Does Residency Status Under a Treaty Affect FBAR Duties? District Court Order Ponders Potential "Escape Hatch" for Taxpayers

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I. Introduction

Disputes over penalties for unreported foreign accounts have been going on for decades, with the intensity escalating when the Internal Revenue Service ("IRS") assumed enforcement authority in 2003 and Congress dramatically increased the penalties in 2004. Some people think that these battles involve a straightforward legal obligation applied to unique facts in each case. They are wrong, as litigation over FinCen Forms 114 ("*FBARs*") has spawned several complex legal issues. The latest unresolved question is whether a lawful permanent resident, also known as a Green Card holder, is still required to file an FBAR if he claims a position under a treaty that he should be treated solely as a resident of a foreign country.

This article examines how individuals obtain and terminate U.S. status, the residency rules in the applicable treaty, typical information-reporting duties for individuals with activities, income and/or assets abroad, important rulings by a District Court in the newest FBAR case, *Aroeste v. United States*, and some key issues not yet addressed in that ongoing clash.[1]

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II. Comments on U.S. Residency

Readers first must have some background about U.S. residency matters in order to appreciate the legal issues addressed and unaddressed in *Aroeste v. United States*.

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A. Obtaining and Terminating U.S. Resident Status

Generally, an individual is considered a "U.S. person" for U.S. tax purposes if he is either a U.S. citizen or a U.S. resident. This characterization is critical because, once an individual becomes a U.S. person, he is subject to all U.S. tax obligations, which include filing annual Forms 1040 (*U.S. Individual Income Tax Returns*) with the IRS, paying taxes in a timely manner, and potentially submitting a long list of international information returns.

Determining whether an individual is a U.S. *citizen* is relatively easy, but confirming the status as a U.S. *resident* can be tricky. Broadly speaking, an individual can become a U.S. resident in four ways: (i) He can obtain a Green Card from the relevant U.S. immigration agency, thereby becoming a "lawful permanent resident;" (ii) He can maintain a "substantial presence" in the United States; (iii) He can make a first-year election to be treated as a U.S. resident; or (iv) He can elect to file joint Forms 1040 with a spouse who is already a U.S. person. This article focuses on the first category, *i.e.*, the Green Card holder.[2]

The Internal Revenue Code states that a Green Card holder maintains such status as long as it "has not been revoked (and has not been administratively or judicially determined to have been abandoned)."[3] The regulations echo this sentiment, stating that U.S. resident status continues "unless it is rescinded, or administratively or judicially determined to have been abandoned."[4]

In 2008, Congress introduced another manner of losing U.S. resident status for tax purposes, which is most relevant to this article. It inserted the following language:

> An individual shall cease to be treated as a lawful permanent resident of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the [IRS] of the commencement of such treatment.[5]

In summary, once an individual becomes a U.S. resident by obtaining a Green Card, he keeps this classification until one of three things occurs: (i) The proper authorities revoke the Green Card; (ii) The individual abandons his Green Card, and the appropriate administrative agency or court issues a ruling confirming such abandonment; or (iii) The individual takes the position that he is not a U.S. resident thanks to the applicable treaty, and he files the necessary items with the IRS to claim his non-resident status, including Form 1040-NR (*U.S. Nonresident Alien Income Tax Return*), Form 8833 (*Treaty-Based Return Position Disclosure*), and Form 8854 (*Initial and Annual Expatriation Statement*), if necessary.

The third way of losing U.S. residency status applies to so-called "dual resident taxpayers." These are individuals considered to be residents, for tax purposes, of both the United States and a foreign country with which the United States has a tax treaty. As explained above, this narrow group of individuals can rid themselves of U.S. residency status by filing Forms 1040-NR with the IRS, enclosing all necessary information returns, and adequately explaining why they should be treated solely as residents of the foreign country pursuant to the tie-breaker rules found in the applicable treaty. This manner of losing U.S. resident status for tax purposes, introduced by Congress in 2008, is consistent with regulations issued years earlier. They stated the following:

> A "dual resident taxpayer" is an individual who is considered a resident of the United States pursuant to the internal laws of the United States *and also* a resident of a treaty country pursuant to the treaty partner's internal laws.
>
> If the alien individual determines that he or she is a resident of the foreign country for treaty purposes, and the alien individual claims a treaty benefit (as a nonresident of the United States) so as to reduce the individual's United States income tax liability with respect to any item of income covered by an applicable tax convention during a taxable year in which the individual was considered a dual resident taxpayer, then that individual shall be treated as a nonresident alien of the United States for purposes of computing that individual's United States income tax liability under the provisions of the Internal Revenue Code and the regulations thereunder .... with respect to that portion of the taxable year the individual was considered a dual resident taxpayer.[6]

B. Relevant Aspects of the Tax Treaty

The taxpayers in *Aroeste v. United States* were Mexican citizens and, arguably, Mexican residents. Therefore, a glimpse at the treaty in effect between the United States and Mexico ("Treaty") is necessary.[7]

Article 1(1) states that the Treaty only applies to persons who are "residents" of the United States and/or

Mexico. Article 4(1) explains that, for Treaty purposes, the term "resident" means "any person, who under the laws of [the United States and/or Mexico], is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature." Article 4(2) of the Treaty contains the infamous tie-breaker rules, which come into play when a person is considered a resident of *both* the United States and Mexico applying the general rules described above. They focus on various factors, such as the country in which a person has a permanent home, close personal and economic relations, a habitual abode, citizenship, *etc.* The Technical Explanation of the Treaty summarizes the residency analysis as follows:

> The determination of residence for purposes of the [Treaty] looks first to domestic law criteria. A person subject to tax as a resident ... under the law of *one* of the Contracting States is a resident of that State. If that person is *not* a resident of the *other* Contracting State for tax purposes under its domestic law criteria, he or it need look no further. If such a person is a dual resident, [then Article 4(2)] provides a series of tests for assigning a single residence to an individual.[8]

III. Duties of U.S Persons

A U.S. person, including a U.S. resident, ordinarily has several duties if he holds a financial interest in a foreign account whose balance surpasses the relevant thresholds. Among the numerous obligations are (i) reporting all passive income (*e.g.*, interest, dividends, capital gains) generated by the account on Form 1040, (ii) checking the "yes" box on Schedule B to Form 1040, disclosing the existence and location of the foreign accounts, (iii) enclosing a Form 8938 (*Statement of Specified Foreign Financial Assets*) with Form 1040, and (iv) e-filing an FBAR.

Failure to meet any of the preceding duties can lead to severe penalties for taxpayers. For instance, underreporting of income triggers back taxes, accuracy-related penalties, and interest charges.[9] Moreover, if the taxpayer does not file Form 8938 in a timely manner, the IRS can assert a penalty of $10,000 per year.[10] Finally, neglecting to file an FBAR can spark huge sanctions. In the case of "non-willful" violations, the maximum penalty might be $10,000 per year.[11] The FBAR penalty increases significantly, though, where a taxpayer's inaction is deliberate; the IRS may assert a fine equal to $100,000 or 50 percent of the balance in the account at the time of the violation, whichever amount is larger.[12]

There is a long list of additional reporting requirements, including, but certainly not limited to, Form 5471 (*Information Returns of U.S. Persons with Respect to Certain Foreign Corporations*), Form 8865 (*Return of U.S. Persons with Respect to Certain Foreign Partnerships*), Form 8858 (*Information Return of U.S. Persons with Respect to Foreign Disregarded Entities*), Form 926 (*Return by a U.S. Transferor of Property to a Foreign Corporation*), and Form 3520 (*Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*).

IV. Description of the Case

The IRS audited the taxpayers, Husband and Wife, and asserted income taxes, various international information return penalties, and FBAR penalties for 2012 and 2013. *Aroeste v. United States* only dealt with the third issue, unreported foreign accounts.

A. Relevant Facts and Procedure

The taxpayers paid a portion of the FBAR penalties. Later, they filed a lawsuit in District Court seeking a refund of the penalties already paid and a judicial waiver of the ones not yet satisfied. The government, led by attorneys for the Department of Justice ("DOJ"), filed a counterclaim asking the District Court to force the taxpayers to pay *all* outstanding amounts.

The District Court basically put the case on hold, indicating that it would wait for the U.S. Supreme Court to rule on another FBAR case addressing similar issues. Despite this general pause, the District Court permitted the taxpayers and the DOJ to continue litigating two issues: (i) Whether Husband was a resident of Mexico under the Treaty; and (ii) Whether Husband was a "U.S. person" required to file FBARs for the years at issue. A discovery disagreement arose, as they so often do, and the parties asked the District Court to intervene.

The taxpayers demanded "the entire administrative record" of the IRS from the audit, and the DOJ refused to provide it. The District Court observed that the entire administrative record was a "voluminous document" consisting of about 7,000 pages, only a small portion of which implicated FBAR matters. The majority of the audit focused on Husband's residency for Treaty purposes.

The District Court, after hearing the basic positions of both sides, ordered them to file a Joint Discovery Motion,

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along with legal briefs focused on two questions. First, how is the Husband's status under the Treaty relevant to the issue of whether he was obligated to file FBARs? Second, assuming that his status is pertinent, how is getting access to the entire administrative record "relevant and proportional" to determining the Husband's status and analyzing whether he was a "U.S. Person" for purposes of filing FBARs?

After considering the Joint Discovery Motion and corresponding briefs, and after listening to additional advocacy during a conference, the District Court reasoned as follows.

B. First Issue

With respect to whether the Husband's status under the Treaty is relevant to the imposition of FBAR penalties, the District Court began by underscoring that the answer depends "on the application of multiple, interconnected statutes and regulations." It then noted that only "U.S. persons" have a duty to file FBARs, and thus they are the only ones who can be sanctioned for not doing so.[13]

The District Court explained that the parties disputed, as an initial matter, whether Husband's status under the Treaty has an effect on the question of whether he is considered a "U.S. person" for FBAR purposes. The taxpayers argued that if Husband is a Mexican resident under the Treaty, then he would *not* be a "U.S. person" when it comes to FBAR duties. The DOJ, by contrast, maintained that the Treaty analysis is immaterial because the Treaty only deals with certain taxes under Title 26 of the Internal Revenue Code, whereas FBAR obligations and penalties derive from Title 31 of the U.S. Code.

The District Court sided with the taxpayers. It noted that the term "U.S. person" in the context of FBARs encompasses U.S. citizens and U.S. residents, with the latter being defined by express cross-reference to Title 26. Specifically, the applicable FBAR regulation states that "a resident of the United States is an individual who is a resident alien under [Code Sec. 7701(b) of Title 26] and the regulations thereunder," with a few alterations.[14] The District Court went on to explain that Code Sec. 7701(b) indicates that an individual can achieve U.S. residency in several ways, one of which is by becoming a lawful permanent resident, otherwise known as a Green Card holder.[15] Based on these two authorities, the District Court concluded that tax treaties "provide a *potential escape hatch* that excuses certain U.S. persons from filing FBARs." The District Court then condensed its reasoning into a five-step process:

- First, "anyone allowed to permanently reside within the United States by virtue of U.S. immigration laws is a lawful permanent resident" for U.S. tax purposes under Code Sec. 7701, unless the relevant treaty considers the individual a resident of the foreign country.[16]
- Second, any lawful permanent resident under Code Sec. 7701 is a "resident alien."[17]
- Third, any "resident alien" under Code Sec. 7701 is a "resident of the United States" when it comes to the FBAR regulations.[18]
- Fourth, any resident of the United States under the FBAR regulations is a "U.S. person" required to file an FBAR.[19]
- Finally, "any person allowed to permanently reside in the United States by virtue of U.S. 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."

Applying the five-step process to the Husband, the District Court explained that he had been a lawful permanent resident, or Green Card holder, for many years. Therefore, he was a resident alien, and by extension, a resident of the United States. The Husband, consequently, is presumed to be a U.S. person required to file FBARs. The question thus becomes whether the Treaty offers Husband "an escape hatch."

Further emphasizing the importance of the Treaty, the District Court ruled that "a determination of [the Husband's] tax residency status under the Treaty is directly relevant to—indeed it is outcome determinative of—the issue of whether he was required to file the FBARs at issue in this lawsuit." The District Court added that if the IRS's entire administrative record is relevant and proportional to deciding the Husband's residency status under the Treaty, as well as to ascertaining whether he was a "U.S. person" for any other reason, then it is discoverable, and the DOJ should hand it over.

C. Second Issue

The District Court then turned to the next issue, which was whether the IRS's entire administrative record was relevant to determining Husband's residency status under the Treaty. It dealt with this matter swiftly, holding that the DOJ must relinquish to the taxpayers all materials related to the two years for which FBAR penalties were imposed, 2012 and 2013, but not for the other years audited by the IRS.

The DOJ presented a series of arguments opposing this ruling, all of which the District Court discarded. The District Court supplied a few quotable lines broadly favoring the taxpayer in the discovery dispute. For instance, with regard to relevancy, it stated the following:

> As the Court has already concluded, [Husband's] residency under the Treaty is a potentially dispositive issue in this matter. If under the Treaty, he was a Mexican resident in 2012 and 2013, he would have no obligation to file FBARs; but if he was a resident of the United States during this time frame, he is liable for some amount of FBAR penalties. [Husband] seeks to prove he was a Mexican resident for tax purposes, and thereby avoid any liability for his admitted failure to file FBARs. The IRS's administrative record bears directly on that issue. It is, therefore, relevant to this matter.

Next, the District Court stated the following when dealing with the DOJ's argument that its disclosure obligations should be minimized because the bulk of the administrative record deals with income tax liabilities and international information return penalties, not FBARs.

> Assessment of the Title 26 (tax and information return penalty) issues are resolved on the same factual basis as the Title 31 (FBAR penalty) issues in the audit. The Court, therefore, concludes that all information related to determining [Husband's] residency under the Treaty in 2012 and 2013 is discoverable, not just that information related to the imposition of FBAR penalties.

Lastly, the DOJ complained that the taxpayers were abusing the discovery process during the FBAR penalty litigation, using it for "leverage" to benefit them in other related disputes (*i.e.*, the income tax battle currently in Tax Court and the upcoming challenge to international information return penalties). The District Court seemed unsympathetic to the DOJ's plight, clarifying that it was only responsible "for determining whether the administrative record is discoverable in *this* case."

V. Interesting and Obscure Issues

The rulings in *Aroeste v. United States* are interesting. However, there are additional issues, unaddressed by the District Court, which might be even more noteworthy. Some of them are examined below.

A. No Advance Residency Rulings

Reflecting on the time, effort, and expense associated with an IRS audit and subsequent litigation, some readers might be asking themselves whether Husband and Wife could have taken affirmative steps and approached the IRS proactively to avoid this costly fight. The short answer is probably not. Here is one reason why. The IRS issues a Revenue Procedure at the beginning of each year identifying the matters on which it will *not* issue Private Letter Rulings or Determination Letters. A recent Revenue Procedure explains that the IRS will not make advance decisions about certain items "either because the issues are inherently factual or for other reasons."[20] It further states that the IRS will not opine on whether, under Code Sec. 7701(b), an individual is a U.S. resident, including whether the individual is considered a U.S. resident because of his "substantial presence" in the United States.[21] Additionally, the Revenue Procedure clarifies that the IRS ordinarily will not rule on "whether certain persons will be considered liable for tax under the laws of a foreign country for purposes of determining if such persons are residents within the meaning of any United States income tax treaty."[22]

B. Foreign Residency Claims and Exit Taxes

Another intriguing issue not covered in *Aroeste v. United States* involves an unintended consequence, namely, the potential downside of having the District Court conclude that Husband and Wife were U.S. residents (thanks to their Green Cards) and also Mexican residents (thanks to the Treaty). This involves a classic good-news-bad-news situation. A longstanding Green Card holder who successfully claims foreign resident status under the tie-breaker rules of a treaty might avoid FBAR penalties, but he also might expose himself to the exit tax by doing so. See below.

1. Overview of Applicable Law

Certain taxpayers who decide to "expatriate" from the United States get stuck with an unexpected bill.[23] The unfortunate ones must pretend to sell all their property at fair market value the day before they depart and pay the resulting income taxes to the IRS.[24] This so-called "exit tax" only applies to "covered expatriates."[25]

Turning to the jargon, the term "expatriate" includes a "long-term resident" of the United States who ceases to be a lawful permanent resident.[26] Individuals who have been Green Card holders during at least eight of the past

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15 years ending the year their Green Card status terminates are long-term residents.[27]

A "covered expatriate" is an expatriate who has an average annual U.S. income tax liability for the past five years exceeding a particular amount, or who has a net worth surpassing a certain threshold, or who cannot certify to the IRS that he has been in full U.S. tax compliance for the past five years.[28] If an expatriate fails even one of the preceding three tests, then he will be considered a "covered expatriate," subject to the exit tax.

The "expatriation date" for long-term residents is the day on which they cease to be lawful permanent residents.[29] As explained above, loss of lawful permanent resident status occurs in several ways, including when an individual takes the position with the IRS that he is a resident of a foreign country under the tie-breaker rules of a treaty by filing Form 1040-NR, Form 8833, and Form 8854, if necessary.[30]

2. Recent Case Highlighting the Issue

The issue of long-term residency status, foreign residency claims pursuant to a treaty, and exit taxes arose in a recent Tax Court case, *Topsnik v. Commissioner*.[31]

Gerd Topsnik was a German citizen by birth. In 1977, he received his Green Card, thereby making him a U.S. resident. He moved to Hawaii that same year. In 1986, Gerd and another individual formed Gourmet Foods, Inc. ("GFI"), a U.S. corporation. Gerd had a falling out with his business associates, and a lawsuit ensued. The litigation eventually settled, the result of which was that GFI purchased Gerd's interest for several million dollars. Gerd did not get all his money at once; rather, he received an initial payment in 2004, with the rest coming as monthly installment payments through 2013.

In 2002, Gerd flew from Germany to the United States, where he presented himself as a returning lawful permanent resident (*i.e.*, Green Card holder). Gerd applied to renew his Green Card in 2003. He stated on his application that he was a lawful permanent resident of the United States and listed his address in Hawaii as his residence. Gerd sold his house in Hawaii in 2003 and then relinquished his status as a Green Card holder in 2010 by filing a Form I-407 (*Abandonment of Lawful Permanent Resident Status*) with U.S. immigration agents.

Gerd filed Forms 1040 for 2004 and 2005, as a U.S. resident, reporting and paying U.S. income tax on the gain from the sale of the GFI stock.

Gerd later changed course with the IRS, claiming that the gain from the sale of GFI stock should *not* be taxed in the United States because of special rules found in the treaty between the United States and Germany ("Convention"). Gerd formalized his new position by filing Forms 1040-NR for 2006, 2007, 2008, and 2009, claiming that he was a resident of Germany, and by attempting to substitute Forms 1040-NR for the original Forms 1040 for 2004 and 2005, again declaring that he was a resident of Germany.

The IRS audited, and the dispute eventually made its way to the Tax Court.

Gerd raised a number of positions with the Tax Court, one of which was that even if he were a U.S. resident until he officially abandoned his Green Card in 2010, he was *also* a German resident. Because he was a "dual resident" during the relevant years, it was necessary to apply the tie-breaker rules in the Convention. These tie-breaker rules, maintained Gerd, demonstrated that he should be considered *only* a German resident for tax purposes. If Gerd's assertions were accurate, the Convention would dictate that only Germany, not the United States, had the right to tax him on the gain from the sale of his GFI stock.

The IRS disagreed, of course. It suggested that Gerd was never a resident of Germany during the relevant period; therefore, there was no need to consult the tie-breaker rules and there was no support for Gerd's theory that he was exempt from U.S. tax on the sale of GFI stock.

The Tax Court sided with the IRS. It held that Gerd was a U.S. resident under internal U.S. law during the relevant years; therefore, it had to uphold the tax liabilities and penalties related to Forms 1040-NR, unless Gerd could prove that he was exempt from U.S. tax under the Convention. This, cautioned the Tax Court, would require Gerd to prove that he was also a German resident during the relevant years, as this term is defined in the Convention, and that he should be considered *solely* a German resident under the tie-breaker rules. The Tax Court did not get beyond the first element; that is, it never needed to engage with the tie-breaker rules.

The Tax Court found that Gerd was only a U.S. resident, and not a German resident, during the relevant years. Accordingly, the United States had sole authority to tax Gerd on the gain from his sale of GFI stock. Gerd, in summary, lost with respect to U.S. income tax issues.

In what is perhaps more relevant to *Aroeste v. United States*, Gerd also lost another Tax Court case, one focused largely on whether he was susceptible to the exit tax.[32] The Tax Court held that Gerd terminated his lawful permanent resident status when he abandoned his Green Card in 2010, and that he was a long-term resident at that time because he had held a Green Card more than eight of the last 15 years. Consequently, Gerd was an

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"expatriate." The Tax Court then ruled that Gerd was a "covered expatriate" because he could not file, and did not file, a Form 8854 with the IRS for 2010 certifying that he had maintained full U.S. tax compliance during the preceding five years. Next, the Tax Court pointed out that Gerd's "expatriation date" was November 2010, when he relinquished his Green Card. As a covered expatriate subject to the exit tax, Gerd had to pretend to sell all his property one day before the expatriation date and pay U.S. income taxes on the net unrealized gain. This included the fair market value of the installment notes that Gerd received in exchange for his sale of the GFI stock.[33]

C. Information-Reporting Duties of Dual Residents

The list of potential international information-reporting obligations is vast, and the type of individuals who must file such returns is often unclear, inconsistent, and irregular. This reality could be particularly relevant to *Aroeste v. United States* as the case continues.

1. Historical Perspective

For starters, we turn to the legislative history and regulations, which set the scene for how individuals, who are considered foreign residents for U.S. income tax purposes, might nonetheless be considered U.S. residents when it comes to filing information returns with the IRS.

The legislative history from 1984 explains the following:

> [A]n alien who is a resident of the United States under the new statutory definition but who is a resident of a treaty partner of the United States (and not a resident of the United States) under a U.S. income tax treaty is eligible for the benefits that the treaty extends to residents of the treaty partner. However, *notwithstanding the treatment of the alien as a resident of the other country for treaty purposes, the Act treats the alien as a U.S. resident for purposes of the internal tax laws of the United States*. For example, if the alien owns more than 50 percent of the voting power of a foreign corporation, [then] the foreign corporation will be a controlled foreign corporation …."[34]

The regulations, issued in 1992, confirm the earlier theme in legislative history:

> Generally, *for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax liability*, the individual shall be treated as a United States resident. Therefore, for example, the individual shall be treated as a United States resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under section 957 or whether a foreign corporation is a foreign personal holding company under section 552.[35]

2. Form 8938

Now, this article jumps forward a few decades to the guidance offered today with respect to three items: Forms 8938, Forms 5741, and FBARs.

> *Further emphasizing the importance of the Treaty, the District Court ruled that "a determination of [the Husband's] tax residency status under the Treaty is directly relevant to—indeed it is outcome determinative of—the issue of whether he was required to file the FBARs at issue in this lawsuit."*

The IRS initially took the position that U.S. residency status for any part of the year, no matter how small or non-exclusive, suffices to trigger the Form 8938 filing requirement. In this regard, the Preamble to the Temporary Regulations initially explained that "[a] resident alien who elects to be taxed as a resident of a foreign country pursuant to a U.S. income tax treaty's residency tie-breaker rules *is a specified individual* for purposes of Code Sec. 6038D and the regulations."[36] This means that the individual generally would have to file a Form 8938 disclosing to the IRS all his specified foreign financial assets the world over. The first version of the Instructions for Form 8938 echoed that sentiment, giving the following warning to individuals with multiples residences: "If you qualify as a resident alien, *you are a specified individual even if you elect to be taxed as a resident of a foreign country under the provisions of a U.S. income tax treaty*. If you have to file Form 8938, attach it to your Form 1040NR."[37]

The IRS received comments to the Temporary Regulations, including at least one suggesting that dual residents who file a Form 8833 claiming foreign residency under the "tie-breaker" rules should *not* be considered a U.S. person for purposes of Form 8938.[38] Unexpectedly, the IRS accepted this recommendation and reversed course regarding dual residents. The IRS explained its capitulation in the Preamble to the Final Regulations, as follows:

> The Treasury Department and the IRS have concluded that reporting under Section 6038D is closely associated with the determination of an individual's income tax liability. Because the taxpayer's filing of a Form 8833 with his or her Form 1040NR (or other appropriate form) will permit the IRS to identify individuals in this category and take follow-up enforcement actions when considered appropriate, *reporting of Form 8938 … is not essential to effective IRS tax enforcement efforts relating to this category of U.S. residents*.[39]

The Final Regulations contain new rules expressly relieving dual residents from filing Forms 8938 in various circumstances.[40]

3. Form 5471

Rules regarding Form 5471 fall somewhere in the middle. The regulations obligate certain individuals claiming to be foreign residents under a treaty to file Forms 5471, but they are allowed to submit an abbreviated version. The regulations explain this partial duty as follows:

> *If* an individual who is a United States person required to furnish information with respect to a foreign corporation under section 6038 is entitled under a treaty to be treated as a nonresident of the United States, *and if* the individual claims this treaty benefit, *and if* there are no other United States persons that are required to furnish information under section 6038 with respect to the foreign corporation, *then* the individual may satisfy the requirements [concerning earnings and profits, transactions with related parties, financial statements, functional currencies and conversions, *etc.*] by filing the audited foreign financial statements of the foreign corporation with the individual's return required under section 6038.[41]

4. FBAR

The most compelling information-reporting duty when it comes to *Aroeste v. United States* is that involving the FBAR.

Neither the FBAR form nor the Instructions thereto specifically address the issue, but the Preamble to the FBAR regulations provides some guidance. First, the Preamble confirms that commentators raised questions about the term "resident" within the definition of a U.S. person and sought clarification on the treatment of individuals who make certain tax-related elections under Code Sec. 7701(b).[42]

Second, the Preamble states that a Green Card holder who claims that he is only a resident of a foreign country thanks to the tie-breaker rules of a treaty still needs to file FBARs. Put differently, the Preamble indicates that if a dual resident elects out of U.S. residency treatment under a treaty, such action does not relieve him from disclosing foreign financial accounts. The relevant text from the Preamble is as follows:

> FinCEN believes that individuals who elect to be treated as residents for tax purposes under Section 7701(b) should file FBARs only with respect to foreign accounts held during the period covered by the election. *A legal permanent resident who elects under a tax treaty to be treated as a non-resident for tax purposes must still file the FBAR.*[43]

A limited number of commentators have already picked up on the potential impact of the Preamble on the FBAR regulations. They find it interesting that the recent Order from the District Court "makes no mention of the Preamble to the FBAR reporting regulations, which states that a legal permanent resident who uses a tax treaty to elect non-resident tax treatment still must file an FBAR."[44] Such commentators were cautious not to read too much into this, though, recognizing that (i) the District Court only issued an Order on a narrow discovery dispute, (ii) the parties likely are preserving some of their legal arguments for later in the litigation, and (iii) the legal effect of a Preamble to a set of regulations, and the amount of deference that the District Court will ultimately grant it, remains unclear.[45] Also noteworthy is the fact that disagreement exists regarding the significance of the Preambles.[46]

Third, as explained above, individuals have four main ways of becoming U.S. residents for tax purposes. Among them are making a first-year election under Code Sec. 6013(g), and electing under Code Sec. 6013(h) to file joint Forms 1040 with a spouse who is a U.S. person. In contrast to the rules, directly above, about taxpayers *electing out* of U.S. status under a treaty, the Preamble says that taxpayers *electing into* U.S. status in these two circumstances might not have to reveal foreign accounts. The relevant portion of the Preamble states the following:

> Commenters also sought clarification about the interaction of elections under Section 6013(g) and (h) of the Internal Revenue Code and the definition of resident. FinCEN wishes to clarify that the determination of whether an individual is a United States resident *should be made without regard to elections under section 6013(g) or 6013(h) of the Internal Revenue Code*.[47]

VI. Conclusion

Will the District Court decide that Husband and Wife should be treated as solely Mexican residents under the tie-breaker rules in the Treaty? If so, will the District Court adhere to its five-step process and exempt them from FBAR duties and penalties? Regardless of the outcome of the first two questions, will the District Court determine that FBAR penalties are improper because Husband and Wife demonstrated "reasonable cause" for any violations? Will the positions advanced by Husband and Wife in the current FBAR litigation before the District Court affect related disputes over income taxes, exit taxes, and international information return sanctions taking place in other venues?[48] These and other interesting questions remain unanswered, which is why taxpayers with international issues should be following this multi-faceted battle as it evolves.

ENDNOTES

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1 *Aroeste v. United States*, District Court, Southern District of California, Case No. 22-cv-682-AJB-KSC, Order on Joint Discovery Motion, Feb. 13, 2023.

2 Code Sec. 7701(b)(1)(i); Reg. §301.7701(b)-1(b).

3 Code Sec. 7701(b)(6).

4 Reg. §301.7701(b)-1(b)(1).

5 Code Sec. 7701(b)(6), Flush Language. This was added by the Heroes Earnings Assistance and Relief Tax Act of 2008, Public Law 1110-245, Section 301(c)(2)(B); U.S. Joint Committee on Taxation, "Technical Explanation of H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008, JCX-44-08 (May 20, 2008) (emphasis added).

6 Reg. §301.7701(b)-7(a)(1).

7 The Treaty is comprised of the (i) Convention between the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with First, Second and Additional Protocol (1992); (ii) Treasury Department Technical Explanation of Convention and First, Second and Additional Protocol (1992); (iii) Second Additional Protocol (2003); (iv) Treasury Department Technical Explanation of the Second Additional Protocol (2003).

8 Treasury Department Technical Explanation of Convention and First, Second and Additional Protocol (1992) (emphasis added).

9 Code Sec. 6662.

10 Code Sec. 6038D(d)(1); Reg. §1.6038D-8(a). Uncertainty remains over whether non-willful FBAR penalties apply on a per-form or per-account basis. *See* Stephen J. Dunn, *Supreme Court Signals Reversal in Bittner*, 177 TAX NOTES FEDERAL 1537 (Dec. 12, 2022).

11 31 USC §5321(a)(5)(B)(i) (as in effect after Oct. 22, 2004).

12 31 USC §5321(a)(5)(C)(i), (D)(ii) (as in effect after Oct. 22, 2004).

13 31 CFR §1010.350(a).

14 31 CFR §1010.350(b)(2).

15 Code Sec. 7701(b)(1)(A)(i).

16 Code Sec. 7701(b)(6).

17 Code Sec. 7701(b)(1)(A)(i).

18 31 CFR §1010.350(b)(2).

19 31 CFR §1010.350(b).

20 Rev. Proc. 2016-7, IRB 2016-1, 239, Section 2.01.

21 *Id.*, Section 3.01(7).

22 *Id.*, Section 4.01(11).

23 Code Sec. 877A.

24 Code Sec. 877A generally applies to individuals who cease to be U.S. citizens or lawful permanent residents on or after June 17, 2008. *See* Notice 2009-85, IRB 2009-45, 598.

25 Code Sec. 877A(a)(1).

26 Code Sec. 877A(g)(2).

27 Code Sec. 877A(g)(5); Conference Report, 104th Congress, 2nd Session, House of Representatives Report 104-736, pg. 324; IRS Publication 519 (*U.S. Tax Guide for Aliens*) (2012), pg. 22.

28 Code Sec. 877A(g)(1)(A); Notice 2009-85, IRB 2009-45, 598, Section 2(A).

29 Code Sec. 877A(g)(3)(B).

30 Code Sec. 7701(b)(6); *See also* Internal Revenue Service. Large Business & International. International Practice Unit—"Determining Tax Residency Status of Lawful Permanent Resident." Dec. 15, 2014 (emphasis added).

31 *G. Topsnik*, 143 TC No. 12 (2014).

32 *G. Topsnik*, 146 TC No. 1, Dec. 60,501 (2016).

33 *Id.*

34 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84 (Dec. 31, 1984), pg. 468.

35 Reg. §301.7701(b)-7(a)(3).

36 T.D. 9657, Preamble to Temporary Regulations, 76 FR 78555 (Dec. 19, 2011) (emphasis added).

37 Instructions for Form 8938 (November 2011), pg. 2 (emphasis added).

38 Preamble to Final Regulations, 76 FR 73818 (Dec. 12. 2014).

39 *Id.* (emphasis added).

40 Reg. §1.6038D-2(e)(1), (2), and (3).

41 Reg. §1.6038-2(j)(2)(ii).

42 76 FR 10238 (Feb. 24, 2011).

43 *Id.* (emphasis added).

44 Andrew Velarde, *Treaty Residency 'Escape Hatch' May Be New FBAR Hot Button Issue*, 178 TAX NOTES FEDERAL 1232 (Feb. 20, 2023).

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[45] *Id.*

[46] Sheldon I. Banoff & Richard M. Lipton, *Preambles to Regulations: Do They Count?* 109, 1 J. TAX'N (Jul. 2008); Sheldon I. Banoff, *Court Gives Legal Effect to Preamble to Proposed Regs!* 80, 1 J. TAX'N (Jan. 1994); IRS Announcement 2008-35; LTR 9133006 (May 13, 1991); *Texasgulf, Inc.*, ClsCt, 89-1 USTC ¶9385, 17 ClsCt 275, 64 AFTR 2d 89-5105 (1989).

[47] 76 FR 10238 (Feb. 24, 2011) (emphasis added).

[48] *See Aroeste v. United States*, District Court, Southern District of California, Case No. 22-cv-682-AJB-KSC (FBAR penalty litigation); *Aroeste v. United States*, Tax Court Docket Nos. 13024-20 and 15372-20 (income tax litigation). An Order issued by the Tax Court confirms that, in addition to FBAR penalties, the IRS has asserted an income tax liability, tax-related penalties, and penalties for unfiled Forms 5471, Forms 3520, and Forms 3520-A. *See Aroeste v. United States*, Tax Court Docket Nos. 13024-20 and 15372-20, Order, May 13, 2022.

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