting its efforts to improve compliance levels in the U.S. population abroad. These included limitations on information reported from foreign sources and IRS' authority to enforce collection in foreign countries, factors which are also noted in our report. Our report also cites IRS' limited use of passport data and potentially unclear filing instructions as factors related to nonfiling abroad that are within IRS' control. The Treasury report discussed the factors that it believes limit the usefulness of passport data, including limitations in the mailing address as a means of identifying and locating applicants residing abroad, and the large number of records received without SSNs. The report also suggests that attempting to penalize applicants who do not provide SSNs could entail more administrative cost than is warranted and notes that most applicants who do not provide SSNs appear to be under 20 years old.

²⁷The largest study involved a sample of 437 taxpayers suspected of being nonfilers. However, as noted in our 1993 report, IRS was unable to locate or contact 60 percent of the taxpayers in the sample. IRS officials further qualified the study because they were unable to travel abroad to do the necessary work.

²⁸GAO/GGD-93-93.

By contrast, we have recommended that IRS explore certain ways of obtaining better information from passport applicants and attempt to enforce the information requirements of section 6039E. We note that it is not necessary for IRS to obtain an applicant's SSN from another source—a high cost factor, according to IRS—because inquiries can be sent to the mailing address cited on the passport application. And the applicant's date of birth, included in the data IRS receives, might allow IRS to focus its efforts on adult applicants. Finally, while most of the applicants we analyzed who did not provide SSNs were under age 20, a significant percentage were adults. In particular, 24 percent were at least 30 years old. And, the age distribution of the applicants we analyzed is not a reliable indicator of the age distribution among all applicants residing abroad because IRS' information on applicants who reside abroad is incomplete, as noted above. Due to this limitation, our analysis excluded U.S. citizens who applied for their passports in the United States before moving abroad, but included passports issued to children who were born abroad to U.S. citizens.

The Treasury report did not recommend any additional IRS actions to improve tax compliance abroad, beyond IRS' ongoing demographic project and planned follow-up. Treasury noted that State Department data on U.S. citizens registered at U.S. consular posts may be of some usefulness to IRS, although the Privacy Act could restrict IRS from obtaining them. We have not recommended that IRS obtain registration data because State Department officials believe that many U.S. citizens residing abroad do not register, and those who do register may remain on file even after they have left the country.

The report also noted that modifying U.S. laws that define when U.S. citizenship is lost for tax purposes—so that the loss does not occur until the individual notifies the State Department—could close an existing loophole. The loophole might allow some individuals to avoid U.S. taxes by claiming a retroactive loss of U.S. citizenship.

Conclusions

The extent and impact of nonfiling abroad remain largely unknown, due to uncertainties in the data we identified on the U.S. population abroad and returns filed from abroad. However, some evidence suggests that nonfiling may be relatively prevalent in some segments of the U.S. population abroad. And the revenue impact, while unknown, could be significant even though it would be reduced by available exclusions and credits.

IRS' ability to identify and collect taxes from nonfilers residing abroad is restricted by the limited reach of U.S. law in foreign countries, particularly U.S. laws on tax withholding, information reporting, and IRS' authority to collect taxes through liens, levies, and seizures. However, IRS has not fully explored the usefulness of passport application data as a means of identifying potential nonfilers abroad and gauging the extent of the problem. Also, some of IRS' filing instructions may confuse some taxpayers and cause them to erroneously believe they are not required to file.

The usefulness of passport data in identifying nonfilers abroad has been limited because IRS has not (1) enforced the requirement for applicants to provide their SSNs and other information and (2) obtained data on the applicant's occupation or, in some cases, country of residence. While passport applications contain no income information, the occupation and age data could help identify individuals residing abroad who are more likely to have income above the filing thresholds, provided IRS could reliably distinguish applicants residing in foreign countries from those who are merely tourists. The cost of obtaining additional data elements on occupation and country of residence would be offset to some degree by savings from the reduced volume of data processed if IRS carries out its plan to restrict the data to applicants residing abroad and exclude tourists who now account for the bulk of the data IRS receives.

IRS had difficulty enforcing the requirement for applicants to provide SSNs and could find it difficult to enforce requirements for additional information on the applicant's occupation and country of residence. However, IRS said some of the difficulty in enforcing the SSN requirement, before abandoning such efforts, stemmed from its self-imposed constraint of not sending inquiries to applicants unless their SSN could be determined from other sources.

Another factor that could contribute to nonfiling abroad is the ambiguity in IRS' filing instructions for Forms 1040 and related guidance, such as Publication 17. The current language could be misinterpreted to mean that income qualifying for the foreign earned income or housing expense exclusions does not need to be considered in determining the filing requirement.

IRS has undertaken an initiative—the Mideast Project—to improve filing compliance among U.S. citizens residing in one region abroad and is now attempting to identify other geographical areas where such efforts may be beneficial. As of December 1997, IRS had obtained foreign data from 10

countries, but these did not include the 7 countries where the State Department estimated that the largest U.S. populations reside. IRS officials expect to obtain data on about 80 percent of the U.S. population abroad and release a draft report on their results in the summer of 1998. IRS has not analyzed passport application data to help identify countries where nonfiling among U.S. citizens may be particularly severe, and missing SSNs currently limit the usefulness of the data for this purpose. While our review was under way, IRS began efforts to make greater use of passport data from individuals residing abroad and is exploring ways of reinstating a program to penalize applicants who do not provide their SSNs.

In its May 4, 1998, report, Treasury suggested that the revenue impact of nonfiling abroad may be limited by the foreign earned income and housing expense exclusions and foreign tax credits. We note that, while the revenue impact is unknown, it is not necessarily rendered insignificant by available exclusions and credits. The report did not recommend any IRS actions for improving tax compliance abroad, but it noted that IRS' ongoing demographic project may identify countries where additional compliance efforts are warranted. The report also discussed several factors limiting the usefulness of passport application data.

Recommendations

To obtain better data on the filing compliance of the U.S. population residing abroad and to promote their understanding of their filing requirements, the Commissioner of Internal Revenue should ensure that IRS

- assesses the usefulness of country of residence and occupation data, in addition to data IRS currently receives from passport applicants, as a means of identifying potential nonfilers abroad and supplementing IRS' other sources of demographic data on U.S. citizens abroad. The assessment might include reviewing a limited random sample of currently available information.
- estimates the cost of obtaining the additional data routinely for passport applicants residing abroad, including those who apply in the United States. If the estimated costs appear to be justified, IRS should (1) prescribe that passport applicants provide the additional items and (2) routinely obtain and analyze the additional data elements.
- undertakes additional efforts to enforce the information requirements of IRC section 6039E, including the requirement for applicants to provide their SSNs. One potential effort would be to contact a random sample of adult

applicants who did not provide an SSN, using the mailing address provided on their passport application.

- revises the instructions for Form 1040 and related guidance, such as Publication 17, to clarify that income that qualifies for foreign earned income exclusions must be considered in determining whether one's gross income exceeds the filing threshold.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Commissioner of Internal Revenue, the Secretary of the Treasury, and the Secretary of State, or their designated representatives. In an April 1, 1998, meeting, responsible Treasury and IRS officials, including IRS' Deputy Assistant Commissioner (International), provided oral comments and suggested clarifications, which we have incorporated where appropriate. IRS indicated that it generally agreed with the draft report and two of its four recommendations—on estimating the cost of obtaining additional types of passport data and revising relevant filing instructions—but questioned the cost efficiency of implementing two of the recommendations. IRS interpreted our recommendation on assessing the usefulness of certain additional passport application data as implying that it pay for and routinely obtain the additional data before knowing if the associated costs are justified. We revised the recommendation to reflect that the assessment could be based on a sample of data currently available to IRS.

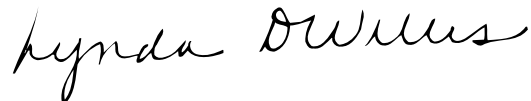
IRS also interpreted our recommendation on attempting to enforce the information requirements of IRC section 6039E as implying that it launch a full-scale enforcement program without first testing the program's cost and feasibility. We revised the recommendation to specify that the effort could be limited to a random sample of applicants who did not provide SSNs. We believe that such a test would constitute additional effort to enforce the requirements as suggested in our recommendation, provided that IRS evaluates the test and continues or modifies the approach as the results warrant.

The State Department provided written comments dated April 6, 1998, that suggested clarifications and additional information, which we have incorporated in this report where appropriate. In particular, the State Department noted that providing the additional passport information suggested in our report would not prove burdensome, but the Department would be concerned if IRS sought to require passport applicants to answer extensive questions on their income and its sources. The State Department also commented that the draft seemed to imply that a statutory provision

denying a passport to an applicant who failed to provide an SSN would be successfully challenged on constitutional grounds. Our intent was only to note that such a policy would raise a significant constitutional issue, and we modified the wording in this report to avoid any unintended implication as to how a legal challenge would be decided.

As agreed with your staff, unless you announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Ranking Minority Member of the House Ways and Means Committee; the Chairman and Ranking Minority Member of the Subcommittee on Oversight, Committee on Ways and Means; various other congressional committees; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. We also will make copies available to others upon request.

Please contact me at (202) 512-9110 if you or your staff have any questions. The major contributors to this report are listed in appendix IV.



Lynda D. Willis
Director, Tax Policy
and Administration Issues

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Abbreviations

AC	Assistant Commissioner
IRC	Internal Revenue Code
IRS	Internal Revenue Service
OPM	Office of Personnel Management
SSN	Social Security number

Major Tax Code Provisions for Individuals Residing Abroad

In general, the foreign earned income exclusion allows taxpayers meeting specific foreign residency requirements to exclude up to \$70,000 of their earned income, as of tax year 1997.¹ The excludable amount is to be increased incrementally to \$80,000 by 2002 per modifications to Internal Revenue Code (IRC) section 911 enacted in 1997.

Excludable income is generally limited to amounts earned for services performed abroad, including salaries and wages (except wages from the U.S. government), and does not include income derived from capital, such as interest, dividends, capital gains, or pension and IRA distributions. The foreign housing exclusion generally allows taxpayers meeting the residency requirements to exclude a portion of their housing expenses if they are employed abroad.² Income qualifying for the foreign earned income exclusion is reduced by the amount of the housing exclusion.³

The foreign income tax credit is available to taxpayers who owe taxes to foreign governments on their foreign source income. To claim the credit, taxpayers must file a Form 1116, which provides for separate calculation of the credit amount for each of eight different income categories.

Also, P.L. 104-191, enacted in August 1996, included modifications to the tax treatment of expatriates and a requirement for the Treasury Department to report within 90 days on the income tax compliance of U.S. taxpayers residing abroad. The legislative history indicates that the Treasury report was mandated because of past difficulties in determining when a U.S. citizen had committed an expatriating act with a tax avoidance purpose and thus must continue to pay U.S. taxes on their worldwide income.⁴

¹Foreign residency in this context requires meeting either a bona fide residency test, based on the intent and nature of one's stay in a foreign country for an entire tax year, or a physical presence test, requiring the taxpayer to be in a foreign country or countries for at least 330 days of any consecutive 12-month period. Questions of bona fide residency are determined by IRS on a case-by-case basis. To qualify for the exclusions, U.S. citizens abroad must also establish that their "tax home," generally defined as the location of one's place of business or employment or where one regularly lives, is located in a foreign country throughout the period of bona fide residency or physical presence.

²The excludable amount is based on total housing expenses less an amount equal to 16 percent of the salary of a GS-14, step 1 government employee (\$9,426 in tax year 1997). A foreign housing deduction is available to those meeting the residency requirements who have self-employment income abroad.

³In effect, this provision reduces the total exclusion for earned income and housing expenses unless the taxpayer's earned income exceeds the total of \$70,000 plus the excludable housing amount.

⁴The expatriation provisions included new criteria, based on an individual's income and net worth, for determining when expatriation occurs for tax avoidance purposes. Those meeting the tax avoidance criteria are liable for U.S. taxes on their worldwide income for 10 years after they expatriate.

Description of Methodology

We obtained data on U.S. taxpayers residing abroad from the State Department and from foreign census or immigration reports collected by the U.N. Demographic Statistics Section; the International Programs Center Library of the U.S. Census Bureau; and Eurostat, a statistical organization of the European Union. We contacted officials at 21 U.S. consulates and embassies—those reporting more than 40,000 U.S. citizens in their jurisdictions—regarding the information used in developing the State Department's estimates, and received written responses from 18 of the 21. We discussed the reliability of foreign government data with IRS and U.S. Census Bureau officials and cross-checked some of the data against estimates collected by Eurostat and against U.S. data on the number of Social Security beneficiaries and federal retirees residing in a given foreign country. We found that the reliability of both the State Department and foreign government estimates is uncertain, as discussed in our findings.

We obtained IRS data on returns filed from abroad for tax year 1995. IRS classifies returns as international if filers cite a foreign mailing address, attach a Form 2555 claiming the foreign earned income or housing exclusions, or provide other indications of a foreign residence, such as by reporting their income in foreign currencies. We discussed the data's reliability with IRS officials and found that its reliability is uncertain, for the reasons noted in our letter.

We also analyzed data on the number of potential nonfilers identified abroad through IRS' Information Matching Program in 1995 relative to the number of returns that IRS classified as being filed from abroad in 1995. We compared that proportion with the same proportion calculated for the general U.S. population in 1995. This approach was limited by the uncertainty of IRS' data on returns filed from abroad and the lack of quantified IRS data on the number of potential nonfilers who were nonresident aliens. We included returns from nonresident aliens in the number of returns filed from abroad for 1995, even though IRS officials believe that nonresident aliens account for relatively few potential nonfiler cases identified through information matching. Excluding nonresident aliens in the returns filed data would have made the proportion for nonfilers abroad appear even larger relative to the proportion of nonfilers in the general U.S. population.

We also attempted to assess the prevalence of nonfiling abroad by matching selected passport application records against IRS' database of SSNs from filed tax returns. In particular, we asked IRS to extract foreign addressed passport records from all passport data it had retained on

Appendix II
Description of Methodology

magnetic media—which included applications processed by the State Department and forwarded to IRS in the last half of 1995 and in 1996. We asked IRS to match the SSNs in these passport records against its database of SSNs from returns filed in tax years 1994 to 1996 to determine the proportion of applicants not filing tax returns each year, by age category. However, 44 percent of the application records did not include SSNs, and so they could not be readily matched. This rendered the results inconclusive, as noted in our findings, because the nonfiling rate found in the cases with SSNs cannot be projected to the missing SSN cases. Also, the match against tax year 1996 returns did not provide useful data because it did not include some unknown number of returns filed late under a 4-month filing extension available to U.S. individuals residing abroad.

Detailed Data Tables

This appendix presents the detailed data related to our analysis of the passport application data IRS receives from the State Department. Table III.1 shows the percent of individuals not filing income tax returns among the passport applicants we analyzed who provided SSNs, compared with the percent not filing from the general U.S. population. Those not filing are not necessarily required to file—that is, those with gross income below the filing thresholds and, in some circumstances, children whose income exceeds the thresholds but is reported on their parents' returns are not required to file. Table III.2 shows the age stratification of the general U.S. population compared with passport applicants with and without SSNs, as of 1995.

Table III.1: Percent of Individuals Not Filing as Primary Filers or Secondary Filers on a Joint Return—Passport Applicants Who Provided SSNs v. General U.S. Population

Tax year	Age range	Taxpayer category	Number in population ^a	Number not filing ^a	Percent not filing
1994	All ages	Passport applicants	170	69	41
		General U.S. population	260,372	96,077	37
	30 to 59	Passport applicants	82	22	27
		General U.S. population	104,669	N/A	N/A
1995	All ages	Passport applicants	170	59	35
		General U.S. population	262,890	95,692	36
	30 to 59	Passport applicants	83	16	19
		General U.S. population	106,634	N/A	N/A

Note: N/A represents not available.

^aNumbers in thousands.

Source: GAO analysis of IRS data and the general population estimates from the U.S. Bureau of the Census, Population Division, release PPL-57.

**Appendix III
Detailed Data Tables**

Table III.2: Age Distribution of Passport Applicants Compared With General U.S. Population

Age ^a	Applicants not providing SSNs		Applicants providing SSNs		Total U.S. population ^b	
	Number	Percent	Number	Percent	Number ^c	Percent
Unknown	14	0.0	28	0.0	0	0.0
0 to 9	54,005	40.6	19,416	11.4	38,727	14.6
10 to 19	33,466	25.2	23,717	14.0	37,643	14.1
20 to 29	13,067	9.8	16,114	9.5	36,567	13.8
30 to 39	10,678	8.0	30,584	18.0	43,938	16.6
40 to 49	7,242	5.5	31,226	18.4	39,252	14.8
50 to 59	5,218	3.9	22,100	13.0	25,296	9.5
60 to 69	4,357	3.3	14,794	8.7	19,891	7.5
70 to 79	3,507	2.6	8,970	5.3	15,651	5.9
80 to 89	1,199	0.9	2,726	1.6	6,951	2.6
90 to 99	128	0.1	344	0.2	1,310	0.5
100 or more	0	0	0	0	57	0
Total^d	132,881	100	170,018	100	265,284	100

^aAge of passport applicants as of the end of 1996.

^bEstimated U.S. population distribution in 1996.

^cNumber in thousands.

^dPercentages do not add due to rounding

Source: GAO analysis of data from IRS (passport records processed in the last half of 1995 and in 1996) and the U.S. Census Bureau.

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