Harsh Consequences of Late Forms 1120-F, New Tax Court Case, and Solutions Still Available to Foreign Corporations

By Hale E. Sheppard*

Hale E. Sheppard explains U.S. filing duties of foreign corporations, the harsh result in a recent Tax Court case, and solutions still available to non-compliant foreign corporations.

I. Introduction

Most taxpayers prefer to supply the Internal Revenue Service ("IRS") as little information as possible, with not filing any returns, forms, or statements whatsoever being optimal. Foreign corporations are no different, falling into two main categories. There are those that know of their duty to file Forms 1120-F (*U.S. Income Tax Return of a Foreign Corporation*) and make efforts to avoid it. Others, by contrast, have minimal international business experience, limited activities in the United States, and/or unsophisticated advisors, resulting in ignorance of Forms 1120-F. Failure by foreign corporations to file Forms 1120-F triggers extreme problems either way. Specifically, in addition to asserting normal penalties for late filing, late payment, and late information returns, the IRS also disallows business-related deductions and credits that foreign corporations normally could claim. Thus, the IRS imposes taxes on the gross income, instead of the net income, of foreign corporations not filing Forms 1120-F. This outcome is particularly harsh when one considers that many fledgling businesses, particularly those entering a new market, often operate a net loss for several years.

This article explains U.S. filing duties of foreign corporations, the harsh result in a recent Tax Court case, *Adams Challenge (UK) Ltd.*, and solutions still available to non-compliant foreign corporations.[1]

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II. Description of Applicable Law—Code Sec. 882

Before appreciating the significance of *Adams Challenge* and remaining remedies for taxpayers, readers must first understand the pertinent rules.

A. General Filing Duty

A foreign corporation generally must file a Form 1120-F if it (i) was engaged in a U.S. trade or business, regardless of whether it derived any income that was effectively connected with such trade or business ("ECI"), (ii) has income, gains, or losses that are treated as if they were ECI, (iii) was not engaged in a U.S. trade or business, but had other U.S.-source income that was not fully paid through tax withholding, (iv) is making a claim for refund, (v) is claiming the benefit of any deductions or credits, or (vi) needs to file a Form 8833 (*Treaty-Based Return Position*) to disclose to the IRS that it is taking the position that a tax treaty overrules or modifies the normal rules found in the Internal Revenue Code.[2]

B. Disallowance of Deductions and Credits

As indicated above, one of the situations mandating the filing of Form 1120-F is when a foreign corporation wants to claim deductions or credits. Here is more on that issue, which is the focus of this article.

Code Sec. 882 generally allows foreign corporations that derive ECI to be taxed at the rates applicable to domestic corporations on "taxable income."[3] In determining "taxable income," foreign corporations (i) include only the amount of gross income that is ECI; and (ii) then they reduce such amount by claiming all allowable deductions and credits.[4] Code Sec. 882(c) and the corresponding regulations allow foreign corporations to claim such tax benefits *only if* they file proper Forms 1120-F with the IRS.[5] Code Sec. 882(c)(2) states the following in this regard:

> A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle *only* by filing or causing to be filed with the Secretary a true and accurate return, in the manner prescribed in subtitle F, including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits.

Reg. §1.882-4(a)(2) expands on this requirement, specifically adding that the Forms 1120-F must be "timely" filed:

> A foreign corporation shall receive the benefit of the deductions and credits otherwise allowed to it with respect to the income tax, *only if it timely files or causes to be filed* with the Philadelphia Service Center, in the manner prescribed in subtitle F, a true and accurate return of its taxable income which is effectively connected, or treated as effectively connected, for the taxable year with the conduct of a trade or business in the United States by that corporation.

C. Trust but Verify

The sanction for not filing timely Forms 1120-F is severe: a complete disallowance of deductions and credits for foreign corporations. The situation can be contentious, even if a foreign corporation meets its filing obligation. The regulations indicate, as one might expect, that a foreign corporation is entitled to the tax benefits claimed on Forms 1120-F *only* to the extent that they are connected with ECI, properly allocated and apportioned to ECI, and substantiated to the satisfaction of the IRS.[6]

D. Forcing the IRS to Do the Job

The IRS tends to get upset when it must do what it believes a taxpayer should have done in the first place, like file a tax return. This sentiment applies to foreign corporations. If a foreign corporation has various types of U.S.-source income but fails to file a Form 1120-F or "protective" Form 1120-F, then the IRS will prepare a Form 1120-F for the foreign corporation based on available data (which ordinarily is unfavorable to the taxpayer), disallow all deductions and credits, assess the resulting liability, and start taking collection actions.[7] This is known as the IRS preparing a substitute for return ("SFR").

E. Ability to File "Protective" Forms 1120-F

Because of the nasty consequences for not filing Forms 1120-F, and because of the complexities of U.S. international tax law, the regulations expressly allow foreign corporations to file "protective" Forms 1120-F.[8]

If a foreign corporation conducts "limited activities" in the United States which it believes do not generate ECI, or if the foreign corporation initially determines that it has no U.S. tax liability under an income tax treaty, then it can file a "protective" Form 1120-F by the normal deadline.[9] This filing serves to preserve the right to claim deductions and credits related to gross income later, if the IRS audits and determines that ECI exists and the foreign corporation's original tax position was

incorrect.[10] The foreign corporation is not required to report income, deductions, and credits on a "protective" Form 1120-F; rather, it attaches a statement indicating that it is filing on a "protective" basis only pursuant to the regulations.[11]

The IRS itself urges taxpayers to file in cases of uncertainty. For instance, the Instructions to Form 1120-F provide the following recommendations to foreign corporations:

> If a foreign corporation conducts limited activities in a tax year that [it] determines does not give rise to [ECI], the foreign corporation *should* follow the instructions for filing a protective return to safeguard its right to receive the benefit of the deductions and credits attributable to that gross income [and] a foreign corporation *should* also file a protective return if it determines initially that it has no U.S. tax liability under the provisions of any applicable income tax treaty (for example, because its income is not attributable to a permanent establishment in the United States).[12]

F. Definition of Timeliness

When taxpayers and tax professionals ponder the term "timely," they generally think of submitting the relevant tax or information return by the original deadline or by the extended deadline, after securing the necessary extension from the IRS.[13] However, the concept of "timely" means different things in different contexts. There are two major categories when it comes to Forms 1120-F, which the IRS sometimes refers to as "special filing dates."[14]

On one hand, if the foreign corporation filed a Form 1120-F for the previous year, or if the current year is the first year for which the foreign corporation is required to file, then the Form 1120-F must be filed within 18 months of the normal deadline for the current year in order to be considered "timely."[15] The normal deadline depends on the degree of contact that a particular foreign corporation has with the United States. Foreign corporations with an office or place of business in the United States must file Forms 1120-F by the 15th day of the fourth month after the close of the relevant year.[16] The deadline for 2020 for a calendar-year foreign corporation with a U.S. office, for instance, would be April 15, 2021. That normal deadline would shift by two months to June 15, 2021, in situations involving foreign corporations lacking a U.S. office or place of business.[17]

On the other hand, if the foreign corporation was obligated to file a Form 1120-F for the previous year but failed to do so, then the Form 1120-F for the current year must be filed within 18 months of the normal deadline for the current year, or before the IRS mails the foreign corporation a notice indicating that its Form 1120-F is missing, whichever is earlier.[18]

Some tax professionals questioned the validity of the "special filing dates" when the IRS first proposed them decades ago. The IRS rejected the criticisms on grounds that Code Sec. 882(c)(2) "clearly provides" for the denial of deductions and credits in the case of late filings and the rules are "justified because of different administrative and compliance concerns with regard to … foreign corporations."[19]

III. Analysis of New Tax Court Case

The Tax Court decided *Adams Challenge* in January 2021, clarifying the idea of "timeliness" in the context of Forms 1120-F and upholding the IRS's ability to fully disallow deductions and credits when foreign corporations are delinquent.

A. Relevant Facts

The taxpayer ("Company") held one income-producing asset during the relevant years, a multi-purpose support vessel ("Boat"). A U.S. company chartered the Boat for purposes of decommissioning oil and gas wells and removing hurricane-related debris in parts of the Gulf of Mexico. The Company earned a total of about $45 million dollars in 2009, 2010, and 2011.

In 2009, the IRS began a "compliance campaign" focused on foreign vessels operating in the Gulf of Mexico on the U.S. Outer Continental Shelf ("OCS"), which is considered part of the United States. The IRS utilized computer databases to identify the owners, operators and classifications of vessels. Then, it employed a tracking service based on satellites to determine the number of days during which each vessel worked on the OCS. Finally, using published industry data about charter rates for different types of vessels, the IRS calculated the annual gross income of various vessels, include the Boat owned by the Company.

The IRS realized that, despite earning approximately $45 million over three years, the Company had not filed Forms 1120-F or "protective" Forms 1120-F for 2009, 2010 or 2011. Therefore, in October 2013, the IRS issued a Notice of Jeopardy Assessment and Right to Appeal ("Jeopardy Notice"), indicating that the Company owed about $23.8 million in taxes, penalties, and interest.

Two months later, in December 2013, the Company filed with the IRS its 2011 Form 1120-F. This occurred

within the "special filing dates" set forth in the regulations, such that it was considered timely, and the IRS acknowledged that the Company was entitled to claim deductions and credits for 2011.[20] However, because the Company did not file Forms 1120 for 2009 or 2010, the IRS prepared SFRs for these two years, using the methods adopted by the "compliance campaign."

The recent Tax Court decision in Adams Challenge is a sobering reminder for foreign corporations that failure to file "protective" or normal Forms 1120-F can trigger the inability to claim business deductions and credits, large U.S. income tax liabilities, significant penalties, and sizable litigation costs.

In November 2014, the IRS sent the Company a Notice of Deficiency for 2009 and 2010, which calculated the tax liability based on gross income, without the benefit of any deductions or credits. The Company filed a timely Petition with the Tax Court in February 2015 disputing the Notice of Deficiency.

Two years later, in February 2017, the Company filed "protective" Forms 1120-F for 2009 and 2010, and attaching a statement explaining its position that it supposedly had no ECI and thus no duty to file Forms 1120-F for such years.

The IRS and the Company first filed Cross Motions for Partial Summary Judgment regarding the character of the income earned by the Company. The Tax Court ruled for the IRS, determining that the income was ECI, was subject to U.S. income tax under the Internal Revenue Code, and was not relieved of such taxation because of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains ("Treaty").[21]

Later, the parties filed a second round of Cross Motions for Partial Summary Judgment, this time focused on whether the IRS could disallow the Company's deductions and credits for 2009 and 2010. The IRS argued that it could disregard these amounts, thanks to the clear language of Code Sec. 882(c)(2), the corresponding regulations, and the caselaw interpreting both. The Company, for its part, primarily contended that the regulations are invalid and the disallowances by the IRS violate two articles of the Treaty. This article focuses on the analysis by the Tax Court of the second Cross Motions for Partial Summary Judgment.

B. The Key Issue and Applicable Law

The Tax Court, predictably, began with the relevant tax statute, Code Sec. 882(c)(2), which creates the following rule:

> A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle *only by filing or causing to be filed with the [IRS] a true and accurate [Form 1120-F], in the manner prescribed in subtitle F*, including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits.

The Tax Court pointed out that Code Sec. 882(c)(2) requires foreign corporations to file Forms 1120-F "in the manner prescribed in subtitle F" of the Internal Revenue Code, but does not mandate that they do so in a timely manner or by a particular deadline. Therefore, surmised the Tax Court, the question in *Adams Challenge* is whether Code Sec. 882(c)(2) establishes a "cutoff point" or "terminal date" after which it is too late for a foreign corporation to file a Form 1120-F and benefit from deductions and credits. Apparently, taxpayers, the IRS, and the courts have been grappling with this issue since as early as 1928.

The Tax Court provided a detailed history lesson in *Adams Challenge*, explaining the manner in which the law and regulations have evolved over the years, and how courts have applied the rules to disparate factual scenarios. The Tax Court explained the status of the law before the issuance of the recent regulations, as follows: (i) Code Sec. 882(c)(2) does not require a foreign corporation to file a timely Form 1120-F in order to get the benefit of deductions and credits; (ii) However, Code Sec. 882(c)(2) establishes a "terminal date," which is when the IRS exercises its authority under Code Sec. 6020(b) to prepare an SFR for a non-filing foreign corporation; (iii) Such "terminal date" was not fixed because the IRS prepares SFRs at different times depending on the circumstances; (iv) A foreign corporation's failure to file a Form 1120-F before the "terminal date" could be excused with a showing of "good faith"; and (v) The requirement in Code Sec. 882(c)(2) for a "true and

accurate" Form 1120-F does not require perfection, but any material omissions or inaccuracies are fatal to a foreign corporation's claims for deductions and credits. The Tax Court then discussed how two sets of regulations, finalized in 1990 and 2003, provided more clarity on the timeliness rules.

C. Analysis by the Tax Court

The Tax Court addressed three main issues in *Adams Challenge*.

1. Issue #1—Who Prevails Under Code Sec. 882(c)(2)?

Because the Company raised the supposed invalidity of the regulations as its primary position, the Tax Court first indulged in which party would prevail based *solely* on Code Sec. 882(c)(2) or its predecessors. In other words, the Tax Court posed the following question: Even if the Company were correct in that the regulations were invalid, would it even matter? No, concluded the Tax Court, as explained below.

The Tax Court clarified that only one valid "return" can be filed for any given year, and that once the IRS has prepared an SFR, the taxpayer is incapable of filing a "true and accurate return" with the IRS, as mandated by Code Sec. 882(c)(2). In *Adams Challenge*, the IRS prepared SFRs for the Company for 2009 and 2010 in April 2014, and then sent a Notice of Deficiency based on such SFRs in November 2014. The Company did not file a "return" (*i.e.*, its "protective" Forms 1120-F) until years later, in February 2017. The Tax Court explained that the Company was not entitled to any deductions or credits for 2009 and 2010 because it failed to file Forms 1120-F before the "terminal date" of November 2014.

The Tax Court then emphasized that the Company was not a candidate for the "good faith" exception to Code Sec. 882(c)(2) either. It pointed out that the IRS issued a Jeopardy Notice in October 2013, making clear its position that the Company had ECI in 2009, 2010 and 2011. Shortly thereafter, in December 2013, the Company filed a "protective" Form 1120-F for 2011, but nothing for 2009 and 2010, despite the fact that the issues and economics were the same or very similar in all three years. The Company underscored the following actions. First, it quickly responded to the first communication from the IRS; that is, the Jeopardy Notice. The Tax Court gave this little weight, explaining that a prompt appeal of a Jeopardy Notice is not a particularly strong indicator of "good faith," considering that failure to do so would have triggered serious consequences, such as the IRS seizing the Boat belonging to the Company. Second, the Company identified itself in 2009 to certain U.S. government agencies, like the Coast Guard. Nonplussed, the Tax Court pointed out that the Company had to register with the Coast Guard in order to operate on the OCS in the Gulf of Mexico and that the Company never disclosed its existence to the IRS. The Tax Court concluded that the Company's two actions simply "did not cut the mustard in assessing its good faith with respect to its U.S. tax obligations." It further emphasized that the relevant question is not whether the Company showed good faith in the abstract, but whether it tried in good faith to file Forms 1120-F for 2009 and 2010 before the IRS prepared the SFRs. According to the Tax Court, the Company did not offer a plausible excuse for not filing until February 2017 and did not demonstrate the existence of "good faith."

2. Issue #2—Are the Underlying Regulations Valid?

After determining that the IRS prevails under Code Sec. 882(c)(2) based on the reasoning described above, the Tax Court, like most judicial bodies, declined to go out on the proverbial limb and make a ruling that was not vital to the case at hand. The Tax Court stated the following in refusing to decide whether the regulations under Code Sec. 882(c)(2), promulgated in 1990 and 2003, are valid:

> [The Company] failed to file is 2009 and 2010 returns by the terminal date established by Section 882(c)(2), namely, the date on which the [IRS] exercised his authority under Section 6020(b) to prepare [SFRs] for it. [The Company] is thus entitled to no deductions or credits for 2009 and 2010 under the statute, *without reference to the regulations. We have not need to address the validity of the regulatory filing deadline here* ….

3. Issue #3—Does the Form 1120-F Filing Duty Violate the Treaty?

Finally, at the end of a profound analysis spanning more than 20 pages, the Tax Court concluded that obligating foreign corporations to file "protective" Forms 1120-F or Forms 1120-F before the IRS prepares SFRs as a condition to benefitting from deductions and credits does not violate the "business profits article" or the "nondiscrimination article" of the Treaty.

IV. Potential Solutions for Delinquent Foreign Corporations

The Company in *Adams Challenge* was in an extremely difficult position. It did not file Forms 1120-F before the IRS prepared SFRs for it, rendering it a loser under Code Sec. 882(c)(2). Moreover, it did not file "protective" Forms 1120-F for 2009 and 2010 until many years after the normal deadline, making it ineligible for clemency under the regulations. Other foreign corporations with more favorable facts, however, still have a chance for a better outcome. The reasons for cautious optimism are described below.

A. Late-Filing Waivers

Aware of the harshness of the deduction-and-credit disallowance rule, the IRS created an exception. Specifically, the regulations indicate that the IRS will ignore tardiness in situations where a foreign corporation can demonstrate that, based on the facts and circumstances, it acted reasonably and in good faith ("Late-Filing Waiver").[22]

The regulations begin by explaining that the IRS will not grant a Late-Filing Waiver if the foreign corporation "knew" it had a duty to file Form 1120-F but "chose not to do so."[23] Moreover, the regulations clarify that a condition to getting a Late-Filing Waiver is cooperation by the foreign corporation in the process of determining its income tax liability for the relevant years.[24] Finally, a foreign corporation is ineligible for a Late-Filing Waiver if it has a "permanent establishment" in the United States, as this term is used in treaties.[25]

With those preliminaries out of the way, the regulations provide that the IRS will grant a Late-Filing Waiver if the foreign corporation can demonstrate that it acted "reasonably and in good faith" in failing to file a timely Form 1120-F or "protective" Form 1120-F.[26] This IRS considers the following factors in deciding whether a foreign corporation meets the standard for relief: (i) Whether the foreign corporation voluntarily identifies itself to the IRS as having failed to file a Form 1120-F before the IRS discovers the issue; (ii) Whether the foreign corporation did not become aware of its ability to file a "protective" Form 1120-F by the normal deadline; (iii) Whether the foreign corporation has previously filed a Form 1120-F; (iv) Whether the foreign corporation failed to file a Form 1120-F because, after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the foreign corporation was unaware of the necessity; (v) Whether the foreign corporation failed to file a Form 1120-F because of intervening events beyond its control; and (vi) Whether other mitigating or exacerbating factors exist.[27]

The regulations contain the following six examples regarding the Late-Filing Waiver, which have been slightly altered to enhance readability.[28]

1. Example 1—Foreign Corporation Voluntarily Discloses

Facts: In Year 1, foreign corporation ("FC") became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, FC incurred losses with respect to its U.S. partnership interest. FC's foreign tax director incorrectly concluded that because it was a limited partner and had only losses from its partnership interest, FC was not required to file a Form 1120-F. FC's management was aware neither of FC's obligation to file a Form 1120-F for those years, nor of its ability to file a "protective" Form 1120-F for those years. FC had never filed a Form 1120-F before. In Year 5, FC began realizing a profit rather than a loss with respect to its partnership interest and, for this reason, engaged a U.S. tax advisor to handle its responsibility to file U.S. returns. In preparing FC's Form 1120-F for Year 5, FC's U.S. tax advisor discovered that Forms 1120-F were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines were not met, FC would be barred from claiming any deductions that otherwise would have given rise to net operating losses on returns for those years, and that would have been available as loss carryforwards in subsequent years. At FC's direction, its U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the IRS in determining FC's income tax liability, for example, by preparing and filing the appropriate Forms 1120-F for Year 1 through Year 4 and by making FC's books and records available to an IRS examiner.

Conclusion: FC has *met* the standard for a Late-Filing Waiver.

2. Example 2—Foreign Corporation Refuses to Cooperate

Facts: Same facts as in Example 1, except that while FC's U.S. tax advisor contacted the appropriate IRS examining personnel and filed Forms 1120-F for Year 1 through Year 4, FC refused all requests by the IRS to provide supporting information (for example, books and records) with respect to such Forms 1120-F.

Conclusion: Because FC did not cooperate in determining its U.S. tax liability for the taxable years for which a Form 1120-F was not timely filed, FC is not granted a Late-Filing Waiver.

3. Example 3—Foreign Corporation Does Not File a "Protective" Return

Facts: Same facts as in Example 1, except that in Year 1 through Year 4, FC's foreign tax director also consulted a U.S. tax advisor, who advised FC's foreign tax director that it was uncertain whether Forms 1120-F were necessary for those years and that FC could protect its right subsequently to claim the loss carryforwards by filing "protective" Forms 1120-F. FC did not file Forms 1120-F or "protective" Forms 1120-F for those years. FC did not present evidence that intervening events beyond FC's control prevented it from filing Forms 1120-F, and there were no other mitigating factors.

Conclusion: FC has *not met* the standard for a Late-Filing Waiver.

4. Example 4—Foreign Corporation with ECI

Facts: In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. FC had minimal business or tax experience internationally, and no such experience in the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC, however, did not file Forms 1120-F for Year 1 or Year 2. FC's management was aware neither of FC's obligation to file Forms 1120-F for those years, nor of its ability to file a "protective" Form 1120-F for those years. FC had never filed a Form 1120-F before. In January of Year 4, FC engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed FC's U.S. activities and advised FC that it should have filed Forms 1120-F for Year 1 and Year 2. FC immediately engaged a U.S. tax advisor who, at FC's direction, promptly contacted the appropriate examining personnel and cooperated with the IRS in determining FC's income tax liability, for example, by preparing and filing the appropriate Forms 1120-F for Year 1 and Year 2 and by making FC's books and records available to an IRS examiner.

Conclusion: FC has *met* the standard for a Late-Filing Waiver.

5. Example 5—IRS Discovers the Non-Compliance

Facts: In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. However, FC's management was aware neither of FC's obligation to file a Form 1120-F for those years, nor of its ability to file a "protective" Form 1120-F for those years. FC had never filed a Form 1120-F before. Despite FC's extensive experience conducting similar business activities in other countries, it made no effort to seek advice in connection with its U.S. tax obligations. FC failed to file either Forms 1120-F or "protective" Forms 1120-F for Year 1 and Year 2. In January of Year 4, an IRS examiner asked FC for an explanation of FC's failure to file Forms 1120-F. FC immediately engaged a U.S. tax advisor, and cooperated with the IRS in determining FC's income tax liability, for example, by preparing and filing Forms 1120-F for Year 1 and Year 2 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing a Form 1120-F, and there were no other mitigating factors.

Conclusion: FC has *not met* the standard for a Late-Filing Waiver.

6. Example 6—Foreign Corporation with Prior Filing History

Facts: FC began a U.S. trade or business in Year 1. FC's tax advisor filed the Forms 1120-F for Year 1 through Year 6, reporting income effectively connected with FC's U.S. trade or business. In Year 7, FC replaced its tax advisor with a tax advisor unfamiliar with U.S. tax law. FC did not file a Form 1120-F for any year from Year 7 through Year 10, although it had effectively connected income for those years. FC's management was aware of FC's ability to file a

"protective" Form 1120-F for those years. In Year 11, an IRS examiner contacted FC and asked its chief financial officer for an explanation of FC's failure to file Forms 1120-F after Year 6. FC immediately engaged a U.S. tax advisor and cooperated with the IRS in determining FC's income tax liability, for example, by preparing and filing Forms 1120-F for Year 7 through Year 10 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing Forms 1120-F, and there were no other mitigating factors.

Conclusion: FC has *not met* the standard for a Late-Filing Waiver.

B. Recent IRS Guidelines

Inconsistencies have arisen over the years concerning whether foreign corporations should submit requests for Late-Filing Waivers, the degree of scrutiny the IRS should apply, the number of years that must be addressed, *etc*. The IRS, in an effort to standardize the process, issued in February 2018 instructions for handling late Forms 1120-F and requests for Late-Filing Waivers ("Guidelines").[29] The official purpose of the Guidelines is "to ensure that examiners are analyzing [Late-Filing Waiver] requests in a fair, consistent, and timely manner under the regulations."

1. Centralized Filing

Perhaps the most significant revelations by the Guidelines are that Revenue Agents and others working on the compliance side of the IRS generally will not entertain late Forms 1120-F filed directly with them, and late Forms 1120-F will effectively be subjected to some form of an audit. The Guidelines provide the following mandate on this topic:

> No one involved in a compliance function should accept as filed a delinquent Form 1120-F from a taxpayer, or discuss in advance of filing a return whether a [Late-Filing Waiver] will be granted. Once a return is filed, and LB&I has selected the return for examination, these Guidelines for handling [Late-Filing Waivers] will apply.[30]

2. Scenarios

The Guidelines describe two situations. Scenario 1 contemplates a foreign corporation that is *not* currently under audit, which voluntarily and pro-actively approaches the IRS about its unfiled Forms 1120-F for prior years. Here, the Guidelines tell IRS personnel to instruct the foreign corporation to file late Forms 1120-F in the regular manner, pursuant to the Instructions to Form 1120-F, despite their tardiness.

Scenario 2 arises when IRS personnel get assigned to audit a foreign corporation with respect to a late Form 1120-F. Actions depend on whether the foreign corporation has already filed a request for a Late-Filing Waiver. If this has occurred, then the Exam Team (which is comprised of the Revenue Agent and his or her direct Manager) should develop the facts relevant to the request for a Late-Filing Waiver, reach a recommendation, and then follow the recommendation-processing rules.[31] Conversely, if the foreign corporation has not previously filed a request for a Late-Filing Waiver, then the Exam Team must notify the foreign corporation of its ability to do so. However, warn the Guidelines, the Exam Team "should not advise, instruct, or otherwise signal the taxpayer to take any particular action." If the foreign corporation decides to submit a request for a Late-Filing Waiver, which seems logical, then the Exam Team should develop the facts, decide whether to grant or deny the request, and then follow the recommendation-processing rules described below.

In instances where the foreign corporation does not take the hint and thus does not file a request for a Late-Filing Waiver right away, the Guidelines instruct the Exam Team to continue the audit and then disallow the deductions and credits in accordance with Code Sec. 882(c)(2). If the foreign corporation changes its mind after seeing the large U.S. tax liability, it can file a request for a Late-Filing Waiver at that time, and the Exam Team will be charged with developing the facts, reaching a recommendation, and then following the recommendation-processing rules.

In addition to addressing the request for a Late-Filing Waiver, the Exam Team will be auditing the Forms 1120-F, of course. The Guidelines clarify that substantiation is king. Whether timely or late, Forms 1120-F with unsupported items will *not* be upheld: "Regardless of the determination on a [Late-Filing Waiver] request, the Exam Team may, as appropriate, propose to disallow specific deductions and credits in any amount to the extent that they are determined not to be allowable under the law or have not been properly substantiated."

3. Recommendation-Processing Rules

The Guidelines indicate that the IRS will handle a request for a Late-Filing Waiver in the following manner.

As explained above, an Exam Team reviews and analyzes the request and makes an initial recommendation on whether to grant or deny it. Then, the Exam Team

prepares a "Waiver Request Package" and sends it to the appropriate Territory Manager. It will contain (i) the Late-Filing Waiver application, with exhibits, (ii) a completed "Waiver Summary Analysis," which is a two-page document created by the IRS to input data about each of the six factors that the IRS must consider, (iii) copies of any Information Document Requests ("IDRs") issued to the foreign corporation, along with its responses, (iv) Examination Report, (v) Protest Letter filed by the foreign corporation, (vi) any Rebuttal by the IRS to the Protest Letter, and (vii) recommendation by the Exam Team.

Next, the Exam Team and Territory Manager review the "Waiver Request Package" and discuss the recommendation. This might result in the Exam Team needing to obtain additional data from the foreign corporation. This data gathering and dialogue continue until the Exam Team and the Territory Manager come to a recommendation and send it to the appropriate Director of Field Operations ("DFO"). The ultimate review and decision-making authority resides with the DFO and a specialized "Waiver Committee."

C. No Assurance of Amnesty

The Guidelines do *not* offer any guarantee that a foreign corporation will be granted a Late-Filing Waiver, latitude on the applicable standard, a reduction of the number of past years for which Forms 1120-F must be filed, *etc*. The Guidelines solely provide a set of rules for foreign corporations and IRS personnel to follow. Consequently, to the extent that the IRS denies a request for a Late-Filing Waiver and thus proposes a significant U.S. tax liability (which is logical given that the IRS would be taxing *gross* income, plus penalties and interest), one would expect to see the foreign corporation initiates Tax Court litigation.

D. Uncertainty About Penalties

The Late-Filing Waiver allows a foreign corporation to escape the harsh treatment contemplated by Code Sec. 882(c)(2); that is, paying U.S. taxes the gross amount of ECI, without the benefit of related deductions and credits. This is beneficial to a foreign corporation, no doubt, but it is far from *carte blanche*. Foreign corporations that file late Forms 1120-F often are subject to other penalties, too.

For instance, the IRS generally may assert so-called delinquency penalties if a taxpayer fails to file certain returns and/or fails to pay certain taxes by the deadline.[32] The IRS may not assert such penalties, however, if the taxpayer can show that the violation was due to "reasonable cause" and not due to "willful neglect."[33] Interestingly, the Instructions to Form 1120-F acknowledge that the IRS might impose delinquency penalties and they direct foreign corporations to present defenses only when the IRS inquiries or audits begin: "Caution! If you believe that reasonable cause exists [for filing a Form 1120-F late], do not attach an explanation when you file Form 1120-F. Instead, if the corporation receives a penalty notice after the return is filed, send the IRS an explanation at that time and the IRS will determine if the [foreign] corporation meets reasonable cause criteria."[34]

Certain U.S. persons generally are required to file a Form 8833 to notify the IRS that they are taking the position that a provision in a treaty to which the United States is a party overrules or modifies a provision of the Internal Revenue Code during the relevant year ("Treaty-Based Return Position").[35] Taxpayers must file a separate Form 8833 for each Treaty-Based Return Position taken, unless the reporting requirement is specifically waived.[36] If a U.S. person is required to file a Form 8833 and fails to do so, then the IRS generally may assert a penalty of $1,000. This sanction increases to $10,000 per violation in the case of a C corporation.[37] The IRS will not assert this penalty, though, when there is "reasonable cause" for the violation and the taxpayer acted in good faith.[38]

Finally, Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) generally must be filed to disclose certain "reportable transactions" between a "reporting corporation" and "related parties," as these terms are specifically defined for purposes of Code Sec. 6038A. There are two main categories of "reporting corporations," one of which is a foreign corporation that operates a U.S. trade or business at any time during the year at issue.[39] A reporting corporation normally must file a separate annual Form 5472 for each related party with which it had any reportable transaction during the taxable year, and the Form 5472 must be filed even though it may not affect the amount of U.S. tax due.[40] A reporting corporation that fails to file a timely and substantially complete Form 5472 faces a penalty of $25,000.[41] However, if the reporting corporation acted in "good faith" and there is "reasonable cause" for not filing a Form 5472, then the IRS will waive the $10,000 penalty.[42]

The standard for achieving a Late-Filing Waiver with respect to Forms 1120-F is "reasonable cause" and "good faith." This is identical or very similar to the thresholds for obtaining abatement of the delinquency penalties, Form 8833 penalties, and Form 5472 penalties described in the preceding paragraphs. Therefore, logic dictates that, if the IRS were to grant a Late-Filing Waiver, then the IRS should also eliminate the other three penalties on the

following grounds. First, thanks to the Late-Filing Waiver, the Form 1120-F is not considered delinquent, such that any tax payments triggered by the Form 1120-F and any international information returns enclosed therewith (*e.g.*, Forms 8833 and Forms 5472) should not be deemed late either. Second, if the IRS concluded that a foreign corporation acted reasonably and in good faith in terms of Form 1120-F, then fairness mandates that the IRS make the same determination with respect to *all* related payment and filing issues. The problem is that the Guidelines to do not mention penalty resolution; there is ominous silence on this critical issue.

V. Conclusion

The recent Tax Court decision in *Adams Challenge* is a sobering reminder for foreign corporations that failure to file "protective" or normal Forms 1120-F can trigger the inability to claim business deductions and credits, large U.S. income tax liabilities, significant penalties, and sizable litigation costs. Fortunately, depending on the circumstances, some foreign corporations can rectify matters by seeking a Late-Filing Waiver, which will be processed pursuant to the recent Guidelines issued by the IRS.

ENDNOTES

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1 *Adams Challenge (UK) Ltd.*, 156 TC No. 2, Dec. 61,809 (Jan. 21, 2021). This article supplements an earlier one by the same author. *See* Hale E. Sheppard, *New Procedures for Late Forms 1120-F and Late-Filing Waivers: The Evolution of IRS Standards and Open Issues for Foreign Corporations*, Int'l Tax J., 2018, 19.

2 2016 Instructions for Form 1120-F (*U.S. Income Tax Return of a Foreign Corporation*), at 2.

3 Code Sec. 882(a).

4 Code Sec. 882(b); Code Sec. 882(c)(1)(A).

5 Code Sec. 882(c)(2); Reg. §1.882-4(a)(2).

6 Reg. §1.882-4(b)(1) and (2).

7 Reg. §1.882-4(a)(4). This is similar to Code Sec. 6020(b).

8 Reg. §1.882-4(a)(3)(vi).

9 Reg. §1.882-4(a)(3)(vi).

10 Reg. §1.882-4(a)(3)(vi).

11 Reg. §1.882-4(a)(3)(vi).

12 2016 Instructions for Form 1120-F (*U.S. Income Tax Return of a Foreign Corporation*), at 2.

13 The extension is obtained by filing Form 7004 (*Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*).

14 IRS Memorandum LB&I-04-0218-007, published as Tax Notes Document 2018-8695.

15 Reg. §1.882-4(a)(3)(i). The normal deadlines are found in Code Sec. 6072.

16 Code Sec. 6072(a); Code Sec. 6072(c); Reg. §1.6072-2(b).

17 Code Sec. 6072(a); Code Sec. 6072(c); Reg. §1.6072-2(b).

18 Reg. §1.882-4(a)(3)(i).

19 T.D. 8322 (Dec. 11, 1990), Preamble.

20 *Adams Challenge (UK) Ltd.*, 156 TC No. 2, Footnote 4 (Jan. 21, 2021).

21 *Adams Challenge (UK) Ltd.*, 154 TC 37 (2020).

22 Reg. §1.882-4(a)(3)(ii).

23 Reg. §1.882-4(a)(3)(ii).

24 Reg. §1.882-4(a)(3)(ii).

25 Reg. §1.882-4(a)(3)(v).

26 Reg. §1.882-4(a)(3)(ii).

27 Reg. §1.882-4(a)(3)(ii)(A) through (F).

28 Reg. §1.882-4(a)(3)(iii).

29 Internal Revenue Service. "LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. §1.882-4(a)(3)(ii)." February 1, 2018.

30 Internal Revenue Service. "LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. §1.882-4(a)(3)(ii)." February 1, 2018. The Guidelines indicate that exceptions to this rigid rule might be appropriate where (i) a related-party is currently under audit, (ii) the IRS is auditing a year other than the one for which a late Form 1120-F was filed, or (iii) the IRS is auditing something other than the late Form 1120-F. *See* footnote 3.

31 Internal Revenue Service. "LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. §1.882-4(a)(3)(ii)." February 1, 2018. Section IV—Processing the Exam Team's Recommendation on a Request for Waiver.

32 Code Sec. 6651(a); Reg. §301.6651-1(a)(1).

33 Code Sec. 6651(a); Reg. §301.6651-1(a)(1).

34 2016 Instructions for Form 1120-F (*U.S. Income Tax Return of a Foreign Corporation*), at 9.

35 Code Sec. 6114; Reg. §301.6601-1(a).

36 Reg. §301.6114-1(c)(1)(iv).

37 Code Sec. 6712(a); Reg. §301.6712-1(a).

38 Code Sec. 6712(b); Reg. §301.6712-1(b).

39 Code Sec. 6038C(a); Reg. §1.6038A-1(c)(1).

40 Reg. §1.6038A-2(a)(1).

41 Code Sec. 6038A(d)(1); Reg. §1.6038A-4.

42 Code Sec. 6038A(d)(3); Reg. §1.6038A-4(b)(1).