TAX 101:
U.S. TAX COMPLIANCE FOR DUAL CITIZEN YOUNG ADULTS

Authors
Nina Krauthamer
Wooyoung Lee
Stanley C. Ruchelman

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INTRODUCTION

It is not uncommon for a young adult who was born in the U.S. to noncitizen parents living temporarily in the U.S. to live abroad. Although he or she may never have returned to the U.S., the young individual is a U.S. citizen, and that status brings with it U.S. tax obligations. In many cases, the young adults may not have had income or personal property, and therefore may not have had reason to file a U.S. tax return. As those young adults graduate from university and enters the workforce, or become the recipients of gifts and bequests, the matter of U.S. tax filing obligations becomes more significant.

Consider Ms. A, a typical young adult, born in the U.S. but living abroad. She may have a bank account in a foreign county, but ordinarily will not have her own source of income. At some point, Ms. A may receive gifts and bequests from her foreign parents or grandparents. At this point in her life, Ms. A's U.S. tax compliance obligations become complex. Because of her fact pattern, she faces many complex filing obligations simply because she resides abroad and almost all of her employment income, investment gains, and family gifts may need to be reported to the I.R.S. Moreover, compliance failures can generate stiff penalties. Ms. A's family may wonder whether she should relinquish her U.S. citizenship. Taking that action triggers further tax obligations and is not a straightforward solution in many instances.

This article discusses the U.S. tax obligations of Ms. A, and suggests two paths forward to exit the U.S. tax system, based on her age.

U.S. INCOME TAX

The most significant filing will be Form 1040 (*U.S. Individual Income Tax Return*). All U.S. citizens are required to report worldwide income and pay income tax to the I.R.S. regardless of where they live. While the due date of this return generally is April 15 of the following year, if Ms. A resides outside the U.S., and works or attends university on a full-time basis outside the U.S., she may qualify for an automatic two-month extension to file a tax return. This automatic extension of the filing date does not extend the time for payment of tax. Interest will be due for amounts not paid by April 15.

If an individual who lives outside the U.S. is not able to file a return by the end of the two-month extended period, she may file for an automatic four-month extension by filing Form 4868 (*Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*) by June 15 following the close of the taxable year. If timely filed, the tax return is due not later than October 15. In addition to the extension to October 15, taxpayers who are based outside the U.S. can request a discretionary

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two-month additional extension of time to file tax returns to December 15. It is customary for the I.R.S. to grant the extension. If for any reason the I.R.S. denies the request, it nonetheless extends the due date of the return until 10 days from the date of the denial.

The young adult may be required to make estimated tax payments during the course of the year on Form 1040-ES. Estimated tax rules apply a "pay-as-you-go" system for tax and is the method used to pay tax on income that is not subject to U.S. withholding, meaning income other than salaries. This includes income from self-employment, interest, dividends, rent, gains from the sale of assets, prizes, and awards. If the taxpayer does not pay enough estimated tax throughout the year, the I.R.S. will impose a penalty based on interest rates set by the I.R.S. for the late payment.

FOREIGN INCOME AND TAXES

If another country imposes tax on Ms. A's income, the U.S. will allow her to claim a foreign tax credit for the taxes paid to that other country. Foreign tax credit computations are made on Form 1116 (*Foreign Tax Credit (Individual, Estate, or Trust)*). Note that the income that is taxed by the foreign country must be considered foreign-source income under U.S. tax concepts in order for the credit to provide a benefit. Changes to I.R.S. regulations applicable to foreign tax credits require a jurisdictional nexus between the income and the foreign tax. Even if the nexus exists, U.S. law generally does not allow the foreign tax credit to offset U.S. tax on U.S. source income.

If Ms. A resides and works abroad, a foreign earned income exclusion and a deduction or an exemption for foreign housing amounts may be available to her when computing her taxable income. Form 2555 (*Foreign Earned Income*) is used for this purpose. If certain requirements are met, an individual may exclude up to $112,000 of foreign-earned income in 2022. In addition, up to $15,680 may be excluded or deducted in 2022 for the foreign housing amount. The maximum amount of those foreign benefits is adjusted annually to reflect inflation.

To claim the foreign-earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, Ms. A must meet all three of the following requirements:

- Her tax home must be in a foreign country. A tax home is the general area of a person's main place of business, employment, or post of duty, regardless of where she maintains a family home. If a person does not have a regular or main place of business because of the nature of her work, her tax home may be the place where she regularly lives. If she has neither a regular or main place of business nor a place where she regularly lives, she is considered to be an itinerant and her tax home is wherever she works at any particular time.
- She must have foreign earned income.
- She must be either (i) a U.S. citizen who is a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, generally January 1 through December 31, or (ii) a U.S. citizen who is physically present in a foreign country for at least 330 full days during any period of 12 consecutive months.

FOREIGN BANK ACCOUNTS

If Ms. A opens a U.S. bank or brokerage account, Form W-9 is required to be filed in addition to any forms that are required under the Common Reporting Standard because of her tax residence. The form provides the bank or brokerage firm with, among other things, the person's Social Security Number ("S.S.N."). A U.S. citizen who does not have a S.S.N. can apply for one on Form SS-5.

If Ms. A opens a foreign bank or brokerage account, two reporting forms must be completed and timely filed, identifying both U.S. citizenship and tax residence outside the U.S.

The F.B.A.R. form (FinCEN Form 114 (*Report of Foreign Bank and Financial Accounts*)) is used to report a U.S. citizen's financial interest in or signature authority over one or more foreign financial accounts when the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year. The F.B.A.R. is filed with the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Treasury Department.

Ms. A is considered to have a financial interest in a foreign financial account in any of the following circumstances:

- She is the owner of record or holder of legal title over a foreign financial account.
- She owns directly or indirectly more than 50% of the total value of shares of stock or more than 50% of the voting power of all shares of stock of a corporation that is the owner of record or holder of legal title over a foreign financial account.
- She owns directly or indirectly an interest in a partnership that is the owner of record or holder of legal title over a foreign financial account and she is entitled to more than 50% of the partnership's profits or holds more than 50% of the partnership capital.
- She is a beneficiary of a trust that is the owner of record or holder of legal title over a foreign financial account and holds a present beneficial interest that is greater than 50% in the assets or income of the trust for the calendar year where the trust.
- She (a) owns more than 50% or the income interests, equity, or voting power of an entity that is not a corporation or (b) is the grantor of a grantor trust under U.S. tax law where the entity or the trust is the owner of record or holder of legal title over a foreign financial account.

A U.S. person has signatory authority over a foreign financial account where, alone or in conjunction with others, she has the authority to control the disposition of assets held in a foreign financial account by direct communication to the bank or other financial institution that maintains the financial account.

The F.B.A.R. must be filed electronically by April 15 following the close of a calendar year. If an extension of time is obtained regarding the filing of a U.S. income tax return, the filing date is extended to October 15. The fact that the filing date for the income tax return is extended to December 15, does not extend the due date of the

F.B.A.R. Penalties may be imposed for a failure to comply, which can be severe if willful. Civil penalties for a nonwillful failure to report do not exceed $10,000 per non violation in the absence of reasonable cause. The ceiling is adjusted each year for inflation. In 2022, the ceiling is $12,921. Currently, a split of opinion exists among the Circuit Courts of Appeal as to whether the nonwillful penalty is imposed separately for each account that is unreported or once for each F.B.A.R. form that is not timely filed. Civil penalties for a willful failure to report do not exceed the greater of $100,000 per willful violation or 50% of the highest balance in the unreported account in the absence of reasonable cause. The dollar denominated ceiling is adjusted each year for inflation. In 2022, the ceiling is $129,210.

In the above discussion, it is implicitly assumed that Ms. A never owned or had a financial interest in a financial account having a balance of $10,000 or its equivalent in foreign currency in any year prior to turning 18 years of age. If one or more accounts having a balance of $10,000 or the equivalent in foreign currency existed, the F.B.A.R. obligation existed during minority according to the FinCEN *BSA Electronic Filing Requirements For Report of Foreign Bank and Financial Accounts (FinCEN Form 114), Release Date January 2017 (v1.4)*,[1] which provides as follows regarding minors at page 6:

> **Responsibility for Child's FBAR**
>
> Generally, a child is responsible for filing his or her own FBAR report. If a child cannot file his or her own FBAR for any reason, such as age, the child's parent, guardian, or other legally responsible person must file it for the child.
>
> **Signing the child's FBAR.** If the child cannot sign his or her FBAR, a parent or guardian must electronically sign the child's FBAR. In item 45 Filer Title enter "Parent/Guardian filing for child."

Form 8938 (*Statement of Specified Foreign Financial Assets*) is a form that is included in an annual income tax return to report specified foreign financial assets when the total value of all the specified foreign financial assets in which a U.S. citizen has an interest meets or exceeds a specified reporting threshold. For an unmarried individual such as Ms. A who resides outside the U.S., reporting is required if the total value of specified foreign financial assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the tax year. If Ms. A were to reside in the U.S.in the future, reporting will required if the total value of specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year. The dollar thresholds for reporting will be increased once Mrs. A becomes married. If she continues to live outside the U.S. and files a joint income tax return with her husband, the thresholds will be more than $400,000 on the last day of the tax year or more than $600,000 at any time during the tax year. If Ms. and her husband move to the U.S. and file a joint income tax return, the thresholds will be more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year.

Ms. A will be considered to reside outside the U.S. if she is entitled to claim the benefit of the foreign earned income exclusion under the standards discussed above. Thus, she must be a *bona fide* resident of a foreign country or countries for an

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[1] See here.

uninterrupted period that includes an entire tax year, or she must be physically present in a foreign country for at least 330 full days during any period of 12 consecutive months.

Specified foreign financial assets include the following assets:

- Financial accounts maintained at a foreign financial institution
- Stock or securities issued by a non-U.S. entity
- Any interest in a foreign entity
- Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person
- A beneficial interest in a trust unless the beneficiary neither knows nor has reason to know that she is a beneficiary
- An interest in a foreign pension plan

If a financial asset is denominated in foreign currency, the maximum value of the asset must be determined in that currency and converted to U.S. dollars, using the currency exchange rate for the last day of the tax year. Assets need not be reported on Form 8938 if reported on certain other forms (*e.g.*, Form 3520, discussed below).

"If Ms. A does not file Form 8938 or fails to report a specified foreign financial asset, the statute of limitations for the tax year may remain open for all or a part of the entire income tax return until three years after the date on which a complete Form 8938 is filed."

If Ms. A does not file Form 8938 or fails to report a specified foreign financial asset, the statute of limitations for the tax year may remain open for all or a part of the entire income tax return until three years after the date on which a complete Form 8938 is filed. If Ms. A does not include in gross income any amount relating to one or more specified foreign financial assets, and the amount omitted is more than $5,000, any tax she owe for the tax year can be assessed at any time within six years after she files a return.

FOREIGN TRUST DISTRIBUTIONS AND GIFTS

Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) is used by a U.S. person to report the receipt of certain large gifts from a foreign person and the receipt of distributions from a foreign trust.

In order for a gift from a foreign individual to be reportable by Ms. A, the gift must exceed $100,000. To determine if Ms. A received gifts in excess of $100,000 from a particular foreign individual, she must aggregate gifts from foreign persons that she knows or has reason to know are related to each other, such as husband and wife donors or father and grandfather donors. Once the $100,000 threshold is met, the donee describes each gift in excess of $5,000 but does not have to identify the donor on the form.

Form 3520 is due on the due date, including extensions, of Ms. A's income tax return and must be sent to the Internal Revenue Service Center, P.O. Box 409101, Ogden, UT 84409. If Ms. A fails to report the receipt of a gift generally, she may become subject to a penalty equal to 5% of the amount of the gift for each month of failure to report, up to a maximum of 25%. The I.R.S. actively pursues the penalty, which may be abated if reasonable cause exists.

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INTERESTS IN FOREIGN ENTITIES

Foreign Corporations in General

Form 5471 (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*) must be filed with a Form 1040 if Ms. A were to become a 10% shareholder (measured by vote or value) in certain foreign corporations. Her ownership may be direct or indirect and requires application of a number of constructive ownership rules.

For most purposes, there is no constructive ownership attributed to a U.S. citizen from a family member who is neither a U.S. citizen nor a U.S. tax resident. However, shares in a foreign corporation that are actually owned by a foreign family member can be attributed to Ms. A for the limited purpose of imposing an obligation to file Schedule O (*Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock*) of Form 5471. In such case, a penalty of $10,000 may be imposed for the failure to report constructive ownership in Schedule O regarding each corporation that is actually owned by a foreign family member.

The Tax Cut & Jobs Act of 2017 repealed a provision in U.S. tax law that allowed U.S. taxpayers to benefit from nonrecognition of gain when assets transferred to a foreign corporation are to be used in the trade or business of that corporation. With limited exceptions, such transfers are now taxable. Form 926 (*Return by a U.S. Transferor of Property to a Foreign Corporation*) is the form designated to report gain from a transfer of assets to a foreign corporation. If a taxpayer fails to fully report a transfer of property to a foreign corporation, a penalty is imposed equal to 10% of the fair market value of the property at the time of the transfer. The penalty is limited to $100,000 unless the failure to comply is due to intentional disregard.

Foreign Corporations that are P.F.I.C.'s

Ownership of a "P.F.I.C." (passive foreign investment company) by Ms. A may cause her to be required to file Form 8621 (*Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*). A P.F.I.C. is a foreign corporation that meets one of two tests:

- At least 50% of the average value of its assets, as measured on the last day of each quarter, are of a kind that produce passive income
- At least 75% of its income for a taxable year consists of passive income

European collective investment vehicles and unit trusts are typically considered to be P.F.I.C.'s. Also, a start-up service business that is funded with cash and that has little in the way of capital assets may trip into P.F.I.C. status unless it is reasonable to believe that it will not be a P.F.I.C. in its second and third years of existence and is actually not a P.F.I.C. in those years.

A U.S. person that is a direct or indirect shareholder of a P.F.I.C. must file Form 8621 for each tax year reporting:

- Receipt of direct or indirect distributions from a P.F.I.C.
- Recognition of gain on a direct or indirect disposition of P.F.I.C. stock

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- Information with respect to a Q.E.F. election or a mark-to-market election
- A required annual report of deferred income and gains

Foreign Partnerships and Eligible Entities

Investment in a foreign partnership by Ms. A may require her to file Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships), similar to the reporting obligations described above. Reporting may be required in several different fact patterns, including the acquisition, ownership, or disposition of substantial interests in a foreign partnership and the disposition by the foreign partnership of appreciated property that was previously contributed by a U.S. person.

Note that foreign law does not control whether an entity is considered to be a partnership. A private limited company generally thought of a corporation for purposes of foreign company law and foreign tax law, may default into partnership status for U.S. tax purposes or may have elected partnership status for U.S. tax purposes at the insistence of a U.S. investor. An example of the former is an unlimited liability corporation formed under the laws of certain provinces in Canada.

RELINQUISHING U.S. CITIZENSHIP

Some foreign young adults with limited ties to the U.S. have considered relinquishing their U.S. citizenship to avoid U.S. tax compliance and future U.S. estate and gift taxation. As a practical matter, young adults who reside abroad and are U.S. citizens, such as Ms. A, can work or study in the U.S should they desire to do so without any limitation under U.S. immigration law. However, once citizenship is renounced, a visa will be required if they choose to re-enter the U.S for work or study purposes.

". . . young adults who reside abroad and are U.S. citizens, such as Ms. A, can work or study in the U.S should they desire to do so without any limitation under U.S. immigration law."

To renounce citizenship, Ms. A must voluntarily and with intent to relinquish her U.S. citizenship appear before a U.S. consular or diplomatic officer in a foreign country and sign an oath of renunciation. A person contemplating expatriation should review the website of the U.S. embassy or consulate in the jurisdiction where expatriation is intended, as procedures vary to some extent among the embassies and consulates.

Citizenship should not be relinquished until Ms. A can certify that she has satisfied her U.S. tax obligations for the five (tax) years prior to the year of expatriation. In addition, she must file Form 8854 (*Initial and Annual Expatriation Statement*) with the I.R.S for the tax year of expatriation.

An expatriating individual who is considered a "covered expatriate" may be required to pay a capital gains tax (known as a "mark-to-market exit tax") on the amount of net gain realized upon a deemed sale or exchange of the individual's property on the day immediately preceding the date of expatriation. However, the first $767,000 of gain is excluded when computing the exit tax.

Under U.S. tax law, gift and estate taxes are generally imposed on the individual making the gift or the estate of the decedent. These taxes are not imposed on the recipient of the gift or bequest. A covered expatriate owning no U.S. situs property is not subject to gift and estate taxes upon the making of a gift during lifetime or leaving a bequest at the conclusion of life. The rules are modified when the maker of the gift or the decedent is a covered expatriate. A U.S. person receiving gifts from

a covered expatriate or receiving a bequest from the estate of a covered expatriate is subject to a special inheritance tax imposed at the highest rate of gift or estate tax under U.S. law (currently 40%). When computing the tax, a U.S. recipient may claim a benefit equal to the annual exclusion provided by U.S. tax law for gifts made by a U.S. donor (currently, $15,000) for amounts received from each covered expatriate.

Ms. A would be a covered expatriate in any of the following fact patterns:

- She has an average net income tax liability of more than a specified amount for the five years preceding expatriation. In 2022, the amount is $178,000 and is adjusted each year for inflation.
- She has a net worth of at least $2.0 million on the date of departure. This amount is not adjusted for inflation.
- She fails to certify under penalties of perjury that she is in compliance with all U.S. tax obligations for the five years preceding expatriation. The instructions for Form 8854 states that the scope of the certification extends to obligations regarding income tax, employment tax, gift tax, and information returns, including obligations to file proper forms and to pay all relevant tax liabilities, interest, and penalties.

There are exceptions for certain dual citizen individuals or minors, although the tax compliance certification must be satisfied in all cases.

Dual Citizen at Birth – Renunciation Prior to 18½ Years of Age

One exception applies to a minor who was a dual citizen at birth. To meet this exception, the following conditions must be met:

- The individual was born a citizen of the U.S. and another country.
- Renunciation occurs before the age of 18½ years.
- The individual has not resided in the U.S. for more than 10 taxable years before the date of relinquishment.

There may be a timing problem in attempting to qualify for this exception. Embassies and consulates are unlikely to entertain a request to relinquish citizenship if the individual is less than 18 years old. That leaves a six-month window for a would-be covered expatriate to relinquish citizenship under this exception. U.S. diplomatic missions face severe backlogs, and it may be difficult to complete the renunciation within the six-month time frame. For example, the U.S. embassy in France notes that the current wait time for a renunciation interview is 12-18 months. The embassy in Denmark has a waiting period of over a year (the earliest appointment now being in mid-2023 .

Dual Citizen at Birth – Renunciation at or After 18½ Years of Age

A second exception applies to an individual who relinquishes citizenship at the age of 18½ years or older. To meet this exception, three conditions must be met:

- The individual was born a citizen of the U.S. and another country.
- The individual continues to be a citizen of, and is taxed as a resident of, the other country as of the expatriation date.

- The individual has not resided in the U.S. for more than 10 taxable years during the 15-taxable-year period ending with the taxable year during which the expatriation date occurs.

This second exception does not apply if the individual is no longer a resident in the country of birth. That individual must re-establish tax residence in the birth country before applying for expatriation. While there may be many ways to demonstrate tax residence, clearly the most obvious way of establishing residence involves filing a tax return for a complete taxable year in the birth country. Also, filing a final year tax return in the third country may be helpful.

CONCLUSION

Coming of age brings with it certain responsibilities for a dual citizen individual. One of those responsibilities stems from the realization that U.S. income tax returns must be filed. In the case of Ms. A, an individual born in the U.S. to non-U.S. parents temporarily present in the U.S., the tax filing obligations can be daunting and compliance failures can be heavily penalized. While one solution is renunciation of citizenship, the path to exiting the U.S. tax system has its complexities and accompanying penalties when not done correctly. For those individuals finding themselves in the circumstances of Ms. A, finding a competent U.S. tax adviser is a necessary step before taking any action.

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