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by Lucy S. Lee

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The IRS Strikes Back: Strengthening Its Antievasion Toolbox

by Lucy S. Lee

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Lucy S. Lee is a shareholder with Greenberg Traurig LLP in Washington.

In this article, the author discusses the IRS's ability to deny U.S. passports to applicants with tax debts exceeding $51,000, as well as other tools the Service uses to combat tax avoidance.

The IRS is striking back. Empowered with a law authorizing the revocation or denial of U.S. passports to individuals with seriously delinquent tax debts, the Service is sending certifications of unpaid tax debt to the State Department to revoke the passports of a significant number of U.S. citizens.

The law was enacted December 4, 2015, as part of the "Fixing America's Surface Transportation Act" (FAST Act, P.L. 114-94). It provides for the revocation or denial of U.S. passports to applicants with "seriously delinquent" tax debt, defined to mean more than $51,000 (indexed for inflation) in unpaid federal taxes, including penalties and interest.[1] Seriously delinquent tax debt is limited to liabilities incurred under Title 26 of the U.S. code and does not include debts collected by the IRS like child support and foreign bank account report penalties.[2]

Under the FAST Act and IRC section 7345, the IRS can work through the U.S. Treasury to transmit a certification of a seriously delinquent tax debt to the State Department for the actual revocation or denial, and the IRS began doing so in February. The FAST Act also permits the State Department to cancel visas of individuals traveling to the United States on foreign passports. Thus, a dual national traveling to the United States on a foreign passport may be denied entry if he has a seriously delinquent U.S. tax debt.

The United States is one of only two nations to impose income, estate, and gift taxes based on citizenship (or lawful permanent residency — that is, green card status), irrespective of where an individual resides. The revocation or denial of a U.S. passport does not affect the individual's citizenship status, nor does it relieve the individual from her prior, current, or future tax reporting and payment obligations.

Rather, the law seeks to penalize noncompliant individuals by denying them the benefit of traveling on a U.S. passport while preserving tax liabilities. An individual wishing to renounce her U.S. citizenship (or green card) must voluntarily and with intent to relinquish appear before a U.S. consular or diplomatic officer in a foreign country and sign an oath of renunciation. Renunciations that do not meet those conditions generally do not have the effect of severing an individual's U.S. tax nexus.

A Matrix of Tax Obligations

The ability to revoke U.S. passports is one of the "power tools" the IRS uses to combat tax avoidance. Another is the ability to impose large

[1] *See also* IRC section 7345(a), authorizing the U.S. Treasury to transmit to the State Department information it receives from the IRS regarding seriously delinquent tax.

[2] Section 7345(b).

monetary and criminal penalties for failing to provide information, even if there is no associated tax liability. For example, a U.S. person[3] having a financial interest in, or signature or other authority over, any foreign financial accounts with an aggregate value exceeding $10,000 at any time during the calendar year must report that relationship by filing Financial Crimes Enforcement Network Form 114, "Report of Foreign Bank and Financial Accounts." He must also note on Schedule B of his federal income tax return that he has that foreign account filing requirement.

The individual must also include the income from those accounts on his U.S. income tax return, claiming a credit or deduction for foreign income taxes paid on that income.[4] Failure to file an FBAR can result in a civil penalty of $10,000 for a non-willful failure, or the greater of $100,000 or 50 percent of the value of all unreported foreign accounts for a willful failure.[5] There can also be criminal penalties.

An individual might also have to file a Form 8938, "Statement of Specified Foreign Financial Assets," if the value of her offshore financial assets exceeds a specific threshold.[6] The so-called specified foreign financial assets must be reported on Form 8938. These include:

- financial accounts maintained by a foreign financial institution;
- other foreign financial assets held for investment if they are not held at a financial institution, including stock or securities issued by a non-U.S. person, any interest in a foreign entity, and any financial instrument or contract whose issuer or counterparty is a non-U.S. person; and
- some other foreign financial assets, including interests in foreign pension or deferred compensation plans, foreign trusts or estates, and some foreign life insurance policies.

Although there are some exceptions for duplicative reporting (for example, for assets reported on Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations"), there is no exception for assets reported on an FBAR. Therefore, if required, both an FBAR and a Form 8938 must be filed, even if they report the same assets. Failure to file can result in an initial penalty of $10,000.

Further, U.S. persons (and some foreign persons) may be subject to information reporting requirements regarding their interests in foreign companies, partnerships, and trusts, as well as the receipt of large foreign gifts or inheritance. For example, a foreign grantor trust with a U.S. owner is required to provide the IRS with specific information regarding its identification, income, and assets.[7] Reporting of that information is generally required on Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner."

While the obligation to report information is imposed on the trustee, the failure to file the information, or to furnish all of it, can result in a monetary penalty against the U.S. owner equaling 5 percent of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of the tax year.[8]

Unlike foreign grantor trusts, foreign non-grantor trusts generally do not have an information reporting requirement (although a foreign trust is required to file a U.S. income tax return if it has income that is effectively connected with a U.S. trade or a business). However, U.S. persons who engage in or maintain specific transactions with foreign trusts during the year are generally required to report them on Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." Those reportable transactions are:

- ownership of a foreign grantor trust;

[3] The term "United States person" generally includes U.S. citizens and residents, domestic partnerships and corporations, and domestic trusts and estates. Section 7701(a)(30).

[4] *See* instructions for FinCEN Form 114.

[5] 31 U.S.C. sections 5321(a) and 5322(b).

[6] For taxpayers living in the United States, $50,000 ($100,000 for married taxpayers filing jointly) on the last day of the tax year, or $75,000 ($150,000 for married taxpayers filing jointly) at any time during the tax year; and for taxpayers living outside the United States, $200,000 ($400,000 for married taxpayers filing jointly) on the last day of the tax year, or $300,000 ($600,000 for married taxpayers filing jointly) at any time during the tax year.

[7] Section 6048(b).

[8] *See* also instructions for Form 3520-A. The instructions also reference potential penalties under section 6662(j) for undisclosed foreign financial asset understatements.

- transfer of property to a foreign trust — that is, the U.S. transferor must notify the IRS of the transfer and provide it with the identities of trustees and beneficiaries; and
- receipt of property or distribution from a foreign trust.[9]

Reporting is also required for any testamentary transfer of property, as well as on the death of a U.S. citizen or resident who was considered to own any portion of a foreign trust or whose estate included a foreign trust's assets.[10] For testamentary transfers and the death of a U.S. owner of a foreign trust, notice must be furnished by the decedent's executor.[11] The failure to timely file a Form 3520, or filing an incorrect or incomplete form, can result in penalties of up to 35 percent of the property transferred to or received from the trust.

Information reporting on Form 3520 is also required when a U.S. person receives in the aggregate gifts or bequests of more than $100,000 from a nonresident alien or a foreign estate during the year.[12] While a foreign person is not subject to the U.S. gift tax on gratuitous transfers of foreign property, the failure on the part of the U.S. recipient to disclose that kind of gift to the IRS can result in a monetary penalty of up to 25 percent of the gift.

Also, if a U.S. individual or company has some direct, indirect, or constructive ownership over a controlled foreign corporation, it must disclose the ownership interest by filing a Form 5471.[13] One form must be filed for each CFC. A CFC is a foreign corporation with U.S. shareholders that own (either directly, indirectly, or constructively) on any day of the corporation's tax year more than 50 percent of its total voting power or value.[14]

For determining whether a foreign corporation is a CFC, the term "U.S. shareholders" has a special meaning, referring only to U.S. shareholders that own at least 10 percent of that corporation's vote or value. Thus, for a foreign corporation to be considered a CFC, more than 50 percent of its outstanding vote or value must be owned in the aggregate by U.S. persons that each own at least 10 percent of its vote or value. Note that constructive ownership rules apply to attribute certain ownership between family members and related entities, including attribution through a "trust." That is, some beneficiaries of foreign trusts can be treated as indirectly engaging in the transaction with the foreign corporation owned by the trust. Note that similar reporting is required regarding foreign partnerships on a Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships."

Reporting on a Form 5471 is also required when a U.S. person acquires at least 10 percent of the vote or value of any foreign corporation.[15] For some transfers of property to a foreign corporation (including a cash transfer of $100,000 or more), additional reporting is required on a Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."[16]

Information reporting is also generally required for each year a U.S. person who is a direct or indirect shareholder of a passive foreign investment company recognizes gain on a direct or indirect disposition of PFIC stock; receives specified direct or indirect distributions from a PFIC; makes a reportable election, as outlined in Part 1 of the form; or includes income under an election to remove the PFIC taint by currently recognizing income — that is, the so-called mark-to-market or qualified election fund elections.[17] That information is reported on Form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund."

The failure to file forms 5471 or 8621 can result in a $10,000 penalty for each failure and serve as an exception to the general three-year statute of limitations for assessing tax. The failure to file a

[9] Section 6048(a). In Notice 97-34, 1997-25 IRB 22, the IRS clarified the notice requirements in section 6048(a). Form 3520, used to report transfers to foreign trusts, is filed with a U.S. transferor's annual income tax return.

[10] Section 6048(a)(3).

[11] Section 6048(a)(4).

[12] Section 6039F(a).

[13] Sections 6038 and 6046; instructions for Form 5471.

[14] Section 957(c).

[15] *Id.* Reporting on Form 8865 is also required for the acquisition of an interest in a foreign partnership of at least 10 percent.

[16] Sections 6038, 6038B, and 6046.

[17] Prop. Treas. reg. section 1.1291-1(i).

Form 926 can result in a penalty equal to 10 percent of the fair market value of the property (capped at $100,000) transferred at the time of the exchange.

The IRS has other power tools, some of which have been covered by the global press, including the civil and criminal actions undertaken not only against individuals failing to file FBARs, but also against their offshore banks and bankers. The IRS partners with the Justice Department to conduct criminal investigations of offshore banks for their role in helping U.S. persons evade U.S. taxes by hiding assets in non-U.S. accounts.

For example, the Justice Department offered a voluntary disclosure program to Swiss banks that may have had reason to believe that they had committed tax-related criminal offenses in connection with undeclared U.S.-related accounts. As a result, numerous banks entered into non-prosecution agreements in exchange for disclosing their cross-border activities and providing detailed information for accounts in which U.S. persons had a direct or indirect interest.

There is also the U.S. Foreign Account Tax Compliance Act, which effectively catapulted information disclosure into the global arena and established the common reporting standards under which financial institutions in many jurisdictions must now gather and share intricate personal and financial data with tax authorities.

Tax Implications of Leaving the United States

Perhaps motivated by the complications and burdens of the "tax matrix," some individuals are choosing to leave the United States. In fact, there has been a major uptick in the number of individuals surrendering their U.S. citizenship since 2013 (FATCA was enacted in 2010 and took effect in 2014). More people renounced their U.S. citizenship in 2016 than in any other year, followed by 2017.

For individuals surrendering their U.S. citizenship (or green card status), the cost of noncompliance can be significantly increased by the expatriation tax. Since 2008, the IRS has imposed that tax on some individuals who surrender their status as U.S. citizens or long-term green card holders. The expatriation tax is effectively an income tax imposed on a fictional sale of all the taxpayer's worldwide assets and on some items of deferred compensation and tax-deferred accounts at the time of expatriation.

In general, long-term residents (defined as green card holders for eight of the 15 years before expatriation) and U.S. citizens who renounce their citizenship or cease to be treated as lawful permanent residents are considered expatriates. Individuals considered covered expatriates are potentially subject to additional U.S. income taxation in the year that includes the expatriation date, which is the date on which an expatriate formally renounces her citizenship (or ceases to be treated as a lawful permanent resident). For U.S. citizens, that is the earliest of:

- the date the individual renounced her U.S. citizenship before a diplomatic or consular officer of the United States (if the voluntary renouncement is later confirmed by the issuance of a certificate of loss of nationality (CLN));
- the date the individual furnished to the State Department a signed statement of her voluntary relinquishment of U.S. citizenship (that is later confirmed by the issuance of a CLN);
- the date the State Department issued a CLN; or
- the date a U.S. court canceled the individual's certificate of naturalization.

For green card holders, the expatriation date is the earliest of:

- the date the individual voluntarily abandoned his lawful permanent resident status by filing Form I-407, "Record of Abandonment of Lawful Permanent Resident Status," with a U.S. consular or immigration officer;
- the date the individual became subject to a final administrative order that he abandoned his lawful permanent resident status;
- the date the individual became subject to a final administrative or judicial order to be removed from the United States under the Immigration and Nationality Act; or
- the date the individual made an election under an applicable income tax treaty to be treated as a tax resident solely of the treaty partner (the so-called residency tie-breaker

election), even if the election is intended to be temporary.

A covered expatriate is an expatriate that meets any of the following three requirements:

- had an average annual U.S. tax liability of at least $165,000 (2018, indexed for inflation) for the last five years;
- has a net worth of at least $2 million; or
- fails to certify that he has been fully U.S. tax compliant for the five years preceding the year that includes the expatriation date.

An individual considered a covered expatriate is subject to U.S. income tax on the appreciation of her worldwide assets as if the assets were sold the day before the expatriation date. Thus, the expatriation tax is essentially a mark-to-market tax that results in a deemed disposition of each asset a covered expatriate owns the day before expatriation, and the gains and losses are subject to tax as if the assets had been sold. A total exclusion of $711,000 (2018, indexed for inflation) may be applied to reduce the gain on the deemed sale.

The mark-to-market tax does not apply to interests in items of deferred compensation, specified tax-deferred accounts, and interests in some trusts. The rules for determining the exit tax imposed on those assets are more complex. Taxation of deferred compensation plans with a U.S. payer may be deferred until that payer makes an actual payment to the covered expatriate.

At the time of payment, the payer will deduct and withhold 30 percent of each taxable payment to the covered expatriate. To defer taxation, the covered expatriate must notify the payer of his status as a covered expatriate and irrevocably waive any right to claim any withholding reduction under any treaty with the United States. If a covered expatriate does not elect to defer the taxation of eligible deferred compensation, or if the payment is from a non-U.S. payer, each distribution will be subject to tax as if the covered expatriate received a distribution of the present value of the deferred compensation as of the day before expatriation.

Covered expatriates are subject to an exit tax on their specified tax-deferred accounts as if they received a distribution of their entire interest in the account on the day before expatriation, although no early distribution tax will apply. Covered expatriates are also subject to 30 percent withholding on future distributions from any non-grantor trust of which they are beneficiaries on the expatriation date.

Finally, gifts or bequests from a covered expatriate to a U.S. citizen or resident are subject to an inheritance tax under new section 2801. The tax will apply to the U.S. recipient of the gift or bequest.

An individual may be able to avoid the expatriation tax through proactive planning. To do so, however, an expatriate must certify that she has been tax compliant for the last five years. Long-term green card holders may be able in limited cases to avoid being regarded as long-term holders (thereby avoiding the expatriation tax) by making retroactive residency tie-breaker elections.

But I'm Not an American — Or Am I?

"I am your father," Darth Vader says in *The Empire Strikes Back*. With those few words, Luke Skywalker's world is turned upside down by the shocking truth that his father is none other than the once-heroic Jedi Knight who surrendered to the Dark Side and led the Empire's eradication of the Jedi Order.

Far less dramatically than Luke's discovery of his ancestry, many individuals are making the shocking discovery that they are Americans. Those so-called accidental Americans generally spend their childhood and a good portion of their adulthood believing in good faith that they are not Americans. The impetus for discovery may not be tax-related, but unfortunately, there may be significant tax consequences. Indeed, it appears quite common for discovery to be triggered by a simple question from an employer or accountant regarding one's birthplace or the nationality of one's parents.

Most individuals become U.S. citizens by virtue of being born in the United States or its possessions. Others do so by being born abroad while having at least one U.S. citizen parent (or grandparent) who meets specific U.S. residency requirements. A typical accidental American could be an individual with non-U.S.-citizen parents who was born in the United States and left at an early age, lived the rest of her life in a foreign country where she is a citizen or resident, and does not identify as an American.

Unbeknownst to them, accidental Americans have always been subject to the same tax matrix as other Americans — that is, U.S. income, estate, and gift taxation worldwide, as well as the same information reporting requirements. IRS enforcement efforts also equally apply. Thus, an accidental American whose status as a U.S. citizen comes to light could be liable for years of back U.S. income taxes, as well as related penalties and interest. The expatriation tax can also apply to accidental Americans. While accidental Americans can generally avoid it under a special exception for dual-nationals at birth, the exception will not apply to protect an accidental American who cannot certify that he has been tax compliant for the previous five years.

Curing Noncompliance — The Clock Is Ticking

So what options are available to an individual who may not have complied fully with his U.S. tax obligations? In a climate in which international tax enforcement tops the government's list of priorities, it is imperative that individuals and their tax advisers understand the intricacies of U.S. tax compliance and devise the best strategy to address any prior noncompliance.

There are several options available to an individual who may not have fully complied with his tax or other information reporting obligations. One of those options, the offshore voluntary disclosure program, ended September 28, 2018 (*see* IR-2018-52).

However, an individual with prior noncompliance can still use one of the streamlined filing compliance procedures. There are a few versions, depending on whether the individual lives in the United States or abroad, and on whether he has missing information returns only and has otherwise filed all returns and paid all taxes. For all streamlined filing procedures, he must be able to certify that failure to comply with U.S. tax rules was non-willful.

Under the streamlined procedure for individuals who live outside the United States, the requirement is to file three years of amended or original tax returns and all relevant information returns, and six years of FBARs. There will generally be no penalty, assuming the individual can certify that his noncompliance was not willful. With the streamlined procedures, the IRS might audit the returns, although as a practical matter the intention of the streamlined procedures is to provide an efficient method of coming back into compliance without the burden of a long audit.

Importantly, the IRS has announced that while the current version of the streamlined filing procedures will remain in place, it might end that program at some point as well. Thus, an individual with potential tax noncompliance should act swiftly to review his tax history and filing obligations and determine a course to remedy any prior mistakes. ■