

TAX 101 – INTRODUCTORY LESSONS: FORM 5471 – HOW TO COMPLETE THE FORM IN LIGHT OF RECENT CHANGES

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Tags

Controlled Foreign Corporations
Form 5471

INTRODUCTION

As part of the obligation to file income tax returns, U.S. persons owning 10% or more of the stock of a foreign corporation – measured by voting power or value of the stock that is owned – are obligated to provide information on the foreign corporation. Ownership is determined by reference to stock directly held, indirectly held through foreign entities, and deemed held through attribution from others. The scope and detail of the information to be reported is dependent on the percentage of ownership maintained by the U.S. taxpayer. As the degree of ownership increases, the amount of information increases. The reporting vehicle is Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations). For returns that report on tax year 2013, this form also reports on the net investment income tax (“N.I.I.T.”) arising through a controlled foreign corporation (“C.F.C.”).

Great emphasis is put on international tax compliance, and from 2009, the I.R.S. systematically assesses penalties for late filing of Form 5471. In addition, the 2010 Foreign Account Tax Compliance Act (“F.A.T.C.A.”) extended the statute of limitations for the I.R.S. to examine a tax return if certain information returns, including Forms 5471, were not timely or properly filed. The statute of limitations will remain open on the entire tax return and not only on Form 5471 if Form 5471 is not timely filed. Once the form is filed the statute of limitation will begin to run.²⁶ To assist the I.R.S. to spot inconsistencies, beginning in tax year 2012, the I.R.S. assigned a unique reference identification number to each foreign entity, which allows the I.R.S. to compare forms filed with respect to a certain company over several years.

The systematic penalty assertion where Forms 5471 were not filed or were filed improperly was examined by the Treasury Inspector General for Tax Administration (“T.I.G.T.A.”) at the end of 2013. T.I.G.T.A. found that the systemic penalties were properly assessed, but that the abatement process required improvement as

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Code §6501(c)(8).

controls were insufficient to ensure the proper abatement of systemically assessed penalties.²⁷

HOW TO FILL IN THE FORM

The rules determining when a Form 5471 is required and the degree of information that must be included are determined by many complicated, overlapping, and sometimes unclear provisions in the Code (primarily Code §6038 and §6046) and accompanying regulations. These rules are supplemented by instructions and I.R.S. publications. As the penalties are substantial, it is prudent for taxpayers with international operations to understand when the form is required and what must be included.

Form 5471 provides for four categories of U.S. persons who must file the form and lists the information required for each category of filer. The information required ranges from: (i) general information about the corporation and certain U.S. shareholders who acquired or disposed of ownership during the year to (ii) a full disclosure of the corporation's financial statements and related-person transactions. The most recent instructions to the form were released in January 2014 and apply to tax years beginning in 2013. These instructions clarify that the constructive ownership exception that previously only applied to two categories of filers will now apply to another category. This exception will be explained below in more detail.

As mentioned above, Form 5471 provides for four categories of filers, with each category requiring different degree of information to be disclosed. Those generally include the following beginning with Category 2 filers as the rules for Category 1 filers have been repealed:²⁸

Category 2 Filer

A U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired, directly or indirectly, stock ownership that meet certain requirements. The relevant requirements are: (i) stock ownership of 10% or more by vote or value (purchased in one or more transactions, during a single tax year or over multiple tax years) ("10% stock ownership requirement") or (ii) a purchase of an additional 10% or greater ownership interest.

A Category 2 filer is required to provide the following information:

1. The corporation's identifying information, including a description of the business activity;
2. Identifying information with respect to each U.S. person who, during the time he is an officer or director,²⁹ acquired stock meeting the 10% stock

²⁷ The T.I.G.T.A. report dated September 25, 2013 was released December 2, 2013.

²⁸ Category 1 was repealed by the American Jobs Creation Act of 2004.

²⁹ If a U.S. person acquired stock in a foreign corporation in September of year one and in December of that same year a U.S. person is appointed director, the

ownership requirements described above. This description should include the acquired stock and the date of the acquisition,³⁰ and

3. Answer specific questions designed to provide information on topics of current concern to the I.R.S., including:³¹
 - a. Ownership of 10% or more of a foreign partnership;
 - b. Ownership of an interest in a trust;
 - c. Ownership of an interest in a disregarded entity;
 - d. Participation in a cost-sharing arrangement;
 - e. Participation in a reportable tax shelter transaction;
 - f. Payment or accrual of foreign taxes for which credit is denied under Code §901(m) relating to covered asset acquisitions in which the U.S. tax basis of the asset is greater than the foreign tax basis; and
 - g. Payment or accrual of foreign taxes for which credit was previously suspended under Code §909, relating to the matching of income and foreign tax credits.

Category 3 Filer:

A Category 3 filer is generally any person who meets one of the following three tests:

4. A U.S. person who acquires (or is deemed to acquire) stock meeting the 10% stock ownership requirement, whether in one block or in an amount that brings him to a 10% or greater ownership interest;
5. A U.S. person who disposes, directly or indirectly, of stock ownership in a foreign corporation so that his ownership is reduced to below 10%; or
6. A non-U.S. person who became a U.S. person while meeting the 10% stock ownership requirement.

A Category 3 filer is required to report most³² of the information a Category 2 filer is required to provide, plus, *inter alia*:

- a. A description of the stock structure,³³

director will not be required to file the form. Treas. Reg. §1.4064-1(a)(3) Example 4.

³⁰ This is done on Part I of Separate Schedule O (Form 5471).

³¹ Schedule G of Form 5471.

³² All information, other than Part I of Separate Schedule O (Form 5471), which reports that persons who acquired the required ownership during the tenor or a U.S. director or officer.

- b. Information regarding all of the corporation's U.S. shareholders owning stock meeting the 10% stock ownership requirement;³⁴
- c. The corporation's U.S. and foreign income tax for the current year;³⁵
- d. The shareholder's acquisitions and dispositions;³⁶
- e. An income statement for the corporation and balance sheets as of the beginning and end of the corporation's accounting period.³⁷

The income statement should be in the corporation's functional currency and in U.S. dollars, and the balance sheet should be prepared under U.S. generally accepted accounting principles ("G.A.A.P.") and in U.S. dollars. If Form 5471 is filed because an existing shareholder became a U.S. person, the residency starting date or the date on which U.S. status became effective should be reported. If the form is filed because of the shareholder's disposition of stock, the form should also include a description of the transaction and identifying information regarding the buyer.³⁸

Category 4 Filer

A Category 4 filer is U.S. person who, directly or indirectly, controls a foreign corporation. For these purposes control means more than 50% of the vote or value for at least 30 days during the year.³⁹

A Category 4 filer is required to provide most⁴⁰ of the information that a Category 3 filer is required to provide, plus, *inter alia*:

- 1. The current and accumulated earnings and profits,⁴¹
- 2. The Subpart F income and other items relevant to the application of the C.F.C. rules,⁴² and
- 3. A description of business transactions between a foreign corporation that is a C.F.C. and any of the following: (i) the U.S. shareholder submitting the form, (ii) any domestic corporation or partnership controlled by the filer, (iii) any U.S. person meeting the 10% stock ownership requirements, (iv) any domestic corporation or partnership controlled by any 10% or greater U.S.

³³ Schedule A of Form 5471.

³⁴ Schedule B of Form 5471.

³⁵ Schedule E of Form 5471.

³⁶ Part II of Separate Schedule O (Form 5471).

³⁷ Schedule C and Schedule F.

³⁸ The instructions to Form 5471 for each Schedule.

³⁹ Code §6038(a)(1).

⁴⁰ All information, other than Part II of Separate Schedule O (Form 5471), which reports, *inter alia*, the shareholder's acquisitions and dispositions.

⁴¹ The current earnings and profits ("E&P") is reported on Schedule H of Form 5471. The accumulated E&P is reported on Separate Schedule J (Form 5471).

⁴² Schedule I of Form 5471.

shareholder, or (v) any 10% or greater U.S. shareholder of any corporation controlling the foreign corporation.⁴³

Category 5 Filer:

A U.S. person who owns (or is deemed to own), directly or indirectly, shares meeting the 10% stock ownership requirements in a C.F.C. for at least 30 days, including on the last day of the tax year.⁴⁴ A C.F.C. is defined as a foreign corporation that has U.S. shareholders that own, directly, indirectly or constructively, more than 50% of the vote or value of the foreign corporation, on any day of the tax year.

A Category 5 filer is required to provide the following information:

1. The corporation's identifying information, including a description of the business activity;
2. Answer specific questions designed to provide information on topics of current concern to the I.R.S., as more elaborately described under Category 3 above;⁴⁵
3. The current and accumulated earnings and profits;⁴⁶ and
4. The Subpart F income and other items relevant to the application of the C.F.C. rules.⁴⁷

A U.S. person who fits within more than one category for a particular year is only required to file one Form 5471 for the year but must include all the information required for all applicable categories.

Note that if a U.S. person is required to file Form 5471 under any one of these categories, the fact that he may be exempt from U.S. tax with respect to his income from this corporation under a tax treaty with the country of his residence would not deter from his obligation to file this form.

⁴³ Separate Schedule M (Form 5471).

⁴⁴ Instructions to Form 5471 (Rev. December 2013) and Code §6038(a)(4). Category 5 also includes a U.S. person who owns any amount of stock of a C.F.C. that is a captive insurance company.

⁴⁵ Schedule G.

⁴⁶ The current earnings and profits ("E&P") is reported on Schedule H of Form 5471. The accumulated E&P is reported on Separate Schedule J (Form 5471).

⁴⁷ Schedule I of Form 5471.

What Constructive Ownership Rules Apply for Purposes of Determining Who Must File?

There are three separate sets of constructive and indirect ownership rules which apply for the purposes of the four different filing categories.

1. For purposes of determining who is required to file as a Category 2 or Category 3 filer the following attribution rules apply:⁴⁸
 - a. **Entity attribution:** a person is deemed to proportionately own stock owned directly or indirectly by a foreign corporation or a foreign partnership in which he is a shareholder or partner.
 - b. **Family attribution:** an individual is deemed to own stock owned, directly or indirectly, by or for (i) his spouse, (ii) his children and grandchildren, (iii) his parents and grandparents and (iv) his siblings (including half-blood). Attribution rules apply from more remote ancestors if still living and great-grandchildren and more remote descendants, if any. Stock that a family member owns by attribution will not be reattributed to another member of his family. This rule caps multiple application of the attribution rules that would otherwise expand their scope indefinitely.
2. For purposes of determining who is required to file as a Category 4 filer the attribution rules of Code §318(a) apply, with some modifications, resulting in:⁴⁹
 - a. **Family attribution:** an individual is deemed to own stock owned, directly or indirectly, by or for: (i) his spouse, (ii) his children (including adopted), (iii) his grandchildren, and (iv) his parents. Stock that a family member owns by attribution will not be reattributed to another member of his family.
 - b. **Partnership and estate attribution:** a person is deemed to proportionately own stock owned by or for a partnership or an estate in which he is a partner or a beneficiary. Stock owned by a partner of a partnership or a beneficiary of an estate is considered as owned by the partnership or the estate. Stock that is attributed to a partnership or an estate is not reattributed to other partners or beneficiaries.
 - c. **Trust attribution:** a person is deemed to own stock owned by a trust of which he is a beneficiary in proportion to his actuarial interest in the trust. This assumes specific distribution patterns are mandatory. However, reliance on actuarial tables may be inappropriate where trust distributions are fully discretionary. In such instance, a trust beneficiary may be required to look at facts and circumstances to

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Code §6046(c) and Treas. Reg. §1.6046-1(i).

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Code §6038(e)(2) and Treas. Reg. §1.6038-2(c).

determine actuarial interest.⁵⁰ This includes (i) patterns of past distributions, (ii) appropriate mortality assumptions, (iii) the trustee's fiduciary duties, and (iv) the relationships between the trustees and beneficiaries. Stock owned by a beneficiary of a trust is considered as owned by the trust, except if the beneficiary's interest in the trust is a remote contingent interest. Stock that is attributed to a trust is not reattributed to other beneficiaries.

- d. Grantor trust attribution: a person is deemed to own stock owned by a grantor trust of which he is treated as the grantor. Stock owned by the grantor of a grantor trust is considered as owned by the trust.
- e. Upward corporation attribution: a shareholder is deemed to proportionately own stock owned, directly or indirectly, by or for a corporation of which he owns 10% or more of the value. A person is deemed in control of a controlled subsidiary corporation if he is in control of the upper level corporation. This means that if the controlling person owns 60% of the upper-tier corporation and the upper-tier corporation owns 60% of a lower-tier corporation, the controlling person is deemed to own all 60% of the lower-tier corporation.
- f. Downward Corporation attribution: a corporation will be deemed to own all stock actually owned, directly or indirectly, by or for any shareholder when the shareholder owns, directly or indirectly, 50% or more of the value of the corporation's stock. Stock that is attributed to a corporation is not reattributed to other shareholders of the corporation under the upward corporation attribution rules discussed above.
- g. Options attribution: a person who has an option to acquire stock is deemed to own this stock.

For purposes of Category 4 filers, attribution to corporations, partnerships, trusts, or estates would only apply from a U.S. shareholder, partner or beneficiary. Thus, there is no attribution from non-U.S. persons.

- 3. For purposes of determining who is required to file as a Category 5 filer the same attribution rules that apply to Category 4 also apply, with the following changes:⁵¹
 - a. There is no family attribution from nonresident individuals.
 - b. Attribution from corporations, partnership, trusts, and estates is expanded in relation to those that apply to Category 4 filers: if a

⁵⁰ Private Letter Ruling 9024076. Note that a private letter ruling may be cited as authority only by the taxpayer to whom issued. Nonetheless, it may indicate the position of the national office of the I.R.S. at the time issued. Here, the ruling was issued 24 years ago.

⁵¹ Code §958

partnership, estate, trust, or corporation owns, directly or indirectly, more than 50% of the total combined voting power in an entity, it is deemed to own all of the voting stock of that entity.

Exceptions from Filing:

As a result of the constructive ownership rules, some duplication in filing may result when two persons are treated as Category 3, 4, or 5 filers for the same shares. Additionally, some difficulties will result Category 3, 4, or 5 filers are not in possession of the information required on the form. The I.R.S. acknowledges some of those issues and applies certain exceptions from filing.

1. Category 3, 4, or 5 filers who have no actual or indirect ownership in a foreign corporation but are required to file solely due to constructive ownership are exempt if the U.S. person whose ownership was attributed to them files Form 5471 and reports all the required information. Filers who do not file Form 5471 based on this exclusion need not include a statement to this effect.
2. In January 2013, the I.R.S. extended this exclusion to apply to Category 5 filers in addition to Category 3 and 4 filers and clarified that no statement of reliance in this respect is required. The exception applies to Category 5 filers only for tax years beginning in 2012 and afterward. The obligation to file remains for prior years. In the instructions published in January 2014, the I.R.S. corrected an omission to refer to the Code §958(a) attribution rules when determining that the Category 5 filer is required to file solely due to constructive ownership.
3. Because this exception is based on the expectation that another U.S. person will actually file Form 5471, it is prudent to confirm that the form was accurately and correctly filed.
4. A Category 2 filer is not required to file Form 5471 in either of the following cases:
 - a. Immediately after a reportable stock acquisition, three or fewer U.S. persons own at least 95% of the value of the corporation and the U.S. person making the acquisition files the form as a Category 3 filer; or
 - b. The Category 2 filer relying on the exception (i) does not have a direct interest in the corporation but is deemed to acquire stock under the constructive ownership rules and (ii) the person from whom the stock ownership is attributed files Form 5471 with all of the required information.
5. A Category 4 or 5 filer is not required to file if that person does not have a direct or indirect interest in the foreign corporation and was required to file solely due to constructive ownership from a nonresident alien.
6. All filers required to file information return with respect to a certain foreign corporation may file a joint Form 5471. If a joint form is filed the person actually filing the form must identify all persons on behalf of whom the form

is filed, and such persons must attach a statement to their tax returns identifying the actual filer and I.R.S. service center receiving the completed form. A Category 3 Filer may only join a form of another if that other person has an equal or greater interest in the foreign corporation.

What Are The Penalties For A Failure to File?

Substantial penalties exist for those who are not in compliance with the Form 5471 filing obligation. In particular, the failure to file a timely Form 5471 or the failure to file a complete or accurate form may result in a penalty of \$10,000 for each foreign corporation for each taxable year in which the failure occurs. If any failure continues for more than 90 days after notice of the failure, an additional penalty of \$10,000 per 30-day period is imposed while the failure continues (up to a maximum of \$50,000 for each failure).⁵² In addition to the monetary penalties, the I.R.S. may reduce any foreign tax credits taken by the U.S. owner by 10%, whether related to this foreign corporation or not. These penalties are assessed in addition to any penalties with respect to any income tax return and even if no income tax is due on the income tax return. Additionally, if the failure is willful, criminal penalties may be assessed.

What Else is New On the 2013 Form?

Beginning in 2013, certain U.S. shareholders filing Form 5471 may be subject to the N.I.I.T. on Subpart F income from C.F.C.'s. Form 5471 refers to the draft instructions for Form 8960, Net Investment Income Tax - Individuals, Estates, and Trusts. The draft instructions for Form 8960 were released on January 2014 and will be discussed in a separate article.

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For persons required to report acquisition and dispositions on Separate Schedule O (Category 3 filer) the penalty may be \$10,000 for each failure for each transaction.