I.R.S. EXPLAINS "SUBSTANTIALLY COMPLETE" IN RELATION TO INTERNATIONAL INFORMATION RETURN

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BACKGROUND

While determining whether a taxpayer has complied with its obligation to provide the I.R.S. with information on its international operations as required by Code §6038 for outbound transactions and by Code §6038A for inbound transactions, it is important that the taxpayer's information return is substantially complete. If it is not, penalties may be imposed for failure to comply with the taxpayer's information reporting obligation. Code §6038 requires certain U.S. persons who are officers, directors, or shareholders of foreign corporations to file Form 5471[1] with respect to each foreign corporation and foreign partnership that they control. Similarly, Code §6038A requires a U.S. corporation that is 25% foreign owned to furnish Form 5472[2] to the I.R.S.

Where a Form 5471 submitted by a filer omits certain required information or contains erroneous information, the filer may be relieved from penalty if, notwithstanding these shortfalls, the information in the return is substantially complete so that the I.R.S. may conclude that substantial compliance exists.[3] The same holds true for an incomplete Form 5472.[4] Thus, a taxpayer must substantially comply with the reporting obligations by providing substantially complete information returns in order to avoid penalties. However, the terms "substantially complete" and "substantially incomplete" are not defined in the Code or its regulations.

This article will discuss an I.R.S. Practice Unit published recently that addresses the I.R.S.'s view of substantial compliance in the context of existing U.S. case law.

"SUBSTANTIALLY COMPLETE" / "SUBSTANTIAL COMPLIANCE" – I.R.S. EXPLANATION

On June 19, 2017, the Large Business & International Division ("L.B.&I.") of the I.R.S. issued a Practice Unit[5] providing guidance as to the meaning of the term

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1 Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*).

2 Form 5472 (*Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*).

3 Treas. Reg. §1.6038-2(k)(3)(ii).

4 Treas. Reg. §1.6038A-4(a)(1).

5 Practice Units are not official pronouncements of law or directives and cannot be used, cited, or relied upon as such. Practice Units provide a general discussion of a concept, process, or transaction, and are a means for collaborating and sharing knowledge among I.R.S. employees. Practice Units may not be used or cited as precedent.

"substantially complete" with respect to international information return penalties. It provides informal guidance to I.R.S. agents examining (i) a U.S. entity with foreign ownership, or (ii) a U.S. branch or subsidiary of a foreign corporation, for purposes of determining whether the required international information return is substantially complete, so that the filing requirement is met.

The Practice Unit begins by explaining the substantial compliance doctrine, which is a judicial concept that applies to certain tax returns, elections, and substantiation of deductions. While the concept of substantially complete has not been the subject of judicial review, the body of case law concerning the substantial compliance doctrine provides guide posts for how a court may interpret whether an international information return is substantially complete. This background can be applied to supplement existing informal guidance on substantial completion or, where the I.R.S. has not provided specific informal guidance, this background can suggest a general approach for an I.R.S. examiner to follow.

The Practice Unit discusses the difference between the strict compliance and substantial compliance doctrines. If a particular item of information or requirement at issue is determined to be related to the "substance or essence" of the statute or regulation, strict compliance is necessary. However, if the requirement is seen as "procedural or directory," then substantial compliance will suffice.

In the context of a full income tax return, the Practice Unit looked to *Beard v. Commr*.[6] for guidance. There, the Tax Court summarized the requirements for a tax return to be considered valid for triggering the start of the period of limitations on assessment:

- It must provide sufficient data to calculate tax liability.
- It must purport to be a return.
- It must reflect an honest and reasonable attempt to satisfy the requirements of the tax law.
- It must be signed under penalties of perjury.
- If a return fails to meet these requirements, it will not be considered valid and will not trigger the running of the statute of limitations.

The Practice Unit then proceeded to address whether an election authorized by law is substantially complete. *Taylor v. Commr.*[7] involved an election under prior law that allowed a farmer to obtain a certain tax benefit in connection with the sale of livestock. When made, the election prevented the application of a recapture rule that would convert some or all of the gain into ordinary income. The taxpayers followed the basic requirements for favorable treatment – including reporting the gain on a tax return – but failed to file a formal election to report the gain as capital gain. The statute required a taxpayer to file an election for the favorable treatment with the following language:

> (B) Time, manner, and effect of election. — An election * * * for any taxable year shall be filed within the time prescribed by law (including

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6 82 T.C. 766 (1984), *affd*. 793 F.2d 139 (6th Cir. 1986).

7 67 T.C. 1071 (1977).

> extensions thereof) for filing the return for such taxable year, and shall be made and filed in such manner as the * * * [I.R.S.] shall prescribe by regulations. Such election shall be binding on the taxpayer for such taxable year and for all subsequent taxable years and may not be revoked except with the consent of the * * * [I.R.S.].[8]

In the case, the I.R.S. argued that the election was necessary for it to identify those taxpayers that claimed the benefit of the provision so that the validity of elections could be reviewed easily. To that end, the I.R.S. characterized the election as "indispensable to the smooth administration of the revenue laws." Nonetheless, the court determined that the I.R.S. had all information within the return to determine that an election was made. The taxpayer was in substantial compliance with Code §1251(b)(4)(B).

> The test for determining the applicability of the substantial compliance doctrine has been the subject of a myriad of cases. The critical question to be answered is whether the requirements relate "to the substance or essence of the statute." * * * If so, strict adherence to all statutory and regulatory requirements is a precondition to an effective election. * * * On the other hand, if the requirements are procedural or directory in that they are not of the essence of the thing to be done but are given with a view to the orderly conduct of business, they may be fulfilled by substantial, if not strict, compliance. * * * Thus[,] our decision must rest upon an analysis of the purpose of section 1251 and the exception contained therein to determine whether the disputed requirements are mandatory or directory. * * * To our mind, the essence of section 1251(b)(4) is to allow a farmer capital gains treatment on the sale or other disposition of farm recapture property if the farmer utilizes the method of accounting that cannot produce the evil section 1251 was enacted to prevent. * * * The election requirements, although undoubtedly helpful in the processing and auditing of returns, are in our view merely directory. We hold that petitioners, having fulfilled the essential requirements of section 1251(b)(4), have effectively made an election under that section on their original returns for the years at issue. [Citations omitted.][9]

A similar conclusion was reached in *Bond. v. Commr.*,[10] a case involving a charitable contribution of property. The income tax regulations[11] in effect for the year required a taxpayer claiming a deduction for a charitable contribution of property worth more than $5,000 to (i) obtain a qualified appraisal, (ii) attach an appraisal summary to the return, and (iii) retain certain information, including the qualified appraisal itself. The Tax Court found that the purpose of the regulation was to provide information helpful to the I.R.S. in processing and auditing returns on which deductions for charitable contributions are claimed. The regulations did not relate to the substance or essence of whether a charitable contribution was actually made, but instead alerted the I.R.S. to the charitable contribution and required taxpayers to provide certain

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8 Code §1251(b)(4).

9 *Taylor v. Commr.*, *supra*, at 1077-1079.

10 100 T.C. 32 (1993).

11 Treas. Reg. §1.170A-13.

information. As a result, the regulatory requirement was held to be directory, rather than mandatory, and the taxpayer was held to have substantially complied.

On the other hand, in *Prussner v. U.S.*,[12] the Court of Appeals for the 7th Circuit found that substantial compliance did not exist when, in lieu of a specific election on an I.R.S.-issued form, the attorney for the taxpayer's estate attached a letter stating that the form would be filed in the near future. The case involved heirs to family farms and other family businesses electing to value the assets of the farm or business in their current use, rather than being required, like other heirs, to value the assets at their commercially most lucrative use. The attorney for the estate failed to attach a recapture agreement to the estate tax return, instead attaching a letter which stated the following:

> * * * unfortunately, the agreement * * * was not fully executed at the time because the heirs reside throughout the United States. I hope to send this agreement to you within the next few weeks.

Four months later, he filed an agreement that complied fully with all the requirements of the regulation – other than timeliness. The I.R.S. disallowed the election and the Court of Appeals affirmed, concluding that the shortfall in the estate's compliance was not a late filing but an incomplete filing:

> There are further differences between day-late filing and incomplete filing. All fixed deadlines seem harsh because all can be missed by a whisker—by a day * * * or for that matter by an hour or a minute. They are arbitrary by nature. The taxpayer in this case missed by four months, and that is the proper comparison to the (curable) case of an incomplete return. The legal system lives on fixed deadlines; their occasional harshness is redeemed by the clarity which they impart to legal obligation. "Deadlines are inherently arbitrary; fixed dates, however, are often essential to accomplish necessary results. The Government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards." * * * There is no general judicial power to relieve from deadlines fixed by legislatures or, as here, by agencies exercising legislative-type powers." To extend the time [for filing an amended return] beyond the limits prescribed in the Act is a legislative not a judicial function.
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> * * * Prussner's lawyer could have obtained some of the signatures, and if he had done so and had filed an incomplete agreement Prussner would have had the protection of the statute–at least if the Illinois beneficiaries were the principal ones. This qualification is important because the requirement of substantial compliance is not satisfied by filing an agreement signed by one contingent remainderman, the main beneficiaries being left off. * * * That would make a joke of the statute by validating the election of a taxpayer who willfully flouted the requirements for a valid election. No matter; Prussner's lawyer could easily have obtained an extension of time for filing the estate tax return. He neither sought an extension of time nor filed an incomplete recapture agreement with the return; he failed to file

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[12] 896 F2d 218 (7th Cir. 1990).

a recapture agreement with the return, period. For this default the statute provides, as the Eighth Circuit has also concluded, no absolution.

INFORMATION RETURNS ENSURE U.S. TAX LAWS ARE OBSERVED

The Practice Unit discusses General Counsel Memorandum ("G.C.M.") 36372,[13] which explains the purpose and goals of an information return and how it is different from an income tax return. The G.C.M. takes the position that information reported on income tax returns is necessary to determine tax liability. As such, if a taxpayer omits information that is not necessary to determine tax liability, the return may be considered complete notwithstanding the omission. By contrast, information returns are required so that the I.R.S. can properly administer the revenue laws. If material information is left off an information return, such omission can impede the I.R.S.'s ability to perform the duties assigned to it by Congress.

The I.R.S. position in G.C.M. 36372 is similar to the arguments of the I.R.S. that were dismissed in the *Taylor* and *Bond* cases, but adopted in *Prusser*. Under *Prusser*, any provision in the Code aimed at providing the I.R.S. with information related to transactions cannot be viewed to be directory. In the I.R.S.'s view, the intent of Congress when enacting those provisions was to have taxpayers provide the I.R.S. with information that could be helpful in determining whether U.S. tax laws are being properly observed. Hence, providing information goes to the essence of the statute.

SUBSTANTIAL COMPLIANCE TEST MAY NOT BE MET EVEN IF MAJORITY OF INFORMATION IS REPORTED ACCURATELY

The Practice Unit directs the taxpayers to a Field Service Advice ("F.S.A.") that explores the concepts of "substantially complied" or "substantially incomplete" with respect to international information returns.

F.S.A. 33381431 discusses substantial compliance with respect to Form 5471. The F.S.A. warns that even though the majority of the information may have been reported accurately and completely, this does not mean that there has been substantial compliance such that a taxpayer is relieved from liability for a penalty. In the F.S.A., the U.S. taxpayer accurately reported the majority of the information, but failed to accurately report major transactions with related parties. The F.S.A. took the position that the related-party information was the essence of the filing requirement. If a taxpayer is allowed to satisfy its filing requirements by accurately providing most of the information, it would have the opportunity to avoid providing any information at all or to provide incorrect information with respect to important transactions.

The F.S.A. rejected the "aggregate approach," under which a taxpayer would be considered to be in substantial compliance if it accurately reported a certain percentage of the information required to be reported on Form 5471. Instead, it concluded that substantial compliance is measured on the basis of each significant item

[13] G.C.M. 36372 discusses the application of Code §6652(d), *i.e.*, the penalty in case of incomplete Forms 990-P and 4848.

of information specified in Code §6038(a)(1) for each individual controlled foreign corporation. It concluded that the U.S. taxpayer did not substantially comply with the Code §6038 reporting requirements because certain significant items were not reported.

SUBSTANTIALLY COMPLETE REQUIRES A FACTS AND CIRCUMSTANCES ANALYSIS

The Practice Unit then proceeds to discuss two Chief Counsel Advices ("C.C.A.'s").

C.C.A. 200429007 considered the meaning of the term "substantially incomplete" in regard to Form 5472 and as that term is used in Treas. Reg. §1.6038A-4(a)(1). The U.S. taxpayer timely filed Form 5472 for transactions with its parent for the relevant tax years. All required information was included on Form 5472. However, some transactions were erroneously reported. The C.C.A. looked at whether the taxpayer had substantially complied with its reporting requirements.

The C.C.A. begins its analysis by listing the information that must be provided on Form 5472:

- Sales and purchases of stock in trade (inventory)
- Sales and purchases of tangible property other than stock in trade
- Rents and royalties paid and received
- Sales, purchases, and amounts paid and received as consideration for the use of all intangible property
- Consideration paid and received for technical, managerial, engineering, construction, scientific, or other services
- Commissions paid or received
- Amounts loaned and borrowed (except open accounts resulting from sales and purchases reported under other items that arise and are collected in full in the ordinary course of business)
- Interest paid and received
- Premiums paid and received for insurance and reinsurance
- Other amounts paid or received not specifically identified, to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting corporation

Further, on Form 5472, a reporting corporation is required to separately categorize by type its transactions with the named foreign related party by listing the amounts paid and received.

The C.C.A. identified two approaches that could be used to determine whether a return is substantially complete. The first is strict compliance: a rigorous interpretation of the rules that would treat virtually any substantive inaccuracy as rendering the return substantially incomplete. Under the strict compliance approach, any error for which reasonable cause does not exist is a substantially incomplete filing of

Form 5472. According to the C.C.A., a taxpayer that underreports or over-reports a particular transaction in a substantial amount frustrates I.R.S. efforts to audit a taxpayer. A taxpayer's error may also compel the I.R.S. to conduct a more intensive investigation than would have been unnecessary had the taxpayer correctly reported the transaction on the Form 5472. Accordingly, it is the error itself, as opposed to whether the error involves an underreporting or over-reporting, that undermines the ability of the I.R.S. to rely upon a taxpayer's reporting of related-party transactions.

"When considering and applying these factors to any particular situation, no one factor is necessarily more important than any other factor."

The second approach is based on substantial compliance, which reflects a facts and circumstances approach. The C.C.A. identifies seven factors that should be considered in determining whether the taxpayer has substantially complied with the reporting requirements:

1. The magnitude of the underreporting, or of the over-reporting, of the erroneous reported transaction(s) in relation to the actual total amount of that reported type of transaction(s)

2. Whether the reporting corporation has reportable transactions other than the erroneous reported transaction(s) with the same related party and correctly reported such other transactions

3. The magnitude of the erroneous reported transaction(s) in relation to all of the other reportable transactions as correctly reported

4. The magnitude of the erroneous reported transaction(s) in relation to the reporting corporation's volume of business and overall financial situation

5. The significance of the erroneous reported transaction(s) to the reporting corporation's business in a broad functional sense

6. Whether the erroneous reported transaction(s) occur(s) in the context of a significant ongoing transactional relationship with the related party

7. Whether the erroneous reported transaction(s) is (are) reflected in the determination and computation of the reporting corporation's taxable income

When considering and applying these factors to any particular situation, no one factor is necessarily more important than any other factor. The factors may contain evaluative characteristics when combined with other facts to indicate the completeness of the report. Overall, these factors give informal guidance on measuring the significance of the errors. While estimates are allowed in completing Form 5472 if actual data is not readily available, the estimates must be within prescribed limits.

C.C.A. 200429007 then looked at four fact patterns and reached conclusions as to the imposition of a penalty under the strict compliance and substantial compliance approaches to penalty exposure regarding Form 5472:

1. In the first fact pattern, inventory purchases are overstated by a factor of 100%. Purchases of $1,000,000 were reported on Form 5472, whereas the actual purchases were $500,000. The I.R.S. concluded that under the strict compliance approach, the Form 5472 was substantially incomplete because of the overstatement of transactions. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error.

2. In the second fact pattern, the taxpayer sold $1,000,000 of goods to its parent and borrowed $600,000 from its parent. On Form 5472, it reported that it borrowed $1,000,000 from its parent. However, only $600,000 was borrowed from the parent. The I.R.S. concluded that, under the strict compliance approach, the Form 5472 was substantially incomplete because the taxpayer did not accurately report the amounts borrowed. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error.[14]

3. In the third fact pattern, the ending balance of related-party loans did not match the opening balance on the following year's Form 5472 for that party. The ending balance of the preceding year was $1,000,000, but the opening balance for the following year was reported to be $600,000, which was found to be erroneous by the I.R.S. The I.R.S. concluded that, under the strict compliance approach, the Form 5472 was substantially incomplete because the taxpayer did not accurately report the opening balance of the related-party loan. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error.[15]

4. In the fourth fact pattern, the taxpayer reported inventory purchases of $1,000,000, but the I.R.S. determined upon examination that the correct amount was $500,000. On the same Form 5472, the taxpayer reported commissions paid in the amount of $1,200,000, but upon examination, the I.R.S. determined that the correct amount was $1,600,000. Considered in the aggregate, only a $100,000 difference existed between the amount of total intercompany transactions. On the other hand, each of the transactions reported were off by material amounts, in one instance by 50% (over-reporting of purchases) and in the other 33% (underreporting of commissions). The I.R.S. concluded that, under the strict compliance approach, the Form 5472 was substantially incomplete because the taxpayer did not make accurately reports in two categories of intercompany transactions. The same conclusion was reached under the substantial compliance standard because of the magnitude of the error regarding at least one of the two categories of intercompany transactions.

In C.C.A. 200645023, a U.S.-based corporate group acquired a foreign-based group in a complex tender offer for shares of the foreign target. Within four months of closing the acquisition, the foreign target and its lower-tier subsidiaries of the foreign target were liquidated into a local country subsidiary of the U.S.-based group. The U.S.-based group timely filed Forms 5471 for the foreign target and its subsidiaries for the period of ownership between the closing and the liquidation. However, with one exception, the forms did not include Schedule O of Form 5471, which is used to advise the I.R.S. of acquisitions and dispositions of share in a foreign corporation, nor did the relevant Form 5471 for each such corporation include a balance sheet under U.S. Generally Accepted Accounting Principles ("U.S. G.A.A.P.").

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[14] The conclusion in the C.C.A. under the substantial compliance approach was subject to confirmation of certain facts, although Chief Counsel expressed a view that the facts likely existed.

[15] The conclusion in the C.C.A. under the substantial compliance approach was subject to the development by the examiner of additional facts, although Chief Counsel expressed a view that the facts likely would show that the Form 5472 was substantially incomplete.

The U.S.-based group contended in part that substantial compliance existed for the Forms 5471 of the foreign target and its subsidiaries. Each Form 5471 was completed based on the best information available to it at that time. Moreover, the only substantive deficiency was that the financial statements were not stated in U.S. dollars or converted to U.S. G.A.A.P., which it stated would have been a monumentally costly task. The C.C.A. concluded that the forms were not substantially complete. The fact that the conversions necessary to file substantially complete Forms 5471 would have been costly is not alone a sufficient reason to demonstrate reasonable cause. The schedules on Form 5471 converted into U.S. G.A.A.P. and U.S. dollars are significant pieces of required information. Secondly, excessive costs would have constituted reasonable cause only if the exercise of ordinary business care and prudence would not have allowed the U.S.-based group to make the conversions.

CONCLUSION

The substantial compliance defense to penalties described in the regulations under Code §§6038 and 6038A is available only to penalties under those sections in connection with Form 5471 and Form 5472. Nonetheless, a court may apply the generally applicable substantial compliance doctrine to other international information returns, including

- Form 8865 (*Return of U.S. Persons with Respect to Certain Foreign Partnerships*),
- Form 8858 (*Information Return of U.S. Persons with Respect to Certain Foreign Disregarded Entities*),
- Form 926 (*Return by a U.S. Transferor of Property to a Foreign Corporation*),
- 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 Trusts with a U.S. Owner*).

Although not binding on taxpayers, the Practice Unit provides valuable insight into the I.R.S. viewpoint on the application of the substantial compliance doctrine and the meaning of substantially complete in relation to Code §§6038 and 6038A. As demonstrated above, however, the I.R.S. view of substantial compliance differs from that held by many taxpayers. Substantial compliance for the I.R.S. is likely simply a lighter form of strict compliance, requiring more steps for the I.R.S. to impose a penalty, but ultimately arriving at the same result.