STATE BAR OF CALIFORNIA
TAXATION SECTION
INTERNATIONAL COMMITTEE

REQUEST FOR GUIDANCE REGARDING DUAL RESIDENTS UNDER TREASURY REGULATIONS SECTION 301.7701(B)-7 WHO ARE TREATED AS NONRESIDENT ALIENS OF THE UNITED STATES[1,2]

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[1] The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

[2] Although the authors, presenters and reviewers of this paper have clients who might be affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

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EXECUTIVE SUMMARY

We live in a world that is becoming more mobile where personal and business relationships can span across several jurisdictions and an individual can become a tax resident of more than one country. Dual resident taxpayers who satisfy certain requirements can invoke the residency provisions of a U.S. tax treaty to determine they are tax residents of a treaty partner.[5]

Depending on the facts and circumstances of each case, and complying with certain filing requirements, the Treasury Regulations[6] (the "Regulations") under Section 301.7701(b)-7(a)(1) provide that such dual resident taxpayers shall be treated as nonresident aliens of the U.S. for calculating their tax liability under the Internal Revenue Code[7] (the "Code") and Regulations.

However, the Internal Revenue Service (the "IRS") seems to take the position, based on Treas. Reg. § 301.7701(b)-7(a)(3), that such individuals are required to file U.S. information returns as resident aliens, although this position has not been made known publicly or consistently.

This position creates numerous practical problems and in some cases inconsistent and even illogical results, imposing a significant burden for the affected taxpayers while generating information returns that appear to be of little or no value to the government while in other cases actually eliminating reporting requirements. The position plainly appears to require taxpayers to certify their status differently for different purposes of FATCA (withholding and reporting) and even differently for purposes of Chapter 3 and Chapter 4. In the case of trusts, especially those affected by section 672(f) (limited application of grantor trust rules to foreign grantors), the substantive tax results may be completely unworkable.

The authors request guidance and confirmation from the U.S. Treasury that a dual resident taxpayer should be treated as a nonresident alien (a) for purposes of calculating the U.S. income tax liability of such

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5 Treas. Reg. § 301.7701(b)-7(a)(1).

6 The term "Regulations" is used throughout to reference the Treasury Regulations under Title 26 of the U.S. Code.

7 Unless otherwise provided, all references to the Code or the IRC are references to the Internal Revenue Code of 1986, as amended, 26. U.S.C. §§ 1 et. seq., as in effect during the relevant period, and references to "Sections" are references to sections of the IRC.

individual under the Code and the Regulations, and (b) for all purposes of the Code, including U.S. information reporting requirements.

The requested guidance and clarification could be made in the form of an amendment to Treas. Reg. § 301.7701(b)-7(a)(1), and propose sample language to this effect.

DISCUSSION

I. BACKGROUND: DEFINITION OF RESIDENT ALIENS AND U.S. TAX TREATIES

A. Statutory definition

The definition of a resident is set out in Code Section 7701(b), which was enacted in 1984 and came into effect for calendar years beginning on or after January 1, 1985.[8] By its terms, Section 7701(b) applies for all purposes of the Code, except Subtitle B, relating to gift tax, estate tax and the tax on generation skipping transfers.

Section 7701(b) provides that a resident alien is an individual who meets one of two tests, the lawful permanent resident test and the substantial presence test.[9] The lawful permanent resident test causes an alien to become a resident from the first day of presence in the United States as a lawful permanent resident under the immigration laws. An individual who becomes a resident alien under this test remains a resident so long as his or her status has not been judicially or administratively revoked or abandoned.[10] The substantial presence test, which is applied on an annual basis, causes an alien to become a resident alien by being physically present in the U.S. on a certain number of days totaling 183 days or more either in a single calendar year or by application of a formula to the most recent calendar year and the immediately preceding two years.[11]

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[8] Tax Reform Act of 1984, Pub. L. 98-369, Sec. 138(a). Other Code provisions with rules relating to tax residence include elective residence under Section 6013(g) or (h) (elections available to certain married couples filing joint returns); Section 865 (source of sale of property); Treas. Reg. Section 20.0-1 (estate tax). See also Section 871(a)(2), taxing capital gains of nonresident aliens present in the U.S. for a period or periods aggregating 183 days or more during the taxable year.

[9] IRC § 7701(b)(1)(A).

[10] IRC § 7701(b)(6).

[11] IRC § 7701(b)(1)(A) and (b)(3). We note that there are three elections under which, in various circumstances, an alien who would otherwise be treated as a nonresident alien may elect to be treated as a resident. We list these here for completeness but in all cases an alien who makes one of these elections may not make a treaty claim to be treated as a nonresident:

- IRC § 7701(b)(4): A nonresident alien may elect to be treated as a resident for part of the calendar year preceding the calendar year in which the individual satisfies the substantial presence test for the whole year.
- IRC § 6013(g): A nonresident alien individual will be treated as a resident if, at the close of the taxable year, he or she was married to a citizen or resident of the U.S., and both of them make an election to file a joint return.

Since a resident alien is taxed on his or her worldwide income, regardless of its source, the status of an alien as a resident or nonresident is the foundation to determine the proper treatment of such individual for U.S. income tax purposes, including determining the tax liability of the individual.

B. The effect of treaties on the residence of individuals

The U.S. has entered into numerous bilateral income tax treaties.[12] Almost all of them contain a provision under which the parties to the treaty agree that for purposes of the treaty, an individual resident in both countries under their respective domestic tax laws will be treated as resident of only one country based on the application of a series of conditions that must be applied in sequential order.

The rules contained in this provision are often referred to as the "tie-breaker rules" and are generally included in Article 4 ("Residence" or, in some older treaties, "Fiscal Domicile") of the U.S. income tax treaties which are largely structured along the lines of Article 4 of the OECD Model Tax Convention on Income and on Capital and the United States Model Income Tax Convention.[13] For reference, Article 4 of the current OECD model is set out below:

"ARTICLE 4

- IRC § 6013(h): An individual who was a nonresident alien at the beginning of the taxable year but, at the close of the year, was a resident of the U.S. and married to a U.S. citizen or resident, may make an election to be treated as a resident for the whole year, so long as the spouse joins in the election.

Although Section 6013(h) does not specifically refer to the couple having to file a joint return, it is interpreted to include this requirement.

The Regulations under Sections 6013(g) and (h) make clear that an alien who makes the election may not, for U.S. income tax purposes, claim under any U.S. income tax treaty not to be a U.S. resident. See Treas. Reg. § 1.6013-6(a)(2)(v) and § 1.6013-7(a)(2). While there is no such provision in the Regulations under Section 7701(b), it seems logical that someone who could only be treated as a resident by making an election under section 7701(b)(4) would not make the election and then argue that they were nonresident for purposes of a treaty.

[12] The current U.S. income tax treaties may be found at: http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z

[13] The current U.S. model is dated November 15, 2006 and is available at http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf (viewed March 15, 2015). Although minor textual changes have been made over the years through a series of models, the basics of article 4 of the U.S. model has remained essentially unchanged. For an example of the application of a treaty residence provision by a U.S. court, see *Podd v. Commissioner*, T.C. Memo. 1998-418 (residence of Canadian individual with permanent home in both countries and inconclusive facts regarding center of vital interests determined based on habitual abode).

RESIDENT

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement."

The interrelation between domestic tax laws and tax treaties is the following: The residence of an individual is first determined by each contracting state under its own laws, without regard to the treaty. If the individual would be treated by each contracting state as resident in that state, then the treaty provides a series of tests, to be applied in a set order of priority, which will cause the individual to be treated as resident of only one of the contracting states. Throughout this paper, when application of a treaty would cause an individual, who would otherwise be treated as a resident

alien under U.S. tax law, to be treated as a resident of the U.S. treaty partner, we will refer to such an alien as a "treaty nonresident".[14]

In the modern world, many individuals fall under the definition of tax residence in two or more countries as a result of their pattern of life, multiple nationalities and residence permits, dispersed families, multiple residences and business activities in multiple countries.[15] Dual residents are individuals who are likely to have relatively higher levels of wealth and income and to own securities, financial accounts and assets in multiple jurisdictions.

The U.S. has an expansive view of its right to treat an individual as a U.S. tax resident. For example, the lawful permanent resident test under Section 7701(b)(1)(A)(i) will cause an individual to be treated as a resident merely by virtue of having been issued a "green card", even though the individual may concurrently be treated as a resident of one or even several other countries under their respective resident criteria. Further, the United States requires administrative or judicial steps to have been taken for status as a lawful permanent resident to be terminated. Moreover, the substantial presence test under Section 7701(b)(a)(ii) can capture a non-immigrant individual who spends, on average, just four months a year in the U.S.

Treaty residence articles therefore play a useful role by assigning residence, and consequent worldwide taxing jurisdiction, to the appropriate country and in generally reducing the tax compliance burden for multi-country individuals. Accordingly, a treaty nonresident should be treated as a tax resident of a treaty partner for all tax purposes, and not as a tax resident of the U.S. for purposes other than computing tax liability.

C. Section 7701(b)(6)

As originally enacted in 1984, section 7701(b)(6) provided a definition of "lawful permanent resident". Treaties were not mentioned. But in 2008, Congress enacted the following flush language:

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[14] *See* Michael J.A. Karlin, *Now You See Them: U.S. Reporting Requirements for Tax Treaty Nonresidents*, Tax Notes International, Volume 67, Number 3, July 16, 2012.

[15] *Id.*

> "An individual shall cease to be treated as a lawful permanent resident of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment."[16]

The amendment was made, with essentially no comment in the legislative history, as a conforming amendment in the context of the enactment of the expatriation rules contained in Section 877A and 2801.[17] Substantially similar language had previously appeared in section 877(e)(1)(B) and was removed from that section at the same time as the amendment to Section 77701(b)(6).

On its face, the language of Section 7701(b)(6), at least in relation to an alien who satisfies the lawful permanent resident test (and does not also satisfy the substantial presence test), appears to be unambiguous. Once an alien "commences to be treated as a resident of a foreign country under a treaty", the alien ceases to be treated as a lawful permanent resident for the purposes of the Code and therefore ceases to be a resident alien.

However, as was the case under former Section 877(e)(1)(B), the application of the statutory provision may be limited to aliens who are "long-term residents" (i.e., green card holders taxed as U.S. residents in 8 of the prior 15 years for whom tie-breaking residence to a treaty partner causes an expatriation) whose treaty nonresidence began after June 18, 2008. This is because the effective date provision states that it applies "to any individual whose expatriation date (as so defined) is on or after [June 18, 2008]". The term expatriation date is defined by section 877A(g)(3) of the Code only with respect to U.S. citizens and long-term residents. It is questionable, therefore, whether the flush language of Section 7701(b)(6) applies to green card holders who are not long-term residents when they otherwise meet the requirements of the provision. However, for any long-term resident (whether or not he or she meets the financial thresholds to be a covered

[16] Heroes Earnings Assistance And Relief Tax Act of 2008, P.L 110-245, section 301(c)(2)(B).

[17] There was no House or Senate report on H.R. 6081, which became P.L. 110-245. The Joint Committee on Taxation describes the change without explaining it. Joint Committee on Taxation, "Technical Explanation of H.R. 6081, The 'Heroes Earnings Assistance and Relief Tax Act Of 2008'", JCX-44-08 (May 20, 2008), available at http://www.jct.gov/x-44-08.pdf (viewed April 10, 2015).

expatriate), the flush language appears clearly to apply and to overrule any inconsistent language in Treas. Reg. § 301.7701-7(a), described below. In other words, such individuals cease to be "lawful permanent residents" under the Code and, therefore, cease to be U.S. tax residents for any purpose (unless they are and remain substantial presence residents).

D. Basic reporting requirement for treaty nonresidents

A treaty nonresident must file a U.S. tax return as a nonresident (IRS Form 1040-NR).[18] In addition, the treaty nonresident will generally be required to attach IRS Form 8833 ("Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)").[19] Code Section 6114 requires that any taxpayer who takes the position that a tax treaty overrules or modifies the Code should disclose the position attaching Form 8833 to his or her tax return.[20] There is an exception from the requirement to file Form 8833, but not from the requirement to file Form 1040-NR, if the amount of payments and income items that would otherwise be required to be reported does not exceed $100,000.[21]

As discussed below, treaty nonresident status is determined by application of a treaty, and the consequence of failing to file the Form 8833 is limited to the imposition of a relatively modest penalty.[22] This filing requirement is only an informational reporting requirement. The effectiveness of the treaty provisions will be based on the facts and circumstances of the individual and his or her decision to file a U.S. income tax return using the applicable treaty, and the Code and the Regulations do not condition the effectiveness of treaty provisions on the filing of Form 8833.

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[18] The term used by the Regulations is "dual resident taxpayer": An individual who is considered a resident of the U.S pursuant to the internal laws of the U.S. and also a resident of a treaty country pursuant to the treaty partner's internal laws. Treas. Reg. § 301.7701(b)-7(a)(1). We prefer the term "treaty nonresident" to describe a dual resident where the tie-breaker rules break in favor of residence in the treaty partner country.

[19] Treas. Reg. § 301.7701(b)-7(b) and (c).

[20] *See* IRC § 6114(a); Treas. Reg. § 301.6114-1(a)(1) and Treas. Reg. § 301.6114-1(d)(1) (applicable to taxable years for which the due date for filing returns (without extensions) is after December 15, 1997).

[21] See Treas. Reg. § 301.6114-1(c)(2) and (b)(8).

[22] Failure to file Form 8833 by an individual could give rise to a penalty of $1,000. IRC § 6712(a) and (c) and Treas. Reg. §301.6172-1(a)(2).

II. THE NARROWING OF THE SCOPE OF TREATY NONRESIDENCE

A. Treatment of treaty nonresidents as nonresident aliens under Treas. Reg. § 301.7701-7(a)(1) and (a)(3)

The Treasury is authorized to prescribe such regulations as may be necessary or appropriate to carry out the provisions of section 7701(b). It has exercised this authority in Treas. Reg. § 301.7701(b)-7.[23] The Regulation provides that an individual eligible to be treated as a resident of another country under a U.S. tax treaty is a resident of the other country for some purposes of the Code, namely computation and withholding of U.S. tax, and not for others.

Specifically, the Regulation provides:

> "(a) Consistency Requirement
>
> "(1) Application. If the alien individual determines that he or she is a resident of the foreign country for treaty purposes, and the alien individual claims a treaty benefit (as a nonresident of the United States) so as to reduce the individual's United States income tax liability with respect to any item of income covered by an applicable tax convention during a taxable year in which the individual was considered a dual resident taxpayer, then that individual shall be treated as a nonresident alien of the United States for purposes of computing that individual's United States income tax liability under the provisions of the Internal Revenue Code and the regulations thereunder (including the withholding provisions of section 1441 and the regulations under that section in cases in which the dual resident taxpayer is the recipient of income subject to withholding) with respect to that portion of the taxable year the individual was considered a dual resident taxpayer.
>
> . . .
>
> "(3) Other Code purposes. Generally, for purposes of the Internal Revenue Code <u>other than the computation of the individual's United States income tax liability</u>, the individual

[23] Adopted by T.D. 8411, 57 F.R. 15237-15254 (1992).

> shall be treated as a United States resident. Therefore, for example, the individual shall be treated as a United States resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under section 957 or whether a foreign corporation is a foreign personal holding company under section 552. In addition, the application of paragraph (a)(2) of this section does not affect the determination of the individual's residency time periods under section 301.7701(b)-4."[24] [Underscore added]

The explanation for the duality contained in this provision in the 1987 proposed regulations under Section 7701(b) was as follows:

> "It clarifies the effect that the definition of resident alien will have on an alien individual who is also a resident of a treaty partner of the United States. The rules require such individuals to determine their tax liability as if they were nonresident aliens under the Code if they choose to claim any treaty benefits as residents of a treaty country."[25]

B. Impact on Reporting Requirements

The language of the Regulations does not explicitly state that a treaty nonresident is to be treated as a resident alien for purposes of the reporting provisions of the Code. Nor is this suggested in the history of the regulations cited above. One might reasonably take the view that information reporting provisions exist only, or at least primarily, to support the computation of a U.S. person's income tax liability. In fact, the example given in paragraph (a)(3) does not relate to reporting, but rather to a

[24] Thus, while the alien may not be taxed on Subpart F income, Section 956 inclusions or deemed dividends under Section 1248, the alien's U.S. resident status may turn the corporation into a CFC for other U.S. persons, and in a manner where they may have no warning at all.

[25] When adopting the final regulations in 1992, the government noted that it had rejected a proposal by several commenters that a treaty nonresident should be treated as a nonresident only for purposes of applying the treaty provisions under which the alien claims a benefit. The alien would be treated as a resident for all other purposes, including computation of the alien's U.S. tax liability on classes of income covered by the treaty but for which the alien has not chosen to apply the treaty provisions. The proposal was rejected because it would permit an alien individual to elect his or her resident status separately for each item of income. See by T.D. 8411, footnote 23, *supra*.

determination of a foreign corporation's status as a controlled foreign corporation that can only affect some other (U.S.) taxpayer's liability.[26]

Despite this, and apparently disregarding the clear language of Section 7701(b)(6) in the case of green card holders (or, at least, long-term residents), it seems that the IRS is taking the position that a treaty nonresident who is taxed as a nonresident alien is nevertheless required to file U.S. information returns as a resident alien.

The following paragraphs discuss some (although not all) of the information returns where the IRS apparently has taken this position. In the authors' view and as further discussed in this paper, this position is inconsistent with the Code and U.S. tax treaties and may not even be supported by Treas. Reg. § 301.7701(b)-7(a).

(1) IRS Form 5471

Historically, the only reference to this position in published guidance is Treas. Reg. Section 1.6038-2(j)(2)(ii), which provides as follows:

> "(ii) If an individual who is a United States person required to furnish information with respect to a foreign corporation under section 6038 is entitled under a treaty to be treated as a nonresident of the United States, and if the individual claims this treaty benefit, and if there are no other United States persons that are required to furnish information under section 6038 with respect to the foreign corporation, then the individual may satisfy the requirements of paragraphs (f)(10), (f)(11), (g), and (h) of this section[27] by filing the audited foreign financial statements of the foreign corporation with the individual's return required under section 6038." [Footnote added]

[26] The Regulation also states that a taxpayer's days of presence in the United States for purposes of computing the application of the substantial presence test are computed without regard to whether during those days, the taxpayer was a treaty nonresident. See the last sentence of paragraph (a)(3). This seems entirely reasonable since the substantial presence test itself counts days of presence regardless of whether, on any given day, the individual was a resident alien. The proper approach is to determine residence first by applying the substantial presence test without regard to a treaty and then by applying any applicable treaty provision. One other note: The regulation also applies for determining whether a foreign corporation was a foreign personal holding company but this is a dead letter given that the FPHC rules were repealed by the American Jobs Creation Act of 2004.

[27] These requirements relate to information to be provided in Schedules F, H, J and M of Form 5471.

Neither the Regulations under Section 6038 nor the instructions to Form 5471 state explicitly that a treaty nonresident must file the form. But Treas. Reg. Section 1.6038-2(j)(2)(ii) apparently assumes that this is the case, in a rather obscure location and manner. If this is indeed the government position, it should be stated somewhere where it is likely to come to the attention of practitioners and the public.

(2) Form 8938

The same issue has also arisen in connection with Form 8938 (Statement of Specified Foreign Financial Accounts), which has been required since the calendar year 2011 for most individual filers within its scope. In the temporary Regulations under Section 6038D adopted in 2011 (the "2011 Regulations"), the government simply says that:

> "The term resident alien has the meaning set forth in section 7701(b) and §§ 301.7701(b)-1 through 301.7701(b)-9 of this chapter."[28]

However, for the first time in the actual instructions to a Form, the IRS stated that a treaty nonresident is nevertheless required to file a form, in this case Form 8938. The instructions to the Form provide that:

> "You are a resident alien if you are treated as a resident alien for U.S. tax purposes under the green card test or the substantial presence test. For more information, see Pub. 519, U.S. Tax Guide for Aliens. If you qualify as a resident alien under either rule, you are a specified individual even if you elect to be taxed as a resident of a foreign country under the provisions of a U.S. income tax treaty. If you have to file Form 8938, attach it to your Form 1040NR." [Emphasis added]

In December of 2014, the Treasury Department and the IRS published final Regulations under Section 6038D[29] concerning annual reporting by specified individuals of specified foreign financial assets.[30] The

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[28] Treas. Reg. § 1.6038D-1T(a)(3), adopted by T.D. 9567, 76 Fed. Reg. 78553-78566 (December 19, 2011).

[29] IRC § 6038D(a) provides: "(a) In general. Any individual who, during any taxable year, holds any interest in a specified foreign financial asset shall attach to such person's return of tax imposed by subtitle A for such taxable year the information described in subsection (c) with respect to each such asset if the aggregate value of all such assets exceeds $50,000 (or such higher dollar amount as the Secretary may prescribe)."

[30] 79 Fed. Reg. 73817 (December 12, 2014).

final Regulations are effective December 12, 2014, and supersede the prior temporary 2011 Regulations.

In the summary of comments to the 2011 Regulations and explanation of revisions to such Regulations, the Treasury and the IRS explained that a number of written comments were received requesting that certain categories of individuals be relieved of the requirement to report specified foreign financial assets under Section 6038D. One category of such individuals was dual resident taxpayers who determine their U.S. tax liability as nonresident aliens and claim tax treaty benefits as provided in Treas. Reg. § 301.7701(b)-7(a)(1) by filing IRS Form 1040NR and attaching Form 8833.

The Treasury and the IRS excepted such dual resident taxpayers from the reporting requirement of Section 6038D, and explained that:

> "The Treasury Department and the IRS have concluded that reporting under Section 6038D is closely associated with the determination of an individual's income tax liability. Because the taxpayer's filing of a Form 8833 with his or her Form 1040NR (or other appropriate form) will permit the IRS to identify the individuals in the category and take follow-up tax enforcement actions when considered appropriate, reporting on Form 8938, "Statement of Specified Foreign Financial Assets", is not essential to effective IRS tax enforcement efforts relating to this category of U.S. residents."[31]

The final Regulations under Code Section 6038D now state that, provided that a treaty nonresident timely files Form 1040NR or 1040NR-EZ and attaches Form 8833, such individual is not required to report specified foreign financial assets on Form 8938 with respect to the portion of the tax year the individual is considered a dual resident taxpayer.[32]

In the definitions that apply for purposes of Code Section 6038D and the final Regulations, a "specified individual" includes a U.S. citizen and a resident alien of the U.S. for any portion of the taxable year,[33]

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[31] 79 Fed. Reg. 73818 (December 12, 2014).
[32] Treas. Reg. § 1.6038D-2(e)(1) and (2).
[33] Treas. Reg. § 1.6038D-1(a)(2).

and the term resident alien "has the meaning set forth in Section 7701(b) and §§301.7701(b)-1 through 301.7701(b)-9".[34]

In the authors' view, this is the correct approach, since, as explained in the preamble to the final 6038D Regulations, the filing of IRS Forms 1040NR and 8833 allows the IRS to identify treaty nonresidents and obtain the information necessary to take appropriate U.S. tax enforcement action, if required. If a treaty nonresident is taxed as a nonresident alien, filing of IRS Form 8938 provides no additional value or relevant information for the calculation of his or her income tax liability.

The authors agree with the exception of treaty nonresidents who timely file Form 1040NR and, if applicable, Form 8833 from the requirement to report specified foreign financial assets under Section 6038D, and would prefer to see the IRS assume this uniform position throughout. Note that the instructions to Form 8938, which have a revision date of December 2014, have not, as of the time of writing, incorporated the exception of treaty nonresidents under the Regulations.[35] The Service has announced a revision to the instructions but there is no indication of this on the Form 8938 instructions that appear in the Forms and Publications section of the IRS website.[36] It would be preferable if some form of notification appears at the top of the Form or the instructions pending incorporation of the changes into the body of the instructions.

(3) Form 3520

The instructions to both Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) and 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner) state that a U.S. person includes a resident alien and cross-refer to Publication 519 (U.S. Tax Guide for Aliens).

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[34] Treas. Reg. § 1.6038D-1(a)(3).

[35] The instructions to IRS Form 8938 ("Statement of Specified Foreign Financial Assets') (Rev. December 2014) continue to state that: "You are a resident alien if you are treated as a resident alien for U.S. tax purposes under the green card test or the substantial presence test. For more information, see Pub. 519, U.S. Tax Guide for Aliens. If you qualify as a resident alien under either rule, you are a specified individual even if you elect to be taxed as a resident of a foreign country under the provisions of a U.S. income tax treaty. If you have to file Form 8938, attach it to your Form 1040NR."

[36] See "Update to 2014 Instructions to Form 8938 (Rev. December 2014)" available at http://www.irs.gov/Businesses/Corporations/Update-to-2014-Instructions-to-Form-8938-1 (March 10, 2015; viewed April 26, 2015).

In its discussion of nonresident and resident aliens, Publication 519 states as follows:

> "If you are treated as a resident of a foreign country under a tax treaty, you are treated as a nonresident alien in figuring your U.S. income tax. For purposes other than figuring your tax, you will be treated as a U.S. resident. For example, the rules discussed here do not affect your residency time periods as discussed later under Dual-Status Aliens."[37]

Publication 519 is silent about information returns, including Forms 3520 and 3520-A.

(4) FATCA Regulations

The Foreign Account Tax Compliance Act ("FATCA") was enacted in 2010 as part of the Hiring Incentives to Restore Employment Act.[38] FATCA has far-reaching impact on U.S. persons residing in the U.S. and both U.S. and non-U.S. persons residing abroad. Among many other items, FATCA introduced: (i) a new reporting requirement for U.S. individuals with foreign assets (Form 8938 discussed above), and (ii) the need for individuals who hold accounts with Foreign Financial Institutions ("FFIs") to certify their status as a U.S. or non-U.S. person for purposes of the withholding tax regime for FFIs under new Code Sections 1471 through 1474.[39]

Under FATCA, individual account holders must provide a self-certification to their FFI in the form of a Form W-8BEN or a Form W-9, of their status as a U.S. person or non-U.S. person. Failure to comply can lead to the account and the individual being deemed "recalcitrant", and subject to a 30% withholding on any passthru payment made by the FFI.[40]

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[37] Available at http://www.irs.gov/pub/irs-pdf/p519.pdf (viewed April 19, 2015) at pages 6-7.
[38] Pub.L. No. 111-14.
[39] A comprehensive discussion of FATCA is beyond the scope of this paper.
[40] According to Treas. Reg. § § 1.1471-5(g), the term "recalcitrant account holder" means any holder (other than an FFI or presumed FFI) of an account maintained by an FFI, the account does not meet the requirements of the exception for depository accounts with a balance of $50,000 or less and does not qualify for any of various exceptions from the documentation requirements and

(i) The account holder fails to comply with requests by the FFI for the documentation or information that is required for determining whether the account is a U.S. account;

(ii) The account holder fails to provide a valid Form W-9 upon request from the FFI or fails to provide a correct name and TIN combination upon request from the FFI when the FFI has received notice from

Notwithstanding its broad application, FATCA and its Regulations are silent on whether a treaty nonresident is or is not a U.S. person. The current definition of a U.S. person, set out in temporary Regulations[41], provides only that:

> "(i) The term U.S. person or United States person means a person described in section 7701(a)(30), the United States government (including an agency or instrumentality thereof), a State (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof). . . ."[42]

Section 7701(a)(30) defines a "United States person" as including a citizen or resident of the United States, and this takes us back to the Section 7701(b) definition of a resident alien. The IRS has not explained whether a U.S. person includes a treaty nonresident for purposes of the FATCA Regulations. On this point, the temporary Regulations are silent.

Whether a treaty nonresident is a U.S. person for FFI certification purposes also requires consideration of the temporary Regulations and any Intergovernmental Agreement ("IGA") applicable to the FFI.[43] Many foreign countries have entered into IGAs have adopted Model 1 IGAs, which require FFIs to report all FATCA-related information to their own governmental agencies, which would then provide such information to the IRS. A smaller number have entered into Model 2 IGAs, under which the foreign country undertakes to take steps to allow its FFIs to register with the IRS and enter into and comply with an FFI Agreement in the form prescribed by the IRS (with some definitional modifications). A number of countries have yet to enter into an IGA and their FFIs are required to enter into an FFI Agreement in the prescribed form.

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the IRS indicating that the name and TIN combination reported by the FFI for the account holder is incorrect;

(iii) If foreign law would (but for a waiver) prevent reporting by the FFI (or branch or division thereof) of prescribed information with respect to such account, the account holder (or substantial U.S. owner of an account holder that is a U.S. owned foreign entity) fails to provide a valid and effective waiver to permit such reporting; or

(iv) The account holder provides prescribed documentation to establish its status as a passive NFFE (other than a withholding partnership or withholding trust) but fails to provide prescribed information regarding its owners.

[41] 79 Fed. Reg. 12811 (March 6, 2014).

[42] Treas. Reg. § 1.1471-1T(b)(141).

[43] The current IGAs entered into by the U.S. are available at http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf (viewed May 13, 2015).

The Model 1 IGAs generally provide that the term "U.S. person" means "a U.S. citizen or resident individual, a partnership or corporation organized in the United States or under the laws of the United States or any State thereof, a trust if (i) a court within the United States would have authority under applicable law to render orders or judgments concerning substantially all issues regarding administration of the trust, and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust, or an estate of a decedent that is a citizen or resident of the United States. This subparagraph 1(ff) shall be interpreted in accordance with the U.S. Internal Revenue Code."[44] [Underscore added]

The problem created by the temporary Regulations and the IGAs is that FATCA includes both a withholding provision and an information reporting provision. If we take the requirements of Treas. Reg. § 301.7701-7(a) at their word, treaty nonresidents are nonresidents for the purposes of the former and residents for the purposes of the latter. So what should treaty nonresidents state in their certifications to FFIs?

It should also be noted that for Chapter 3 withholding purposes, treaty nonresidents are treated as nonresident aliens and therefore have to provide Form W-8BEN to withholding agents. Many treaty nonresidents have to certify their residence status for purposes of both Chapter 3 and Chapter 4. It would be bizarre if a treaty nonresident were required to treat himself or herself differently for purposes of certification under Chapter 3 and Chapter 4 and one may imagine the consternation of an FFI receiving both.

As stated throughout this paper, the authors consider that treatment of treaty nonresidents should be consistent, so that they are deemed nonresident aliens for all purposes, including self-certification of their U.S. tax status to FFIs. At the very least, the authors believe that clarification is required for treaty nonresidents and the FFIs with whom they deal.

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[44] Available at https://www.treasury.gov/press-center/press-releases/Documents/reciprocal.pdf (viewed May 13, 2015). The language of the versions of the Model 2 IGA (applicable to countries with which we have a tax treaty) is substantially similar. Model 2 IGA, article 1(y) http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Model-2-Agreement-Preexisting-TIEA-or-DTC-6-6-14.pdf (viewed May 15, 2015).

(5) FBAR

Under the Bank Secrecy Act ("BSA")[45] regulations, every "United States person" who has a financial interest in, or signature or other authority over, foreign financial accounts that have an aggregate value exceeding $10,000 at any time during the calendar year must file an information report regarding such foreign accounts.[46] Previously known as the Report of Foreign Bank and Financial Accounts (or FBAR), the form was replaced in 2013 by the Financial Crimes Enforcement Network ("FinCEN") Form 114. This reporting obligation is not a requirement under the Code, which is codified in Title 26 of the U.S. Code; rather, it is a requirement under the BSA, which is codified in Title 31 of the U.S. Code.

Final BSA regulations were issued in 2011[47] and, among other revisions, introduced a new definition of "United States person". For purposes of the BSA regulations, a "United States person" includes a citizen of the U.S. and a resident of the U.S.[48] A "resident of the United States" is an individual who is a resident alien under Code Section 7701(b) and the regulations thereunder.[49]

The regulations, the FBAR itself[50] and the instructions to the FBAR that until 2012 were part of the form and since 2013 are published on FinCEN's website,[51] are all silent on the effect of tax treaties on the definition of a U.S. resident.

However, the preamble to the BSA regulations provides that "a legal permanent resident who elects under a tax treaty to be treated as a non-resident for tax purposes must still file the FBAR." Based only on this sentence in the preamble, a lawful permanent resident is deemed a U.S. person for FinCEN Form 114 purposes, even if he or she elects to be taxed as a nonresident under a U.S. tax treaty.

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[45] 31 U.S.C. § 5311-5330.

[46] 31 CFR § 1010.350(a) and (b).

[47] 76 FR 10234 (February 24, 2011), available at http://www.irs.gov/pub/irs-tege/2011-4048.pdf (viewed April 19, 2015).

[48] 31 CFR § 1010.350(b).

[49] 31 CFR § 1010.350(b)(2).

[50] Until 2012, the FBAR was required to be filed on paper on Form TD F 90-22.1; since 2013, it is required to be filed electronically on FinCEN Form 114.

[51] Available at http://www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf (viewed April 19, 2015).

The preamble to the BSA regulations does not address U.S. residents who satisfy the substantial presence test but are dual resident taxpayers under Treas. Reg. § 301.7701(b)-7(a)(1). Does the IRS (under the enforcement authority delegated by FinCEN) expect these individuals, who will file IRS Forms 1040NR and 8833, to file FinCEN Form 114?

A conservative approach for a treaty nonresident would be to file FinCEN forms. A penalty not to exceed $10,000 may be imposed on non-willful violations of filing FinCEN forms and/or recordkeeping requirements.[52] Willful failures may give rise to very heavy civil and/or criminal penalties.

III. "ELECTING" TREATY NONRESIDENCE

We note here that the IRS has begun to refer to an alien "electing" to be treated as a resident of a treaty country.[53] However, taxpayers do not "elect" to be treated as nonresident under U.S. tax treaties.[54]

As discussed in part I.D of this paper, Section 6114 requires a taxpayer who takes the position that a treaty overrules or otherwise modifies an internal revenue law to disclose such position on a tax return or, if no return of tax is required to be filed, in such form as the Secretary may prescribe. There is a penalty for failing to file a Form 8833 where required[55], but the IRS has recognized that the failure to file the form does not deprive a taxpayer of treaty rights.[56] And if payments or income items

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[52] 31 U.S.C. § 5321(a)(5)(A).

[53] For example, see the instructions to Form 8938, footnote 35 *supra*. Another example is the instructions to Form 1040NR, which until 2012 did not refer to an election. The current instructions for Form 1040NR provide "even if you are a U.S. resident under one of these tests, you still may be considered a nonresident alien if you qualify as a resident of a treaty country within the meaning of an income tax treaty between the United States and that country *and elect to be treated as a resident of that country*." (emphasis added).

[54] We believe this trend may have originated with the American Institute of Certified Public Accountants (AICPA) comments on revisions to the FBAR regulations proposed by FinCEN in 2010. See AICPA, "Comments on Notice of Proposed Rulemaking (RIN-1506-AB08) regarding Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts", available at http://www.aicpa.org/advocacy/tax/international/downloadabledocuments/aicpa%2004.30.2010%20fbar%20comment%20letter.pdf (viewed 4/26/2015) at page 11. For more discussion, see Michael Karlin, "The Meaning Of Residence for FBAR Purposes", 13 Journal of Tax Practice & Procedure 51, 56 (2011).

[55] Section 6712 ($1,000 penalty; $10,000 for C corporations).

[56] See "Service Explains Use of Treaty-Based Return Position Disclosure Form", 2009 TNT 67-58 (August 3, 2007; released April 10, 2009) (program manager technical assistance held that treaty benefits

affected by the treaty residence article do not exceed $100,000, there is not even an obligation for the treaty nonresident to file Form 8833.

This treaty residence "election" suggests that a taxpayer must affirmatively file an election to treat himself or herself as a treaty nonresident. However, unlike in the case of elections, which are subject to time limits and other procedural requirements, the failure to claim benefits within any particular time period cannot preclude treaty benefits (subject to the potential application of statute of limitations rules). There is, for example, no analog to the deduction disallowance rules that apply to foreign persons who earn effectively connected income and fail to file tax returns. We recommend that the references to "elect' and "election" be discontinued in regulations, forms and publications and be replaced by the word "claim".'

IV. PRACTICAL PROBLEMS WITH TREATING TREATY NONRESIDENTS AS U.S. RESIDENTS

A. Unreasonable and unexpected consequences for treaty nonresidents

Few tax preparers know about all the reporting requirements applicable to U.S. persons. In our experience, many experienced international tax practitioners are unaware of Treas. Reg. Section 301.7701(b)-7(a)(3) or fail to appreciate that it relates not only to the classification of controlled foreign corporations (CFCs) but also to the applicability of the reporting requirements.

The treatment of treaty nonresidents as U.S. residents may turn unsuspecting nonresident aliens into unintentional lawbreakers. Take the case of a citizen of Canada who is retired, having worked all his life in Canada. He maintains a house in Canada. All of his family live in Canada, he votes there, he has a Canadian driver's license, he belongs to social and religious organizations in Canada. All of his assets are in Canada, other than a Florida condominium and a small checking account with a U.S. bank. He usually spends between 100 and 140 days a year in the United States and between 225 and 265 days a year in Canada. One year, the citizen spends 190 days in the United States, then reverts to the usual pattern. Throughout this period, Canada treats the individual as a Canadian resident (Canada, as

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cannot be denied if the taxpayer is entitled to them; the examiner was entitled to impose a penalty of $1,000 under section 6712).

it happens, is very reluctant to treat individuals as relinquishing their Canadian residence).

Such an individual might satisfy the numerical tests under the substantial presence test in some years but, in most of those years, the individual could file a return and take the position, incontestably on these facts, that he or she was a nonresident under the "closer connection" test (which requires, *inter alia,* that the taxpayer have a "tax home" in Canada, as well as more Canadian connecting factors than to the United States). But during the one year in which the number of days of presence exceeded 183, the only way for the individual to be treated as a resident of Canada would be through application of article IV of the treaty with Canada. Can it be the position of the U.S. government that, in that year, the individual must file Forms 5471, 8865 and 8858, Form 8621, Form 3520 and an FBAR?[57] Moreover, having determined that an individual must now report, what need does the IRS have for the information? None of the items of income or assets reported on these Forms will be reportable as income. What is the purpose of collecting this information?

B. Unintended consequences for the IRS

Let us consider a couple of unintended consequences of considering treaty nonresidents as resident aliens for U.S. reporting requirements under Treas. Reg. Section 301.7701(b)-7(a)(3). Suppose an individual who is a treaty nonresident makes several gifts of non-U.S. situs money or other property to his U.S. citizen spouse during a calendar year that exceed $100,000 in the aggregate. Under the IRS construct, the gifts would *not* be reportable on Form 3520 because, the donor, although a resident neither for income tax purposes nor for estate and gift tax purposes,[58] would be a U.S. resident for reporting purposes.

Another example is a U.S. corporation owned 100% by a treaty nonresident. Since the treaty nonresident is treated as a resident for reporting purposes, the U.S. corporation is treated as owned by a U.S.

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[57] The regulations under section 7701 also provide that a "closer connection" claim may only be made on a timely filed return, subject to the usual exception if the failure to file timely is shown to be due to reasonable cause. By contrast, the IRS generally cannot prevent an untimely claim to be a nonresident based on a treaty. So what are we to make of the alien who is entitled to make both claims but fails to make the statutory claim on a timely basis?

[58] If the treaty nonresident in our example is not domiciled in the U.S. for U.S. estate and gift tax purposes.

resident and does not have a 25% foreign shareholder. Therefore, it would not have to file Form 5472.

This cannot be what the IRS expects nor is it a reasonable result: While a treaty nonresident would have to file a Form 5471 with respect to a foreign corporation when he had no U.S. tax consequences from the ownership of shares of a foreign corporation, a U.S. corporation owned by a treaty nonresident would not have to report a treaty nonresident as an owner or file a Form relating to transactions with that foreign person, when this information is plainly relevant to the tax treatment of the U.S. corporation.

Considering a treaty nonresident as a U.S. resident for the purposes of the FATCA Regulations will similarly have unexpected consequences.

C. An especially troublesome example: the treatment of trusts

The inconsistent treatment of treaty nonresidents for substantive and information reporting purposes is especially troublesome in the case of trusts, where the status of the grantor as a resident or nonresident alien may determine whether the trust is a grantor trust or a nongrantor trust. Under Section 672(f), with limited exceptions, the grantor trust rules apply only to the extent that this results in an amount being currently taken into account in computing the income of a U.S. person. Is a trust with a treaty nonresident grantor, which but for Section 672(f) would be a grantor trust for income tax purposes, a grantor trust for reporting purposes? Is it a grantor trust for substantive purposes so far as persons other than the grantor are concerned, such as the trust itself or the beneficiaries – as the CFC example in the Regulations might suggest?

It appears that the IRS takes the view that such a trust is a nongrantor trust for income tax purposes but a grantor trust for reporting purposes. This is easily stated, but the results are contradictory and result in Form 3520 and/or Form 3520-A filings by the grantor and the U.S. beneficiaries that are inconsistent with the substantive tax treatment of the trust. For example, if the trust is a grantor trust for reporting purposes, does that mean that the beneficiary will be provided with a Foreign Grantor Trust Beneficiary Statement instead of a Foreign Nongrantor Trust Beneficiary Statement (and therefore checks "Yes" in line 29 of Part III of Form 3520 and "No" in line 30) when the trust is a nongrantor trust for substantive tax

purposes? How valuable to the IRS is a Form 3520-A filed by a treaty nonresident, in which the treaty nonresident reports as a grantor trust a trust that is actually a nongrantor trust?

The language of Treas. Reg. § 301.7701(b)-7(a) also suggests that, if the grantor is a treaty nonresident, the trust itself may actually be a grantor trust for substantive purposes and might therefore not be subject to tax on U.S. income. We may recall that language: "Generally, for purposes of the Internal Revenue Code *other than the computation of the individual's United States income tax liability*, the individual shall be treated as a United States resident." (emphasis added) Does this mean that the trust is deemed a grantor trust for purposes of computing its tax liability, even though for purposes of computing the grantor's tax liability, the trust is a nongrantor trust? The example given by the Regulation (involving the potential classification of a foreign corporation as a controlled foreign corporation) would seem to require that the Regulation intended that the liability of third parties should be determined by treating the treaty nonresident as a resident.[59]

Attached to this paper as Exhibit A is a common scenario the authors have experienced with U.S. international tax clients, which may provide additional background and a practical example regarding the complexities of considering treaty nonresidents as U.S. residents for information reporting requirements with respect to trusts.

If treaty nonresidents are deemed U.S. residents for information reporting purposes, this leads to the filing of inconsistent information returns with respect to the same treaty nonresident and factual situation. We would suggest that a simpler solution would be to treat treaty nonresidents as nonresidents for all purposes and not just for the limited purposes set out in the Regulations. And in the case of trusts, the treatment should be consistent not only for the grantors of trusts but also for the trusts themselves and their beneficiaries.

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[59] A similar problem concerns the determination of whether a trust is a foreign or domestic. To be a domestic trust, "one or more United States persons have the authority to control all substantial decisions of the trust (control test)." Treas. Reg. § 301.7701-7(a)(1)(ii). Is a treaty nonresident a United States person for these purposes? Once again, the language of Treas. Reg. § 301.7701(b)-7(a), and especially the CFC example, would suggest that the application of the control test should be applied as if the treaty nonresident was indeed a United States person. This does not seem a particularly sensible result.

V. ARGUMENTS IN SUPPORT OF WHY TREATY NONRESIDENTS SHOULD BE DEEMED NONRESIDENT ALIENS FOR INFORMATION REPORTING PURPOSES

Several arguments support the proposition that treaty nonresidents should be treated as nonresident aliens of the U.S. for all purposes of the Code.

A. Treating treaty nonresidents as resident aliens for purposes of information return requirements is not necessary and does not fairly balance the interests of the government and the burdens on taxpayers

The authors believe that a fair balancing of the burdens on taxpayers and the government's legitimate interest in tax administration strongly indicates that the need of the government for the data that is collected from information returns required of treaty nonresidents is minimal compared to the burden imposed on the filers.

The authors have asked themselves whether the data has any value to the IRS. What actually will be done with all these information returns attached to Form 1040NR? They will not yield any information relevant to the computation of any U.S. person's tax nor is any of the information relevant to the computation of a treaty nonresident's tax. At most it could provide the IRS with information that would be relevant only if the filer's claim to be a treaty nonresident were found to be incorrect.[60] The authors could not think of another situation in which the government requires information to be filed just in case the taxpayer's position is wrong.[61]

By contrast, and consistently with the authors' direct experience, the burden on taxpayers can be significant, sometimes extremely significant. In the authors' view, the correct approach is the one adopted by

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[60] We note that Form 8833 already requires aliens reporting a treaty-based position, including treaty nonresidence, to "list the nature and amount (or a reasonable estimate) of gross receipts, each separate gross payment, each separate gross income item, or other item (as applicable) for which the treaty benefit is claimed".

[61] The closest we could come up with is Schedule UTP (Uncertain Tax Positions), required only of very large corporations that issue audited financial statements. The position of an individual taxpayer, even a wealthy one, can is hardly be compared to such corporations.

the final Section 6038D Regulations,[62] since, as explained in the preamble to those Regulations, the filing of IRS Forms 1040NR and 8833 allows the IRS to identify treaty nonresidents and obtain the information necessary to take appropriate U.S. tax enforcement action, if required. If a treaty nonresident is taxed as a nonresident alien, filing of IRS Form 8938 provides no additional value nor relevant information for the calculation of his or her income tax liability.

The authors therefore agree with the exception of treaty nonresidents who timely file Forms 1040NR and 8833 from the requirement to report specified foreign financial assets under Section 6038D, and would prefer to see the IRS assume this uniform position throughout. As previously noted, the published instructions to Form 8938, should be revised to be consistent with the exception under the final Regulations.

B. The position is not permitted under the plain language of the Code

Section 7701(b)(6) states that a lawful permanent resident who claims treaty benefits as a nonresident "shall cease to be treated as a lawful permanent resident of the United States", with no suggestion that this has only a limited effect. As we have seen, there is substantial uncertainty concerning the precise scope of this language. Congress may have intended that it only apply to aliens who have satisfied the definition of a long-term resident before commencing to be treated as a resident under a treaty provision. But at least so far as those aliens are concerned, the language is clear.

So far as other green card holders, as well as aliens who satisfy the substantial presence test, are concerned, Section 894 provides that the provisions of Title 26 are to be applied to any taxpayer with due regard to any treaty obligation which applies to the taxpayer. An individual treated, after application of the typical tiebreaker, as a resident of the treaty partner is, indeed, not a resident for the purposes of any tax described in the treaty, in particular, the income tax. As stated elsewhere, this should include filing requirements and information returns designed to enforce the income tax imposed on citizens and residents of the United States. Moreover, the

[62] *See* Treas. Reg. § 1.6038D-2(e)(1) and (2).

position of treaty nonresidents should be the same regardless of whether they meet the lawful permanent resident test, the substantial presence test or both.

C. Reporting requirements are directly and primarily related to determination of an alien's tax liability

Generally, a U.S. income tax treaty defines the taxes to which the treaty applies, which include "the Federal income taxes imposed by the Internal Revenue Code",[63] and the term "for the purposes of this Convention".[64]

The reporting requirements of the Code exist primarily for the purpose of enabling the IRS to administer and enforce the Code. They do not have some independent significance, in which the Code consists of a series of provisions imposing and defining tax obligations and a somehow completely independent set of reporting obligations that have relevance or meaning outside the context of enforcing our tax laws. Nor, surely, can it be the case that when a treaty speaks of applying to the Federal income taxes imposed by the Code, it does not apply to the interest, additions to tax and penalties that motivate compliance and deter and punish non-compliance. Our treaty partners would probably be surprised to find that their tax residents are potentially subject to a whole range of draconian penalties designed to aid the enforcement of the income tax payable by U.S. citizens and residents.

The authors believe that the Treasury Department and the IRS do not have the power to employ Regulations or instructions in Forms to override two clear statutes and limit the effect of our tax treaties. While a statute can override a treaty, a Regulation cannot do so, since a treaty has the same status as a statute.[65] The regulatory authority in Section 7701(b) is to carry out the purposes of the Section, not to introduce unauthorized

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[63] *See* for example, Article 2(3) ("Taxes Governed by the Convention") of the U.S.-Mexico Tax Treaty and Article 2(2) ("Taxes Covered") of the U.S. - Canada Tax Treaty.

[64] For example, Articles 3(1) ("General Definitions"), 4(1) ("Residence"), 5(1) ("Permanent Establishment"), 7(5) ("Business Profits") of the U.S.-Mexico Tax Treaty and Articles 3(1) ("General Definitions"), 4(1) ("Residence"), 5(1) ("Permanent Establishment"), of the U.S.- Canada Tax Treaty

[65] Treaties are agreements between sovereign governments and while, under the Supremacy Clause of the United States Constitution, article VI, paragraph 2, a treaty has the same status as an Act of Congress, a treaty generally confers no rights on private persons either in the United States or in the other country. The rules in tax treaties confer rights on U.S. taxpayers under U.S. law only because section 894(a)(1) and, in this case, section 7701(b)(6) say so; whether the same is true in other countries depends on the constitutions and laws (and administrative practice) of those countries.

exceptions or to narrow its otherwise comprehensive scope by restrictive interpretation.

D. It is not clear that Treas. Reg. § 301.7701(b)-7(a)(3) actually supports the requirement for treaty nonresidents to report

The reporting requirements of the Code are an integral part of the computation of an individual's tax liability. On this basis, Treas. Reg. § 301.7701(b)-7(a)(3) does not require the treaty nonresident to be treated as a resident for reporting purposes. Forms 5471, 8865, 8858 and 8621, and now Form 8938, are all required to be filed with an income tax return, and their purpose is to enable a taxpayer to compute and the IRS to determine the liability of the filer for U.S. income taxes.[66] The Forms perform this function for citizens and resident aliens, but they are not relevant to the computation of the liability of nonresident aliens, including treaty nonresidents. Assuming that the treaty nonresident is in fact a resident of another country under a treaty, what is the purpose of obtaining the information requested by the Forms?

The example given in paragraph (a)(3) shows that the provision could be interpreted so as not to conflict with treaties or the Code. The example deals with the classification of foreign corporations as CFCs and foreign personal holding companies. This classification affects other U.S. taxpayers. For substantive tax purposes, the classification does not affect the treaty nonresident, who is not taxable under Subpart F nor otherwise subject to taxation of foreign source income derived from foreign corporations. If paragraph (a)(3) were limited to such situations, that is, situations where the treaty nonresident's status affected only third parties, treaty nonresidents would not have to file Form 5471 (or other international reporting forms) and it would at least not be inconsistent with both treaties and the Code.

[66] Although Forms 3520 and 3520-A are filed separately from income tax returns, they are clearly forms designed to provide information relevant to the income tax liability of U.S. grantors or beneficiaries of trusts.

E. Different treatment for individuals with a closer connection to a foreign country

The Code and the Regulations provide an exception for an individual[67] who satisfies the substantial presence test, provided that the individual is present in the U.S. for fewer than 183 days in the current year, the individual maintains a tax home (as defined in Section 162(a)(2)) in a foreign country during the current year, and the individual has a closer connection during the current year to a foreign country in which he or she maintains a tax home than to the U.S.[68] Under certain circumstances, an individual can have a closer connection to two foreign countries, but no more than two.[69]

Such individuals must file Form 8840 to claim this exception from the substantial presence test.[70] The analysis of a closer connection with a foreign country is fact-driven and depends on the facts and circumstances of each case. Some of the facts that are taken into account are the location of: the individual's permanent home, the individual's family, personal belongings (such as automobiles, furniture, clothing and jewelry owned by the individual and his or her family), social, political, cultural or religious organizations with which the individual has a current relationship, the location where the individual conducts his or her routine personal banking activities, the location of the jurisdiction in which the individual holds a driver's license and votes, etc.

The closer connection exception is relevant to our discussion because an individual who satisfies this exception is treated as not meeting the substantial presence test for that calendar year, and as a result is not a resident alien. For all purposes of the Code, including information reporting requirements, such an individual is treated as a nonresident alien.

If individuals who meet the closer connection exception are treated as nonresident aliens, the authors believe the same treatment should be applied to treaty nonresidents. Pursuant to the position of the IRS, a

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[67] The closer connection exception is not available to an individual who has applied, or taken other affirmative steps, to acquire permanent resident status during the current year or has an application pending for adjustment of status during the current year. Treas. Reg. § 301.7701(b)-2(f).

[68] *See* IRC § 7701(b)(3)(B) and Treas. Reg. § 301.7701(b)-2.

[69] Treas. Reg. § 301.7701(b)-2(e).

[70] IRC § 7701(b)(8).

treaty nonresident is subject to a series of information reporting requirements, while an individual who meets the closer connection exception does not have to file any information returns, nor an FBAR since the BSA regulations incorporate the Code definition of resident alien.

The authors believe the treatment of an individual in either scenario should as a matter of policy be the same, since in both situations the foreign individual is taxed in the same manner as a nonresident alien.

F. Trap for poorly advised taxpayers (and persons who deal with them) and an unnecessary burden for well-advised ones (the minority)

The position of the IRS that a treaty nonresident is subject to reporting requirements as if he or she were a resident alien has not been widely publicized. As noted above, the only place it had ever appeared in published materials issued by the government has been in the obscure language and location of Treas. Reg. § 1.6038-2(b)(2)(ii) and, for the first time, in the instructions to Form 8938.

Our own experience is that the requirement for treaty nonresidents to file forms has until recently been unknown to experienced international tax practitioners, even those who are aware that a foreign corporation's status as a CFC would be determined for purposes of taxing other U.S. shareholders as if a treaty nonresident were a resident. We have, moreover, found no discussion of this in leading international tax treatises and other secondary materials.[71]

In fact, the instructions to Form 8938 have complicated matters because the same instructions have not been included in the other Forms. If

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[71] See, for example, Kuntz & Peroni, U.S. International Taxation, Warren Gorham & Lamont/Thomson Reuters (looseleaf 1992-date), ¶ B1.02[2][c][x] and ¶ SB1.02[2][c][x], esp. note 227, and ¶ B2.10[3] text accompanying note 38.; Rhoades & Langer, U.S. International Taxation and Tax Treaties, Mathew Bender (looseleaf 1971-date), ¶23.09[1], which does state, citing Treas. Reg. § 1.6038-2(j)(2)(ii), that an alien must file financial information about a foreign corporation unless other U.S. persons are required to furnish the information (this is not quite what the regulations says, however); neither Blum, Canale, Hester and O'Connor, Reporting Requirements Under the Code for International Transactions, Portfolio 947-1st, nor Bissell, U.S. Income Taxation of Nonresident Alien Individuals, Portfolio 907-3rd (BNA) mention paragraph (a)(3) at all. A fine and comprehensive article by Professor Richard Westin, "U.S. Tax Compliance Requirements for Nonresident Aliens and Their Entities", 40 TM International Journal 144 (3/11/2011) does not discuss the question of reporting requirements for treaty nonresidents. See, however, Levin, A U.S. Tax Primer on Dual Status Individuals" 44 TM International Journal 220 (April 2015), which was published while this paper was being finalized, as well as Karlin, footnote 14, *supra*.

Treasury and the IRS do not accept our proposal or some version of it, the IRS should at least update instructions to other Forms as well as Publication 519 to explain the government's position.

G. The position leads to inconsistent results

Conversely, as noted above in various situations and in the fact pattern described in Exhibit A, treating a treaty nonresident as a resident leads to inconsistent results in the application of Sections 6038A and 6038C (corporations with 25% foreign shareholders), 6039F (gifts from foreign persons) and 6048 (reporting with respect to foreign trusts), as well as potentially unexpected substantive results for foreign trusts with U.S. income. In some cases, these results are illogical, as in the case of the foreign trust with a treaty nonresident grantor that must be treated as a non-grantor trust under section 672(f) for substantive purposes but as a grantor trust for reporting purposes or the case of a treaty nonresident who might be required to give an FFI a Form W-8BEN for Chapter 3 withholding purposes and Form W-9 (or even both Form W-8BEN and Form W-9) for FATCA purposes.

VI. REQUEST FOR GUIDANCE

The authors request guidance and confirmation from the U.S. Treasury that a treaty nonresident should be treated as a nonresident alien: (a) for purposes of calculating the U.S. income tax liability of such individual under the Code and the Regulations, and (b) for all purposes of the Code relating to the taxation of the alien, including U.S. information reporting requirements.

The requested guidance and clarification could be made in the form of an amendment to Treas. Reg. § 301.7701(b)-7(a)(1),[72] which could be amended to read as follows:

> "(a) Consistency requirement—
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> **(1)** ***Application.*** The application of this section shall be limited to an alien individual who is a dual resident taxpayer pursuant to a provision of a treaty that provides for resolution of conflicting claims of residence by the United States and its

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[72] Example 1 of Treas. Reg. § 301.7701(b)-7(e) should be modified accordingly.

treaty partner. A "dual resident taxpayer" is an individual who is considered a resident of the United States pursuant to the internal laws of the United States and also a resident of a treaty country pursuant to the treaty partner's internal laws. If the alien individual determines that he or she is a resident of the foreign country for treaty purposes, and the alien individual claims a treaty benefit (as a nonresident of the United States) so as to reduce the individual's United States income tax liability with respect to any item of income covered by an applicable tax convention during a taxable year in which the individual was considered a dual resident taxpayer, then**:**

(a) that individual shall be treated as a nonresident alien of the United States for purposes of computing that individual's United States income tax liability under the provisions of the Internal Revenue Code and the regulations thereunder (including the withholding provisions of section 1441 and the regulations under that section in cases in which the dual resident taxpayer is the recipient of income subject to withholding) with respect to that portion of the taxable year the individual was considered a dual resident taxpayer**;**

(b) that individual shall be treated as a nonresident alien of the United States for any reporting requirement imposed on any person under the Code, including sections 1298(f), 6012, 6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048; and

(c) the status of any trust as foreign or domestic, the determination of whether any portion of the trust is owned by a United States person for purposes of Subpart E of Part 1 of Subchapter J, and whether a gift is treated as made by a United States or a foreign person for purposes of section 6039C shall be determined on the basis that such a dual resident taxpayer is treated as a nonresident alien.

(2) ***Computation of tax liability.*** If an alien individual is a dual resident taxpayer, then the rules on residency provided in the convention shall apply for purposes of determining the individual's residence for all purposes of that treaty.

(3) ***Other Code purposes Residency Periods.*** Generally, for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax

> liability, the individual shall be treated as a United States resident. Therefore, for example, the individual shall be treated as a United States resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under section 957 or whether a foreign corporation is a foreign personal holding company under section 552. In addition, t**T**he application of paragraph (a)(2) of this section does not affect the determination of the individual's residency time periods under § 301.7701(b)-4.
>
> (4) Special rules for S corporations. [Reserved]"[73] [Emphasis and proposed deletions added]

This guidance would clarify the treatment of: (a) individuals who satisfy the substantial presence test or the lawful permanent resident test but are treaty nonresidents, and (b) individuals who satisfy the requirements of Code Section 7701(b)(6) and cease to be treated as lawful permanent residents of the U.S.[74] for all purposes of the Code (including the filing of information returns).

The authors also believe that the rule that the status of a corporation as a controlled foreign corporation should be determined on the basis of an individual's status as resident or nonresident after application of any treaty provision. The problem with the current rule is that if a U.S. person who seeks to determine whether a corporation is a controlled foreign corporation or not needs to know the status of another shareholder, asking a treaty nonresident shareholder is very likely to result in that shareholder providing incorrect information, because neither the U.S. shareholder nor the treaty nonresident may be aware of the nuances of the current rule. While the authors do not have data on how many foreign corporations are treated as CFCs or how many U.S. persons become "United States shareholders" solely as a result of treating treaty nonresidents as U.S. residents (that is, the treaty nonresident's shareholdings are what makes the difference), it does

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[73] When the Section 7701(b) Regulations were adopted in 1992, the IRS reserved its position with respect to S corporations because it had proposed regulations, which were never finalized, addressing the treatment of dual residents. See Proposed Regulation 301.7701(b)-7(a)(4), REG-209720-94; INTL-40-94 (April 27, 1992).

[74] Individuals who cease to be treated as lawful permanent residents of the U.S. under Section 7701(b)(6) should therefore no longer be deemed resident aliens under Section 7701(b)(1) nor U.S. persons under Section 7701(a)(30)(A).

not seem likely that the number is great or that it is worth maintaining these complexities to capture them.

The requested guidance would also clarify the treatment of individuals under other statutes that incorporate by reference the Code definition of "U.S. person" or "resident alien", including for example, the BSA Regulations which incorporate the definition of resident alien of Code Section 7701(b).

With respect to FBARs, the authors accept that FinCEN does not have to apply tax treaties in defining who is a U.S. resident for purposes of the FBAR, which is neither a tax form nor a requirement of tax law. FinCEN chose to use tax law concepts of residence for purposes of the FBAR but it has shown itself willing to adapt the tax law definition by using a different definition of the United States and equally it does not have to apply income tax treaty definitions of residence. It can at least be plausibly argued that the government's interest in learning about the foreign financial holdings of those on whom it has conferred the right of permanent residence extends beyond tax administration and should not be limited by the effect of tax treaty residence provisions.

We nevertheless would recommend that the IRS confer with FinCEN about this issue and seek to make the definition of residence for purposes of FBARs and tax forms consistent. At the very least, the position with respect to treaty nonresidents who meet the substantial presence test but do not hold green cards should be clarified and the instructions to Form 114 should address this topic.

We believe that our recommendations would bring about a helpful simplification of an unnecessarily complicated and confusing area of the law. But even if the government does not accept our basic recommendation, that treaty nonresidents should be treated as nonresident aliens for reporting purposes, the government should at the very least:

- Make changes to the forms and instructions including, following consultation with FinCEN, FBARs, and, where appropriate, the Regulations to clearly alert taxpayers of their obligations.

- Clarify to the public its position on the proper interpretation of section 7701(b)(6).

- At least until it has publicized its position by the changes described above, accept as a matter of routine that treaty nonresidents should not be subject to the draconian penalties otherwise imposed for noncompliance with the reporting requirements.[75]

[75] This is consistent with the intent of the Delinquent International Information Return Submission Procedures (and the Delinquent FBAR Submission Procedures), respectively available at http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-International-Information-Return-Submission-Procedures and http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-FBAR-Submission-Procedures (viewed April 26, 2015).

VII. CONCLUSION

In our global economy and as more foreign individuals seek to invest in or increase their business presence in the U.S., the authors believe that the number of treaty nonresidents will only continue to increase. Southern California, where the authors reside and practice law, has benefited from the inflow of investment, businesses and services of foreign investors. These individuals are likely to have a high level of wealth and sophistication concerning their assets and financial matters. However, U.S. international taxation issues can be a complex area even for these individuals.

Treaty nonresidents who fall within the scope of Treas. Reg. § 301.7701(b)-7(a) and satisfy the filing requirements of Section 301.7701(b)-7(b) are treated as a nonresident aliens under the Code and Regulations for calculating their U.S. income tax liability. Since these individuals are already determining their U.S. tax liability by identifying, calculating and paying such tax liability with their nonresident returns, the Treasury and the IRS have the means to identify such individuals and take enforcement action, if appropriate, concerning such individuals. Therefore, the interests of the Treasury and the IRS should not be affected.

This reasoning has been set forth in the final Regulations under Section 6038D, which exclude treaty nonresidents from the filing requirement of Form 8938, "Statement of Specified Foreign Financial Assets". The authors strongly believe that uniform treatment should be applied to all treaty nonresidents who comply with the filing requirements of Section 301.7701(b)-7(b) (e.g., timely filing Form 1040NR and 8833), so that they are treated as nonresident aliens for all Code purposes and therefore excepted from U.S. information reporting requirements.

Clarification on the treatment of treaty nonresidents is important to make out our domestic law consistent with the provisions and effect of U.S. tax treaties, including the "tie-breaker rules". This clarification could be issued in the form of an amendment to Treas. Reg. § 301.7701(b)-7(a)(1), by expressly providing that treaty nonresidents are deemed nonresident aliens of the U.S. for all Code purposes. Importantly, the position of the IRS would be publicly available for compliance.

In addition, the requested clarification would be beneficial for the IRS because information returns would be filed consistently and properly by U.S. citizens and resident aliens (including lawful permanent residents)

who are taxed on worldwide income. The information contained in such information returns would be available to the IRS for enforcement action, since it is related to the U.S. tax liability determination of the filer. In contrast, the IRS currently requires and must therefore process information returns filed by treaty nonresidents where the information is not related to determining the tax liability of the filer or, in most cases, any other U.S. taxpayer. In situations where the interaction between a U.S. person and a treaty nonresident gives rise to the filing of U.S. information returns, such returns would be filed consistently and correctly by treating the U.S. person as such and the treaty nonresident as a non-U.S. person (e.g., the receipt of gifts by a U.S. person from a treaty nonresident donor totaling more than $100,000 during a calendar year would be treated as foreign gifts and would therefore be reportable).

If the clarification requested by the authors is made, the treatment of individuals who cease to be lawful permanent residents under Code Section 7701(b)(6) would also be clarified, in the sense that such individuals are no longer resident aliens and are not required to file U.S. information returns as resident aliens.

Clarification is also needed for purposes of implementing FATCA. As explained above, FATCA is both a withholding and an information reporting statute, and it is therefore not clear how a treaty nonresident is supposed to certify his or her status. The authors recommend that treaty nonresidents should certify themselves as nonresidents and that this would result in certifications consistent with those required for purposes of Chapter 3 withholding.

Finally, the authors recommend that the IRS should initiate discussion with FinCEN to clarify the position with respect to treaty nonresidents, preferably by treating treaty nonresidents as nonresidents for the purposes of FBAR filing and recordkeeping purposes but at least by ascertaining FinCEN's position and having it made clear in the instructions to Form 114 and, preferably, the BSA regulations.

EXHIBIT A

Fact pattern: Filing of inconsistent information returns as a result by considering treaty nonresidents as U.S. residents

As an example of a common scenario with U.S. international tax clients, let us assume that Mr. Oscar Alvarez is a citizen and resident of Mexico, residing in Mexico City. Mr. Alvarez is married to a U.S. citizen, Mrs. Johnson-Alvarez, and they have three children who are dual citizens. Five years ago, Mrs. Johnson-Alvarez and the three children moved to Southern California so their oldest child could attend university in California. Since then, Mr. Alvarez travels frequently from Mexico City to Southern California to visit his family. Mr. Alvarez is tax resident of Mexico, having a permanent home and conducting his business activities in Mexico City. He does not own or direct any businesses in the U.S. For the tax year 2014, Mr. Alvarez is deemed a resident alien because he satisfies the "substantial presence test" for 2014. However, based on the facts and circumstances of his case, his U.S. international tax attorney has advised Mr. Alvarez that he should be deemed a "dual resident taxpayer", and that under Article 4 of the U.S.-Mexico Tax Treaty, he should be taxed in the U.S. as a nonresident alien.

Mr. Alvarez is not domiciled in the U.S. During the calendar year 2014 Mr. Alvarez made several gifts to his spouse by wire transfers from his personal account in Mexico, which exceeded $100,000 in the aggregate.

The house where Mrs. Johnson-Alvarez and her children live in California is owned by a California revocable trust. Mr. Alvarez and Mrs. Johnson-Alvarez are the Settlors of the trust. The trust owns another residential real property located in California which is leased to a third party. Both Settlors contributed funds to the trust to purchase the real properties. Each Settlor has the power to revoke the trust as to the property contributed by each of them. Mr. Alvarez serves as sole trustee. Both spouses are the beneficiaries of the trust.

If for the tax year 2014 Mr. Alvarez is deemed a nonresident alien for all Code purposes, Mrs. Johnson-Alvarez must file IRS Form 3520 for 2014 to report the gifts she received from her foreign husband.[76]

Mr. Alvarez, as a nonresident alien, holds at least once substantial power over the administration of the trust. Therefore, the trust should be deemed a foreign trust.[77] Therefore, Mrs. Alvarez must also complete part II of Form 3520, since she has the power to revoke the property she contributed to the trust and is a U.S. person who is deemed an owner of part of the assets of a foreign trust under Code Sections 671-679.[78] In addition, Mrs. Johnson-Alvarez must also ensure that the trust files IRS Form 3520-A.[79]

The reporting requirements described above are consistent with the treatment of Mr. Alvarez as a nonresident alien under Treas. Reg. Section 301.7701(b)-7(a)(1). However, if Mr. Alvarez is deemed a U.S. resident for information reporting requirements under Treas. Reg. § 301.7701(b)-7(a)(3), this can lead to the filing of inconsistent information returns with respect to the same individual. This position requires "mental gymnastics" to sort through the numerous reporting requirements that could apply if a treaty nonresident files information returns as a U.S. resident.

In our example, are the gifts from Mr. Alvarez to his spouse no longer deemed "foreign gifts" under Section 6039F, so that Mrs. Johnson-Alvarez is not required to report the gifts on Form 3520?[80] Is the trust deemed a domestic trust because one or more U.S. persons have the authority to control all substantial decisions of the trust?[81] Is Mrs. Johnson-Alvarez no longer required to ensure the trust files Form 3520-A as required under Code Section 6048(b)? Should Forms 3520 and 3520-A be filed considering the reporting obligations of Mrs. Johnson-Alvarez only, and treating Mr. Alvarez as a nonresident alien?

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[76] As required by IRC § 6039F.

[77] *See* Treas. Reg. § 301.7701-7(d)(1)(i) and IRC § 7701(a)(31)(B).

[78] IRC § 6048(b). Other reporting requirements could apply under IRC §6048(a) if there is a reportable event.

[79] IRC § 6048(b).

[80] IRC § 6039F(b) provides that "For purposes of this section, the term 'foreign gift' means any amount received from a person other than a United States person which the recipient treats as a gift or bequest. Such term shall not include any qualified transfer (within the meaning of section 2503(e)(2)) or any distribution properly disclosed in a return under section 6048(c)."

[81] Treas. Reg. § 301.7701-7(a).