

## FATCA of the HIRE Act Crashes Head On into the ‘Twilight Zone’ (Lawful Permanent Residents Living Overseas)

By Patrick W. Martin<sup>1</sup>

### I. Introduction

Earlier this year on March 18, 2010, President Obama signed into law the *Hiring Incentives to Restore Employment Act* (the “HIRE Act”). The government “stimulus” dollars in the HIRE Act has its cost and loss of revenues. The lost revenues are expected to be paid in part with new international tax provisions that were enacted, and are known as part of the *Foreign Account Tax Compliance Act* (“FATCA”). These provisions are expected to raise revenue of U.S. \$8.714 billion according to the Joint Committee Report.

These FATCA provisions have broad application and significantly change the rules in a number of international tax areas, which can be summarized as follows:

- New withholding taxes and new withholding rules applicable to foreign intermediaries and account holders (including financial institutions and certain non-financial institutions such as private hedge funds, private equity investment funds);
- New tax on foreign trust deemed payments of income (from DNI) to settlors, beneficiaries and certain related parties who use foreign trust property (e.g., use of a residential home owned by a foreign trust);
- New foreign trust reporting rules and additional penalties for failure to file;
- New reporting of a broadly defined group of foreign assets (with a US\$50,000 threshold), in addition to the existing informational reporting rules;
- New reporting requirements for U.S. shareholders in passive foreign investment companies (“PFICs”);
- Elimination of “portfolio interest” bearer bonds which had previously not been subject to U.S. withholding tax;
- A new 40% penalty imposed on certain understated income amounts (with a low threshold of only \$5,000) from foreign assets; and
- New tax on “dividend equivalent amount” on certain contracts.

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What do the FATCA provisions have to do with lawful permanent residents residing overseas? FATCA is a revenue raiser that Congress created to try to off-set the massive spending that is currently being incurred. As a revenue raiser, it is intended to impose additional taxes and penalties on various U.S. persons, i.e., U.S. taxpayers.

Why or how could Congress impose these FATCA provisions on persons who are not U.S. citizens who reside outside of the U.S.? How can these new taxes and penalties apply to persons residing overseas? Does Congress have jurisdiction to impose such taxes and penalties in these cases?

#### **A. Lawful Permanent Residents Residing Overseas (“Resident Alien”)**

The U.S. income tax law has broad application to any “resident alien” who are not citizens of the United States per the definition in the Internal Revenue Code and the Regulations. U.S. citizens are taxed on their worldwide income, regardless of where they might physically live.<sup>2</sup> Similarly, this worldwide system of income taxation is extended to “resident aliens” including persons who are defined as “lawful permanent residents” under the Code.

The tax consequences of this rule are many. Various provisions of the Internal Revenue Code are tied back to the definition of a “U.S. person” who includes someone deemed a “resident alien” as compared to a “nonresident alien.” For instance, payments made by U.S. payors of “. . . interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income . . .” (“FDAP income”) to “resident aliens” residing outside of the United States are not subject to the U.S. withholding tax. Will and are those “resident aliens” who reside outside the United States voluntarily filing U.S. resident income tax returns and reflecting and paying tax on this FDAP income (e.g., on Social Security payments)? How many FDAP income dollars are being sent annually overseas to “green card holders” with no withholding tax and no subsequent filing of resident income tax returns or U.S. income taxes being paid on these amounts?

How much FDAP income is unlawfully escaping taxation under the current system of “lawful permanent residency” under the system of voluntary compliance? Are overseas persons who have “lawful permanent residency” under Treasury Regulation Section 301.7701(b)-1(b) remitting and paying income taxation once it passes overseas?

The definition of who has “lawful permanent residency” for income tax purposes is based, in large part (but not exclusively), upon U.S. immigration law. The Immigration and Nationality Act (the “Act” or “INA”) defines permanent resident status as being lawfully accorded the privilege of permanently residing in the United States as an immigrant.<sup>3</sup> Furthermore, for immigration law purposes, this lawful permanent residency status requires that the person physically reside in the territory of the United States in a permanent form.<sup>4</sup> Although a person may have multiple residences, residence in the United States must be a permanent one.

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<sup>2</sup> See I.R.C. Sections 61 and Treas. Reg. §§ 1.1-1(b) and 1.1-1(a)(1).

<sup>3</sup> INA sec. 101(a)(20); 8 U.S.C. sec. 1101(a)(20).

<sup>4</sup> The Act defines the term “lawfully admitted for permanent residence” as “the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, such status not having changed.” INA § 101(a)(20) [8 U.S.C. § 1101(a)(20)]. The Act defines a special immigrant “returning resident” as “an immigrant, lawfully admitted for permanent residence, who is returning from a temporary visit abroad.” INA § 101(a)(27)(A) [8 U.S.C. § 1101(a)(27)(A)]. An immigrant, whether or not in possession of a valid entry document, may be permitted to enter the United States if he satisfies the definition of a special immigrant returning resident.

If a non-U.S. citizen permanently leaves the United States and takes up permanent residency in their home country, or any other country outside of the United States, they will apparently no longer have the lawful privilege (for immigration law purposes) of returning and residing permanently in the United States.<sup>5</sup> Nevertheless, Treasury Regulation Section 301.7701(b)-1(b) provides that these individuals retain their U.S. person status (as a “resident alien”) for U.S. income tax purposes. Under the existing regulatory rules, these individuals continue to be taxed on their worldwide income.

## **B. Can Congress Constitutionally Tax Lawful Permanent Residents Residing Oversea?**

This raises many interesting questions, including, whether the U.S. government may constitutionally impose worldwide income taxation upon non-U.S. citizens who have never had a right to vote nor who have any legal right to reside or otherwise enjoy the benefits of the U.S. federal government or of citizenship? If the non-U.S. citizen has no lawful right, under the U.S. immigration laws, to reside in the United States, can the U.S. government impose U.S. taxation on that persons worldwide income?

The Treasury Department has succinctly identified these problems created by the current law in its study entitled “*Income Tax Compliance by U.S. Citizens and U.S. Lawful Permanent Residents Residing Outside the United State and Related Issues*” dated May 1998.<sup>6</sup> In that study, the Treasury Department noted as follows:

If . . . a green card holder remains outside the United States for longer than the permitted period but does not attempt to re-enter the United States, no administrative or judicial proceeding will be undertaken regarding the validity of his or her green card. Accordingly, the individual will technically remain subject to worldwide U.S. tax jurisdiction under current law, even though his or her green card might no longer be recognized as valid by INS or an immigration judge. The Code and immigration laws could be harmonized so that the U.S. no longer exercises worldwide tax jurisdiction over individuals to the extent the immigration laws would no longer hold the green card to be valid if the individual attempted to use it for re-entry, and the individual is able to document that fact. As noted above, worldwide taxation of green card holders is premised in part on the benefits available to such individuals. However, in the case of green card holders whose status as such would not be recognized as valid, the primary benefit associated with the status – the ability to re-enter the United States – is no longer present.<sup>7</sup>

The new FATCA provisions will impose significantly greater tax burdens on LPRs residing overseas who continue to be “resident aliens”. The LPR will have to report various assets they have (in excess of US\$50,000) to the U.S. federal government under the new FATCA provisions. In addition, they will be subject to new penalties for pay tax on the use of foreign trust property (now that a “deemed payment” is treated as occurring under FATCA) failure to report foreign assets, they

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<sup>5</sup> The Act does not define “abandonment” or “a temporary visit abroad,” and the Act does not otherwise address when an alien’s lawful permanent resident (“LPR”) status ceases to exist absent an Immigration Judge’s finding of removability after the occurrence of removal proceedings. See *United States v. Yakou*, 428 F.3d 241, 247 (D.C. Cir. 2005). The Board of Immigration Appeals (the “Board”), however, has long recognized that an alien’s status may change by operation of law, such that an alien may abandon his LPR status without a finding of removability (or, formerly, deportability or excludability) after a formal adjudicatory process. See *Yakou*, 428 F.3d at 247-51 (discussing case law regarding abandonment and holding that an alien may abandon LPR status without formal administrative action); see also *Matter of Quijencio*, 15 I. & N. Dec. 95 (B.I.A. 1974); *Matter of Kane*, 15 I. & N. Dec. 258 (B.I.A. 1975); *Matter of Muller*, 16 I. & N. Dec. 637 (B.I.A. 1978); *Matter of Abdoulin*, 17 I. & N. Dec. 458, 460 (B.I.A. 1980); *Matter of Huang*, 19 I. & N. Dec. 749 (B.I.A. 1988).

<sup>6</sup> See report at <http://www.ustreas.gov/press/releases/reports/tax598.pdf>.

<sup>7</sup> Id at page 44.

The author has identified a fairly simple solution to this problem (which has already been suggested in the U.S. Treasury Department report).<sup>8</sup> The regulations (and the Code if a statutory modification is necessary) would be harmonized with the immigration laws. If a non-U.S. citizen resides permanently outside the United States, so they no longer have the right, under immigration laws to live in the U.S., these persons should also not be considered U.S. “lawful permanent residents” for U.S. income tax purposes. A mechanism could be put into place, whereby the individuals could document that they have no right to reside in the U.S. under immigration laws and thus not be U.S. “resident aliens” for tax purposes.

This author is of the view, that the current statutory language allows for a regulatory solution since the statute requires that in order to be a resident alien “. . . such individual [must have] . . . the status of having been lawfully accorded the privilege of residing permanently in the United States . . .” If the non-U.S. citizen has moved from and permanently resides outside the United States, they should, for purposes of and consistent with Section 7701(b)(6)(A), no longer be deemed to have the status of lawfully having the privilege of residing in the United States consistent with immigration law.

## II. Problem: Current Law And Reason For Proposed Clarification

Internal Revenue Code Section 7701(b)(1)(A) and (i) defines a “resident alien” for U.S. income tax purposes and includes any individual who is “. . . a lawful permanent resident of the United States at any time during such calendar year.” A “resident alien” has far reaching consequences for U.S. income tax purposes (and possibly U.S. estate and gift tax purposes), since the worldwide income of a “resident alien” is subject to U.S. reporting and income taxation. Also, there are extensive U.S. withholding tax consequences for payments made by U.S. persons (including payments made by the U.S. Social Security Administration) to “nonresident aliens” but not for payments made to “resident aliens.” Furthermore, various informational reporting requirements apply to “resident aliens.”<sup>9</sup>

Code Section 7701(b)(1)(A)(i) and (b)(6) and its reference to “lawful permanent residency” is based upon U.S. immigration law as the regulations indicate. Specifically, (b)(6)(A) and (B) provide that “. . . an individual is a lawful permanent resident of the United States at any time if-- (A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and (B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).”

FATCA also now imposes a host of reporting requirements intended (in the author’s view) to identify assets of U.S. income tax residents (e.g., those who satisfy the “substantial presence test” for the number of days they reside in the U.S. and U.S. citizens residing overseas) and to tax them in many cases. Without clarifying the LPR rules, they will also technically be subject to these FATCA rules.

### A. Regulatory Definition of “Lawful Permanent Resident” is Different than the Statutory Language?

This statutory rule was adopted in 1984 and the language “has the status of having been lawfully accorded the privilege of residing permanently in the United States” and “such status has not been revoked” cause great difficulty when read in conjunction with the regulatory rule. The 1992 regulations (Section 301.7701(b)-1(b)), largely mirrors the statutory language and provides in relevant part that “A lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws. **Resident status is deemed to continue unless it is rescinded or administratively or judicially determined to have been abandoned** [Emphasis added].” The regulations largely follow the legislative history and the statutory language but seem to add a further requirement that such lawful status (for immigration law purposes) is “deemed to continue” for tax law purposes unless administratively or judicially determined to have been abandoned.

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<sup>8</sup> Id at page 44.

<sup>9</sup> See I.R.C. Sections 6035, 6038 and 6039F.

The statutory language requires that both (i) lawful permanent status under immigration laws be accorded the individual and (ii) that status has not been revoked. If, under U.S. immigration law, the non-U.S. citizen no longer has the right to reside in the United States, then he or she should fail the requirement of (b)(6)(A) of having lawful permanent status and hence no longer be a resident alien for tax purposes.

As explained above, the INA defines permanent resident status as being lawfully accorded the privilege of permanently residing in the United States as an immigrant.<sup>10</sup>

The legislative history seems to support the language contained in the regulations as it provides that “The Committee believes that aliens who have entered the United States as permanent residents and who have not officially lost or surrendered the right to permanent U.S. residence should be taxable as U.S. residents. These persons have rights that are similar to those afforded citizens (including the right to enter the United States at will); equity demands that they contribute to the cost of running the government as much as citizens.”<sup>11</sup>

The language in the regulations and the legislative history is problematic, as it seems to require persons who have abandoned their green cards, for immigration law purposes to continue to be treated as “resident aliens” for U.S. income tax purposes and also for U.S. withholding tax purposes. The regulations require an administrative or judicial act to sever the status of “lawful permanent residency.” It is not clear that this position is consistent with a plain reading of the statute, which requires the non-U.S. citizen to have “lawful permanent resident status.” Once “lawful permanent residency” has been abandoned for U.S. immigration law purposes (e.g., by permanently residing outside the U.S.), the foreign citizen has no lawful right to re-enter the United States. Of course, once a non-U.S. citizen no longer has a right to live or reside in the United States, equity surely cannot demand that they be required to pay U.S. income taxation on their worldwide income?

## **B. Can the U.S. Constitutionally Impose U.S. Income Taxation on the Worldwide Income of Non-U.S. Citizens Permanently Residing Overseas?**

While the U.S. system of income taxation based upon citizenship, regardless of physical residency may seem unfair or somehow inequitable to some, the U.S. Supreme Court concluded it constitutional in the 1920s.<sup>12</sup> In *Cook v. Tait*, a U.S. citizen resided and domicile permanently in Mexico City had his property and sources of income also in Mexico. The Supreme Court found that U.S. taxation of his Mexican source income was indeed constitutional based upon his U.S. citizenship. The basic rationale of the Court was that the U.S. federal government provides, or at least can provide, much protection and benefits to U.S. citizens regardless of their residency and regardless of the location of their property. The U.S. Supreme Court then noted that “government by its very nature benefits the citizen and his property wherever found, and that opposition to it holds on to citizenship while it ‘belittles and destroys its advantages and blessings by denying the possession by government of an essential power required to make citizenship completely beneficial.’”<sup>13</sup>

This system of worldwide taxation of income (plus estate and gift tax transfers)<sup>14</sup> based only upon citizenship, regardless of source, seems odd to most countries, since almost all countries of the world impose income taxation only if an individual is physically resident in a particular country. The Philippines is

<sup>10</sup> See INA Section 101(a)(20); 8 U.S.C. Section 1101(a)(20)

<sup>11</sup> P.L. 98-369, DEFICIT REDUCTION ACT OF 1984 HOUSE REPORT NO. 98-432(II) MAR. 5, 1984.

<sup>12</sup> See *Cook v. Tait*, 265 US 47 (1924),

<sup>13</sup> *Id.*, 265 US 47, 56 (1924).

<sup>14</sup> See United States Congress Joint Committee on Taxation entitled *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (U.S.G.P.O., June 1, 1995), <http://www.house.gov/jct/s-17-95.pdf>.

apparently one of the few other countries that also impose Philippines taxation based upon citizenship, regardless of physical residency.<sup>15</sup>

The uniqueness of this tax treatment arises since the U.S. also imposes worldwide income taxation on U.S. resident aliens (regardless of their physical residence). One Appeals court has acknowledged that “In the case of our own citizens domiciled elsewhere, we exact income taxes upon their entire income, from whatever source derived [citing *Cook v. Tait*] . . . . While this legislation is severe, and as a matter of economic policy may not be sound, it is hard to see why aliens who have acquired a fixed abode here should fare better.”<sup>16</sup>

There is an important distinction, of course, between U.S. citizens who reside overseas and non-U.S. citizens who reside overseas. The former enjoys the benefits of citizenship and the rights and obligations of voting in a democracy and the protection, of his or her assets and physical person wherever his or her assets might reside. A non-U.S. citizen, however, who resides outside the United States and who has no legal right to reside in the United States, surely has no unique citizenship rights or protections afforded by the federal government (neither for his assets nor his person wherever they might be located).

Accordingly, the language in Section 301.7701(b)-1(b) that seems to extend “resident alien” status to “lawful permanent residents” living overseas, who have abandoned their immigration status, should be examined and the regulatory rule analyzed in light of the statute, legislative history, and constitutional limits of taxation. Clearly, the U.S. Supreme Court in *Cook v. Tait* acknowledged the policy of a law and taxing U.S. citizens residing overseas, and the *Bowring v. Bowers* court articulated its logic as it extends to foreign persons who live in the U.S. How could the U.S. Supreme Court conclude that such protections of citizenship or logic of physical residency also be extended to non-U.S. citizens residing outside the United States?

### **C. U.S. Withholding Tax Does not Apply and How FDAP Income Flees the Country Without Taxation?**

A most important consequence of the current regulatory definition of “lawful permanent residency” is that it erodes the government’s coffers as it causes it to lose withholding taxes it would otherwise receive. Once the FDAP Income (e.g., payments by the Social Security Administration) is sent overseas to non-U.S. citizens who still have “lawful permanent residency” how many of these overseas residents file and pay U.S. income tax returns? The results are not encouraging, as found in the Treasury Department’s 1993 study *Tax Administration: IRS Activities to Increase Compliance of Overseas Taxpayer*.

To further explain, U.S. payors and withholding agents (which is broadly defined in Section 1441(a)) must withhold 30 percent of “. . . fixed or determinable annual or periodical gains, profits, and Income. . . .” (“FDAP income”)<sup>17</sup> made to non-resident aliens.<sup>18</sup> If non-U.S. citizens are residing permanently outside of the United States (e.g., retired individuals with Social Security benefits accrued), by the definition of Treasury Regulation Section 301.7701(b)-1(b), the recipients are not “nonresident aliens” but are rather “resident aliens.” Thus no U.S. withholding tax obligation arises on the U.S. payor in these circumstances where the foreign resident person satisfies the current regulatory rule of “lawful permanent residency.”

Should U.S. payors of FDAP income to persons residing overseas not be subject to the withholding tax requirements when the foreign resident person no longer has the right to live in the United States? This problem is compounded when the results of the U.S. Treasury Department’s study regarding tax compliance by U.S. citizens and lawful permanent residents residing overseas are considered.<sup>19</sup> In short, the government

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<sup>15</sup>See *Id.* footnote 14 and Appendix B to the Joint Committee on Taxation report.

<sup>16</sup> *Bowring v. Bowers*, 24 F.2d 918 (1928), *cert. denied*, 277 US 608 (1929).

<sup>17</sup> See I.R.C. Sections 871.

<sup>18</sup> See I.R.C. Sections 1441.

<sup>19</sup> See footnote 6.

found a very low compliance level (in large part because of the complexity of the law) for persons residing overseas. How many dollars of FDAP Income are sent annually overseas to these persons who have “lawful permanent residency” under the regulatory rule? How many of these dollars of FDAP Income are then reporting on a U.S. resident or non-resident (with a tax treaty position) tax return?

This problem is only compounded further, under the new FATCA rules that require the taxpayer and various other parties to provide documentation of the status of the taxpayer. Can the LPR who has no right to live in the U.S. provide a W-8 certifying themselves as a foreign person? Must they provide IRS Form W-9, certifying themselves as U.S. taxpayers (thus thwarting the payment of withholding taxes that are due, in addition to the new withholding tax regime under FATCA)?

### **III. Solution to the Crashing Head On Problem**

There is a relatively benign solution in the author’s viewpoint. The regulations could be harmonized with the immigration laws. If a non-U.S. citizen resides permanently outside the United States, so they no longer have the right, under immigration laws to live in the U.S., these persons should also not be considered U.S. “lawful permanent residents” for U.S. income tax purposes. The language of Section 301.7701(b)-1(b)) and the words “is deemed to continue” should be reconsidered and revised.

A mechanism could also be put into place, whereby a number of methods could be used to establish loss of “permanent resident status.” For instance, individuals could document and certify to the fact that they have no right to reside in the U.S under immigration laws and thus not be U.S. “resident aliens” for tax purposes. A certification regarding their permanent residence could be provided and filed with the non-U.S. citizen’s last resident U.S. income tax return and/or their first non-resident U.S. income tax return. Additionally, a method to strongly encourage foreign resident non-U.S. citizens to comply with the U.S. income tax law, could allow for U.S. payors of FDAP income (e.g., the Social Security Administration, U.S. Banks, etc.) to withhold tax under certain circumstances (e.g., when no U.S. address is provided for the foreign recipient and no certification of U.S. citizenship is received). IRS Form W-8BEN, etc. could be modified to incorporate a certification requirement on non-U.S. citizens residing permanently overseas with a green card, to include such a certification.

The principle benefit of this proposal is to provide consistency in the tax law with the immigration law to better enable the Service to enforce the collection of U.S. income taxes as they apply to foreign persons living outside of the United States.

#### IV. Conclusion

The current law (at least the regulatory definition) is inconsistent with immigration law as to who is determined to be a “lawful permanent resident.” Moreover, the unique consequence of the regulatory rule, which imposes U.S. taxation on the worldwide income of non-U.S. citizens (who live permanently outside the United States) is most possibly unconstitutional. This problem is only further exacerbated by the passage of FATCA. How can the U.S. federal government constitutionally exact U.S. taxation on the worldwide income of a non-U.S. citizen who permanently resides outside the United States and who has no lawful right to live or return to live in the U.S.?

The regulations can be modified slightly and a mechanism incorporated into the law whereby non-U.S. citizens who permanently reside outside the U.S. will have an affirmative duty of certification to avoid withholding tax on FDAP Income from U.S. sources. Finally, by bringing the immigration law in harmony with the tax law, the U.S. government will likely increase over-all tax receipts by collecting U.S. withholding taxes on FDAP income paid to persons who permanently reside overseas. Such an approach will compel better compliance with existing tax law, and put the onus on the foreign resident non-U.S. citizen to file U.S. tax returns to demonstrate they are indeed a “resident alien” and thus entitled to a refund of the 30 percent withholding tax.

In the meantime, until the law is modified or clarified, practitioners and especially taxpayers residing overseas with invalid green cards, should be aware that they are U.S. income tax residents (absent a tax treaty override) and should annually file U.S. income tax returns as if they were living in the United States.

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