SECTION 911 EXCLUSION: UNIQUE ELECTIONS, NEW CASE, LESSONS LEARNED

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In order to exclude foreign wages from gross income, U.S. taxpayers must make a proper Section 911 election.

The good news for Americans living and working abroad is that they might be able to exclude from their gross income (and thus avoid paying federal income taxes on) all or a portion of their foreign wages. The bad news is that, in order to claim this benefit, expatriates need to make a proper election under Section 911. This, like so many things in the tax world, is easy in theory, yet hard in practice. Countless taxpayers, along with legal and accounting professionals lacking sufficient international tax experience, are unfamiliar with the unique procedures for making a valid Section 911 election. They may also be unaware of the possible ways of correcting a filing oversight. A recent Tax Court case, *Redfield*,[1] serves as a parable, supplying various lessons about the importance of tax procedure, particularly for those working overseas.

Overview of Section 911

Section 911 generally allows individuals who meet certain requirements concerning either residency or physical presence in a foreign country to exclude from their gross income all or part of their foreign earned income.[2] Section 911 also allows qualified individuals to exclude or deduct some amounts related to foreign housing costs.[3] Once a taxpayer makes a Section 911 election for a particular year, it applies to all subsequent years, unless revoked.[4]

Section 911 does not specify the time and manner of making the election; rather, Congress directed the IRS to address this by regulation, mandating that the IRS "shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of [Section 911]."[5] This is consistent with the broader rule that "any election under [the Internal Revenue Code] shall be made at such time and in such manner as the [IRS] shall prescribe."[6]

The regulations under Section 911 contain the relevant procedural rules. They provide that an election must be made on Form 2555, Foreign Earned Income, or a comparable form and must contain information sufficient to determine whether the taxpayer is qualified for Section 911.[7] They further explain that, at a minimum, the election must include the following data:

(i) The individual's name, address, and social security number;

(ii) The name of the individual's employer;

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(iii) Whether the individual claimed exclusions under section 911 after 1981 and within the five preceding taxable years;

(iv) Whether the individual has revoked a previously made election and the taxable year for which such revocation was effective;

(v) The exclusion or exclusions the individual is electing;

(vi) The foreign country or countries in which the individual's tax home is located and the date when such tax home was established;

(vii) The status (either bona fide residence or physical presence) under which the individual claims the exclusion;

(viii) The individual's qualifying period of residence or presence;

(ix) The individual's foreign earned income for the taxable year including the fair market value of all noncash remuneration; and

(x) If the individual elects to exclude the housing cost amount, the individual's housing expenses.[8]

Taxpayers can make a Section 911 election in one of the following four manners:

Manner one. Taxpayers can attach Form 2555 to a timely Form 1040, U.S. Individual Income Tax Return, including any filing extensions.[9]

Manner two. Taxpayers can attach Form 2555 to a timely Form 1040X, Amended U.S. Individual Income Tax Return, amending a previously-filed, timely Form 1040.[10]

Manner three. Taxpayers can attach Form 2555 to a late Form 1040, if they file the Form 1040 within one year of its original due date, not counting extensions.[11]

Manner four. Taxpayers can attach Form 2555 with a Form 1040 filed *after* the periods described in Manner One, Manner Two, and Manner Three, on the following conditions:

- Manner Four A: If the taxpayer *owes no federal income tax* after taking into account the Section 911 exclusion, then he or she can file Form 1040 attaching Form 2555 either *before or after* the IRS discovers that he or she failed to make the election.[12]
- Manner Four B: If the taxpayer *owes federal income tax* after taking into account the Section 911 exclusion, then he or she must file Form 1040 attaching Form 2555 *before* the IRS discovers that he or she failed to make the election.[13]

Put another way, if a taxpayer has a federal income tax liability of $0 (assuming that the taxpayer were allowed to exclude the relevant amount of foreign earned income), then he or she can file a Form 1040 enclosing Form 2555 at any time, including after the IRS has already notified the taxpayer that it is aware of his or her failure to make a Section 911 election. However, if a taxpayer owes the IRS money (even after assuming that the taxpayer were allowed to exclude the relevant amount of foreign earned income), then the IRS will accept a late Section 911 election by the taxpayer only if he or she makes it before the IRS discovers the problem.

The regulations clarify that, if a taxpayer is filing a Form 1040 pursuant to Manner Four A or Manner Four B, then the taxpayer must type or legibly print the following at the top of the first page of the Form 1040: "Filed Pursuant to Section 1.911-7(a)(2)(i)(D)."[14]

As explained above, the validity of a Section 911 election made under Manner Four A or Manner Four B primarily depends on two factors: (1) whether the IRS has discovered that the taxpayer failed to make a Section 911 election, and (2) whether the taxpayer owes federal income tax on the relevant Form 1040 after considering the impact of the Section 911 exclusion. With respect to what constitutes discovery by the IRS, guidance can be found in the Internal Revenue Manual (IRM). It indicates that discovery by the IRS includes, among other things, launching an audit or issuing a substitute for return (SFR) before a taxpayer has filed a Form 1040 enclosing Form 2555.[15] Under the system of alleged voluntary compliance, the IRS is authorized to create a Form

1 TCM 2017-71.
2 Section 911(a); Reg. 1.911-1(a).
3 Section 911(a); Reg. 1.911-1(a); Section 911(c); Reg. 1.911-4.
4 Section 911(e)(1); Reg. 1.911-7(a)(1).
5 Section 911(d)(9).
6 Section 7805(d).
7 Reg. 1.911-7(a)(1).
8 Reg. 1.911-7(a)(1).
9 Reg. 1.911-7(a)(2)(i)(A).
10 Reg. 1.911-7(a)(2)(i)(B).
11 Reg. 1.911-7(a)(2)(i)(C).
12 Reg. 1.911-7(a)(2)(i)(D)(1).
13 Reg. 1.911-7(a)(2)(i)(D)(2).
14 Reg. 1.911-7(a)(2)(i)(D)(3).
15 IRM, section 21.8.1.2.8 (10-01-2007).

1040 for a taxpayer, called an SFR, when a taxpayer fails to voluntarily file a Form 1040 on his or her own. The relevant tax provision contains the following marching orders:

> If any person required by the Internal Revenue Code or by the regulations to make a return . . . fails to make such return at the time prescribed therefor, or makes, willfully or otherwise, a false, fraudulent or frivolous return, the [IRS] shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise. The [IRS] may make the return by gathering information and making computations through electronic, automated or other means to make a determination of the taxpayer's tax liability.[16]

Regarding whether a taxpayer "owes no federal income tax" after taking into account the Section 911 exclusion, the IRS has adopted a broad interpretation favoring taxpayers. The IRS's position is stated as follows in Chief Counsel Advice 200226010:

Section 911 generally allows individuals who meet certain requirements concerning either residency or physical presence in a foreign country to exclude from their gross income all or part of their foreign earned income.

> It is our position that the phrase "owes no federal income tax" [in the context of Manner Four], means that tax examiners should apply any payments, such as withholding tax, estimated tax, tax credit, etc. to offset any federal income tax liability, to determine whether the taxpayer "owes no federal income tax." The intent of this regulation section is to allow a taxpayer whose only income at issue is excluded foreign earned income to file a late section 911 election. Thus, the tax examiners should examine whether a taxpayer has a refund or a balance due. If the taxpayer has a refund or no balance due, [then] the taxpayer "owes no federal income tax" under [Manner Four] and does not need to request a private letter ruling from us.

Recent Tax Court cases

Redfield. The relevant facts in *Redfield* are sparse. The taxpayer was in the Marines for 12 years, eventually leaving as a disabled veteran suffering from memory loss and post-traumatic stress disorder. He accepted a civilian position in Afghanistan beginning in 2010. Unfortunately, soon after taking the job, his condition worsened, and he was obligated to quit and return to the U.S. before completing the one-year job. The taxpayer requested an automatic six-month filing extension for 2010, pushing the deadline to 10/15/11, but he never filed his 2010 Form 1040. Therefore, in May 2014, the IRS prepared an SFR, and soon thereafter, in September 2014, the IRS issued the taxpayer a notice of deficiency based on the earlier SFR.

The taxpayer did not file a petition with the Tax Court challenging the notice of deficiency; rather, like many taxpayers who are unfamiliar with the intricacies and importance of tax procedure, he filed a late 2010 Form 1040 enclosing a Form 2555 in an effort to exclude from gross income his wages from Afghanistan. Even after taking into account the Section 911 exclusion and the tax payments that he previously made, the 2010 Form 1040 still showed a tax liability of approximately $6,000.

After reviewing the late 2010 Form 1040, the IRS issued a second notice of deficiency, on which *Redfield* is based. In the notice of deficiency, the IRS disallowed the Section 911 exclusion because the taxpayer: (1) had not made a proper election in a prior year, and (2) failed to make a valid election for 2010. It also imposed penalties. After completion of the initial pleadings in the Tax Court, the IRS filed a motion for summary judgment.

The Tax Court began its analysis by giving an overview of Section 911 and stressing the need to make a valid Section 911 election in accordance with the regulations. It then indicated that all parties agreed that the taxpayer did not satisfy Manner One, Manner Two, Manner Three, or Manner Four A (because the 2010 Form 1040 still showed a tax liability of some $6,000 after taking into account the Section 911 exclusion). The sole focus of the Tax Court case, therefore, was whether the taxpayer had satisfied Manner Four B.

The IRS argued that the taxpayer did not meet Manner Four B because the IRS discovered the problem, prepared an SFR, and later issued a notice of deficiency before the taxpayer ultimately filed his 2010 Form 1040. The Tax Court agreed with the IRS, thus depriving the taxpayer of the benefits of Section 911. The Tax Court based its determination on its review of the clear language of the regulations, as well as a recent Tax Court case with "remarkably similar" facts, *McDonald*.[17] The Tax Court was sympathetic to the taxpayer's plight, but this could not, and should not, alter the legal result, which was based on the reading of the clear regulations under Section 911. The Tax Court justified its decision in the following manner:

> We acknowledge [the taxpayer's] military service to this country and recognize that he emerged far from unscathed from his tours of duty in Afghanistan. We understand that the procedural requirements for making a timely [Section 911] election are not exactly intuitive and that the scars [the taxpayer] incurred during his military service may have contributed to the tax delinquency at issue. While these facts may be relevant to the penalty and additions to tax that the IRS determined, they do not alter the requirement of a timely election. As to that requirement we must give effect to the regulations that the [IRS] has issued under [its] delegated authority from Congress and to this Court's prior construction of those regulations. That being so, we unfortunately have no alternative but to hold that [the taxpayer] did not make a timely and valid [Section 911] election for 2010. He is therefore not entitled to exclude from gross income any foreign earnings under Section 911.

As dicta, the Tax Court proceeded to explain that, even if the taxpayer had met the criteria for late-filing of the Section 911 election under Manner Four B, he still would have lost the case, because his 2010 Form 1040 lacked the magic words.

> [The taxpayer] did not follow the instruction set forth in [the Section 911 regulations], namely, that a taxpayer filing a return under these circumstances 'must type or legibly print the following statement at the top of the first page of the Form 1040: Filed Pursuant to Section 1.911-7(a)(2)(i)(D).' We need not decide whether this omission, standing alone, would be sufficient to invalidate an otherwise timely [Section 911] election.

McDonald. As indicated above, in proclaiming the IRS victorious in *Redfield*, the Tax Court relied on a case from just two years earlier, *McDonald*, involving a similar situation. In that case, the taxpayer left the U.S. in 2009 to work overseas. She never filed a 2009 Form 1040, so the IRS prepared an SFR for her based on the available data. A few months later, in April 2012, the IRS issued to the taxpayer a notice of deficiency based on the SFR. The taxpayer did not dispute the notice of deficiency by filing a timely petition with the Tax Court. Instead, a month after the IRS issued the notice of deficiency, in May 2012, the taxpayer filed her 2009 Form 1040, attaching a Form 2555, and enclosing a check to pay the full tax liability still showing on the 2009 Form 1040, after applying the Section 911 exclusion.

The IRS initiated an audit of the 2009 Form 1040, ultimately rejecting the Section 911 election for 2009 on grounds that the taxpayer: (1) had not made an election in an earlier year, (2) did not make a valid election for 2009, and (3) did not satisfy the special procedural rules in the Section 911 regulations. This resulted in increased taxes, plus late-filing, late-payment, and accuracy-related penalties, all of which were featured in the second notice of deficiency issued by the IRS. The taxpayer filed a petition with the Tax Court to challenge the second notice of deficiency, and, after the initial pleadings had ended, the IRS and the taxpayer each filed a motion for partial summary judgment.

The Tax Court recognized that the taxpayer did not meet Manner One, Manner Two, Manner Three, Manner Four A (because she still had a liability after applying Section 911), and Manner Four B (because the IRS had discovered the missing Section 911 election before the taxpayer made it). The Tax Court explained the following in quickly dispensing Manner Four B:

> [T]he IRS discovered that [the taxpayer] failed to make a valid election before she filed her Form 1040 for 2009. Specifically, the IRS discovered that she failed altogether to file any return—and thus discovered that she had failed to file Form 2555—no later than the date on which it issued the SFR in January 2012, i.e., months before [the taxpayer] filed her first Form 1040 for 2009 in May 2012.

Tax Cases as parables: A review of interesting issues

All Tax Court cases are parables; they are relatively short stories, featuring human characters, which, if one is paying attention, illustrate one or more instructive life lessons or principles. *Redfield* is no exception. Below are some interesting points raised by the case.

Seeking Section 9100 relief. It is interesting to note that the taxpayer in *Redfield*, who seemingly had a number of facts supporting the notion that he had "reasonable cause" for filing late the

[16] Reg. 301.6020-1(b)(1); Section 6020(b).
[17] TCM 2015-169.

Section 911 election (e.g., he is a disabled veteran, suffering from memory loss and post-traumatic stress disorder, whose first non-military job abroad was in 2010, and who was dealing with tricky and obscure rules regarding Section 911) did not take a procedural path that would have allowed him to present such facts; that is, seeking a private letter ruling from the IRS National Office pursuant to Reg. 301.9100-3.[18] Please note that obtaining permission from the IRS to file a late election via a private letter ruling request is commonly known as getting "Section 9100 relief."

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Section 9100 relief and Section 911 elections. If a taxpayer is not eligible to make a Section 911 election without prior approval from the IRS under Manner One, Manner Two, Manner Three, or Manner Four, then the taxpayer can proactively approach the IRS by filing a private letter ruling request under Reg. 301.9100-3 seeking permission to make a late election. This possibility is confirmed by two IRS informational documents, which state that "[i]n the event that you do not satisfy [Manner Four A or Manner Four B], you may request relief through the private letter ruling process under Treas. Reg. § 301.9100-3 for an extension of time to make a late Section 911 election."[19] It is further confirmed by the long list of private letter rulings, discussed below, exactly on point.

Applicable IRS policies. In formulating the standards for granting Section 9100 relief, the IRS has identified two policies that must be balanced. The first policy is promoting efficient tax administration by fixing limited time periods for taxpayers to choose among alternative tax treatments and to encourage prompt tax reporting. The second policy is "permitting taxpayers that are in reasonable compliance with the tax laws to minimize their tax liability by *collecting from them only the amount of tax they would have paid if they had been fully informed and well advised.*"[20]

Relief under Reg. 301.9100-3. The IRS has discretion to grant reasonable extensions for filing certain elections.[21] The regulations provide that extension requests "will be granted" by the IRS when the taxpayer provides sufficient evidence to establish to the satisfaction of the IRS that the following two factors have been met: (1) the taxpayer acted reasonably and in good faith, and (2) granting the extension will not prejudice the interests of the U.S. government.[22] These two factors are examined below.

The taxpayer acted reasonably and in good faith. With respect to the first factor, a taxpayer is generally deemed to have acted reasonably and in good faith if one of the following is true:

- The taxpayer requests Section 9100 relief before the IRS discovers the failure to make the election.
- The taxpayer failed to make the election because of intervening events beyond his or her control.
- The taxpayer failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), he or she was unaware of the necessity for the election.
- The taxpayer reasonably relied on the written advice of the IRS.

[18] This is likely due to the fact that the taxpayer lacked guidance from a qualified tax professional; the Tax Court notes that the taxpayer was advancing his case on a *pro se* basis.

[19] IRS INFO 2002-0017; IRS INFO 2002-0158.

[20] TD 8742, 12/30/97.

[21] Reg. 301.9100-1(c).

[22] Reg. 301.9100-1(c).

[23] Reg. 301.9100-3(b)(1). A taxpayer will not be considered to have reasonably relied on a qualified tax professional if the taxpayer knew or should have known that the tax professional was either not competent to render advice on the election or unaware of all the relevant facts. *See* Reg. 301.9100-3(b)(2).

[24] Reg. 301.9100-3(b)(3).

[25] Reg. 301.9100-3(c).

[26] Reg. 301.9100-3(c)(1)(i).

[27] Reg. 301.9100-3(c)(1)(ii).

[28] *See,* e.g, Ltr. Rul. 9203031; Ltr. Rul. 9206014; Ltr. Rul. 9208018; Ltr. Rul. 9209018; Ltr. Rul. 9210038; Ltr. Rul. 9223044; Ltr. Rul. 9233011; Ltr. Rul. 9304027; Ltr. Rul. 9325016; Ltr. Rul. 9325019; Ltr. Rul. 9325051; Ltr. Rul. 9325053; Ltr. Rul. 9325058; Ltr. Rul. 9328022; Ltr. Rul. 9328023; Ltr. Rul. 9329006; Ltr. Rul. 9329007; Ltr. Rul. 9330014; Ltr. Rul. 9330041; Ltr. Rul. 9332013; Ltr. Rul. 9332043; Ltr. Rul. 9337015; Ltr. Rul. 9814025; Ltr. Rul. 200116027; Ltr. Rul. 200321007; Ltr. Rul. 200450031; Ltr. Rul. 201119011; Ltr. Rul. 201347016; Ltr. Rul. 201507013; Ltr. Rul. 201507016; Ltr. Rul. 201539018; and Ltr. Rul. 201650006.

- The taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the relevant election.[23]

Notwithstanding the general rules described above, a taxpayer will be deemed *not* to have acted reasonably and in good faith if any of the following is true:

- The taxpayer seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under Section 6662 at the time the taxpayer requests Section 9100 relief, and the new position requires or permits a regulatory election for which relief is requested.
- The taxpayer was informed in all material respects of the required election and related tax consequences, but chose not to file the election.
- The taxpayer uses hindsight in requesting Section 9100 relief. In other words, if specific facts have changed since the due date for making the election that make the election more advantageous to a taxpayer now, the IRS will not ordinarily grant relief. In such cases, the IRS will grant an extension request only when the taxpayer provides "strong proof" that the taxpayer's decision to seek relief did not involve hindsight.[24]

The government's interests will not be prejudiced. With respect to the second element, the regulations contain the two standards that the IRS uses in determining whether the interests of the U.S. government would be prejudiced by the granting of an extension request.[25]

First, they provide that the interests of the U.S. government are prejudiced if granting the extension request would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the election than the taxpayer would have had if the election had been timely made, taking into account the time value of money.[26]

Second, the regulations indicate that the interests of the U.S. government are ordinarily prejudiced if the assessment period for the tax year in which the election should have been made, or the assessment period for any tax years that would have been affected by the election had it been timely made, are closed.[27] This serves to ensure that what is good for the goose is good for the gander. If the IRS is precluded from assessing tax, penalties, and interest against a taxpayer because the assessment period for a particular year has already expired, then the taxpayer cannot go back to that year and take unfair advantage.

A review of helpful private letter rulings. The IRS has issued several private letter rulings granting Section 9100 relief to expatriate taxpayers under a wide variety of circumstances. These usually involve some combination of ignorance of the law, misunderstanding of filing duties and thresholds, incorrect information given by multinational companies, loss or theft of tax-related documentation while abroad, and reasonable reliance on bad advice from qualified tax professionals.[28]

Similar to the situation in *Redfield*, the IRS has offered Section 9100 relief to multiple taxpayers, despite the fact that the IRS discovered the problem before the taxpayer filed a Section 911 election. Summaries of the relevant PLRs, none of which was cited by the taxpayer in defending his position before the Tax Court, are set forth below.

- Ltr. Rul. 9205029. The taxpayer worked for a company abroad for several years. Based on a memorandum about tax duties that the taxpayer received from the company each year, he did not file Forms 1040 for three consecutive years. The taxpayer later learned, as a result of correspondence from the IRS, that he was required to file Forms 1040. By that time, the relevant filing deadlines had passed. The IRS granted Section 9100 relief.
- Ltr. Rul. 9230007. The taxpayers started working abroad. Before the deadline for filing the relevant Form 1040, the taxpayers hired an ac-

countant to prepare and file the Form 1040 and provided such accountant with all necessary information. After the filing deadline, the taxpayers discovered, from a letter from the IRS, that the accountant had not filed the Form 1040. The taxpayers confronted the accountant, who admitted to the IRS in the form of an affidavit that he was hired to prepare the Form 1040 and he was given all the appropriate data, but he was unable to complete the Form 1040 because of a serious health problem. The IRS granted Section 9100 relief.

To prevent problems from occurring or to avoid exacerbating matters once they have gone wrong, expatriates should seek assistance from professionals experienced in the finer points of international tax.

- Ltr. Rul. 93333029. The taxpayer was doing public service in Haiti during 1986 and 1987. Apparently, the taxpayer attempted to send her 1986 Form 1040 to the IRS from Haiti in mid-1987, but it was never received by the IRS. In May 1990, the taxpayer received a notice from the IRS requesting that she file her 1986 Form 1040, in response to which the taxpayer sought Section 9100 relief. The IRS granted it.
- Ltr. Rul. 9413010. At the request of his employer, the taxpayer completed an annual statement to elect the benefits of Section 911. The taxpayer believed, incorrectly but in good faith, that he was exempt from U.S. taxes on foreign income and was not required to file a Form 1040 by furnishing this statement to his employer. The taxpayer first learned of his error when the IRS "inquired" about his missing Forms 1040. The IRS granted Section 9100 relief.
- Ltr. Rul. 9533044. The company's standard procedure when transferring a U.S. person abroad involved having the departing person sign a "Section 911 Exclusion Statement." The taxpayer did so, thereby triggering the erroneous belief that he was not obligated to file Forms 1040 while overseas. The IRS contacted the taxpayer about his unfiled 1982 Form 1040 in 1987. Even after taking into account the Section 911 exclusion, the taxpayer still had a U.S. tax liability showing on the 1982 Form 1040. Nevertheless, the IRS granted Section 9100 relief.
- Ltr. Rul. 9547044. Before taking a position with an international organization in France in 1989, the taxpayer met with a tax manager at a Big Six accounting firm specializing in expatriate taxation. The taxpayer discussed the concept of Section 911 during the meeting, but the exact procedures and requirements for making the election were not addressed. In 1992, the taxpayer retained a lawyer in France to assist with completing Forms 1040 for 1989 and 1990. It took the lawyer considerable time to finish this task because of his heavy workload and the delay by the international organization in sending the funds to cover the U.S. tax liability, even after applying Section 911. While waiting, the IRS sent an "inquiry" about the noncompliance. The IRS granted Section 9100 relief anyway.
- Ltr. Rul. 9613022. In 1990, the taxpayer left Iowa with the intention of establishing permanent residency in Brazil. The taxpayer believed that she was not required to file Forms 1040 for the time that she was in Brazil. In late 1992, the taxpayer learned that she was required to file a 1990 Form 1040. The taxpayer then retained an accountant. The 1990 Form 1040, filed in 1995, showed that the taxpayer still owed tax after taking into account the Section 911 exclusion. By this time, the IRS had already sent a notice of levy concerning 1990 to the taxpayer's last known address, which was in the U.S. The IRS granted Section 9100 relief.
- Ltr. Rul. 200631005. The taxpayer started working for a company in a foreign country. She received a letter from the company explaining that the U.S. taxes that she was required to pay while abroad would be deducted from her wages through the normal payroll process. Based on this letter, the taxpayer believed that the company would be doing all that was necessary regarding her U.S. tax duties, and the Forms W-2 were sent by the company to her U.S. address. Accordingly, the taxpayer never filed Forms 1040 while away. After returning to the U.S., the taxpayer received a notice from the IRS asking about the unfiled Forms 1040. She then hired accountants, who filed the missing Forms 1040 enclosing Forms 2555. The IRS granted Section 9100 relief.
- Ltr. Rul. 200633006. The taxpayer served in the military, retired, and then took a civilian

[29] Section 6212(a).

[30] Section 6213(a).

[31] Section 6213(a).

[32] Rev. Proc. 98-54, 1998-2 CB 531, section 4.02; IRM, section 8.2.2.14 (10/24/07).

position abroad. The company for which he was working told him that his foreign wages would be exempt from U.S. taxes, and the taxpayer was unaware of the need to make a Section 911 election. The taxpayer, while in the process of a divorce, failed to file Forms 1040 for three straight years. The IRS sent him a notice about the unfiled Forms 1040, and the taxpayer responded by hiring an accountant to get compliant. The IRS granted Section 9100 relief.

Possibility of the IRS rescinding the notice of deficiency. Because SFRs are prepared by the IRS based exclusively on information from third-parties, in situations where taxpayers have not voluntarily filed their own Forms 1040, they are likely to be incomplete and inaccurate. In *Redfield*, the IRS generated an SFR for the taxpayer and then issued a notice of deficiency based on such SFR. The taxpayer failed to file a timely petition disputing the SFR, and he overlooked another possibility, too. He might have considered asking the IRS to rescind the notice of deficiency, such that he could file his Form 1040, without the stress and expense of Tax Court litigation, and then resolve the matter on an administrative level.

The IRS has the right to issue a notice of deficiency to a taxpayer to propose a shortfall in taxes and assert related penalties.[29] The taxpayer generally has 90 days to file a petition with the Tax Court disputing the notice of deficiency.[30] If the taxpayer fails to do so, then the IRS is authorized to "assess" the amounts claimed in the notice of deficiency (i.e., put them on the IRS's books as a tax debt) and start taking collection actions, including filing tax liens and effectuating levies.[31] Most taxpayers and their representatives are aware of these general rules, but they are often ignorant of a relatively obscure tool, the possibility of getting a notice of deficiency withdrawn.

Section 6212(d) states that the IRS may, with the consent of the taxpayer, rescind any notice of deficiency issued to such taxpayer. The IRS is not required to rescind anything; the action or inaction by the IRS is within its sole discretion.[32] IRS guidance indicates that rescission might be appropriate when: (1) the issuance of the notice of deficiency was an administrative error (because it was issued to the wrong taxpayer, for the wrong period, or prematurely because the IRS neglected to consider the assessment-period extension that the taxpayer granted to the IRS); (2) the taxpayer submits information to the IRS showing that the actual tax due is less than the amount shown in the notice of deficiency; or (3) the taxpayer requests a conference with the Appeals Office for purposes of entering into a settlement, and the Appeals Office agrees that the case is susceptible to settlement.[33] However, the IRS makes clear that a notice of deficiency cannot be rescinded if the 90-day period during which the taxpayer could have filed a petition with the Tax Court has expired or if the taxpayer has already filed a timely petition.[34] Rescission ordinarily is carried out by the IRS and the taxpayer executing a Form 8626, Agreement to Rescind Notice of Deficiency, although this can also occur if the IRS issues a document containing all necessary data.[35] IRS guidance expressly states that a properly executed Form 8626 or an acceptable alternative document "is the only way that a Notice of Deficiency may be rescinded."[36] According to legislative history, Congress introduced the notion of rescission for purposes of efficiency, preserving time and resources:

> In a number of cases, both the IRS and the taxpayer would prefer that the statutory notice [of deficiency] be withdrawn so that the matter can be disposed of administratively without the involvement of the Tax Court. Therefore, the committee has determined that it is appropriate, where both the IRS and the taxpayer agree, to permit withdrawal of the statutory notice. This will permit the matter to be disposed of in the most efficient way.[37]

Common international information return problems. *Redfield* is solely a federal income tax case, with no mention of other problems, such as the taxpayer's failure to file with the IRS certain international information returns, either as attachments to the 2010 Form 1040 or separately. However, the reality is that, while this might not have been an issue for the taxpayer in *Redfield*, most taxpayers living and working abroad also hold an interest in various foreign accounts or other foreign financial assets, which must be disclosed to the IRS, as explained below.

A U.S. person ordinarily has several duties if he or she holds a financial interest in a foreign account whose balance surpasses the relevant thresholds: (1) report all income deposited into the account on Form 1040; (2) report all passive income (e.g., interest, dividends, capital gains) generated by the account on Form 1040; (3) check the "yes" box in Part III (Foreign Accounts and Trusts) of Schedule B to Form 1040, disclosing both the existence and location of the foreign account; (4) enclose a Form 8938, Statement of Specified Foreign Financial Assets, with Form 1040; (5) if the account holds any foreign mutual funds, enclose a Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, with Form 1040; and (6) separately e-file a FinCEN Form 114 (FBAR).

Failure to meet any of the preceding duties can lead to severe penalties for taxpayers. For instance, even in a relatively benign case, underreporting of income triggers back taxes, accuracy-related penalties, and interest charges.[38] Moreover, if the taxpayer fails to file Form 8938 in a timely manner, the IRS can assert a penalty of $10,000 per year.[39] Finally, neglecting to file an FBAR can spark huge sanctions. In the case of "non-willful" violations, the maximum penalty is $10,000 per unreported account, per year.[40] The FBAR penalty increases significantly, although, where a taxpayer's inaction is deliberate; the IRS may assert a fine equal to $100,000 or 50% of the balance in the account at the time of the violation, whichever amount is larger.[41] Because the FBAR penalty can reach 50% of the account balance each year, and because the general assessment period for FBAR penalties is six years from the time of the violation, it is not atypical to see a

[33] Rev. Proc. 98-54, section 4.04; IRM, section 8.2.2.14.2 (10/24/07).

[34] Rev. Proc. 98-54, section 4.05.

[35] Rev. Proc. 98-54, section 5.

[36] Rev. Proc. 98-54, section 5.07.

[37] H. Rep.'t No. 426, 99th Cong., 1st Sess., 1995 (p. 843); *see also*, S. Rep.'t No. 313, 99th Cong., 2nd Sess., 9186; H. Rep.'t No. 841, 99th Cong., 2nd Sess., 1986.

[38] Section 6662.

[39] Section 6038D(d)(1); Reg. 1.6038D-8(a).

[40] 31 U.S.C. section 5321(a)(5)(B)(i).

[41] 31 U.S.C. sections 5321(a)(5)(C)(i), (D)(ii).

[42] Section 6038(b)(1); Reg. 1.6038-2(k)(1)(i); Section 6046(f); Reg. 1.6046-1(k).

[43] Section 6038(b)(2); Reg. 1.6038-2(k)(1)(ii); Section 6046(f); Reg. 1.6046-1(k).

[44] Section 6501(c)(8)(B) contains a limitation, stating that the assessment period will remain open only with respect to "the item or items" related to the late Form 8938 if the taxpayer can demonstrate that the violation was due to reasonable cause and not due to willful neglect.

situation where the penalties asserted by the IRS for failure to report accounts far exceeds the maximum amount that was ever held in such accounts.

Several other international information returns exist, including, but not limited to, Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations; Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation; Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships; Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities; and Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Penalties for not filing these types of returns can add up. For example, if a person fails to file a Form 5471, files a late Form 5471, or files a timely but "substantially incomplete" Form 5471, then the IRS may assert a penalty of $10,000.[42] This penalty increases on a monthly basis, to a maximum of $50,000, if the problem persists after notification by the IRS.[43]

It is important to note that failure to timely file all applicable international information returns (except the FBAR) not only triggers a penalty, but also gives the IRS an unlimited period to audit the Form 1040 to which the information returns should have been attached, and then assess additional taxes, penalties, and interest charges. A relatively obscure procedural provision, Section 6501(c)(8)(A), contains a powerful tool for the IRS. It generally states that where a taxpayer does not properly file a long list of international information returns, the assessment-period remains open "with respect to any tax return, event, or period" to which the information returns relate until three years after the taxpayer ultimately files the information returns.[44] Consequently, if a taxpayer never files, for example, a Form 8938, Statement of Specified Foreign Financial Assets, to reveal his or her interest in foreign financial assets, then the three-year assessment-period never begins to run against the IRS. This prevents taxpayers with undisclosed foreign assets from running out the clock, so to speak, on the IRS.

Resolving Section 911 and related international problems. As indicated above, *Redfield* involves only federal income taxes; it does not allude to any violations for unreported foreign assets. However, in most instances where a U.S. individual is living and working abroad, particularly for prolonged periods, the problems are not limited to just failures to file timely Forms 1040 and pay all corresponding U.S. taxes. In such cases, taxpayers can take advantage of five current options, offered by the IRS, for resolving international tax noncompliance in past years. These options are: (1) participating in the 2014 Streamline Foreign Offshore Procedure (SFOP); (2) participating in the 2014 Streamline Domestic Offshore Procedure (SDOP); (3) participating in the 2014 Offshore Voluntary Disclosure Program (OVDP); (4) filing late FBARs on a penalty-free basis pursuant to the Delinquent FBAR Submission Procedure (DFSP); or (5) filing late information returns (other than FBARs) on a penalty-free basis according to the Delinquent International Information Return Submission Procedures (DIIRSP).

Reciting the details of each of the five voluntary disclosure programs is well beyond the scope of this article. Suffice it to say that a U.S. individual, living and working abroad, who did not file Forms 1040 attaching Forms 2555 to secure the Section 911 exclusion, and who unintentionally failed to file international information returns to report foreign financial assets, would not be eligible for the DIIRSP and DFSP (because these programs are generally limited to taxpayers who previously reported all foreign income and paid all taxes related to foreign assets but inadvertently overlooked the related information returns) and would not be eligible for the SDOP (because filing timely, though inaccurate, Forms 1040 is a prerequisite for this program). These types of taxpayers likely would shy away from the OVDP, participating only as a last resort, because this program features the highest "offshore" penalty, equal to 27.5% or 50% of the highest total value of the noncompliant foreign assets, and demands tax filings for the largest number of past years. Taxpayers, like the one in *Redfield*, generally would prefer to resolve matters through the SFOP.

In order to be eligible to participate in the SFOP, a taxpayer (who is a U.S. citizen or green card holder) must meet the following criteria: (1) the taxpayer was physically outside the U.S. for at least 330 days in one or more of the past three years; (2) the taxpayer did not have an "abode" in the U.S. during the relevant year or years; (3) the taxpayer either failed to file annual Forms 1040 with the IRS or filed annual Forms 1040 that did not properly report all income from everywhere in the world; (4) the taxpayer might have also failed to file with the IRS the proper international information returns; (5) the failure to report all income to the IRS, as well as the failure to file all proper international information returns, was the result of "non-willful" conduct by the taxpayer; (6) neither the IRS nor the U.S. Department of Justice has initiated a civil examination or criminal investigation of the taxpayer or a related party; and (7) the taxpayer is an individual (or the estate of an individual) because the SFOP is not open to business entities.

Under the SFOP, taxpayers are required to file Forms 1040 for only the past three years, international information returns (other than FBARs) for the past three years, and FBARs for the past six years. Most importantly, the IRS does not impose any penalties whatsoever on taxpayers who successfully participate in the SFOP.

Conclusion

The foreign earned income exclusion under Section 911 can be a significant boost to taxpayers, provided that they are aware of the benefit and how, exactly, to claim it. As evidenced by *Redfield*, many expatriates are unfamiliar with the special election procedures in the Section 911 regulations, as well as various alternatives for fixing a blown election. Taxpayers who are ignorant of Section 911 matters might also be in the dark about the duty to file information returns to report foreign financial assets, along with the series of voluntary disclosure programs offered by the IRS to rectify unintentional violations. To prevent problems from occurring or to avoid exacerbating matters once they have gone wrong, expatriates should seek assistance from professionals experienced in the finer points of international tax.

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