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Treaty Nonresidents: The Umpire Strikes Back

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To the Editor:

In 2012 I wrote an article titled "Now You See Them: U.S. Reporting Requirements for Tax Treaty Nonresidents."[1] Three years later, my friend Liliana Menzie and I were part of a delegation of California tax lawyers who visited Treasury and the IRS, where we presented a paper that was later also published by *Tax Notes* titled "Requesting Guidance for Treaty Nonresidents."[2]

In those articles we criticized the IRS's apparent belief that an individual treated as a nonresident under the provisions of a tax treaty is nevertheless required to file various information reports relating to international assets. Among the points we made was that the support for this position appeared to be a mistaken interpretation of Treasury's own regulations, and that we considered that the government did not have the right to override a treaty by regulation. Moreover, we argued that the government position was contrary to the clear language of section 7701(b)(6), led to unnecessary confusion, and required taxpayers to spend large sums on professional fees to provide information to the government for which it does not have any use.

We also discussed the effect of nonresidence on the obligation to file foreign bank account reports. We noted that regulations, which were proposed by the Financial Crimes Enforcement Network in 2010 and adopted in 2011, chose to define residence by reference to IRC section 7701(b) and its regulations. We pointed out that the Bank Secrecy Act (BSA), the FBAR itself, and its instructions, were all silent on the definition of a U.S. resident. As we said in 2015:

> 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?

We may have an answer, or at least a partial answer, from a federal judge, although the procedural posture of the case in which the answer was given is a little peculiar. In *Aroeste*,[3] Judge Karen S. Crawford, a U.S. magistrate judge, ruling on a discovery motion, decided that the legal question of Mr. Aroeste's residence under the Mexico-U.S. income tax treaty was directly relevant to his claim to recoup penalty payments and set aside outstanding penalties for the non-filing of FBARs for 2012 and 2013.[4] She therefore required the government to produce portions of the administrative record concerning its position. We understand that the government has in fact produced a significant amount of information to Mr. Aroeste in response to the order.

The judge considered whether Mr. Aroeste's status under the treaty has any effect on the FBAR filing requirement. The government argued that

[1] 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.

[2] Liliana Menzie and Karlin, "Requesting Guidance for Treaty Nonresidents," *Tax Notes*, Sept. 7, 2015, p. 1115.

[3] *Aroeste v. United States*, No. 22-cv-00682.

[4] *Id.*

Mr. Aroeste's status under the treaty is irrelevant because the treaty solely concerns residence for income tax purposes under title 26 of the U.S. Code, whereas FBAR penalties are assessed under title 31. The government's problem with this argument was that FinCEN had chosen to define residence by explicit reference to title 26 and its regulations. The judge had no difficulty tracing the definitions:

> A non-U.S. citizen is treated as a "resident alien" if he or she is a "lawful permanent resident of the United States at any time" during an applicable calendar year. 26 U.S.C. section 7701(b)(1)(A)(i). An individual is a "lawful permanent resident" if he or she has been "lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with immigration laws" and if "such status has not been revoked (and has not been administratively or judicially determined to have been abandoned)." *Id*. section 7701(b)(6). However, "lawful permanent resident" status ceases to exist — at least for tax purposes — if an 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." *Id*.

The court rejected the government's argument that it "does not matter" how Mr. Aroeste was treated under the treaty because "it only matters that Mr. Aroeste has lawful permanent residence and has not rescinded that residency." The court pointed out that the statutory framework explicitly provides that "lawful permanent resident" status can be abrogated, for tax purposes only, by application of the treaty, without requiring individuals to forsake their immigration status to claim the taxation benefits of a tax treaty.

One may observe that FinCEN did not need to cross-reference the tax definition of residence, but having chosen to do so, it must live with the consequences.[5] It does not appear on the face of the judgment in *Aroeste* that the government sought to rely on the language of the preamble to the final FBAR regulations referred to above, but it would have been at the very least inappropriate or simply wrong to do so. Preambles and other similar explanatory language may be used to clarify intent or ambiguity but they cannot be used to contradict the plain language of the regulation. If the government meant what it said in the preamble, it should have said so in the regulation itself, both to legitimize its position and to give prospective filers fair warning, which it also failed to give in the FBAR itself or its instructions.

As the judge mentions in her order, Mr. Aroeste has a case pending in the Tax Court that apparently raises the same questions.

As a policy matter, I believe that the government should abandon its position in the *Aroeste* case. More broadly, it should not require tax reporting by treaty nonresidents as if they were residents. I have no new arguments to offer, beyond what Liliana and I said in 2015 — but those arguments are still valid and they deserve some attention. Those arguments noted the confusion created by the government position, the weakness of its theoretical underpinnings, and the uselessness of the information that might be collected (as the government itself essentially acknowledged by exempting treaty nonresidents from the need to file Form 8938, the tax counterpart of the FBAR).

In 2015 Liliana and I were told point-blank that the government did not have the bandwidth to address these points. I have since more than once asked for this issue to be part of the IRS chief counsel's priority guidance list, to no avail. I would guess that the time spent litigating the *Aroeste* case has far exceeded what it would have taken to fix the problems of inconsistent treatment of treaty nonresidents. ■

Sincerely,

Michael J.A. Karlin
Mar. 6, 2023

[5] In fact, the government knew how to change definitions in the case of the FBAR regulations, in which it uses a different definition of the "United States" from the definition in the Internal Revenue Code. *See* 31 C.F.R. section 1010.350(b)(2) ("A resident of the United States is an individual who is a resident alien under 26 U.S.C. 7701(b) and the regulations thereunder but using the definition of 'United States' provided in 31 CFR 1010.100(hhh) rather than the definition of 'United States' in 26 CFR 301.7701(b)-1(c)(2)(ii).").