The University of San Diego School of Law – Chamberlain International Tax Institute

University of San Diego SCHOOL OF LAW

Aroeste v. the United States: Limits on Government Authority Re: Tax Treaty Law

- *Bret Wells, University of Houston Law Center (Houston)*
- *Michael J. Miller, Roberts and Holland LLP (New York City)*
- *Michael J. A. Karlin, Karlin & Peebles, LLP (Los Angeles)*
- *Leo Unzeitig, Chamberlain Hrdlicka (San Antonio)*

Aroeste v. United States: Las reglas de desempate en materia de residencia y los límites de la autoridad fiscal en la aplicación de multas por la omisión de declaraciones informativas

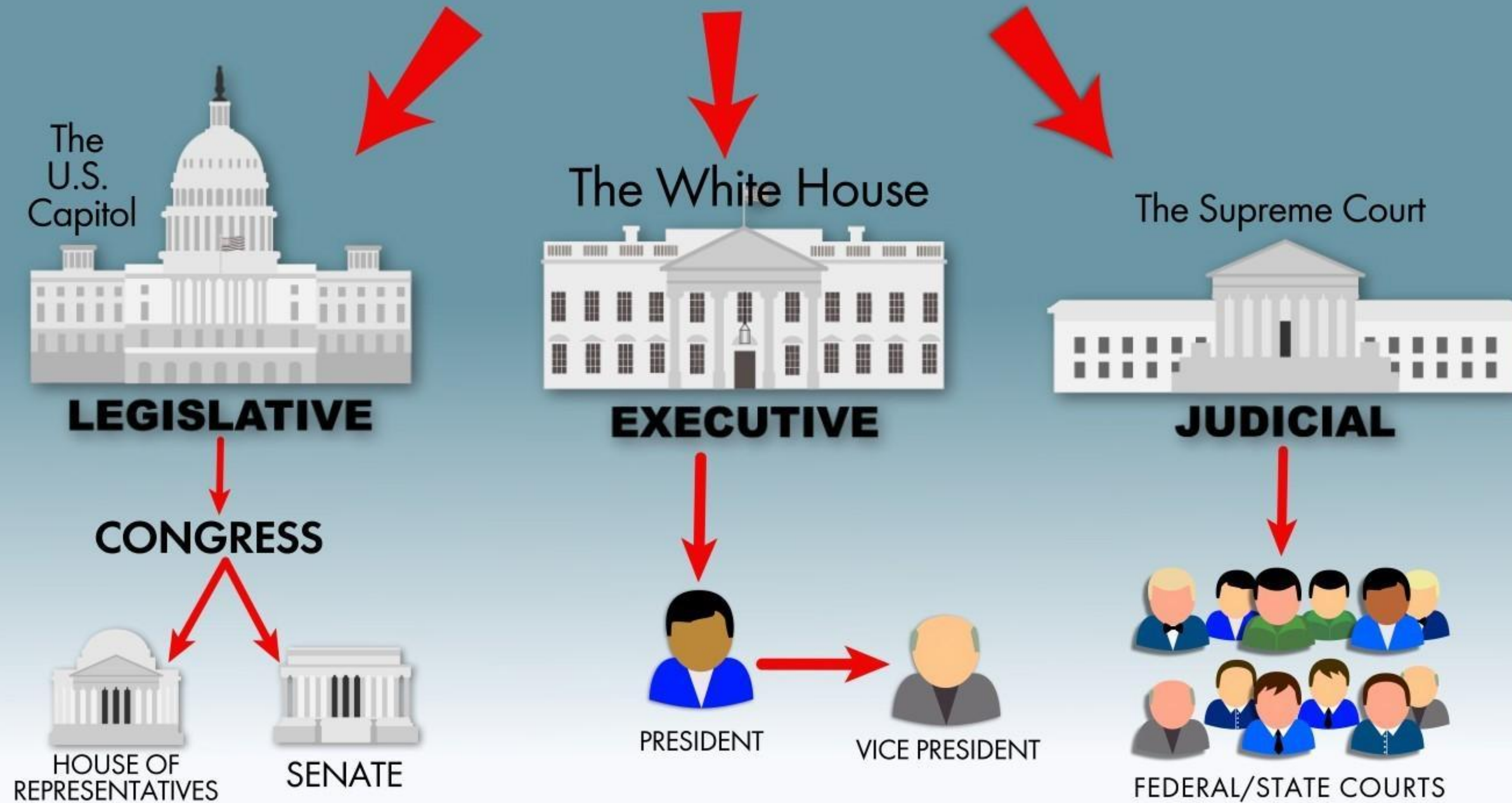
February 19th & 20th, 2024
Mérida I Yucatán I México

Chamberlain Hrdlicka
Attorneys at Law
Abogados especializados en materia fiscal

The Relationship of Statutes and Treaties

U.S. Constitutional Background

University of San Diego SCHOOL OF LAW



The Constitution and Making Treaties

- Under Article II, the president is to have power "by and with the advice and consent of the Senate, to make treaties, provided two thirds of the senators present concur."
- Alexander Hamilton explained that the reason for the "intermixture of powers" between the executive and legislative branches is that treaties are "contracts with foreign nations, which have the force of law, but derive it from the obligations of good faith. They are not rules prescribed by the sovereign to the subject, but agreements between sovereign and sovereign." Federalist Paper 75.
- Hamilton emphasized that the executive is the most fit to negotiate with foreign countries but that the "vast importance of the trust, and the operation of treaties as laws, plead strongly for participation" of the Senate and that the executive cannot act alone.

The Place of Treaties in Domestic Law

- The United States, like other countries, has had to address the place of treaties, including tax treaties, within its law. In summary:
  - The Constitution is supreme. A treaty cannot be enforced if it is inconsistent with the Constitution. *Missouri v. Holland*, 252 U.S. 416 (1920).
  - Statutes are enacted by Congress and become law if (a) signed by the President or (b) if vetoed, Congress overrides the veto by a two-thirds majority in both the Senate and the House of Representatives.
  - Treaties are negotiated by the Executive Branch and signed by the President. To become effective, a treaty must be ratified by a two-thirds vote of the Senate – the House has no role. (The other country also has to ratify the treaty and instruments of ratification must be exchanged.)
  - Statutes and treaties share an equal rank. The Constitution's Supremacy Clause (Article VI, Section 2) provides: "This Constitution, and the laws of the United States which shall be made in pursuance thereof, and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land."

Relationship of Statutes and Treaties

- When a statute and a treaty cover the same subject matter, the approach of U.S. courts is as follows:
  - First, seek to harmonize, so as to avoid finding a conflict (see next slide).
  - Second, if there is a conflict, a statute may override a previously entered into treaty, even if to do so would be a violation of international law.
  - Third, however, a court will assume that, when enacting a statute, Congress did not intend to override a treaty without clearly stating such intent in either the statute itself or in the legislative history of the statute.
    - Legislative history includes reports by committees of the House and Senate, and joint reports and reports of conference committees that harmonize legislation before enactment.
- Treaties are often to be interpreted in the light of reports by the Senate Foreign Relations Committee. In the case of tax treaties, the understanding of the U.S. negotiators is set out in Technical Explanations submitted to the Senate by the U.S. Treasury Department.

Harmonizing Treaties and Statutes

- Harmonize
  - Where both a treaty and a statute relate to the same issue, "courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either." *Whitney v. Roberts*, 124 U.S. 190, 194 (1888).
  - Legislative acts should only be construed to override a treaty provision in two limited circumstances (1) if Congress explicitly and unequivocally indicated its intention to override the provisions of at treaty, or (2) when the provisions of a treaty and the statute are truly incompatible by their own terms. *McCulloch v. Sociedad Nacional de Marinos de Honduras*, 372 U.S. 10 (1963).
  - If there is one possible construction of a treaty and statutory provision of the Code that allows both to carry their purpose, it should always be preferred instead of one that overrides one in favor of the other.

Direct Conflict

University of San Diego SCHOOL OF LAW

- If there is no way to harmonize, or if Congress intended a statute to override a treaty, the last-in-time rule comes into play
- Under this rule, when the provisions of a self-executing treaty and a federal statute conflict, U.S. courts must apply whichever of the two reflects the "latest expression of the sovereign will" of the United States. *Reid v. Covert*, 354 U.S. 1 (1956).

Tax Code Provisions about Treaties

- Section 894 – the Code shall be applied with "due regard to any treaty obligation."
- Section 7852(d)(1) – "For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."

The Aroeste Case

Aroeste v. United States - Background

- The Aroestes were lifelong citizens and residents of Mexico.
- They obtained green cards in the early 1980s.
- Estela Aroeste became a U.S. citizen in 2011.
- They originally filed joint Forms 1040 (U.S. Individual Income Tax Return) for several years. The years at issue in the case are 2012 and 2013.
  - The status "Married Filing Jointly" is only permitted if either (a) both spouses are U.S. citizens or residents or (b) one of the spouses is a U.S. citizen and the two elect to be treated as residents and waive treaty benefits (IRC section 6013(g).
- They were advised to enter into Offshore Voluntary Compliance Program (OVDP) to correct compliance failures relating to non-U.S. income and assets.
- They later opted out of the OVDP. Mr. Aroeste filed a separate return as a nonresident under U.S.-Mexico Income Tax Treaty (filing Forms 1040NR and Forms 8833).

Aroeste v. United States - Background

- Following their opting out of the OVDP, a Revenue Agent audited the taxpayers for several years.
- The agent "assessed" FBAR penalties on a per-account basis.
- The agent also assessed income tax deficiencies as well as penalties for failure to file international information returns that are required of U.S. persons.
- The case that has been decided at the District Court level concerns FBARs. The income tax case pending before the U.S. Tax Court has not yet been decided.

Aroeste v. United States - Procedure

University of San Diego SCHOOL OF LAW

- The U.S. government filed suit to reduce FBAR penalties to judgment in Southern District of Florida.
  - Could never perfect service on Aroestes who reside in Mexico and thus government dropped suit Florida and counterclaimed in California.
- Alberto and Estela filed an illegal exaction claim under the Little Tucker Act in Southern District of California
- There is also a pending Tax Court case that deals with the Aroestes and the tax treatment of Mr. Aroeste's claim not to be a U.S. resident. No judgment has yet been issued in that case.

The District Court Decides the Case

- On November 20, 2023, on motions for summary judgment by both parties, Judge Anthony Battaglia denied the government motion and mostly granted Mr. Aroeste's motion for a discharge of FBAR penalties and a refund of the penalties already paid. *Aroeste v. United States*, No. 3:22-CV-00682 (S.D. CA).
- The judge ordered Mr. Aroeste to pay a penalty of $1,000 for each failure to file timely Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) to report his position that he was not a U.S. resident because of the application of the Treaty.
- In January, it was announced that the government has filed a notice of appeal of the judgment to the Ninth Circuit Court of Appeals. The appeal is pending.

Background to the Decision – the FBAR Requirement

- The Financial Crimes Enforcement Network (FinCEN) is a unit of the U.S. Treasury Department.
- Under the Bank Secrecy Act, Title 31 U.S. Code, FinCEN requires Unted States persons to file each year a Report of Foreign Bank and Financial Accounts (known to all as the FBAR) arises from Bank Secrecy Act, Title 31, if the aggregate value of all foreign accounts exceeded $10,000 during the year
- In 2010, FinCEN promulgated a regulation that defined *who* is subject to the FBAR filing requirement that became effective in 2011. This regulation included United States citizens and residents and certain entities.
- Before 2011, the term “United States resident” was not defined. The new regulation adopted the tax law definition contained in in Title 26 U.S. Code (*i.e.*, the U.S. Internal Revenue Code, or “IRC”) section 7701(b), but with a definition of “United States” that included U.S. territories.

Aroeste v. United States – Court's Analysis

The Court decided that the issue should be decided based on a five-step analysis:

1. Under 26 U.S.C. § 7701(b)(6), anyone allowed to permanently reside within the United States by virtue of US immigration laws is a "lawful permanent resident" for tax purposes ***unless*** an applicable tax treaty allows that person to be treated as a resident of a foreign country for tax purposes only;
2. Under 26 U.S.C. § 7701(b)(1)(A)(i), any "lawful permanent resident" is a "resident alien";
3. Under 31 C.F.R. § 1010.350(b)(2), any "resident alien" is a "resident of the United States";
4. Under 31 C.F.R. § 1010.350(b), any "resident of the United States" is a "United States person" required to file an FBAR;
5. Therefore, any person allowed to permanently reside in the United States by virtue of US immigration laws must file an FBAR unless that person is entitled to be treated as a resident of a foreign country under a tax treaty

What Is the Effect of a Tax Treaty?

- Because FinCEN had adopted the definition of residence in the IRC, the question arose, what if an individual meets the statutory definition, as supplemented by Treasury Regulations, but is nevertheless treated as a resident of another country with which the United States has an income tax treaty and, under the tiebreaker provision of the treaty, the individual is treated as a resident of the other country.
- The FinCEN regulations, the FBAR and the instructions to the FBAR are all silent on this point. In the preamble to the regulations when they were issued in 2011, FinCEN stated "[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." Judge Battaglia rejected the government's reliance on this language given the plain language of the regulation itself, which makes no mention of any exception for individuals who are nonresidents under a treaty.

Treaty Provisions on Residence

University *of* San Diego SCHOOL OF LAW

- The U.S.-Mexico Tax Treaty contains a "tie-breaker", based on an OECD model. Almost identical provisions appear in numerous tax treaties. Article 4 provides a series of tests to be applied in order of priority:

  " 2. Where . . . an individual is a resident of both Contracting States, then his residence *shall* be determined as follows:

  a) he *shall* be deemed to be a resident of the State in which he has **a permanent home** available to him; if he has a permanent home available to him in both Contracting States, he *shall* be deemed to be a resident of the State which his personal and economic relations are closer (**center of vital interests**);
  b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he *shall* be deemed to be a resident 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 of the State of which he is a national;
  d) in any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement."

- The Judge held (and the government conceded) that under Article 4, Mr. Aroeste was a resident of Mexico. See the Appendix for more detail about the underlined terms above.

Other Issues in the Case – 1

- Section 6114 provides that each taxpayer who "takes the position that a treaty of the United States overrules (or otherwise modifies) an internal revenue law of the United States shall disclose" such position on a return or in the form prescribed. The form in question is Form 8833.
- Mr. Aroeste eventually filed this form after opting out of the OVDP but it was long past the date to be timely.
- The Government argued that Alberto "implicitly labeled himself as a resident alien" when he filed a joint Form 1040 with his wife rather than a Form 1040NR and that by doing so he "waived his ability to asset a treaty position."
- The Judge decided that there was no waiver; the only consequence was a $1,000 penalty for failure to file the form. The Judge noted that this was the only consequence provided by IRC section 6712 ("If a taxpayer fails to meet the requirements of section 6114, there is hereby imposed a penalty equal to $1000 . . .") and there was nothing in the regulations to the contrary.

Other Issues in the Case – 2

- The Judge reviewed the flush language in IRC section 7701(b)(6).

  "An individual **<u>shall cease</u>** to be treated as a lawful permanent resident of the United States if [i] 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, [ii] does not waive the benefits of such treaty applicable to residents of the foreign country, and [iii] notifies the Secretary of the commencement of such treatment". (Numbering added for clarity.)

- The Judge decided that Mr. Aroeste had met all three requirements and in particular that to satisfy item (iii) there was no timely filing requirement.
- The government argued that Mr. Aroeste had failed to file Form 8854 (Initial and Annual Expatriation Statement). The Judge held that this requirement was invalid, as it was required by Notice 2009-85, which had not been issued in compliance with the Administrative Procedures Act.

Other Issues in the Case – 3

University of San Diego SCHOOL OF LAW

- At least in the FBAR case, issues relating to Treas. Reg. sec. 301.7701(b)-7(a)(3) remain unresolved.

  "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."

- Does this include international information returns and possibly FBARs? The Judge did not consider this point nor, so far as we can tell, did the government raise it.

What’s Next?

Advice to Taxpayers

- The Aroeste case will help taxpayers who are under audit or are worrying about whether to file late FBARs and international information returns.
- However, until and unless Mr. Aroeste's position is upheld on appeal, if FBARs and international information returns can be filed timely, taxpayers should carefully weigh whether to file those returns
  - The returns will not result in any tax but will definitively avoid penalties, although the cost of compliance may be substantial.
  - What about past years that are untimely? Should treaty residents of Mexico and other countries file and should they file current and future years only? Can/should filings be done on a protective basis?

A Question for the Government

- Why does the government want international information returns and FBARs from treaty nonresidents?
- It would be very unusual to ask for information that is only useful if the taxpayer's position concerning application of a tax provision (in this case a treaty) is wrong.

Appendix

More on the meaning of terms in the treaty residence provision (Article 4)

Tax Treaty – Permanent Home

- The term "permanent home" is not defined in the treaty
- OECD commentary describes a permanent home as one in which:
  - "the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.)."
    - See OECD Model Treaty Commentary at ¶ 13, pg. 87.

Tax Treaty – Center of Vital Interests

- Treaty does not define the center of vital interests.
- OECD commentary describes it as follows:
  - "If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State."
    - See OECD Model Treaty Commentary at ¶ 15, pg. 87; see also Podd v. Commissioner, T.C. Memo. 1998-418 (relying on the OECD commentary in construing the center of vital interest test).

Tax Treaty – Habitual Abode

- OECD commentary explains that
  - In . . . the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently.
    - See OECD Model Treaty Commentary at ¶ 13, pg. 87.

Speakers

Bret Wells
University of Houston Law Center (Houston)
bwells@central.uh.edu
+1 713 743 2502

Michael J. Miller
Roberts and Holland LLP (Nueva York)
MMiller@rhtax.com
+1 212 903 8757

Michael J.A. Karlin
Karlin & Peebles, LLP (Los Ángeles)
mjkarlin@karlinpeebles.com
+1 323 852 0033

Leo Unzeitig
Chamberlain Hrdlicka (San Antonio)
leo.unzeitig@chamberlainlaw.com
+1 210 278 5814