RELIEF FOR EXPATS

The IRS Approach to Dealing with the Expat Community is Schizophrenic

The IRS has introduced relief that is designed to provide a simplified method for resolving income tax noncompliance as well as a streamlined approach to expatriation.

Author: KEVIN E. PACKMAN

KEVIN E. PACKMAN is an attorney in Holland & Knight's Private Wealth Services Group. He leads the firm's International Estate Planning Group as well as the Tax Controversy and Litigation Team. Mr. Packman's practice includes advising high-net-worth private clients (whether U.S. or foreign) with tax, trusts, and estates. This also includes pre-immigration planning and expatriation planning. Mr. Packman is an ACTEC Fellow.

It came out of the blue, completely unexpected. On the surface, it had so much promise. After years of clamoring for tax relief, the U.S. expat community found itself on the receiving end of a gift from the IRS. In News Release IR 2019-151 released on September 6, 2019, the IRS introduced Relief Procedures for Certain Former Citizens (hereinafter, "IRS Relief"). **1** While the IRS Relief is designed to provide a simplified method for resolving income tax noncompliance as well as a streamlined approach to expatriation, it is not the holy grail for which the expat community clamored.

Tax 101

The Internal Revenue Code (the "Code") requires U.S. taxpayers to file tax returns annually reporting their worldwide income. The Code also obligates taxpayers to file numerous information forms. There

appears to be a form obligation for just about every connection a taxpayer could have to a foreign asset or person. For example, a non-exhaustive list of forms include those that require taxpayers to detail their (i) connection to foreign entities such as trusts, corporations, partnerships and disregarded entities, **2** (ii) connection to foreign assets such as bank and investment accounts, life insurance and pensions, **3** and (iii) receipt of foreign gifts and inheritances. **4** Failure to file these forms not only keeps the statute of limitations open indefinitely, but it also exposes the taxpayer to substantial tax, interest and penalties. None of these forms can be filed without the taxpayer's social security number. Unfortunately, taxpayers can qualify as U.S. citizens without having a social security number. The delay and cost associated with obtaining a U.S. Social Security number have led to many a taxpayer's inability to comply with these annual filing obligations. Even if a taxpayer is aware of these filing obligations and has a Social Security number, for many taxpayers residing abroad, difficulties exist in finding a competent advisor who can assist them with their U.S. obligations.

Benefits of the IRS Relief

It is perhaps with these difficulties in mind, the IRS Relief eliminates the necessity of reporting the taxpayer's social security number on the tax returns and information forms. Furthermore, eligible citizens are relieved of the obligation to pay any tax, interest or penalties with their delinquent filings. Notwithstanding, the eligible taxpayers need to file six years of tax returns along with all required information returns. The first five years of tax returns are back tax returns, and the sixth year's return is a dual status return in the year of the expatriation. The sixth year's return must also include Form 8854. If a taxpayer has an unfiled gift tax return obligation, any such Forms 709 can also be filed pursuant to the IRS Relief.

Who qualifies for the IRS Relief?

The IRS Relief is only available to certain U.S. citizens who were noncompliant with their taxes and who expatriated after March 18, 2010, which is the effective date of the Foreign Account Tax Compliance Act ("FATCA"). **5** Thus, individuals residing abroad in possession of a U.S. green card are not eligible for the IRS Relief. Similarly, if a U.S. citizen has ever filed a Form 1040, such taxpayer is precluded from any benefits offered by the IRS Relief. To be eligible, the taxpayer must satisfy each of the following:

> (1) Have a net worth less than $2 million on the date of the expatriation and the date that the IRS Relief submission is filed.
> (2) Have an aggregate income tax liability for the six years that does not exceed $25,000. The individual's aggregate income tax liability is determined after applying all deductions, exclusions, exemptions, and credits for the six years of income tax returns being filed.

Moreover, the taxpayer's noncompliance must be due to non-willful conduct. Non-willful conduct means, "conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith

misunderstanding of the requirements of the law."

How to apply for the IRS Relief?

Provided an otherwise eligible taxpayer qualifies for the IRS Relief, there is no application to submit to the IRS. Similarly, there is no payment required. Rather, the taxpayer simply needs to file the following documents with the IRS Service Center in Austin, Texas:

- A copy of Form DS-4083, Certification of Loss of Nationality of the United States, which must be stamped approved by the Department of State. The taxpayer may submit a copy of a court order cancelling a naturalized citizen's certificate of naturalization in lieu of Form DS-4083. However, a taxpayer can only receive these items after completing the process of expatriation. Consequently, the IRS Relief is only available for taxpayers who have already expatriated. Therefore, it is likely that the IRS Relief will be sought for the income tax and Form 8854 benefits.
- A copy of the taxpayer's valid passport or birth certificate and government issued identification.
- For the five years preceding the year of expatriation, original Forms 1040 with all applicable information returns. As noted earlier, taxpayers should also submit any delinquent Forms 709. On the top of the first page of each of the documents submitted, the individual should write in red ink, "Relief for Certain Former Citizens."
- For the year of expatriation, an original Form 1040 reporting worldwide income up through the date of expatriation and a Form 1040NR. Both returns should include all required information returns. Form 8854 must accompany the original Form 1040 in this year. To assist with the processing, on the top of the first page of each of these documents submitted, the individual should write in red ink, "Relief for Certain Former Citizens."

All documents need to be mailed to the IRS at the following address:

Internal Revenue Service

3651 South I-H 35

Mail Stop 4301 AUSC

Attention: Relief for Certain Former Citizens

Austin, Texas 78741

Once the IRS completes its review of a taxpayer's submission, it will send an acknowledgment. The IRS also stressed that individuals who do not satisfy the eligibility requirements for the IRS Relief, but who submit documents through this procedure will be dealt with harshly. Such taxpayers will be liable for all taxes, penalties and interest. This invariably includes the harsh information return penalties. Since the IRS Relief is only available to a certain group of individuals who have expatriated, it is important to know

what qualifies as expatriating.

How to expatriate

This results from the fact that to expatriate, an individual must voluntarily and with intent to relinquish U.S. citizenship, (1) appear in person before a U.S. consular or diplomatic officer; (2) in a foreign country at a U.S. Embassy or Consulate; and (3) sign an oath of renunciation. **5.1** A U.S. citizen's expatriation date will be the earliest of the following four dates:

(1) When the individual renounces U.S. nationality before a diplomatic or consular officer of the U.S. pursuant to paragraph (5) of section 349(a) of the Immigration and Nationality Act.
(2) When the individual furnishes the State Department with a signed statement of voluntary relinquishment of U.S. nationality conforming with paragraph (1), (2), (3), or (4) or section 349(a) of the Immigration and Nationality Act.
(3) When the State Department issues a certificate of loss of nationality.
(4) When a U.S. court cancels a citizen's certificate of naturalization. **6**

Steps 1 and 2 must be confirmed by the State Department's issuance of a certificate of loss of nationality. **7** Until the State Department approves the expatriation, the taxpayer will remain a U.S. citizen and subject to U.S. tax on worldwide income. At such time as the expatriation is accepted, however, the expatriation date will be retroactive to the date when the taxpayer renounced such citizenship in front of the diplomatic or consular officer.

What is the impact of expatriating?

Congress buried new expatriation law as an offset into the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART legislation"). **8** The HEART legislation introduced **Sections 877A** and **2801** to the Code, which together penalize certain taxpayers (i.e., citizens and long-term permanent residents) who wish to relinquish their U.S. status. The changes brought by the HEART legislation apply to individuals who qualify as "covered expatriates."

There is a three-part test to determine if an individual is a covered expatriate. **9** The net worth test indicates that if an individual has a net worth of at least $2 million on the date of expatriation, the individual will be a covered expatriate. Similarly, the income tax test provides that for the five years prior to expatriation, the individual's average annual net income tax liability must not exceed the annual threshold in **Section 877(a)(2)(A)** . For 2019, the threshold is $168,000. Although the net worth threshold is not tied to inflation, the average income tax threshold is so impacted. Even if the U.S. citizen does not have the specified net worth or income tax liability, if the U.S. citizen fails to file Form 8854 and certify under penalties of perjury that the U.S. citizen has been compliant with U.S. tax laws for the five-year period prior to expatriation, the U.S. citizen also will be a covered expatriate.

In simplistic terms, there are tax costs associated with being a covered expatriate. The focal point of the HEART legislation is the mark-to-market exit tax in **Section 877A** . This subjects covered expatriates to tax on the net unrealized gain in their property. The property is deemed sold on the day before the expatriation date and, the extent to which the gain exceeds $725,000, the covered expatriate will pay a tax. **10** However, the exit tax is not the only negative consequence of expatriating. Rather, **Section 2801** also imposes another tax on covered gifts and covered bequests a U.S. taxpayer receives from a covered expatriate.

A "covered gift," under **Section 2801(e)(1)(A)** , is any property acquired by gift directly or indirectly from an individual who is a covered expatriate at the time the gift is received (i.e., who has not subsequently resumed U.S. tax residency as of the time of the transfer).

A "covered bequest," under **Section 2801(e)(1)(B)** , is any property acquired directly or indirectly by reason of death from an individual who was a covered expatriate immediately before death.

The U.S. recipient of either a gift or bequest from a covered expatriate is subject to transfer tax on the product of (1) the highest estate tax rate in effect under **Section 2001(c)** on the date of receipt, or, if greater, the highest gift tax rate in effect under **Section 2502(a)** on that date, and (2) the value of the covered gift or covered bequest. **11**

Certain dual citizens and children despite failing the net worth and income tax tests above are exempt from qualifying as a covered expatriate if they meet the below threshold and file Form 8854.

> (1) The dual citizenship exemption applies to taxpayers who (1) have obtained U.S. citizenship solely by reason of birth as well as citizenship of another country. At the time of the expatriation, the individual (2) must remain both a citizen and income tax resident of the other country, and (3) the individual must not have qualified as a U.S. resident under the substantial-presence test for more than ten years out of the 15-year period ending with expatriation. **12**
>
> (2) Children who expatriate before (1) attaining the age of 18½ and (2) who did not qualify as a U.S. resident under the substantial-presence test for more than ten years out of the 15-year period ending with expatriation can qualify for the second exception. **13**

Under the prior expatriation law that no longer applies to anyone, individuals who expatriated had to file Form 8854 to notify the IRS of the expatriation. **14** While there was no due date for the filing of the initial Form 8854, such an expat remained subject to U.S. income tax on the expat's worldwide income until the form was filed. **15** This perverse result led to situations where the individual could expatriate for U.S. immigration purposes, but not for U.S. tax purposes. Now, individuals who expatriate after the HEART legislation are also required to file Form 8854 reflecting their expatriation. **16** Any expats who fail to file Form 8854 or file an incomplete form are subject to a $10,000 penalty. **17** There is, however, a reasonable cause defense under which the government may waive the penalty.

Congressional action causing difficulties for expats

This is not the first time the IRS has appeared to favor the expat community, but it has come after many years of what must have felt like a constant attack. For example, after decades of playing around with the laws impacting those who have relinquished their expatriation, the HEART legislation was introduced in 2008. **18** The HEART legislation was quickly followed by the first Offshore Voluntary Disclosure Program ("OVDP"), which was announced in March 2009. **19** The 2009 OVDP and its subsequent iterations were publicized as a means with which to come into compliance. Into this world of enhanced compliance, FATCA was enacted on March 18, 2010. **20**

There has been no shortage of media coverage detailing the problems faced by the expat community as a result of FATCA. Two recent articles highlight the difficulty U.S. taxpayers residing abroad are having maintaining their foreign accounts: (i) British citizens born in America face having bank accounts frozen **21** and (ii) FATCA could push French banks to close up to 40,000 accounts. **22** As a result of these difficulties, U.S. citizens have been giving up their citizenship in record numbers. **23**

As if to add insult to injury, the IRS then began to shut its overseas taxpayer assistance centers in 2010 and closed its final assistance centers in early 2015. **24** That same year, to flex its muscles and further penalize noncompliant taxpayers, Congress included within the FAST Act **25** legislation that permits the IRS to share tax details with the State Department. **26** The net effect of this change that was enacted on December 4, 2015 is that IRS will certify seriously delinquent tax debts to the State Department, which will either revoke passports or deny passport applications for certain taxpayers. **27** Although there are due process provisions in place, the impact of such legislation is destined to have a more severe impact on expats.

Then in what must have been an unwanted Christmas surprise, the Tax Cuts and Jobs Act ("TCJA") placed a unique burden on all U.S. taxpayers who owned a foreign corporation. **28** Whereas any U.S. taxpayer resident in the U.S. can own a business and avoid the impact of TCJA, no such exception exists for the U.S. taxpayers residing abroad. For instance, U.S. citizens owning controlled foreign corporations were subject to the transition tax, and also had to consider restructuring their active businesses to mitigate the unfavorable tax consequences brought by TCJA. Finally, in a prelude to the IRS Relief, on July 19, 2019, IRS announced six new compliance campaigns, one of which focused on expatriation. **29** The expatriation campaign was going to focus on those individuals who had expatriated, but had failed to comply with the tax reporting and filing obligations. With significant changes to U.S. tax law and no IRS foreign taxpayer assistance offices open, expats can still seek guidance from the IRS. However, to obtain that assistance, the expat must have the patience to sit on hold, as the help is available by phone from the IRS International Call Center 6 am - 11 pm eastern standard time at 267-941-1000. The Call Center can also be reached by fax at 267-466-1055.

Prior IRS assistance intended for expats

As referenced, despite reducing the services available to the international community in the past ten years while increasing the difficulties on those living abroad, the IRS has provided certain benefits. In the

prior iterations of the OVDP, the IRS exercised leniency on the expat community when it came to penalties.

For example, the 2011 OVDP introduced two groups of taxpayers who could qualify for a 5% penalty on the value of their foreign assets instead of the 25% penalty that applied to everyone else. Those taxpayers included:

- FAQ 52.2: taxpayers who are foreign residents and who were unaware they were U.S. citizens; **30** and
- FAQ 52.3: taxpayers who are foreign residents and who meet all three of the following conditions for all of the years of their voluntary disclosure: (a) taxpayer resides in a foreign country; (b) taxpayer has made a good faith showing that taxpayer has timely complied with all tax reporting and payment requirements in the country of residency; and (c) taxpayer has $10,000 or less of U.S. source income each year. **31**

The first category refers to the Accidental American. Of course, there was no mechanism by which the IRS could determine if the individual truly was unaware. For taxpayers in the second category only, the penalty was limited to the value of their bank accounts and did not extend to non-financial assets.

A little more than 2 ½ years later, the IRS released Fact Sheet 2011-13 titled "Information for U.S. Citizens or Dual Citizens Residing Outside the U.S." on December 7, 2011. The Fact Sheet indicated that the IRS was aware some taxpayers who were dual citizens and residents of a foreign country had failed to file FBARs, and that many of these taxpayers were now aware of the requirement to do so. As a result, the Fact Sheet reviewed a number of filing obligations and indicated that "penalties will not be applied in all cases."

One month later, the 2012 OVDP was introduced in January 2012 and increased the offshore penalty to 27.5%. However, for the same two categories of taxpayers, it also included the same 5% penalty categories.

Six months later on June 26, 2012, the IRS introduced a new streamlined filing compliance program for "Non-Resident, Non-Filer U.S. Taxpayers." **32** The program became effective on September 1, 2012 and provided a means for certain taxpayers to come into compliance and avoid the draconian penalties associated with FBARs and other information returns. Those taxpayers whose noncompliance posed a low-risk were eligible for the program. The IRS did not indicate how the following nine factors were weighed other than to say if they were present the compliance risk may rise:

(1) The taxpayer is seeking a refund.
(2) The taxpayer has material economic activity in the U.S.
(3) The taxpayer has failed to declare all of the taxpayer's income in the taxpayer's country of residence.
(4) The taxpayer is under IRS audit or examination.
(5) The taxpayer has received an FBAR warning letter or been assessed FBAR penalties.
(6) The taxpayer has a foreign account outside of the taxpayer's country of residence.

(7) The taxpayer does not have a financial interest in an entity located outside of the country of residence.
(8) The taxpayer has U.S. source income.
(9) There are indications that the taxpayer was involved in sophisticated tax planning or avoidance.

For those taxpayers who qualified, the streamlined program required them to file three years of income tax returns with all required information returns as well as six years of FBARs. Most notably, there would be NO penalties associated with non-filed FBARs or information returns. The program was available "for non-residents including, but not limited to, dual citizens who have not filed U.S. income tax and information returns."

Almost two years later, a new Foreign Streamline program began on July 1, 2014, and it benefited not only U.S. citizens resident abroad, but it also applied to any U.S. taxpayer that could satisfy its residency requirements. Notably, it eliminated the nine factors that led to heightened risk and low income tax thresholds. Eligible taxpayers only need to file three years of tax returns, three years of information returns, and six years of FBARs. They are required to pay the resulting tax and interest, but there are no tax penalties (i.e., late filing or late payment), as well as no offshore penalty. The Foreign Streamline program remains in existence today and is by far the best program for taxpayers with noncompliance. However, it is not perfect. In order to use the Foreign Streamline and file the required tax and information forms, the taxpayer must have a social security number, which as detailed above is eliminated in the IRS Relief. Notwithstanding, the Foreign Streamline does not have a maximum income tax threshold below which a taxpayer must be in order to qualify.

Generally, individuals are rewarded for coming forward first, and those who delay are dealt with more harshly. In the context of offshore noncompliance, this has simply not occurred. While penalties may be abated, there is simply no mechanism by which the IRS can reimburse taxpayers for the increased costs associated with participating in the OVDP when they could have qualified for the 2012 streamlined program or the Foreign Streamlined program, both of which abate penalties and require much less than under the OVDP.

Conclusion

As noted in the title of this article, the IRS cannot seem to get out of its own way when providing assistance to the expat community. Certainly, eliminating the requirement to have a social security number is a welcome relief. Additionally, tying eligibility for the IRS Relief to the covered expatriate tests in **Section 877A** makes sense. However, the IRS reduces the income tax threshold for eligibility in the IRS Relief well below that in **Section 877A** . There are many ways in which an expat could have an aggregate income tax liability over six years in excess of $25,000. Thus, the net effect is that the IRS Relief will provide assistance to a fraction of the expat community who could have otherwise benefited from it.

1 https://www.irs.gov/newsroom/irs-announces-new-procedures-to-enable-certain-expatriated-individuals-a-way-to-come-

2 See IRS Form 3520, 3520-A, 5471, 8621, 8858 and 8865.

3 See FinCen Form 114, Form 3520, Form 3520-A and Form 8938.

4 See IRS Form 3520.

5 P.L. 111-147, 3/18/10.

5.1 section 349(a)(5) of the Immigration and Nationality Act, 8 U.S.C. section 1481(a)(5).

6 Section 877A(g)(4) .

7 *Id*.

8 P.L. 110-245, 6/17/08.

9 Section 877A(g)(1) .

10 Sections 877A(a)(1) and (3).

11 Section 2801(b) .

12 Section 877A(g)(1)(B)(i) .

13 Section 877A(g)(1)(B)(ii) .

14 Section 6039G .

15 Sections 7701(n)(1) and (2) prior to the HEART legislation.

16 Section 6039G .

17 **Section 6039G(c)** .

18 P.L. 110-245, 6/17/08.

19
www.irs.govnewsroom/irs-offshore-voluntary-disclosure-efforts-produce-65-billion-45000-taxpayers-participate

20 P.L. 111-147, 3/18/10.

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25 P.L. 114-94, 12/4/15.

26 P.L. 114-94 at Section 32101(i).

27 *Id.*

28 P.L. 115-97, 12/22/17.

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https://www.irs.gov/businesses/corporations/the-irs-large-business-and-international-division-lbi-announces-the-approv

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https://www.irs.gov/individuals/2011-offshore-voluntary-disclosure-initiative-frequently-asked-questions-and-answers

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https://www.irs.gov/individuals/2011-offshore-voluntary-disclosure-initiative-frequently-asked-questions-and-answers

32 https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures