Hide and Seek: The "Retroactive" Informational Reporting Requirements in the U.S. possessions

By Alexis A. Fallon

Alexis A. Fallon examines the informational reporting requirements of Code Sec. 937.

With the second official filing season of the informational reporting requirement for Form 8898 over for residents of Guam, U.S. Virgin Islands, American Samoa and Commonwealth of the Northern Mariana Islands (CNMI).[1] The IRS is in full swing of its compliance effort of tracking certain tax residents of the U.S. possessions.[2] The new reporting requirement is a result of the passage of American Jobs Creation Act of 2004 ("ACJA"),[3] where U.S. Congress imposed new residency and reporting requirements on residents of the U.S. possessions. Ostensibly, the new information reporting is to assist the IRS in tracking residents in the U.S. possessions. However, the new reporting requirement is another tool to assist the IRS' crackdown on abusive residency positions in the U.S. possessions, namely in the U.S. Virgin Islands. As the tax years covered by the statute are still subject to audit, this informational reporting will provide an additional source of information for the IRS to review residential filing positions.

The ACJA substantially changed residency requirements, the sourcing rules, the "effectively connected income" rules and "U.S. trade and business" rules in the U.S. possessions. The principle purpose of the changes is to prevent abuse of the tax advantages by questionable residency positions in those jurisdictions and to curb deleterious effect of these abuses on the U.S. tax base. While the residency rules are clearly not retroactive, the enabling language of the new Code Sec. 937 and the accompanying House Committee Report leave open whether the income sourcing rules could be retroactive in nature. "The provision generally codifies the existing rules for determining when income is considered to be from sources within a possession by providing that, as a general rule, for all purposes of the Code, the principles for determining whether income is U.S. source are applicable for the purposes of determining whether income is possession source."[4] This Committee's report begs the question whether the conferees intend that this new law is interpretative in nature and thus could be utilized in a "retroactive" manner.

Reporting Requirement

IRS Form 8898, *Statement for Individuals Who Begin or End Bona Fide Residence in the U.S. possessions,* tracks the *bona fide* residency of new or former residents of the U.S. possessions and their U.S. sourced income. A reporting event occurs when an individual's gross world-wide income exceeds $75,000 and one of the following events occur: (1) where an individual is filing his income tax return in the U.S. possessions and where in the previous year the individual filed his income tax return in the United States; (2) where an individual is a citizen or resident of the United States and files his annual income tax return in the United States and takes the position that he ceased to be a *bona fide* resident of the U.S. possessions; and (3) where an individual was a bona fide resident of American Samoa or Puerto Rico after a tax year for which an individual was required to file an income tax return as a *bona fide* resident of

Alexis Fallon, J.D. L.L.M.-Taxation, formerly a U.S. tax policy advisor to the Governor of the Northern Mariana Islands and a Senior International Tax Consultant with PricewaterhouseCoopers.

Guam or the CNMI. Failure to file an informational return or to file it incorrectly could result in a penalty of $1,000 and possible criminal penalties.[5]

These informational reporting rules have gone through numerous amendments and changes in a short period of time. While the basic requirements of who has to file remains unchanged, there are new regulations and procedures for the 2006 tax year. This article will review the regulations that apply to the 2006 tax year and the historic informational requirements that were due for prior tax years beginning in 2001 through to 2005 due on October 16, 2006.

> This new informational reporting requirement belies the complexity of tax jurisdictional issues that will arise between the U.S. Possessions and the IRS.

Revised Rules for 2006 Tax Year

In Notice 2006-73,[6] the IRS deleted two questions related to the closer connection test in Form 8898 dated January 2007.[7] The taxpayers are required to maintain the information that was required in the previous version of the form such that the taxpayers are required to retain a list of social, cultural, religious, professional and political organizations that the taxpayer belongs to and maintain a list of donations made to various charities.

Second major change was providing another alternative to the presence test 183-day presence rule.[8] This new regulation only applies to the 2006 tax year.[9] The testing period is expanded to a three-year look back to allow for a cumulative day count equaling 549 days. The test requires that the taxpayer be present at least 60 days in the calendar year and that the total number of days over the three-year period equal to 549 days. The testing period for the day count is the current tax year plus the preceding two tax years. Thus the day count will be for the 2006 tax year, the number of days for 2006, 2005 and 2004.

Transition Period of Retroactive Reporting for Tax Years 2001 Through to 2005

For the transition period for tax years 2001 through to 2004, there is a reporting requirement for the year if you became or ceased to be a *bona fide* resident of the U.S. possessions and had a world-wide gross income in excess of $75,000. A reporting event is triggered when an individual no longer qualifies as a U.S. possessions resident under old residency rules of Code Secs. 931, 932, 933 and 935.[10] Individuals who have a reporting event that occurred in 2004 or before can elect to apply either residency rules under the prior law or the rules issued in the temporary regulations.[11] The "presence test' will not apply until January 2005. Note that there is no reporting requirement for individuals who are already *bona fide* residents of the U.S. possession prior to 2001. For tax year 2005, individuals must meet all three tests in order to qualify as a *bona fide* resident ("BFR"). For the 2005 tax year the prior version of the presence test will apply which means there is no cumulative day count over a three-year period alternative.

New *Bona Fide* Residency Rules

As of January 2005, in order to file and pay taxes in the U.S. possessions, an individual must qualify as a BFR of the U.S. possessions. An individual qualifies as a BFR of the U.S. possessions if the individual meets the requirements set out in Code Sec. 937. Code Sec. 937 has three tests for determining residency: (1) the presence test, (2) the tax home test and (3) the closer connection test.

A safe harbor rule, "Exception for the Year of the Move," modifies the application of the tax home and closer connection tests of the Bona Fide Residency tests.[12] This exception is not available to individuals prior to 2004. The exception for Puerto Rico differs from the rest of the U.S. possessions. Generally, if an individual meets the requirements of this exception and meets the day requirement for the presence test, the individual is relieved from meeting the requirements of the tax home and closer connection tests. If an individual does not qualify for this exception, then he has the burden of meeting all three tests.

Presence Test for 2006 Tax Year

The general rule is an individual must be present in the U.S. possessions for 183 days. However, the regulations provide four alternatives for the initial 183-day presence test. Compliance with any one of these alternatives will satisfy the presence test. The first alternative is that the individual was not present in the United States for more than 90 day; if so, the individual satisfies the presence test.[13] The second alternative is the individual spends more days in the U.S. possessions than in the United States and does not have "earned income" in excess of the statutory limit.[14] This regulation satisfies Congress's directive that U.S. Treasury make exceptions for military personnel, workers in the fisheries trade and retirees who may travel outside the U.S. possessions for personal reasons.[15] For example a member of the U.S. Armed Forces still qualifies as *bona fide* resident of the possession in an earlier tax year if his or her absence from the that possession during the current tax year is in compliance with military orders will not affect the individual's status as a *bona fide* resident. Thus, any income received as compensation for personal services such as wages, salaries, and professional fees is "earned income" and cannot exceed $3,000 per year.

A careful review of the residency rules shows that the new residency laws function more as a retention of jurisdiction over U.S. citizens who move to the U.S. Possessions.

The third alternative as explained previously allows for a cumulative day count over a three-year period. This alternative is similar to the substantial presence rules found in Code Sec. 7701 for determining whether a nonresident alien has a taxable presence in the United States. To be eligible for this test, the taxpayer must have been present in the possession for 60 days in the current tax year and the prior days presence in the tax year will be countable. Such that, the day count is 549 days over a three-year period inclusive of the present tax year.

The last alternative to satisfy the presence test occurs when the individual has no "significant connection" test provides an exclusive list of factors.[16] The final regulations, effective as of January 31, 2006, replace the permanent connection test with the "significant connection" test. The permanent connection did not provide an exclusive list. In deference to public comments to the proposed regulations, U.S. Treasury when promulgating this new "significant connection" test codified two exceptions. One, in one the residence of the spouse or dependent child is disregarded, if the parties are legally separated.[17] The other exception permits an individual who has rental property in the United States but only if it is only available for his use two weeks out of the calendar year and rented the remaining portion of the year.[18]

Presence Test for 2005 Tax Year

There were only three alternative tests in the 2005 tax year for the 183-day presence test, the less than 90 days presence in the United States for the tax year in question and with earned income less than $3,000 in the United States or not having a "permanent connection" to the United States. The "permanent connection test" had a short lived life applicable only for the 2005 tax year and has since been replaced with the "significant connection test."[19] "Permanent connection" evaluates the nonexclusive list of factors in connection to the individual's activities in the United States: 1) whether the individual's spouse or dependents reside in the United States; 2) whether the individual has a dwelling continuously available in the United States; or 3) whether the individual votes or maintains voting registration in the United States. However, there are two factors that are disregarded for the purpose of the "permanent connection" test. The first factor is disregarded when a U.S. individual holds a valid U.S. professional license. The second disregarded factor is when nonimmediate family members reside in the United States.

Tax Home Test

Primarily, an individual's tax home is an individual's principal place of business. If the nature of the business does not have a principal location, it is the individual's abode in a real and substantial sense. Similarly, if a person is on disability or retired, the test is also where the individual's abode in real and substantial sense.

The temporary regulation's definition of tax home is slightly more flexible than the "permanent connection test" where simply maintaining a dwelling that is used by the individual's spouse or dependents does not necessarily mean that the individual has a tax home in the United States. This definition under the "tax home" section also differs from the new regulation significant connection test.

Once the IRS determines that the individual has a "tax home" in the United States, the regulations create a presumption that the individual's home cannot be in the U.S. possessions.[20] The U.S. Treasury's position is once a tax home is established outside of the relevant U.S. possession, it forecloses any further inquiry as to the individual's residency.[21] But it does appear from the regulatory language that this is only a presumption because otherwise it would foreclose the U.S. possessions from asserting its statutory taxing jurisdictions. So, meeting the definition of tax home in the United States only shifts the burden of proof to the individual to prove that the individual has a tax home in the U.S. possessions. Thus, the contemporaneous documentation requirements are critical for individuals who fall into one of these presumptions. This could create a condition where both the U.S. possessions and the U.S. government could assert tax jurisdiction over the individual.

In the event that this situation arises, all of the U.S. possessions and the IRS have tax coordination agreements that provide for resolution of double taxation issues for a particular individual. Rev. Proc. 2006-23[22] provides the rule for applying to Competent Authority to resolve the dual taxation issue.

Closer Connection Test

The closer connection test uses the criteria found in the "tax home" test and "permanent connection" test to evaluate whether the individual's activities provide a closer connection to the United States or a foreign country. A foreign country does not include any other U.S. possession. This test evaluates the following factors: an individual's permanent home; immediate family; current social, political, cultural or religious affiliations; where an individual conducts routine personal banking activities; and the jurisdiction in which individual holds a driver's license. The IRS uses all of these connections to evaluate the individual's ties to the United States or to the U.S. possessions. To the extent that there are more factors linking the individual to the U.S. possessions, the more likely the individual will satisfy this test.

Implications

Tax Jurisdiction

This new informational reporting requirement belies the complexity of tax jurisdictional issues that will arise between the U.S. possessions and the IRS. As all the U.S. possessions are unique in their administration of local tax law, the determination of residency will not be uniform and the possibilities for inconsistent residency determinations abound. A careful review of the residency rules shows that the new residency laws function more as a retention of jurisdiction over U.S. citizens who move to the U.S. possessions. The law does not diminish the ability of the U.S. possessions to determine its tax jurisdiction over the individuals in dispute. U.S. Congress did not say that the U.S. possessions could not assert residency over their taxpayers. As stated previously, there is a possibility of double taxation over certain individuals. As many of the U.S. possessions are potentially facing severe revenue shortfall as the result of the AJCA of 2004, there will be more motivation to assert their jurisdiction over these individuals to maintain their tax base.

The law does not diminish the ability of the U.S. Possessions to determine its tax jurisdiction over the individuals in dispute.

Retroactive Nature

Perhaps what is most disturbing about the AJCA is the cryptic language of the House Committee Report supporting the Act where new sourcing rules clothed as only interpretative in nature and not a clear concession by Congress that these new sourcing rules are a new law. While this article did not discuss the constitutionality of retroactive tax legislation, the article would not be complete without a mention of this issue.

As for residency rules, the regulations and the retroactive informational reporting demonstrate the IRS's intentions with regards to the liberal Economic Development Program in the U.S. Virgin Islands. The IRS is going to use the interpretative basis for the sourcing rules to reallocate income that was deriving a reduced tax rate to make these items of income to be subject to U.S. rates of taxation.

Economic Development

On the flip side, these insular areas are in dire need of investment capital and solid economies. Tax incentives once provided by U.S. Congress are now being taken away with new draconian source rules. The inconvenient locations of these islands hinders economic development. The model of success for the U.S. insular areas, has been Puerto Rico. Puerto Rico came about with liberal tax policies that allowed for the creation of the pharmaceutical sector and the financial sectors. These liberal tax policies have been diminished since the 1970s. Instead of just closing the loopholes for Puerto Rico after significant economic development has been achieved and continue liberal tax policies to the other underdeveloped insular areas, U.S. Congress has consistently diminished tax policies that were effective in spurring economic development.

ENDNOTES

1 Unless the taxpayer has elected an extension. (This analysis will exclude the informational reporting requirements for residents of Puerto Rico)
2 Author wishes to the note the use of the term "U.S. possessions" is no way intend to offend residents of the insular areas but is merely referring to a term of art used in the Internal Revenue Code.
3 American Jobs Creation Act of 2004 (P.L. 108-357), codified at Code Sec. 937.
4 H.R. REP. NO. 108-755, at 780.
5 Reg. §1.937-1(h).
6 Notice 2006-73 , IRB 2006-35, 339 (deleting questions 17 and 29).
7 *J.H. Holt,* DC-VI, 2007-1 USTC ¶50,260 (Oct. 12, 2006) (taxpayer protested constitutionality of the questions regarding political and religious affiliations and donations of charities thereto).
8 Reg. §1.937-1(c)(1)(ii).
9 Reg. §1.937-1(h)(2).
10 Reg. §1.937-1(i).
11 Temporary Reg. §1.937-1T.
12 Reg. §1.937-1(e)(2)(f).
13 Temporary Reg. §1.937-1T(c)(1)(ii).
14 Temporary Reg. §1.937-1T(c)(1)(iii).
15 T.D. 9194.
16 Reg. §1.9371(c)(1)(iv).
17 Reg. §1.937-1(c)(5)(ii)(B)(iii).
18 Reg. §1.937-1(c)(5)(ii)(B).
19 Temporary Reg. §1.937-1T(c)(1)(iv).
20 Reg. §1-911-2(b).
21 T.D. 9248.
22 Rev. Proc. 2006-23, IRB 2006-20, 900.