

ESTIMATED TAX PENALTY FOR CITIZENS OR RESIDENTS OF THE UNITED STATES LIVING ABROAD

Part III -- Administrative, Procedural, and Miscellaneous

Section 1: Purpose

This notice addresses the foreign earned income exclusion and housing cost amount for certain citizens and residents of the United States living abroad as modified by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345, (TIPRA). This notice provides that, under certain circumstances, the Internal Revenue Service (Service) will waive section 6654 penalties for underpayment of estimated tax by certain citizens and residents of the United States living abroad.

Section 2: Background

Generally, the Internal Revenue Code requires individuals to pay federal income tax as they earn income. To the extent these taxes are not withheld from an individual's wages, an individual taxpayer must pay estimated taxes in four installments. Section 6654(a) of the Code provides for an addition to tax where a taxpayer fails to make a sufficient and timely payment of "estimated tax."

In general, estimated taxes are required in four installments and the amount of any required installment shall be 25 percent of the "required annual payment." See section 6654(c) and (d)(1)(A). The term "required annual payment" means the lesser of 90 percent of tax shown on the return for the taxable year (or, if no return is filed, 90 percent of tax for such year), or 100 percent of tax shown on the return of the individual for the preceding taxable year if the adjusted gross income (AGI) shown on the return of the individual for the preceding taxable year is less than or equal to \$150,000. If the AGI shown on the return of the individual for the preceding taxable year exceeds \$150,000, the required annual payment is 110 percent of tax shown on that return.

If the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year, the required annual payment is 90 percent of tax shown on the return for the current taxable year. See section 6654(d)(1)(B).

Section 911(a) of the Code allows a qualified individual to elect to exclude from U.S. gross income the foreign earned income and housing cost amount of that individual. Prior to the enactment of TIPRA, the maximum amount of foreign earned income that could be excluded under section 911 in 2006 was \$80,000. The housing cost amount that an individual could exclude under section 911 was the taxpayer's "reasonable" housing expenses over a floor equal to 16% of the salary of a GS-14 federal worker. The exclusions for foreign earned income and housing cost amounts operated like other exclusions in the Code and were ignored when determining the tax rate applicable to non-excluded income.

On May 17, 2006, TIPRA was enacted into law. Section 515 of TIPRA made several changes to section 911 of the Code. First, TIPRA increased the foreign earned income exclusion cap by indexing it for inflation after 2005. Thus, the amount of foreign earned income that may be excluded in 2006 is \$82,400. Second, TIPRA modified the housing cost amount by changing the manner in which the floor is calculated and by generally imposing a cap equal to 30% of the maximum amount of the taxpayer's foreign earned income exclusion. Third, TIPRA imposed a "stacking" rule on the amounts excluded under section 911, so that income not excluded by

section 911 is subject to the same rate of tax as would have been applicable had the taxpayer not elected the section 911 exclusion. Thus, an individual with \$82,400 of excluded income and \$20,000 of taxable income will be taxed at rates that apply to taxable income in the range of \$82,400 to \$102,400 (25% or 28%), rather than \$0 to \$20,000 (10% or 15%).

Section 3: Transitional Penalty Relief for Underpayment of Estimated Taxes

The TIPRA changes to section 911 were enacted in May 2006, but they are effective for taxable years beginning after December 31, 2005. Therefore, taxpayers relying on the law as it existed prior to the retroactive change may have underpaid their estimated tax liabilities for 2006.

Section 6654(e)(3) authorizes the Service to waive section 6654 penalties for underpayments of estimated tax in unusual circumstances to the extent its imposition would be against equity and good conscience. Pursuant to this authority, the Service will waive the section 6654 penalty for calendar year 2006 for an underpayment of estimated tax to the extent that the underpayment is attributable to the modifications made by section 515 of TIPRA. This waiver is available only to qualified individuals who file a Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion, with their timely filed Form 1040, U.S. Individual Income Tax Return, or Form 1040X, Amended U.S. Individual Income Tax Return.

Section 4: Contact Information

The principal author of this notice is Karen E. Briscoe of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice contact Mrs. Briscoe at (202) 622-8117 (not a toll-free call).