Form 5471: How Does New IRS Guidance Impact the "Substantially Complete" Defense?

By Hale E. Sheppard

Hale E. Sheppard examines the "substantially complete" defense to Form 5471 penalties.

I. Introduction

After suffering a near miss, hearing "close but no cigar" provides little consolation. It provides even less comfort when coming from the IRS. Unfortunately, this is precisely what is happening in the context of Forms 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*. Since 2009, the IRS has been automatically assessing penalties of $10,000 per violation for missing or late Forms 5471. Now, based on guidance from the IRS in October 2015, it appears that the IRS has instructed its troops to aggressively penalize timely Forms 5471 that were not "substantially complete." This is a major issue because (i) increasing numbers of U.S. taxpayers will be subject to the Form 5471 filing requirement as they globalize, (ii) Form 5471 is one of the most complicated international information returns in existence today, and (iii) filling out Form 5471 depends on obtaining large amounts of data in a timely manner from a reluctant foreign entity, and then contending with obstacles caused by differences in accounting methods, tax years, currency conversions, foreign languages, *etc*. These realities result in the filing of many Forms 5471, by well-intentioned taxpayers, that may or may not be considered "substantially complete" by the IRS. This article examines the "substantially complete" defense to Form 5471 penalties, the new IRS guidance indicating that it intends to narrowly construe this defense and several obscure items related to effectively representing taxpayers with Form 5471 problems.

II. Overview of Form 5471 Filing Requirement

Four categories of U.S. persons who are officers, directors and/or shareholders of certain foreign corporations must file an annual Form 5471 with the IRS

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to report their relationships with the corporations.[1] Form 5471 is filed as an attachment to the person's federal income tax return.[2] If a person fails to file a Form 5471, files a late Form 5471 or files a timely but "substantially incomplete" Form 5471, then the IRS may assert a penalty of $10,000.[3] This penalty increases on a monthly basis, to a maximum of $50,000, if the problem persists after notification by the IRS.[4] The IRS will not impose penalties, however, if there was "reasonable cause" for a late/missing Form 5471 or if a timely Form 5471 was "substantially complete."[5] The regulations state the following with respect to the substantially complete defense:

Since 2009, the IRS has been automatically assessing penalties of $10,000 per violation, per year for missing or late Forms 5471.

> In the case of a [Form 5471] that has been filed as required by [Code Sec. 6038] except for an omission of, or error with respect to, some of the information required, if the person who filed the [Form 5471] establishes to the satisfaction of the [IRS] that the person has substantially complied with this section, then the omission or error shall not constitute a failure under this section.[6]

The substantially complete defense is unique to Form 5471 and certain other international information returns, and it gives taxpayers and their advisors hope that the IRS might exercise leniency when determining whether penalties are appropriate. This optimism may be groundless, as recent documents from the IRS demonstrate that the substantially complete defense likely will be accepted only in the narrowest of circumstances.

III. New Guidance from the IRS

The Large Business and International ("LB&I") division of the IRS trains its personnel in various ways, one of which is issuing them so-called International Practice Units (IPUs). The IPUs began in 2012 and were first released to the public two years later, in 2014. As of the writing of this article, approximately 70 IPUs have been published. IPUs do not constitute legal precedent, but many Revenue Agents give them considerable weight in conducting audits, determining whether penalties apply, *etc.*[7]

In October 2015, the LB&I division released an IPU focused on penalties for Form 5471 violations by certain categories of U.S. persons.[8] It contains a fair amount of information about the circumstances under which the IRS will consider a Form 5471 to be "substantially incomplete" and thus subject to penalties. The IPU divides defective Forms 5471 into two main categories.

A. Facially Incomplete Forms 5471

The IPU contains a list of items that represent incompleteness on the face of Form 5471. These include the following: (i) not identifying on Page 1 the category (or categories) into which the taxpayer falls or the amount of voting stock that the taxpayer owns in the foreign corporation, without which the IRS cannot determine which Schedules to Forms 5471 the taxpayer must complete; (ii) including only of partial data regarding the identity and location of the foreign corporation, which the IRS needs in order to expand an audit to cover related entities and individuals; (iii) not completing any required Schedule to Form 5471; (iv) stating that certain information required by Form 5471 will be provided by the taxpayer only upon express request from the IRS; (v) using computer-generated Forms 5471 that have not been approved by the IRS; and (vi) not providing proper financial statements for the foreign corporations.[9] These constitute the types of "conspicuous" errors that a front-line worker at an IRS Service Center could immediately detect and then either mark the related tax return for audit or send a notice instructing the taxpayer to rectify the deficiencies.[10]

B. Forms 5471 with More Subtle Incompleteness

In a section called "beyond their face," the IPU cites various IRS pronouncements and cases that apparently will be shaping the IRS's position regarding Form 5471 and the substantially complete defense. These items are examined below.

1. CCA 200645023[11]

The taxpayer was a U.S. corporation, which was the parent of a group that conducted global operations through numerous foreign subsidiaries. As part of a complicated transaction, the taxpayer acquired and then controlled for approximately four months a foreign corporation. The taxpayer received tax advice from a U.S. tax professional, indicating that the taxpayer should file a Form

5471 for each of the three foreign subsidiaries held by the foreign corporation. The taxpayer disagreed with this advice, believing that it was not obligated to file Forms 5471 because, under a substance-over-form analysis or the step-transaction doctrine, the taxpayer never really owned the foreign corporation. Nevertheless, the taxpayer filed Forms 5471 in a timely manner. The Forms 5471 were incomplete in that they failed to attach Schedules O (Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock), and they failed to report certain items in U.S. dollars and in accordance with U.S. generally accepted accounting principles (GAAP). The IRS penalized the taxpayer.

The taxpayer argued that the Forms 5471 were "substantially complete" because (i) they were based on the best data available at the time of filing and (ii) the only substantive deficiency, not converting foreign financial statements into U.S. dollars and then presenting them using GAAP, was not done because it would have been a "monumental costly task for it to do so."

With respect to the "substantially complete" issue, the IRS stated that Schedule C (Income Statement) and Schedule F (Balance Sheet) must be in GAAP, Schedules C (Income Statement) and Schedule E (Income, War Profits, and Excess Profits Taxes Paid or Accrued) must use U.S. dollars and functional currencies are "significant pieces of required information" and thus "substantial" for purposes of Form 5471.

The IRS then acknowledged, by reference to Code Sec. 6651, that high administrative costs might be a defense, but only if the task at hand (*i.e.*, completing certain aspects of Form 5471) would cause "undue hardship" for the taxpayer. The regulations under Code Sec. 6651 state that a late payment will be considered due to reasonable cause where "the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability *and was nevertheless either unable to pay the tax or would suffer an undue hardship … if he paid on the due date*."[12] The regulations go on to explain that the term "undue hardship" means more than a mere inconvenience; the taxpayer must show that it would suffer a substantial financial loss if it were required to complete the relevant tax duty.[13] As one might expect, from the IRS's perspective, a taxpayer rarely confronts a financial hardship significant enough to warrant penalty abatement.[14]

After declining the substantially complete argument, the IRS then characterized a seemingly positive fact for the taxpayer as a negative. The taxpayer contended that its filing of complete, timely Forms 5471 in past years should mitigate penalties for deficient Forms 5471 in the present. The IRS stated its you-should-know-better position in the following manner:

> [T]he fact that [the taxpayer] has a strong compliance history in filing Forms 5471 for its non-U.S. affiliates indicates that the failure to file complete Forms 5471 in this case was not inadvertent because [the taxpayer] was familiar with the proper manner in which to complete Forms 5471 for its non-U.S. affiliates.

2. CCA 200429007[15]

This IRS pronouncement deals with Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, not Form 5471, but the IPU directs IRS personnel to consult it nonetheless. The IRS examines four situations in CCA 200429007, concluding each time that the Forms 5472 were not "substantially complete." These situations are summarized below.

First Situation—Overstating Amounts. The taxpayer disclosed all relevant items on Form 5472, but inadvertently overstated certain amounts. For example, the taxpayer reported purchases of inventory of $1,000, and the IRS later determined during an audit that the correct number should have been $500. The IRS found that this type of overstatement rendered the Form 5472 "substantially incomplete." The IRS reasoned as follows in arriving at this conclusion:

> A taxpayer that underreports, or over-reports, a particular transaction in a substantial amount frustrates the [IRS's] efforts to audit that taxpayer. A taxpayer's error may also compel the [IRS] to conduct a more intensive investigation than would have been necessary 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, which undermines the ability of the [IRS] to rely upon a taxpayer's reporting of related party transactions*.

The IRS also explained that it applies a seven-factor test in determining whether an error or omission makes an international information return, like Form 5472, "substantially incomplete." These factors consist of the following: (i) the magnitude of the overstated or understated amounts compared to the actual amounts that should have been reported; (ii) whether the taxpayer had other reportable transactions with the same party and correctly reported such transactions; (iii) the size of the

erroneously reported transaction in relation to all other reportable transactions that were correctly reported; (iv) the magnitude of the unreported transactions in relation to the taxpayer's volume of business and overall financial situation; (v) the significance of the unreported transactions to the taxpayer's business in a broad, functional sense; (vi) whether the unreported transactions occurred in the context of a significant, ongoing transactional relationship with a related party; and (vii) whether the unreported transactions affect the taxpayer's taxable income in the relevant year.

Second Situation—Reporting Excessive Data. The taxpayer reported amounts of intercompany receivables on Form 5472 that were not required to be reported because of an exception to the general rule. In other words, the taxpayer provided excess data, not overstated amounts. When the IRS raised this fact with the taxpayer during an audit, the taxpayer rectified the issue by voluntarily providing a corrected Form 5472. The IRS concluded, nevertheless, that the original Form 5472 was "substantially incomplete."

Third Situation—Mismatch. The ending-balance of related-party loans on the Form 5472 for the first year did not match the opening-balance on the Form 5472 for the following year. The taxpayer correctly reported the interest income received because of the loan, such that this was solely an "information mismatch" issue, not a tax issue. The IRS concluded that this type of error yielded the Forms 5472 "substantially incomplete."

Fourth Situation—Small Net Change. The taxpayer over-reported one amount and then underreported another amount on the same Form 5472. For instance, the taxpayer disclosed purchases of inventory of $1,000 instead of $500 and then showed commissions paid of $1,200 instead of $1,600. The net effect was an error of $100. This IRS determined that each of these errors separately, and the two errors together, caused the Form 5472 to be "substantially incomplete." Below is a portion of the IRS's reasoning for penalizing the taxpayer in this situation:

> First, it is important to recognize that when a taxpayer has made several errors on a Form 5472 it is necessary to analyze each of these errors in isolation in order to determine whether the error causes the Form 5472 to be "substantially incomplete," *and* to analyze the errors in the aggregate in order to determine whether the total effect of the errors causes the Form 5472 to be "substantially incomplete." It is possible that no single error, among several on a Form 5472, would render that form "substantially incomplete." However, the net effect of those errors, in the aggregate, may cause the Form 5472 to be considered "substantially incomplete." For example, a taxpayer could over-report by $100X each of the following: Purchases of Stock in Trade, Commissions Paid and Rents Paid. Although individually each of these errors may not be significant, the aggregate effect of these errors that result in over-reporting expenses by $300X may be considered significant enough to make the Form 5472 "substantially incomplete." *Accordingly, we believe that if one of the errors in isolation or the aggregate effect of all of the errors causes the Form 5472 to be "substantially incomplete," then the Form 5472 in its entirety is "substantially incomplete."*

3. Non-Docketed Service Advice Review (NSAR) 20167[16]

The taxpayer in this case filed timely Forms 1120 and enclosed Forms 5471; however, they were missing certain data. Specifically, the taxpayer had not completed Schedule A (Stock of the Foreign Corporation), Schedule B (U.S. Shareholders of Foreign Corporation), Schedule C (Income Statement), Schedule E (Income, War Profits, and Excess Profits Taxes Paid or Accrued), Schedule F (Balance Sheet), Schedule H (Current Earnings and Profits), Schedule J (Accumulated Earnings and Profits) and Schedule M (Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons). Nearly every page of the Forms 5471 stated that the taxpayer would be willing to furnish additional information upon request. The IRS penalized the taxpayer for filing "substantially incomplete" Forms 5471.

The taxpayer argued that the penalties were unwarranted because the incomplete Forms 5471 had no impact on the taxpayer's U.S. tax liability (*i.e.*, all income was properly reported on Form 1120) and the taxpayer disclosed to the IRS the existence of the foreign corporation. Because there was no dispute that the Forms 5471 were incomplete, the IRS rejected the taxpayer's position on grounds that no "reasonable cause" existed for not providing the required data in numerous Schedules to Forms 5471. The IRS also noted that "the fact there is no tax impact here is of no consequence."

4. Field Service Advice[17]

The taxpayer was a large multinational manufacturer that filed timely Forms 5471. The IRS discovered as part of an audit that some of the Forms 5471 contained incomplete or inaccurate information with respect to certain items, such as sales with related companies and intercompany loans. The IRS penalized the taxpayer, and the taxpayer disagreed. The taxpayer defended itself on two main theories. First, it contended that the Forms 5471 were "substantially complete." Second, even if they were not,

the taxpayer explained that sanctions would be inequitable in light of guidance from the IRS in News Release 90-58 about Forms 5471.

With respect to the substantially complete defense, the taxpayer stated that any errors or omissions were minor relative to the large amount of data supplied on Forms 5471. The IRS acknowledged that the taxpayer included most of the required information on Forms 5471 for each of its foreign subsidiaries, it filed timely Forms 5471 as attachments to annual Forms 1120, and it quickly took corrective actions with the IRS when the issues were raised during audit. Despite this, the IRS explained that Form 5471 penalties are appropriate when "significant pieces of required information [are] inaccurately reported or omitted," particularly when the majority of the data shown on Forms 5471 are routine and change infrequently. The IRS emphasized that the taxpayer failed to accurately report major transactions with related parties, inserting either $0 or a small figure on Form 5471, when they actually involved millions of dollars. The IRS then rejected what it calls the "aggregate approach" to analyzing Form 5471 compliance because, under that method, a taxpayer could supply two-thirds of the required information (omitting the key one-third) and then claim that it was immune from penalties as a result of the substantially complete defense. The IRS stated that it was more appropriate to analyze the issue on a "significant item by significant item basis" for each separate Form 5471.

The IRS also discarded the equity argument raised by the taxpayer. News Release 90-58 stated that "taxpayers who fail to file complete and timely Forms 5471 will be notified in writing from the Philadelphia Service Center as to what is needed to avoid being penalized. Taxpayers should send the missing information promptly or establish reasonable cause for failing to do so." The taxpayer construed this to mean that the IRS would contact those filing substantially incomplete Forms 5471 before asserting penalties. Since the IRS never notified the taxpayer of any problems related to his timely Forms 5471, it understood that no news was good news. The IRS characterized this interpretation of the News Release as unreasonable, explaining that the items described by the IRS that would trigger a warning were all "conspicuous errors" that could easily be detected by Service Center personnel and immediately addressed with a taxpayer. According to the IRS, the taxpayer's failures were extensive and not amenable to preliminary detection by Service Center personnel. Moreover, the IRS pointed out that the taxpayer had committed similar violation in past years, for which it had been penalized. In summary, the IRS concluded that the taxpayer's supposed reliance on News Release 90-58 was unjustified given the "consistency, magnitude, and persistence of such errors over the preceding years."

5. Congdon[18]

This case involves a Motion for Summary Judgment filed by the U.S. Department of Justice (DOJ) in a refund case initiated by the taxpayer in an effort to recoup Form 5471 penalties that he paid. It does not involve an analysis of the substantive issues, such as whether the taxpayer had "reasonable cause" for the violations and/or whether the substantially complete defense applied. Indeed, for purposes of allowing the court to rule on the Motion for Summary Judgment, the taxpayer conceded that the Forms 5471 at issue were "substantially incomplete."

The taxpayer was the sole owner of a foreign corporation. The IRS determined during an audit that the taxpayer had properly reported all taxable income on his tax return; therefore, the only issue was information returns, namely, Forms 5471. The taxpayer raised the following defenses: (i) Form 5471 penalties are inappropriate in situations, like here, where all income and expenses related to the foreign corporation were properly reported on the taxpayer's annual tax return; (ii) the taxpayer misunderstood his filing status as described in the IRS's instructions to Form 5471; (iii) the taxpayer has no tax skills, education or training; and (iv) since the taxpayer reported all economic details about the foreign corporation on his personal tax return, he thought it sufficed to file Form 5471 simply disclosing the existence and ownership of the foreign corporation.

This hope may be groundless, as recent documents from the IRS demonstrate that the substantially complete defense likely will be accepted only in the narrowest of circumstances.

The court determined that there was a genuine dispute of fact regarding whether the taxpayer had reasonable cause, so it declined to grant the Motion for Summary Judgment filed by the DOJ. Notably, in making its ruling, the court revealed some sympathy for the taxpayer's position, underscoring that the taxpayer had no tax, accounting or legal experience, the Form 5471 violation essentially constituted a first-time offense, the taxpayer paid all taxes related to the foreign corporation in a timely manner and the taxpayer disclosed all necessary information about the foreign corporation to the IRS "albeit on the wrong form."

IV. Digging Deeper—Important Form 5471 Issues

The guidance in the recent IPU about Forms 5471 is important by itself. However, to really appreciate its significance, one must consider some related, obscure issues. They are discussed below.

A. Late Forms 5471 Now Trigger Automatic Penalties

Perhaps the most significant, and least known, aspect of Form 5471 is that the IRS has been *automatically* imposing Form 5471 penalties for several years. Since 2009, if a U.S. tax return is filed after the deadline and Forms 5471 are attached, then the IRS will automatically assess a $10,000 per-violation penalty and immediately start the collection process. This is true regardless of whether the taxpayer includes an eloquent, thorough and persuasive statement of "reasonable cause" with the late Form 5471.[19] Lest any doubt remain about the IRS's rigidity on this point, the recent IPU about Form 5471 penalties states the following: "For Form 1120s filed late after December 31, 2008, the [IRS] automatically assesses an initial penalty of $10,000 for each Form 5471 attached. *It is assessed even when a request for reasonable cause was submitted with the Form 1120*."[20]

One must review two separate reports by the U.S. Treasury Inspector General for Tax Administration (TIGTA) to understand how the IRS arrived at this assess-penalties-now-consider-excuses-later situation. The initial TIGTA report was released in 2006.[21] It recognized that Forms 5471, along with Forms 5472, play a fundamental role in promoting international tax compliance. According to TIGTA, their importance is reflected "in the severity of the penalties" for filing violations.[22] TIGTA observed in its 2006 report that (i) the IRS should have asserted $79.2 million more in penalties in just one year; (ii) the under-penalization was attributable to the fact that sanctions had historically been asserted by Revenue Agents, manually, only in the limited situations that they detected the noncompliance during an audit; and (iii) the IRS was "missing opportunities to promote better compliance with the filing requirements for Forms 5471 and 5472 by not assessing the late-filing penalties more often."[23] TIGTA made two main recommendations to the IRS in its 2006 report. First, the IRS should convene a study group to determine whether to "automate" the penalty-assessment process for Form 5471 and Form 5472. Second, the IRS should commence a "pilot program" for automatic assessment of penalties.[24] The IRS accepted and implemented both suggestions from TIGTA.

The follow-up report was released by TIGTA in 2013.[25] The 2013 report confirms that the IRS officially introduced the automated penalty program in 2009 with respect to Forms 5471. Before the program was in place, in 2008, the total penalties were $7.6 million. By contrast, once the IRS started automatically imposing late Form 5471 penalties, the figures jumped dramatically: $71.5 million in 2009, $48.6 million in 2010, $54.3 million in 2011 and $41 million in 2012.[26] The 2013 report also explains that, in addition to assessment Form 5471 penalties more frequently, the IRS was also trending toward granting fewer abatements after the fact. The IRS abated 78 percent of the total penalty amounts in 2009 but only 39 percent in 2012.[27] The 2013 report contained several recommendations, including further decreasing the number of penalty abatements. One way to achieve this reduction, said TIGTA, would be to obligate IRS personnel to review and implement the strict rules in the Form 5471 "Decision Tree" discussed later in this article.[28]

B. First-Time Abate Policy Is Narrowly Applied

The good news is that the IRS has a general first-time-penalty-abatement policy, and taxpayers facing large Form 5471 penalties often cite this policy in seeking relief.[29] This policy states that the IRS will grant abatement, with respect to virtually all delinquency penalties (including late-filing penalties under Code Sec. 6651, late-payment penalties under Code Sec. 6651 and federal tax deposit penalties under Code Sec. 6656) in situations where a taxpayer has not been required to file a certain return before, or the taxpayer has no prior penalties of this type.[30] If the taxpayer meets these criteria, then the IRS generally issues a letter to the taxpayer confirming that abatement is being granted solely on the basis of the first-time-penalty-abatement policy, not because the taxpayer has demonstrated that it had reasonable cause for the violation.[31]

The first-time-penalty-abatement policy is bittersweet, though, because it does *not* apply to (i) "returns with an event-based filing requirement," (ii) situations where a taxpayer filed a tax return late for one of the past three years but was not penalized, and (iii) "information reporting that is dependent on another filing, such as various forms that are attached [to an income tax return]."[32] Many IRS personnel simply deny requests for abatement of Form 5471 penalties based on these exclusions from the first-time-penalty-abatement policy.

Others will render a determination after consulting the "Decision Tree," which is discussed below.

C. The "Decision Tree" for Form 5471 Penalties

If someone does not know the rules of the game, it is unlikely that he will triumph. This holds true in the area of penalty disputes with the IRS. Below are two common errors related to Form 5471 penalties.

1. First Common Error

A common error by taxpayers and representatives lacking tax-dispute experience is to believe that the standards for penalty mitigation are the same in all contexts. They are not. Take the following examples.

- Generally, the IRS may assert accuracy-related penalties under Code Sec. 6662 on tax underpayments resulting from certain types of misconduct, including negligence.[33] Penalties may not be imposed, however, if there was "reasonable cause" and the taxpayer acted in "good faith."[34]
- The IRS ordinarily can assert penalties under Code Sec. 6651 if a taxpayer files tax returns late or makes tax payments late. The IRS cannot unleash these delinquency penalties, though, if the taxpayer shows that the violation was due to "reasonable cause" and not due to "willful neglect."[35]
- Code Sec. 6654(a) generally authorizes penalties when there is an underpayment of estimated taxes. There are exceptions to this general rule, of course, such as when a taxpayer can show that imposing the penalty would be "against equity and good conscience" because of casualty, disaster or "other unusual circumstances."[36]
- Under Code Sec. 6721, the IRS generally may assert penalties when a taxpayer files a delinquent, incomplete or incorrect information return.[37] However, penalties may not be asserted where the failure is due to "reasonable cause" and the taxpayer acted in a "responsible manner."[38]
- As discussed above, the IRS immediately asserts Form 5471 penalties under Code Sec. 6038 or Code Sec. 6046, unless the taxpayer can demonstrate that there was "reasonable cause" for delinquent filings or that timely filings were "substantially complete."[39]

2. Second Common Error

Along with mistakenly believing that the standards for penalty mitigation are identical in all contexts, some people think that the concept of "reasonable cause" is the same for all tax provisions containing this phrase. This assumption is incorrect, and it causes problems for those seeking abatement of Form 5471 penalties.

In determining the appropriateness of penalties, the IRS and the courts often turn to general notions of "reasonable cause." Here are some common justifications accepted by the IRS. First, a taxpayer may establish reasonable cause by showing that it exercised ordinary business care and prudence, but nevertheless was unable to comply with the law.[40] Second, a taxpayer's misunderstanding of fact or law may constitute reasonable cause. The regulations provide that "[c]ircumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer."[41] Third, a taxpayer's ignorance of the law may give rise to reasonable cause. The IRS's Penalty Handbook acknowledges that reasonable cause "may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances," such as the level of complexity of a tax or compliance issue.[42] Fourth, a taxpayer's reasonable reliance on an independent, informed, qualified tax professional often reaches the level of reasonable cause.[43]

Form 5471 penalties generally are *not* resolved by applying the standards described above, but rather by utilizing an obscure "Decision Tree" designed by the IRS specifically for Form 5471 penalties. This "Decision Tree," found in the recesses of the Internal Revenue Manual, features standards that are much more stringent than those located elsewhere.[44] The following guidance from the "Decision Tree" demonstrates that attaining abatement of Form 5471 penalties can be challenging:

- If the taxpayer claims that it was unaware of the Form 5471 filing requirement, the "Decision Tree" instructs the IRS to deny abatement because "ordinary business care and prudence requires taxpayers to determine their tax obligations when establishing a business in a foreign country."
- The "Decision Tree" mandates that penalty abatement be denied where the taxpayer seeks clemency because of financial problems.
- The "Decision Tree" further indicates that the IRS will show no mercy in situations where a taxpayer states that Form 5471 was late because the transactions, tax laws or business structure was complicated.
- If the taxpayer claims that multiple layers of ownership prevent the taxpayer from obtaining all the data necessary to file a timely Form 5471, the "Decision Tree" instructs the IRS not to abate penalties.
- Rejection of the penalty abatement request will also occur, according to the "Decision Tree," when the

taxpayer cites challenges in obtaining the necessary foreign data as the excuse for late Forms 5471.

- The "Decision Tree" demands imposition of penalties if the reason for late Forms 5471 is that the person with sole authority to file Forms 5471 was absent for a reason other than death or serious illness. Moreover, even if death or serious illness of the sole responsible person is claimed, the IRS will only accept this justification if (i) the corporation can provide tangible proof, such as insurance claim, police report, letters or bills from hospitals or newspaper clippings describing event; (ii) the absence was not foreseeable; (iii) the absence occurred before and in close proximity to the filing deadline; and (iv) the taxpayer filed the Forms 5471 within two weeks of when the absence ended.
- The IRS will not waive Form 5471 penalties under the "Decision Tree" if the taxpayer personally neglected to submit a filing-extension request. Likewise, the "Decision Tree" denies abatement where the taxpayer hired a third party (such as an accounting firm) to prepare returns and believed, erroneously, that such third party submitted a filing-extension request on behalf of the taxpayer.
- Abatement requests will also be rejected under the "Decision Tree" if the taxpayer relies on the ignorance-of-the-law defense and the taxpayer was either a U.S. resident or resided outside the United States but failed to get advice from a U.S. tax professional.
- For purposes of seeking penalty abatement, the "Decision Tree" clarifies that reliance on an accountant or attorney might be appropriate in certain situations, but reliance by a taxpayer on the following types of people is not reasonable: bookkeeper, financial advisor, business associate, information in a tax plan or promotion and person assisting in establishing the corporation.
- Finally, the "Decision Tree" indicates that it might abate penalties based on the reasonable-reliance-on-a-qualified-tax-professional defense if, and only if, the taxpayer relied on an accountant or attorney, the taxpayer provided such tax professional all relevant information, the taxpayer supplied the information before the deadline for filing Form 5471, the tax professional advised the taxpayer that it was not required to file Form 5471, the taxpayer has tangible evidence to prove the preceding facts and, in the opinion of the IRS, the taxpayer's reliance was reasonable. The "Decision Tree" goes on to state that the taxpayer's reliance will be considered unreasonable (and thus Form 5471 penalties will not be abated) if the taxpayer did not take steps to independently investigate or the taxpayer did not get a second opinion. This aspect of the "Decision Tree" is particularly remarkable because it is contrary to the legal precedent established by the U.S. Supreme Court years ago on this exact point. In a famous tax case from 1985, *R.W. Boyle*, the highest court in the land explained that taxpayers are not required to seek or obtain a second opinion as a condition to benefitting from the reasonable-reliance-on-a-qualified-tax-professional defense:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[45]

D. Form 5471 Violations Keep Assessment Periods Open

The standard penalty of $10,000 per year can hurt a taxpayer. The most significant consequence of not filing Forms 5471 has nothing to do with money, though. It concerns time, specifically the amount of time that the IRS has to audit the relevant issues. A relatively obscure procedural provision, Code Sec. 6501(c)(8)(A), contains a powerful tool for the IRS. It generally states that where a taxpayer fails to file a timely Form 5471 (and/or a long list of other international information returns), the assessment period remains open "with respect to any tax return, event, or period" to which the Form 5471 relates until three years after the taxpayer ultimately files Form 5471.[46] Thus, if the taxpayer never files a Form 5471, then the general three-year assessment period never begins to run against the IRS. This prevents taxpayers with Form 5471 violations from running out the clock, so to speak, on the IRS.

The recent IPU regarding Form 5471 penalties sheds additional light on this issue. Revenue Agents tend to begin auditing one or two years whose general three-year assessment period remains open. To the extent that the Revenue Agent identifies tax noncompliance during those years, he expands the audit to cover future "open" years, *i.e.*, years for which the taxpayer has already filed a tax return. Because of Code Sec. 6501(c)(8), the IPU instructs Revenue Agents to look forward and backward. The IPU states the following in this regard: "As you identify Forms 5471 that were required, but not filed, for the

exam year(s), *consider reviewing whether those forms were required, but not filed, in earlier tax years*."[47] Moreover, the IPU takes the position that Code Sec. 6501(c)(8) holds the assessment period open indefinitely, not only where a taxpayer fails to file a Form 5471 but also in instances where a taxpayer filed a timely but "substantially incomplete" Form 5471. Without citing specific support for the notion, the IPU emboldens Revenue Agents to advance the argument that "[t]he statute of limitations for assessing and collecting penalties under IRC § 6038 *expires three years after a substantially complete Form 5471 is filed*."[48]

E. Comparison of the IPU with Standards in Recent Disclosure Programs

The strictness of the IRS's position regarding the substantially complete defense, as evidenced by the IPU released in October 2015, is interesting when contrasted with the IRS's flexible stance on penalty abatement involving Forms 5471 (and other international information returns) in recent disclosure programs.

The IRS has announced a series of international disclosure programs since 2009, including the 2012 Offshore Voluntary Disclosure Program (OVDP). The IRS issued a set of Frequently Asked Questions (FAQs) in connection with the OVDP, one of which allowed taxpayers who failed to file certain information returns but did not deprive the IRS of any tax revenue to pro-actively resolve issues with the IRS on a penalty-free basis. In particular, FAQ #18 stated the following:

> FAQ #18—QUESTION. Question 17 states that a taxpayer who only failed to file an FBAR should not use this process. *What about a taxpayer who only has delinquent Form 5471s or Form 3520s but no tax due*? Does that taxpayer fall outside this voluntary disclosure process?
>
> FAQ #18—ANSWER. A taxpayer who has failed to file tax information returns, *such as Form 5471 for controlled foreign corporations (CFCs)* or Form 3520 for foreign trusts but who has reported, and paid tax on, all their taxable income with respect to all transactions related to the CFCs or foreign trusts, should file delinquent information returns with the appropriate service center according to the instructions for the form and attach a statement explaining why the information returns are filed late. (The Form 5471 should be submitted with an amended return showing no change to income or tax liability.) *The IRS will not impose a penalty for the failure to file the delinquent Forms 5471 and 3520 if there are no underreported tax liabilities and you have not previously been contacted regarding an income tax examination or a request for delinquent returns*.

In June 2014, the IRS announced several new programs, which obsoleted the 2012 OVDP and FAQ #18. The IRS retained the favorable treatment for taxpayers who failed to file timely (or presumably complete) international information returns, such as Forms 5471. One of the new programs is called the Delinquent International Information Return Submission Procedure (DIIRSP). It provides that taxpayers that have not filed one or more international information returns can file them with the IRS on a penalty-free basis if the taxpayers (i) do not need to use the OVDP or another program to file tax returns to report additional income and pay additional tax, (ii) have "reasonable cause" for not timely filing the information returns, (iii) are not under a civil examination or a criminal investigation by the IRS, and (iv) have not already been contacted by the IRS about the delinquent information returns. Several months later, the IRS made the standards even more flexible by issuing new FAQs specifically for the DIIRSP. New FAQ #1 provides that taxpayers with some income tax problems can still resolve matters with the IRS on a penalty-free basis, provided that they can present an acceptable case of "reasonable cause" for the violations. New FAQ #1 states the following:

> [The previous FAQ #18] was only available to taxpayers who were fully tax compliant. The [new DIIRSP] clarifies how taxpayers may file delinquent international information returns in cases where there was reasonable cause for the delinquency. *Taxpayers who have unreported income or unpaid tax are not precluded from filing delinquent international information returns* … .

Given the technical nature of Form 5471, its unique standards and procedures and its latent issues, those faced with penalties would be wise to seek assistance from those with specialized experience in the field.

V. Conclusion

Penalties will continue to rise because more U.S. taxpayers are going global, Form 5471 is extremely complicated, completing Form 5471 depends on obtaining significant amounts of data in a timely manner from foreign entities that are often disinclined to provide anything to the IRS and taxpayers must wrestle with challenges caused by differences in foreign accounting methods, bookkeeping practices, tax years, currencies, languages, *etc*.

This article highlights that this reality is exacerbated in five main ways. First, based on the items cited in the IPU issued in October 2015, Revenue Agents might determine that Forms 5471 are "substantially incomplete" and should be penalized in the following situations: where the taxpayer (i) omits identification data on Form 5471 (such as the filing category, amount of voting stock owned, full name and location of foreign corporation, *etc.*); (ii) states that certain information will be provided only upon request by the IRS; (iii) uses unapproved, computer-generated Forms 5471; (iv) lacks proper financial statements for the foreign corporation; (v) fails to report figures in U.S. dollars and/or using U.S. GAAP, when required; (vi) cites as an excuse the high administrative cost of complying with Form 5471 requirements; (vii) has demonstrated Form 5471 compliance in past years; (viii) overstates and/or understates certain amounts, even if this results in little to no overall tax changes; (ix) reports unnecessary information, presumably on the theory that superfluous data distracts the IRS from the real issues; (x) shows a "mismatch" on Forms 5471 for successive years; (xi) leaves blank one or more required Schedules on Form 5471; or (xii) has either one large error or omission, or several smaller errors or omissions. Second, if a Form 5471 is late, the IRS automatically assesses the penalty and begins taking collection actions (*e.g.*, notices, tax liens and levies), even if the taxpayer submits a compelling "reasonable cause" statement with the late Form 5471. Third, the first-time-penalty-abatement policy generally does not apply to Form 5471. Fourth, in determining whether "reasonable cause" exists for abatement, the IRS applies the ultra-stringent "Decision Tree" specifically designed for Form 5471 penalties. Fifth, the IRS has instructed its Revenue Agents, pursuant to Code Sec. 6501(c)(8), to expand audits to cover past years whose three-year general assessment periods have already expired if they detect Form 5471 problems in the original years under audit.

Given the technical nature of Form 5471, its unique standards and procedures and its latent issues, those faced with penalties would be wise to seek assistance from those with specialized experience.

ENDNOTES

1 Code Sec. 6038; Reg. §1.6038-2; Code Sec. 6046; Reg. §1.6046-1; Code Sec. 6679; Reg. §301.6679-1; Instructions to Form 5471.
2 Code Sec. 6038(a)(2); Reg. §1.6038-2(i).
3 Code Sec. 6038(b)(1); Reg. §1.6038-2(k)(1)(i); Code Sec. 6046(f); Reg. §1.6046-1(k).
4 Code Sec. 6038(b)(2); Reg. §1.6038-2(k)(1)(ii); Code Sec. 6046(f); Reg. §1.6046-1(k).
5 Reg. §1.6038-2(k)(3)(i).
6 Reg. §1.6038-2(k)(3)(ii). The regulations refer to "substantial compliance" with the rules, while administrative and judicial guidance generally utilizes the concept of "substantial completeness."
7 Jasper L. Cummings, Jr., *LB&I International Practice Units*, Tax Notes (Nov. 23, 2015), at 1077; Kristen A. Parillo & Jaime Arora, *IRS Plans to Release International Training Materials*, Tax Notes (Mar. 24, 2014), at 1317.
8 "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty." International Practice Unit (updated as of Oct. 7, 2015).
9 "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty." International Practice Unit (updated as of Oct. 7, 2015).
10 *See* IRS News Release, IR 90-58, March 29, 1990.
11 CCA 200645023 (June 20, 2006).
12 Reg. §301.6651-1(c)(1); Reg. §1.6161-1(b).
13 Reg. §301.6651-1(c)(1); Reg. §1.6161-1(b).
14 For guidance about the meaning of "undue hardship" in the tax context, *see, e.g.*, *C.E. Wolfe*, DC-MT, 85-2 USTC ¶9476, 612 FSupp 605; *C.J. Rogers, Inc.*, DC-MI, 91-1 USTC ¶50,297; *In re Upton Printing Co.*, BC-DC-LA, 95-2 USTC ¶50,377, 186 BR 904, 76 A.F.T.R.2d; *In re Sykes & Sons, Inc.*, BC-DC-PA, 95-2 USTC ¶50,620, 188 BR 507, 76 A.F.T.R.2d 95-7419; *In re Frederick Savage, Inc.*, BC-DC-FL, 95-1 USTC ¶50,189, 179 BR 342, 75 A.F.T.R.2d 95-1967; *Bostar Foods, Inc.*, DC-KY, 97-1 USTC ¶50,285, 79 A.F.T.R.2d 97-1041; *Van Camp & Bennion*, CA-9, 2001-1 USTC ¶50,446, 251 F3d 862; *Fran Corp.*, CA-2, 99-1 USTC ¶50,208, 164 F3d 814; *Diamond Plating Co.*, CA-7, 2005-1 USTC ¶50,107, 390 F3d 1035; *Francis P. Harvey & Sons, Inc.*, DC-MA, 2005-1 USTC ¶50,154; *Burt, Inc.*, DC-IN, 2007-1 USTC ¶50,416, 99 A.F.T.R.2d 2007-1856.
15 CCA 200429007 (May 28, 2004).
16 2002 IRS NSAR 20167, 2002 WL 32167873 (May 20, 2002).
17 Field Service Advice, 1997 WL 33381431, 1997 FSA Lexis 34 (Feb. 14, 1997).
18 *Congdon*, DC-TX, 108 AFTR 2d 2011-6340 (2011).
19 IRM §21.8.2.20.1 (Oct. 1, 2014).
20 "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty." International Practice Unit (updated as of Oct. 7, 2015).
21 U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006).
22 U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006), at 1–2.
23 U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006), at 2.
24 U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006), at 7-8.
25 U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013).
26 U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations

Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 2.

[27] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 2.

[28] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 8.

[29] IRM §20.1.1.3.6.1(7) (Aug. 5, 2014).

[30] IRM §20.1.1.3.6.1(7) (Aug. 5, 2014).

[31] IRM §20.1.1.3.6.1(7) (Aug. 5, 2014).

[32] IRM §20.1.1.3.6.1(8) and (9) (Aug. 5, 2014).

[33] Code Sec. 6662(a).

[34] Code Sec. 6664(c).

[35] Code Sec. 6651(a); Reg. §301.6651-1(a)(1).

[36] Code Sec. 6654(e)(3)(A).

[37] Code Sec. 6721(a)(1); Reg. §301.6721-1(a)(1).

[38] Code Sec. 6724(a); Reg. §301.6724-1(a)(1),(2). In this context, "reasonable cause" exists if there are significant mitigating factors with respect to the failure, or the failure arose from events beyond the taxpayer's control. *See* Reg. §301.6724-1(a)(2). The idea of acting in a "responsible manner" is also unique for purposes of Code Sec. 6721, with the regulation defining it to mean that (i) the taxpayer exercised reasonable care, which is the standard of care that a reasonably prudent person would use under the circumstances in the course of its business in determining its filing obligations, and (ii) the taxpayer undertook significant steps to avoid or mitigate the failure, including requesting filing extensions where practicable, attempting to prevent any foreseeable impediment or failure, acting to remove an impediment or the cause of the failure after it occurred and rectifying the failure as promptly as possible once the impediment was removed or the failure was discovered. *See* Reg. §301.6724-1(d)(1); IRM §20.1.7.9.2 (Nov. 16, 2007).

[39] Code Sec. 6038; Reg. §1.6038-2(k)(3).

[40] IRM §20.1.1.3.1.2 (Aug. 20, 1998).

[41] Reg. §1.6664-4(b)(1).

[42] IRM §20.1.1.3.1.2.1 (Aug. 20, 1998).

[43] Reg. §1.6664-4(c)(1).

[44] IRM Exhibit 21.8.2-1—Failure to File or Late-Filed Form 5471—Decision Tree.

[45] *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 251, 105 SCt 687 (emphasis added).

[46] Code Sec. 6501(c)(8)(B) contains a limitation, stating that the assessment period will open remain only with respect to "the item or items" related to the late Form 5472 if the taxpayer can demonstrate that the delinquency was due to reasonable cause and not due to willful neglect.

[47] "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty." International Practice Unit (updated as of Oct. 7, 2015).

[48] "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty." International Practice Unit (updated as of Oct. 7, 2015).