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By Liliana Menzie and Michael J.A. Karlin

Liliana Menzie is an attorney with DLA Piper in San Diego, and Michael J.A. Karlin is a partner with Karlin & Peebles LLP in Los Angeles. They wish to thank Michael G. Pfeifer and Michael J. Miller for their invaluable insights and comments.

Menzie and Karlin identify several problems with the IRS's apparent position that dual resident taxpayers are required to file U.S. information returns as resident aliens. They request guidance and confirmation from Treasury that a dual resident taxpayer should be treated as a nonresident alien in calculating the individual's U.S. income tax liability and for all purposes of the code, including U.S. information reporting requirements.

This report is one in a series of proposals sponsored by the California Bar Association and presented to various policymakers and government officials. However, the comments in it reflect the individual views of the authors who prepared them and do not represent the position of the State Bar of California or the Los Angeles County Bar Association.

Table of Contents

I. Background

A. Statutory Definition of Resident Alien

The definition of a resident is set out in section 7701(b), which was enacted in 1984 and came into effect for calendar years beginning after 1984.[1] By its terms, section 7701(b) applies for all purposes of the code, except subtitle B, dealing with estate, gift, and generation-skipping transfer taxes.

Section 7701(b) provides that a resident alien is an individual who meets one of two tests: the lawful permanent resident test or the substantial presence test.[2] 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 as long as his status has not been judicially or administratively revoked or abandoned.[3] The substantial presence test, which is applied annually, causes an alien to become a

[1]Tax Reform Act of 1984 (P.L. 98-369), section 138(a). Other code provisions with rules concerning tax residence include elective residence under section 6013(g) or (h) (elections available to some married couples filing joint returns), section 865 (source of sale of property), and section 2001 (estate tax). *See also* section 871(a)(2), taxing capital gains of nonresident aliens present in the United States for a period or periods aggregating 183 days or more during the tax year.

[2]Section 7701(b)(1)(A).

[3]Section 7701(b)(6).

resident alien by being physically present in the United States 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.[4]

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

B. The Effect of Treaties on Residence

The United States has entered into numerous bilateral income tax treaties.[5] Almost all of them contain a provision under which the parties 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. Those so-called tiebreaker rules are generally included in article 4 (''Residence'' or ''Fiscal Domicile'') of the U.S. income tax treaties, which are largely structured along the lines of article 4 of the OECD model treaty[6]:

ARTICLE 4
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.

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[4]Section 7701(b)(1)(A) and (b)(3). There are three elections under which, in various circumstances, an alien who would otherwise be treated as an NRA may elect to be treated as a resident. We list them 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:

- Section 7701(b)(4): An NRA 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.
- Section 6013(g): An NRA will be treated as a resident if, at the close of the tax year, he was married to a U.S. citizen or resident, and both of them elect to file a joint return.
- Section 6013(h): An individual who was an NRA at the beginning of the tax year but at the close of the year was a U.S. resident and married to a U.S. citizen or resident, may elect 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 that requirement.

The regulations under section 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* reg. section 1.6013-6(a)(2)(v) and -7(a)(2). Although there is no similar provision in the regulations under section 7701(b), it seems logical that someone who could be treated as a resident only 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.

[5]The current U.S. income tax treaties are *available at* http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties—-A-to-Z.

[6]The current U.S. model treaty (Nov. 15, 2006) is *available at* http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf. 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 (the residence of a Canadian individual with a permanent home in both countries and inconclusive facts regarding the center of vital interests was determined based on habitual abode).

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 a resident in that state, the treaty's tiebreaking rules apply. Throughout this report, 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 treaty partner, that alien is referred to as a "treaty nonresident."[7]

In the modern world, many individuals fall under the definition of tax resident in two or more countries as a result of multiple nationalities and residence permits, dispersed families, multiple residences, and business activities in multiple countries.[8] Dual residents are likely to have relatively higher levels of wealth and income and to own securities, financial accounts, and assets in multiple jurisdictions.

The United States 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 more other countries under their respective resident criteria. Also, the United States requires administrative or judicial steps for termination of lawful permanent resident status. Moreover, the substantial presence test under section 7701(b)(1)(A)(ii) can capture a non-immigrant individual who spends, on average, just four months a year in the United States.

Treaty residence articles therefore play a useful role by assigning residence and consequent worldwide taxing jurisdiction to the appropriate country and generally reducing the tax compliance burden for multicountry individuals.

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:

> 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.[9]

The change was made, with essentially no comment in the legislative history, as a conforming amendment in conjunction with Congress's enactment of the expatriation rules in sections 877A and 2801.[10] Substantially similar language had previously appeared in section 877(e)(1)(B) and was removed from that section at the same time section 7701(b)(6) was amended.

The language of section 7701(b)(6) appears to be unambiguous, at least for an alien who satisfies the lawful permanent resident test and does not satisfy the substantial presence test. Once an alien "commences to be treated as a resident of a foreign country under a treaty," he 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 (green card holders taxed as U.S. residents in eight of the prior 15 years for whom tiebreaking 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) only for 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 (regardless of whether he meets the financial thresholds to be a covered expatriate), the flush language appears to clearly apply and to overrule any inconsistent language in reg. section 301.7701-7(a), described below. In other words, those 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).

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[7]*See* Michael J.A. Karlin, "Now You See Them: U.S. Reporting Requirements for Tax Treaty Nonresidents," *Tax Notes Int'l*, July 16, 2012, p. 267.

[8]*Id.*

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

[10]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. JCT, "Technical Explanation of H.R. 6081, the 'Heroes Earnings Assistance and Relief Tax Act of 2008,'" JCX-44-08 (May 20, 2008).

D. Basic Reporting Requirement

A treaty nonresident must file a U.S. tax return as a nonresident (Form 1040NR).[11] Also, the treaty nonresident will generally be required to attach Form 8833, ''Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).''[12] Section 6114 requires that any taxpayer who asserts that a tax treaty overrules or modifies the code should disclose the position, attaching Form 8833 to his tax return.[13] There is an exception from the requirement to file Form 8833, but not from the requirement to file Form 1040NR, if the amount of payments and income items that would otherwise be required to be reported does not exceed $100,000.[14]

As discussed below, treaty nonresident status is determined by application of a treaty, and the consequence of failing to file Form 8833 is limited to the imposition of a relatively modest penalty.[15] 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 decision to file a U.S. income tax return using the applicable treaty; the code and the regulations do not condition the effectiveness of treaty provisions on the filing of Form 8833.

II. The Narrowing Scope of Treaty Nonresidence

A. Treatment of Treaty Nonresidents

Treasury is authorized to prescribe regulations as may be necessary or appropriate to carry out the provisions of section 7701(b). It exercised that authority in reg. section 301.7701(b)-7.[16] The regulations provide 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
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> (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.
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> * * *
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> (3) Other Code purposes. 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, 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.[17] [Emphasis added.]

The 1987 proposed regulations under section 7701(b) explained the duality in that provision 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

[11]The regulations use the term ''dual resident taxpayer,'' which is an individual who is considered a U.S. resident under the internal laws of the United States and also a resident of a treaty country under the treaty partner's internal laws. Reg. section 301.7701(b)-7(a)(1). We prefer the term ''treaty nonresident'' to describe a dual resident when the tiebreaker rules favor residence in the treaty partner country.

[12]Reg. section 301.7701(b)-7(b) and (c).

[13]*See* section 6114(a), reg. section 301.6114-1(a)(1), and reg. section 301.6114-1(d)(1) (applicable to tax years for which the due date for filing returns (without extensions) is after Dec. 15, 1997).

[14]*See* reg. section 301.6114-1(c)(2) and (b)(8).

[15]An individual's failure to file Form 8833 could give rise to a penalty of $1,000. Section 6712(a) and (c); reg. section 301.6712-1(a)(2).

[16]T.D. 8411.

[17]Thus, although the alien may not be taxed on subpart F income, section 956 inclusions, or deemed dividends under section 1248, his U.S. resident status may turn the corporation into a controlled foreign corporation for other U.S. persons — and with no warning whatsoever.

were nonresident aliens under the code if they choose to claim any treaty benefits as residents of a treaty country.[18]

B. Impact on Reporting Requirements

The regulations do not explicitly state that a treaty nonresident is to be treated as a resident alien for purposes of the code's reporting provisions. Nor is that treatment suggested in the history of the regulations. One could reasonably argue 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 reg. section 301.7701(b)-7(a)(3) does not concern reporting but rather the determination of a foreign corporation's status as a controlled foreign corporation, which can affect only some other (U.S.) taxpayer's liability.[19]

Despite this, and apparently disregarding the clear language of section 7701(b)(6) for green card holders (or at least long-term residents), the IRS seems to be asserting that a treaty nonresident who is taxed as a nonresident alien is still required to file U.S. information returns as a resident alien.

Discussed below are some of the information returns for which the IRS has apparently taken this position. As elaborated throughout this report, we believe that position is inconsistent with the code and U.S. tax treaties and may not even be supported by reg. section 301.7701(b)-7(a).

1. Form 5471, 'Information Return of U.S. Persons With Respect to Certain Foreign Corporations.'

Historically, the only reference to the IRS's position in published guidance is reg. section 1.6038-2(j)(2)(ii), which provides:

> 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[20] by filing the audited foreign financial statements of the foreign corporation with the individual's return required under section 6038. [Footnote added.]

Neither the regulations under section 6038 nor the instructions to Form 5471 state explicitly that a treaty nonresident must file the form. But 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's position, it should be stated somewhere where it is likely to come to the attention of practitioners and the public.

2. Form 8938, 'Statement of Specified Foreign Financial Accounts.' The same issue has also arisen in connection with Form 8938, which has been required since 2011 for most individual filers within its scope. In the 2011 temporary regulations under section 6038D, the government simply says: ''The term resident alien has the meaning set forth in section 7701(b) and sections 301.7701(b)-1 through 301.7701(b)-9 of this chapter.''[21] However, for the first time in actual instructions to a form, the IRS said that a treaty nonresident is nevertheless required to file Form 8938. Those instructions provide:

> 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.

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[18]In the preamble to the 1992 final regulations, the government noted that it had rejected a proposal by several commenters that a treaty nonresident should be treated as a nonresident only in 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 had not chosen to apply the treaty provisions. The proposal was rejected because it would have permitted an alien to elect his resident status separately for each item of income. *See* T.D. 8411.

[19]The last sentence of reg. section 301.7701(b)-7(a)(3) also states that in determining the application of the substantial presence test, a taxpayer's days of presence in the United States are computed without regard to whether he was a treaty nonresident during those days. This seems entirely reasonable, because 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. Note that the regulation also applies in determining whether a foreign corporation was a foreign personal holding company, but this is a dead letter given that the foreign personal holding company rules were repealed by the American Jobs Creation Act of 2004 (P.L. 108-357).

[20]These requirements concern information to be provided in schedules F, H, J, and M of Form 5471.

[21]Reg. section 1.6038D-1T(a)(3) in T.D. 9567.

In late 2014 Treasury and the IRS published final regulations under section 6038D[22] on the annual reporting of specified foreign financial assets by some individuals.[23] The final regulations are effective December 12, 2014, and supersede the 2011 temporary regulations. The preamble to the final regulations explains that Treasury and the IRS received several written comments requesting that some categories of individuals be relieved of the requirement to report specified foreign financial assets under section 6038D. One category was dual resident taxpayers who determine their U.S. tax liability as NRAs and claim tax treaty benefits as provided in reg. section 301.7701(b)-7(a)(1) by filing Form 1040NR and attaching Form 8833.

Treasury and the IRS excepted those dual resident taxpayers from the reporting requirement of section 6038D, explaining:

> 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.[24]

The final regulations under section 6038D now state that if a treaty nonresident timely files Form 1040NR or 1040NR-EZ and attaches Form 8833, that individual is not required to report specified foreign financial assets on Form 8938 for the portion of the tax year the individual is considered a dual resident taxpayer.[25]

In the definitions that apply for purposes of section 6038D and the final regulations, the term ''specified individual'' includes a U.S. citizen and a resident alien of the United States for any portion of the tax year,[26] and the term ''resident alien'' has the meaning provided in section 7701(b) and reg. sections 301.7701(b)-1 through 301.7701(b)-9.[27]

We believe that is the correct approach, since, as explained in the preamble to the final 6038D regulations, the filing of 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 an NRA, the filing of Form 8938 provides no additional value or relevant information for the calculation of his income tax liability.

We 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 we 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 yet incorporated the exception of treaty nonresidents under the regulations.[28] The IRS 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.[29] It would be preferable if some form of notification appeared at the top of the form or the instructions pending incorporation of the changes into the body of the instructions.

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

In its discussion of NRAs and resident aliens, Publication 519 states:

> 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,

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[22]Section 6038D(a) provides:

> 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).

[23]T.D. 9706.

[24]*Id.*

[25]Reg. section 1.6038D-2(e)(1) and (2).

[26]Reg. section 1.6038D-1(a)(2).

[27]Reg. section 1.6038D-1(a)(3).

[28]The instructions to Form 8938 (rev. Dec. 2014) continue to state:

> 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.

[29]*See* ''Update to 2014 Instructions to Form 8938 (Rev. December 2014)'' (Mar. 10, 2015), *available at* http://www.irs.gov/Businesses/Corporations/Update-to-2014-Instructions-to-Form-8938-1.

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.[30]

Publication 519 is silent on information returns, including forms 3520 and 3520-A.

4. FATCA regulations. The Foreign Account Tax Compliance Act was enacted in 2010 as part of the Hiring Incentives to Restore Employment Act.[31] FATCA has far-reaching impact on U.S. persons residing in the United States and on U.S. and non-U.S. persons residing abroad. Among many other items, FATCA introduced (1) a new reporting requirement for U.S. individuals with foreign assets (Form 8938); and (2) the need for individuals who hold accounts with foreign financial institutions to certify their status as a U.S. or non-U.S. person for purposes of the withholding tax regime for FFIs under new sections 1471 through 1474.[32]

Under FATCA, individual account holders must self-certify to their FFIs (in forms W-8BEN or W-9) 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 thus subject to 30 percent withholding on any passthrough payment made by the FFI.[33]

Despite their broad application, FATCA and its regulations are silent on whether a treaty nonresident is a U.S. person. The current definition of a U.S. person, set out in temporary regulations,[34] provides only:

> 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).[35]

Section 7701(a)(30) defines a United States person as including a citizen or resident of the United States, which 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 applicable to the FFI.[36] Many foreign countries that have entered into IGAs have adopted Model 1 IGAs requiring FFIs to report all FATCA-related information to their own governmental agencies, which can then provide that information to the IRS. A smaller number have entered into Model 2 IGAs, under which the foreign country undertakes 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). Several countries have yet to enter into an IGA, and their FFIs are required to enter into an FFI agreement in the prescribed form.

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)*

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[30]Publication 519, *U.S. Tax Guide for Aliens*, at 6-7 (Jan. 26, 2015).

[31]P.L. 111-14.

[32]A comprehensive discussion of FATCA is beyond the scope of this report.

[33]According to reg. section 1.1471-5(g), the term "recalcitrant account holder" means any holder (other than an FFI or presumed FFI) of an FFI-maintained account that 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:

- the account holder fails to comply with the FFI's requests for the documentation or information required for determining whether the account is a U.S. account;
- the account holder fails to provide a valid Form W-9 on request from the FFI or fails to provide a correct name and taxpayer identification number combination on request from the FFI when the FFI has received notice from the IRS indicating that the name and TIN combination reported by the FFI for the account holder is incorrect;
- if foreign law would (but for a waiver) prevent reporting by the FFI (or branch or division thereof) of prescribed information regarding the 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 that reporting; or
- the account holder provides prescribed documentation to establish its status as a passive nonfinancial foreign entity (other than a withholding partnership or withholding trust) but fails to provide prescribed information regarding its owners.

[34]T.D. 9657.

[35]Reg. section 1.1471-1T(b)(141)(i).

[36]The current IGAs entered into by the United States are *available at* http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx.

shall be interpreted in accordance with the U.S. Internal Revenue Code.[37] [Emphasis 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 reg. section 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?

Note that for chapter 3 withholding purposes, treaty nonresidents are treated as NRAs and therefore must 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 differently for purposes of certification under chapter 3 and chapter 4. One can imagine the consternation of an FFI receiving both certifications for the same individual.

As stated throughout this report, we believe the treatment of treaty nonresidents should be consistent, so they are deemed NRAs for all purposes, including self-certification of their U.S. tax status to FFIs. At a minimum, clarification is required for treaty nonresidents and the FFIs with which they deal.

5. FBAR. Under the Bank Secrecy Act (BSA)[38] regulations, every U.S. 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 those foreign accounts.[39] The foreign bank account report, previously Form TD F 90-22.1, was replaced in 2013 by Financial Crimes Enforcement Network Form 114, ''Report of Foreign Bank and Financial Accounts.'' This reporting obligation is not a requirement under the tax code but rather is a requirement under the BSA (codified in Title 31 of the U.S. Code).

Final BSA regulations, issued in 2011,[40] introduced a new definition of U.S. person. For purposes of the BSA regulations, a U.S. person includes a citizen of the United States and a resident of the United States.[41] A resident of the United States is an individual who is a resident alien under section 7701(b) and its regulations.[42]

The regulations, the FBAR itself,[43] and the instructions to the FBAR[44] 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 nonresident for tax purposes must still file the FBAR.'' Based only on that sentence, a lawful permanent resident is deemed a U.S. person for FinCEN Form 114 purposes, even if he elects to be taxed as a nonresident under a U.S. tax treaty.

The preamble to the BSA regulations does not address U.S. residents who satisfy the substantial presence test but who are dual resident taxpayers under reg. section 301.7701(b)-7(a)(1). Does the IRS (under the enforcement authority delegated by FinCEN) expect those 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 FinCEN form filing or record-keeping requirements.[45] Willful failures can give rise to heavy civil or criminal penalties.

III. 'Electing' Treaty Nonresidence

The IRS has begun to refer to an alien ''electing'' to be treated as a resident of a treaty country.[46] However, taxpayers do not ''elect'' to be treated as nonresidents under U.S. tax treaties.[47]

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[37]''Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA'' (reciprocal IGA). The language of the versions of the Model 2 IGA (applicable to countries with which the United States has a tax treaty) is substantially similar. *See* ''Model 2 IGA, Preexisting TIEA or DTC,'' art. 1(y).

[38]31 U.S.C. sections 5311-5330.

[39]31 CFR section 1010.350(a) and (b).

[40]RIN 1506-AB08, 31 CFR part 1010.

[41]31 CFR section 1010.350(b).

[42]31 CFR section 1010.350(b)(2).

[43]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.

[44]Until 2012, the FBAR instructions were part of the form. Since 2013, they are published on FinCEN's website at http://www.fincen.gov/forms/files/FBARpercent20Linepercent20Itempercent20Filingpercent20Instructions.pdf.

[45]31 U.S.C. section 5321(a)(5)(A).

[46]For example, see the instructions to Form 8938, *supra* note 29. 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).

[47]We believe this trend may have originated with comments by the American Institute of Certified Public Accountants 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,'' at 11

(Footnote continued on next page.)

If a taxpayer maintains that a treaty overrules or otherwise modifies an internal revenue law, section 6114 requires that he disclose that position on a tax return or, if no tax return must be filed, in a form prescribed by Treasury. There is a penalty for failing to file Form 8833 when required,[48] but the IRS has recognized that the failure to file the form does not deprive a taxpayer of treaty rights.[49] And if payments or income items 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 as a treaty nonresident. However, unlike for elections, which are subject to time limits and other procedural requirements, the failure to claim benefits within any particular 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 for Treaty Nonresidents

A. Unreasonable and Unexpected Consequences

Few return preparers know about all the reporting requirements applicable to U.S. persons. We have found that many experienced international tax practitioners are unaware of reg. section 301.7701(b)-7(a)(3) or fail to appreciate that it relates not only to the classification of CFCs but also to the applicability of the reporting requirements.

The treatment of treaty nonresidents as U.S. residents may turn unsuspecting NRAs into unintentional lawbreakers. Consider a citizen of Canada who is retired, having worked all his life in Canada, where he maintains a house. All his family live in Canada; he votes there; he has a Canadian driver's license; and he belongs to social and religious organizations in Canada. All 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 he 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 it happens, is reluctant to treat individuals as relinquishing their Canadian residence).

That individual might satisfy the numerical tests under the substantial presence test in some years, but in most of those years, he could file a return and take the position — incontestably on these facts — that he was a nonresident under the closer connection test (which requires that the taxpayer have a tax home in Canada, as well as more Canadian connecting factors than U.S. connecting factors). 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 Canada-U.S. treaty. Does the U.S. government maintain that the individual must file forms 5471, 8865, 8858, 8621, 3520, and an FBAR in that year?[50] Assuming the individual must now report, what need does the IRS have for the information? None of the items of income or assets reported on the forms will be reportable as income. What is the purpose of collecting this information?

B. Unintended Consequences for the IRS

There are unintended consequences to considering treaty nonresidents as resident aliens for U.S. reporting requirements under reg. section 301.7701(b)-7(a)(3). Suppose that during a calendar year 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 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,[51] would be a U.S. resident for reporting purposes.

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

(Apr. 30, 2010). For more discussion, see Karlin, ''The Meaning of Residence for FBAR Purposes,'' 13 *J. Tax Prac. & Proc.* 51, 56 (2011).

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

[49]*See* PMTA 01188 (program manager technical assistance concluded that treaty benefits cannot be denied if the taxpayer is entitled to them; the examiner was entitled to impose a penalty of $1,000 under section 6712).

[50]The regulations under section 7701 also provide that a ''closer connection'' claim may be made only on a timely filed return, subject to the usual exception if the failure to timely file 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 of the alien who is entitled to make both claims but fails to timely make the statutory claim?

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

by a U.S. resident and does not have a 25 percent foreign shareholder. Therefore, it would not have to file Form 5472.

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

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

C. Troublesome Example Concerning Trusts

The inconsistent treatment of treaty nonresidents for substantive and information reporting purposes is especially troublesome for trusts because the grantor's status as a resident alien or NRA may determine whether the trust is a grantor trust or a non-grantor 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. If a trust has a treaty nonresident grantor and, but for section 672(f), would be a grantor trust for income tax purposes, is it a grantor trust for reporting purposes? Is it a grantor trust for substantive purposes insofar 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 believes that the trust is a non-grantor trust for income tax purposes but a grantor trust for reporting purposes. This is easily stated, but the results are contradictory and generate Form 3520 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, will the beneficiary be provided a Foreign Grantor Trust Beneficiary Statement instead of a Foreign Nongrantor Trust Beneficiary Statement (and therefore check yes in line 29 of Part III of Form 3520 and no in line 30) when the trust is a non-grantor trust for substantive tax purposes? How valuable to the IRS is a Form 3520-A filed by a treaty nonresident when the treaty nonresident reports as a grantor trust a trust that is actually a non-grantor trust?

The language of reg. section 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. 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 it is a non-grantor trust for purposes of computing the grantor's tax liability? Based on the example provided (involving the potential classification of a foreign corporation as a CFC), the regulation seems to intend that the liability of third parties be determined by treating the treaty nonresident as a resident.[52]

Exhibit A to this report reflects a common scenario we have experienced with U.S. international tax clients. It provides additional background and a practical example of the complexities that arise when treaty nonresidents are considered U.S. residents for information reporting requirements for trusts.

If treaty nonresidents are deemed U.S. residents for information reporting purposes, this leads to the filing of inconsistent information returns for the same treaty nonresident and factual situations. We believe 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 for trusts, the treatment should be consistent not only for the grantors but also for the trusts themselves and their beneficiaries.

V. Treaty Nonresidents Should Be NRAs

Several arguments support the proposition that treaty nonresidents should be treated as NRAs of the United States for all purposes of the code.

A. Aliens: Information Returns Have No Value

The government's need for the data collected from information returns required of treaty nonresidents is minimal when weighed against the burden imposed on the filers.

Do the data have any value to the IRS? What actually will be done with all the information returns attached to Form 1040NR? They will yield no information relevant to the computation of any U.S. person's tax, nor is any of the information

[52]A similar problem concerns the determination of whether a trust is 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)." Reg. section 301.7701-7(a)(1)(ii). Is a treaty nonresident a U.S. person for these purposes? Once again, the language of reg. section 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 U.S. person. This does not seem a particularly sensible result.

relevant to the computation of a treaty nonresident's tax. At most, it could give the IRS information that would be relevant only if the filer's claim to be a treaty nonresident were found to be incorrect.[53] We can think of no other situation in which the government requires information to be filed just in case the taxpayer's position is wrong.[54]

By contrast, and consistent with our direct experience, the burden on taxpayers can be significant — sometimes extreme. The correct approach is the one adopted by the final section 6038D regulations.[55] As explained in the preamble to those regulations, the filing of 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 an NRA, the filing of Form 8938 provides no additional value or relevant information for the calculation of his income tax liability.

We agree that treaty nonresidents who timely file forms 1040NR and 8833 should be excepted from the requirement to report specified foreign financial assets under section 6038D, and we 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. Not Permitted Under 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." There is no suggestion that this has only a limited effect. As we have seen, there is much uncertainty about the precise scope of this language. Congress may have intended that it apply only 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 insofar as those aliens are concerned, the language is clear.

For other green card holders, as well as for aliens who satisfy the substantial presence test, section 894 provides that the provisions of Title 26 are to be applied to any taxpayer with due regard to any treaty obligation that applies to the taxpayer. An individual who, after application of the typical tiebreaker rule, is treated 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 U.S. citizens and residents. Moreover, the 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, Imposition of Tax Not Separate

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,"[56] and it defines the phrase "for the purposes of this Convention."[57]

The code's reporting requirements exist primarily to enable the IRS to administer and enforce the tax laws. They have no independent relevance or meaning outside the code provisions that impose and define tax obligations. And surely, when a treaty speaks of applying to the federal income taxes imposed by the code, it must apply to the interest, additions to tax, and penalties that motivate compliance and deter and punish noncompliance. 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.

Treasury and the IRS do not have the power to use regulations or form instructions to override two clear statutes and limit the effect of tax treaties. While a statute can override a treaty, a regulation cannot, since a treaty has the same status as a statute.[58] The regulatory authority in section 7701(b) is to carry out the purposes of the section, not to

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[53]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."

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

[55]*See* reg. section 1.6038D-2(e)(1) and (2).

[56]*See, e.g.*, art. 2(3), "Taxes Governed by the Convention" of the Mexico-U.S. treaty; and art. 2(2) "Taxes Covered" of the Canada-U.S. treaty.

[57]*E.g.*, art. 3(1) "General Definitions," art. 4(1) "Residence," art. 5(1) "Permanent Establishment," and art. 7(5) "Business Profits" of the Mexico-U.S. treaty; and art. 3(1) "General Definitions," art. 4(1) "Residence," and art. 5(1) "Permanent Establishment" of the Canada-U.S. treaty.

[58]Treaties are agreements between sovereign governments and while, under the supremacy clause of the U.S. Constitution (Art. VI, para. 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.

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

D. Regulation Does Not Mention Reporting

The code's reporting requirements are an integral part of the computation of an individual's tax liability. On that basis, reg. section 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. Their purpose is to enable a taxpayer to compute, and the IRS to determine, the filer's liability for U.S. income taxes.[59] The forms perform this function for citizens and resident aliens, but they are irrelevant to the computation of the liability of NRAs, 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 reg. section 301.7701(b)-7(a)(3) shows that the provision could be interpreted to not conflict with treaties or the code. The example deals with the classification of foreign corporations as CFCs and foreign personal holding companies. That 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 or otherwise subject to taxation of foreign-source income derived from foreign corporations. If the regulation were limited to those situations — that is, situations in which the treaty nonresident's status affected only third parties — treaty nonresidents would not have to file Form 5471 (or other international reporting forms), and the provision would not be inconsistent with both treaties and the code.

E. Different Treatment for Closer Connection

The code and the regulations provide an exception for an individual[60] who satisfies the substantial presence test if the individual is present in the United States for fewer than 183 days in the current year, maintains a tax home (as defined in section 162(a)(2)) in a foreign country during the current year, and during that year has a closer connection to a foreign country in which he maintains a tax home than to the United States.[61] Under some circumstances, an individual can have a closer connection to two foreign countries, but no more than two.[62]

Those individuals must file Form 8840 to claim this exception from the substantial presence test.[63] The analysis of a closer connection with a foreign country depends on the facts and circumstances of each case. Some of the factors considered are the location of the individual's permanent home; the location of individual's family; the location of personal belongings (such as automobiles, furniture, clothing, and jewelry owned by the individual and his family); the location of social, political, cultural, or religious organizations with which the individual has a current relationship; where the individual conducts his routine personal banking activities; and the jurisdiction in which the individual holds a driver's license and votes.

An individual who satisfies the closer connection test 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, that individual is treated as an NRA.

If individuals who meet the closer connection exception are treated as NRAs, the same treatment should be applied to treaty nonresidents. Under the IRS's position, a treaty nonresident is subject to a series of information reporting requirements, but an individual who meets the closer connection exception does not have to file any information returns or an FBAR because the BSA regulations incorporate the code definition of resident alien.

The treatment of an individual in either scenario should be the same as a matter of policy because in both situations the foreign individual is taxed in the same manner as an NRA.

F. Trap for Poorly Advised Taxpayers

The IRS's position that a treaty nonresident is subject to reporting requirements as if he were a resident alien has not been widely publicized. As noted above, the only place it has ever appeared in published government materials has been in the obscure language and location of reg. section 1.6038-2(b)(2)(ii) and in the instructions to Form 8938.

Until recently, seasoned international tax practitioners were unaware that treaty nonresidents are required to file forms. That was true even for practitioners who knew that a foreign corporation's status as a CFC would be determined for purposes

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[59]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.

[60]The closer connection exception is unavailable 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. Reg. section 301.7701(b)-2(f).

[61]*See* section 7701(b)(3)(B) and reg. section 301.7701(b)-2.

[62]Reg. section 301.7701(b)-2(e).

[63]Section 7701(b)(8).

of taxing other U.S. shareholders as if a treaty nonresident were a resident. Moreover, we have found no discussion of this requirement in leading international tax treatises and other secondary materials.[64]

In fact, the instructions to Form 8938 have complicated matters because the same instructions are not included in the other forms. If Treasury and the IRS do not accept our proposal, or some version of it, the IRS should at least update instructions to the other forms, and update Publication 519, to explain the government's position.

G. Inconsistent Results Due to IRS Position

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 percent foreign shareholders), 6039F (gifts from foreign persons), and 6048 (reporting for foreign trusts), and potentially unexpected substantive results for foreign trusts with U.S. income. In some cases, those results are illogical, as for (1) a 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 (2) a treaty nonresident who might be required to give an FFI a Form W-8BEN for chapter 3 withholding purposes and a Form W-9 (or even both Form W-8BEN and Form W-9) for FATCA purposes.

VI. Request for Guidance

We request guidance and confirmation from Treasury that a treaty nonresident should be treated as an NRA (1) in calculating the U.S. income tax liability of that individual under the code and the regulations; and (2) for all purposes of the code concerning 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 reg. section 301.7701(b)-7(a)(1)[65] as follows:

> (a) Consistency requirement —
>
> (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 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 U.S. 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 U.S. 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 tax 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 section 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 U.S. person for purposes of subpart E of part 1 of subchapter J, and whether a gift is treated as made by a U.S. or a foreign person for purposes of section 6039C

[64] *See, e.g.*, Joel D. Kuntz and Robert J. Peroni, *U.S. International Taxation*, paras. B1.02[2][c][x] and SB1.02[2][c][x] (loose leaf 1992-date) (especially note 227, and para. B2.10[3] text accompanying note 38). Rufus von Thulen Rhoades and Marshall J. Langer, *U.S. International Taxation and Tax Treaties*, para. 23.09[1] (loose leaf 1971-date), states, citing reg. section 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. However, that is not quite what the regulations says. Neither Matthew S. Blum et al., *Reporting Requirements Under the Code for International Transactions*, Portfolio 947-1st, nor Thomas S. Bissell, *U.S. Income Taxation of Nonresident Alien Individuals*, Portfolio 907-3d, mentions paragraph (a)(3) at all. A fine and comprehensive article by professor Richard A. Westin, ''U.S. Tax Compliance Requirements for Nonresident Aliens and Their Entities,'' 40 *Tax Mgmt. Int'l J.* 144 (2011), does not discuss the question of reporting requirements for treaty nonresidents. *But see* Jeffrey S. Levin, ''A U.S. Tax Primer on Dual Status Individuals,'' 44 *Tax Mgmt. Int'l J.* 220 (2015) (which was published while this report was being finalized); and Karlin, *supra* note 7.

[65] Example 1 of reg. section 301.7701(b)-7(e) should be modified accordingly.

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. Generally, for purposes of the Internal Revenue Code other than the computation of the individual's U.S. income tax liability, the individual shall be treated as a U.S. resident. Therefore, for example, the individual shall be treated as a U.S. resident in 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 periods under reg. section 301.7701(b)-4.

(4) Special rules for S corporations. [Reserved.][66]

This guidance would clarify the treatment of (1) individuals who satisfy the substantial presence test or the lawful permanent resident test but are treaty nonresidents; and (2) individuals who satisfy the requirements of section 7701(b)(6) and cease to be treated as lawful permanent residents of the United States[67] for all purposes of the code (including the filing of information returns).

We also believe that the rule regarding the status of a corporation as a CFC 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 CFC needs to know the status of another shareholder, asking a treaty nonresident shareholder will likely 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. Although we have no 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 seems unlikely that the number is great or that it is worth maintaining those 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 section 7701(b)'s definition of resident alien.

We 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. At a minimum, it can be 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 nonetheless 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 on 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 that topic.

We believe 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 be treated as NRAs for reporting purposes, the government should at a minimum:

- change the instructions and forms, including the FBAR (following consultation with FinCEN), 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); and
- at least until it has publicized its position through the changes described above, accept as a matter of routine that treaty nonresidents

[66]When the section 7701(b) regulations were adopted in 1992, the IRS reserved its position regarding S corporations because it had proposed regulations, which were never finalized, addressing the treatment of dual residents. *See* prop. reg. section 301.7701(b)-7(a)(4), REG-209720-94 (INTL-40-94).

[67]Individuals who cease to be treated as lawful permanent residents of the United States 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).

should not be subject to the draconian penalties otherwise imposed for noncompliance with the reporting requirements.[68]

VII. Conclusion

The number of treaty nonresidents will only continue to increase in our global economy as more foreign individuals seek to invest in or increase their business presence in the United States. Southern California, where we reside and practice law, has benefited from the inflow of investment, businesses, and services of foreign investors. Those individuals are likely to have a high level of wealth and sophistication concerning their assets and financial matters. Even for them, however, U.S. international taxation issues can be a complex area.

Treaty nonresidents who fall within the scope of reg. section 301.7701(b)-7(a) and satisfy the filing requirements of reg. section 301.7701(b)-7(b) are treated as NRAs under the code and regulations for purposes of calculating their U.S. income tax liability. Since those individuals are already determining their U.S. tax liability by identifying, calculating, and paying that tax liability with their nonresident returns, Treasury and the IRS have the means to identify them and take enforcement action if appropriate. Therefore, the interests of 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. We strongly believe that uniform treatment should be applied to all treaty nonresidents who comply with the filing requirements of reg. section 301.7701(b)-7(b) (for example, timely filing forms 1040NR and 8833), so that they are treated as NRAs for all code purposes and therefore excepted from U.S. information reporting requirements.

Clarification on the treatment of treaty nonresidents is important to make our domestic law consistent with the provisions and effect of U.S. tax treaties, including the tiebreaker rules. This clarification could be issued in the form of an amendment to reg. section 301.7701(b)-7(a)(1) by expressly providing that treaty nonresidents are deemed NRAs of the United States for all code purposes. Importantly, the IRS's position would be publicly available for compliance.

Further, 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 in those 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 now requires and must therefore process information returns filed by treaty nonresidents when the information is unrelated to determining the tax liability of the filer or, in most cases, any other U.S. taxpayer. When the interaction between a U.S. person and a treaty nonresident gives rise to the filing of U.S. information returns, those 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. (For example, a U.S. person's receipt of gifts from a treaty nonresident donor totaling more than $100,000 during a calendar year would be treated as reportable foreign gifts.)

If the requested clarification is made, the treatment of individuals who cease to be lawful permanent residents under section 7701(b)(6) would also be clarified, in the sense that those 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 statute and an information reporting statute. It is therefore unclear how a treaty nonresident is supposed to certify his status. We recommend that treaty nonresidents certify themselves as nonresidents, which would result in certifications consistent with those required for purposes of chapter 3 withholding.

Finally, we recommend that the IRS initiate discussions with FinCEN to clarify the position on treaty nonresidents, preferably by treating them as nonresidents for the purposes of FBAR filing and record-keeping purposes. At a minimum, the IRS should ascertain FinCEN's position and make it clear in the instructions to FinCEN Form 114 and the BSA regulations.

Exhibit A

Fact Pattern: Treating Treaty Nonresidents as U.S. Residents Results in Filing of Inconsistent Information Returns

The following is an example of a common scenario with U.S. international tax clients. Assume that Oscar Alvarez is a citizen and resident of Mexico, residing in Mexico City. Alvarez is married to a U.S. citizen, Mary Johnson-Alvarez, and they have three children who are all dual citizens. Five years ago, Johnson-Alvarez and the three children moved to Southern California so the oldest child

[68]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.

could attend a university there. Alvarez has since been traveling frequently from Mexico City to Southern California to visit his family. He is a tax resident of Mexico. He has a permanent home in Mexico City and conducts his business activities there. He does not own or direct any businesses in the United States.

For 2014 Alvarez is deemed a resident alien because he satisfies the substantial presence test for that year. However, based on the facts and circumstances of Alvarez's case, his U.S. international tax attorney has advised him that he should be deemed a dual resident taxpayer and that under article 4 of the Mexico-U.S. tax treaty, Alvarez should be taxed in the United States as an NRA.

Alvarez is not domiciled in the United States. During 2014 he 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 Johnson-Alvarez and the children live in California is owned by a California revocable trust. Alvarez and Johnson-Alvarez are the settlors of the trust. The trust owns another residential real property 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. Alvarez serves as sole trustee. Both spouses are the beneficiaries of the trust.

If Alvarez is deemed an NRA for 2014 for all code purposes, Johnson-Alvarez must file Form 3520 for 2014 to report the gifts she received from her foreign husband.[69]

Alvarez, as an NRA, holds at least one substantial power over the administration of the trust. Therefore, the trust should be deemed a foreign trust.[70] As a result, Johnson-Alvarez must also complete Part II of Form 3520, because 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 sections 671 through 679.[71] Also, Johnson-Alvarez must ensure that the trust files Form 3520-A.[72]

The reporting requirements described above are consistent with the treatment of Alvarez as an NRA under reg. section 301.7701(b)-7(a)(1). However, if he is deemed a U.S. resident for information reporting requirements under reg. section 301.7701(b)-7(a)(3), this can lead to the filing of inconsistent information returns for the same individual. This position requires mental gymnastics to sort through the many reporting requirements that could apply if a treaty nonresident files information returns as a U.S. resident.

In our example, are the gifts from Alvarez to his spouse no longer deemed foreign gifts under section 6039F, so that Johnson-Alvarez need not report them on Form 3520?[73] 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?[74] Is Johnson-Alvarez no longer required to ensure that 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 Johnson-Alvarez only and treating Alvarez as an NRA?

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[69]As required by section 6039F.

[70]*See* reg. section 301.7701-7(d)(1)(i) and section 7701(a)(31)(B).

[71]Section 6048(b). Other reporting requirements could apply under section 6048(a) if there is a reportable event.

[72]Section 6048(b).

[73]Section 6039F(b) provides:

> 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).

[74]Reg. section 301.7701-7(a).