

## Area of Focus #4 Taxpayers Continue to Be Burdened by the IRS's Approach to International Tax Administration

### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

### DISCUSSION

The National Taxpayer Advocate has previously raised a number of issues regarding implementation of the Foreign Account Tax Compliance Act (FATCA) and the IRS's international withholding and refund policies.<sup>2</sup> Some of these problems were reiterated by taxpayers and their representatives in Public Forums recently held by the National Taxpayer Advocate.<sup>3</sup> Lacking either statistically valid data or analytical justification, the IRS has adopted a coercive approach to international taxpayers, reflecting an assumption that all such taxpayers are suspect of fraudulent activity.<sup>4</sup>

The National Taxpayer Advocate continues to be concerned that:

- The IRS's processes for reviewing and validating Chapter 3 and Chapter 4 refund requests unnecessarily burden taxpayers;<sup>5</sup>
- Contemplated IRS policy changes would make the availability of Form 1042-S credits and refunds to covered taxpayers contingent on the actions of withholding agents;
- U.S. expatriates are especially vulnerable to FATCA-related hardships; and
- Businesses incur costs and risk exposures that could be minimized if the IRS adopted a more efficient and user-friendly approach to international tax administration.

### The IRS's Processes for Reviewing and Validating Chapter 3 and Chapter 4 Refund Requests Unnecessarily Burden Taxpayers

Beginning January 1, 2015, the IRS systemically froze all Chapter 3 refunds.<sup>6</sup> The intent was to freeze all refund claims until the accuracy of a refund request could be verified by matching the taxpayer's Form

1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 National Taxpayer Advocate 2016 Annual Report to Congress 220-29; National Taxpayer Advocate 2015 Annual Report to Congress 346-52; National Taxpayer Advocate 2013 Annual Report to Congress 238-48. Foreign Account Tax Compliance Act (FATCA) was passed by the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

3 National Taxpayer Advocate Public Forum, Washington D.C. (May 17, 2016) 25-26.

4 National Taxpayer Advocate 2016 Annual Report to Congress 221.

5 Under IRC §§ 1441-1443 (Chapter 3), the IRS imposes withholding on payments made to non-resident aliens and foreign corporations and allows credits and refunds of the amounts to which these taxpayers are entitled. Likewise, IRC §§ 1471-1474 (Chapter 4) mandates withholding under FATCA on payments to foreign financial institutions (FFIs) or similar institutions in specified circumstances and refers taxpayers to Chapter 3 for rules governing the credit or refund of those withheld amounts.

6 Internal Revenue Manual (IRM) 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR* (Aug. 1, 2016).

---

**Lacking either statistically valid data or analytical justification, the IRS has adopted a coercive approach to international taxpayers, reflecting an assumption that all such taxpayers are suspect of fraudulent activity.**

---

1042-S against the withholding agent's copy that had been filed with the IRS.<sup>7</sup> Originally, the freeze window was established as six months from the time the return was due or filed, whichever was later, but that window was subject to unilateral extension by the IRS.<sup>8</sup>

The IRS developed an automated matching tool designed to classify likely valid and invalid claims, but tests showed that the system generated a 94 to 98 percent error rate and it was determined to be inoperable.<sup>9</sup> Thereafter, the IRS switched to an interim semi-automated tool,<sup>10</sup> which likewise yielded an unacceptably high rate of false positives and kept some taxpayers waiting for their refunds for over a year by the time the IRS suspended the matching program and announced the release of the remaining frozen refunds in June 2016.<sup>11</sup> At various points, more than 100,000 taxpayers had become subject to refund freezes.<sup>12</sup> A number of low-risk taxpayers, such as foreign students studying in the U.S., experienced particular hardship from these freezes.<sup>13</sup>

To its credit, the IRS is undertaking a long-term redesign of its Form 1042-S refund processes and has included TAS in the discussions. Currently, the IRS is using interim procedures under which it freezes some, but not all, Form 1042-S refunds for review prior to their release.<sup>14</sup> Under these interim procedures, as with domestic taxpayers, the IRS places the responsibility for correcting reporting errors by withholding agents on the shoulders of taxpayers. This approach, however, has severe consequences for international taxpayers, because, unlike in the domestic context, the IRS will not accept alternative proofs of withholding, and because withholding agents are not always willing or able to resolve documentation mismatches, regardless of whether the errors are attributable to actual misreporting on their part, or false positives on the part of the IRS. This circumstance has caused taxpayers, particularly those who are unsophisticated or unrepresented, a range of difficulties.<sup>15</sup>

Beyond causing unnecessary taxpayer burden, the Form 1042-S approach could create litigation risks for the IRS. In *Portillo v. Commissioner*, the Fifth Circuit Court of Appeals held that by failing to substantiate a Form 1099, the accuracy of which was challenged by the taxpayer, the IRS made a “naked assessment,” acted arbitrarily, and failed its burden of proof.<sup>16</sup> Courts generally have limited *Portillo* to

<sup>7</sup> IRM 21.8.1.11.14.2, *FATCA - Programming Beginning January 2015 Affecting Certain Forms 1040NR* (Aug. 1, 2016).

<sup>8</sup> *Id.* National Taxpayer Advocate Fiscal Year (FY) 2017 Objectives Report to Congress 81.

<sup>9</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2016-20-077, *Foreign Account Tax Compliance Act Program Withholding and Refund Release 2.0 Project Development and Testing* 6 (Aug. 2016).

<sup>10</sup> IRS, *IRS Takes Steps to Help Students; Outlines Interim Process for Obtaining Refunds of Withholding Tax Reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding* (June 6, 2016), <https://www.irs.gov/uac/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042s-foreign-persons-us-source-income-subject-to-withholding>.

<sup>11</sup> National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress 81.

<sup>12</sup> IRS response to TAS fact check (Oct. 31, 2016).

<sup>13</sup> National Taxpayer Advocate FY 2017 Objectives Report to Congress 82–83.

<sup>14</sup> IRM 21.8.1.11.14.3, *FATCA- 1042-S Matching Program - General Information - Identifying Related Letters, Transaction Codes, Reason Codes, 1042-S Data Fields* (Oct. 1, 2016, Feb. 9, 2017).

<sup>15</sup> National Taxpayer Advocate 2016 Annual Report to Congress 222–24.

<sup>16</sup> *Portillo v Comm'r*, 932 F.2d 1128 (5th Circuit, 1991). The burden of proof in tax cases generally rests with the taxpayer. In a deficiency proceeding, however, when a taxpayer establishes that an assessment is “arbitrary and erroneous,” the burden shifts to the IRS to prove the correct amount of any taxes owed. *Id.*, 1133.

unreported income cases arising in the domestic context.<sup>17</sup> Nevertheless, the IRS faces the risk that, in a case involving the creation of a deficiency attributable to a Form 1042-S mismatch, a court could extend *Portillo* and rule that IRS reliance on a withholding agent's Form 1042-S while rejecting a taxpayer's sworn Form 1040NR is arbitrary, particularly where the program's false positive rate is high. Such a finding could result in immediate dismissal of the IRS's case.

Further, even in a refund case, a taxpayer could come before a court and, using any available evidence, demonstrate that the withholding for which the refund is claimed actually occurred. Such a showing would open to judicial scrutiny the IRS's policy of relying solely on withholding agents' Forms 1042-S without any other validation, an approach treated as arbitrary in the Form 1099 context by the *Portillo* line of cases. Additionally, it would enable a taxpayer to challenge the IRS's current legal view that the IRS has no obligation to provide refunds unless it actually receives full remittances from withholding agents.<sup>18</sup>

To minimize taxpayer hardship and limit potential litigation, TAS encourages the IRS to focus its scrutiny on the relatively small percentage of Form 1042-S filers posing a high risk for noncompliance or fraud. This group can be identified through analysis of data available to the IRS, a step that would allow for a streamlining of resources and the tailoring of enforcement programs. Just as importantly, it would allow the IRS to reduce the burdens imposed on the vast majority of Form 1042-S taxpayers, who appear to be more compliant than U.S. taxpayers overall.<sup>19</sup>

### Contemplated IRS Policy Changes Would Make the Availability of Form 1042-S Credits and Refunds to Covered Taxpayers Contingent on the Actions of Withholding Agents

The IRS is also considering Chapter 3 and Chapter 4 guidance that would allow full credits or refunds only if the IRS can confirm that the withholding agent remitted the full amount of the aggregate liabilities for which the withholding agent is responsible.<sup>20</sup> If a withholding agent has only partially satisfied their deposit requirements with the IRS, the guidance would provide for a *pro rata* allocation of the amount deposited among taxpayers seeking to claim credits or refunds for the withholding in question.<sup>21</sup> This guidance does contemplate some exceptions, but none would allow taxpayers to demonstrate entitlement to their credit or refund by establishing that withholding at source had actually occurred.

The IRS's intentions regarding Chapter 3 and Chapter 4 refunds, as evidenced in Notice 2015-10 and related activities, are troubling. This policy would force many relatively powerless taxpayers, rather than the IRS, to police withholding agents and to bear the risk of noncompliance. Instead of attempting to shift burdens to taxpayers, IRS efforts would be better served by focusing on recalcitrant populations of taxpayers and withholding agents, and vigorously enforcing compliance within these groups. Such a targeted approach would have the added benefit of avoiding legal challenges to the IRS's current position, as discussed above, that it has the right to withhold credits and refunds from taxpayers anytime it does not receive full remittances from withholding agents.

17 See *Parker v. Comm'r*, 117 F.3d 785 (5th Circuit, 1997); *Pittman v. Comm'r*, 100 F.3d 1308 (7th Circuit, 1996); *Tinsman v. Comm'r*, 2000 Tax Ct. Memo LEXIS 62. See also *U.S. v. Janis*, 428 U.S. 433 (1976).

18 Notice 2015-10, 2015-20 I.R.B. 965.

19 National Taxpayer Advocate 2016 Annual Report to Congress 221.

20 Notice 2015-10, III.A., 2015-20, I.R.B. 965; Department of the Treasury 2016-2017 Priority Guidance Plan (Oct. 31, 2016).

21 Notice 2015-10, III.B., 2015-20, I.R.B. 965.

### U.S. Expatriates Are Especially Vulnerable to Foreign Account Tax Compliance Act (FATCA)-Related Hardships

The enforcement-oriented outlook resulting in and perpetuated by the passage of FATCA generated the Form 1042-S issues discussed above. The legislation and its administration by the IRS also have had a detrimental impact on the well-being of many U.S. expatriates. Because of the record-keeping and reporting requirements of FATCA, many foreign financial institutions (FFIs) have stopped providing banking services to U.S. citizens.<sup>22</sup> As a result of this banking “lock-out” and the additional tax reporting burdens placed on individuals by FATCA, record numbers of expatriates have been renouncing their U.S. citizenship.<sup>23</sup>

The National Taxpayer Advocate and others have proposed a “same country exception” as a means of solving these problems and minimizing the burden of FATCA compliance for both individual U.S. taxpayers and FFIs.<sup>24</sup> This exception would exclude from FATCA coverage financial accounts held in the country in which a U.S. taxpayer is a *bona fide* resident, would mitigate concerns about the collateral consequences of FATCA raised by U.S. nonresidents, and would reduce reporting burdens faced by FFIs. Neither the IRS nor Congress has yet implemented this recommendation.

### Businesses Incur Costs and Risk Exposures That Could Be Minimized If the IRS Adopted a More Efficient and User-Friendly Approach to International Tax Administration

Financial organizations face substantial record-keeping burdens and economic risks as a result of the manner in which the IRS has implemented FATCA. This has prompted some financial organizations and their representatives to energetically seek repeal of the legislation.<sup>25</sup> Other financial institutions have worked more quietly with the IRS in an effort to simplify reporting requirements and clarify the definition of “good faith efforts.”<sup>26</sup> A return by the IRS from its current withholding and enforcement orientation to its prior information gathering approach would reduce the burdens placed on FFIs and potentially minimize some of the remaining FATCA opposition.

## FOCUS FOR FISCAL YEAR 2018

In Fiscal Year 2018, TAS will:

- Analyze data to determine the validity of IRS assumptions about noncompliance and risk with respect to nonresidents receiving Forms 1042-S;
- Explore the validity of the IRS’s legal justification for treating nonresidents receiving Forms 1042-S differently from other taxpayers subject to withholding;
- Assess whether the results of these inquiries justify issuance of a Taxpayer Rights Impact Statement, which would serve as the predecessor of a Taxpayer Advocate Directive;

22 Andrew Velarde, *Will the FATCA Same-Country Exception Become the Rule?* 152 TAX NOTES 1073 (Aug. 17, 2016).

23 Andrew Velarde, *U.S. Quarterly Expat List Tops Record, Includes U.K.’s Johnson*, 154 TAX NOTES 809 (Feb. 8, 2017). These numbers appear to have dipped in the quarter ending March 31, 2017, although the reasons for that drop and whether it represents the beginning of a new trend are unclear. Zoe Sagalow, *Half as Many Expatriated as Last Quarter, Latest U.S. List Shows*, 2017 TNT 89-6 (May 10, 2017).

24 National Taxpayer Advocate Public Forum, Washington D.C. (May 17, 2016) 25-6; Andrew Velarde, *Will the FATCA Same-Country Exception Become the Rule?* 152 TAX NOTES 1073 (Aug. 17, 2016).

25 Nigel Green *Launches Campaign to Repeal Obama-Era FATCA Law*, TAX ANALYSTS Doc. 2017-1863 (Feb. 7, 2017).

26 IRS, *IRS FATCA Roundtable: Industry Concerns and Suggestions* 3 (Nov. 16, 2015).

- Work with the IRS to improve the policies and procedures associated with the redesigned Form 1042-S withholding and verification program;
- Advocate for U.S. taxpayers and businesses experiencing hardships and burdens flowing from IRS administration of the FATCA regime; and
- Provide TAS employees, taxpayers, and tax practitioners with enhanced training and guidance regarding the most commonly arising FATCA-related issues.