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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8981]

RIN 1545-BA40

Disallowance of Deductions and Credits for Failure to File Timely Return

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the disallowance of deductions and credits for nonresident alien individuals and foreign corporations that fail to file a timely U.S. income tax return. The current regulations permit nonresident aliens and foreign corporations the benefit of deductions and credits only if they timely file a U.S. income tax return in accordance with subtitle F of the Internal Revenue Code, unless the Commissioner waives the filing deadlines. The temporary regulations revise the waiver standard. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective January 29, 2002.

Applicability Date: For dates of applicability, see §§1.874-1T(b)(4) and 1.882-4T(a)(3)(iv) of these regulations.

FOR FURTHER INFORMATION CONTACT: Nina E. Chowdhry (202) 622-3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 871(b)(1) provides that a nonresident alien individual engaged in a trade or business within the United States shall be taxed on income effectively connected with the conduct of the trade or business within the United States. Likewise, under section 882(a)(1), a foreign corporation engaged in a trade or business within the United States shall be taxed on its income effectively connected with the conduct of the trade or business within the United States. In determining the amount of effectively connected taxable income, both the nonresident alien individual and the foreign corporation (collectively, foreign taxpayers) generally may deduct from effectively connected gross income expenses that are properly allocated and apportioned to that gross income. However, under sections 874(a)(1) and 882(c)(2), a foreign taxpayer generally is entitled to those deductions, and to allowable credits, only if it files a true and accurate U.S. income tax return in the manner prescribed in subtitle F of the Internal Revenue Code (Code), including on the return all the information necessary for the calculation of the deductions and credits.

Sections 1.874-1(b)(1) and 1.882-4(a)(3)(i) provide filing deadlines beyond which a return entitling the foreign taxpayer to deductions and credits may not be filed. Under §§1.874-1(b)(2) and 1.882-4(a)(3)(ii), as currently in effect, the Commissioner may waive the filing deadlines prescribed in §§1.874-1(b)(1) and 1.882-4(a)(3)(i) in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by a foreign taxpayer who does not file a return (a non-filer). When these regulations were promulgated in 1990, Treasury and the IRS intended that the waiver standard balance the legislative intent to establish strong compliance measures with respect to required income tax return filing by foreign taxpayers

with a means to grant relief from the filing deadlines in appropriate cases. In practice, the IRS has found that the standard currently in §§1.874-1(b)(2) and 1.882-4(a)(3)(ii) (the waiver standard) is too restrictive and does not achieve this balance.

Explanation of Provisions

The temporary regulations in this document revise the waiver standard contained in §§1.874-1(b)(2) and 1.882-4(a)(3)(ii) and provide examples of the application of the revised standard. The revised waiver standard provides that the filing deadlines may be waived by the Commissioner or his or her delegate if the non-filer establishes that, based on the facts and circumstances, the non-filer acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return). For this purpose, a non-filer is not considered to have acted reasonably and in good faith if the non-filer knew that it was required to file the return but chose not to file the return. In addition, a non-filer shall not be granted a waiver unless the non-filer cooperates in determining the non-filer's U.S. tax liability for the taxable year for which the return was not filed. The following factors will be considered by the IRS in determining whether a non-filer, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return: whether the non-filer voluntarily identifies itself to the IRS as having failed to file a U.S. income tax return before the IRS discovers the failure to file; whether the non-filer did not become aware of the non-filer's ability to file a protective return by the deadline for filing the protective return; whether the non-filer had not previously filed a U.S. income tax return; whether the non-filer failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account relevant experience and level of sophistication), the non-filer was unaware of the necessity for filing the return; whether the non-filer failed to file a U.S.

income tax return because of intervening events beyond the non-filer's control; and whether other mitigating or exacerbating circumstances existed.

Effective Date

These regulations apply to open years for which requests for waivers of application of sections 874(a) and 882(c) are filed on or after January 29, 2002.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because no notice of proposed rulemaking is required, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principal author of these regulations is Nina Chowdhry of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.874-1T also issued under 26 U.S.C. 874. * * *

Section 1.882-4T also issued under 26 U.S.C. 882(c). * * *

Par. 2. Section 1.874-1 is amended by:

1. Revising paragraph (b)(2).
2. Paragraphs (b)(3) and (b)(4) are redesignated as paragraphs (b)(5) and (b)(6), respectively.
3. New paragraphs (b)(3) and (b)(4) are added.

The revision and additions read as follows:

§1.874-1 Allowance of deductions and credits to nonresident alien individuals.

* * * * *

(b)(2) through (4) For further guidance, see §1.874-1T(b)(2) through (4).

* * * * *

Par. 3. Section 1.874-1T is added to read as follows:

§1.874-1T Allowance of deductions and credits to nonresident alien individuals (temporary).

(a) through (b)(1) For further guidance, see §1.874-1(a) through (b)(1).

(b)(2) Waiver. The filing deadlines set forth in paragraph (b)(1) of this section may be waived if the nonresident alien individual establishes to the satisfaction of the Commissioner or his or her delegate that the individual, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return (as described in

§1.874-1(b)(6))). For this purpose, a nonresident alien individual shall not be considered to have acted reasonably and in good faith if the individual knew that he or she was required to file the return and chose not to file the return. In addition, a nonresident alien individual shall not be granted a waiver unless the individual cooperates in determining his or her U.S. income tax liability for the taxable year for which the return was not filed. The Commissioner or his or her delegate shall consider the following factors in determining whether the nonresident alien individual, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return:

(i) Whether the individual voluntarily identifies himself or herself to the Internal Revenue Service as having failed to file a U.S. income tax return before the Internal Revenue Service discovers the failure to file;

(ii) Whether the individual did not become aware of his or her ability to file a protective return (as described in §1.874-1(b)(6)) by the deadline for filing the protective return;

(iii) Whether the individual had not previously filed a U.S. income tax return;

(iv) Whether the individual failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account his or her relevant experience and level of sophistication), the individual was unaware of the necessity for filing the return;

(v) Whether the individual failed to file a U.S. income tax return because of intervening events beyond the individual's control; and

(vi) Whether other mitigating or exacerbating factors existed.

(3) Examples. The following examples illustrate the provisions of this paragraph (b). In all examples, A is a nonresident alien individual and uses the calendar year as A's taxable year.

The examples are as follows:

Example 1. Nonresident alien individual discloses own failure to file. In Year 1, A became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, A incurred losses with respect to A's U.S. partnership interest. A's foreign tax advisor incorrectly concluded that because A was a limited partner and had only losses from A's partnership interest, A was not required to file a U.S. income tax return. A was aware neither of A's obligation to file a U.S. income tax return for those years nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In Year 5, A began realizing a profit, rather than a loss, with respect to the partnership interest, and, for this reason, engaged a U.S. tax advisor to handle A's responsibility to file U.S. income tax returns. In preparing A's U.S. income tax return for Year 5, A's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines in §1.874-1(b)(1) were not met, A would be barred by §1.874-1(a) from claiming any deductions that otherwise would have given rise to net operating losses on returns for these years, and would have been available as loss carryforwards in subsequent years. At A's direction, A's U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in §1.874-1(b)(1).

Example 2. Nonresident alien individual refuses to cooperate. Same facts as in Example 1, except that while A's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, A refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because A did not cooperate in determining A's U.S. tax liability for the taxable years for which an income tax return was not timely filed, A is not granted a waiver as described in paragraph (b)(2) of this section of any applicable filing deadlines in §1.874-1(b)(1).

Example 3. Nonresident alien individual fails to file a protective return. Same facts as in Example 1, except that in Year 1 through Year 4, A also consulted a U.S. tax advisor, who advised A that it was uncertain whether U.S. income tax returns were necessary for those years and that A could protect its right subsequently to claim the loss carryforwards by filing protective returns under §1.874-1(b)(6). A did not file U.S. income tax returns or protective returns for those years. A did not present evidence that intervening events beyond A's control prevented A from filing an income tax return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in §1.874-1(b)(1).

Example 4. Nonresident alien with effectively connected income. In Year 1, A, a

computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. A had minimal business or tax experience internationally, and no such experience in the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A, however, did not file U.S. income tax returns for Year 1 or Year 2. A was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In November of Year 3, A engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed A's U.S. activities and advised A that A should have filed U.S. income tax returns for Year 1 and Year 2. A immediately engaged a U.S. tax advisor who, at A's direction, promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in §1.874-1(b)(1).

Example 5. IRS discovers nonresident alien's failure to file. In Year 1, A, a computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. However, A was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. Despite A's extensive experience conducting similar business activities in other countries, A made no effort to seek advice in connection with A's U.S. tax obligations. A failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In November of Year 3, an Internal Revenue Service examiner asked A for an explanation of A's failure to file U.S. income tax returns. A immediately engaged X, a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in §1.874-1(b)(1).

Example 6. Nonresident alien with prior filing history. A began a U.S. trade or business in Year 1 as a sole proprietorship. A's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with A's U.S. trade or business. In Year 7, A replaced its tax advisor with a tax advisor unfamiliar with U.S. tax law. A did not file a U.S. income tax return for any year from Year 7 through Year 10, although A had effectively connected income for those years. A was aware of A's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted A and asked

for an explanation of A's failure to file income tax returns after Year 6. A immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in §1.874-1(b)(1).

(4) Effective date. Paragraphs (b)(2) and (3) of this section are applicable to open years for which a request for a waiver is filed on or after January 29, 2002.

(b)(5) through (e) For further guidance, see §1.874-1(b)(5) through (e).

Par. 4. Section 1.882-4 is amended by:

1. Revising paragraph (a)(3)(ii).

2. Paragraphs (a)(3)(iii) through (a)(3)(v) are redesignated as paragraphs (a)(3)(v) through (a)(3)(vii), respectively.

3. New paragraphs (a)(3)(iii) and (a)(3)(iv) are added.

The revision and additions read as follows:

§1.882-4 Allowance of deductions and credits to foreign corporations.

(a) * * *

(3) * * *

(ii) through (iv) For further guidance, see §1.882-4T(a)(3)(ii) through (iv).

* * * * *

Par. 5. Section 1.882-4T is added to read as follows:

§1.882-4T Allowance of deductions and credits to foreign corporations (temporary).

(a) through (a)(3)(i) For further guidance, see §1.882-4(a) through (a)(3)(i).

(a)(3)(ii) The filing deadlines set forth in §1.882-4(a)(3)(i) may be waived if the foreign corporation establishes to the satisfaction of the Commissioner or his or her delegate that the

corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return (as described in §1.882-4(a)(3)(vi))). For this purpose, a foreign corporation shall not be considered to have acted reasonably and in good faith if the foreign corporation knew that it was required to file the return and chose not to file the return. In addition, a foreign corporation shall not be granted a waiver unless the foreign corporation cooperates in the process of determining its income tax liability for the taxable year for which the return was not filed. The Commissioner or his or her delegate shall consider the following factors in determining whether the foreign corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return:

(A) Whether the corporation voluntarily identifies itself to the Internal Revenue Service as having failed to file a U.S. income tax return before the Internal Revenue Service discovers the failure to file;

(B) Whether the corporation did not become aware of its ability to file a protective return (as described in §1.882-4(a)(3)(vi)) by the deadline for filing a protective return;

(C) Whether the corporation had not previously filed a U.S. income tax return;

(D) Whether the corporation failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the corporation was unaware of the necessity for filing the return;

(E) Whether the corporation failed to file a U.S. income tax return because of intervening events beyond the corporation's control; and

(F) Whether other mitigating or exacerbating factors existed.

(iii) The following examples illustrate the provisions of this section. In all examples, FC is a foreign corporation and uses the calendar year as its taxable year. The examples are as follows:

Example 1. Foreign corporation discloses own failure to file. In Year 1, FC became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S.

trade or business. During Year 1 through Year 4, FC incurred losses with respect to FC's U.S. partnership interest. FC's foreign tax director incorrectly concluded that because FC was a limited partner and had only losses from FC's partnership interest, FC was not required to file a U.S. income tax return. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years nor of FC's ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In Year 5, FC began realizing a profit, rather than a loss, with respect to the partnership interest, and, for this reason, engaged a U.S. tax advisor to handle FC's responsibility to file U.S. income tax returns. In preparing FC's income tax return for Year 5, FC's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines in §1.882-4(a)(3)(i) were not met, FC would be barred by §1.882-4(a)(2) from claiming any deductions that otherwise would have given rise to net operating losses on returns for these years, and would have been available as loss carryforwards in subsequent years. At FC's direction, FC's U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in §1.882-4(a)(3)(i).

Example 2. Foreign corporation refuses to cooperate. Same facts as in Example 1, except that while FC's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, FC refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because FC did not cooperate in determining its U.S. tax liability for the taxable years for which an income tax return was not timely filed, FC is not granted a waiver as described in paragraph (a)(3)(ii) of this section of any applicable filing deadlines in §1.882-4(a)(3)(i).

Example 3. Foreign corporation fails to file a protective return. Same facts as in Example 1, except that in Year 1 through Year 4, FC's tax director also consulted a U.S. tax advisor, who advised FC's tax director that it was uncertain whether U.S. income tax returns were necessary for those years and that FC could protect its right subsequently to claim the loss carryforwards by filing protective returns under §1.882-4(a)(3)(vi). FC did not file U.S. income tax returns or protective returns for those years. FC did not present evidence that intervening events beyond FC's control prevented FC from filing an income tax return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in §1.882-4(a)(3)(i).

Example 4. Foreign corporation with effectively connected income. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. FC had minimal business or tax experience internationally, and no such experience in the United States. Through FC's direct efforts, U.S.

sales of the software produced income effectively connected with a U.S. trade or business. FC, however, did not file U.S. income tax returns for Year 1 or Year 2. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of FC's ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In January of Year 4, FC engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed FC's U.S. activities and advised FC that FC should have filed U.S. income tax returns for Year 1 and Year 2. FC immediately engaged a U.S. tax advisor, at FC's direction, who promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in §1.882-4(a)(3)(i).

Example 5. IRS discovers foreign corporation's failure to file. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. However, FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of FC's ability to file a protective return for those years. FC had never filed a U.S. income tax return before. Despite FC's extensive experience conducting similar business activities in other countries, FC made no effort to seek advice in connection with FC's U.S. tax obligations. FC failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In January of Year 4, an Internal Revenue Service examiner asked FC for an explanation of FC's failure to file U.S. income tax returns. FC immediately engaged X, a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond FC's control prevented FC from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in §1.882-4(a)(3)(i).

Example 6. Foreign corporation with prior filing history. FC began a U.S. trade or business in Year 1. FC's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with FC's U.S. trade or business. In Year 7, FC replaced its tax advisor with a tax advisor unfamiliar with U.S. tax law. FC did not file a U.S. income tax return for any year from Year 7 through Year 10, although FC had effectively connected income for those years. FC's management was aware of FC's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted FC and asked FC's chief financial officer for an explanation of its failure to file U.S. income tax returns after Year 6. FC immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in

determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond FC's control prevented FC from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph §1.882-4(a)(3)(i).

(iv) Paragraphs (a)(3)(ii) and (iii) of this section are applicable to open years for which a request for waiver is filed on or after January 29, 2002.

(a)(3)(v) through (b)(2) For further guidance, see §1.882-4(a)(3)(v) through (b)(2).

Robert E. Wenzel
Deputy Commissioner of Internal Revenue.

Approved:

Mark Weinberger
Assistant Secretary of the Treasury