

I.R.S. ANNOUNCES SIX COMPLIANCE CAMPAIGNS

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The I.R.S. Large Business and International division (“LB&I”) recently announced the approval of the following six additional compliance campaigns:

- Interest capitalization for self-constructed assets
- Non-compliance with respect to Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, and Form 3520-A, *Annual Information Return of Foreign Trust with U.S. Owner*
- Compliance with respect to Form 1042, *Annual Withholding Tax Return for U.S.-Source Income of Foreign Persons*, and Form 1042-S, *Foreign Person’s U.S.-Source Income Subject to Withholding*
- Nonresident alien tax treaty exemptions
- Nonresident alien “Schedule A” and other deductions
- Nonresident alien individual tax credits

According to the announcement, the decision to approve these compliance campaigns is the result of LB&I data analysis and suggestions from I.R.S. employees. As discussed below, the compliance campaigns will use various methods, including examinations and statutory penalty assessments, as well as less direct methods such as education and outreach. Notably, all but one of the campaigns relate to international compliance.

INTEREST CAPITALIZATION FOR SELF-CONSTRUCTED ASSETS

Code §263A denies deductibility for certain direct and indirect costs incurred with respect to property. Such costs must be capitalized (*i.e.*, added to the tax basis of the property) and utilized as depreciation or amortization deductions over the useful life of the property. Property subject to Code §263A capitalization includes real property and tangible personal property produced by the taxpayer (*e.g.*, certain costs incurred by a builder in constructing homes). Under certain circumstances, interest expense must be capitalized under Code §263A. Interest expense capitalization applies to interest a taxpayer pays or incurs during the production period when producing property that meets the definition of designated property. Designated property means (i) any real property, or (ii) tangible personal property that has (a) a long useful life (depreciable class life of 20 years or more), (b) an estimated production period exceeding two years, or (c) an estimated production period exceeding one year and an estimated cost exceeding \$1,000,000.

This campaign will use examinations, letters, and taxpayer education to improve compliance. The focus will be placed on verifying that interest is properly capitalized for designated property and the computation to capitalize that interest is accurate.

NON-COMPLIANCE WITH RESPECT TO FORMS 3520 AND 3520-A

Forms 3520 and 3520-A are information returns used to report information on transactions with certain foreign trusts and gifts received from foreign persons (in the case of Form 3520) and foreign trusts with U.S. owners (in the case of Form 3520-A). As with other information returns pertaining to cross-border transactions, the penalties for late or incomplete filing of Forms 3520 and 3520-A are significant.

The announcement states that this campaign will focus on examinations and penalty assessments. However, this would seem to be counter productive if the persons penalized are those who voluntarily file Form 3520 late as a result of upgrading the quality of tax advisers. The penalties can be severe, being the greater of \$10,000 or the amount listed in the following table.

Non-compliance Item	Penalty
Failure to report the creation of or transfer to a foreign trust	35% of the gross value of any property transferred by U.S. person
Failure to report receipt of the distribution from a foreign trust	35% of the gross value of the distributions received by U.S. person
Failure to report required information on assets treated as owned by U.S. person under the grantor trust rules	5% of the gross value of all foreign trust assets
Failure to report a foreign gift or bequest, or filing an incorrect or incomplete form	5% of the gift or bequest for each month during which the failure continues, up to a maximum of 25%

COMPLIANCE WITH RESPECT TO FORMS 1042 AND 1042-S

Taxpayers who make payments of certain U.S.-source income to foreign persons (e.g., payments of interest, dividends, rents, or royalties) must comply with the related withholding, deposit, and reporting requirements. The compliance of withholding agents is the only practical manner by which to collect withholding taxes from foreign persons. This campaign addresses withholding agents who make payments but do not meet all of their compliance duties. The announcement suggests that the primary method to be used in this campaign will be examinations.

Notably, this campaign is concerned with compliance duties other than paying withholding taxes. Such duties may include filing Forms 1042 and 1042-S completely and correctly, sometimes done to obscure the recipient in the country of residence. This is especially the case since foreign tax identification numbers are now required.

NONRESIDENT ALIEN TAX TREATY EXEMPTIONS

Income tax treaties provide benefits to nonresident aliens (*i.e.*, foreign individuals who are neither U.S. citizens nor residents) such as lower withholding tax rates and the exemption of certain income from U.S. Federal income tax. This campaign is intended to increase compliance in claiming tax treaty exemptions for nonresident aliens related to income effectively connected to a U.S. trade or business and a certain investment-type income known as Fixed, Determinable, Annual, or Periodic (“F.D.A.P.”) income.

The announcement states that some nonresident alien taxpayers (i) incorrectly interpret and apply treaty benefits, (ii) provide incorrect or incomplete forms to the withholding agents, or (iii) rely on incorrect information returns provided by U.S. payors to improperly claim treaty benefits. The I.R.S. will implement this campaign through a variety of methods, including outreach, education, and examinations. Again, this is an issue where non-compliance is addressed to exchange of information with tax authorities in the taxpayer’s country of residence.

NONRESIDENT ALIEN “SCHEDULE A” AND OTHER DEDUCTIONS

This campaign is intended to increase compliance in the proper deduction of eligible expenses by nonresident aliens on Form 1040NR, *Nonresident Alien Income Tax Return*, Schedule A (Itemized Deductions).

The Tax Cuts and Jobs Act of 2017 (“T.C.J.A.”) introduced significant changes to the rules regarding itemized deductions. In general, itemized deductions have been significantly reduced or eliminated under the T.C.J.A.

According to the I.R.S., some nonresident aliens either (i) misunderstand or misinterpret the rules for allowable deductions, (ii) do not meet all the qualifications for claiming the deduction, or (iii) do not maintain proper records to substantiate the expenses. Presumably, the new law will create more compliance issues.

The I.R.S. will implement this campaign through a variety of methods, including outreach, education, and examinations.

NONRESIDENT ALIEN INDIVIDUAL TAX CREDITS

The Code provides numerous tax credits for individual taxpayers. Individual tax credits are available under a variety of circumstances, including paying expenses for education and maintaining children or other dependents. This campaign is intended to increase the compliance of nonresident aliens with respect to individual tax credits. Nonresident aliens who (i) have no qualifying earned income, (ii) do not provide substantiation or proper documentation, or (iii) do not have qualifying dependents may erroneously claim certain dependent-related tax credits. Furthermore, some nonresident aliens claim education credits, which are only available to U.S. citizens or residents.

The I.R.S. will implement this campaign through a variety of methods, including outreach, education, and examinations.

