SOUTH DAKOTA TRUST ASSOCIATION
FALL FORUM 2025

RECENT DEVELOPMENTS IN U.S. INTERNATIONAL TAX & "FOREIGN" [INCLUDING SOUTH DAKOTA] TRUSTS

Date: October 10, 2025

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AGENDA -

- Recent Developments –
  - Proposed Trust Regulations
  - July 2025 Federal Tax Legislation – Pre-immigration and Expatriation with Trusts
  - South Dakota Trusts that are “Foreign Trusts”
  - Tax Treaty Impact of Non-U.S. citizen Settlors of South Dakota Trusts
  - Penalties and Reporting
- The Horizon –
  - ❑ International Tax audits of Multi-National Families: Individuals and Enablers of Foreign Tax Fraud – Utilizing U.S. Financial Institutions and Trusts Subject to U.S. Law - Title 18 and Title 31 Focus (Not Title 26)

INTERNATIONAL REPORTING, CASES AND CASE DEVELOPMENTS -

- The Horizon –
  - International Tax audits of Multi-National Families: Individuals and Enablers of Foreign Tax Fraud – Utilizing U.S. Financial Institutions - Title 18 and Title 31 Focus (Not Title 26)

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Fighting FATCA Tax Fraud Through Cross-Agency Enforcement

by Patrick W. Martin and Daniel C. Silva

Reprinted from *Tax Notes International*, October 23, 2023, p. 535

RECENT DEVELOPMENTS –
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- Proposed Trust Regulations
- July 2025 Federal Tax Legislation – Pre-immigration and Expatriation with Trusts
- South Dakota Trusts that are “Foreign Trusts”
- Tax Treaty Impact of Non-U.S. citizen Settlors of South Dakota Trusts
- Penalties and Reporting

- The Horizon –
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- International Reporting -

Foreign Trust Proposed Regulations

PENALTIES FOR FAILURE TO REPORT FOREIGN LARGE GIFTS

- Prop. Reg. § 1.6039F-1(a) imposes upon taxpayers a general obligation to report in Form 3520 foreign gifts received that exceed an aggregate amount of $ 100,000 in a taxable year. Failure to report would subject that taxpayer to a penalty of 5% of the amount of the foreign gift for each month for which the failure to report persists, without exceeding 25% percent of the aggregate amount of the foreign gift (“Gift Penalty”). In addition to the Gift Penalty, the IRS can also assess the tax consequences of the receipt of foreign gifts based on all facts and circumstances.

PENALTIES FOR FAILURE TO REPORT THE CREATION OF, TRANSFERS OF PROPERTY TO, AND DISTRIBUTIONS OF PROPERTY FROM A FOREIGN TRUST

Prop. Reg. § 1.6677-1 elaborates on the penalties for failure to report in Forms 3520 and/or 3520-A certain information with respect to foreign trusts pursuant to section 6048 and its respective Proposed Regulations. Prop. Regs. §§ 1.6048-2 through 1.6048-4 provide the following three main reporting obligations:

- (a) Under Prop. Reg. § 1.6048-2 the grantor of a foreign trust, the transferor of property to a foreign trust, or the executor of the decedent's estate are obligated to report in Part I of Form 3520 certain reportable events. These reportable events consist of (1) the creation of a foreign trust by a US person, (2) the direct, indirect, or constructive transfer of any money or property to a foreign trust by a US person, including a transfer by reason of death, and (3) the death of a citizen or resident of the US who was treated as the grantor of the foreign trust and any portion of such foreign trust was included in the decedent's gross estate ("Reportable Event").

- (b) Under Prop. Reg. § 1.6048-4 any person who receives directly, indirectly, or constructively any distribution from a foreign trust is obligated to report such distribution in Part III of Form 3520.

- (c) Under Prop. Reg. §1.6048-3 any US person who is wholly or partly treated as owner of a foreign trust is responsible for ensuring that a Form 3520-A along with its respective owner and beneficiary statements are duly furnished and filed by the end of the tax year. Failure to comply with the reporting obligations contained in Prop. Regs. §§ 1.6048-2 and 1.6048-4 on Form 3520 would subject the taxpayer to a penalty equal to the greater of $10,000 or 35% of the gross reportable amount ("Transaction Penalty"). Additionally, failure to comply with the reporting obligation contained in Prop. Reg. §1.6048-3 in Form 3520-A would subject the taxpayer to a penalty equal to the greater of $10,000 or 5% of the gross reportable amount ("Owner Penalty").

DEFINITION OF A U.S. PERSON

- Prop. Reg. § 1.6039F-1(f)(1). The Proposed Regulations amend the definition of a U.S. person. For purposes of sections 6039F and 6048, a dual resident who claims benefits under an income tax treaty will no longer be classified as a U.S. person. This is helpful in a number of regards but creates confusion for a U.S. person receiving a gift from such person, specifically with respect to the Form 3520 reporting obligation.

NRA THAT RECEIVES A LOAN – LATER BECOMES U.S. PERSON

- Prop. Reg. § 1.643(i)-1(b)(3) provides that if a nonresident alien individual who is a grantor or beneficiary of a foreign trust receives a loan from the trust, and, while the loan is outstanding, subsequently becomes a U.S. person within two years of the loan origination date, the individual will be deemed to have received a distribution from the foreign trust with respect to the outstanding amount of the loan as of the first day the individual is considered a U.S. person.

RECENT DEVELOPMENTS –

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PROPOSED FOREIGN TRUST REGULATIONS –

- The Treasury and the IRS recently published proposed regulations related to foreign trusts.

- See Transactions with Foreign Trusts and Reporting of Information on Transactions with Foreign Trusts and Large Foreign Gifts : Rule proposed by the Internal Revenue Service on 05/08/2024 .When will proposed regulations become final?

- Noteworthy rule: Proposed § 1.6048-2(b) - A "reportable event" also includes a U.S. person's transfer of property to a domestic trust that becomes a foreign trust, as described in § 1.684-4 (outbound migrations of domestic trusts),

- Proposed § 1.6048-4 - (4) *Inbound migrations of foreign trusts.* A distribution includes an inbound migration of a foreign trust. An inbound migration of a foreign trust occurs when a foreign trust becomes a domestic trust. In such case, the foreign trust is treated as distributing the trust corpus and income to the domestic trust on the date the foreign trust becomes a domestic trust.

THE "ALL" OR "NOTHING" (RE: TAXES)

- Subtitle A and Subtitle B exempts "non-residents" from most U.S. tax on most worldwide assets and income – the "NOTHING"

- "Residents" are subject to worldwide tax – the "ALL"

- Given worldwide tax exposure of U.S. resident for income tax purposes (and potentially U.S. transfer tax purposes), most effective tax planning *can be achieved prior to a move to the U.S.* since the nonresident is then neither subject to U.S. income tax nor U.S. transfer (i.e., estate and gift) tax on non-U.S. assets.

- The use of trusts, as part of pre-immigration tax planning can present significant opportunities –
  - e.g., accelerating income assets in trust prior to U.S. residency, selling or getting a fair market value basis of appreciated assets; keeping unrealized loss assets and substantiate tax basis prior to U.S. residency

POTENTIAL FOREIGN TRUST REFORM - REGULATIONS (TAX DEFINITION)

- "Foreign trust" vs. Trust that is a "United States Person"

  - Key technical distinctions; no such thing as a "domestic trust" in the IRC or the Treas. Reg.

  - IRS PLR 200243031 – first and only PLR to address when a trust subject to U.S. Law (California law in that case) was a "foreign trust"

  - IRS confirmation that a trust subject to U.S. law could nevertheless be a "foreign trust" for U.S. federal income tax and estate tax purposes.

POTENTIAL FOREIGN TRUST REFORM - REGULATIONS (TAX DEFINITION)

- "Foreign trust" vs. Trust that is a "United States Person"
  - PLR 200243031 – first and only PLR to address when a trust subject to U.S. Law (e.g., South Dakota would be the same result) was a "foreign trust"

    –IRS confirmation that the non-resident was the "grantor" treated as the owner of the trust assets.
  - Now a "no rule" area by the IRS

  - You have a "Foreign Trust" – Now What?

In this case, Settlor retained the absolute power to revest title to the trust corpus in himself. Accordingly, the exception to the general rule of section 672(f)(1) is applicable and the rules of §§ 671-679 may be applied to treat Settlor as the owner of the Trust. For federal income tax purposes, Settlor is treated as the owner of the entire Trust under § 676.

INTERNATIONAL INFORMATION REPORTING RETURNS:

- Form 3520: *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts* (IRC §§ 6039F, 6048(a), 6677);
- Form 3520A: *Annual Report of Foreign Trust with a U.S. Owner* (IRC § 6048, 6677);
- Form 5471: *Information Return of U.S. Persons With Respect to Certain Foreign Corporations* (IRC §§ 6038, 6046);
- Form 5472: *Information Return of 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business* (IRC §§ 6048A, 6048C);
- Form 8938: *Statement of Specified Foreign Financial Assets* (IRC § 6038D).
- Form 8854: *Initial and Annual Expatriation Statement (*IRC §§ 877, 877A, 2801, et. seq.*).*
- Form 1040-C, *U.S. Departing Alien Income Tax Return* - Departing Alien Clearance (Sailing Permit)
- Form 2063, *U.S. Departing Alien Income Tax Statement and Annual Certificate of Compliance*

RECENT DEVELOPMENTS –
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- July 2025 Federal Tax Legislation – OBBB - No major modifications to IRC impacting “foreign trusts” –
  - No modifications of the lifetime exclusion amounts for non-U.S. citizens who are not domiciled in the U.S.
  - No change in the international information reporting rules
- Corporate tax rates – 21% and foreign source income taxed at 14% (permanent) – when trust holds shares of a U.S. corporation

DUE DILIGENCE - COMPLIANCE CONSIDERATIONS

- South Dakota Trusts that are “Foreign Trusts”
  - Due diligence for trustees when a trust is a “foreign trust”
  - What reporting requirements exist for trustees when a South Dakota Trust is a foreign trust
  - What reporting requirements exist for the settlor(s) and/or beneficiaries when a South Dakota Trust is a foreign trust

Due diligence - KYC - compliance Considerations

South Dakota Trusts that are "Foreign Trusts"

Form	Title	IRC
W-8BEN	Certificate of foreign status of beneficial owner for United States tax withholding and reporting – foreign individuals.	§1441
W-8BEN-E	Certificate of foreign status of beneficial owner for United States tax withholding and reporting – foreign entities.	§1442
W-8ECI	Certificate of foreign person's claim for exemption from withholding on income effectively connected with the conduct of a trade or business in the United States.	§1441
W-8IMY	Certificate of foreign intermediary, foreign flow-through entity, or certain U.S. branches for United States tax withholding and reporting.	§1441

Form **W-8BEN**

(Rev. October 2021)

Department of the Treasury
Internal Revenue Service

Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)

▶ For use by individuals. Entities must use Form W-8BEN-E.

▶ Go to *www.irs.gov/FormW8BEN* for instructions and the latest information.

▶ Give this form to the withholding agent or payer. Do not send to the IRS.

OMB No. 1545-1621

Do NOT use this form if:	**Instead, use Form:**
• You are NOT an individual	W-8BEN-E
• You are a U.S. citizen or other U.S. person, including a resident alien individual	W-9
• You are a beneficial owner claiming that income is effectively connected with the conduct of trade or business within the United States (other than personal services)	W-8ECI
• You are a beneficial owner who is receiving compensation for personal services performed in the United States	8233 or W-4
• You are a person acting as an intermediary	W-8IMY

Note: If you are resident in a FATCA partner jurisdiction (that is, a Model 1 IGA jurisdiction with reciprocity), certain tax account information may be provided to your jurisdiction of residence.

Part I Identification of Beneficial Owner (see instructions)

1 Name of individual who is the beneficial owner

2 Country of citizenship

3 Permanent residence address (street, apt. or suite no., or rural route). **Do not use a P.O. box or in-care-of address.**

City or town, state or province. Include postal code where appropriate.

Country

4 Mailing address (if different from above)

City or town, state or province. Include postal code where appropriate.

Country

5 U.S. taxpayer identification number (SSN or ITIN), if required (see instructions)

6a Foreign tax identifying number (see instructions)

6b Check if FTIN not legally required . . . . ☐

Form **W-8IMY**

(Rev. October 2021)

Department of the Treasury
Internal Revenue Service

Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting

▶ Section references are to the Internal Revenue Code.

▶ Go to *www.irs.gov/FormW8IMY* for instructions and the latest information.

▶ Give this form to the withholding agent or payer. Do not send to the IRS.

OMB No. 1545-1621

Do not use this form for:	**Instead, use Form:**
• A beneficial owner solely claiming foreign status or treaty benefits (other than a qualified intermediary (QI) acting as a qualified derivatives dealer (QDD))	W-8BEN or W-8BEN-E
• A hybrid entity claiming treaty benefits on its own behalf (other than a QI acting as a QDD)	W-8BEN-E
• A foreign person claiming that income is effectively connected with the conduct of a trade or business in the United States	W-8ECI
• A disregarded entity with a single foreign owner that is the beneficial owner (other than a QI acting as a QDD) of the income to which this form relates. Instead, the single foreign owner should use	W-8BEN, W-8ECI, or W-8BEN-E
• A foreign government, international organization, foreign central bank of issue, foreign tax-exempt organization, foreign private foundation, or government of a U.S. possession claiming the applicability of section(s) 115(2), 501(c), 892, 895, or 1443(b)	W-8EXP
• U.S. entity or U.S. citizen or resident	W-9
• A foreign person documenting itself for purposes of section 6050W	W-8BEN, W-8BEN-E, or W-8ECI

Part I Identification of Entity

1 Name of organization that is acting as intermediary

2 Country of incorporation or organization

3 Name of disregarded entity (if applicable), see instructions

4 Chapter 3 Status (entity type) (Must check one box only.):

- ☐ QI (including a QDD). Complete Part III.
- ☐ Nonqualified intermediary. Complete Part IV.
- ☐ Territory financial institution. Complete Part V.
- ☐ U.S. branch. Complete Part VI.
- ☐ Withholding foreign partnership. Complete Part VII.
- ☐ Withholding foreign trust. Complete Part VII.
- ☐ Nonwithholding foreign partnership. Complete Part VIII.
- ☐ Nonwithholding foreign simple trust. Complete Part VIII.
- ☐ Nonwithholding foreign grantor trust. Complete Part VIII.

5 Chapter 4 Status (FATCA status) (See instructions for details and complete the certification below for the entity's applicable status.) (Must check one box only.):

- ☐ Nonparticipating foreign financial institution (FFI) (including an FFI related to a Reporting IGA FFI other than a deemed-compliant FFI, participating FFI, or exempt beneficial owner). Complete Part IX (if applicable).
- ☐ Owner-documented FFI. Complete Part XI.
- ☐ Restricted distributor. Complete Part XVII.

DUE DILIGENCE - KYC – TRUSTEE HAS ALL THE INFORMATION

- Taxpayer information
- Beneficial Owner – W8-BEN (e.g., like W8-9 forms held by Swiss Banks)
- KYC compliance under Title 31 – kept in the files of the trustee and the U.S. Financial institution
- **How does the U.S. federal government obtain this information in the hands of the trustee or U.S. financial institution?**

RECENT DEVELOPMENTS - - COMPLIANCE CONSIDERATIONS

- South Dakota Trusts that have “foreign beneficial owners”

  Corporate Transparency Act -

  - Domestic entities that are formed in 2025 must report with FinCEN within 30 days of formation –
  - What reporting requirements exist for the settlor(s) and/or beneficiaries when a South Dakota Trust is a foreign trust?

AGENDA -

- Tax Treaty Impact of Non-U.S. citizen Settlors of South Dakota Trusts
  - Penalties and Reporting
- Case Law Developments – fundamental change
  - \- *Aroeste v. United States*, Case No. 22-cv-00682 (S.D. Cal., Nov. 20, 2023)

TREATY BENEFITS - Aroeste v. United States, Case No. 22-cv-00682 (S.D. Cal., Nov. 20, 2023)

- Mr. Aroeste was a U.S. green card holder (since the 1980s) with Mexican citizenship and his permanent residence and domicile always in Mexico. He filed as a tax resident in his home country of residence – Mexico.
- The law of the U.S.-Mexico Tax Treaty was critical in the Court's analysis and conclusions.
- A U.S. CPA filed 1040 resident tax returns for many years (married filing jointly returns), even though the non-U.S. citizen never lived in the United States and spent only vacations in the U.S. (e.g., not more than 30 days each year). No analysis of the tax treaty was undertaken by the CPA. His wife was a naturalized U.S. citizen.
- This went on for more than two decades when the taxpayer was advised of how the tax treaty law provides a different result. In 2016, he filed "corrected" U.S. federal income tax returns on Form 1040-NR and claiming treaty benefits (going back to years 2012, 2013 and 2014) reporting his non-residency status and filing Form 8833 (Treaty Based Return Position Disclosure). Late filed Form 8833
- Non-resident spouses who are not both "United States persons" (are not eligible to file joint tax returns. IRC § 6013(a).
- An election can be made under IRC § 6013(g) which has very specific requirements. The U.S. resident tax returns, previously filed as married were invalid returns.

Aroeste v. United States, Case No. 22-cv-00682 (S.D. Cal., Nov. 20, 2023)

- The Government argued that: (i) Aroeste was a "United States person" as he waived treaty benefits by not "claiming" them on a timely filed return, (ii) he failed to provide notice (by not attaching Form 8854, Initial and Annual Expatriation Statement (required under Notice 2009-85)), and (iii) was still required to file FBARs per the preamble in 31 C.F.R. § 1010.
- District Court held that green card holders who qualify as nonresidents under a treaty are not considered "United States person" (as defined in IRC § 7701(a)(30)(A) and (b)(1)(A)(i) per the flush language of IRC § 7701(b)(6) that provides the and individual ceases to be treated as a "lawful permanent resident" by application of the treaty), and therefore are not required to file FBARs. Timely filing of Form 8833 was not a condition for the taxpayer to apply the law of the treaty.
- The Court held IRS Notice 2009-85 was invalid as a matter of law as it did not comply with the APA.
- Additionally, the IRS had a U.S. Tac Court case and administrative penalties case of over $3M of penalties largely from a trust subject to U.S. law that was a "foreign trust": taxpayer prevailed in all cases, including the 3520/IRC 6048/6677 penalties tied to the treaty conclusion

Aroeste v. United States, Case No. 22-cv-00682 (S.D. Cal., Nov. 20, 2023)

- The Court held IRS Notice 2009-85 was invalid as a matter of law as it did not comply with the APA.
- *"The Court agrees with Aroeste. Although Aroeste gave untimely notice of his treaty position, the Court finds this does not waive the benefits of the Treaty as asserted by the Government. Rather, I.R.C. § 6712 provides the consequences for failure to comply with I.R.C. § 6114, namely a penalty of $1,000 for each failure to meet § 6114's requirements of disclosing a treaty position."*
  - See- ***Aroeste v United States*** – Order Nov 2023, p. 10.
- Government argued that late filed returns waived the tax treaty benefits. Notably, the court confirmed that failure to provide timely notice of the treaty position did not waive the treaty law applicable and the benefits of the treaty.

- Court also held that Aroeste was subject to a $1,000 penalty under IRC § 6712 for failing to timely disclose the treaty-based return position. However, the statutory time period by which the IRS needed to make the assessment had long passed.

NOTICE 2009-85 **– IT AIN'T THE LAW!**

- Primary guidance issued under Sec. 877A (still no proposed, temp, or final regs under 877A)

- Notice included, as Section 9. Gifts or Bequests:

Gifts or bequests form a covered expatriate on or after June 17, 2008, are subject to a transfer tax under new section 2801. Separate guidance will be issued for U.S. persons who receive gifts or bequests on or after June 17, 2008 from expatriates who are subject to this notice. Satisfaction of the reporting and tax obligations for covered gifts or bequests received will be deferred, pending the issuance of guidance. That guidance will provide a reasonable period of time between the issuance of that guidance and the date prescribed for such reporting and tax payments.

- ***Aroeste*** **court confirmed Notice 2009-85 did not comply with the APA and thus is not binding**

- Final regulations under Sec. 2801 finally arrived in January; no 877A regs. have been issued

Aroeste v. United States, Case No. 22-cv-00682 (S.D. Cal., Nov. 20, 2023)

- **Why is *Aroeste* important to all individuals, companies, trusts and other taxpayers (either "United States person" or residents in a treaty country) for international matters?**
- IRS' position that timely filing of Form 8833 was a condition for the taxpayer to apply the law of the treaty is FALSE. IRS' decades long practice since 6114 was adopted. Court concluded otherwise.
- Taxpayers get the benefits of the treaty law, notwithstanding procedural lapses.
- Filing the wrong forms, or not filing them at all, does not strip taxpayers (including global taxpayers outside the U.S. who can benefit from the tax treaty provisions) of the benefits provided in the treaty law.
- **Practice pointers: Do proper due diligence regarding individuals physical residency status, if they have a "green card"**
- How Many LPRs are Living in Tax Treaty Countries like Aroeste (Now including Chile)? What are the Legal-Tax Consequences? (Part I of II)
    - See an earlier post: DHS Report: 3.89M Emigrated LPRs — Who Falls Under the Tax Treaty Escape Hatch?
    - What happens to those who have not formally abandoned their lawful permanent residency status. See, "LPR Tax Limbo" – Formal Abandonment of LPR (Form I-407) – (2020). Oops, did you accidentally expatriate for 877 and 877A purposes?

PENALTIES FOR NOT PROVIDING TREATY DISCLOSURES

- Disclosures not made under IRC § 6114 give rise to a statutory penalty under IRC § 6712:
  - *If a taxpayer fails to meet the requirements of section 6114, there is hereby imposed a penalty equal to $1,000 ($10,000 in the case of a C corporation) on each such failure.*
    - Exceptions - Disclosure is generally waived for an individual if the aggregate amount for the taxable year does not exceed $10,000 unless reporting is required by instructions to Form 8833. The government also has th

- *See,* Martin, P. 37 Int'l Tax J. 37 (2011): ***U.S. Tax Treaties and Code Sec. 6114: Why a Taxpayer's Failure to Take a Treaty Position Does Not Deny Treaty Benefits;*** *see also* IRS PMTA 2007-01188 (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 IRC § 6712).

BLOG RESOURCE – PATRICK W. MARTIN (WEALTH TAXES, EXIT TAXES, ETC.)

Tax-Expatriation

Matters of U.S. Citizenship Renunciation-Relinquishment & LPR Abandonment

Burdens of U.S. International Tax Compliance: Why some USCs residing overseas ultimately renounce U.S. citizenship (dizzying tax compliance)

POSTED ON FEBRUARY 6, 2025

The value of a U.S. citizenship is known throughout the world. Immigrating to the U.S. is something that is valued by millions of individuals around the world. The following table from State Department data explains the principle reasons people chose to immigrate to the U.S. – to come to the U.S.:

Work is the most common reason for authorized immigration.

Recent Posts

CRIMINAL TAX DEVELOPMENTS: FATCA FRAUD WITH TRUSTS SUBJECT TO U.S. LAW

INTERNATIONAL REPORTING, CASES AND CASE DEVELOPMENTS -

- The Horizon –
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Fighting FATCA Tax Fraud Through Cross-Agency Enforcement

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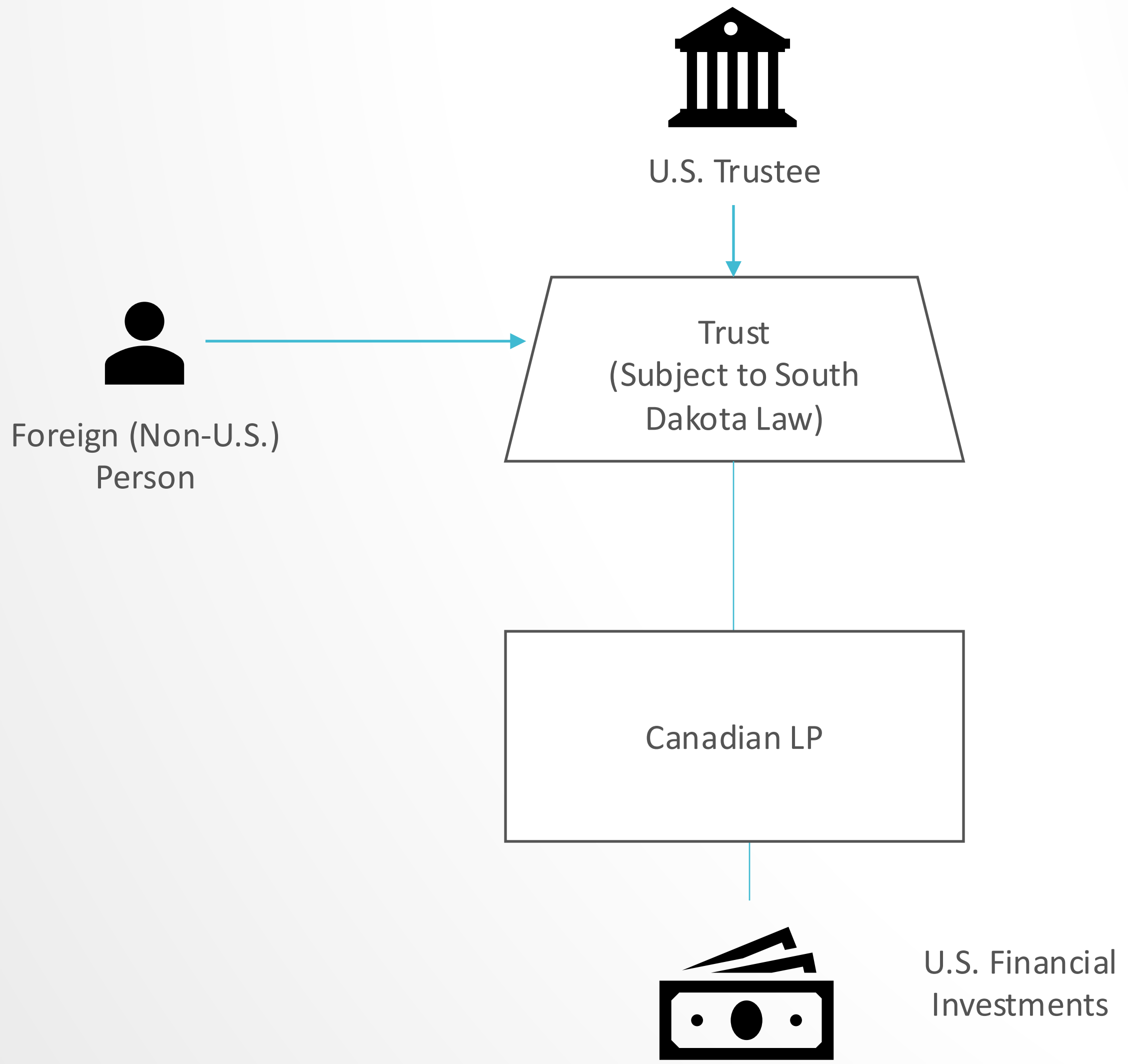
Reprinted from *Tax Notes International*, October 23, 2023, p. 535

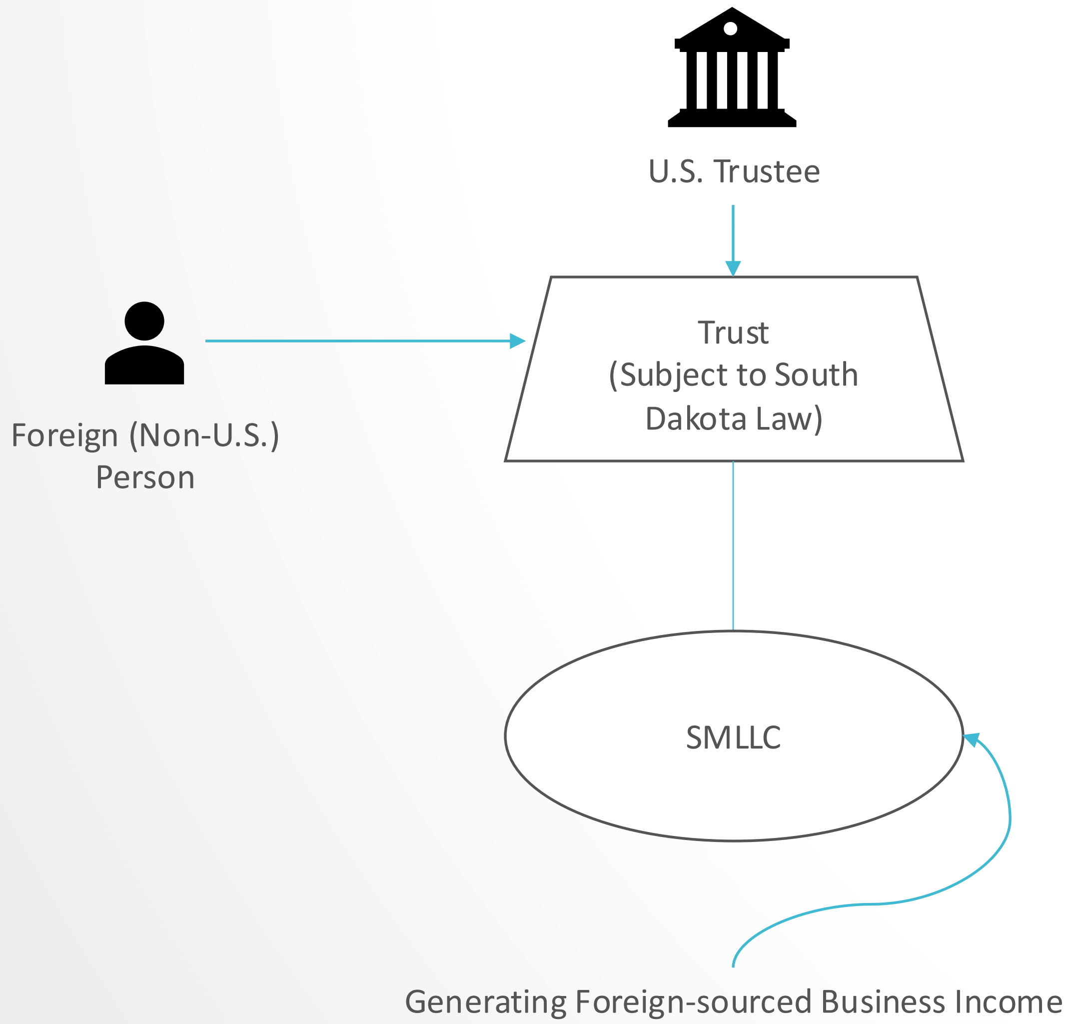
CRIMINAL TAX DEVELOPMENTS

- **Jeopardy: Pasquantino**
  - What's conspiracy?
  - What's wire fraud?
  - What's money laundering?
  - What's aiding and abetting?

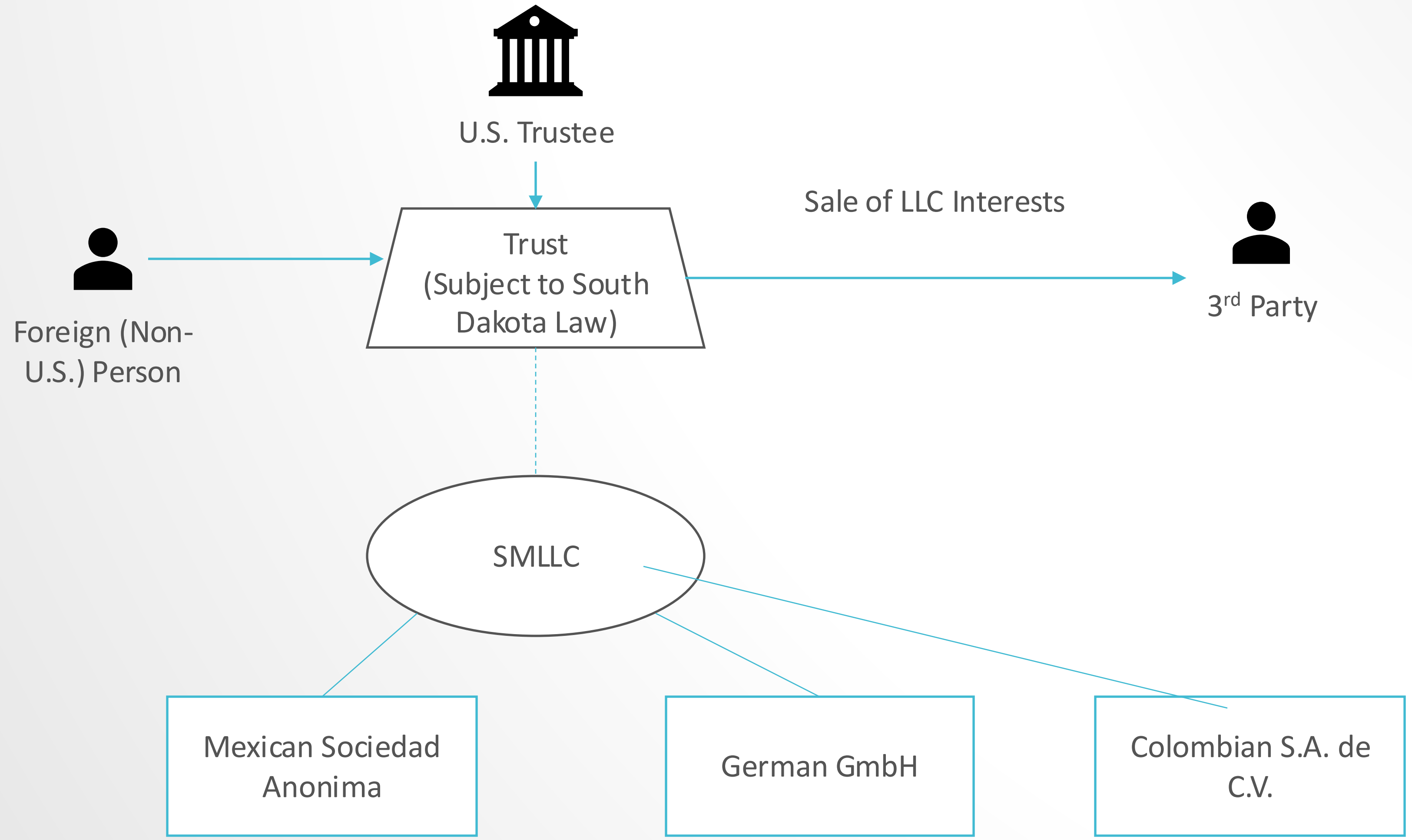
SCENARIO 1


U.S. Trustee
Foreign (Non-U.S.) Person
Trust (Subject to South Dakota Law)
Canadian LP
U.S. Financial Investments

SCENARIO 2


U.S. Trustee
Foreign (Non-U.S.) Person
Trust (Subject to South Dakota Law)
SMLLC
Generating Foreign-sourced Business Income

SCENARIO 3


U.S. Trustee
Trust
(Subject to South
Dakota Law)
Sale of LLC Interests
Foreign (Non-
U.S.) Person
3rd Party
SMLLC
Mexican Sociedad
Anonima
German GmbH
Colombian S.A. de
C.V.

FURTHER INTERNATIONAL TAX DEVELOPMENTS – READ AT YOUR LEISURE -

TIMELINE OF DEVELOPMENT OF REPORTING REQUIREMENTS

1954- 26 U.S. Code § 6046 - Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock

1960-26 U.S. Code § 6038 - Information reporting with respect to certain foreign corporations and partnerships

1962-26 U.S. Code § 6048 - Information with respect to certain foreign trusts

1970-The Requirement to file an FBAR begins as part of the Bank Secrecy Act (BSA)

1980s

1982-26 U.S. Code § 6038A - Information with respect to certain foreign-owned corporations

1982-26 U.S. Code § 6046A - Returns as to interests in foreign partnerships

1984-26 U.S. Code § 6038B - Notice of certain transfers to foreign persons

1986-26 U.S. Code § 1295 - Qualified electing fund

1986-26 U.S. Code § 6039E - Information concerning resident status

1990s

1990-26 U.S. Code § 6038C - Information with respect to foreign corporations engaged in U.S. business

1996-26 U.S. Code § 6039F - Notice of large gifts received from foreign persons

1996-26 U.S. Code § 6039G - Information on individuals losing United States citizenship

2000s

2001- USA Patriot Act is passed, Section 314(b) permits financial institutions, upon providing notice to the United States Department of treasury, to share information with one another in order to report activities that may involve money laundering or terrorist activity

2010-26 CFR **§ 1.1298-1 - Section 1298(f)** annual reporting requirements for United States persons that are shareholders of a passive foreign investment company

2010-26 U.S. Code § 6038D - Information with respect to foreign financial assets

INTERNATIONAL INFORMATION REPORTING RETURNS:

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- Form 3520A: *Annual Report of Foreign Trust with a U.S. Owner* (IRC § 6048, 6677);
- Form 5471: *Information Return of U.S. Persons With Respect to Certain Foreign Corporations* (IRC §§ 6038, 6046);
- Form 5472: *Information Return of 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business* (IRC §§ 6048A, 6048C);
- Form 8938: *Statement of Specified Foreign Financial Assets* (IRC § 6038D).
- Form 8854: *Initial and Annual Expatriation Statement (*IRC §§ 877, 877A, 2801, et. seq.*).*
- Form 1040-C, *U.S. Departing Alien Income Tax Return* - Departing Alien Clearance (Sailing Permit)
- Form 2063, *U.S. Departing Alien Income Tax Statement and Annual Certificate of Compliance*

INTERNATIONAL INFORMATION REPORTING RETURNS:

- Form 8865: *Return of U.S Persons with Respect to Certain Foreign Partnerships* (IRC §§ 6038, 6038B, 6046A)
- Form 8621: Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund (IRC §§ 1291-1298)
- Form 2555: *Foreign Earned Income* (IRC § 911)
- Form 1116: *Foreign Tax Credit* (IRC §§ 901-909)
- Form 8833: *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)* (IRC §§ 6114 & 6712)
- Form 926: *Return by a U.S. Transferor of Property to a Foreign Corporation* (IRC §§ 6038B(a)(1)(A), 367(d), or 367(e))

- *FinCen Form 114, Report of Foreign Bank and Financial Accounts* (FBAR). (31 U.S. Code §§ 5314 & 5312)
- *Corporate Transparency Act – Beneficial Ownership Information (31* U.S. Code §§ 5336)

IRC § 6777 PENALTY - LAST UPDATED: JANUARY 15, 2025

IRS Hears Concerns from TAS and Practitioners, Makes Favorable Changes to Foreign Gifts and Inheritance Filing Penalties

The IRS has ended its practice of automatically assessing penalties at the time of filing for late-filed Forms 3520, Part IV, which deal with reporting foreign gifts and bequests.

By the end of the year the IRS will begin reviewing any reasonable cause statements taxpayers attach to late-filed Forms 3520 and 3520-A for the trust portion of the form before assessing any Internal Revenue Code (IRC) §6677 penalty.

ABATEMENT OF PENALTIES -

- **First time Abatement?**
    - The First Time Abatement (FTA) administrative waiver is not applicable to International Penalties addressed in IRM 8.11.5. [International penalties include the IRC 6038 series located in Chapter 61 – Subchapter A –Part III of the IRC; and, the IRC 6677 and IRC 6679 series located in Chapter 68 – Subchapter B - Assessable Penalties.]

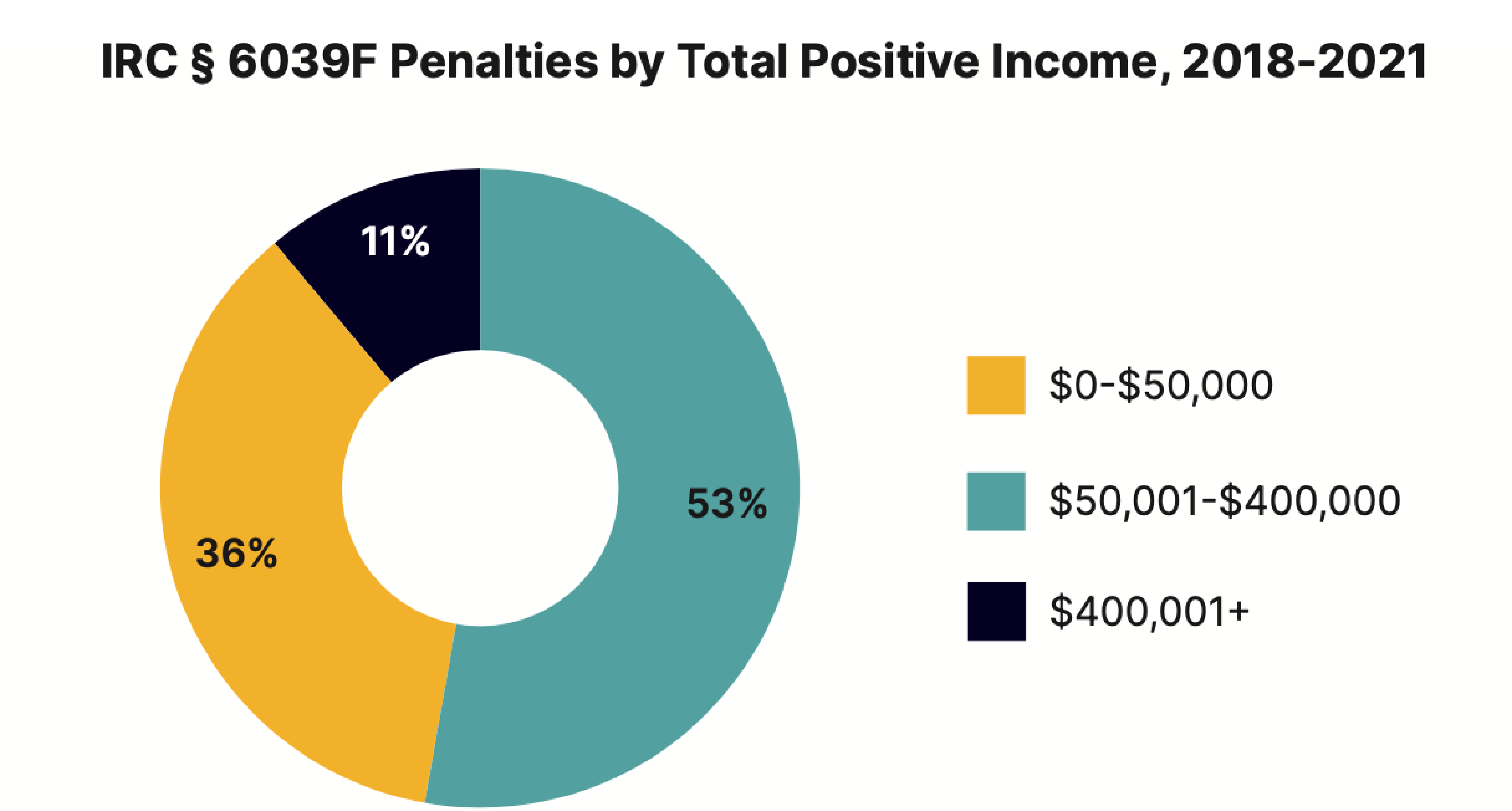
    Part 8. Appeals, Chapter 11. Penalties Worked in Appeals, Section 5. International Penalties

- **Other Requests for Abatement - Remedies?**
    - **Form 843, Claim for Refund and Request for Abatement**
    - **Form 656-L, Offer in Compromise (Doubt as to Liability**
        - **IRM - 5.19.24 Doubt as to Liability Offer in Compromise**
        - **Audit reconsideration:**

- **Supervisory Approval - § 6751**

IRC § 6039F PENALTY DATA FOR INDIVIDUALS BY TOTAL POSITIVE INCOME

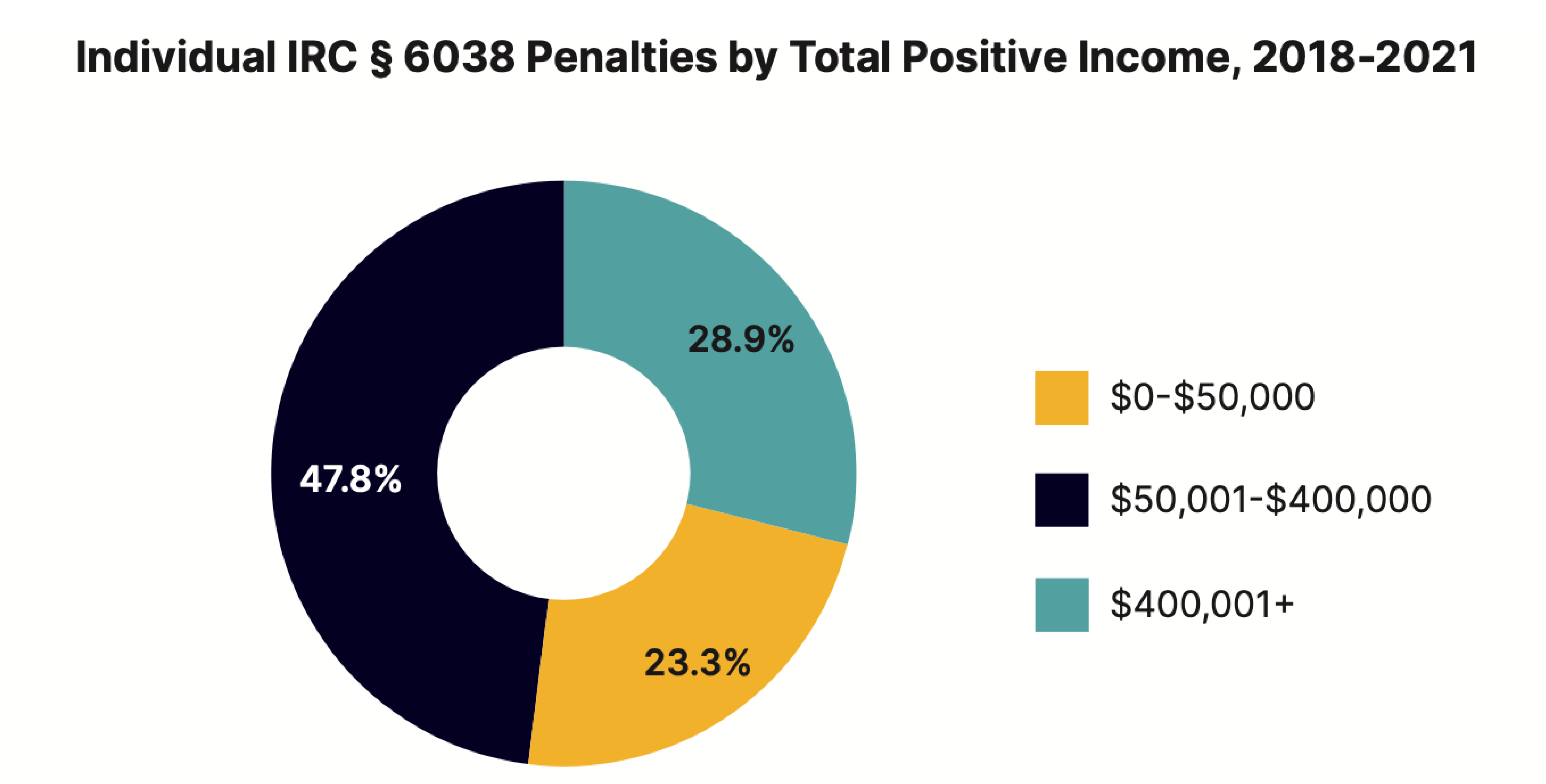
- During the years 2018-2021



Taxpayer Advocate Annual Report to Congress 2023 (pg.106) https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23_MSP_08_International.pdf

IRC § 6038 PENALTY DATA FOR INDIVIDUALS BY TOTAL POSITIVE INCOME

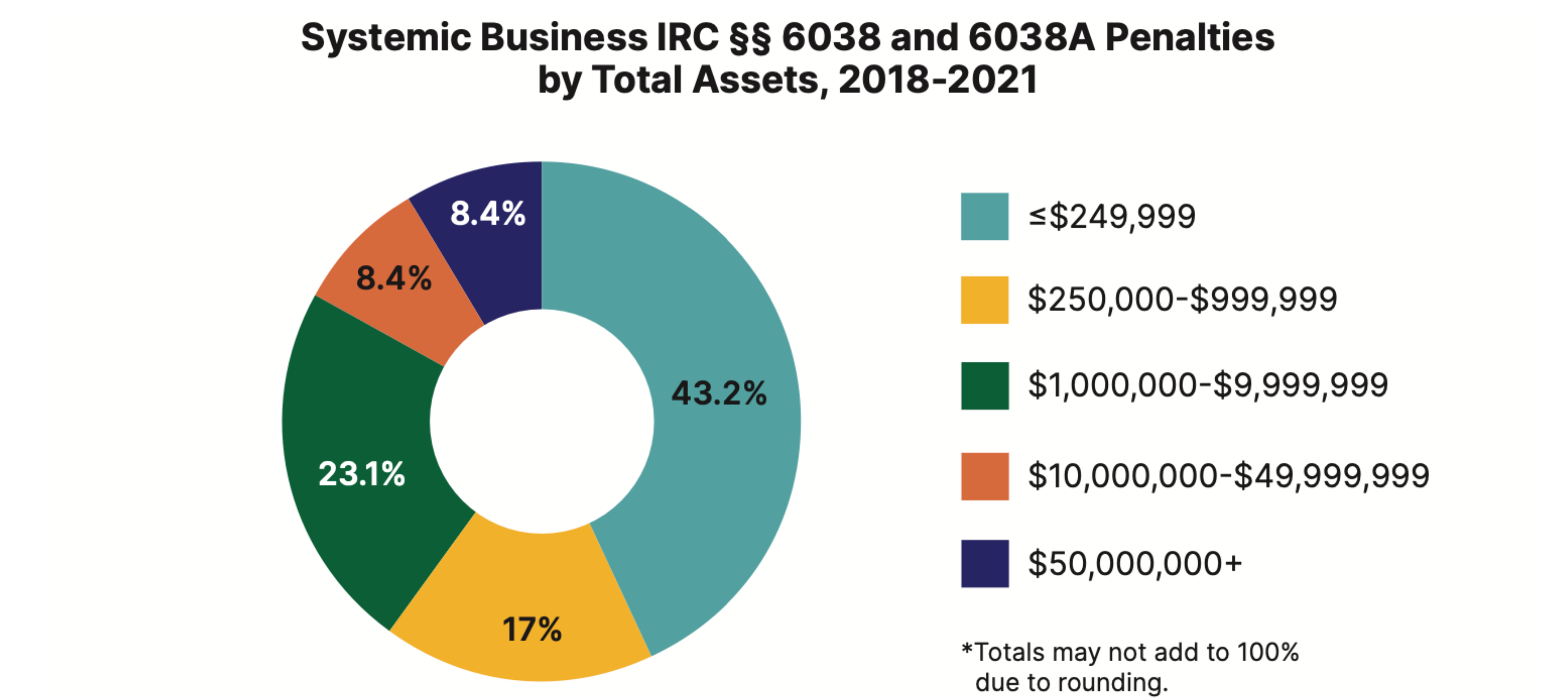
- During the years 2018-2021



Taxpayer Advocate Annual Report to Congress 2023 (pg.108) https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23_MSP_08_International.pdf

IRC § 6038 AND 6038A PENALTIES FOR BUSINESSES BY TOTAL ASSETS

- **During the years 2018-2021**
- Small and midsize businesses, like individuals, bear a disproportionate burden of these penalties: Small and midsize businesses comprise 83% of IRC 6038 and 6038A penalties: In dollar terms, small and midsize businesses are subject to 64% of the aggregate business penalties imposed under IRC 6038 and 6038A



Taxpayer Advocate Annual Report to Congress 2023 (pg.108) https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23_MSP_08_International.pdf

RECENT CASES OF NOTE :

- ***Moore v. United States***, 602 U.S. 572 (2024)
- ***Loper Bright Enterprises v. Raimondo***, 603 U.S. 369 (2024) authored by Chief Justice Roberts.
- ***Corner Post, Inc. v. Board of Governors of the Federal Reserve System***, 603 U.S. 799 (2024).
- ***Liberty Global, Inc. v. United States,*** 600 F. Supp. 3d 1286 (D. Colo. 2023). * On Appeal to the 10th Circuit
- ***Aroeste v United States***, 22-cv-00682-AJB-KSC (20 Nov. 2023):
  - Originally, the DOJ Office of Solicitor General filed an appeal to the 9th Circuit. Later they dismissed leaving stand the law of the District Court - U.S. Government Files Motion to Dismiss Appeal of Aroeste (9th Circuit) (2024)
- ***Farhy v. Commissioner***, 160 TC No. 6 (2023). + ***Mukhi*** + ***Safdieh***
- ***SEC v. Jarkesy,*** 144 S. Ct. 2117 (2024)

NEW DEVELOPMENTS- A BUNCH

- Three Precedent Setting Cases in International Information Reporting ("IIR") in 6 Weeks: * Aroeste, * Bittner, and * Farhy: all Interconnected via Title 26, Title 31 and U.S. Income Tax Treaties

- Six Weeks, Three International Information Reporting Decisions (Tax Notes: Martin, Villegas & Chain)

- These IIR decisions relate to –
  - Title 31 penalties for Foreign Bank Account Reports ("FBARs"),
  - Title 26 IIR penalties specific to reporting of ownership interests in foreign companies [and "reportable events" with foreign trusts[1]], and
  - How these two federal statutory regimes of Title 31 and 26 crossover into international law as set forth in U.S. income tax treaties negotiated with different countries around the world.

"Each of these three cases are interconnected and have significant impact to individuals with global lives, global assets, multi-national family members and those who have businesses or accounts in different parts of the world." – Patrick W. Martin

https://tax-expatriation.com/2023/04/17/three-precedent-setting-cases-in-international-information-reporting-iir-in-6-weeks-aroeste-bittner-and-farhy-all-interconnected-via-title-26-title-31-and-u-s-inc/

FARHY V. COMMISSIONER, 160 TC NO. 6 (2023). + ***MUKHI***

- Judge Marvel decision was technical and thorough and mechanically explains how the IRS lacks the statutory authority to assess the penalties under section 6038(b)(1) consistent with other U.S. Tax Court decisions (see *Aroeste*) - and, therefore the IRS, cannot proceed with the administrative collection actions against the taxpayer

- The IRS must bring an action in federal district court – a suit to enforce the penalty (ala Title 31) -

* ***Mukhi v. Commissioner***, 162 TC No. 8 (2024) – appealable to the 8th Circuit

* USTC – meant what it said in Farhy – " . . . *Last week we issued Mukhi II […], in which we held that we still think we're right in our interpretation of section 6038, and expressly held that we would continue our disagreement with the DC Circuit in cases appealable to other circuits.*"[10]

- ***Safdieh v. Commissioner,*** No. 11680-20L (TC Dec. 5, 2024) -) – appealable to the 2nd Circuit

* USTC – meant what it said in Farhy -

Golsen v. Commissioner of Internal Revenue, 54 T.C. 742 (1970), *cert. denied*, 404 U.S. 940 (1971)

What is an assessable penalty?

The Tax Court separately in an Order in the case of *Alberto Aroeste & Estela Aroeste vs. Commissioner* concluded it had no jurisdiction over IIR penalties under Sections 6038(b) and 6677:

> By negative implication, any other taxes — even if imposed in Title 26 — fall outside this Court's deficiency jurisdiction. *Williams v. Commissioner*, 131 T.C. 54, 58 (2008). Penalties under section 6038(b) are imposed by respondent under subtitle F, chapter 61, and are thus outside the Court's deficiency jurisdiction. *Ruesch*, 154 T.C. at 297. Penalties under section 6677 are imposed by respondent under subtitle F, chapter 68, subchapter B, and are explicitly exempt from the deficiency procedures for income, estate, gift, and certain excise taxes. § 6677(e); see also *Smith v. Commissioner*, 133 T.C. 424, 428–29, n.3, 4 (2009).

Docket Nos. 13024-20, 15372-20; Order dated May 13, 2022.

Definition of Resident

Aroeste v. US, No. 22-cv-00682-AJB-KSC, 2023 WL 8103149 (S.D. Ca. 2023)

SUBSEQUENT DEVELOPMENTS- "THE AROESTE RULE " - : Reg. §28.2801–6(c)(1) and (2) limit a US resident for gift tax purposes to those persons that would be treated as such for income tax purposes (after application of a treaty tie-breaker rule). See T.D. 10027, 90 Fed. Reg. 3376 (Jan. 14, 2025).

"THE AROESTE EFFECT" - :

* Invalid IRS Form 8854 as a matter of law.

* Section 6013(g) election was never filed – when originally filed married filing jointly returns were prepared

* International information penalties are being pursued more cautiously (along with other cases with significant impact: e.g., Wrzesinski v US (2023). , Bittner v. United States (02/28/2023), **United States** v. Boyd, 991 F3d 1077 (9th Cir. 2021); *Jones v. United States*, 2020 WL 4390390 (C.D. Cal. May 11, 2020);

* IRS Commissioner- IRS Hears Concerns from TAS and Practitioners, Makes Favorable Changes to Foreign Gifts and Inheritance Filing Penalties ...

AROESTE V. UNITED STATES - BACKGROUND

- **KEY FACTS -** 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 married filing jointly Forms 1040 (U.S. Individual Income Tax Return) for several years on the advice of a relatively sophisticated CPA in L.A. The years at issue in the case started as 2012 and 2013 and then the IRS expanded them for many more years going back more than a decade.
  - 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 reluctantly "assessed" FBAR penalties on a per-account basis; and it was her supervisors who insisted upon rejecting the law of the income tax treaty.
- The agent also reluctantly assessed income tax deficiencies as well as penalties for failure to file international information returns that are required of "United States persons" treating Mr. Aroeste as one. More than 30 professionals from the IRS and DOJ worked on the case over many years. More than $3 million in penalties were assessed under Title 26.
- The Title 31 case that has been decided by the District Court in favor of Mr. Aroeste.

AROESTE V. UNITED STATES - BACKGROUND

- There were three cases on-going. One at the U.S. Tax Court, one at the District Court which was decided in favor of the taxpayer ***Aroeste v United States***, 22-cv-00682-AJB-KSC (20 Nov. 2023): and an administrative case

- Originally, the DOJ Office of Solicitor General filed an appeal to the 9th Circuit. Later they dismissed leaving stand the law of the District Court - U.S. Government Files Motion to Dismiss Appeal of Aroeste (9th Circuit)

- The income tax case pending before the U.S. Tax Court has been decided and has been recently dismissed with modest taxes owing for Mr. Aroeste as a non-resident (not a "United States person").

- See -Form 8854 Filing: TIGTA Report Reveals Compliance Gap

- See Update: Does the IRS have access to the USCIS immigration data for "current" and "former" lawful permanent residents (LPRs)?

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, based upon the law of the tax treaty, and a refund of the penalties already paid. *Aroeste v. United States*, No. 3:22-CV-00682 (S.D. CA).
- The judge considered whether Mr. Aroeste would need 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. The statute of limitations to assess that $1,000 penalty had long lapsed and the IRS never assessed such penalty under 6114.

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 treated as a resident of a foreign country under a tax treaty**

TREATY PROVISIONS ON RESIDENCE

- 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 – 2

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

  "An individual **shall cease** 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

- An individual who is a "lawful permanent resident" as referenced in the tax law (Section 7701(b)(6)) cross-references the U.S. immigration law. The first requirement of that statutory tax rule in § 7701(b)(6)(A)) is that "(A) *such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws* ***[such status not having changed]***. . .[emphasis added]" This means the tax definition is dependent upon the immigration laws, which are found in Title 8, Immigration and Nationality Act. Importantly, the last part of that sentence (i.e., [such status not having changed] is a requirement in the immigration law (Title 8), but does not appear in the tax definition.

- The term "*lawful permanent resident*" cannot be found in Title 8 as a noun or object (i.e., the individual). Instead, the immigration law defines the status of a person in 8 U.S. Code § 1101(a) as follows:- ". . . (20) The term "*lawfully admitted for permanent residence" means the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, such status not having changed.*"

ADVICE TO TAXPAYERS

- *The Court agrees with Aroeste. Although Aroeste gave untimely notice of his treaty position, the Court finds this does not waive the benefits of the Treaty as asserted by the Government. Rather, I.R.C. § 6712 provides the consequences for failure to comply with I.R.C. § 6114, namely a penalty of $1,000 for each failure to meet § 6114's requirements of disclosing a treaty position.*
- See- ***Aroeste v United States*** – Order Nov 2023, p. 10.

QUESTIONS FOR THE GOVERNMENT -

- Why does (did) the government want international information returns and FBARs from treaty nonresidents?

  - The IRS position has apparently changed based upon the language of the proposed foreign trust language which adopts an "Aroeste" reading of the law and the application of the tax treaties.

  - CCA from 2025 – 202501011 (3 Jan 2025) – neglects to apply the treaty law?

7701.21-20

Number: **202501011**
Release Date: 1/3/2025

From: [redacted]
Sent: Wednesday, July 10, 2024 2:57:58 PM
To: [redacted]
Cc: [redacted]
Bcc:
Subject: [redacted]

[redacted]:

As we understand it: (i) the taxpayer held a green card continuously (i.e., had the status of a lawful permanent resident of the United States for immigration purposes at all times) from and has indicated that he abandoned the green card in (although no evidence of a judicial or administrative determination of abandonment has been provided); (ii) he left the United States in and has not returned; (iii) he did not timely file income tax returns for the years at issue ( ), but in he submitted nonresident returns for ; and (iv) he has attached a Form 8833 to each such return filed in , claiming to be a resident for purposes of the income tax treaty. Thus, his claim is that he commenced treatment as a resident for purposes of the treaty no later than .

Tax Treaties

TREATY V. STATUTE

- The United States maintains income tax treaties with 66 countries.
- What happens when a treaty is in direct conflict with a statute?
- Is there an irreconcilable conflict? If not, can the two be read in harmony?
    - "[I]f there is no conflict between the two, then the Code and the treaty should be read harmoniously, to give effect to each." *Adams Challenge (UK) Limited v. Commissioner*, 156 T.C. 16, 44 (2021) (quoting *Pekar v. Commissioner*, 113 T.C. 158, 161 (1999)).
    - Regarding harmonization, "courts 'construe earlier and later provisions in a way that is consistent with the intent of each and that results in an absence of conflict between the two.' A **conflict** is found only where there is 'a clear repugnancy' between the **statute** and the **treaty**. Thus, 'a later treaty will not be regarded as repealing an earlier statute by implication unless the two are absolutely incompatible and the statute cannot be enforced without antagonizing the treaty.' 'If both can exist the repeal by implication will not be adjudged.'" *Id*. (internal citations omitted). Second, what is the "last expression of sovereign will"?
- What is the "last expression of sovereign will"?
    - "By the constitution, a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other.... [I]f the two are inconsistent, the one last in date will control the other.... If the country with which the treaty is made is dissatisfied with the action of the legislative department, it may present its complaint to the executive head of the government, and take other measures as it may deem essential for the protection of its interests.... *The duty of the courts is to construe and give effect to the latest expression of the sovereign will*."
        - *Kappus v. Commissioner*, 337 F.3d 1053, 1058 (D.C. Cir. 2003) (quoting *Whitney v. Robertson*, 124 U.S. 190, 194–95 (1888)).

INCOME TAX TREATY

- Section 6114(a): Each taxpayer who, with respect to any tax imposed by this title, takes the position that a treaty of the United States overrules (or otherwise modifies) an internal revenue law of the United States shall disclose (in such manner as the Secretary may prescribe) such position—**(1)** on the return of tax for such tax (or any statement attached to such return), or **(2)** if no return of tax is required to be filed, in such form as the Secretary may prescribe.

- Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, is used.
- Treas. Reg. § 301.6114-1(b) requires certain items to be disclosed (although this list is not exhaustive), for example:
  - Treaty reduces or modifies the taxation of gain or loss from the disposition of a U.S. real property interest;
  - Treaty alters the source of any item of income or deduction;
  - Treaty grants a credit for a specific foreign tax for which a foreign tax credit would not be allowed by the Code;
  - Residency is determined under treaty and not under Code

FAILURE TO FILE FORM 8833

- Section 6712:
  - **(a) General rule.**--If a taxpayer fails to meet the requirements of section 6114, there is hereby imposed a penalty equal to $1,000 ($10,000 in the case of a C corporation) on each such failure.
  - **(b) Authority to waive.**--The Secretary may waive all or any part of the penalty provided by this section on a showing by the taxpayer that there was reasonable cause for the failure and that the taxpayer acted in good faith.
  - **(c) Penalty in addition to other penalties.**--The penalty imposed by this section shall be in addition to any other penalty imposed by law.

- *Pekar v. Commissioner*, 113 T.C. 158 (1999): "Unless excepted by regulations, each U.S. taxpayer who takes a position that a treaty of the United States overrules any provision of the Internal Revenue Code and effects a reduction of any tax must disclose that position on either a Form 8833 . . . A taxpayer who fails in a material way to disclose one or more positions taken for a taxable year is subject to a separate penalty for each failure to disclose a position. . . . However, there is no indication that this failure estops a taxpayer from taking such a position." n. 5
- *Aroeste v. United States*: "The Court agrees with Aroeste. Although Aroeste gave untimely notice of his treaty position, the Court finds this does not waive the benefits of the Treaty as asserted by the Government. Rather, I.R.C. § 6712 provides the consequences for failure to comply with I.R.C. § 6114, namely a penalty of $1,000 for each failure to meet § 6114's requirements of disclosing a treaty position."

The term "permanent home" is not defined in the treaty. We thus turn to the unique rules for construing treaty terms. Most important is that Courts are generally required to give effect to the *intent* of the treaty parties when the treaty was negotiated. <u>Sumitomo Shoji American, Inc. v. Avagliano</u>, 457 U.S. 176, 185 (1982); see also Crow v. Commissioner, 85 T.C. 376, 380 (1985); quoting <u>Maximov v. United States</u>, 299 F.2d 565 (2d Cir. 1962) ("The goal of treaty interpretation is 'to give the specific words . . . A meaning consistent with the genuine shared expectations of the contracting parties.'").

Courts typically go beyond the treaty's literal language and "examine the Treaty's 'purpose, history and context.'" <u>Taisei Fire and Marine Ins. Co., Ltd. v. Commissioner</u>, 104 T.C. 535, 548 (1995).

International Noncompliance

ARE THERE EVER REQUIREMENTS TO CORRECT NON-COMPLIANCE?

- Treasury Department Circular No. 230: “Regulations Governing Practice before the Internal Revenue Service” provides ethical considerations for tax practitioners and attorneys when dealing with taxpayers and the Internal Revenue Service.

- Regarding prior omissions, Circular 230 provides:
  - § 10.21 Knowledge of client’s omission. A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, <u>***knows that the client has not complied with the revenue laws***</u> of the United States <u>***or has made an error in or omission from any return***</u>, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, <u>***must advise the client promptly of the fact of such noncompliance, error, or omission***</u>. The practitioner <u>***must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission***</u>.

WHAT REQUIREMENT EXISTS (IF ANY) TO FILE AMENDED RETURNS?

DISCRETION AND "SHOULD" LANGUAGE

- If the IRS has the discretion to accept or reject an amended return, the question then arises: Is a taxpayer required to file an amended return when an error or omission is discovered on an originally filed tax return? Journal of Accountancy
- **Regs. Sec. 1.451-1(a)** states that "if a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, [the taxpayer] ***should***, if within the period of limitation, file an amended return and pay any additional tax due" (emphasis added). **Regs. Sec. 1.461-1(a)(3)** contains similar **"should" language** with respect to amended returns and the discovery of erroneous deductions taken in prior years.

PRACTICAL CONSIDERATIONS IN NOT CORRECTING NON-COMPLIANCE

- No statute of limitations for non-filed returns:
  - I.R.C. § 6501 provides:
    - **(a)GENERAL RULE** Except as otherwise provided in this section, ***the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed***
    - **(c)EXCEPTIONS**
      - **(3)NO RETURN** In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.
- Penalties: failure to file returns will often, if not always, lead to a failure to file and/or failure to pay penalty, under I.R.C. § 6651, and potentially accuracy-related or fraud penalties, under I.R.C. § 6662 or 6663, respectively.
- Criminal considerations: if the failure to file was willful, then there may be criminal culpability. *See* I.R.C. §§ 7201, 7202, 7203.

STATUTE OF LIMITATIONS – RE: INTERNATIONAL INFORMATION RETURNS

- IRC § 6501(c)(8)(A):
  - "In the case of any information which is required to be reported to the Secretary * * * under section 1298(f), 6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048, the time for assessment of any tax imposed by this title with respect to any tax return, event, or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section."
    - Section 6039F, requiring a Form 3520 for a large foreign gift, is not included in IRC § 6501(c)(8)(A).

- IRC § 6501(c)(8)(B):
  - "If the failure to furnish the information referred to in subparagraph (A) is due to reasonable cause and not willful neglect, subparagraph (A) shall apply only to the item or items related to such failure."

STREAMLINED FILING COMPLIANCE PROCEDURES – AT YOUR CLIENT'S PERIL?

- Designed for Non-Willful US Taxpayers
  - Non-willfulness is defined as negligence, inadvertence, mistake, or good faith misunderstanding of the requirements of the law.
  - Cannot use Streamlined if the IRS has initiated a civil examination of taxpayer's income tax returns for any taxable year (need not be a year covered by the Streamlined submission).
- Taxpayers must file amended income tax returns (taxpayers residing in US) or either amended or delinquent income tax returns (taxpayers residing abroad) for past 3 years (including paying the tax liabilities); plus, file FBARs for past 6 years.
- Must file a certification with the streamlined submission detailing why the delinquency was non-willful.
- Penalties:
  - In lieu of FBAR or other international reporting penalties, taxpayers residing in US must pay penalty of 5% of the includible assets.
  - 0% Penalty for taxpayers residing abroad.

ELIGIBILITY FOR STREAMLINED SUBMISSION

- Streamlined Domestic Offshore Procedures:
  - Does not meet the non-residency requirements (*i.e.*, within the preceding three years the individual did not have a U.S. abode and was physically outside of the U.S. for at least 330 full days);
  - Taxpayer must have filed returns for the most recent three years;
  - Taxpayer must have failed to report gross income from a foreign financial asset and pay tax on that income, and may have failed to file their FBAR or other international information returns with respect to the foreign financial asset; and
  - Taxpayer's failure(s) was non-willful.
- Streamlined Foreign Offshore Procedures:
  - Meet non-residency requirements; and
  - Taxpayer must have failed to report gross income from a foreign financial asset and pay tax on that income and may have failed to file their FBAR or other international information returns with respect to the foreign financial asset.

IRS Streamlined Filing Compliance Procedures

DELINQUENT FBAR SUBMISSION PROCEDURES – AT YOUR CLIENT'S PERIL?

- Designed for Taxpayers who reported all income and paid all tax on income tax returns but failed to file FBARs.
- Eligibility requirements:
    - FBARs have not been filed;
    - Taxpayer is not under civil examination or criminal investigation; and
    - Taxpayer has not already been contacted by the Service.
- No penalty will be imposed for the failure to file delinquent FBARs, so long as the information was properly reported on your income tax return and all tax was paid, if there was a tax liability, in connection with the foreign account.
- File using normal e-filing procedures but must include a reason for the untimely filing, to be provided on the front page of the FBAR.

AMENDED TAX RETURN – PROTECTION OF A QAR

- In lieu of using a formal disclosure program, taxpayers can choose to submit amended income tax returns.
- Treas. Reg. § 1.6664-2(c)(2) provides:
  - "The *amount shown as the tax by the taxpayer on his return* includes an amount shown as additional tax on a qualified amended return (as defined in paragraph (c)(3) of this section), except that such amount is not included if it relates to a fraudulent position on the original return."
- A QAR requires:
  - Amended return;
  - Filed after the due date of the return for taxable year;
  - Must be submitted before taxpayer is contacted by the Service for an examination (or criminal investigation);

AMENDED TAX RETURN – PROTECTION OF A QAR

- A QAR requires:
  - Amended return;
  - Filed after the due date of the return for taxable year;
  - Must be submitted before taxpayer is contacted by the Service for an examination (or criminal investigation);
  - Must be submitted before taxpayer is contacted by the Service in connection with promoting abusive tax shelters;
  - Must be submitted before a pass-through entity is first contacted by the Service;
  - Must be submitted prior to the issuance of a summons; and
  - Must be submitted before the Commissioner announces a revenue, ruling, revenue procedure, notice, or announcement, which are published in the Internal Revenue Bulletin, that provides a settlement initiative to compromise or waive penalties with respect to a listed transaction.

THE IRS'S PROCEDURE TO ASSESS PENALTIES

- Many Foreign Information Return penalties are being systematically asserted, meaning that a penalty is automatically issued whenever there is a late-filed form or a form is missing information, without regard to the individual circumstances of the taxpayer.

- In many cases, the penalties are wildly disproportionate to the taxpayer's mistake, and serve no purpose other than to discourage taxpayers from voluntary compliance.

- The government appears to view this foreign information return penalties as assessable penalties treating them as “paid upon notice and demand” and not subject to the deficiency procedures, and thus assuming they cannot be challenged in Tax Court.

- For example,§6671(a) specifically falls within Subchapter B of chapter 68 assessable penalties. This sections determines that a penalty within Subchapter 68B should be assessed and collected in the same manner as a tax.

- Finally, as with all penalties, the IRS is supposed to obtain proper managerial approval before a determination.

What is an assessment?

The U.S. Tax Court in *Farhy*, cited case law that defines an assessment as “the formal recording of a taxpayer’s tax liability” by the Service. The SCOTUS has noted it is “essentially a bookkeeping notation.”

*

See, Baltic v. Commissioner, 129 T.C. 178, 183 (2007). *See, Hibbs v. Winn*, 542 U.S. 88, 100 (2004) (“An assessment is made 'by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary.'” (quoting section 6203)); Treas. Reg. § 301.6203-1.

See, Laing v. United States, 423 U.S. 161, 170 n.13 (1976) (“The 'assessment,' essentially a bookkeeping notation, is made when the Secretary or his delegate establishes an account against the taxpayer on the tax rolls.”).

What is an assessable penalty?

The U.S. Tax Court in *Farhy* explains what “assessable penalties” are as used in section 6201(a), which includes certain penalties (but not all penalties in the Code). These are those that “must be paid upon notice and demand and assessed and collected in the same manner as taxes.” The Court went on to say that, “the term ‘assessable penalties’ used in section 6201 does not automatically apply to all penalties in the Code not subject to deficiency procedures.” The Tax Court concluded that penalties under section 6038(b) (i.e. failure to file IRS Form 5471*, Information Return of U.S. Persons with Respect to Certain Foreign Corporations*) are not “assessable penalties.”

Citing - *Smith v. Commissioner*, 133 T.C. 424, 428 (2009). lls.”).

What is an assessable penalty?

This raises the question of what other IIR penalties are not “assessable penalties”? The Order in Alberto Aroeste & Estela Aroeste vs. Commissioner distinguishes between (i) section 6038(b) penalties (Chapter 61 of Subtitle F) and (ii) section 6677 penalties (Chapter 68 of Subtitle F). Section 6677 are clearly ones that can be assessed. The problem individuals’ face is the inability to obtain judicial review by the taxpayer if she does not agree with the Service’s determination of the IIR penalties. The Tax Court in Farhy means those facing 6038(b) penalties will obtain such review in a federal district court or court of federal claims, once the DOJ pursues its civil lawsuit for enforcement within the time required by the statute.

A previous report by one of the authors provided the following summary of IIR statutory penalties; in two categories, Chapter 68 and Chapter 61. The statute as reflected in these charts designates Subchapter B of Chapter 68 of Subtitle F as “assessable penalties”.

THE ASSESSMENT PROCESS

- Penalties will be determined (sometimes automatically) and approved on the Form 8278;
- Then a CP Notice (either CP15 or CP215) will be generated and sent to taxpayer;
  - Taxpayer may protest the CP Notice.
- After the initial notice, the collection notices will be sent (typically Notices CP501-504) to taxpayer.
  - Can submit a Collection Appeal Request, Form 9423.
- Final step of the collections process is for the Service to issue either (or both) a final notice of intent to levy or a notice of federal tax lien.
  - These notices allow taxpayer to request a collection due process hearing, which results in a notice of determination that can be reviewed by the U.S. Tax Court.

NOTICES OF DEFICIENCY

- Notice of deficiency (90-day letter):
  - "If the Secretary determines that there is a deficiency in respect of any tax imposed by subtitles A or B or chapter 41, 42, 43, or 44 he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail. Such notice shall include a notice to the taxpayer of the taxpayer's right to contact a local office of the taxpayer advocate and the location and phone number of the appropriate office." I.R.C. § 6212(a).
  - 90 days to seek a redetermination in the U.S. Tax Court (150 days if taxpayer is not within U.S.).

- "A notice of deficiency, also called a "statutory notice of deficiency" (SNOD) or, "90-day letter" , is a legal notice in which the Commissioner determines the taxpayer's tax deficiency. IRC 6212 and IRC 6213 require that the IRS issue a notice of deficiency before assessing additional income tax, estate tax, gift tax, generation-skipping transfer tax and certain excise taxes unless the taxpayer agrees to the additional assessment. The notice of deficiency is a legal determination that is presumptively correct and consists of the following:
  - A letter explaining the purpose of the notice, the amount of the deficiency, and the taxpayer's options.
  - A waiver to allow the taxpayer to agree to the additional tax liability.
  - A statement showing how the deficiency was computed.
  - An explanation of the adjustments." I.R.M., pt. 4.8.9.2(1) (08-11-2016).

INTERNATIONAL PENALTIES REQUIRING NOD?

- Notice of deficiency is generally required for:
  - I.R.C. § 6038(c) – Penalty of Reducing Foreign Tax Credit Plus Continuation Penalty
  - I.R.C. § 6038A(e) – Noncompliance Penalty for Failure to Authorize an Agent or Failure to Produce Records
  - I.R.C. § 6038C(d) – Noncompliance Penalty for Foreign Related Party Failing to Authorize the Reporting Corporation to Act as its Limited Agent
  - I.R.C. § 6039F(c) – Taxability of Gift from Foreign Persons
  - I.R.C. § 6686 – Information Returns for Former FSCs
  - I.R.C. § 6688 – Reporting for Residents of U.S. Possessions
- I.R.M., pt. 8.11.5.1(4) (12-18-2015.

APPEALS

- "Proceedings before Appeals are informal. Testimony under oath is not taken, although matters alleged as facts may be required to be submitted in the form of affidavits, or declared to be true under the penalties of perjury. Taxpayers may represent themselves or designate a qualified representative to act for them." Treas. Reg. § 601.106(c).

- Collection Appeal Rights (CAP) request: CAP requests are submitted on Form 9423, *Collection Appeal Request*. CAP requests can be submitted:
  - Before or after the IRS files a Notice of Federal Tax Lien
  - Before or after the IRS levies or seizes your property
  - Termination, or proposed termination, of an installment agreement
  - Rejection of an installment agreement
  - Modification, or proposed modification, of an installment agreement. *See* IRS Publication 1660 (Rev. 1-2020).

PROCEDURE FOR REQUESTING ABATEMENT AND APPEALING PENALTY ASSESSMENT

- The Internal Manual states that the taxpayer is entitled to post-assessment, but pre-payment, Appeals review of the penalty. See Internal Revenue Manual 8.11.5.1.
- The IRS does not automatically suspend collection activity in order to provide taxpayers with this pre-payment right to appeal, and routinely fails to respond to taxpayers' requests to suspend collection during their appeals.
- If the appeal is unsuccessful, many tax advisors believe the taxpayer's only option for judicial review is to pay the penalty in full and file a refund claim, there is no clear case law as to what is the procedural path for judicial review.

COLLECTION DUE PROCESS HEARING

- IRS Collections will typically end with one of two notices: Final Notice of Intent to Levy or Notice of Federal Tax Lien. These notices are governed by I.R.C. §§ 6320 and 6330. In response to these notices, Taxpayer can request a CDP hearing.

- The following is considered during a CDP hearing:
  - "Verification from the Secretary that the requirements of an applicable law or administrative procedure have been met." I.R.C. § 6330(c)(1).
  - Appropriate spousal defenses (i.e., innocent spouse relief); I.R.C. § 6330(c)(2)(A)(i).
  - Challenges to the appropriateness of the collection action; I.R.C. § 6330(c)(2)(A)(ii) and
  - Collection alternatives (i.e., offer-in-compromise, installment agreement, currently-not-collectible status). I.R.C. § 6330(c)(2)(A)(iii).
  - Underlying liability (so long as there was no prior opportunity, or a NOD was issued). I.R.C. § 6330(c)(2)(B).

CDP HEARING (CONT'D)

- Appeals' determination must include:
  - Verification;
  - Issues raised by Taxpayer; and
  - "Whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary." I.R.C. § 6330(c)(3).
- Appeals cannot consider the following issues:
  - Issues previously raised and considered in another CDP hearing or a judicial proceeding;
  - "the issue meets the requirement of clause (i) or (ii) of section 6702(b)(2)(A); or
  - a final determination has been made with respect to such issue in a proceeding brought under subchapter C of chapter 63. I.R.C. § 6330(c)(4).

CDP COLLECTION ALTERNATIVES

- Offers in Compromise
  - IRC 7122 authorizes the IRS to compromise a taxpayer's tax liability on the basis of 1) doubt as to collectability, 2) doubt as to liability, or 3) the promotion of effective tax administration.
  - IRS will accept an offer where it is unlikely to collect the liability in full and the amount offered reflects the reasonable collection potential
- Installment Agreements
  - IRC 6159 authorizes the IRS to enter into written agreements which allow taxpayers to pay their tax due in installments over a period of months or years, where it is demonstrated that doing so will facilitate full or partial collection of such liability
- Currently Not Collectable
  - The IRS will place an account in currently not collectable status where a taxpayer has insufficient leviable income and assets.
- Bankruptcy
  - 11USC 727 / 11USC 523(a)Taxes discharged in bankruptcy are reported as currently not collectable by the IRS.
- Audit Reconsideration
  - Process IRS uses to reevaluate the results of a prior audit if the taxpayer disagrees with the original assessment and there is now new information that was not previously considered. Typically granted where, 1) the taxpayer did not appear for the audit, 2) the taxpayer moved or did not receive IRS correspondence, or 3) the taxpayer has new documentation that is pertinent to the audit issues.

BEST PRACTICES DURING APPEALS & CDP HEARINGS

- Written protest should be written like a legal brief, including a legal analysis that contains the IRAC method (Issue, Rule, Application, Conclusion);
- Hazards of litigation should be used during Appeals (hazards of litigation is only considered during Appeals and in litigation, it is not otherwise considered by the Service);
- Face-to-face hearing may be the best method, it may make sense to prepare a PowerPoint or bring some type of demonstrative exhibit during the meeting;
- Request a copy of the administrative record (either through the Freedom of Information Act department or the Appeals officer) and review the Service’s file prior to the hearing;
- Raise every possible issue, often an issue will be considered waived if not raised;
- Always make sure that Appeals maintains its independence (there is a preclusion on ex parte communication, and this should be abided); and
- If any additional issues or raised or supplemental arguments made, ensure that they are faxed to the Appeals officer (with a request that the document be included in the administrative record).

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