INTERNATIONAL PRACTICE UNIT:
MONETARY PENALTIES FOR FAILURE TO FILE FORM 5471

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INTRODUCTION

Background

Concern among governments regarding the level of international tax compliance has been on the rise in recent years. This has lead to the enactment of the Foreign Accounts Tax Compliance Act ("F.A.T.C.A."), the O.E.C.D. Common Reporting Standard, and the O.E.C.D. Base Erosion and Profit Shifting ("B.E.P.S.") project.

In the U.S., the I.R.S. has initiated increased enforcement efforts to ensure compliance with information reporting obligations. Such efforts include increased assessment of penalties. Form 5471 is one of the key information forms for U.S. companies operating abroad. The I.R.S. takes this form seriously, as reflected in the severity of penalties that can be imposed for compliance failures. Several years ago, the I.R.S. initiated an automated penalty process as the first measure to increase compliance. In late 2013, the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") issued a report recommending tightening the penalty abatement procedures applicable to the automated penalties. The recommendation to tighten the abatement of penalties is a negative incentive to file a complete and accurate Form 5471.

The complicated and overlapping rules applicable to the preparation of Form 5471 are explained in a "how to" article published in *Insights* Vol. 1 No. 2.[1] This article addresses the penalties that can be imposed when the I.R.S. reviews a case involving a Form 5471 that has been filed late or that is filed on time but is not substantially complete. The goal is to explain the opportunity of abating penalties that may be imposed.

The Monetary Penalty and Reasonable Cause Relief – T.I.G.T.A. Report

The penalty for not filing a required Form 5471, for filing not timely, or for filing a substantially incomplete form is $10,000 per form per year (the "initial penalty"). Additional penalties for continued failure may be imposed, up to $50,000 per Form 5471 required (the "continuation penalty").

While the systematic imposition of penalties has improved compliance, the government found that many penalties were abated, perhaps inappropriately. The T.I.G.T.A. report made the following findings:

- In 43% of the cases reviewed, the penalties were inappropriately abated.
- In 45% of the inappropriately abated cases, the taxpayer claimed that the

[1] Galia Antebi and Stanley C. Ruchelman, "Tax 101 – Introductory Lessons: Form 5471 – How to Complete the Form in Light of Recent Changes," *Insights* 1, no. 2 (2014).

Form 1120 was timely filed, but did not provide any proof to support the claim.

- In 15% of those cases, the taxpayer requested relief as a first-time filer.
- In 12.5% of such cases, the taxpayer claimed an absence of knowledge regarding the form or relied on advice from a tax professional that was not knowledgeable of the filing obligation.
- In 10% of such cases, the taxpayer claimed an inability to timely file Form 1120 with an attached Form 5471 because the financial records were unobtainable or because of a financial problem.
- In 10% of such cases, the taxpayer claimed that the late filing was caused by either an unintentional taxpayer or tax preparer oversight.

The report stated that according to I.R.S. policy, the abatement request should have been denied in all such cases. It stated that ignorance of the law, forgetting to request an extension, being a first-time filer, having difficulty obtaining financial information, or having financial problems are not grounds for relief of penalties.

"For returns file after March 18, 2010… the S.O.L. for assessing tax for an income tax return associated with a substantially incomplete Form 5471 expires three years after the date on which a substantially complete Form 5471 is provided."

THE PRACTICE UNIT

The above-mentioned T.I.G.T.A. report recommended tightening the abatement process, and the I.R.S. is now focusing on the assessment of a monetary penalty process internally and on the review of reasonable cause applications. On October 7, 2015, the I.R.S. issued the International Practice Service Process Unit – Audit (the "Practice Unit"), a guide that provides I.R.S. agents with advice on how to handle audit cases where it has been determined the taxpayer had a requirement to file a Form 5471.[2] This Practice Unit is limited to the review of cases where the requirement to file was that of Category 4 and 5 Filers, *i.e.*, those having control over foreign corporations (Category 4) and those owning at least 10% of a Controlled Foreign Corporation ("C.F.C.") on the last day of the corporation's tax year (Category 5).[3]

The Practice Unit provides that for returns filed after March 18, 2010, or returns filed prior to March 19, 2010 for which the statute of limitations ("S.O.L.") was otherwise open on that date, the S.O.L. for assessing tax for an income tax return associated with a substantially incomplete Form 5471 expires three years after the date on which a substantially complete Form 5471 is provided. The extended S.O.L. applies to any tax return or period to which the information relates, *i.e.*, it applies to all items of income and deduction reported on the income tax return to which the Form 5471 was required to be attached. In addition, related income tax returns for prior periods are not required to be under examination in order to assess penalties for those years. Therefore, the Practice Unit suggests that I.R.S. agents who find that Form 5471 was required but not filed for the exam year also review earlier years to determine whether this form was required but not filed in such years. In reviewing whether all required forms were timely and properly filed, the Practice Unit suggests reviewing and comparing different documents as part of the audit process. The goal is to ensure that the examiner has a full picture of the global structure. Thus, the

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[2] Practice Unit FEN/9433.01_06(2013)(c).

[3] Constructive ownership rules apply in determining ownership for both categories of filers.

examiner should look at all returns and forms,[4] tax organization charts, and legal entity charts for the year under audit plus the two preceding tax years, as well as forms filed with the Securities Exchange Commission.

For income tax returns filed late, the initial penalty is assessed automatically, even when a request for reasonable cause was submitted with the tax return. The assessment results in a notice stating that the taxpayer may pay the penalty or request an abatement of the penalty for late filing due to reasonable cause.[5] After review of the reasonable cause statement, the penalty is either abated or the taxpayer must pay it or petition to the Office of Appeals.

If reasonable cause is found to exist for late filing, penalties may nevertheless be assessed if Form 5471 was substantially incomplete. While the first step in the process is a review of the face of the form for completeness and consistency, the complete review must include the taxpayer's explanation as well as an assessment of the magnitude and the complexity of the error found. The information required on Form 5471 must be furnished even if that information may not affect the amount of any tax due under the Code. According to the Practice Unit, the following could be an indication that Form 5471 is not substantially complete:

- Any error on page 1 of the form is an indication that the form is not "substantially complete." This includes
    - omitting to check the box of the category of the filer or incorrectly checking this box,
    - omitting the percentage of voting stock owned or filling in an incorrect percentage,
    - not attaching all the required schedules,
    - omitting the name or address of the foreign corporation or certain information regarding its corporate formation.
- Required schedules that are missing constitute by themselves an incomplete form.
- When inconsistencies or math errors are found on the face of the form and such errors are significant in amount, the form is substantially incomplete.
- When a Form 5471 is filed with a statement saying the required information will be furnished upon request or audit, the form is substantially incomplete.
- Providing consolidated financial statements of two or more foreign corporations is a common reason for noncompliance or error in completing the form.
- Filing requirements do not apply to a foreign corporation that has been dissolved. However, I.R.S. agents are encouraged to seek that the winding up transactions are reported on the final Form 5471. To do that, the Practice

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[4] *E.g.*, Form 1120, *Corporate Income Tax Return, and Form 8832, Entity Classification Electio* .

[5] This notice does not initiate the 90-day period for application of the continuation penalty. The I.R.S. must send taxpayers a letter notifying them of the requirement to file and that a 90-day count begins.

Unit suggests that I.R.S. agents request a copy of all exam-year general ledger transactions for such companies and look for significant transactions that may have occurred and been unreported.

- Filing requirements also apply to a dormant foreign corporation.

Providing too much of the required information can also be an indication that the form is not substantially complete. A 1997 Field Service Advice ("F.S.A.") mentioned in the Practice Unit states that Congress did not intend that providing excessive information be treated as substantial compliance. Under a strict interpretation of the regulation, over-reporting is problematic because the error itself undermines the ability of the I.R.S. to rely upon the taxpayer's reporting of related-party transactions. Nevertheless, the F.S.A. recommended that "substantial compliance" be determined by reference only to significant items. The examiner should determine if an error was significant in amount and whether the I.R.S.'s ability to gather information necessary to conduct an effective examination was impacted.

Under Chief Counsel Advice ("C.C.A.") 200429007, a facts and circumstances analysis is the preferred analysis over a strict interpretation of the regulations. This C.C.A., while only an informal guide, provides seven factors to use in such analysis. No one factor is necessarily more important than any other factor, but the factors themselves may contain evaluation characteristics which, when combined with other facts, indicate the completeness of the reporting. According to the C.C.A., the following are the facts and circumstances that should be considered:

"Providing too much of the required information can also be an indication that the form is not substantially complete."

- The magnitude of the underreporting or overreporting of the erroneous reported transaction
- Whether the reporting corporation has reportable transactions other than the erroneous reported one with the same related party and whether such other transactions were correctly reported
- The magnitude of the erroneous reported transaction in relation to all of the other correctly reported transactions
- The magnitude of the erroneous reported transaction in relation to the corporation's volume of business and overall financial situation
- The significance of the erroneous reported transaction to the corporation's business in a broad functional sense
- Whether the erroneous reported transaction occurred in the context of a significant ongoing transactional relationship with the related party
- Whether the erroneous reported transaction is reflected in the determination and computation of the reporting corporation's taxable income

Under C.C.A. 200645023, significant pieces of required information, the lack of which will be treated as "significantly incomplete," include

- balance sheets and income statements, in accordance with U.S. Generally Accepted Accounting Principles ("G.A.A.P."), and
- income statements and income tax amounts that are in both functional and U.S. currencies.

Once an agent determines that the taxpayer has failed to timely file an accurate information return, he must issue a notice letter to the taxpayer. Such notice letter will initiate the count for the application of the continuation penalty, which begins 90 days after the date of the letter and continues until a substantially complete Form 5471 is provided. Extensions on the 90-day period are not provided for in the Code and are subject to the discretion of the agent. The Practice Unit warns that the notice letter must be sent to the taxpayer, not its representative, because such action can assist the taxpayer in his or her claim in appeals or in court that the notice letter was ineffective. If in response to the notice a substantially incomplete Form 5471 is filed, the continuation penalty period is still in effect. In such circumstances, while an I.R.S. agent is not required to send a second notice letter, it is good practice for appeals and in court, as it will show that the taxpayer had knowledge that the subsequently submitted Form 5471 was substantially incomplete.

"Reasonable cause could not have existed earlier than the due date for filing or the dat of the notice letter."

Reasonable Cause

As mentioned above, the Code provides that the initial penalty can be abated if the compliance failure is due to "reasonable cause" and not due to willful neglect. In order for the exception to apply, the taxpayer must file a statement in writing that provides all the facts alleged to be reasonable cause and contains a declaration that the statement was made under penalties of perjury. When a proper statement is filed, the I.R.S. will consider whether the reporting requirements should be treated as met. I.R.S. agents should look for the dates of the supporting documents and events, as reasonable cause could not have existed earlier than the due date for filing or the date of the notice letter. The Practice Unit further instructs agents to review all tax years open under the statutes and assure that such years are in compliance prior to considering reasonable cause relief.

The Practice Unit provides that the following facts may be treated under certain circumstances as reasonable cause:

- Erroneous advice or reliance
- Unable to obtain records
- Death, serious illness, or unavoidable absence

Ignorance of the law, by itself, is not reasonable cause. However, in conjunction with other factors, it might be. An honest misunderstanding of the law that is reasonable in light of all the relevant facts could suggest reasonable cause. To determine whether reasonable cause exists, the additional factors that should be considered include

- the taxpayer's education,
- past penalties,
- whether the taxpayer could not reasonably be expected to know of recent changes in the law or forms, and
- the level of complexity of a tax or compliance issue.

Generally, the most important factor in determining whether a taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's efforts to report the proper tax liability. In U.S. v. Boyle, the Supreme Court noted that reasonable cause

requires the taxpayer to demonstrate that it exercised “ordinary business care and prudence” but nevertheless was “unable to file the return within the prescribed time.”

Generally, reliance on the substantive advice of an informed, qualified professional is reasonable. In contract, reliance on a professional to carry out ministerial duties not requiring special expertise, such as timely filing a return, is not reasonable cause. Arguments based on distance to the place where the company’s books and records are kept, language limitations, currency, and accounting practice and systems may not be reasonable cause for reporting errors because most persons required to file Form 5471 have the same circumstances. The cost of converting the financial statements to U.S. dollars and U.S. G.A.A.P. would constitute reasonable cause only if the exercise of ordinary business care and prudence would not have allowed the corporation to make the conversions because such conversion would have caused it undue hardship. While an isolated error may indicate inadvertence, not intention, a large number of incomplete Forms 5471 filed by a taxpayer do not indicate an isolated oversight but an intentional decision to file incomplete Forms 5471. Moreover, a taxpayer’s strong compliance history may indicate that the failure to file complete forms is not inadvertent.

Note that the fact that a foreign jurisdiction would impose civil or criminal penalties on the taxpayer or any other person for disclosing the required information and/or refusal on the part of a foreign trustee to provide information for any other reason does not constitute a reasonable cause.

If reasonable cause is determined to exist, the extended S.O.L. only applies to items related to the missing information on Form 5471.

CONCLUSION

Filing an incomplete or inaccurate Form 5471 results in high penalties under the practice now followed by the I.R.S. Reasonable cause relief is now more tightly reviewed by the I.R.S. and strong arguments are needed, supported by documentation demonstrating ordinary business care and prudence were exercised but nevertheless a complete return could not be timely filed.

It should be noted that the automatic relief from penalties for delinquent Forms 5471, which was available to taxpayers that had no underreported tax liabilities under F.A.Q. 18 to the 2012 Offshore Voluntary Disclosure Program, was eliminated when F.A.T.C.A. became effective on July 1, 2014.