The Impact of the Follow-up Process on the 2002 Foreign Tax Credit Study Data

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Introduction

The follow-up process is an important step in the data cleansing process of the foreign tax credit study conducted by the Statistics of Income Division of the IRS. The study itself collects data from corporate tax forms and their attached Form 1118's. Analysts review the data, correct anomalies, and disseminate the results. In certain cases, the analysts request additional information beyond what was originally reported by the taxpayer. This paper focuses on the 290 returns selected for additional data requests and the impact of the data received as a result on the study as a whole.

Overview of the Foreign Tax Credit

The need for a foreign tax credit became apparent with the advent of the modern U.S. income tax in 1913. Since this date, U.S. taxpayers have been subject to taxation on their worldwide income. U.S. corporations with international operations or investments may also be taxed on their foreign-source income in the country in which the income is earned. The result is double taxation. To correct this problem, the United States passed into law foreign tax credit provisions, beginning with the Revenue Act of 1918. This credit allows U.S. corporations to offset the U.S. tax on their foreign-source taxable income with a credit for the foreign taxes that were already paid.

In the close to 90 years that the foreign tax credit has been in existence, the rules and ways in which this credit is reported have undergone many transformations. Perhaps the change that most affected the way that the credit is calculated today occurred with the passage of the Revenue Act of 1962. It required corporations to compute a separate limitation for non-business related interest income. This step prevented corporations from combining foreign-source income from business operations taxed at rates higher than the U.S. rate with interest-bearing investments abroad that was subject to little or no foreign tax.

For tax year 2002, taxpayers were required to compute a separate foreign tax credit limitation for each of 11 different income categories. The taxpayer is required to report their gross income, various deductions, taxable income, and foreign taxes paid or accrued by country in each appropriate income category. Within each category, taxpayers separate their income, deductions and taxes by type.

The foreign tax credit remains the largest credit that U.S. corporations claim to reduce their U.S. income tax. For tax year 2002, 9,383 corporations claimed a total credit of $42.4 billion. Corporations report the foreign income and taxes related to the credit on Form 1118, Computation of Foreign Tax Credit-Corporations, filed with their income tax returns. Gross income, deductions, and taxable income attributed to various countries are reported on Schedule A, while foreign taxes paid or accrued and the foreign tax credit calculation are reported on Schedule B. Schedules C through Schedule J support items on Schedules A and B.

The statistics in this article are based on information reported on Forms 1118 and related corporate returns filed with accounting periods ending between June 30, 2001 and July 3, 2002. The returns in our study were selected after administrative processing but prior to any amendments or audit examination. The estimates are based on a stratified probability sample of 4,157 returns selected from a population of corporations filing a Form 1118, so they are subject to sampling error. Each return in the sample is given a distinct weight, calculated by dividing the number of returns in a certain section of the study (industry, accounting period, etc.) by the number of sample returns for the same section. The purpose of these weights is to adjust for the various sampling rates used, relative to the population. For the purposes of this paper, weighted totals are used for all counts and numerical values.

The Follow-up Process

During entry of the Form 1118 data, the system performs close to three hundred consistency tests. The data entry personnel resolve some of these tests and some are shipped to SOI headquarters for further review. If the analysts can't resolve the remaining errors, and the taxpayer reports a foreign tax credit, a letter may be sent to the taxpayer asking for additional information. (Many corporations with an overall loss file a Form 1118 in order to compute the carryover of taxes available for use in subsequent tax years. Since the form is not required in these cases, we do not typically ask for additional information for these returns.) We ask that the taxpayer respond within sixty days of the original letter, but usually grant requests for extensions. If we did not receive a response before the deadline, we phoned the taxpayer. The responses received are used for statistical and analytical purposes only and are not part of tax enforcement or administration.

The most common error that will trigger a letter is missing country detail. We also frequently send letters to those missing Schedule H or Schedule F. Other data requested includes explanations for discrepancies between the various schedules on Form 1118 and discrepancies between Form 1120, Corporation Income Tax Return and Form 1118. On the Form 1118, the most common discrepancies are between

- Total not definitely allocable deductions on Schedule A and Schedule H, for the same income type
- Schedule A, total gross income and Schedule F, branch income, for the same country
- Schedule A, definitely allocable deductions and Schedule F, deductions
- Schedule A, total income or loss before adjustments and Schedule B, taxable income
- Total income or loss before adjustments on Schedule A and Schedule J, for the same income type

Between the Form 1118 and the Form 1120, the most common differences are between:

- total taxable income
- total U.S. income tax against which credit is allowed
- total foreign tax credit
- deemed dividends (subpart F dividends)
- other foreign dividends
- dividend gross-up

By far the most common discrepancy between these two forms is a discrepancy in the dividends and/or dividend gross-up reported on Schedule C of the Form 1120 and the sum of the dividends and gross-up reported on Schedule A of the Form 1118. This is partly because Schedule C tends to be poorly filed and partly because there are some legitimate reasons for differences in the dividend amounts reported on these forms. In general, we do not ask taxpayers to account for the dividend discrepancies unless we are already requesting other information.

The table below lists the number of requests sent by type. (Since we often requested more than one type of information from one company, the total number of requests exceeds the number of returns in the follow-up process.)

Number of Requests Sent, by Type

Reason for Follow-up	Number of Requests
Missing country detail	178
Discrepancies between Form 1120and Form 1118	84
Schedule F missing	52
Schedule H missing	32
Missing amounts from Sch. H	28
Discrepancy between Sch. A & Sch. F	8
Taxable income discrepancy (Sch. A & J or B & J)	7
Missing Form 1118	7
Other	12

This paper focuses on those returns missing country detail for foreign source income and/or foreign taxes paid, those missing Schedule F, and those missing Schedule H, because these problems were most likely to be the primary reason for requesting additional information.

Follow-Up Response

The foreign tax credit study for tax year 2002 included data from 4,157 corporate tax returns, representing a population of 9,383. A weighted total of 290 returns were selected for additional data requests. At the end of the study, we had received a response from 206 of these requests, a response rate of 71%. Of those that responded, a majority, (166 or 81%) provided a fully satisfactory answer to our inquiries and supplied the missing data that they had failed to provide in their original filed tax return. A smaller group of responses, 31 out of 206 (15%), supplied us with at least some information that they had previously withheld. It should be noted that in many of the cases where we were requesting country detail for either income or taxes paid, the taxpayer was unable to provide this information due to software or time constraints. We chose to rate only 9 out of 206 responses (4.4%) as completely unsatisfactory. The remainder of our requests, 84 out of 290 (29%), did not respond in any form.

The follow-up letters sent out for the tax year 2002 study represent companies from a wide range of industries. Using NAICS (North American Industry Classification System) to sort these corporations, we discovered that the most well represented industry in our study was manufacturing, accounting for 121 out of the 290 (41.7%) additional data requests. Although manufacturing returns overall accounted for just 18% of the total number of returns, they comprised 50% of the total foreign source gross income, so the rate of follow-up is perhaps slightly lower than expected. The next most populous group was the finance/insurance industry, with 48 out of 290 (16.6%). This is as expected, as this industry accounts for about 11 percent of all returns and more importantly, 16 percent of total foreign source gross income. The third most populous group was the information industry, with 34 out of the 290 (11.7%) total, compared to 6% of the total number of returns and almost 10% of the total foreign source gross income. Although more additional data requests were sent to certain industries than others, we did not find a substantially better or worse response rate when comparing these industries at the end of our study.

Missing Schedule F

One of the Form 1118 supporting schedules that tends to be missing or poorly filed is Schedule F, Gross Income and Definitely Allocable Deductions for Foreign Branches. Amounts from this schedule are included in the total gross income and definitely allocable deductions on Schedule A, but are not directly carried forward. The only indication we have that a Schedule F may be missing is if branch taxes were reported on Schedule B, Part I, but no Schedule F was filed and therefore the branch income and branch deductions associated with those taxes are unknown. Sometimes we can impute a Schedule F using the Schedule A and prior year data. In other cases, we must write to the taxpayers. Since 261 taxpayers had this condition, we generally limited our requests to those returns that reported over $1,000,000 of branch taxes or whose branch taxes equaled 25% of the total foreign taxes paid or accrued. Of course, if we were sending a letter to a taxpayer due to some other problem, we included a request for the missing Schedule F even if the return did not meet either criterion.

We requested a Schedule F from 52 corporations who had reported branch taxes but who had not included a completed Schedule F with their Form 1118. These taxes totaled to about one billion dollars, approximately 20% of the total foreign branch taxes reported by all corporations. Of these corporations, 32 or 62%, sent in Schedule F data. The total foreign branch gross income reported in response to our letter for these returns was about $12 billion, 15% of the total for all returns. These taxpayers also supplied almost $7 billion in previously unreported foreign branch definitely allocable deductions, about 17% of the total for all returns. By the conclusion of the study, taxpayers had sent in Schedule F's to support a total of $751 million in branch taxes paid, or about 69% of all the unsupported branch taxes from the returns who received letters. Unsupported taxes from all returns then, declined from 22% of all foreign branch taxes, to 6%, due to the follow-up process.

When we examine the ratio of supported taxes, post follow-up, to the original unsupported tax amounts for those returns selected for follow-up, by industry, we see most of the major industry groups supplied Schedule F's to support more than 70% of the originally unsupported branch taxes. The one exception is the wholesale and retail trade industry group, which provided support for only 29% of the taxes missing support from Schedule F.

Follow-Up Returns Missing Schedule F (in millions of dollars)

Industry	Unsupported Branch Taxes Paid	Taxes supported by Schedule F after Follow-ups	Percent (col. 2/ col. 1)
Manufacturing	$634	$453	72%
Wholesale/ retail trade	13	4	29
Information	30	28	93
Finance/ Insurance	97	80	82
Services	230	185	80
Total	**$1,003**	**$749**	**75%**

Schedule H

Another of the supporting schedules included within Form 1118 is the Schedule H, Apportionment of Deductions Not Definitely Allocable. This schedule is used to apportion deductions that cannot be definitely allocated to a certain item or class of income. Schedule H is filed only once with each Form 1118 and has two distinct parts. Part I is comprised of research and development deductions while Part II is a combination of interest deductions and other miscellaneous deductions that do not fit into a specific category. These two parts are then added together to arrive at a total not definitely allocable deduction figure for the schedule. This total figure is also reported on Schedule A, along with the company's definitely allocable deductions.

Every corporation filing a Form 1118 that reports not definitely allocable deductions is required to complete a Schedule H that documents these deductions. We contact taxpayers whose Schedule H is missing and whose not definitely allocable deduction amount exceeds $10 million.

In tax year 2002, taxpayers failed to report a Schedule H to support a total of $6.8 billion in not definitely allocable deductions. This was approximately 7% of the $100.4 billion in total not allocable deductions from all returns. We wrote follow-up letters to 32 companies with a request to provide a completed Schedule H. These corporations represented a total of $4.8 billion in not definitely allocable deductions on Schedule A that were not supported by a Schedule H. This figure accounted for roughly 71% of the not definitely allocable deductions not supported by a Schedule H in our study prior to follow-up. As a result of this process, we received responses from 18 (56%) of the companies. They provided supporting Schedule H's that accounted for $3.18 billion of the $4.8 billion (66%) total represented by the 32 companies. Thus, the follow-up process decreased the amount of apportioned deductions not supported by a Schedule H from 7% to 3.6% of the total apportioned deductions.

Unallocated Income

From a data analysis standpoint, it is desirable for the taxpayer to assign as much of their foreign income, deductions and taxes paid total to a specific foreign country as possible. However, they do have the option of categorizing either all or part of their income, deductions or foreign taxes paid or accrued to other or various countries. One of our main goals in sending follow-up letters is to obtain specific country detail for any large amounts assigned to various countries.

As with the missing schedules, we established criteria for requesting additional country detail when the taxpayer failed to allocate a significant amount of foreign source gross income to the country or region of source. Generally, we send a letter to those corporations with $25 million or more of unallocated gross foreign source income or $10 million of unallocated foreign source taxable income. Although we will ask for country detail for the definitely allocable deductions if the return meets the income test and some or all of the deductions have not been sourced, country detail here is not considered essential to the study. (Many taxpayers prorate their deductions to countries based on each country's share of foreign gross income and therefore, our system prorates any amounts remaining in "other countries" at the end of the study accordingly.)

We sent follow-up letters to a total of 160 companies. The unallocated foreign source gross income for these returns was approximately $79 billion; about 89 % of the total unallocated income ($88.8 billion) and 20% of the total foreign source gross income ($390 billion). Other income accounted for 42% of the unallocated amount while the next largest category, gross rents, royalties and license fees, comprised 23%. Some of these returns had not allocated any of their income, but many had already allocated a considerable portion before we requested additional country detail. Overall, the unallocated amount for these returns was 50 % of their total foreign source gross income.

Of these 160 companies, 88 sent in a satisfactory response, 19 sent in a partial response, five included an unsatisfactory response and the remaining 48 never responded.

A Comparison of Total, Unallocated and Allocated Income, by Type (in billions of dollars)

	Total FS Gross Income from all Returns	Unallocated Income from Follow-up Returns	Allocated Income from Follow-up Returns
Dividends	$95.4	$6.6	$5.5
Interest	55.2	12.4	8.1
Rents	67.1	18.3	5.1
Services	21.8	8.8	2.9
Other	150.8	33.0	21.1
Totals	**$390.3**	**$79.0**	**$42.7**

By comparing the percentage of total foreign source income and the percentage of unallocated income from all returns, across industries, we can get an indication of which industries were more or less likely to allocate their income to the country of source. Manufacturing companies, for example, earned 50% of the total foreign source gross income, but accounted for 36% of the unallocated income. On the other hand, the information industry comprised just 10% of the total, but 26% of the unallocated income. Finance and insurance companies had only a slightly higher percent of unallocated income than expected based on their percentage of gross income. The other industry groups accounted for about the same fraction of unallocated income as total foreign source income.

Total Foreign-Source (FS) and Unallocated Income, by Industry Group (In billions of dollars)

Industry Group	Total Gross FS Income	% of total	Unallocated Income	% of total
Manufacturing	$194.6	50%	$32.1	36%
Information	37.2	10%	23.2	26%
Finance/Insurance	60.9	16%	17	19%
Management of Companies	45.2	12%	5.0	6%
Other Industries	52.3	5%	11.6	3%
Totals	**$390.3**		**$88.8**	

Taxpayers allocated $42.7 billion of their total gross foreign source income to countries and or regions; about 54% of the original unallocated amount. They were much more likely to allocate their interest or other income than gross rents, royalties and license fees or their income from the performance of services. Roughly half of the allocated income was other income while almost 20 percent was interest income. Most significantly, the total gross foreign source income attributed to countries or regions as a result of taxpayer correspondence accounted for approximately 11% of the total foreign source gross income for all returns.

The rates of follow-up response for those corporations missing country detail for their gross income and the percentage of foreign source gross income allocated in response to our requests also vary by industry. The professional, technical and scientific industry group and the management of companies and enterprises group had the highest satisfactory response rates. Manufacturing and the wholesale and retail trade group also had satisfactory response rates that were well over 50%. Rates for transportation and warehousing, information and the finance and insurance group, however, ranged from 33 to 42%. A comparison of the original amount not attributable to specific countries or regions to the amount allocated after receiving our requests yields similar results. Top of this list is again the professional, technical and scientific services industry, with an allocation rate of 81%. The management of companies and enterprises industry and the manufacturing industry follow close behind, with 79 and 71 percent respectively. Finance and insurance, however, allocated just over half of the amount missing country detail while the information industry allocated about 37%.

A Comparison of Unallocated and Allocated Income for Follow-up Returns, by Industry (in billions of dollars)

Industry Group	Income Not Allocated	Allocated Income	% Allocated
Manufacturing	$27	$19	71%
Wholesale/ Retail Trade	3	1	40%
Transportation/ warehousing	4	1	13%
Information	22	8	37%
Finance/ Insurance	15	8	53%
Professional/ scientific/ technical services	1	1	81%
Management of companies	4	3	79%
Other industries	2	1	57%
Totals	**$79**	**$42.7**	**54%**

While the percentage allocated from the professional, technical and scientific industries may be impressive, it is important to remember that the total allocated amounts received from this industry group is relatively small. Of the total allocated amount received, manufacturing comprised nearly 45% while the finance and insurance industry group and the information industry each accounted for 19% of the data.

Unallocated Taxes Paid or Accrued

As with the other conditions that cause us to send a follow-up letter to a certain company, it is necessary to set a minimum threshold for foreign taxes paid amounts for which we want to obtain country detail. After a review of taxpayer reporting trends, we decided to request additional country detail for any unknown foreign tax amount totaling more than $5 million. Using this number as a guideline, we sent follow-up letters to 79 U.S. corporations requesting additional taxes paid country detail.

For tax year 2002, these companies represented a total of $5.51 billion in foreign taxes paid, $2.7 billion (48.5%) being attributed to unknown or various countries before follow-up. This second figure represents 85% of the $3.1 billion total unknown foreign taxes paid amount prior to follow-up in our study. These totals were broken down by category as follows: $170.8 million of foreign taxes paid on interest income, $10.7 million (6.2%) for country unknown; $906.5 million of foreign taxes paid on rents, royalties, and license fees, $703.3 million (77.6%) unknown; $2.1 billion of foreign taxes paid on foreign branch income, $905.4 million (43.8%) unknown; $234 million of foreign taxes paid on services, $219.7 (93.9%) unknown; and $1.8 billion of foreign taxes paid on other income, $641.2 million (36.2%) unknown.[1]

By the conclusion of our tax year 2002 study, we received responses from 55 of the 79 companies (69.6%) we had contacted to obtain taxes paid country detail for $2.7 billion of taxes paid attributed to various/unknown countries, approximately 14% of the total taxes paid from all returns and roughly 85% of the total unallocated taxes from all returns. Taxpayers allocated a majority of their previously unallocated taxes paid on service income, while they provided country detail for about a third of their taxes paid on interest and other income. (See figure).

A Comparison of Total, Unallocated and Allocated Taxes, by Type (in millions of dollars)

	Unallocated Taxes from Follow-up Returns	Allocated Taxes From Follow-up Returns	Percent Allocated
Interest	$10.7	$3.1	29%
Rents	703.3	216.6	31%
Branch Income	905.4	459.5	51%
Services	219.7	206.7	94%
Other	641.2	204.7	32%
Total	**$2,675**	**$1,214.9**	**45%**

The additional information we received substantially enhanced the accuracy and usefulness of the study data. Overall, the total amount of taxes paid attributed to various/unknown countries was reduced by $1.2 billion, from $2.7 billion to $1.5 billion, a 45% reduction. This $1.2 billion amounted to almost 7% of the total foreign taxes paid.

Taking a closer look at the follow-up letters we sent for foreign taxes paid country detail, we discovered that the manufacturing industry accounted for the highest percentage of these requests, with 26 out of 79 (32.9%) total. The finance/insurance and information industries were also well represented, with 19 (24.1%) and 13 (16.5%) requests, respectively. Even though the information industry accounted for less overall requests than manufacturing and finance/insurance, it possessed the most foreign taxes paid to unknown countries, with $976.3 million (36.6%) of the total prior to follow-up. Manufacturing was a close second, with $943.8 million (35.3%) of the total. The finance/insurance industry accounted for only a fraction of these totals prior to follow-up, with $221.7 million (8.3%). At the end of our study, each of these industries saw a decrease in the amount and percentage of foreign taxes paid to various countries. The most significant drop in unallocated taxes paid was seen in manufacturing, whose unknown foreign taxes paid went from $943.8 million to $307.7 million, a 67% decrease. The finance and insurance

[1] For the purposes of this paper we chose not to examine totals for foreign taxes paid on dividends or 863(b) income

sector experienced the largest percentage decrease in unknown foreign taxes paid of these three industries, going from $221.7 million to $91.3 million (59%). The information industry showed the smallest change between pre and post follow-up taxes paid data, going from $976.3 million to $931 million, a 5% reduction.

A Comparison of Unallocated and Allocated Taxes for Follow-up Returns, by Industry (in millions of dollars)

Industry Group	Taxes Not Allocated	Allocated Taxes	% Allocated
Manufacturing	$943.8	$636.1	67%
Wholesale/ Retail Trade	86.1	61	71%
Transportation/ Warehousing	24.9	24	96%
Information	976.3	45.3	5%
Finance/Insurance	221.7	130.4	59%
Professional/ Scientific/ Technical services	6.7	3.5	52%
Management of companies	263.4	228.9	87%
Other industries	152.1	85.7	56%
Total	$2,675	$1,214.9	45%

Conclusions

Overall, the response rate for follow-ups was sufficient to make the process worthwhile. Since our data requests covered almost 90% of the unallocated income and 87.5% of the unallocated taxes, it appears that our thresholds for these data requests are adequate. In future studies, we may want to keep in mind that the information industry is far less likely than the other significant industry groups in our study to provide additional country detail for both foreign source income and foreign taxes paid. Our criteria for missing Schedule F's also appears adequate, as we sent follow-ups for 92% of the unsupported branch taxes. Although we sent follow-ups for a lower percentage of the total unsupported apportioned deductions (71%), it is not clear whether lowering our thresholds for writing to taxpayers to see if we can acquire Schedule H support is justified, since the total unsupported apportioned deductions was just 7% of the total.

Reflecting upon our results, it appears that the follow-up process has a substantial impact on the overall quality of our data. By requesting missing Schedule H's, we obtained support for about 3% of the total not definitely allocable deductions. Asking for additional country detail enabled us to allocate 11% of the total foreign gross income and nearly 7% of the total foreign taxes paid or accrued to the source country or region. Although our figures for gross branch income and deductions are still underreported, without our requests for missing Schedule F's, we would be missing 15% of the gross foreign branch income and 17% of the foreign branch deductions now reported for this study year. The improvement in the quality of the data as a result of our follow-up letters more than justifies the effort involved in this process and will be continued in future studies.