tax notes international
Volume 67, Number 3 ■ July 16, 2012



# Now You See Them: U.S. Reporting Requirements for Tax Treaty Nonresidents

by Michael J.A. Karlin

Reprinted from *Tax Notes Int'l*, July 16, 2012, p. 267

# SPECIAL REPORTS

## Now You See Them: U.S. Reporting Requirements for Tax Treaty Nonresidents

by Michael J.A. Karlin

Michael J.A. Karlin is a partner with Karlin & Peebles, LLP, in Beverly Hills, California.



This article discusses the application of tax reporting requirements to aliens who, under the residence provisions (typically article 4) of an income tax treaty, are treated as a resident only of the treaty country. I think the Internal Revenue Service is headed in the wrong direction here and should reverse course.

### I. Summary

For purposes of the Internal Revenue Code except subtitle B (relating to estate and gift taxes and the tax on generation-skipping transfers), the term ''resident alien'' or just ''resident'' has been defined since 1985 by section 7701(b). That section provides that an individual is a resident alien if he meets one of two tests — the lawful permanent residence test, applicable to green card holders, or the substantial presence test, applicable to non-immigrants who spend minimum numbers of days in the United States.

The United States has entered into numerous bilateral income tax treaties. Almost all of them contain a provision under which the parties to the treaty agree that for purposes of the treaty and the taxes covered by the treaty, an individual resident in both countries under their respective domestic laws will be treated as resident of only one of the countries based on the application of a series of standard tests.

The IRC contains provisions both within section 7701(b) and more generally in section 894 in which the United States accepts that an individual is not a resident alien if he is a resident of another country by reason of a treaty. I refer to such an individual as a ''treaty nonresident.'' An individual who asserts that he is a treaty nonresident must file a Form 8833, ''Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b),'' unless payments or items of income the treatment of which would be modified by treaty do not exceed $100,000.

Treasury regulations[1] provide that treaty nonresidence applies only for purposes of computing tax and withholding and not for other purposes of the code (for example, for determining whether a corporation is a controlled foreign corporation). But recently, it appears that the IRS is contending that a treaty nonresident is subject, as if he were a resident alien, to the international activity reporting forms.[2]

The IRS has previously failed to make this position clear. Apart from an indirect and obscurely located reference in the regulations under section 6038 (the authority for Form 5471), there is no provision in the regulations that states that treaty nonresidents must file

[1]Reg. section 301.7701(b)-7(a).

[2]These forms include:
- Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations'';
- Form 8865, ''Return of U.S. Persons With Respect to Certain Foreign Partnerships'';
- Form 8858, ''Information Return of U.S. Persons With Respect to Foreign Disregarded Entities'';
- Form 8938, ''Statement of Specified Foreign Financial Assets'';
- Form 926, ''Return by a U.S. Transferor of Property to a Foreign Corporation'';
- Form 8621, ''Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund''; and
- Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.''

forms as if they were residents. There has, until recently, never been such a statement in the instructions to the forms. Now, however, the IRS has issued Form 8938, in which it explicitly instructs individuals who are resident aliens under either test that they must file the form even if they ''elect'' to be taxed as a treaty nonresident.

In this article, I argue that if the IRS really intends to take this position, it needs to publicize the requirement adequately. But I also argue that this position is inconsistent with our treaties and with the IRC and is therefore invalid. It may not even be justified by the very regulation, reg. section 301.7701(b)-7(a)(3), on which it presumably rests. It also operates as a trap for poorly advised taxpayers and an unnecessary burden for well-advised ones (the minority). It has unintended and unreasonable consequences. And finally it is bad policy, which results in the government collecting data from treaty nonresidents that it does not need while failing to require data for transactions between treaty nonresidents and U.S. persons that would be useful to the government.

For these reasons, I would argue that the IRS needs to reverse course and treat treaty nonresidents as nonresidents for purposes of the reporting requirements of the IRC, both because this is the law and because these reporting requirements serve no reasonable purpose. The Service should also confirm that a treaty nonresident is a nonresident for purposes of reporting by corporations on Form 5472, ''Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business,'' and for reporting on Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Trusts,'' by U.S. persons who receive gifts from the treaty nonresident.

## II. Discussion

### A. The Effect of Treaties on Residence

Almost all comprehensive bilateral income tax treaties to which the United States is a party contain a residence article 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.[3]

The basic approach of these provisions is this: The residence of an individual is to be 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, the treaty provides a series of tests, to be applied in a set order of priority, that will cause the individual to be treated as resident of only one of the contracting states. Under the first test in the OECD and Treasury Department models, an individual is 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 is deemed to be a resident only of the state with which his personal and economic relations are closer (center of vital interests). If neither of these tests settles the matter, the individual is deemed to be a resident only of the state in which he has an habitual abode. If the individual has an habitual abode in both states or in neither of them, he will be deemed to be a resident only of the state of which he is a national. Finally, if the individual is a national of both states or of neither of them, the competent authorities of the treaty partners must settle the question by mutual agreement. It is very rare for dual resident cases to be submitted to a mutual agreement procedure.

Before a treaty tiebreaker can be considered, therefore, the first question is whether the individual is a resident under U.S. domestic law. For this purpose, section 7701(b) provides that an alien will be treated as a resident alien if he meets one of two tests: the lawful permanent resident test and the substantial presence test. 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. The substantial presence test, which is applied on an annual basis, causes an alien to become a resident based on the number of days the alien was physically present in the United States in the calendar year and, in some cases, the preceding two years.

On the subject of treaties, section 7701(b)(6) provides that:

> 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.

Section 7701(b) does not address the effect of treaties on aliens who meet the substantial presence test. Presumably, those aliens can rely on section 894, which 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.

Who are the aliens who are affected by the residence provisions of tax treaties? They are individuals who, in an increasingly mobile world and globalized

[3]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. 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 have 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).

economy, can readily fall into the definition of 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. Dual residents are individuals who are likely to have relatively higher levels of wealth and income and to own securities, financial accounts, and other assets in multiple jurisdictions.

The United States has an expansive view of its right to treat an individual as a resident: The lawful permanent resident test will cause an individual to be treated as a resident merely by virtue of having been accorded the right to reside permanently in the United States, even though the individual may have the legal right to reside in one or even several other countries. The substantial presence test can capture a non-immigrant individual who spends, on average, just four months a year in the U.S. Other countries similarly treat as residents individuals who over a period of years spend a substantial amount (but less than a majority) of their time in the country.

Treaty residence articles play a useful role by assigning residence, and therefore worldwide taxing jurisdiction, to the appropriate country and in reducing the tax compliance burden for multi-country individuals. As will be seen, the United States is increasingly taking a position that deprives treaty nonresidents of the reasonably anticipated benefits of these treaty provisions. As explained in more detail, this position appears invalid and unwise.

### B. Basic Reporting Requirement

A treaty nonresident is generally required to file a return on Form 1040NR and must include Form 8833, ''Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).''[4] As discussed below, the treaty nonresident's status is determined by application of the treaty and the consequence of failing to file the Form 8833 is limited to the imposition of a relatively modest penalty. It does not, however, seem unreasonable to require an individual who would otherwise be a resident alien to alert the IRS of a contrary result based on the application of a treaty.

### C. Narrowing the Scope of Treaty Nonresidence

*1. Introduction*

If one stopped there, it would be clear that a treaty nonresident should be treated as a nonresident for all purposes of our tax laws. However, Treasury is authorized to prescribe regulations as may be necessary or appropriate to carry out the provisions of section 7701(b). It has exercised this authority in reg. section 301.7701-7. In effect, the regulation provides that an individual eligible to be treated as a resident of another country under the treaty is a resident of the other country for some purposes of the IRC and not for others.

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 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.[5]

This language 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. One might reasonably take the view, however, that all these provisions exist only or at least primarily to support the

[4]Reg. section 1.6014-1(b)(8) (applicable to tax years for which the due date for filing returns (without extensions) is after December 15, 1997). The requirement does not apply to a treaty nonresident whose items of income affected by being treated as a nonresident do not exceed $100,000. Reg. section 1.6014-1(c)(2).

[5]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 in which they may have no warning at all.

computation of a U.S. person's income tax liability. The example given in paragraph (a)(3) does not relate to reporting, but rather to a determination of a foreign corporation's status as a CFC that can only affect some other (U.S.) taxpayer's liability.[6]

*2. Form 5471*

However, the government position apparently is (or is in the course of becoming) that a treaty nonresident remains a resident for *reporting* purposes of the IRC. Historically, the only reference to this in published guidance is reg. section 1.6038-2(j)(2)(ii), which provides:

> (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[7] 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. It is, indeed, unfortunate that if this is the government position, it should fail to state this in a location where it is likely to come to the attention of practitioners and the public.

*3. FBAR*

More recently, this issue was addressed in regulations regarding foreign bank account reports published in February 2011 by Treasury's Financial Crimes Enforcement Network. Although FinCEN is responsible for these regulations and they are not tax regulations, the FBAR reporting requirement has come to be administered and enforced primarily by the IRS.

Before the 2011 FinCEN regulations, the term ''resident'' was undefined by the Bank Secrecy Act of 1970, regulations under the act, or the FBAR form itself (T.D. F 90-22.1, ''Report of Foreign Bank and Financial Account'').[8] The regulations added a definition of resident for FBAR purposes that essentially tracks the section 7701(b) definition of resident alien for purposes of the IRC, except for an expanded definition of the United States to include certain territories.

Neither the regulations themselves nor the revised FBAR (2011 and 2012 editions) addresses the question of treaty nonresidents. But in the preamble to the regulations, the government states:

> Commenters also raised questions with respect to the term ''resident'' in the definition of United States person. These commenters sought clarification on the treatment of individuals who make certain elections under section 7701(b) of the Internal Revenue Code. FinCEN believes that individuals who elect to be treated as residents for tax purposes under section 7701(b) should file FBARs only with respect to foreign accounts held during the period covered by the election. *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.[9] [Emphasis added.]

It seems clear enough that FinCEN will treat an individual who holds a green card as a resident for FBAR purposes, even if the individual asserts that he is nonresident for tax purposes under a treaty. A negative inference can plainly be drawn that an individual who is resident under the substantial presence test (that is, even after application of the foreign tax home/closer connection test)[10] and who makes a claim of nonresidence under a treaty should be treated as not being a resident for FBAR purposes. But it is not known for sure what the government's position is on this point and, as noted, the regulations, the form, and the instructions to the form are all silent on the effect of tax treaties.

*4. Form 8938*

The same issue has also arisen regarding Form 8938, ''Statement of Specified Foreign Financial Accounts,'' which will be required for the 2011 calendar year for most individual filers within its scope. In the

---

[6]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 foreign personal holding company rules were repealed by the American Jobs Creation Act of 2004.

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

[8]I wrote extensively about this subject in ''The Meaning of Residence for FBAR Purposes'' in the *Journal of Tax Practice & Procedure*, Feb.-Mar. 2011. An updated version of the article (the published version did not fully take into account the final regulations) is available at http://www.karlinpeebles.com/publications/mjak/article_on_FBAR_residence_2011-03-03_v3.pdf.

[9]76 F.R. 10234 at 10238, 3rd col. (Feb. 24, 2011).

[10]Section 7701(b)(3)(B).

recently promulgated temporary regulations under section 6038D, the government simply states:

> The term resident alien has the meaning set forth in section 7701(b) and [section] 301.7701(b)-1 through 301.7701(b)-9 of this chapter.[11]

However, for the first time in the actual instructions to a form, the IRS has made clear that a treaty nonresident is nevertheless required to file a form, in this case Form 8938. The form's instructions 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.]

*5. Proposed FATCA Regulations*

The recently proposed Foreign Account Tax Compliance Act regulations are silent on whether a treaty nonresident is or is not a U.S. resident. The proposed regulations provide only that:

> (i) U.S. person. 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).[12]

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 section 7701(b) definition of a resident alien. Presumably, the IRS is relying on reg. section 301.7701(b)-7(a)(3) for the proposition that a U.S. person includes a treaty nonresident for purposes of the FATCA regulations, but the proposed regulations do not explicitly state this.

Given the critical importance of determining who is a U.S. person for a wide variety of purposes, the IRS should clarify the status of treaty nonresidents for FATCA purposes. And, as I argue below, it should think about what it really wants before it simply applies its developing expansive interpretation of paragraph (a)(3) to require reporting by treaty nonresidents.

## D. 'Electing' Treaty Nonresidence

I must pause here to note that it is not appropriate to refer to an alien ''electing'' under a treaty to be taxed as a resident of a foreign country. Perhaps this would not matter if the only reference to an election were in the preamble to the final FinCEN regulations regarding FBARs. But now the Service has repeated this mistake in the instructions to Form 8938, which is an IRS form.

Taxpayers do not ''elect'' to be treated as nonresident under treaties. They simply are residents of the United States or of the treaty partner, based on the applicable tests provided by the treaty when both countries, under their respective domestic laws, would otherwise classify the individual as a resident of their country. Section 6114 requires a taxpayer who asserts that a treaty overrules or otherwise modifies an internal revenue law must disclose that assertion on a tax return or, if no return of tax is required to be filed, in the form the secretary of the Treasury may prescribe. The IRS has prescribed the use of Form 8833 for this purpose in most cases, including taking the position that the taxpayer is not resident under a treaty. There is a penalty for failing to file the form,[13] but the IRS recognizes that the failure to file the form does not deprive a taxpayer of treaty rights.[14] 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 is a mistake with consequences. It suggests that a taxpayer must affirmatively file an election to treat himself as a treaty nonresident, when this is plainly not true. Elections typically have time limits — but there is no time limit for taking a treaty position. Treaty nonresidence is the self-executing consequence of an agreement between the United States and another sovereign jurisdiction on how the residence of an individual is to be determined. While the United States plainly has the right to require an alien who is resident in a treaty country under that country's laws to provide information that would enable residence to be determined, treaty residence, at least in theory, results from the mandatory application of the treaty tiebreaker tests.

## E. Practical Problems

What we have here is a swamp.

*1. Unintended Consequences for the IRS*

Let's consider first a couple of unintended side effects of the literal-minded application of reg. section 301.7701(b)-7(a)(3). Suppose an individual who is a treaty nonresident makes a gift of property to a U.S. taxpayer. That gift is *not* reportable on Form 3520 because the donor is a U.S. person for purposes of the reporting requirement. So what we have is a gift that is

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

[12]Prop. reg. section 1.1471-1(a)(46).

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

[14]*See* ''Service Explains Use of Treaty-Based Return Position Disclosure Form,'' *Doc 2009-2407* or *2009 WTD 68-29* (Apr. 10, 2009; released Aug. 3, 2007) (program manager technical assistance held 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).

not reportable by the donee because the donor, although a resident neither for income tax purposes nor for estate and gift tax purposes, is a U.S. resident for reporting purposes.

Or take a U.S. corporation owned 100 percent 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. resident and does not have a 25 percent foreign shareholder. So it does not have to file Form 5472.

This cannot be what the IRS wants in either case: The treaty nonresident must file a Form 5471 with respect to a foreign corporation when he has no tax consequences from the ownership of shares in the corporation. On the other hand, a U.S. corporation does not have to report a nonresident as an owner or file a form regarding transactions with that person, when this information is plainly relevant to the tax treatment of the corporation.

Defining a treaty nonresident as a resident for the purposes of the FATCA regulations will similarly have unexpected consequences.

*2. Unreasonable Consequences for Treaty Nonresidents*

These requirements turn unsuspecting nonresident aliens into lawbreakers. Few tax preparers know about all the reporting requirements applicable to U.S. persons. In our experience, 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.

Take the case of a citizen of Canada who usually spends 140 days a year in the United States and 225 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 is reluctant to treat individuals as relinquishing their Canadian residence.) The individual might satisfy the numerical tests under the substantial presence test but, in most years, the individual could file a claim that he was a nonresident under the foreign tax home/closer connection test. But during the one year in which the number of days 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. Is it really the position of the U.S. government that in that year, the individual must file forms 5471, 8865, 8858, 8621, 3520, 8938, and an FBAR?[15] Is it reasonable? Really?

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 else might the Service do with the information?

*3. The IRS Must Make Its Position Known*

If the IRS is going to take this position, it should consistently alert aliens and their tax advisers not just in Form 8938 but in all the other forms. It should also amend paragraph (a)(3) to clarify its position. The Service also should determine what FinCEN's position is concerning the application of the FBAR requirement to treaty nonresidents (is it required of treaty nonresidents who meet the substantial presence test but not the lawful permanent resident test?) and then modify the instructions to the FBAR to alert aliens and their advisers of their responsibilities. It should also stop referring to an individual ''electing'' to be a treaty nonresident.

Also, when a non-immigrant alien both claims the benefit of the foreign tax home/closer connection test and takes the position that he is a treaty nonresident and, subsequently, the foreign tax home/closer connection claim is not upheld but the treaty claim is upheld, the alien should be exempted from filing all the forms or should be given an extension to file them. The alien should not have to include protective language or make protective filings.

Congress and the IRS have determined that heavy penalties are needed to deter noncompliance by U.S. taxpayers regarding the reporting of foreign assets and income that either are not subject to third-party reporting or are subject to much less reliable and timely reporting. These penalties should not be used against largely unsuspecting nonresidents when it may not have occurred to them (or their advisers) that they must provide information to the U.S. government that is wholly irrelevant to the determination of their U.S. tax liability. Also, the Service should issue internal guidance that the fact that an individual is a treaty nonresident is a factor that supports an argument that failure to file such reports is due to reasonable cause.

## F. The IRS Should Reverse Course

I would argue, however, that the IRS should reverse course for the following reasons:

- the current position is inconsistent with our treaties;
- the position is not permitted under the plain language of the IRC;
- a regulation, still less the instructions on a form, cannot override a treaty;

[15]The regulations under section 7701 also provide that if the foreign tax home/closer connection claim may only be included in a timely filed return, it is subject to the usual exception if the failure to file timely is shown to be due to reasonable cause. By contrast, the Service cannot prevent an untimely claim to be a nonresident based on a treaty. So what should one make of the

**(Footnote continued in next column.)**

alien who is entitled to make both claims but fails to make the statutory claim on a timely basis?

- it is not clear that paragraph (a)(3) supports the requirement for treaty nonresidents to report — rather it can be interpreted not to require reporting and not to conflict with treaties or the IRC;
- the Service's position operates as a trap for poorly advised taxpayers and an unnecessary burden for well-advised ones (the minority);
- the IRS has little if any use for the data; and
- the position leads to absurd results.

*1. The Current Position Is Inconsistent With Our Treaties*

A typical income tax treaty provides a definition ''for the purposes of this Convention'' and in the taxes covered provision says that it applies to the federal income taxes imposed by the IRC. The reporting requirements of the code exist 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 beyond 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 IRC, it does not apply to the interest, additions to tax, and penalties that motivate compliance and deter and punish noncompliance. Our partners generally take the common-sense view that an individual who is a resident of the United States under the tiebreaker is a nonresident of the other country for all purposes of their income tax laws, and they probably would 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.

*2. The Position Is Not Supported by 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. So far as aliens who satisfy the substantial presence test are concerned, as noted earlier, section 894 provides that the provisions of title 26 are to be applied to any taxpayer regarding any treaty obligation that applies to the taxpayer. The government's obligation under its treaties is clear: 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).

I believe that the Treasury Department and the IRS do not have the right to employ regulations to override two clear statutes. The regulatory authority in section 7701(b) is to carry out the purposes of the section, not to introduce unauthorized exceptions or to narrow its otherwise comprehensive scope by restrictive interpretation.

*3. A Regulation Cannot Override a Treaty*

A regulation, still less the instructions on a form, cannot override a treaty. While a statute can override a treaty, a regulation cannot do so, since a treaty has the same status as a statute.[16] And still less can the IRS override treaties as it purports to do in the instructions to Form 8938 regarding treaty nonresidents.[17]

*4. Para. (a)(3) Does Not Support Reporting Requirement*

The reporting requirements of the IRC are an integral part of the computation of an individual's tax liability. On this basis, paragraph (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. The forms perform this function for citizens and resident aliens, but they are entirely 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, the government does not need any of 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 IRC. 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 or otherwise subject to taxation of foreign-source income derived from foreign corporations. If paragraph (a)(3) were limited to such situations, that is, when the treaty

---

[16]Treaties are agreements between sovereign governments and while, under the supremacy clause of the U.S. 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.

[17]I would accept that the government can define who is a U.S. resident however it chooses for purposes of the FBAR, which is not a tax form or a requirement of tax law. The government chose to use tax law concepts 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 treaties. One may question the wisdom of this choice as a practical matter, but it can at least plausibly 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.

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.

*5. The IRS's Position Operates as a Trap*

The Service's position operates as a trap for poorly advised taxpayers and an unnecessary burden for well-advised ones (the minority). 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 places it has ever appeared in published materials issued by the government are in reg. section 1.6038-2(b)(2)(ii) and, for the first time, the instructions to new Form 8938.

My 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. I have, moreover, found no discussion of this in leading international tax treatises and other secondary materials.[18]

In fact, the instructions to Form 8938 have actually muddied the waters because the same instructions have not been included in the other forms. One might take the view that if this is what the IRS means, it should say so in other forms as well.

*6. The IRS Has Little if Any Use for the Data*

The IRS should also ask itself whether the data has any value to the United States. What actually will be done with all these forms attached to Form 1040NR? They will not yield any information relevant to the computation of any U.S. person's tax or to the computation of a treaty nonresident's tax. At most it could provide the Service with information that would be relevant only if the filer's claim to be a treaty nonresident were found to be incorrect.[19] For the vast majority of filers who take legitimate positions to be treaty nonresidents, the provision of the information is a waste of time for both them and the IRS.

*7. The Position Leads to Absurd Results*

As noted above, treating a treaty nonresident as a resident leads to absurd results in the application of sections 6038A and 6038C (corporations with 25 percent foreign shareholders), 6039F (gifts from foreign persons), and 6048 (reporting regarding foreign trusts).

## G. What Should Treaty Nonresidents Do?

The question obviously arises what treaty nonresidents should do. As always, the answer depends on whether the treaty nonresident has already failed to file forms on the basis that he is a nonresident or is merely contemplating what to do in the future.

For those who have failed to file the forms and wish to do so, the IRS provided a relatively simple solution in the two recent offshore voluntary disclosure programs (2009 and 2011). In the questions and answers for both programs, a taxpayer with no undeclared income could amend his returns and file the forms, attaching an explanation for the failure.[20] This option is available only to taxpayers with no undeclared offshore income, but by definition, almost all treaty nonresidents should fall into this category.

In January 2012 the IRS announced a third program, with no time limits.[21] At the time of writing, details of the program have not yet been published, although the news release promised details on the IRS website within a month. It is not known if the third program will also provide relief for taxpayers with unfiled forms but no undeclared income.

If the third program does not provide for penalty-free filings of forms for those with no undeclared income, the treaty nonresident faces a difficult choice. On the one hand, the IRS and the Justice Department have repeatedly insisted that taxpayers who have failed to comply with requirements to file FBARs or other

[18] *See, e.g.*, Kuntz and Peroni, *U.S. International Taxation*, Warren Gorham & Lamont/Thomson Reuters (loose leaf 1992-date), para. B1.02[2][c][x] and para. SB1.02[2][c][x], esp. note 227, and para. B2.10[3] text accompanying note 38; Rhoades and Langer, *U.S. International Taxation and Tax Treaties*, Matthew Bender (loose leaf 1971-date), para. 23.09[1], which does state, 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 (this is not quite what the regulations say, 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 para. (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 *Tax Mgmt. Int'l J.* 144 (Mar. 11, 2011), does not discuss the question of reporting requirements for treaty nonresidents.

[19] 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.''

[20] Q&A 9 (2009 program — see http://www.irs.gov/newsroom/article/0,,id=210027,00.html); Q&A 17 (FBARs) and 18 (international tax forms) (2011 program — see http://www.irs.gov/businesses/international/article/0,,id=235699,00.html).

[21] ''IRS Offshore Programs Produce $4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens,'' IR-2012-5, Jan. 9, 2012 (see http://www.irs.gov/newsroom/article/0,,id=252162,00.html).

international tax reporting forms must not file ''quietly'' but must file voluntary disclosures.[22] On the other hand, to insist that a treaty nonresident who has failed to file information forms make a voluntary disclosure in every single case, when in virtually no case will there have been any undisclosed income and in most cases the treaty nonresident will have a plausible or compelling excuse based on reasonable cause and lack of willfulness, would be, whatever the government may say, grossly overreaching and a waste of government and taxpayer resources. The alien may be better off not making any disclosures and defending any assertion of penalties using the argument that paragraph (a)(3) does not require reporting and that it is in any event invalid and then arguing that any failure was based on reasonable cause and was not willful.

Regardless of what the treaty nonresident chooses to do about past years, a decision must be made concerning filing for the current and future years. I would counsel that the treaty nonresident, especially any green card holder, file the FBAR. While the treaty issue is not addressed in either the FinCEN regulations or the form, it would be unwise to ignore the words of the preamble cited above.[23] Moreover, as has been pointed out on many occasions, including earlier in this article, the FBAR is not a tax form and FinCEN is not bound by tax treaties. Its choice of the tax definition of residence is convenient and administratively desirable, but FinCEN does not have to follow the tax definition in every particular. Finally, if properly advised, the treaty nonresident cannot assert that a prospective failure to file is non-willful, as compared with past failures in a state of ignorance.

The recommendation regarding tax forms is more complex. Nevertheless, the safest course would be to file. This is particularly the case for Form 8938, in which the IRS specifically requires that the form be filed by a treaty nonresident. In the case of other forms, there is no specific requirement, but Form 8938 does provide that the filer need not include information on the form if the filer filed form 3520, 3520-A, 5471, 8621, or 8865 and need instead only report the number of forms filed. (Mysteriously, the form makes no mention of Form 8858.)

In light of the recent Supreme Court decision in *Mayo*, it would be brave, even foolhardy, for a treaty nonresident or his advisers to rely on the invalidity or incorrectness of a regulation that purports to interpret or implement a statute.[24] A treaty nonresident may therefore have little choice but to submit to heavy regulatory burdens rather than face the uncertainties and expense of challenging the validity of a regulation.

A treaty nonresident who nevertheless is determined not to file Form 8938 or other forms should include a disclosure concerning the position that paragraph 3(a) does not require the forms to be filed and file Form 8275-R claiming that any such requirement is invalid. Both the disclosure and Form 8275-R could also assert that the instruction in Form 8938 is invalid. Alternatively or in addition, the treaty nonresident might wish to make a disclosure that he is taking the position that, as discussed earlier, paragraph (a)(3) does not require the filing of reports. These are good arguments and they are certainly plausible ones. But in the current climate, I would also suggest that discretion is the better part of valor.

## Conclusion

In summary, the Service position on the limited effect of treaty nonresidence is invalid as applied to reporting requirements that exist to support the computation of citizens' and residents' tax liability. It is, furthermore, an unduly restrictive interpretation of our treaty obligations and an unwarranted narrowing of the relevant provisions of the IRC, and it results in unnecessary and unexpected burdens on the taxpayers in question while leading to some unintended consequences detrimental to the interests of government. It's time to reverse course. In the meantime, I would counsel treaty nonresidents to file the forms. But it would be good if the IRS were to rethink the position. ◆

---

[22]For a recent, and entirely typical example, see comments of Rebecca Sparkman, acting executive director of investigative and enforcement operations for the IRS Criminal Investigation division, reported in ''Banks Beware: IRS Criminal Investigations Expanding,'' *Doc 2012-3496* or *2012 TNT 35-4* (Feb. 22, 2012) (''For taxpayers who hope to somehow slip under the radar by filing amended returns and getting compliant but not calling attention to it by using the specified voluntary disclosure procedures, Sparkman warned of the low possibility of success. Figuring that this would happen, the IRS is 'actively looking for those supposed quiet disclosures,' she said, adding, 'We will go after them criminally and civilly.'').

[23]*See* text accompanying note 8 *supra*.

[24]*Mayo Foundation for Medical Education and Research v. United States*, Docket No. 09-837 (Jan. 11, 2011), reinforcing the high level of deference to government regulations announced in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Perhaps a little comfort might be gleaned from the Supreme Court's even more recent decision in *United States v. Home Concrete & Supply LLC*, ___U.S. ___, No. 11-139 (Apr. 25, 2012).