



**EXPAT TAX
HANDBOOK**

Solutions For
Delinquent Taxpayers

Tax Year 2018

The Expat Tax Handbook – Solutions for Delinquent Taxpayers
Straightforward Explanations with Helpful Expat Tax Tips

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1. Federal Income Tax Filing Obligations

Who Needs to File?

As a basic rule, **U.S. citizens and green card holders**, even those residing outside the United States, are considered to be U.S. residents for tax purposes and are therefore subject to U.S. tax reporting on their worldwide income.

One may also be considered a U.S. tax resident if the **substantial presence test** is met for the calendar year. Under this test, one must be physically present in the United States on at least: (a) 31 days during the current calendar year; and (b) A total of 183 days during the current year and the 2 preceding years, counting all the days of physical presence in the current year, but only one-third the number of days of presence in the first preceding year, and only one-sixth the number of days in the second preceding year.

What Types of Income Are Reportable?

Expats must annually report all of their **worldwide income**, i.e., whether the income is U.S. source or foreign source. This means that in addition to your U.S. source income, your U.S. income tax return should also include, among other things:

- Wages from your foreign employer
- Self-employment income earned abroad
- Foreign dividends and interest income
- Rental income from foreign properties
- Foreign royalties
- Foreign capital gains or losses on stocks, bonds, real estate
- Foreign pension and social security benefits
- Exercise of certain stock options

Tax Filing Status

Your federal income **tax filing status** affects the tax rate applicable to your income as well as the availability of deductions and credits to reduce your taxable income or offset your income tax. Taxpayers must use one of five filing statuses:

- Married Filing Jointly
- Qualifying Widow(er) with Dependent Child
- Head of Household
- Single
- Married Filing Separately

Federal Income Tax Rates

In general, the **tax rate** applicable to your income will depend on your tax filing status and your taxable income amount. Beneficial rates may apply to certain types of income, for example, capital gains and qualifying dividends. The Tax Cuts and Jobs Act of 2017 (the "Trump Tax Reform") generally reduced the federal income tax rates for the 2018 tax year (with the top rate, for example, being reduced from 39.6% to 37%). The IRS publication official announcing the new rates can be found here:

https://www.irs.gov/irb/2018-10_IRB#RR-2018-06

Filing Minimum Thresholds

In some cases, if your income is below a certain **threshold amount**, you may not be required to file a federal income tax return. The draft Form 1040 Instructions currently include a chart that lists the new minimum thresholds under the Trump Tax Reform.

The IRS notes that if you qualify for a refundable credit (such as the earned income credit or the additional child tax credit), you should file a return to get a refund even if you are not otherwise required to file a return.

Alternative Minimum Tax

It is important to note that for certain high-income taxpayers, a so-called **alternative minimum tax** ("AMT") may apply. This additional tax is calculated separately from a taxpayer's regular tax and is paid in addition to the regular tax if certain criteria are met. AMT is intended to ensure that high-income taxpayers pay a minimum amount of income tax (e.g., in the case where the taxpayer's income is otherwise reduced due to available deductions and credits).

Net Investment Income Tax

If an individual has income from investments, the individual may be subject to a 3.8 percent Net Investment Income Tax ("NIIT") on the lesser of their **net investment income** (such as interest, dividends, capital gains, rental and royalty income, among others), or the amount by which their modified adjusted gross income exceeds the statutory threshold amount based on their filing status.

The current thresholds are \$250,000 (married filing jointly), \$125,000 (married filing separately), or \$200,000 (single or head of household). In general, NRAs and NRA spouses are not subject to the NIIT.

2. Tax and Information Returns and Due Dates

U.S. Federal Income Tax Return

U.S. expats are generally required to file their federal income tax returns (Form 1040) by April 15th of the following year, just like U.S. residents. However, if you live outside the U.S. on April 15th, you are entitled to an automatic extension (without the filing of an extension form) until June 15th.

It should be noted that if you owe tax, the extension applies only to the tax return filing and not the tax payment. Therefore, you must still submit your payment by April 15th to avoid paying interest on your late payment (late payment penalties do not commence until June 15th). An automatic extension can also be filed resulting in additional time to file until October 15th.

Due to the weekend and a holiday, the extended due date for the 2018 tax return is moved from June 15 to **June 17, 2019**.

An even further extension may be granted if October 15 does not provide sufficient time to file the tax return. An Expat Tax Professional should be consulted to discuss this extension option.

Information Returns – Filed with the IRS

Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations:

This form generally applies to certain U.S. individuals who own interests in foreign (i.e., non-U.S.) corporations. Certain transactions involving such foreign corporations would need to be reported on this form.

Due Date: Form 5471 is due with the income tax return (Form 1040), including extensions.

Form 8938 (FATCA Reporting), Statement of Specified Foreign Financial Assets:

If you reside outside the U.S. and have a bank account or investment account in a foreign financial institution, you are generally required to include Form 8938 with your U.S. federal income tax return if you meet certain thresholds.

Due Date: Form 8938 is due with the income tax return (Form 1040), including extensions.

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts:

Owners of foreign trusts must report on Form 3520 whether or not there are specific transactions during the tax year. Certain transactions between a foreign trust and a U.S. person need to be reported on Form 3520, and the trust itself may be required to file Form 3520-A.

Also required to be reported on Form 3520 is the receipt of certain large gifts or bequests (more than \$100,000) from a NRA or foreign estate to a U.S. person.

Due Date: Form 3520 is due with the income tax return (Form 1040), including extensions (the Form 3520-A is due by March 15).

Other Informational Forms

- Form 8621: must be filed by certain shareholders of passive foreign investment companies (such as foreign mutual funds)
- Form 8865: must be filed for each controlled foreign partnership in which the taxpayer is a 10% or more partner
- Form 8858: must be filed for each wholly owned foreign entity for which a "check the box" election (i.e., an entity classification election) has been made

Due Dates: These other forms are due with the income tax return (Form 1040), including extensions.

Information Returns – Filed with Other Agencies

Foreign Bank and Financial Account Report – FBAR

The FBAR is not a tax form and it is not filed with the IRS. Instead, it is an informational report that is submitted with the Treasury Department.

Any U.S. account holder (person or entity) with a financial interest in or signature authority over one or more foreign financial accounts, with more than \$10,000 in aggregate value in a calendar year, must file the FBAR annually with the Treasury Department.

The FBAR form (FinCEN Form 114) must be filed electronically using the BSA E-Filing System maintained by the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN").

Due Date: The FBAR due date is April 15th, but with a maximum extension for a 6-month period ending on October 15th.

3. Taxpayer Delinquency and Penalties

U.S. filing tax delinquency can manifest in a number of ways. Delinquency can result from the following:

- Tax return is filed late
- Information return (e.g., FBAR, Form 5471, Form 3520) is filed late
- Returns are incorrect or incomplete
- Tax payment is past due
- Estimated tax payment was not made
- Underpayment of tax

Severe penalties may be associated with any or all of the above delinquencies. The following highlights some of the penalties for delinquent taxpayers.

Tax Return Penalties

Income tax return (Form 1040) filing delinquency can result in the following penalties:

- **Failure to file penalty** – 5% of the taxes owed for each month outstanding (capped at 25% of the total tax liability).
- **Failure to pay penalty** – 0.5% of the taxes due for each month outstanding (no cap).
- **Accuracy-related penalty** – depending on the particular facts, an additional 20% penalty may apply if your income is substantially understated or if your underpayment was due to negligence or disregard of rules or regulations. The penalty does not apply, however, to any portion of an underpayment for which there was reasonable cause and where the taxpayer acted in good faith.

Expat Tax Tip #1 – The misuse of tax preparation software, even if unintentional or accidental, is not a viable defense against the accuracy-related penalty.

Case Law Example – In a case where the taxpayers were found to be negligent in claiming the first-time homebuyer credit, the U.S. Tax Court upheld the accuracy-related penalty imposed by the IRS. The Court rejected the taxpayers' defense that TurboTax was responsible for improperly claiming the credit. [Morales v. Commissioner](#), T.C. Memo 2012-341.

IRS Information Return Penalties

Examples of information return delinquency penalties include the following:

- **Form 5471/8865/8858 Civil Penalties** – \$10,000 penalty per year per entity. If the form is not filed within 90 days after the IRS has mailed a notice of failure, an additional \$10,000 penalty (per foreign corporation) is charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of \$50,000 for each failure. Additionally, foreign taxes available for credit can be significantly reduced as a result of delinquency.
- **Form 3520 Civil Penalties** – The initial penalty is equal to the greater of \$10,000, or 35% of the gross value of any property transferred to or distributed from a foreign trust, or 5% of the gross value of the portion of the trust's assets. Additional penalties may be imposed if the noncompliance continues after the IRS mails a notice of failure to comply with the required reporting.
- **Criminal Penalties** – A willful violation can result in the imposition of criminal penalties, which include additional fines and jail time.

FBAR Penalties – Willful versus Non-willful

Examples of FBAR delinquency penalties include the following:

- **FBAR Civil Penalties** – Negligent or “**non-willful**” delinquency can result in a penalty of \$10,000 per account per year unless there is reasonable cause for failing to file. A willful failure to file could be subject to civil penalties equal to the greater of \$100,000 or 50% of the balance in each unreported account.
- **FBAR Criminal Penalties** – A “**willful**” violation can result in fines of up to \$250,000 in fines and 5 years of jail time.

The IRS has issued interim guidance to examiners for implementing procedures to improve the administration of the FBAR, available at:

<http://www.irs.gov/pub/foia/ig/spder/SBSE-04-0515-0025%5B1%5D.pdf>

In it, IRS examiners are advised that it may be appropriate to apply one penalty for each open year, regardless of the number of unreported foreign financial accounts. In such case, the penalty for each year would be limited to \$10,000. For even less egregious cases, the facts and circumstances may indicate that asserting non-willful penalties for each year of delinquency may not be appropriate. In such case, the examiner may assert a single penalty for all years of delinquent FBARs, which is not to exceed \$10,000.

Expat Tax Tip #2 – Willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements – so-called “willful blindness.”

Case Law Example – The Taxpayer failed to report his interest in two Swiss bank accounts that he opened in the early 1990’s. On his 2000 income tax return, the taxpayer checked the “no” box on his tax return as to whether he had an interest in a foreign financial account, and he did not file the FBAR form. After reaching a settlement on criminal charges (4 years in prison + \$25,000 fine + \$3.5M restitution), the IRS further imposed and the Court of Appeals upheld penalties of \$100,000 per account under the claim of willful violation. The Court based its decision on a “willful blindness” standard. United States v. Williams, 489 Fed.Appx. 655 (4th Cir. 2012).

In its Internal Revenue Manual, the IRS lists a number of additional situational examples where taxpayers would be considered willful violators, including:

- A person filed the FBAR in earlier years but failed to file the FBAR in subsequent years when required to do so. When asked, the person does not provide a reasonable explanation for failing to file the FBAR. In addition, the person may have failed to report income associated with foreign bank accounts for the years that FBARs were not filed.
- A person received a warning letter informing him of the FBAR filing requirement, but the person continues to fail to file the FBAR in subsequent years. When asked, the person does not provide a reasonable explanation for failing to file the FBAR. In addition, the person may have failed to report income associated with the foreign bank accounts.
- A person admits knowledge of, and fails to answer, a question concerning signature authority over foreign bank accounts on Form 1040, Schedule B of his income tax return. When asked, the person does not provide a reasonable explanation for failing to answer the Schedule B question and for failing to file the FBAR.

Importantly, the Manual adds that if the failure to file the FBAR or to keep records is due to “**reasonable cause**,” no penalty should be asserted. The IRS offers limited guidance in defining “reasonable cause.” A tax professional should be consulted to understand if reasonable cause is a viable defense under the circumstances of his or her case.

4. The IRS Amnesty Programs – Streamlined Procedures and VDP

The Streamlined Procedures

The Streamlined Procedures are designed for delinquent taxpayers who can certify that their failure to previously report all income, pay all tax, and submit all required tax information returns, including FBARs, resulted from **non-willful** conduct.

There are two types of Streamlined Procedures, one for U.S. taxpayers residing outside the United States (the “Foreign Offshore Procedures”), and the other for U.S. taxpayers residing in the United States (the “Domestic Offshore Procedures”).

Determining Residency

A U.S. expat considered to reside outside the United States if - in at least one year during the three-year period that tax returns must be submitted under the streamlined procedures – he both:

- (1) did not have a U.S. “abode” (generally, one’s home, habitation, residence, domicile, or place of dwelling); and
- (2) was physically outside the United States for at least 330 full days (meaning, the taxpayer did not spend more than 35 days in the United States).

Expat Tax Tip #3 – While the IRS’s residency rules seem relatively straightforward, our experience with clients has been that each individual has a unique story to tell and each story requires a unique interpretation of the residency rules.

Streamlined Foreign Offshore Procedures

Under the Streamlined Foreign Offshore Procedures (taxpayers residing outside the United States), the taxpayer is required to submit:

- ❖ 3 years of tax returns and information returns
- ❖ 6 years of FBARs
- ❖ Non-willful certification (Form 14653)

Under this program, the taxpayer **avoids all of the penalties** normally associated with delinquency (e.g., failure-to-file and failure-to-pay penalties, accuracy-related

penalties, information return penalties, FBAR penalties). The participant is required to pay only the following:

- ❖ Unpaid taxes
- ❖ Interest

Streamlined Domestic Offshore Procedures

The Domestic Offshore Procedures (for taxpayers residing in the United States) have the same submission requirements as the Foreign Offshore Procedures, namely 3 tax returns, 6 FBARS, and the non-willful certification.

The Domestic Offshore Procedures differ from the Foreign Offshore Procedures in two main ways:

- (1) A domestic resident taxpayer that has failed to file a U.S. income tax return in any of the three most recent tax years cannot participate in the domestic offshore procedures (while a foreign resident taxpayer that has been similarly delinquent can participate in the foreign offshore procedures).
- (2) Further, even if the taxpayers qualifies, the domestic offshore procedures bear a **5% penalty** on the highest aggregate balance/value of one's foreign financial assets (while the foreign offshore procedures have no such penalty).

Non-willful certification (Form 14653)

Prior to 2016, the Form 14653 required that taxpayers include a general narrative of facts which lead to the failure to timely report all income, pay all tax, and submit all required information, including FBARS. In January of 2016, the form was significantly revised. It now requires that the taxpayer's explanation of non-willfulness include the following:

- Specific reasons for your past failure, whether favorable or unfavorable to you, including your personal background, financial background, and anything else you believe is relevant to your failure.
- An explanation as to the source of funds in all of your foreign financial accounts/assets. For example, explain whether you inherited the account/asset, whether you opened it while residing in a foreign country, or whether you had a business reason to open or use it.
- An explanation of your contacts with the account/asset including withdrawals, deposits, and investment/ management decisions.
- A complete story about your foreign financial account/asset.

- If you relied on a professional advisor, provide the name, address, and telephone number of the advisor and a summary of the advice (this requirement was previously included).
- If married taxpayers submitting a joint certification have different reasons, provide the individual reasons for each spouse separately in the statement of facts (this requirement was also previously included).

Other Considerations

When participating in the Streamlined Procedures, various tax issues need to be analyzed in order to file previous returns in the best manner possible and mitigate the payment of back taxes to the IRS.

Some of the issues that are normally addressed in the case of U.S. expats include:

- The Foreign Earned Income Exclusion
- The Foreign Housing Exclusion
- The Foreign Tax Credit
- The Passive Foreign Investment Company ("PFIC") rules
- The Controlled Foreign Corporation ("CFC") Rules
- Income Tax Treaty provisions

Example – Xina Patterson, a native Californian, moved to London at end of 2010 at the age of 32 for a work promotion at her UK-headquartered company, which included a healthy raise and pension benefits. Xina had worked for several years in San Francisco before the big move and had diligently filed her U.S. tax returns using Turbo Tax each year. Starting in 2011, she began working at her new London office. She purchased a nearby flat and opened a checking account at a local bank. Thinking her U.S. tax responsibilities ended upon her move, she stopped filing U.S. tax returns after 2010. In 2014, upon trying to open a savings account at a second bank, she was asked to fill out an IRS Form W-9. She did so without thinking much of it. In 2015, during a casual conversation with a co-worker and fellow U.S. expat, Xina realized that she was in fact a delinquent U.S. expat taxpayer.

Result – Zina is a very good candidate for the Streamlined Procedures because of the overall non-willful nature of her delinquency. If successful, she could avoid a number of harsh penalties and greatly mitigate back taxes owed to the IRS.

Voluntary Disclosure Program ("VDP")

On September 28, 2018, the IRS terminated its previous program for willful violators seeking to avoid criminal prosecution, the so-called Offshore Voluntary Disclosure Program (OVDP). In its wake, the IRS started a modified program, the so-called "Voluntary Disclosure Program (VDP)", which applies to all voluntary disclosures, whether domestic or offshore.

Under the new program, voluntary disclosures will generally include a six-year disclosure and examination period, but can vary depending on the circumstances of the taxpayer. Taxpayers must submit all required returns and reports for the disclosure period, and then examiners will determine applicable taxes, interest, and penalties under existing law and procedures.

As stated in the IRS announcement, the penalties under the new program will be imposed as follows:

- i. The civil penalty for fraud or the civil penalty for the fraudulent failure to file income tax returns (together, the "civil fraud penalty"), the rate of which is 75%, will apply to the one tax year with the highest tax liability.
- ii. In limited circumstances, examiners may apply the civil fraud penalty to more than one year in the six-year scope (up to all six years) based on the facts and circumstances of the case, for example, if there is no agreement as to the tax liability.
- iii. Examiners may apply the civil fraud penalty beyond six years if the taxpayer fails to cooperate and resolve the examination by agreement.
- iv. Willful FBAR penalties will be asserted in accordance with existing IRS penalty guidelines.
- v. A taxpayer is not precluded from requesting the imposition of accuracy related penalties instead of civil fraud penalties or non-willful FBAR penalties instead of willful penalties. (Given the objective of the voluntary disclosure practice, granting requests for the imposition of lesser penalties is expected to be exceptional. Where the facts and the law support the assertion of a civil fraud or willful FBAR penalty, a taxpayer must present convincing evidence to justify why the civil fraud penalty should not be imposed.)
- vi. Penalties for the failure to file information returns will not be automatically imposed. Examiner discretion will take into account the application of other penalties (such as civil fraud penalty and willful FBAR penalty) and resolve the examination by agreement.

vii. Penalties relating to excise taxes, employment taxes, estate and gift tax, etc. will be handled based upon the facts and circumstances with examiners coordinating with appropriate subject matter experts.

viii. Taxpayers retain the right to request an appeal with the Office of Appeals.

Expat Tax Tip #4 – In contrast to the former Offshore Voluntary Disclosure Program (OVDP), the new Voluntary Disclosure Program (VDP) for willfully delinquent taxpayers will apply to all voluntary disclosures, whether domestic or offshore. To avoid criminal prosecution, participants in the program will provide returns and FBARs for 6 years and will be subject to, among other things, civil fraud penalties and willful FBAR penalties.

5. Alternative Approaches

As described above, the Internal Revenue Service now offers two main amnesty programs. While the programs can offer beneficial results for many delinquent U.S. expats, they still expose many delinquent taxpayers to potentially severe penalties. For instance, under each program, taxpayers must still pay tax due with interest. Further, the streamlined domestic procedures bear a 5% penalty, and the new VDP bears a number of onerous penalties.

These disadvantages have led some delinquent taxpayers to abandon the amnesty programs and instead try their luck with the following alternative approaches.

- (1) “Noisy” Disclosure – Under this approach, the taxpayer files past delinquent returns with a statement explaining the reasons for the delinquency.
- (2) “Quiet” Disclosure – Under this approach, the taxpayers files delinquent returns without any statement of explanation.
- (3) Prospective Filing – Under this approach, the taxpayer ignores past delinquencies and complies only with respect to tax years moving forward.

We do not recommend the above alternative approaches for a number of reasons. First, the IRS frowns upon attempts by taxpayers to circumvent the programs specifically designed to benefit delinquent taxpayers. Second, the outcomes associated with the alternative approaches can vary so greatly and can potentially lead to disastrous results. Third, we have yet to encounter a situation that justifies the risks associated with these approaches in contrast to the IRS

amnesty programs, which offer the taxpayer certainty and a clean record moving forward.

Expat Tax Tip #5 – Depending on your risk appetite, you may be tempted to hide your head in the sand if you are a delinquent taxpayer. We do not recommend this approach. The IRS has specific amnesty programs designed to help you clean up your tax history. The experts at Expat Tax Professionals can help you decide which program is best for you and can guide you through the entire amnesty process.

6. Summary Table of Delinquent Taxpayer Options

	Circumstances When Program Is Recommended	Eligibility	Submissions to the IRS	Results / Penalties
Streamlined - Foreign	U.S. non-resident whose delinquency is due to non-willful conduct	<ul style="list-style-type: none"> Non-resident for U.S. tax purposes Delinquency due to non-willful conduct 	<ul style="list-style-type: none"> 3 years of tax returns and information returns 6 years of FBARs Non-willful certification 	<ul style="list-style-type: none"> No penalties Payment of tax due with interest No final agreement
Streamlined - Domestic	U.S. resident whose delinquency is due to non-willful conduct	<ul style="list-style-type: none"> U.S. tax resident Delinquency due to non-willful conduct Taxpayer has not failed to file required U.S. income tax return in any of the three most recent tax years. 	<ul style="list-style-type: none"> 3 years of tax returns and information returns 6 years of FBARs Non-willful certification 	<ul style="list-style-type: none"> 5% offshore penalty Payment of tax due with interest No final agreement
Voluntary Disclosure Program	Taxpayer who is delinquent on domestic or offshore items with potential exposure to criminal liability and/or substantial civil penalties due to willful conduct	No specific requirements	<ul style="list-style-type: none"> 6 years of tax returns and information returns 6 years of FBARs 	<ul style="list-style-type: none"> 75% civil fraud penalty applies to tax year with highest tax liability Willful FBAR Penalties apply Penalties may be reduced

Quiet / Noisy / Prospective Disclosure	These alternative approaches are not recommended	No specific requirements	Either past returns with a statement (noisy), past returns with no statement (quiet), or submissions of returns only moving forward (prospective)	If the IRS discovers the delinquency, severe civil and criminal penalties can result.
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7. Form-Specific Amnesty Programs – Delinquent FBAR and International Information Return Procedures

Delinquent FBAR Submission Procedures (“DFSP”)

For U.S. expats who are delinquent only with respect to their FBAR filings, the DFSP offers an easy process through which they can submit missing FBARs without being subject to penalties. Under the program, one would be required to submit missing FBARs going back six years while including a brief statement explaining why the FBARs were filed late.

In order to be eligible for the program, the taxpayer would need to meet the following criteria:

- the taxpayer is not required to submit missing or amended tax returns (because all income was properly reported on the taxpayer’s original returns);
- the taxpayer is not under a civil examination or a criminal investigation by the IRS; and
- the taxpayer has not already been contacted by the IRS regarding their delinquent FBARs.

Assuming the taxpayer meets the above criteria, the IRS has stated that it will not impose a penalty for failure to file the delinquent FBARs.

Delinquent International Information Return Submission Procedures (“DIIRSP”)

These procedures offer an easy process for those who do not need to use one of the main amnesty programs to file delinquent or amended tax returns to report and pay additional tax, but who:

- have not filed one or more required international information returns (e.g., Form 5471 or Form 3520);
- have “**reasonable cause**” for not timely filing the information returns;
- are not under a civil examination or a criminal investigation by the IRS; and
- have not already been contacted by the IRS about the delinquent information returns.

Under these procedures, the taxpayer must file the delinquent information returns with a statement of all facts establishing reasonable cause for the failure to file. Assuming the taxpayer meets these criteria, the IRS will not impose a penalty for failure to file the delinquent information returns.

The IRS offers limited guidance in defining “reasonable cause.” A tax professional should be consulted to understand if reasonable cause is a viable claim under these procedures.