IRS SETS ITS SIGHTS ON NONRESIDENT ALIENS WITH U.S. RENTAL PROPERTY

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One can anticipate that the IRS will soon direct enforcement resources at the principal causes of the tax non-compliance related to U.S. rental properties owned by nonresident aliens.

Foreign investment in U.S. real property generally sounds good, and it sounds even better when those reaping the financial benefits are paying the proper amount of U.S. income taxes—or at least some. Unfortunately, according to a recent study by the Treasury Inspector General for Tax Administration ("TIGTA Report"), a significant percentage of nonresident aliens ("NRAs") investing in U.S. real property are not following the applicable rules, and this non-compliance is costing the IRS tens of millions of dollars in tax revenue each year.[1] Embarrassed, annoyed, or perhaps inspired by the findings in the TIGTA Report, the IRS has now committed to taking several steps, including launching a "compliance initiative."

Taxation of rental income from U.S. real property

To appreciate the significance of the recent TIGTA Report, one must first have a basic understanding of the U.S. tax rules related to rental real property that is located in the United States and held by an NRA.

Overview of general rules. Passive income (including rental income) that is generated by U.S. sources, is not connected with a U.S. trade or business, and is received by an NRA generally is subject to a 30% income tax rate on the *gross* amount of income.[2] This means that the so-called withholding agent (normally the renter, lessee, or property manager) must reserve a significant portion of the total income and send it to the IRS, as opposed to the NRA. By comparison, an NRA who is engaged in a U.S. trade or business during a year is taxed at the normal graduated/progressive rates on *net* income; that is, after taking into account the deductions that are effectively connected with the business.[3]

There are special rules for certain rental real estate. Section 871(d) provides that an NRA who obtains income from U.S. real property held for the production of income or from any interest in such property, which income is not otherwise treated as income effectively connected with a U.S. trade or business, has the option of electing to treat all such income (including rental income) as effectively connected income.[4] The main benefits of the Section 871(d) election for an NRA are that he or she can (1) essentially convert the passive renting of U.S. real property into an active trade or business for U.S. tax purposes, (2) avoid a flat tax rate of 30% on gross income, effectuated by tax withholding at source, and (3) claim a mul-

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titude of tax deductions related to the property. Once an NRA makes a Section 871(d) election for one year, it remains in effect for all later years, unless the IRS gives the NRA permission to revoke it.[5]

An NRA who makes the Section 871(d) election reports income and deductions related to the U.S. real property on Schedule E, "Supplemental Income and Loss from Rental Real Estate, Royalties, Partnerships, S Corporations, Estates, Trusts, REMICs, etc.," of Form 1040NR.

Approximately 50 years ago, Congress provided the following example of the anticipated functioning of the Section 871(d) election:

> A, [an NRA], owns two parcels of real estate located in the United States. One parcel is improved with an office building, which A has leased on a long-term, net-lease basis. The other parcel is unimproved and is held for investment purposes. During the taxable year 1967, A is at no time present in the United States or engaged in trade or business within the United States. In 1967, A elects [under Section 871(d)] to have the income from the improved real estate treated as income effectively connected with the conduct of a trade or business within the United States. A has no other income from United State sources during the taxable year. In determining his income subject to tax under Section 1 of the Code, A is allowed any deductions which are allowable under amended Section 873; and for such purposes deductions attributable to such real property and to the income therefrom is to be treated as connected with income which is effectively connected with the conduct of a trade or business within the United States.…[6]

The IRS, likewise, has taken the opportunity to simplify and summarize the relevant rules for NRAs in its Publication 519.

> If you have income from real property located in the United States that you own or have an interest in and hold for the production of income, you can choose to treat all income from that property as income effectively connected with a trade or business in the United States. The choice applies to all income from real property located in the United States and held for the production of income and to all income from any interest in such property. This includes income from rents.... You can make this choice only for real property income that is not otherwise effectively connected with your U.S. trade or business. If you make the choice, you can claim deductions attributable to the real property income and only your net income from real property is taxed.[7]

The TIGTA Report provides an example of how making a Section 871(d) election could financially benefit an NRA. If an NRA received $36,000 of gross rental income from U.S. property during a year and did not make a Section 871(d) election, then such income would be subject to income tax of $10,800 (i.e., 30% of $36,000). By contrast, if the NRA were to make the election, the gross rental income would be reduced by mortgage interest, depreciation, management fees, taxes, insurance expenses, etc., and the remaining net income amount would be taxed at the graduated/progressive rates, which might be below 30%.[8]

The IRS has now committed to taking several steps, including a 'compliance initiative.'

Detail about the Section 871(d) election. More focus on the Section 871(d) election is needed to grasp the problems identified in the TIGTA Report.

Section 871, like many tax provisions, is vague about how to make the relevant election, limiting itself to stating that it "may be made only in such manner and at such time as the [IRS] may by regulations prescribe."[9] The regulations explain the election procedure in the following manner:

> An election made under this section without the consent of the [IRS] shall be made for a taxable year by *filing with*

[1] Treasury Inspector General for Tax Administration. "Additional Controls Are Needed to Help Ensure that Nonresident Alien Individual Property Owners Comply with Tax Laws." Reference No. 2017-30-048 (8/23/17), available at www.treasury.gov/tigta/auditreports/2017reports/201730048fr.pdf.

[2] Section 871(a).

[3] Sections 871(b); Section 873.

[4] Section 871(d); Reg. 1.871-10. Note that there is a similar net-income election option in many bilateral tax treaties to which the United States is a party. See, e.g., Article 6(5) of the U.S. Model Treaty for 2016, which states the following: "A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were business profits attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years, unless the competent authority of the Contracting State in which the property is situated agrees to terminate the election." Treaty issues and the related Form 8833, "Treaty-Based Return Position Disclosure under Section 6114 or 7701(b)," are not addressed in this article.

[5] Sections 871(d)(1), Section 871(d)(3); Reg. 1.871-10(a) ("[If] an election has been properly made under this section for a taxable year, the election remains in effect, unless properly revoked, for subsequent taxable years even though during any such subsequent taxable year there is no income from the real property, or interest therein, in respect of which the election applies.").

[6] H. Rep't No. 89-1450, 89th Cong., 2d Sess, 1966-2 CB 965.

[7] IRS, "U.S. Tax Guide for Aliens," Publication 519 (hereinafter, "Pub. 519"), page. 21, available at www.irs.gov/pub/irs-pdf/p519.pdf.

[8] Treasury Inspector General for Tax Administration, "Additional Controls Are Needed to Help Ensure that Nonresident Alien Individual Property Owners Comply with Tax Laws," Reference No. 2017-30-048 (8/23/17), page 5, available at www.treasury.gov/tigta/auditreports/2017reports/201730048fr.pdf.

[9] Section 871(d)(3).

the income tax return required under Section 6012 and the regulations thereunder for such taxable year a *statement* to the effect that the election is being made. This statement shall include (a) a complete schedule of all real property, or any interest in real property, of which the taxpayer is titular or beneficial owner, which is located in the United States, (b) an indication of the extent to which the taxpayer has direct or beneficial ownership in each such item of real property, or interest in real property, (c) the location of the real property or interest therein, (d) a description of any substantial improvements on any such property, and (e) an identification of any taxable year or years in respect of which a revocation or new election under this section has previously occurred.[10]

Section 871, like many tax provisions, is vague about how to make the relevant election.

The IRS provides slightly different guidance in its Publication 519 directed at NRAs. There, the IRS states the following about "making the choice" to treat U.S. rental real estate as an active trade or business:

> Make the initial choice by attaching a statement to your return, or amended return, for the year of the choice. Include the following in your statement: That you are making the choice; Whether the choice is under Internal Revenue Code Section 871(d) (explained earlier) or a tax treaty; A complete list of all your real property, or any interest in real property, located in the United States...Cast your fate to the wind"; The extent of your ownership in the property; The location of the property; A description of any major improvements to the property; The dates you owned the property; Your income from the property; Details of any previous choices and revocations of the real property income choice.[11]

In addition to making a proper, timely Section 871(d) election with the IRS, the NRA must adequately inform the withholding agent (e.g., the renter, lessee, or property manager) of his or her current tax stance. The NRA does this by supplying the withholding agent a Form W-8ECI, "Certificate of Foreign Person's Claim that Income Is Effectively Connected with the Conduct of a Trade or Business in the United States," which notifies such agent that the rental income should be exempt from the standard 30-percent withholding.[12] If the NRA does not make a Section 871(d) election, then he or she must provide the withholding agent with a Form W-8BEN "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting—Individuals," thereby confirming that the gross rental income will be subject to 30% withholding in the United States, or some lower rate contemplated by treaty.[13]

Need for a timely tax return. Section 874(a) generally provides that an NRA is not permitted to claim deductions unless the he or she files a true, accurate, and timely Form 1040NR.[14] This includes deductions related to rental real estate that become available to NRAs after making a Section 871(d) election. The concept of what "timely" filing means is unique in this context. If an NRA filed a Form 1040NR for the previous year, or if the current year is the first year for which the NRA is required to file a Form 1040NR, then, to be considered timely, the NRA must file the Form 1040NR within 16 months of the due date.[15] If the current year is not the first year for which the NRA is required to file a Form 1040NR and the NRA did not file the Form 1040NR for the previous year, then the deadline for filing the Form 1040NR for the current year is, the earlier of (1) 16 months from the due date or (2) the date on which the IRS mails a notice to the NRA advising him or her that Forms 1040NR have not been filed and that he thus may not claim most deductions and/or credits.[16]

Summing it all up. Cases dealing directly, and substantively, with the Section 871(d) election are scarce. One of the few is *Espinosa,*[17] which does a good job of summarizing the tax/legal standards and applying the facts.

The taxpayer in *Espinosa* was an NRA. He owned two rental properties in the United States, one in Texas and another in New Mexico. They both produced rental income but, after taking into account the relevant expenses, each property generated a net loss. The taxpayer was required to file a Form 1040NR annually, but failed to do so.

The IRS sent the taxpayer a letter in November 1992, inquiring about Forms 1040NR and indicating that the it would prepare substitute for returns (SFRs) based on the available data if he did not voluntarily file by December 1992. The taxpayer did not so file. In January 1993, the IRS sent another letter to the taxpayer saying that it would prepare SFRs if he refused to

[10] Reg. 1.871-10(d)(1)(ii) (emphases added).
[11] Pub. 519, *supra* note 7at 21.
[12] Section 1441(c).
[13] Section 1441(a).
[14] Section 874(a); Regs. 1.874-1(a), (b).
[15] Reg. 1.874-1(b)(1). The due date is set forth in Section 6072(c).
[16] Reg. 1.874-1(b)(1).
[17] 107 TC 146 (1996).
[18] *Id.* at 150.
[19] *Id.* at 158.
[20] Treasury Inspector General for Tax Administration, *supra* note 1 at 2-3.
[21] *Id.* at 7-8.

file Forms 1040NR within 20 days. Again, the taxpayer did not so file. The result of this stubbornness was a notice from the IRS in March 1993 advising the taxpayer that it had prepared SFRs, without giving the taxpayer the benefit of any deductions. Later, in October 1993, the taxpayer actually filed all outstanding Forms 1040NR, which reflected net losses from the two rental properties. Each Form 1040NR contained a Section 871(d) election to treat the properties and income as effectively connected with a U.S. trade or business. In January 1994, the IRS issued a notice of deficiency covering four years that (1) ignored the late Forms 1040NR filed by the taxpayer, along with the Section 871(d) election enclosed with the first one, (2) used the SFRs to determine the taxes due, and (3) asserted delinquency penalties under Section 6651 and estimated tax penalties under Section 6654. The taxpayer filed a timely petition with the Tax Court to dispute the notice of deficiency.

The Tax Court did a commendable job of clarifying the three possible stances for NRAs holding U.S. rental real property. It explained the following:

> Thus, in dealing with rental income, there are three possible computations of tax liability facing [an NRA]:
>
> (1) If the rental income is not effectively connected with a trade or business within the United States, and no election is made under Section 871(d), then the tax is computed at the 30-percent rate on gross rental income under Section 871(a);
>
> (2) If the income is effectively connected with a trade or business within the United States, or if an election [under Section 871(d)] is made to treat the income as effectively connected, the tax is computed pursuant to Section 871(b), on net rental income at the graduated rates prescribed by section 1, provided that the taxpayer has filed a return as required by Section 874(a); and
>
> (3) Where the income is effectively connected and the taxpayer fails to file a tax return as required by Section 874(a), the tax is computed on gross rental income at the graduated rates prescribed in section 1.[18]

The taxpayer in *Espinosa* acknowledged that Section 874(a) disallows deductions if no Form 1040NR is filed; however, he argued that filing Forms 1040NR after the IRS sent multiple notices inquiring about the missing Forms 1040NR, but before the IRS had issued a Notice of Deficiency, constitutes a timely filing. Thus, he said, he should be entitled to all the deductions warranted after making a Section 871(d) election. The Tax Court rejected the taxpayer's argument, regardless of the harsh outcome:

> We hold in the circumstances of this case that the submission of returns by [the NRA] after [SFRs] had been prepared by [the IRS], and after [the NRA] had been notified that no deductions are allowable but prior to the issuance of the notice of deficiency, is insufficient to avoid the sanction of Section 874(a). We recognize that the application of Section 874(a) in this case may appear draconian. That result, however, flows from the nature of the statute. As we have suggested, were we to hold otherwise, we essentially would reward [the NRA] for ignoring the repeated requests [by the IRS] that he comply with the filing requirements of the Code.[19]

Analysis of the TIGTA Report

The TIGTA Report paints a fairly bleak picture about U.S. tax compliance. It begins by putting things into perspective, explaining that NRAs have purchased a significant amount of U.S. real property in recent years, a large portion of which is used to generate rental income. The TIGTA Report indicated that NRAs purchased $34.8 billion worth of such property in 2013, $45.5 billion in 2014, $54.4 billion in 2015, and $43.5 billion in 2016.[20]

Four main categories of non-compliance. With the dimensions thus established, the TIGTA Report identified four major problems.

Section 874(a) generally provides that an NRA may not claim deductions unless the he or she files a true, accurate, and timely Form 1040NR.

First, TIGTA discovered that a considerable number of NRAs were claiming net income treatment on the annual Forms 1040NR, despite the fact that they never made a proper Section 871(d) election. TIGTA studied a number of first-time Forms 1040NR reporting rental income and expenses on Schedule E, because the Section 871(d) election is only made the first year and then remains in effect unless later revoked with the permission of the IRS. Of the 149 Forms 1040NR that TIGTA analyzed, only 32% (i.e., 47) of the NRAs included a Section 871(d) election, and only six of the elections were complete. The remaining 68% (i.e., 102 taxpayers) deducting expenses related to U.S. rental property did not even enclose a Section 871(d) election with their Forms 1040NR. Extrapolating from this study, TIGTA estimates that approximately 12,000 NRAs failed to comply with the Section 871(d) regulations in just one year.[21]

What does all this mean from an economic perspective? According to the TIGTA Report, the 102 taxpayers who inappropriately acted as if they had made a Section 871(d) election (when this was not the case) reported gross rental income of $1.78 million in one year. They then improperly reduced this gross amount by $1.88 million in rental expenses, the result of which was that 58 percent of the noncompliant NRAs paid no U.S. income tax or got a tax refund. In reality, because of their failure to make a proper Section 871(d) election, the 102 NRAs should have been subject to the flat 30-percent tax on gross income, which would have yielded the IRS approximately $534,000 in income taxes (*i.e.*, 30 percent of $1.78 million).[22] When these figures are projected over the entire population, TIGTA estimates that the IRS loses about $56 million per year.[23]

'[I]n in dealing with rental income, there are three possible computations of tax liability....'

Second, TIGTA learned that some NRAs are double dipping, taking inconsistent tax positions in order to acquire two improper benefits. This is made possible, according to the TIGTA Report, because the Service's systems do not adequately input or track the data about U.S. rental property that is supplied to the IRS in the first-year Section 871(d) election statement attached to Form 1040NR. The initial benefit is that certain NRAs deduct rental expenses annually and subject the remaining net income to the graduated/progressive tax rates, which are often less than the standard 30% withholding rates on gross income. The additional benefit comes when the property is later sold. Some unscrupulous NRAs conveniently forget to reduce their basis in the property by the amount of the depreciation expenses that they took over the years, thereby diminishing the total gain when they sell the property. In short, some NRAs recognize the Section 871(d) election (even if they did not properly claim it) for purposes of reducing annual taxes on rental income, and then fail to acknowledge such election when it comes time to sell.[24]

Third, some NRAs never file Forms 1040NR, never notify withholding agents that they should be subject to a 30% tax rate on gross income, and thus never pay any amount of U.S. income taxes on rental income from U.S. real property. Putting numbers to this phenomenon, TIGTA calculates that 13% of NRAs with U.S. real property simply fail to file Forms 1040NR, which triggers approximately $61 million in unreported rental income annually.[25]

Fourth, many withholding agents (i.e., renters, lessees, and property managers) are doing a deplorable job of collecting taxes on behalf of the IRS and of meeting their information-reporting duties. Generally speaking, withholding agents are charged with gathering the proper data from the property owner. That data which ordinarily comes as a Form W-8BEN or Form W-8ECI. If the withholding agent receives a Form W-8BEN (or receives nothing), then he or she is obligated to withhold, and later send to the IRS, 30% of the gross rental payments. On the other hand, if the withholding agent gets a Form W-8ECI, he or she has no duty to redirect a portion of the payment to the IRS.

Withholding agents must file Forms 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," for each tax year in which rent is paid to NRAs, even when the NRA is exempt from withholding. They must also file Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," if taxes were actually withheld from the rental payments and remitted to the IRS. The TIGTA Report indicates that non-compliance in this area is rampant. Indeed, only 3.6% of the NRAs owning U.S. real property who reported rental income and expenses on Schedule E of their Forms 1040NR were supported by a corresponding Form 1042-S filed by the withholding agent.[26]

When it comes to finger-pointing, TIGTA seems to let withholding agents off the hook, resigning itself to the fact that improved compliance by NRAs likely will not be achieved by applying additional pressure to withholding agents:

> The property owner's residency status creates a reporting requirement for the renter, and most renters would not be aware of this reporting requirement unless notified by the property owner. Yet the law provides for stiff penalties when they fail to file. The tax compliance regime with respect to [NRAs] who do not file the required [Section 871(d)] election appears to be impracticable. While there is both high noncompliance by [NRAs] for the filing of [Section 871(d)] elections and a high filing and withholding noncompliance rate of renters of foreign-owned U.S. property, the compliance regime is dependent on [NRAs] informing renters of their tax status so that renters can then remit a portion of their rent payments to the IRS. There is a lack of clear information regarding the obligations of renters in such situations, but it is not clear that providing more information to the public would affect the noncompliance. Whether renters are in-

volved in short-term vacation rentals or long-term residential rentals, they do not appear to be an effective means to achieve higher tax compliance by [NRAs].[27]

Suggestions for improvement. The TIGTA Report identifies a few proposals for enhancing compliance by NRAs. Ideas include (1) revising the Form 1040NR, such that taxpayers can make the Section 871(d) election there by checking a box, (2) creating a legal presumption that the reporting of rental income and expenses on Schedule E to Form 1040NR constitutes an election, and (3) inputting and analyzing the data provided by the NRA in the election statement, regardless of its form.[28] The most important recommendation, made by TIGTA and embraced by the IRS, is to develop and implement a "compliance initiative" to address the problems caused by NRAs who do not properly report U.S. rental income.[29]

Rectifying matters with the IRS before enforcement hits

When TIGTA publishes a report for all the world to see, concludes that the Service's enforcement efforts are lacking and result in tens of millions of dollars in lost tax revenue each year, and the IRS commits to effectuating a "compliance initiative," people to start to worry. And so they should. As primary targets of the upcoming "compliance initiative," those most anxious would be (1) the NRAs who are claiming net income treatment on their annual Forms 1040NR without first making a proper Section 871(d) election, and (2) the NRAs who do not file Forms 1040NR at all, do not provide Forms W-8BEN to allow automatic U.S. tax withholding on gross rental income, and, consequently, do not pay U.S. income taxes on rental income from U.S. real property.

The key for those in jeopardy is pro-actively approaching the IRS before the IRS identifies them, initiates an audit, and asserts significant taxes, penalties, and interest charges. Potential options include, but are certainly not limited to (1) making a late Section 871(d) election within the three-year time period set forth in the Section 871 regulations without the need to first seek permission from the IRS, (2) applying for a private letter ruling allowing a late Section 871(d) election under Reg. 301-9100-3, or (3) requesting a waiver of the requirement to file a timely Form 1040NR (with election enclosed) under the Section 874 regulations. The following is a brief discussion of these options.

Inapplicability of international voluntary disclosure programs. The IRS has been actively publicizing and promoting a variety of international tax disclosure programs since 2009. The main programs in effect now are the 2014 Offshore Voluntary Disclosure Program, the Streamlined Foreign Offshore Procedure, and the Streamlined Domestic Offshore Procedure. The non-compliance by NRAs owning U.S. rental real estate involves foreign individuals and U.S.-source funds flowing outside the United States, so it undeniably has international elements. Some people might assume that resolving matters through one of the programs identified above is the best path. This is incorrect, though, because such programs only address situations involving U.S. persons with unreported foreign-source income and/or unreported foreign financial assets.

Solutions for NRAs who filed Forms 1040NR but no election. NRAs claiming net income treatment on their annual Forms 1040NR without making proper a Section 871(d) election have two main possibilities.

The TIGTA Report paints a fairly bleak picture about U.S. tax compliance.

Making a late election pursuant to the Section 871 regulations. NRAs might file an amended Form 1040NR within the designated period to retroactively make the Section 871(d) election, which they can do without seeking advanced permission from the IRS. The regulations provide detail about the time during which an NRA can make a late Section 871(d) election, as follows:

> [An NRA] may, for the first taxable year for which the election under this section is to apply, make the initial election at any time before the expiration of the period prescribed by Section 6511(a), or by Section 6511(c) if the period for assessment is extended by agreement, for filing a claim for credit or refund of the tax imposed by chapter 1 of the Code for such taxable year. This election may be made without the consent of the [IRS].[30]

What does this mean, exactly? Under Section 6511(a), a claim for refund or credit generally must be filed by a taxpayer within three years from the time that the relevant tax return was filed (regardless of whether the relevant tax

[22] *Id.* at 8-9.
[23] *Id.* at 9.
[24] *Id.* at 11-12.
[25] *Id.* at 18-19.
[26] *Id.* at 15-16.
[27] *Id.* at 16 and 19.
[28] *Id.* at 11-14.
[29] *Id.* at 20.
[30] Reg. 1.871-10(d)(1)(i).

return was timely filed or late), or within two years from the time that the relevant taxes were paid, whichever period expires later.[31] Here is an example of how this might function.

Example: If an NRA filed Form 1040NR for Year 1 on October 15 of Year 2, and was oblivious to the need to attach a statement making a Section 871(d) election, he or she would have until October 15 of Year 5 to file an amended Form 1040NR enclosing the late election for Year 1. Since it is effective for all subsequent years, the retroactive election for Year 1 would allow net income treatment in Year 2, Year 3, and so forth.

The TIGTA Report identifies a few proposals for enhancing compliance.

Making a late election thanks to Section 9100 relief. If an NRA is unable to file a retroactive election to cover all affected years because the first Form 1040NR was filed after the general refund-period contemplated by Section 6511(a), or if the NRA wants the explicit, advanced blessing of the IRS, another option remains: seeking a private letter ruling from the IRS National Office pursuant to Reg. 301.9100-3. This is commonly known as getting "Section 9100 relief."

Applicable IRS Policies. In formulating the standards for granting Section 9100 relief, the IRS has identified two policies that must be balanced. The first policy is promoting efficient tax administration by fixing limited time periods for taxpayers to choose among alterative tax treatments and to encourage prompt tax reporting. The second policy is "permitting taxpayers that are in reasonable compliance with the tax laws to minimize their tax liability by *collecting from them only the amount of tax they would have paid if they had been fully informed and well advised.*"[32]

Relief under Reg. 301.9100-3. The IRS has discretion to grant reasonable extensions for filing certain elections.[33] The regulations provide that extension requests "will be granted" by the IRS when the taxpayer provides sufficient evidence to establish that (1) the taxpayer acted reasonably and in good faith, and (2) granting the extension will not prejudice the interests of the U.S. government.[34] These two factors are examined below.

Acting reasonably and in good faith. A taxpayer is generally deemed to have acted reasonably and in good faith if any one of the following is true:

- The taxpayer requests Section 9100 relief before the IRS discovers the failure to make the relevant election.
- The taxpayer failed to make the election because of intervening events beyond his control.
- The taxpayer failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), he was unaware of the necessity for the election.
- The taxpayer reasonably relied on the written advice of the IRS.
- The taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the relevant election.[35]

Notwithstanding the general rules described above, a taxpayer will be deemed *not* to have acted reasonably and in good faith if any one of the following is true:

- The taxpayer seeks to alter a tax return position for which an accuracy-related penalty has been or could be imposed under Section 6662 at the time the taxpayer requests Section 9100 relief, and the new position requires or permits a regulatory election for which relief is requested.
- The taxpayer was informed in all material respects of the required election and related tax consequences, but chose not to file the election.
- The taxpayer uses hindsight in requesting Section 9100 relief. In other words, if specific facts have changed since the due date for making the election that make the election more advantageous to a taxpayer now, the IRS will not ordinarily grant relief. In such cases, the IRS will grant an extension request only when the taxpayer provides "strong proof" that the tax-

[31] Section 6511(a); Reg. 301.6511(a)-1(a).
[32] T.D. 8742, 1998-5 IRB 4, 62 Fed. Reg. 68,168 (emphasis added).
[33] Reg. 301.9100-1(c).
[34] Reg. 301.9100-1(c).
[35] Reg. 301.9100-3(b)(1). A taxpayer will not be considered to have reasonably relied on a qualified tax professional if the taxpayer knew or should have known that the tax professional was either not competent to render advice on the election or unaware of all the relevant facts. See Reg. 301.9100-3(b)(2).
[36] Reg. 301.9100-3(b)(3).
[37] Reg. 301.9100-3(c).
[38] Reg. 301.9100-3(c)(1)(i).
[39] Reg. 301.9100-3(c)(1)(ii).
[40] Section 874(a); Regs. 1.874-1(a), (b).
[41] Reg. 1.874-1(b)(2).
[42] Reg. 1.874-1(b)(2)(i)-(vi).
[43] Reg. 1.874-1(b)(3), Example s 1-6.

payer's decision to seek relief did not involve hindsight.[36]

No prejudice to government interests. The regulations contain the two standards that the IRS uses in determining whether the interests of the U.S. government would be prejudiced by the granting of an extension request.[37]

First, they provide that the interests of the U.S. government are prejudiced if granting the extension request would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the election than the taxpayer would have had if the election had been timely made, taking into account the time value of money.[38]

Second, the regulations indicate that the interests of the U.S. government are ordinarily prejudiced if the assessment period for the tax year in which the election should have been made, or the assessment period for any tax years that would have been affected by the election had it been timely made, are closed.[39] This serves to ensure that what's good for the goose is good for the gander. If the IRS is precluded from assessing tax, penalties, and interest against a taxpayer because the assessment period for a particular year has already expired, then the taxpayer cannot go back to that year and take unfair advantage.

Solutions for NRAs who failed to file Forms 1040NR. As indicated above, Section 874(a) generally deprives an NRA of the deductions related to U.S. rental property, unless he or she files a timely Form 1040NR.[40] The IRS can waive the duty to timely filing, though, if the NRA demonstrates to the satisfaction of the IRS that, based on all the facts and circumstances, he or she acted reasonably and in good faith in failing to file a Form 1040NR.[41] The IRS is supposed to consider the following factors in making this decision: (1) whether the NRA voluntarily approaches the IRS before the IRS discovers the failure to file Form 1040NR; (2) whether the NRA was aware of his or her ability to file a "protective" Form 1040NR; (3) whether the NRA filed a Form 1040NR for earlier years; (4) whether, after exercising reasonable diligence (taking into account the experience and sophistication level of the NRA), he or she was understandably unaware of the duty to file Form 1040NR; (5) whether the failure to file Form 1040NR was due to intervening events beyond the control of the NRA; and (6) whether other mitigating or exacerbating factors exist.[42] These criteria are strikingly similar to those for obtaining Section 9100 relief from the IRS through the private letter ruling process.

How does this work in the real world? The regulations provide the following examples as guidance.[43]

> Example (1). [NRA] discloses own failure to file. In Year 1, A became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or

business. During Year 1 through Year 4, A incurred losses with respect to A's U.S. partnership interest. A's foreign tax advisor incorrectly concluded that because A was a limited partner and had only losses from A's partnership interest, A was not required to file a U.S. income tax return. A was aware neither of A's obligation to file a U.S. income tax return for those years nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In Year 5, A began realizing a profit rather than a loss with respect to the partnership interest and, for this reason, engaged a U.S. tax advisor to handle A's responsibility to file U.S. income tax returns. In preparing A's U.S. income tax return for Year 5, A's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines [had passed], A would be barred [under Section 874(a)] from claiming any deductions that otherwise would have given rise to net operating losses on returns for these years, and that would have been available as loss carryforwards in subsequent years. At A's direction, A's U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard ... for waiver of any applicable filing deadlines.

The key for those in jeopardy is pro-actively approaching the IRS before the IRS identifies them.

Example (2). [NRA] refuses to cooperate. Same facts as in Example 1, except that while A's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, A refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because A did not cooperate in determining A's U.S. tax liability for the taxable years for which an income tax return was not timely filed, A is not granted a waiver ... of any applicable filing deadlines.

Example (3). [NRA] fails to file a protective return. Same facts as in Example 1, except that in Year 1 through Year 4, A also consulted a U.S. tax advisor, who advised A that it was uncertain whether U.S. income tax returns were necessary for those years and that A could protect A's right subsequently to claim the loss carryforwards by filing protective returns ... A did not file U.S. income tax returns or protective returns for those years. A did not present evidence that intervening events beyond A's control prevented A from filing an income tax return, and there were no other mitigating factors. A has not met the standard ... for waiver of any applicable filing deadlines.

Example (4). [NRA] with effectively connected income. In Year 1, A, a computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. A had minimal business or tax experience internationally, and no such experience in the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A, however, did not file U.S. income tax returns for Year 1 or Year 2. A was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In November of Year 3, A engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed A's U.S. activities and advised A that A should have filed U.S. income tax returns for Year 1 and Year 2. A immediately engaged a U.S. tax advisor who, at A's direction, promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard ... for waiver of any applicable filing deadlines.

Example (5). IRS discovers [NRA's] failure to file. In Year 1, A, a computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. A, however, was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. Despite A's extensive experience conducting similar business activities in other countries, A made no effort to seek advice in connection with A's U.S. tax obligations. A failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In November of Year 3, an Internal Revenue Service examiner asked A for an explanation of A's failure to file U.S. income tax returns. A immediately engaged a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard ... for waiver of any applicable filing deadlines.

Example (6). [NRA] with prior filing history. A began a U.S. trade or business in Year 1 as a sole proprietorship. A's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with A's U.S. trade or business. In Year 7, A replaced this tax advisor with a tax advisor unfamiliar with U.S. tax law. A did not file a U.S. income tax return for any year from Year 7 through Year 10, although A had effectively connected income for those years. A was aware of A's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted A and asked for an explanation of A's failure to file income tax returns after Year 6. A immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard ... for waiver of any applicable filing deadlines.

The preceding examples have varying degrees of relevance to the type of taxpayers on which this portion of the article is focused; that is, NRAs who did not file Forms 1040NR, were not engaged in a U.S. trade or business, were not subjected to automatic U.S. tax withholding on gross rental income, and thus did not pay U.S. income taxes on U.S.-source rental income. The most relevant is Example 1, which illus-

trates a remarkably common situation in which first-time investors find themselves as a result of unfamiliarity with the complicated U.S. tax system.

Conclusion

The TIGTA Report identifies the magnitude of tax non-compliance related to U.S. rental properties owned by NRAs. The violations seem widespread, and the expense to the IRS, in terms of lost tax revenue, is large by any definition. Now that TIGTA has placed public focus on the Service's ineffectiveness in this area, and now that the IRS has committed to making certain procedural changes and to implementing a "compliance initiative," one can anticipate that the IRS will soon direct enforcement resources at the principal causes of the problem. According to TIGTA, these include NRAs who are claiming net income treatment on their annual Forms 1040NR without first making a proper Section 871(d) election, NRAs who are avoiding U.S. income taxes altogether by not filing Forms 1040NR or facilitating tax withholding at source, and withholding agents (i.e., renters, lessees, and property managers) who are not demanding the initial identifying documentation from U.S. property owners, not withholding and remitting an appropriate percentage of rent payments to the IRS, and not filing Forms 1042 and Forms 1042-S so that the IRS can track the matter.

In light of upcoming enforcement by the IRS, and given the potentially large taxes and penalties at play, those who have run afoul of their U.S. tax obligations will obtain a better result by voluntarily approaching the IRS, before receiving a notice or audit-selection letter. The discussion above identifies and generally describes some potential manners for rectifying matters with the IRS, and others exist. NRAs and withholding agents who find themselves in U.S. tax non-compliance would be wise to retain specialized legal/tax help, analyze their options, and proactively address matters with the IRS before any leverage that they still have to achieve a favorable result disappears. ■