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ASSESSMENT AND COLLECTION OF U.S. TAXES FROM NON-U.S. TAXPAYERS.

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* * * * * The U.S. Supreme Court once described the policy behind statutes of limitation as follows:

> [Congress has regarded it as] ill-advised to have an income tax system under which there would never come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest./1/

Section 6501(a) attempts to enforce that policy by providing as a general rule that the IRS has three years from the time a return is filed to assess ″any tax imposed by this title,″ which covers income, estate, gift, and excise taxes./2/ The statute of limitations on assessment may be extended to six years if the taxpayer omits more than 25 percent of its gross income from its return, or it may be extended indefinitely if no return is filed./3/ A federal tax lien arises against all ″property or rights to property″ belonging to the taxpayer, if those taxes go unpaid./4/ That lien gives the IRS the ability to levy on all amounts that third parties owe to the taxpayer./5/

Although the operation of those rules is relatively straightforward in the purely domestic setting, their application is less clear when the taxpayer is a non-U.S. person. For example, does the filing of IRS Forms 1042, ″Annual Withholding Tax Return for U.S. Source Income of Foreign Persons,″ and 1042-S, ″Foreign Person's U.S. Source Income Subject to Withholding,″ by a withholding agent constitute the filing of a ″return″ of the foreign person and therefore start the running of the general three-year statute of limitations on assessment regarding that foreign person? Does the statute of limitations on

assessment remain open for assessing tax against a withholding agent when no withholding return (Form 1042) has been filed, even though the non-U.S. payee's income tax liability cannot be assessed or collected because of the expiration of the statute of limitations on assessment or collection? Also, if the IRS does assess additional taxes against a foreign taxpayer that owns only foreign-situs assets, does the IRS have the ability to levy on those foreign-situs assets? This article will address those and other issues that arise in connection with attempts to assess and collect U.S. taxes from non-U.S. taxpayers./6/

Statute of Limitations on Assessment in General As noted above, section 6501(a) provides the general rule that "the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed." If the IRS fails to assess the tax within three years, it is not only prohibited from collecting the tax administratively by lien and levy, it is also barred from instituting a court proceeding for the collection of the tax after the three-year period on assessment expires./7/ The critical act that starts the statute of limitations on assessment is the filing of a "return," which for this purpose means "the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit)."/8/

There are several important exceptions to the general three-year statute of limitations. For one, the statute of limitations will be extended indefinitely if a taxpayer files a false return, engages in a willful attempt to evade tax, or files no return at all./9/ Another exception exists when a donor fails to report a gift, the value of which is required to be reported on a gift tax return, in which case the IRS may assess gift tax at any time, unless the donor has disclosed the item on a return or in a document attached to the return./10/

A further exception was added recently by the American Jobs Creation Act of 2004, P.L. 108-357. Under new section 6501(c)(10), the statute of limitations on assessment regarding a "listed transaction" that a taxpayer fails to disclose will not expire before one year after the earlier of (i) the date on which the secretary is furnished the information required under section 6011, or (ii) the date that a material adviser meets the requirements of section 6112 regarding a request by the secretary under section 6112 relating to the undisclosed listed transaction. Section 6707A(c)(2) defines a listed transaction as a reportable transaction that is the same as, or substantially similar to, a transaction identified by the secretary as a tax avoidance transaction for purposes of section 6011. *Rev. Proc. 2005-26, 2005-17 IRB 965,* 2005 WTD 69-12 or Doc 2005-7334, provides guidance for taxpayers that are subject to that provision.

Sections 6501(e)(1) and (2) also provide two very important provisions that extend the general three-year statute of limitations on assessment to six years in certain situations. Section 6501(e)(1) extends the statute of limitations on the assessment of income tax to six years if the taxpayer omits from gross income an amount "properly included therein" that is in excess of 25 percent of the amount of gross income stated in the return. Similarly, section 6501(e)(2) extends the statute of limitations on assessment of estate or gift tax to six years if the taxpayer omits from the gross estate or from the total amount of the gifts made during the period amounts in excess of 25 percent of the gross amount stated in the return. Neither of those provisions apply, however, if the particular item that is omitted is disclosed in a manner adequate to apprise the secretary of the nature and amount of such item.

What Constitutes a Return for Section 6501 Purposes? As previously indicated, the critical act that starts the running of the statute of limitations for purposes of section 6501 is the filing of a "return."/11/ Neither the code nor the regulations define what constitutes a return for that purpose. The Tax Court, however, has stated that a return, within the meaning of section 6501(a), is filed when the return (i) purports to be a return; (ii) evinces an honest and

reasonable attempt to satisfy the requirements of the tax; (iii) contains sufficient information to calculate the taxpayer's tax liability; and (iv) is executed by the taxpayer under penalties of perjury./12/ Therefore, the form or document need not state any amount due as tax or calculate any tax, provided that it contains all the data from which the tax could be computed and assessed./13/

As to non-U.S. taxpayers, one of the issues that arises is whether the filing of IRS Forms 1042 and 1042-S constitute the filing of a return for purposes of commencing the limitation on assessment against a non-U.S. taxpayer under section 6501(a). In general, non-U.S. taxpayers are subject to U.S. federal income tax on two categories of income: (i) certain passive types of U.S.-source income (for example, interest, dividends, rents, annuities, and other types of "fixed or determinable annual or periodical income," collectively known as FDAP), and (ii) income that is effectively connected to a U.S. trade or business (ECI)./14/ FDAP income is subject to a 30 percent withholding tax that is imposed on a foreign person's gross income/15/ (subject to reduction or elimination by an applicable income tax treaty) and ECI is subject to tax on a net basis at the graduated tax rates generally applicable to U.S. persons./16/

Forms 1042 and 1042-S are required to be filed whenever payments of U.S.-source FDAP income are made to non-U.S. taxpayers, regardless of whether those payments are exempt from U.S. withholding tax under a treaty or

code exception./17/ The person responsible for filing the Forms 1042 and 1042-S is the withholding agent (that is, the person required to withhold the tax), rather than the non-U.S. person itself.

In *ICI Pension Fund v. Commissioner, 112 T.C. 83,* Doc 1999-9072, 1999 WTD 45-44 (1999), the issue was whether the IRS was prohibited from assessing deficiencies against a non-U.S. pension fund more than three years after Forms 1042 and 1042-S were filed for U.S.-source payments made to that fund. ICI was a pension fund that had its principal office in London. For the tax periods at issue, ICI neither was engaged in a U.S. trade or business nor did it have any income that was effectively connected with a U.S. trade or business or that was attributable to a permanent establishment in the United States. During the 1991 and 1992 tax years, ICI received dividends on stock of U.S. corporations, resulting in U.S. federal income tax withholding of more than $ 1.5 million each year. The withholding agent timely filed Forms 1042 and 1042-S with the IRS on which it reported and withheld the proper amount of tax. Those forms required ICI to neither list its taxpayer identification number nor sign the forms under penalties of perjury. In 1992 and 1993, ICI submitted Forms 990-T to the IRS, claiming a refund of the taxes withheld in 1991 and 1992 on the grounds that it was a tax-exempt entity under section 501(c)(5). The IRS issued the refunds for both years. Later, however, the IRS determined deficiencies against ICI for 1991 and 1992. Although ICI conceded it was not a tax-exempt organization, it argued that the IRS was prohibited from assessing tax against it for those years.

Specifically, ICI argued that the assessment for 1991 was time-barred because the IRS issued the deficiency notice more than three years after the withholding agent filed the Form 1042 for that year. The Tax Court rejected that argument, reasoning that ICI was the ″taxpayer″ for purposes of section 6501(a), but that the withholding agent's Form 1042 was not ICI's ″return.″ In fact, the court stated that the Form 1042 did not even constitute a return for purposes of section 6501 because it did not set forth sufficient information to allow the IRS to determine ICI's liability, and because it wasn't signed by ICI or its trustee under penalties of perjury. As a result, the Tax Court held that the IRS was not time-barred from assessing taxes against ICI for the years at issue./18/

The ICI decision is interesting because non-U.S. taxpayers generally are not required to file U.S. federal income tax returns to the extent that their U.S. federal income tax liability is fully satisfied by

way of withholding./19/ Originally, when ICI received the dividend payments, the withholding agent withheld the proper amount of tax and therefore ICI was not required to file a U.S. federal income tax return. However, because ICI requested and received a refund of the taxes that were withheld, ICI was no longer subject to the general rule that non-U.S. taxpayers are not required to file U.S. federal income tax returns when their taxes are fully satisfied by way of withholding./20/ It was that fact that caused ICI to be subject to the unlimited statute of limitations under section 6501(c)(3) and allowed the IRS to assess taxes against ICI, rather than against the withholding agent, which is usually the case regarding U.S.-source payments of FDAP income.

Another issue that commonly arises regarding the statute of limitations on assessment of taxes against non-U.S. taxpayers is whether a ″protective return″ constitutes a valid return for purposes of the period of limitations on assessment under section 6501(a). That issue arises because, unlike a typical tax return filed by a non-U.S. taxpayer engaged in a U.S. trade or business, a protective return generally does not contain information on cost of goods sold and deductible expenses that is necessary to compute the taxpayer's effectively connected taxable income.

In particular, non-U.S. taxpayers whose U.S. activities give rise to income effectively connected to a U.S. trade or business (for example, ECI) are subject to U.S. federal income on that income on a net basis at the graduated tax rates generally applicable to U.S. persons. Unlike FDAP income, which is subject to a 30 percent withholding tax on a gross basis, non-U.S. taxpayers are allowed to deduct expenses that are allocable to ECI. A foreign taxpayer, however, is entitled to the benefit of deductions and credits only if it timely files, ″in the manner prescribed in subtitle F, a true and accurate return of its taxable income which is effectively connected″ with the conduct of a trade or business in the United States./21/ If a foreign taxpayer determines that its activities do not give rise to gross income that is ECI, it may nevertheless file a return on a timely basis and thereby protect its right to receive the benefit of the deductions and credits attributable to that gross income if it is later determined that the original determination was incorrect./22/ If such a protective return is filed, the foreign taxpayer is not required to report any gross income as effectively connected or any deductions or credits, but it should attach a statement indicating that the return is being filed to protect the corporation's right to deductions and credits./23/

In FSA 3809 (June 11, 1996), the primary issue was whether a protective return filed by a Canadian corporation that sold goods in the United States constituted a return for purposes of section 6501(a) and therefore began the three-year statute of limitations. The IRS ruled that it did, stating that if the protective return did not constitute a return for purposes of section 6501(a), it would, in effect, ″make compliance with section 1.882-4(a)(3)(iv) a trap for the un-

wary, so that following the explicit requirements set forth in that regulation . . . would cause a taxpayer to fail to comply with another provision of the Code." According to the IRS, that would not only subject the taxpayer to an unlimited period of limitations for assessment, but also could cause the taxpayer to be subject to penalties under section 6651 for failure to file a return.

The IRS also reasoned that the court decisions that discuss the general requirements for what constitutes a return for purposes of section 6501(a) do not take into account the specific return requirements for foreign corporations set forth in subtitle F of the code and regulations thereunder; namely, that if the foreign corporation has no gross income for the tax year, it is not required to complete the Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation," return schedules, but instead must attach a statement to the return indicating the nature of any exclusions claimed and the amount of those exclusions to the extent those amounts are readily determinable./24/ Based on those factors, the IRS ruled that it did "not believe that a successful argument can be made that protective returns that satisfy the requirements of section 1.882-4(a)(3)(iv) . . . are not returns for purposes of starting the Section 6501(a) period of limitations."/25/

Although only a field service advice (FSA), that ruling is significant for non-U.S. taxpayers that conduct limited activities in the United States and are attempting to preserve their right to claim deductions and credits should the IRS determine that those activities amount to a U.S. trade or business. That is especially true in light of the final regulations under section 1.882-4(a)(3), which appear to deny deductions and credits if protective returns are not filed in a timely manner, which was not always the case./26/

When Will the Three-Year Statute Be Extended? As noted above, section 6501(e)(1) provides that if a taxpayer omits more than 25 percent of its gross income from an income tax return, the IRS has six years from the filing of that return to assess tax or to begin a proceeding in court to collect the tax without assessment. When attempting to apply the six-year statute of limitations, the IRS must prove by a preponderance of the evidence that the rule applies./27/ For purposes of that rule, however, items that are omitted from a taxpayer's return will not be taken into account if the corresponding amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the IRS of the nature and amount of the item.

In the context of U.S.-source payments of FDAP income to non-U.S. taxpayers, the question has arisen whether the special six-year period of limitation for assessment, in section 6501(e)(1), applies when a withholding agent omits from the Form 1042 items of gross income paid to nonresident aliens and those omissions exceed 25 percent of the amount shown on the Form 1042. In *Northern Indiana Public Service Co. v. Commissioner, 101 T.C. 294,* Doc 93-10593, 93 TNI 196-29 (1993), the taxpayer was a U.S. corporation that wholly owned a foreign subsidiary in the Netherlands Antilles. The foreign subsidiary made interest payments attributable to Euronote obligations issued to non-U.S. taxpayers. The IRS determined that the foreign subsidiary was inadequately capitalized and therefore treated the U.S. corporate parent as making the interest payments. As a result, the IRS held that the U.S. corporate parent was liable for the 30 percent withholding tax under section 1441 for the tax years 1982 through 1985.

While the taxpayer filed Forms 1042 and 1042-S for the years at issue on which it reported amounts paid to non-U.S. taxpayers, the taxpayer failed to include the interest payments that were attributable to the bondholders of the Euronotes. The taxpayer conceded that the amount of those interest payments was in excess of 25 percent of the amount of "gross income paid" that was stated on the Form 1042, but argued that the IRS was prohibited in 1989 from assessing tax attributable to the 1982 interest payments because the general three-year statute of limitations on assessment had expired./28/ The IRS contended that the six-year statute of limitations on assessment was applicable and, therefore, it had the authority to assess those taxes. More specifically, the taxpayer as the withholding agent argued that the six-year period for assessment of tax under section 6501(e) did not apply to its Form 1042, because the Form 1042 "is a tax return designed to report . . . withholding tax liability on amounts paid to foreign persons" rather than gross income, and section 6501(e) pertains only to gross income received by a taxpayer. The Tax Court rejected that argument, holding that section 6501(e) applies to Form 1042 because that section states that it applies "in the case of any tax imposed by subtitle A," which includes sections 1441 and 1442. The Tax Court also noted that *reg. sections 301.6501(e)-1(a)(1)(i)* refer to "a return of a tax imposed by subtitle A," which includes Form 1042. The Court quoted *Colony Inc. v. Commissioner, 357 U.S. 28, 36 (1958),* in which the Supreme Court held that the predecessor of section 6501(e) was enacted:

> [T]o give the Commissioner an additional two years [now three] to investigate tax returns in cases where, because of the taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item.

Accordingly, the court in Northern Indiana applied the six-year statute of limitations to assess taxes against the withholding agent despite the fact that the taxes were borne economically by the non-U.S. taxpayers, who either re-

ported the full amount of gross income on a timely filed U.S. tax return or were not required to file a U.S. tax return because their tax liability was fully satisfied by way of withholding. Query whether the result would have been the same if the payments the withholding agent omitted were not even gross income to the non-U.S. taxpayers, in the first instance.

That issue arose in 1997 FSA Lexis 205 (June 26, 1997). In that FSA, a German corporation owned a percentage of the stock of a U.S. corporate subsidiary. The U.S. sub transferred its interest in certain European subsidiaries to the German shareholder and simultaneously declared a dividend in the amount of the aggregate value of the interests transferred. At the time of the distribution, the U.S. sub had no current or accumulated earnings and profits. Also, the ″dividend″ that was paid did not exceed the German shareholder's basis in the U.S. sub's stock. Accordingly, the distribution constituted a nontaxable return of capital./29/

The U.S. subsidiary timely filed for the year at issue a Form 1042 reporting payments to foreign persons but failed to report the distribution to the German shareholder. The normal three-year statute of limitations on assessment for that return under section 6501(a) had expired. Subsequently, a Form 872 was executed to extend the statute of limitations to six years under section 6501(e). The taxpayer argued that the distribution was not income, because it was not a dividend (that is, the taxpayer had no earnings and profits) and therefore there was no income item to withhold on and to report on Form 1042. As a result, the taxpayer contended that there was no 25 percent omission of gross income from the Form 1042 that would cause the six-year statute of limitations on assessment to apply.

The IRS disagreed, stating that the purpose behind section 6501(e), as described by the Supreme Court in Colony Inc., is relevant to the taxpayer's omission in the FSA as well as the omission of the taxpayer in Northern Indiana. Namely, the IRS is subject to the same special disadvantage in detecting errors: In neither case does the return on its face provide a clue to the existence of the omitted item. In other words, the IRS contended that the concerns behind section 6501(e) are similar to the concerns behind *reg. section 1.1441-3(b)*: Corporate distributions are treated as if they are taxable dividends subject to withholding and reporting on Form 1042 because otherwise the IRS would be specially disadvantaged in detecting the payment, determining its taxability, and collecting any tax that might be due. Therefore, the IRS ruled that the six-year statute of limitations on assessment applied.

That ruling demonstrates the IRS's broad interpretation as to what constitutes an omission from gross income for purposes of section 6501(e) and appears to be the wrong result. It is difficult to imagine a court agreeing that an omission of gross income includes a payment that does not even constitute ″gross income″ under the code./30/ The IRS seemed to acknowledge that fact when it stated that ″sections 881 and 1442 impose tax on gross income, and section 6501(e) also relates to omissions of gross income. Because the distribution . . . was not in fact gross income, there are litigating hazards with respect to this issue.″ The IRS also indicated that it is ″questionable″ whether any penalties would apply in the situation because, if the taxes were assessed and paid now, the shareholder would be entitled to a refund./31/

A more complicated issue has arisen whether the unlimited statute of limitations under section 6501(c)(3) will apply for issuing a notice of deficiency to a U.S. subsidiary that fails to withhold tax and timely file a Form 1042, if the withholding tax liability arises from a section 482 adjustment to the subsidiary's income, the tax on which cannot be assessed or collected because of the expiration of the statute of limitations under section 6501(a). In 1997 FSA Lexis

518, a federal income tax examination of a U.S. subsidiary's Form 1120 resulted in an allocation of income to that subsidiary from its Japanese parent under section 482./32/ That income allocation caused an increase in the subsidiary's earnings and profits and resulted in a ″conforming″ section 482 adjustment that was treated as a dividend by the subsidiary to the parent./33/ The IRS's position was that this dividend was subject to withholding tax and, because no Forms 1042 were filed by the subsidiary for the years at issue, the unlimited statute of limitations on assessment applied for those years. The IRS stated, however, that the subsidiary did not have sufficient earnings and profits to cause the distribution to be characterized as a dividend to the parent without the section 482 adjustment, and the IRS was prohibited from assessing the income tax on the income resulting from the section 482 adjustment to the subsidiary because of the expiration of the three-year statute of limitations.

Accordingly, the issue was whether the statute of limitations for issuing a notice of deficiency relating to the subsidiary's withholding tax liability on its Forms 1042 remained open, despite the fact that assessment and collection of the taxpayer's income tax liability on its Forms 1120 were barred by the statute of limitations. Somewhat surprisingly, the IRS ruled that the statute of limitations concerning the withholding tax liabilities did remain open./34/

The IRS based its determination on the premise that the income tax liability of a recipient of income is separate

and distinct from the liability of a withholding agent. That analysis is consistent with the Tax Court's holding in S.K. Liquidating Co. v. Commissioner, 64 T.C. 713, 716 (1975), where the court held that "the two statutory notices of deficiency (one with respect to the withholding agent and the other with respect to the non-U.S. payee) . . . are based on two separate returns, the returns cover different taxable periods, and the asserted liabilities originate from taxes enacted for different purposes."/35/ Nevertheless, the IRS's analysis appears to contradict the Interstate Fire Insurance Co./36/ decision. In circumstances different from those at issue in the FSA, the Sixth Circuit held "as a general rule the use and application of Section 482 does not result in an enforceable tax consequence until there has been a reallocation resulting in a reassessment of taxes." In the FSA, it would not have been possible for the IRS to assess taxes on the subsidiary's income resulting from the section 482 adjustment because the statute of limitations on assessment against the subsidiary was time-barred. In light of that factor and the possibility of litigation, the IRS recommended that the field agent "continue to coordinate with the National Office."

Foreign Partners in U.S. Partnerships Similar statute of limitations questions arise in the context of foreign partners in U.S. partnerships that are engaged in a U.S. trade or business. Under section 1446, a partnership (whether domestic or foreign) engaged in a U.S. trade or business during the tax year is required to withhold tax on a foreign partner's share of effectively connected taxable income. Those withholding rules require the partnership to make quarterly payments of withholding tax based on the estimated amount of effectively connected taxable income./37/ Each foreign partner is allowed a credit for its share of the withholding tax paid by the partnership. Those withholding taxes are required to be reported on IRS Form 8804, which is separate and apart from the Form 1065, the partnership's annual information return.

Like section 6501(a), section 6229(a) provides the general rule that the IRS has three years from the date a partnership files the Form 1065 to assess additional taxes against the partners of that partnership if the assessment is attributable to a partnership item./38/ In the case of a failure by the

partnership to file a return, the tax attributable to the partnership item can be determined at any time./39/ Also, if any partnership omits more than 25 percent of its gross income from the Form 1065, the general three-year statute of limitations on assessment is extended to six years./40/

Regarding foreign persons who are partners in U.S. partnerships that are engaged in a U.S. trade or business, the issue has arisen whether the statute of limitations for making assessments under section 6229 is controlled by the filing of Form 1065 by the partnership or by the filing of Form 8804, the form required to report and pay the withholding tax imposed under section 1446. In 1993 FSA Lexis 69, a foreign corporation was the general partner, and two foreign individuals were the limited partners in a domestic limited partnership that was engaged in a U.S. trade or business. The partnership timely filed Forms 1065 for the years at issue but failed to file Forms 8804, reporting the withholding tax liabilities under section 1446. The issue was whether the IRS was prohibited from assessing the withholding tax against the partnership because it had been more than three years since the partnership filed the Form 1065.

The IRS ruled that the period of limitation for assessing section 1446 withholding tax does not expire before the date that is the later of three years from the date on which the Form 8804 is filed or the last day for filing that return, without regard to extensions. Citing reg. section 301.6501(b)-1(b), the IRS noted that the annual return required under section 1446 (that is, Form 8804) is separate from the Form 1065 and the attachments thereto, and is not to be filed as part of the partnership's Form 1065. As a result, when no Form 8804 is filed, the period of limitations will remain open and the withholding taxes may be assessed at any time./41/ That ruling is not surprising as it is consistent with the general rule espoused by the Tax Court in S.K. Liquidating Co. that the tax return of the withholding agent (that is, the partnership) is different from the tax return of the recipient of the income (that is, the foreign partners).

Can the Taxes Be Collected Once Assessed? Although many of the cases and rulings discussed above generously interpret the statute of limitations on assessment provisions in favor of the IRS, as a practical matter it may not always be possible for the IRS to collect the taxes even if they are assessed. Once an assessment has been made against a taxpayer, the IRS is required to give the taxpayer notice of the assessed amount and demand payment within 60 days./42/ If the taxpayer fails to pay the assessed amount after notice and demand for payment, the federal tax lien arises under section 6321. That federal tax lien attaches to property wherever situated, including foreign-situs property./43/ The code, however, does not provide the IRS with express statutory authority to take administrative collection action against foreign-situs property. Accordingly, absent a collection assistance treaty provision, the IRS must pursue judicial collection remedies. While judicial efforts to collect U.S. federal taxes by levy on U.S.-situs assets of a non-U.S. taxpayer should not prove to be very difficult,/44/ the same cannot be said when a non-U.S. taxpayer has assets located outside the United States. For example, in United States v. Omar, S.A.,/45/ the IRS attempted to prevent a U.S. bank from making payments from an account located in its foreign branch on behalf of Omar, S.A., a Uruguayan corporation. After the IRS started to investigate potential personal holding company tax liabilities of Omar, the corporation's lawyers warned the IRS that if it continued to try to assess the taxes, the corporation would expatriate all of its U.S. holdings, thereby removing them from the IRS's power to levy.

As soon as Omar began to liquidate certain holdings and expatriate the receipts, the IRS issued a jeopardy assessment, served notice of lien and levy on the bank, and sued in federal district court to restrain the bank from removing Omar's assets outside of the United States. The U.S. District Court

for the Southern District of New York immediately granted a temporary restraining order as well as a preliminary injunction to prevent the bank from transferring Omar's property outside the United States.

The appellate court phrased the issue as whether the bank held property of Omar that was subject to the jurisdiction of the district court. After examining New York's banking laws, the Second Circuit found that no obligation existed between the bank's main office and its subsidiary branches and therefore a claim against the branch bank was not collectible against the parent bank in New York. Accordingly, the bank had no property to which the tax lien could attach./46/

The U.S. Supreme Court, however, reversed the Second Circuit, but limited the issue to whether the United States could, by injunction, protect any rights it might have against a bank over which the district court had personal service. The Court stated that, while the foreign branch was not fully obligated to make payments to the New York bank, the latter was required by federal banking law to maintain sufficient control over its branches. As a result, the Supreme Court found that the district court had jurisdiction to issue an injunction "to prevent further dissipation of assets."/47/

The issue becomes even more complex when the IRS attempts to collect assessed taxes through a foreign court, regardless of whether the taxpayer's obligation is first reduced to a judgment in a U.S. court. In United States v. Harden,/48/ the IRS brought an action in a U.S. district court to collect income taxes allegedly due from the taxpayer. After the U.S. district court entered a judgment against the taxpayer for a portion of the taxes in question, the IRS brought suit in the courts of British Columbia to enforce the judgment of the U.S. district court. The taxpayer attempted to have the action set aside for lack of jurisdiction. The trial judge and the Court of Appeals for British Columbia held that the IRS could not use Canadian courts to enforce a tax assessment, even if reduced to judgment, and ordered the writ set aside. The Court of Appeals stated "[t]here is a well recognized rule, which has been enforced for at least 200 years or thereabouts, under which these Courts will not collect the taxes of foreign States for the benefit of the sovereigns of those foreign States; and this is one of those actions which these Courts will not entertain."/49/ That decision was later affirmed by the Supreme Court of Canada. Harden demonstrates the difficulties the IRS likely would encounter in trying to enforce its tax claims through the courts of a foreign jurisdiction.

Based on those decisions, it appears that the IRS's best opportunity to collect U.S. taxes from a non-U.S. taxpayer would be under a collection assistance provision contained in a U.S. tax treaty. In general, there are two types of collection assistance provisions in U.S. tax treaties: (i) "narrower purpose provisions" and (ii) "broader purpose provisions." The majority of the income tax treaties concluded with the United States contain the narrower purpose clause, which are basically designed to ensure that the tax treaty benefits are enjoyed only by those entitled to them, and therefore function primarily as antiabuse provisions. The typical narrower purpose collection assistance provision reads as follows:

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(1) Each of the Contracting States shall endeavor to collect on
the behalf of the other Contracting State such amounts as may
be necessary to ensure that relief granted by the present
Convention from taxation imposed by such other Contracting
State does not inure to the benefit of persons not entitled
thereto.
 (2) This paragraph shall not impose upon either of the
Contracting States the obligation to
carry out administrative measures that would be contrary to its
sovereignty, security or public policy./50/
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The second category of collection assistance provision (the broader purpose provision) found in U.S. tax treaties serves a much different function from the narrower purpose one. The former obligates the contracting states to lend assistance and support to each other in collecting taxes to which the treaty applies, without regard to the limited antiabuse purpose. Only five U.S. income tax treaties contain such a provision -- those with Denmark, France, Canada, the Netherlands, and Sweden. Similarly, only five U.S. estate and/or gift tax treaties contain similar provisions -- those with Finland, France, Greece, Italy, and South Africa.

The typical broader purpose provision provides, in relevant part, that:

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(1) The Contracting States undertake to lend assistance and
support to each other in the collection of the taxes to which
this Convention applies (together with interest, costs, and
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additions to the taxes and fines not being of a penal character) in cases where the taxes are definitively due according to the laws of the State making the application.

(2) Revenue claims of each of the Contracting States which have been finally determined will be accepted for enforcement by the State to which application is made and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes.

(3) If the revenue claim has not been finally determined, the State to which application is made will take such measures of conservancy (including measures with respect to transfer of property of nonresident aliens) as are authorized by its laws for the enforcement of its own taxes./51/

Given that only five income tax treaties and five estate and/or gift tax treaties contain such a provision, it is not surprising that there have been very few reported decisions interpreting them. In the only domestic case on the subject, *Miller v. United States, 955 F. Supp. 795,* Doc 96-31715, 96 TNI 238-20 (N.D. Ohio 1996), U.S. District Court upheld an IRS treaty collection request to the Dutch government, which resulted in the seizure of the taxpayer's assets held in a bank safe deposit box in the Netherlands./52/ Despite that decision, because of the relatively few treaties that contain broader purpose collection assistance provisions and the lack of favorable case law supporting the IRS in its extraterritorial enforcement and collection efforts, the IRS may be facing an uphill battle when it comes to collecting U.S. taxes that have been assessed against non-U.S. taxpayers.

Conclusion

Assessment and collection of U.S. taxes from non-U.S. taxpayers requires special consideration of the interplay between the agency role and the taxpayer role, as well as treaty considerations. If the non-U.S. taxpayer timely files a U.S. tax return itself, the normal statutes of limitation on assessment and collection are likely to apply. If, however, the return is only that of a withholding agent, the normal three-year or six-year statute of limitations on assessment may or may not apply, with special rules regarding claims for refund, protective returns, and situations in which nontaxability of the amounts in issue may also be involved. Foreign persons who are partners in U.S. partnerships must also make special efforts to insure that both partnership income tax returns and withholding tax returns are timely filed. Collection of taxes by levy or judicial proceedings, including injunctive relief, raises further obstacles and may involve resorting to tax treaties, albeit limited in both number and scope. Taxpayers are well-advised to look at the issues in the broadest context because relief is otherwise elusive, the legal issues expensive to resolve, and exposure to penalties significant.

FOOTNOTES

/1/ *Rothensies v. Electric Storage Battery Co., 329 U.S. 296 (1946), 1947-1 C.B. 109.*

/2/ Section 6511 provides that taxpayers are limited to three years from the time a return is filed or two years from the time the tax is paid, whichever is later, to file a claim for refund. All section references are to the U.S. Internal Revenue Code of 1986, as amended, or the regulations promulgated thereunder.

/3/ Sections 6501(e)(1), (c)(3).

/4/ Section 6321.

/5/ Section 6331. That assumes that the 10-day "notice and demand" provisions in section 6331(a) are satisfied.

/6/ For purposes of this article, a non-U.S. taxpayer refers to a person other than a U.S. person. Therefore, in the context of individuals it refers to someone who is neither a U.S. tax resident nor a U.S. citizen, and in the context of corporations it refers to an entity that is formed outside of the United States. See sections 7701(a)(30) and (a)(4).

/7/ Section 6501(a) provides that "no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period."

/8/ This provision was added in 1997 in response to *Bufferd v. Commissioner, 506 U.S. 523,* Doc 93-1222, 93 TNT 19-17 (1993), where the U.S. Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date of the filing of the shareholder's return, not the S corporation's return.

/9/ Sections 6501(c)(1), (2), and (3), respectively.

/10/ Section 6501(c)(9).

/11/ In general, a return is considered filed when it is mailed. Section 7502(a)(1).

/12/ See *Beard v. Commissioner, 82 T.C. 766, 777 (1984),* aff'd *793 F.2d 139 (6th Cir. 1986),* where the Tax Court summarized the tests articulated in *Florsheim Bros. Dry Goods v. United States, 280 U.S. 453 (1930); Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934);* and *Badaracco v. Commissioner, 464 U.S. 386 (1984).*

/13/ *Germantown Trust Co. v. Commissioner, 309 U.S. 304, 308 (1940).*

/14/ Sections 871(a) and (b).

/15/ Sections 1441 and 1442.

/16/ Sections 871(b) and 882(a).

/17/ *Reg. sections 1.1461-1(b)* and (c).

/18/ See also *Unilever Superannuation Trustees Ltd. v. Commissioner, T.C. Memo. 1999-67,* Doc 1999-9086, 1999 WTD 45-45, which was factually identical to the ICI case, and *Holstrom v. Commissioner, 35 B.T.A. 1092 (1937),* and *Cantrell & Cochrane Ltd. v. Commissioner, 19 B.T.A. 16 (1930),* both of which involved similar issues.

/19/ *Reg. section 1.6012-1(b)(2)*.

/20/ See *reg. section 1.6012-1(b)(2)*, which specifically provides that "[t]his subdivision does not apply to . . . a non-resident alien individual making a claim . . . for the refund of an overpayment of tax."

/21/ *Reg. section 1.882-4(a)(2)*.

/22/ *Reg. section 1.882-4(a)(3)(iv)*.

/23/ Id.

/24/ *Reg. section 1.6012-2(g)(1)(i)*.

/25/ It is also interesting to note that the IRS ruled in CCA 200317021, Doc 2003-10421, 2003 WTD 82-14, that a non-U.S. taxpayer who incorrectly files a Form 1040, as opposed to a Form 1040NR, would nevertheless be considered as filing a "return" for assessment purposes. Moreover, in CCA 200251013, Doc 2002-27813, 2002 TNT 246-43, the IRS ruled that a Form 1040NR with a taxpayer identification number different from that of the Form 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax," constituted a valid return for purposes of the statute of limitations on assessment under section 6501.

/26/ See the preamble to the regulations under section 1.882-4(a)(3), in which the IRS asserted that the statute "clearly provides for the denial of deductions and credits if returns are not filed in a timely manner." *1990-2 C.B. at 172.* That is inconsistent with the prior case law in this area in which the courts did not impose a timeliness requirement for a foreign taxpayer to receive the benefit of deductions and credits. See *Anglo-American Direct Tea Trading Co. v. Commissioner, 38 B.T.A. 711 (1938),* nonacq. 1939-1 C.B. 39; Mills, Spence & Co. v. Commissioner, 1938 B.T.A.M. par. 38,342.

/27/ *Armes v. Commissioner, 448 F.2d 972 (5th Cir. 1971); Phillip Bros. Chemicals Inc. v. Commissioner, 52 T.C. 240 (1969),* aff'd *435 F.2d 53 (2d Cir. 1970).*

/28/ Form 1042S requires taxpayers to state "Gross income paid." The amount listed on Form 1042S is transferred to line 16 of Form 1042, which is labeled "Gross amount paid."

/29/ Section 301(c).

/30/ Cf. *United States v. D'Agostino, 145 F.3d 69,* Doc 98-14943, 98 TNT 91-17 (2d Cir. 1998) (taxpayers could not be found guilty of tax evasion for failing to report as constructive dividends certain unlawfully diverted corporate funds because the corporation had no earnings and profits and therefore the shareholders did not fail to report any "gross income").

/31/ *Reg. section 1.1441-3(b)(1)* requires tax to be withheld on the gross amount of any distribution made by a corporation other than a nontaxable distribution payable in stock or stock rights or a distribution that is treated as a distribution in part or full payment in exchange for stock. Other than those two exceptions, withholding is required re-

gardless of whether the distribution is taxable under section 871 or 881. The payee's only recourse is to file a claim for refund.

/32/ Section 482 provides the commissioner broad authority to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among controlled parties to prevent evasion of taxes or to clearly reflect income.

/33/ When the IRS makes an allocation of income under section 482, appropriate collateral adjustments will also be made regarding other members of the group affected by the allocation. See generally *reg. section 1.482-1(g)*. Thus, for example, when the IRS makes a primary allocation that increases the income of one member of the group, it must also make a correlative allocation that decreases the income of the other affected member(s). See *reg. section 1.482-1(g)(2)*. Also, as provided by *reg. section 1.482-1(g)(3)*, certain other adjustments (referred to as conforming adjustments) must be made to conform taxpayers' accounts to reflect the section 482 allocation.

/34/ See, however, *FSA 200223021,* Doc 2002-13631, 2002 WTD 117-30 (Feb. 26, 2002), where the IRS ruled that a section 482 conforming adjustment that was negotiated as part of a closing agreement under *Rev. Proc. 65-17, 1965-1 C.B. 833,* was not considered an omission from gross income in determining whether there was a greater-than-25-percent omission from the gross income stated on a Form 1042.

/35/ See also *Rev. Rul. 75-552, 1975-2 C.B. 476,* where the IRS ruled that the 30 percent withholding tax imposed by section 1441 is a separate and distinct tax from the income tax imposed by section 11.

/36/ *Interstate Fire Insurance Co. v. United States, 215 F. Supp. 586, 598 (E.D. Tenn. 1963),* aff'd *339 F.2d 603 (6th Cir. 1964).*

/37/ Prop. reg. section 1.1446-3(b); *Rev. Proc. 89-31, 1989-1 C.B. 895.*

/38/ A partnership item is defined as any item required to be taken into account for the partnership's tax year if that item is more appropriately determined at the partnership level than at the partner level. Section 6231(a)(3).

/39/ Section 6229(c)(3).

/40/ Section 6229(c)(2).

/41/ See also 1995 FSA Lexis 456, where a similar issue arose. Issues involving U.S. partnerships that have a principal foreign situs but receive U.S.-source income would appear to involve similar issues.

/42/ Section 6303.

/43/ *In Re Guyana Development Corporation v. United States, 96-1 U.S. Tax Cas. (CCH) P50,061.*

/44/ See *United States v. Rexach, 390 F.2d 631 (1st Cir. 1968),* cert. denied *393 U.S. 833* (First Circuit allowed the IRS to assess and collect taxes against U.S.-situs assets owned by a former U.S. citizen).

/45/ *210 F. Supp. 773 (S.D.N.Y. 1962),* rev'd sub nom. *United States v. First National City Bank, 321 F.2d 14 (2d Cir. 1964),* rev'd *379 U.S. 378 (1965).*

/46/ It should be noted that there is a special rule for levies on banks that have foreign branches and are engaged in business in the United States or in U.S. possessions. Under that rule, deposits held by the foreign branches are not subject to levy unless the notice of levy specifies that the IRS intends to reach the foreign deposits. Moreover, the notice of levy cannot specify that intention unless (i) the IRS believes that the taxpayer is within the jurisdiction of a U.S. court and also believes that the foreign branch possesses deposits of the taxpayer, or (ii) the IRS believes that the taxpayer is not within the jurisdiction of a U.S. court; the foreign branch possesses the taxpayer's deposits; and the deposits were transferred from a U.S. branch to a foreign branch to hinder or delay collection of tax. *Reg. section 301.6332-1(a)(2)*.

/47/ See also *United States v. Montreal Trust Co., 235 F. Supp. 345 (S.D.N.Y. 1964),* rev'd *358 F.2d 239 (2d Cir. 1966),* cert. denied *384 U.S. 919 (1966),* where the IRS attempted to attach foreign-situs assets owned by a nonresident alien decedent through a U.S. court. The Second Circuit, in reversing the district court, held that the decedent had engaged in sufficient business activity in New York, through his "agents," to be served under the state's long-arm statute.

/48/ 63-1 USTC Para. 9217 (C.A. Brit. Col. 1962), aff'd 12 AFTR 5736 (Sup. Ct. Can. 1963).

/49/ 63-1 USTC para. 9217, at 87,438.

/50/ Article 26 of the U.S. model income tax treaty. Nontax treaty issues are beyond the scope of this article.

/51/ Article 28 of the France-U.S. income tax treaty.

/52/ See also *United States v. Van Der Horst, 270 F. Supp. 365 (D. Del. 1967),* where the court held that the requirements of the former collection assistance provision of the Netherlands-U.S. income tax treaty were not satisfied and therefore the provision did not apply.

END OF FOOTNOTES