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United States – Individual Not Required to File FBAR Under U.S.-Mexico Treaty

On November 20, 2023, the U.S. District Court for the Southern District of California ruled in *Aroeste v. United States*[1] that an individual who holds a U.S. green card but lives in Mexico can determine his residency under the residency tie-breaker provisions of the U.S.-Mexico income tax treaty so as to be treated as a U.S. nonresident and, as result, is not required to file a *Report of Foreign Bank and Financial Accounts* ("FBAR") for the years at issue. The court also ruled that the fact that he did not originally make the treaty tie-breaker claim on a timely-filed return did not preclude him from being treated as a U.S. nonresident.

WHY THIS MATTERS

This case represents a significant win for the taxpayer, who would have been liable to pay penalties for his failure to file FBARs for the years in issue if he had not prevailed on the treaty residency issue. It opens the possibility that U.S. green card holders living in other countries that have income tax treaties with the United States could also invoke this treaty benefit so as not to be required to file FBARs. It should be noted, however, that the government could appeal the decision in this case to the Ninth Circuit Court of Appeals, which could reverse the decision and reinstate the FBAR filing requirement for this taxpayer and the resulting penalties.

Background

The taxpayer, Mr. Aroeste, is a Mexican citizen who has lived in Mexico his whole life. He obtained a U.S. green card in 1984. His wife became a U.S. naturalized citizen in 2011. The couple owns a condominium in Florida, but used this only for vacation purposes. Mr. Aroeste has always filed his Mexican tax returns as a resident of Mexico.

During the tax years in issue (2012 and 2013) Mr. Aroeste held five financial accounts in Mexico with an aggregate balance in excess of $10,000. These accounts would be reportable on an FBAR if he met the definition of a "United States person" for 2012 and 2013. His tax returns for those years were initially filed as a U.S. resident, with a filing status of married filing jointly, but no FBARs reporting his Mexican financial accounts were filed for these years. In 2016, however, he submitted purported corrected income tax returns for 2012 and 2013, using a filing status of married filing separately and claiming to be a nonresident of the United States pursuant to the tie-breaker provisions of the U.S.-Mexico income tax treaty.[2] He attached Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, to these returns. He subsequently filed original tax returns for tax years 2015 through 2021 on which he also claimed to be a nonresident of the United States pursuant to the U.S.-Mexico income tax treaty.

In May 2020, the U.S. Treasury assessed $50,000 in FBAR penalties against Mr. Aroeste for both 2012 and 2013, totaling $100,000. He paid $3,004 towards these penalties and the government, after applying mitigation, asserts that he continues to owe $21,852. Mr. Aroeste sued to recoup the $3,004 penalty payment and discharge the outstanding liability. The government counter-claimed to recover the balance of unpaid penalties. Both parties filed motions for summary judgment.

The Court's Decision

The parties to the litigation agreed that the issue for the court to decide was whether Mr. Aroeste was a "United States person" and thus required to file FBARs, for 2012 and 2013. Mr. Aroeste asserted he ceased to be a U.S. resident under the U.S.-Mexico income tax treaty and was instead treated as a resident of Mexico. The government asserted Mr. Aroeste was a United States person and he failed to assert the treaty position until he was audited years after he could legally claim that position.

The court noted that the FBAR statutory rules require every United States person who has a financial interest in, or signature authority over, a foreign financial account to report the account annually to the IRS on an FBAR.[3] This reporting requirement applies for any year in which the maximum aggregate balance of all the foreign financial accounts exceeds $10,000 at any time during the calendar year.

The court then cited the definition of a "United States person" in the FBAR regulations, which includes a "resident of the United States," which in turn is defined to include any individual who is a resident alien under section 7701(b) the Internal Revenue Code (I.R.C.) and the regulations thereunder.[4] Thus, the FBAR regulations incorporate by reference the definition of a resident individual used for income tax purposes. Under this definition, any individual who is a lawful permanent resident (i.e., a green card holder) is a resident of the United States. However, an individual ceases to be treated as a lawful permanent resident if he or she commences to be treated as a resident of a foreign country under the provisions of an income tax treaty between the United States and a foreign country, does not waive the benefits of such treaty, and notifies the IRS of the commencement of such treatment.[5]

Having reviewed the relevant definitions in the FBAR and I.R.C. rules, the court concluded that any lawful permanent resident must file an FBAR unless that person is entitled to be treated as a resident of a foreign country under a tax treaty.

The court then addressed the question of whether Mr. Aroeste had met the requirements to commence to be treated as a resident of Mexico under the U.S.-Mexico income tax treaty, or whether he had waived such benefits or had forfeited them by having failed to notify the IRS of such commencement by failing to file Form 8833 with his original tax return for the years in question. On this issue, the court concluded that his failure to give timely notice of his treaty position did not waive the benefits of the treaty, but instead resulted in a financial penalty of $1,000 for each such failure.

The court also ruled that failure to file Form 8854, *Initial and Annual Expatriation Statement*, with his tax returns did not undermine Mr. Aroeste's right to assert his treaty position on the grounds that the requirement to file this form was issued in IRS Notice 2009-85, which did not comply with the notice-and-comment procedure mandated by the Administrative Procedure Act and was not therefore valid.

Having determined that Mr. Aroeste was entitled to claim to be treated as a resident of Mexico and a nonresident of the United States under the U.S.-Mexico income tax treaty, the court then applied the tie-breaker tests set out in the treaty to Mr. Aroeste's facts to determine whether he was a resident of Mexico during the tax years in issue. Article 4 of the treaty provides that where an individual is a resident of both countries, his residency shall be determined as follows:

> a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);
>
> b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
>
> c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
>
> d) in any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement.

Because Mr. Aroeste owned homes in both countries that were available to him, the permanent home test was not conclusive. The court therefore proceeded to the center of vital interests test. The court noted that he lived with his wife in Mexico and spent over 75 percent of his days there during the years in issue. In addition, he was a member of social organizations in Mexico, most of his friends were in Mexico, he voted in Mexico, his cars and personal belongings were in Mexico, as well as his doctors and dentist, his health insurance and cell phone carrier were in Mexico, and he received all his mail in Mexico. These facts were sufficient to support a finding that Mr. Aroeste's residence was in Mexico for the years in issue.

The U.S. government did not dispute this conclusion but argued that Mr. Aroeste was still required to file the FBAR notwithstanding that he was a Mexican resident under the treaty. In support of this argument, the government pointed to the preamble to the FBAR regulations, which states that a "legal permanent resident who elects under a tax treaty to be treated as a non-resident for tax purposes must still file the FBAR." The court, however, rejected this argument, pointing out that it is contradicted by the plain language of the FBAR regulations themselves.

Finally, the court rejected an argument on behalf of Mr. Aroeste that the government had failed to timely assess failure to file penalties by reason of technical errors in the penalty assessment documentation. The court found any errors in this regard to be immaterial. However, the court's ultimate conclusion was that Mr. Aroeste was not subject to penalties for failure to file FBARs.

FOOTNOTES:

1 Aroeste et al. v. United States; No. 3:22-cv-00682 (S.D. Cal. 2023).

2 For the text of the U.S.-Mexico income tax treaty, see https://www.irs.gov/pub/irs-trty/mexico.pdf.

3 31 U.S.C. § 4314. It is important to note that the FBAR statute forms part of Title 31 of the United States Code, whereas the statutory tax rules that comprise the Internal Revenue Code are in Title 26.

4 31 C.F.R. § 1010.350(b)(2).

5 Internal Revenue Code (I.R.C.) § 7701(b)(6).

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