

Office of Chief Counsel
Internal Revenue Service
memorandum

SPR-252775-96
CC:INTL:BR4:GSoba

date: January 3, 1997

to: Assistant Commissioner (International)

from: Charles P. Besecky, ^{CPB} Branch Chief CC:INTL:BR4
Associate Chief Counsel (International)

subject: 15th Annual International Tax Conference
Requirements of Treas. Reg. §§ 1.874-1 and 1.882-4

This is in reply to your request for advice on how to respond to inquiries concerning Treas. Reg. §§ 1.874-1 and 1.882-4 that may arise during your appearance at the 15th Annual International Tax Conference in Miami, Florida, January 15 through 17, 1997.

Issue: Whether the Service should provide for an amnesty period within which foreign corporations and nonresident aliens with income effectively connected with a United States trade or business could file federal income tax returns for tax years ending after July 31, 1990 without being subject to the deduction denial provisions of Treas. Reg. §§ 1.874-1(b)(1) and 1.882-4(b)(1). The purpose of the amnesty would be to encourage nonresident aliens and foreign corporations with income from U.S. trades or businesses, but who have failed to file the necessary returns, to come forward and voluntarily file their delinquent returns within a time period that the Service would announce.

Recommendation: For the reasons set forth below, we recommend that the Service maintain the position that (1) the 1989 proposed regulations and the 1990 final regulations provided adequate notice of the filing requirements provided in these regulations, (2) providing such an amnesty period would reward nonresident aliens and foreign corporations that played the audit lottery, and (3) District Directors and the Assistant Commissioner (International) have adequate discretion to waive the filing time periods provided by the regulations based on the facts and circumstances of the particular taxpayer.¹ Traditionally, the

¹ If pressed for examples where the Service would exercise this discretion in favor of delinquent taxpayers, we
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Service has not used amnesties as a compliance tool and agreeing to the proposal would set an undesirable precedent.

Discussion: Internal Revenue Code sections 874(a) and 882(c)(2) deny the benefits of deductions in computing taxable income from U.S. trades or businesses to nonresident aliens and foreign corporations unless they file true and accurate federal income tax returns. Substantially similar provisions have existed in our tax laws since the Revenue Act of 1918. Prior to 1990, the regulations did not provide a bright line test for cutting off a taxpayer's ability to file a late return and avoid the deduction prohibition of sections 874(a) and 882(c)(2). Case law purported to apply a facts and circumstance test, but in actuality, allowed taxpayers the benefit of the deductions as long as they filed, or attempted in good faith to file, their returns prior to the Commissioner filing returns on their behalf. See Espinosa v. Commissioner, 107 T.C. No. 9 (1996) and cases cited therein. This situation provided nonresident aliens and foreign corporations with an incentive to play the audit lottery, refusing to file a return reporting the income associated with their U.S. trades and businesses until uncovered by the Service. They could then file their returns and claim the benefits of any deductions available to them.

In July 1989, the Service issued proposed regulations under sections 874 and 882 imposing bright line limits on the filing of late returns by nonresident aliens and foreign corporations. The notice of proposed rulemaking provided that the regulation would be effective for the first tax year ending after July 31, 1990. Final regulations were issued in December 1990.

To claim deductions in computing their net effectively connected income under the final regulations, nonresident aliens must file a return no later than 16 months after the return due date. Foreign corporations must file their returns no later than 18 months after the return due date. The Service can reduce this period if a taxpayer did not file a return for the immediately preceding year and the current year is not the first year for which a return is due. The Service accomplishes this by mailing a notice to the taxpayer notifying the taxpayer that the return has not been filed and that the taxpayer may no longer claim any deductions or credits.²

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recommend that you avoid specifics and suggest that each case would have to be evaluated on its facts.

² A nonresident's failure to file a return will not
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A notice or other program providing a period of time within which nonresident aliens and foreign corporations could come in and file delinquent returns for tax years ending after July 31, 1990 is, we believe, not warranted. Affected taxpayers have been on notice of these regulations, either in proposed or final form, since July 1989. The July 28, 1989 Notice of Proposed Rulemaking gave clear guidance that the regulation would impose a strict time limit. We know of no statements issued by the Service that could have created any ambiguity in the meaning, application, or effective dates of these regulations.

The regulations impose a strict but clear time limit to address the difficult problem of foreign taxpayers playing the audit lottery, and mitigating their damages by filing a return once discovered. The regulations set forth a fair rule and an amnesty would provide an unfair advantage to non-compliant taxpayers.

Further, the regulations provide the District Directors and the Assistant Commissioner (International) with discretion to waive these time periods in rare and unusual circumstances, for good cause, based on facts presented by the taxpayer. Treas. Reg. §§ 1.874-1(b)(2) and 1.882-4(a)(3)(ii). Therefore, the District Director and the Assistant Commissioner (International) have the discretion to address any inequity based on an examination of a taxpayer's specific facts and circumstances.

Finally, we would hesitate before testing these regulation in circumstances where a foreign taxpayer voluntarily came forward and filed delinquent returns. A stronger test would exist where a taxpayer filed delinquent returns only after being uncovered by the Service and an inquiry into the earlier years commenced.

If you have any questions, please call George Soba at (202) 622-3680.

²(...continued)

preclude the nonresident's claiming credit for taxes withheld under sections 31, 32, 33, 34, and 852(b)(3)(D)(ii). A foreign corporation's failure to file a return will not preclude it from claiming taxes withheld under sections 33, 34, and 852(b)(3)(D)(ii) or the charitable contribution deduction under section 170.