

UPDATES & OTHER TIDBITS

Authors

Wooyoung Lee

Tags

Automatic Exchange of
Information
Constitutionality
Deposit Interest Rules
Form 1042-S
Passports
Penalties
Seriously Delinquent
Tax Debt

FIFTH CIRCUIT UPHOLDS PASSPORT- REVOCAION PENALTY

In *Franklin v. U.S.*,¹ the Fifth Circuit recently upheld the constitutionality of Code §7345, a provision of the Code that was in 2015. It allows the I.R.S. to effect the revocation of a U.S. citizen's passport where the individual is in seriously delinquent tax debt.

I.R.S. Procedure

The threshold for seriously delinquent tax debt is \$50,000, with adjustments for inflation. Debt includes unpaid tax liability, penalties, and interest from late payments. Certain debts, such as debt of a bankrupt taxpayer, are excluded from this definition.

When the I.R.S. determines that a person is in seriously delinquent debt, it issues a CP508C Notice to the taxpayer, with a copy to the Secretary of State. This prevents the State Department from issuing or renewing a passport to the taxpayer, although the taxpayer's passport is not automatically revoked. Before denying a new or renewed passport, the State Department will give a taxpayer 90 days to sort out the situation.

Revocation may occur if the I.R.S. goes further and recommends revocation to the State Department. Before making such a recommendation, the I.R.S. will issue a Letter 6152, (Notice of Intent to Request U.S. Department of State Revoke Your Passport), to the taxpayer, informing him or her of the possible revocation. The letter requests that the taxpayer call the I.R.S. within 30 days to resolve the situation. Recommendations of revocation are typically reserved for taxpayers who promised to pay or could have paid off the debt but did not.

Avenues of Relief

Several avenues of relief are available to such taxpayers:

- The I.R.S. may not submit a certification to the State Department if the relevant debt is the subject of a requested or pending collection due process hearing.
- The individual and the I.R.S. may enter into an installment agreement allowing for the payment of the debt over time.
- The I.R.S. may accept an offer in compromise proposed by the taxpayer for the satisfaction of the debt at a lower amount.

¹ No. 21-11104, 2022 BL 326674.

- The U.S. Department of Justice may enter into a settlement agreement to satisfy the debt.
- Collection against a married couple filing a joint tax return may be suspended as to one of the spouses claiming innocent spouse relief under Code § 6015.
- The application of Code §7345 to the taxpayer is the subject of an ongoing challenge in U.S. District Court or the Tax Court.

Franklin involved a court challenge to the application of Code §7345 after an offer in compromise was denied.

The Case

James Franklin is a U.S. citizen who failed to report a foreign trust of which he was the beneficial owner. When the I.R.S. discovered his failure in compliance, it levied penalties in the amount of \$421,766. Two years later, it began taking steps to collect those penalties.

One of the steps was to issue a certification to the State Department that the taxpayer was in seriously delinquent tax debt. Mr. Franklin, believing the I.R.S.'s assessment was procedurally improper due to lack of proper supervision within the I.R.S. of the person asserting the penalty, offered to pay the agency a compromise sum. The I.R.S. declined, and the taxpayer brought suit.

Mr. Franklin asserted two reasons in support of his request for relief. The first was that procedural deficiencies invalidated the I.R.S.'s assessment. This claim was dismissed for lack of jurisdiction by both the U.S. Federal District Court and the Fifth Circuit Court of Appeals. The Anti-Injunction Act prevents a court from having jurisdiction to prevent the I.R.S. from collecting tax except as provided by statute.²

The second assertion challenged the constitutionality of the statute that resulted in a violation of substantive due process. Once that issue was raised, the court was required to determine the proper level of scrutiny for evaluating the claim. The standards are strict-scrutiny, intermediate scrutiny, or rational basis scrutiny.

The court first considered whether the strict-scrutiny standard applied. This standard is reserved for situations involving fundamental rights. This standard imposes an obligation on the government to show that the law is narrowly tailored to serve a compelling state interest. The court determined that strict scrutiny was inappropriate in a matter covered by Code §7345.

While early Supreme Court cases suggested that international travel might be a fundamental right,³ later cases distinguished international travel from interstate travel.⁴ The latter was a fundamental right, while the former was only an extension of the general right to liberty. The strict-scrutiny standard was not applicable.

² 26 U.S.C. § 7421(a).

³ *Zemel v. Rusk*, 381 U.S. 1 (1965); *Aptheker v. Secretary of State*, 378 U.S. 500 (1964); *Shelton v. Tucker*, 364 U.S. 479, 488 (1960).

⁴ *Califano v. Aznavorian*, 439 U.S. 170 (1978); *Haig v. Agee*, 453 U.S. 280 (1981); *Regan v. Wald*, 468 U.S. 222 (1984).

Next, the court applied an intermediate level of scrutiny. Intermediate scrutiny requires that the challenged restriction must serve important governmental objectives and must be substantially related to achievement of those objectives. Collecting taxes is an important government objective and denying passport privileges is related to that objective in two ways. First, it incentivizes paying the debt. Second, it makes it difficult for delinquent taxpayers to hide assets in foreign countries. The court also approved of the law's scope. The statute targeted serious debts, included several procedural safeguards, and allowed erroneously affected taxpayers an opportunity to seek relief in court. Congress properly fashioned an arrow, not a bazooka, for the I.R.S. to use.

Note that the court reserved on determining that the intermediate standard of review applied to the case. It could have held that the rational standard of review applied,⁵ but whichever standard was applicable the decision would be the same – no fundamental right exists under the Constitution regarding international travel.

The Fifth Circuit's decision followed the Tenth Circuit's validation of Code §7345 last year.⁶

TURKEY ADDED TO AUTOMATIC EXCHANGE OF INFORMATION LIST

Background

Over the past decade, the U.S. Treasury Department and the I.R.S. has focused on exchange of tax information with foreign tax authorities. Typically, the I.R.S. obtains information automatically from abroad regarding foreign financial accounts maintained by U.S. persons. F.A.T.C.A. is the prime example of the I.R.S. obtaining information under automatic exchange of information arrangements. In addition, the I.R.S. has a robust program that provides information to foreign tax authorities regarding U.S. bank accounts maintained in the name of foreign individuals who are resident in specific countries. The program requires domestic banks that pay interest to individual account holders who are neither resident in nor citizens of the U.S. ("N.R.N.C. individuals") to report the transaction on Form 1042-S (*Foreign Person's U.S. Source Income Subject to Withholding*).⁷ The information on the Form 1042-S is transmitted to the relevant participating country.

This rule does not apply automatically to all such payments to N.R.N.C. individuals. Instead, the I.R.S. maintains two lists of countries covered by the rules. The first list is comprised of countries with which the U.S. has an information-exchange agreement, such as through an income-tax treaty.⁸ The I.R.S. also maintains a second list of countries with which it shares information automatically under a Tax Information Exchange Agreement. Information that the I.R.S. collects under these



⁵ The rational-basis standard is the lowest of the three standards that must be met by the government when it defends the constitutionality of a statute. The challenge to the statute fails once the government demonstrates that the law is rationally related to a legitimate government interest.

⁶ *Maehr v. U.S. Dept. of State*, 5 F.4th 1100 (10th Cir. 2021).

⁷ Treas. Reg. §1.6049-4(b)(5).

⁸ Treas. Reg. §1.6049-8(a).

rules will be shared with the tax authorities of countries on this list. The presence of an N.R.N.C. individual's country of residence on either list triggers the bank's reporting requirement.

Mechanically, banks can rely on a customer's Form W-8BEN (*Beneficial Owners Certificate of Foreign Status for U.S. Tax Withholding*) to determine the customer's residence and consequently the banks' reporting obligations.

The I.R.S. updates both lists annually. The most recent change is the addition of Turkey to the list regarding automatic exchanges of information.⁹ This will not affect payments during the rest of 2022, but automatic exchange of information will apply to interest payments to Turkish deposit holders made in 2023 or later. Turkey was already part of the other list, so such payments were already reportable.

All Countries on the Lists

Country	Info-Exchange Agreement	Automatic Exchange of Info
Antigua & Barbuda	Yes	No
Argentina	Yes	No
Aruba	Yes	No
Australia	No	Yes
Austria	Yes	No
Azerbaijan	Yes	Yes
Bangladesh	Yes	No
Barbados	Yes	No
Belgium	Yes	Yes
Bermuda	Yes	No
Brazil	Yes	Yes
British Virgin Islands	Yes	No
Bulgaria	Yes	No
Canada	Yes	Yes
Cayman Islands	Yes	No
Chile	Yes	No
China	Yes	No
Colombia	Yes	Yes
Costa Rica	Yes	No
Croatia	Yes	Yes
Curaçao	Yes	Yes
Cyprus	Yes	Yes
Czech Republic	Yes	Yes
Denmark	Yes	Yes
Dominica	Yes	No

⁹ Rev. Proc. 2022-35.

Country	Info-Exchange Agreement	Automatic Exchange of Info
Dominican Republic	Yes	Yes
Egypt	Yes	No
Estonia	Yes	Yes
Faroe Islands	Yes	No
Finland	Yes	Yes
France	Yes	Yes
Georgia	Yes	No
Germany	Yes	Yes
Gibraltar	Yes	Yes
Greece	Yes	Yes
Greenland	Yes	No
Grenada	Yes	No
Guernsey	Yes	Yes
Guyana	Yes	No
Honduras	Yes	No
Hong Kong	Yes	No
Hungary	Yes	Yes
Iceland	Yes	Yes
India	Yes	Yes
Indonesia	Yes	No
Ireland	Yes	Yes
Isle of Man	Yes	Yes
Israel	Yes	Yes
Italy	Yes	Yes
Jamaica	Yes	Yes
Japan	Yes	No
Jersey	Yes	Yes
Kazakhstan	Yes	No
Latvia	Yes	Yes
Liechtenstein	Yes	Yes
Lithuania	Yes	Yes
Luxembourg	Yes	Yes
Malta	Yes	Yes
Marshall Islands	Yes	No
Mauritius	Yes	Yes
Mexico	Yes	Yes
Moldova	Yes	No
Monaco	Yes	No



Country	Info-Exchange Agreement	Automatic Exchange of Info
Morocco	Yes	No
Netherlands	Yes	Yes
Netherlands Special Municipalities ¹⁰	Yes	No
New Zealand	Yes	Yes
Norway	Yes	Yes
Pakistan	Yes	No
Panama	Yes	Yes
Peru	Yes	No
Philippines	Yes	No
Poland	Yes	Yes
Portugal	Yes	Yes
Romania	Yes	No
Russia	Yes	No
Saint Lucia	Yes	Yes
Singapore	Yes	Yes
Saint Maarten	Yes	No
Slovakia	Yes	Yes
Slovenia	Yes	Yes
South Africa	Yes	Yes
South Korea	No	Yes
Spain	Yes	Yes
Sri Lanka	Yes	No
Sweden	Yes	Yes
Switzerland	Yes	No
Thailand	Yes	No
Trinidad & Tobago	Yes	No
Tunisia	Yes	No
Turkey	Yes	Yes
Ukraine	Yes	No
United Kingdom	Yes	Yes
Venezuela	Yes	No

¹⁰ Bonaire, Sint Eustatius, Saba

Disclaimer: This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.