
By Hale E. Sheppard

Hale E. Sheppard examines recent regulations and IRS procedures relating to Form 5472, which could trigger the immediate assessment of thousands of penalties each year.

I. Introduction

International tax compliance issues are terribly convoluted, Congress seems determined to escalate the complexity each year, and the IRS is showing less clemency to taxpayers that violate the rules. Nowhere are these realities more evident than with Form 5472 (Information Return of a 25 percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business), a relatively unknown international information return.

The IRS introduced new regulations in December 2014 about filing procedures for Form 5472, which it will no doubt characterize as a positive change for taxpayers. The alleged benefits of the new regulations are debatable, but some things about Form 5472 are certain: The IRS introduced an automated/systematic penalty program that will trigger the immediate assessment of thousands of Form 5472 penalties each year, the IRS ordinarily will not apply its first-time-abate policy to Form 5472 penalties, the IRS consults an ultra-stringent “Decision Tree” when evaluating Form 5472 cases, the IRS raises willful blindness theories when disputing requests for abatement, and failures to file Forms 5472 effectively cause the assessment period to remain open forever with respect to any
tax return, tax event, or tax period to which the missing
Forms 5472 relate.
Many taxpayers (and too often their advisors) have little
knowledge of these matters. This article addresses the is-
 issues described above with hopes of providing taxpayers
a degree of clarity on items that otherwise would remain
in obscurity, to the advantage of the IRS.

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II. Overview of Form 5472 Filing
Requirement

A. Brief History of Code Secs. 6038A
and 6038C

Foreign investment and foreign business activity in the
United States increased significantly in the 1980s. The
U.S. government, through Congress and the IRS, began
taking steps to ensure that such items were properly taxed
and monitored. One example of these efforts was the
enactment of Code Sec. 6038A in 1982. The primary
purpose of that legislation was to gather additional in-
formation about foreigners to prevent the manipulation
of related-party transactions and the resulting decrease in
U.S. tax revenues.1 The congressional rationale for passing
Code Sec. 6038A was the following:

Transactions between related parties are required to be
at arms-length prices. This rule applies, for example,
to transactions between a U.S. parent and its foreign
subsidiaries, as well as to transactions between a
foreign parent and its U.S. subsidiaries. Under prior
law, a U.S. parent corporation was required to report
transactions with its foreign affiliates and transactions
between its foreign affiliates, but no such reporting
was required of transactions between a U.S. subsidi-
ary of a foreign corporation and its foreign affiliates.
Consequently, the existence of such transactions did
not necessarily come to the attention of the Internal
Revenue Service. Congress believes that a requirement
that such transactions be reported will reduce transfer
price abuses and similar abuses and will place foreign
controlled U.S. entities on equal footing with U.S.
corporations controlled by U.S. persons.2

Code Sec. 6038A originally applied to U.S. corpora-
tions with significant ownership by foreign persons. It
was later expanded to cover foreign corporations engaged
in a trade or business in the United States, irrespective of
the percentage of foreign ownership.3 In 1990, Congress
enacted Code Sec. 6038C, which essentially split the re-
quirements: U.S. corporations that were foreign-owned
would be governed by Code Sec. 6038A, while foreign
corporations with U.S. operations would be controlled
by Code Sec. 6038C.4 Despite this statutory separation,
the two tax provisions share the same regulations (i.e.,
those under Code Sec. 6038A), and corporations subject
to either provision must supply the IRS with information
each year in the same manner (i.e., on Form 5472).

B. Analysis of Key Concepts

Form 5472 generally must be filed by a “reporting corpo-
ration” in order to disclose to the IRS certain “reportable
transactions” between it and “related parties.” Thus,
taxpayers must analyze each of these three concepts to
determine if they are forced to file Forms 5472. These
concepts are terribly complicated and technical, even for
tax professionals, and a detailed discussion is beyond the
scope of this article. However, having a general under-
standing of the three key terms is important. They are
summarized below.

1. What Is a “Reporting Corporation?”
The filing obligations are created by two interrelated tax
provisions.
Under Code Sec. 6038A, a “reporting corporation” is a
U.S. corporation that is at least 25 percent foreign-owned.5
A U.S. corporation is considered to be a 25-percent
foreign-owned corporation for these purposes if at least 25
percent of its stock is owned, either directly or indirectly,
by one foreign person at any time during the relevant
tax year.6 This foreign person is commonly known as the
“25-percent foreign shareholder.” In this context, “foreign
persons” include any individual who is not a U.S. citizen
or U.S. resident, any individual who is a citizen of a U.S.
possession, any foreign government, and any partnership,
association, company, corporation, trust, or estate that is
not domestic.7

According to Code Sec. 6038C, a “reporting corpora-
tion” is also any foreign corporation that operates a U.S.
trade or business at any time during the year at issue. The regulations clarify that if a foreign corporation is a resident of a foreign country that has a tax treaty with the United States, then it will not be considered a “reporting corporation,” unless it has a so-called “permanent establishment” in the United States.

2. What Is a “Related Party?”
A “related party” is broadly defined to cover (i) any 25-percent foreign shareholder of the reporting corporation, (ii) any person who is related to the 25-percent foreign shareholder according to certain ownership-attribution rules, (iii) any person who is related to the reporting corporation under the same ownership-attribution rules, and (iv) any entity that is owned or controlled by the same persons as the reporting corporation pursuant to the transfer-pricing rules in Code Sec. 482. The term “related party” does not include any corporation filing a consolidated federal income tax return with the reporting corporation.

3. What Is a “Reportable Transaction?”
The term “reportable transaction” encompasses several items, including, but not limited to, sales and purchases of inventory and other tangible property, rents and royalties paid and received, consideration paid for use of all intangible property, consideration paid for services rendered (including technical, managerial, engineering, construction, scientific and others), commissions paid and received, certain amounts loaned or borrowed, interest paid or received, premiums received for insurance or reinsurance, and the catch-all, other amounts paid to or received from related parties that are taken into account in determining the taxable income of the reporting corporation.

There is one notable exception. A transaction is not considered a “reportable transaction” (and thus not required to be reported on Form 5472) if (i) neither the reporting corporation nor the related party is a U.S. person, (ii) the transaction will not generate in any year gross income from U.S. sources or income effectively connected with a U.S. trade or business, and (iii) the transaction will not generate in any year any expenses, losses, or other deductions that could be allocated or apportioned to such income.

To make matters even more complex, the regulations indicate that the “reportable transactions” in which either a U.S. partnership or a foreign partnership engages will be attributed to any “reporting corporation” whose ownership interest in the partnership (either direct or indirect), combined with the ownership interests of all “related parties” to the “reporting corporation,” is 25 percent or more of the total partnership interests. Thus, if a partner is deemed to engage in “reportable transactions” with “related parties” under this special attribution rule, then it must properly disclose on Form 5472. The size of the transactions, though, is limited to the extent of the percentage of the partnership interest held by the “reporting corporation” partner. For example, if a partnership buys $1,000 of products from the foreign parent of a reporting corporation whose interest in the partnership is 50 percent, then the reporting corporation only needs to report $500 (i.e., 50 percent of $1,000) of purchases from a foreign related party on Form 5472.

4. Examples
The preceding summary of the three key concepts (i.e., “reporting corporation,” “related party,” and “reportable transaction”) demonstrates that determining whether a Form 5472 must be filed can be a daunting proposition for many taxpayers, particularly those unfamiliar with the tricky U.S. international tax rules. A further taste of this complexity comes from reviewing some of the examples in the IRS’s regulations, which are set forth below. Though hard to believe, the following examples have already been simplified by the author for enhanced clarity.

- First Foreign Corporation owns 100 percent of each of Second Foreign Corporation and Third Foreign Corporation. Second Foreign Corporation engages in a U.S. business through a U.S. branch. The U.S. branch engages in related-party transactions with First Foreign Corporation. Second Foreign Corporation is a “reporting corporation.” Third Foreign Corporation is a foreign “related party.” First Foreign Corporation is a direct 25-percent foreign shareholder of both Second Foreign Corporation and Third Foreign Corporation. Neither First Foreign Corporation nor Third Foreign Corporation is a “reporting corporation.”

- First Foreign Corporation owns 25 percent of the stock of each of Second Foreign Corporation and Third Foreign Corporation. Second Foreign Corporation and Third Foreign Corporation each own 20 percent of the stock of Domestic Corporation. The remaining 80 percent of the stock of Domestic Corporation is owned by an unrelated domestic corporation. Neither Second Foreign Corporation nor Third Foreign Corporation is engaged in a U.S. business. Under the applicable entity-attribution rules, First Foreign Corporation constructively owns its proportionate share of the stock of Domestic Corporation, which is owned directly by Second Foreign Corporation and Third Foreign Corporation. Thus, First Foreign Corporation is treated as constructively owning five
percent of Domestic Corporation through each of Second Foreign Corporation and Third Foreign Corporation, for a total of 10 percent of the stock of Domestic Corporation. Consequently, Domestic Corporation is not a “reporting corporation” because no 25-percent foreign shareholder exists.\footnote{17}

- Domestic Partnership is engaged in a U.S. business. Domestic Partnership is owned (i) 75 percent by First Foreign Corporation, which, in turn, is owned 100 percent by Second Foreign Corporation, and (ii) 25 percent by Domestic Corporation, which, in turn, is owned 100 percent by Third Foreign Corporation. Domestic Partnership only engages in transactions with Second Foreign Corporation and Third Foreign Corporation, not with First Foreign Corporation. Under the applicable rules, First Foreign Corporation is engaged in a U.S. business through the Domestic Partnership. First Foreign Corporation and Domestic Corporation are considered “reporting corporations” and must report their pro rata shares of the transactions with Second Foreign Corporation and Third Foreign Corporation. Thus, First Foreign Corporation must report 75 percent of Domestic Partnership’s transactions with Second Foreign Corporation, and Domestic Corporation must report 25 percent of Domestic Partnership’s transactions with Third Foreign Corporation.\footnote{18}

- Foreign Partnership owns 100 percent of Domestic Corporation and 25 percent of Foreign Corporation. The remaining 75 percent of Foreign Corporation is publicly owned by numerous small shareholders. Sales transactions occur between Domestic Corporation and Foreign Corporation. Domestic Corporation is a “reporting corporation.” The IRS determines that Domestic Corporation and Foreign Corporation are each controlled by Foreign Partnership under the transfer-pricing rules in Code Sec. 482. Therefore, Foreign Corporation is a “related party” to Domestic Corporation, and the sales transactions between Domestic Corporation and Foreign Corporation must be reported on Form 5472.\footnote{19}

\section*{C. Form 5472 Filing Requirement}

A reporting corporation must file a separate annual Form 5472 with respect to each related party with which it had any reportable transaction during the relevant year.\footnote{20} This, of course, opens the door for taxpayers to violate numerous filing duties and incur numerous penalties in just one year. Notably, Forms 5472 must be filed with the IRS, even though the information they contain may not affect the amount of U.S. tax due.\footnote{21} When, where, and how a reporting corporation files Forms 5472 has evolved over the years, and these ever-changing procedures are the focus of a subsequent part of this article.

\section*{D. Record-Keeping Requirement}

In addition to filing Forms 5472, a reporting corporation must also maintain records of reportable transactions in sufficient detail to establish the correct tax treatment of the transactions.\footnote{22} These records must be kept as long as they may be relevant to determining such treatment, and they must generally be kept within the United States.\footnote{23}

There are exceptions to this special record-keeping requirement in cases of small reporting corporations (\textit{i.e.}, those that have less than $10 million in U.S. gross receipts for a tax year) and small reportable transactions (\textit{i.e.}, where the aggregate value of all gross payments a reporting corporation makes to and receives from foreign related parties during the tax year does not exceed $5 million and is less than 10 percent of the reporting corporation’s U.S. gross income).\footnote{24} However, neither of these two record-keeping exceptions relieves a reporting corporation from its obligation to file annual Forms 5472.\footnote{25} In other words, while the IRS might liberate certain small entities and items from the extra record-keeping burden, it still demands reporting of the relevant transactions on Forms 5472.

\section*{E. Penalties for Form 5472 Violations}

A reporting corporation that fails to file timely Forms 5472 is subject to civil penalties.\footnote{26} Likewise, a reporting corporation that files timely, yet “substantially incomplete,” Forms 5472 will be punished.\footnote{27} The IRS generally may impose a penalty of $10,000 for each violation for each year, which can add-up quickly if a reporting corporation fails to file multiple Forms 5472 for an extended period.\footnote{28}

This penalty increases where the failure to file Forms 5472 continues after the IRS notifies the reporting corporation of its noncompliance. Specifically, if the reporting corporation fails to supply the IRS with the missing Forms 5472 within 90 days of notice from the IRS, then the penalty increases by $10,000 per month.\footnote{29}

If these sanctions for not filing Forms 5472 seem severe, then Congress and the IRS have accomplished their goal, as revealed in the legislative history:

Congress has long recognized that international transactions and foreign taxpayers present difficult
tax administration problems. In particular, foreign taxpayers have unique opportunities to avoid detection of failures to comply with tax reporting and payment obligations. For this reason, the committee believes that strong and effective sanctions must apply to failures to comply with reporting obligations related to foreign taxpayers.⁴⁰

F. Exceptions to Penalties

The regulations contain some special rules regarding penalty mitigation.

1. First Exception—Reasonable Cause Defense

If the reporting corporation acted in “good faith” and there is “reasonable cause” for not filing a Form 5472 or maintaining proper records, then the initial $10,000 penalty may be waived and the running of the 90-day correction period may be tolled.³¹ The reporting corporation must make an affirmative showing of all the relevant facts in a written statement made under penalties of perjury to demonstrate that good faith and reasonable cause exist.³²

The IRS makes its determination of whether the reporting corporation acted reasonably and in good faith on a case-by-case basis, taking into account all the pertinent facts and circumstances.³³ The regulations provide the following guidance in this regard: (i) An honest misunderstanding of fact or law by the reporting corporation may indicate reasonable cause and good faith in light of the experience and knowledge of the reporting corporation; (ii) Isolated computational or transcriptional errors are consistent with reasonable cause and good faith; (iii) Reliance by the reporting corporation on erroneous information return, erroneous professional advice, or other erroneous data constitutes reasonable cause and good faith only if such reliance was reasonable under all the circumstances; (iv) A reporting corporation may have grounds for penalty abatement if it has a reasonable belief (i.e., it does not know or have reason to know) that it is not owned by a 25-percent foreign shareholder; and (v) Reasonable cause may exist in situations where a foreign owner is considered a “related party” solely under the broad principles of the transfer-pricing rules in Code Sec. 482, and the reporting corporation had a reasonable belief that its relationship with the foreign owner did not meet these broad principles.³⁴

2. Second Exception—Substantial Compliance Defense

The regulations also contemplate a “substantial compliance” defense to penalties, which is categorized as a subset of “reasonable cause.” This defense only applies if the reporting corporation filed a timely, but incomplete or inaccurate, Form 5472.³⁵ Upon introducing this defense in the earliest regulations, the IRS envisioned salvation for many taxpayers: “The [IRS] anticipates that the broad range of estimates and descriptions allowed in [the Section 6038A regulations] will prevent most inadvertent errors from causing a technical violation if the reporting corporation has made a reasonable effort to comply.”³⁶

3. Third Exception—Reasonable Estimates Defense

The regulations also provide flexibility in terms of the figures reported on Forms 5472, allowing latitude of 25 percent on either side. In this regard, the regulations state that “[a]ny amount reported [on Form 5472] is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount.”³⁷ Adding yet more flexibility, the regulations go on to clarify that, even if the “reasonable estimate test” described above is not met, the reporting corporation may nevertheless prove that amount was reasonable (and thus no penalties should be imposed) by submitting a statement explaining the relevant facts and circumstances.³⁸

4. Fourth Exception—Small Amounts Defense

The regulations provide that, if any actual amount required to be reported does not exceed $50,000, then simply stating this on Form 5472 suffices. Reporting corporations are directed to write “$50,000 or less” in the pertinent places.³⁹

5. Fifth Exception—Small Reportable Corporation Defense

The IRS must “liberally” apply the reasonable-cause-and-good-faith exception in cases where four factors are met: The reporting corporation (i) is a small corporation, i.e., its gross receipts for the relevant year are $20 million or less, (ii) had no knowledge of the duty to file Form 5472 and/or maintain special records, (iii) has a limited presence in and contact with the United States, and (iv) promptly and fully complies with all requests by the IRS to file Forms 5472, and to furnish books, records, or other materials relevant to reportable transactions.⁴⁰

III. Evolution of Form 5472 Filing Requirements—Déjà Vu

The filing requirements for Form 5472 are different from other international information returns, and they have changed several times over the years. Together, this has
caused problems and penalties for taxpayers. Below is a survey of the evolution of the two key regulations, Reg. §1.6038A-2(d) and (e).

A. 1985 Regulations

The IRS first issued proposed regulations regarding Code Sec. 6038A in 1983. They contained just one straightforward rule about filing Forms 5472:

**Time and place for filing return.** Returns on Form 5472 required under this section shall be filed with the reporting corporation’s income tax return [i.e., Form 1120 or Form 1120-F] on or before the date required by law (including extensions of time) for the filing of such income tax return ...

The IRS changed its mind about the filing requirement during the next several months, as evidenced by the language in the final regulations issued in 1985. Such regulations retained the standard mandate of attaching Forms 5472 to the corporate income tax return, but added new rules for situations where the corporate income tax return would be late and a new obligation to send a copy of Form 5472 to a specialized IRS office. The final regulations featured the following instructions.

**Time and place for filing return.** Returns on Forms 5472 required under this section shall generally be filed with the reporting corporation’s income tax return for the same taxable year, and the due date (including extensions) for filing that income tax return is the due date for filing Form 5472.

However, if a reporting corporation’s income tax return is not timely filed (including extensions), then Form 5472 shall be filed with the Internal Revenue Service Center with which the reporting corporation’s income tax return is required to be filed, and shall be filed on or before the date required by law (including extensions of time) for filing such income tax return.

**Duplicate filing required.** [Regardless of whether it is filed on time or late], the reporting corporation shall file a duplicate copy of each Form 5472 (at the same time as the original is filed) with the Internal Revenue Service Center, Philadelphia, PA 19255.

The IRS justified the addition of the duplicate-filing requirement by stating that this will facilitate use of information in a centralized statistical analysis program without delays and costs to the IRS of sorting, copying, and sending the Forms 5472 from the regional Service Centers to the specialized Service Center in Philadelphia.

B. 1991 Regulations

In June 1991, the IRS issued another set of regulations regarding Code Sec. 6038A, which contained the following mandates about filing Forms 5472. The general rule, set forth in Reg. §1.6038A-2(d), stated the following:

**Time and Place for Filing Returns.** A Form 5472 required under this section shall be filed with the reporting corporation’s income tax return for the taxable year by the due date (including extensions) of that return. [Moreover,] a duplicate Form 5472 (including any attachments and schedules) shall be filed at the same time with the Internal Revenue Service Center, Philadelphia, PA 19255.

The regulations in 1991 also featured a special rule, in Reg. §1.6038A-2(e), for situations where the reporting corporation was going to file its Form 1120 or Form 1120-F late. It stated the following:

**Untimely Filed Return.** If the reporting corporation’s income tax return is untimely filed, then Form 5472 (with a duplicate to Philadelphia) nonetheless shall be timely filed at the Service Center where the [corporate income tax] return is due. When the income tax return is ultimately filed, a copy of Form 5472 must be attached.

In summary, the regulations indicated that a reporting corporation must file Form 5472 with its annual income tax return by the due date of that return. It also had to file a duplicate Form 5472 with the IRS Service Center in Philadelphia by that deadline. If the reporting corporation’s income tax return was filed late, then Form 5472 nevertheless had to be timely filed at the IRS Service Center where the income tax return was due. In addition, when the reporting corporation eventually filed its income tax return, it was required to attach a copy of the previously filed Form 5472.

C. 2004 Regulations

Technology had advanced since the earlier regulations were issued, and more reporting corporations were filing Forms 1120 and Forms 1120-F electronically. Cognizant of these realities, the IRS issued new regulations in
Time and Place for Filing Returns. A Form 5472 required under this section shall be filed with the reporting corporation’s income tax return [i.e., Form 1120 or Form 1120-F] for the taxable year by the due date (including extensions) of that return. A duplicate Form 5472 (including any attachments and schedules) shall be filed at the same time with the Internal Revenue Service Center, Philadelphia, PA 19255. A Form 5472 that is timely filed electronically satisfies the duplicate filing requirement.

In the Preamble to the 2004 regulations, the IRS made a prediction about the future, promising yet more simplification.

In subsequent filing seasons, it is anticipated that electronic filing technology will allow separate electronic filing of Form 5472 [i.e., separate from the Form 1120 or Form 1120-F]. The Treasury Department and the IRS intend that the guidance [in the 2004 regulations] would apply to any such separate electronic filing of Form 5472. Accordingly, a Form 5472 that is timely and separately filed electronically would be treated as satisfying the requirement timely to file a duplicate Form 5472 with the Philadelphia Service Center.\(^48\)

The change to the general rule in Reg. §1.6038A-2(d) only affected Forms 5472 that were filed electronically as attachments to a Form 1120 or Form 1120-F. Accordingly, the 2004 regulations did not impact reporting corporations filing paper returns.

Moreover, upon modifying the regulations in 2004, the IRS did not make any changes to the special rule, in Reg. §1.6038A-2(e), for situations where the reporting corporation files its Form 1120 or Form 1120-F late. By default, then, reporting corporations were still required to (i) file timely Forms 5472 with the IRS Service Center at which they were required to file Form 1120 or Form 1120-F, (ii) file timely copies of the Forms 5472 with the IRS Service Center in Philadelphia, and (iii) attach copies of the previously filed Forms 5472 when they filed the delinquent Form 1120 or Form 1120-F.

D. June 2014 Regulations

The IRS changed its mind, yet again, when it issued temporary and proposed regulations in June 2011, modifying both the general rule in Reg. §1.6038A-2(d) and the special rule for late returns in Reg. §1.6038A-2(e).\(^49\) The modifications, as shown below, consisted of deleting certain language from both regulations:

\[\text{[W]hile the Treasury Department and the IRS intend that a timely filed electronic Form 5472 would be treated as satisfying the untimely filed return provision, there are currently no procedures for electronically filing Form 5472 independent of an electronically filed income tax return. Thus, a reporting corporation that does not timely file an income tax return must still timely file a paper Form 5472 in order to satisfy the untimely filed return provision. If the IRS institutes procedures for the separate electronic filing of Form 5472, reporting corporations}\]
will no longer be required to file a paper Form 5472 when filing the Form 5472 separate from an income tax return.\textsuperscript{51}

No public comments were received and no request for a public hearing was made, so the IRS adopted and finalized the preceding regulations in June 2014. In doing so, the IRS confirmed that the “only remaining provision for filing a Form 5472 separately from the filer’s income tax return applies to cases in which the filer’s income tax return is not timely filed.”\textsuperscript{52}

Taxpayers, therefore, often find themselves at a real disadvantage when it comes to challenging Form 5472 penalties.

**E. December 2014 Regulations**

At the same time that the IRS finalized the regulations in June 2014 and thus rendered obsolete the requirement to file copies of Forms 5472 with the IRS Service Center in Philadelphia, the IRS also issued proposed regulations designed to eliminate the special rules in Reg. §1.6038A-2(e) aimed at late-filed Forms 1120 and Forms 1120-F. If adopted, the regulations “would require that Form 5472 be filed in all cases only with the filer’s income tax return for the taxable year by the due date (including extensions) of that return.”\textsuperscript{53} What the IRS proposed, in short, was to completely eliminate the existing guidance regarding what taxpayers must do if they will be filing a late Form 1120 or Form 1120-F. The deletion of regulatory language is shown here.

Un TIMELY Filed Return. If the reporting corporation’s income tax return [i.e., Form 1120 or Form 1120-F] is untimely filed, Form 5472 (with a duplicate to Philadelphia) nonetheless must be timely filed at the service center where the return is due. When the income tax return is ultimately filed, a copy of Form 5472 must be attached.

The IRS’s official stance about the simplification of the Form 5472 filing requirements is explained in the Preamble to the proposed regulations in June 2014. The IRS, referencing approximately 30 years of experience with the matter, now believes that the untimely return provision (i.e., Reg. §1.6038A-2(e)) is not conducive to efficient tax administration because it differs from the filing methods and penalty structures applicable to other international information returns, such as Forms 5471 (for controlled foreign corporations) and Forms 8865 (for certain foreign partnerships). Those international information returns must be filed with a taxpayer’s income tax return by the relevant due date (including extensions), and there is no separate rule, like Reg. §1.6038A-2(e), which would demand or permit filing of such returns apart from the relevant income tax returns.\textsuperscript{34}

The IRS received merely two sets of comments to the proposed regulations; it declined to adopt one, and it discounted the other as unresponsive. Ultimately, the IRS adopted the proposed regulations without substantive changes, such that, for tax years ending on or after December 24, 2014, the only remaining rule in the Code Sec. 6038A regulations about filing Forms 5472 consists of Reg. §1.6038A-2(d), in the following form:

*Time for Filing Returns.* A Form 5472 required under this section shall be filed with the reporting corporation’s income tax return [i.e., Form 1120 or Form 1120-F] for the taxable year by the due date (including extensions) of that return.\textsuperscript{55}

Thus, after the passage of over 30 years, the issuance of numerous sets of regulations (proposed, temporary, and final), the solicitation and review of public comments, the holding of public hearings, the revamping of IRS forms and instructions, etc., the IRS has now managed to come full circle in terms of the Form 5472 filing requirement. Indeed, the singular, straightforward requirement that the IRS first proposed way back in 1983, as seen below, has now been dusted-off and reintroduced as a “new” rule in 2014. Please compare this regulatory *déjà vu.*

**Proposed rule from 1983**

*Time and place for filing return.* Returns on Form 5472 required under this section shall be filed with the reporting corporation’s income tax return on or before the date required by law (including extensions of time) for the filing of such income tax return ...\textsuperscript{56}

**“New” rule from 2014**

*Time for filing returns.* A Form 5472 required under this section shall be filed with the reporting corporation’s income tax return for the taxable year by the due date (including extensions) of that return.\textsuperscript{57}
IV. Digging Deeper—Which Form 5472 Issues Are Important?

The IRS likely will try to characterize these “new” rules from December 2014 as a positive step for taxpayers, a move toward simplification in the ultra-complex world of international tax compliance. Those who regularly work in this field might disagree with the IRS’s spin, though. The remainder of this article analyzes why the December 2014 regulations might hurt (as opposed to help) taxpayers, as well as a list of other interesting, yet obscure, issues related to Forms 5472.

A. Pressure to File Timely Forms 1120 (Along with Timely Forms 5472)

The IRS will portray the “new” rules from 2014 as a good thing, citing simplicity for taxpayers and conformity with other international information return rules, such as those applicable to Forms 5471 (for controlled foreign corporations) and Forms 8865 (for certain foreign partnerships). The reality, however, is that the “new” filing procedures will cause problems for many taxpayers and their return-preparers for the following reason.

As explained above, a Form 5472 generally must be filed by a “reporting corporation” in order to disclose to the IRS data about certain “reportable transactions” between it and “related parties.” Anyone who has worked with foreign-owned U.S. corporations and/or foreign corporations operating in the United States knows that analyzing each of the three elements presents its own set of challenges, but obtaining the data necessary to accurately identify and calculate the “reportable transactions” can be grueling. These difficulties often derive from the fact that the relevant entities are located in different countries, maintain different types of books and records, operate in different languages, utilize different currencies, adhere to different fiscal years, have different levels of awareness of and/or attitudes toward the duty to reveal to the IRS what they deem confidential business data, etc. Because of these troubles in gathering full, timely data from all related parties, certain “reporting corporations” that know that their Forms 1120 (when ultimately completed) will show little to no U.S. tax liability have traditionally filed timely Forms 5472 with the proper IRS office, taken their time in filing the Form 1120, and attached a copy of the previously filed Forms 5472 with the late Form 1120, expressly notifying the IRS that such Forms 5472 have been previously submitted.58

The preceding methodology worked well for “reporting corporations” because (i) it allowed them extra time to complete the Forms 1120, (ii) it did not trigger late-filing penalties or late-payment penalties under Code Sec. 6651 because such penalties are based on the size of the income tax underpayment by the corporations, and there was little to no U.S. tax liability, and (iii) it avoided penalties on Forms 5472 because they were filed before the deadline and, even if the original Forms 5472 were not entirely correct or complete as originally filed, the corporations would rely on the substantial-compliance defense, the reasonable-estimate defense, the small-amounts defense, the small-reportable-corporation defense, and/or the reasonable-cause defense.

Now, with the “new” filing rules introduced in December 2014, this methodology effectively disappears because the only manner in which a Form 5472 can be filed is as an enclosure/attachment to a Form 1120 or Form 1120-F.

B. Late Forms 5472 Now Trigger Automatic Penalties

Perhaps the most significant, and least known, aspect of Form 5472 is that the IRS has been automatically imposing Form 5472 penalties since 2013. The IRS, after achieving considerable economic success by automatically sanctioning other types of international information returns, decided to implement the so-called “systematic assessment” mechanism for Forms 5472 in 2013. Since that time, if a Form 1120 or Form 1120-F is filed after the deadline and Forms 5472 are enclosed/attached, then the IRS will automatically assess a $10,000 per-violation penalty and immediately start the collection process, regardless of whether the taxpayer includes with the late Forms 5472 a statement of reasonable cause.59

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-possibly-consider-excuses-later situation. The initial TIGTA report was released in 2006.60 It recognized that Forms 5472, along with Forms 5471 (for controlled foreign corporations), play a fundamental role in promoting international tax compliance. Indeed, according to TIGTA, their importance is reflected “in the severity of the penalties” for violations.61 TIGTA observed in its 2006 report that (i) the IRS should have asserted $79.2 million more in penalties in 2002 alone, (ii) the underpenalization was attributable to the fact that sanctions had historically been asserted by Revenue Agents, manually, only in the limited situations that they detected the non-compliance, 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.” 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. The IRS agreed with and implemented both suggestions from TIGTA.

The follow-up report by TIGTA was released in 2013. It indicated that one of the biggest issues facing the IRS is accelerating globalization. To help meet the challenges of international tax administration, the IRS has adopted a four-part strategy: (i) Expand employee knowledge and awareness of international tax issues; (ii) Develop deep expertise and capabilities in key international issue areas; (iii) Enhance coordination with foreign treaty partners and international organizations; and (iv) Aggressively target areas of significant risk. This, explains the 2013 report from TIGTA, has generated “increased enforcement efforts on international information reporting requirements and increased assessments of related penalties.” Let’s talk statistics. The 2013 report confirms that the IRS officially introduced the automated/systematic penalty program in 2009 with respect to Forms 5471 affixed to late income tax returns. Before the program was in place, in 2008, the total penalties were $7.6 million. By contrast, once the IRS started automatically/systematically 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. The 2013 report confirms that, based on this degree of success with Forms 5471, the IRS decided to expand the automated/systematic penalty program to Forms 5472 in January 2013. The TIGTA report makes it clear that the IRS anticipates this new move to be lucrative, as Form 5472 penalties in 2011 alone would have reached approximately $103 million if the automated/systematic penalty program had been in place that year. The TIGTA report contained several recommendations, including further expanding the automated/systematic penalty program to even more areas starting in 2014. TIGTA also suggested that the IRS decrease the number of abatements granted after the IRS has automatically/systematically assessed penalties. One way to achieve this reduction of abatements, said TIGTA, would be to obligate IRS personnel to review and implement the strict rules in the Form 5471 and Form 5472 “Decision Tree” discussed in detail later in this article.

Are the new automated/systematic penalty procedures just a huge money grab for the IRS, or do they constitute a genuine desire by the IRS to improve international tax compliance? The bigger question is, who cares? The reality is that the IRS has in place a return-processing system that will generate millions of dollars in Form 5472 penalties each year, and taxpayers need to be prepared to prevent and/or dispute such penalties, as appropriate.

C. 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 5472 penalties often cite to this policy in seeking relief. This policy states that the IRS will grant penalty 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. If the taxpayer meets these criteria, then the IRS generally issues a letter to the taxpayer containing the following paragraph confirming that abatement is being granted solely on the basis of the first-time-abatement policy, not because the taxpayer has demonstrated that it had reasonable cause for the violation.

We are pleased to inform you that your request to remove the (use applicable penalty, i.e. failure to file, failure to pay, or failure to deposit) penalty(ies) has been granted. However, this action has been taken based solely on your compliance history rather than on the information you provided. This type of penalty removal is a one-time consideration available only for a first-time penalty charge. IRS will base decisions on removing any future (failure to file, failure to pay, failure to deposit) penalties on any information you provide that meets reasonable cause criteria. You should receive a notice of penalty adjustment within the next few weeks.

The first-time-penalty-abatement policy is bittersweet, as is so often the case with IRS issues. The bad news is that the policy does not apply to (i) “returns with an event-based filing requirement,” (ii) situations where a taxpayer filed a Form 1120 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 [like Forms 5472] that are attached [to income tax return].” Some IRS personnel simply deny requests for waiver of Form 5472 penalties based on these exclusions from the first-time-penalty-abatement policy. More specialized IRS personnel generally apply the four-step process, explained
below, which is designed specifically for overlapping penalties involving Forms 1120 and Form 5472.74

- Step 1. If the taxpayer seeks abatement of both the delinquency penalties related to Form 1120 and abatement of Form 5472 penalties, then the Internal Revenue Department at the IRS Office in Ogden, Utah will first review the issues related to Form 1120.

- Step 2. If the related delinquency penalty for the Form 1120 is abated because the taxpayer demonstrates that there was "reasonable cause" for the violation, then Form 5472 penalties should be abated using the same rationale/code.

- Step 3. If the delinquency penalty for the Form 1120 is abated not because "reasonable cause" existed but rather because of the application of the first-time-penalty abatement policy, then Form 5472 penalties can be abated under the same rationale/code, only if the IRS has not asserted Form 5472 penalties within the past three years.75

- Step 4. If the related delinquency penalty for Form 1120 is not abated (i.e., because the first-time-penalty-abatement policy does not apply and there was no reasonable cause for the violation), then IRS personnel must consult the "Failure to File or Late-Filed Form 5472 Decision Tree" to determine whether the Form 5472 can be abated independently of the Form 1120 issue.

Thus, if a penalty issue reaches Step 4, described above, then the IRS must resolve the issue pursuant to the rules set forth in the "Decision Tree" designed for Form 5472. The Internal Revenue Manual expands on the use of the "Decision Tree," indicating that all requests by taxpayers for abatement based on reasonable cause must be analyzed in accordance with the terms of the "Decision Tree," if the Form 5472 penalties were systematically/automatically assessed by the IRS computers, as opposed to being assessed by a Revenue Agent conducting an audit.76

D. Functioning of the "Decision Tree" for Form 5472 Penalties

If someone does not know the rules of the game, it is terribly unlikely that such person will triumph. This holds true in the area of penalty disputes with the IRS.

1. First Common Error

A common error by inexperienced tax representatives 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.77 Penalties may not be imposed, however, if there was "reasonable cause" and the taxpayer acted in "good faith."78

- 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."79

- 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."80

- Under Code Sec. 6721, the IRS generally may assert penalties when a taxpayer files a delinquent, incomplete, or incorrect information return.81 However, penalties may not be asserted where the failure is due to "reasonable cause" and the taxpayer acted in a "responsible manner."82

2. Second Common Error

Along with mistakenly believing that the standards for penalty mitigation are the same in all contexts, some people think that the concept of "reasonable cause" is the same for all tax provisions containing this phrase, including Code Sec. 6038A. This is logical, but incorrect, and causes problems for those seeking penalty abatement of Form 5472 penalties.

In determining the appropriateness of penalties, the IRS and the courts often turn to general notions of "reasonable cause," as summarized in the IRS's Penalty Handbook and the regulations. Here are some common justifications presented by taxpayers and accepted by the IRS. First, a taxpayer may establish reasonable cause by showing that the taxpayer exercised ordinary business care and prudence, but nevertheless was unable to comply with the law.83 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."84 Third, a taxpayer's ignorance of the law may give rise to reasonable cause. The Penalty Handbook acknowledges that in some instances taxpayers may not be aware of specific obligations to file and/or pay taxes.85 It further 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. Fourth, a taxpayer's reasonable reliance on an independent, informed, qualified tax professional often reaches the level of reasonable cause. For purposes of the reasonable-reliance defense, the regulations broadly define the concept of “advice” to cover “any communication” from a qualified advisor and clarify that “[a]dvice does not have to be in any particular form.”

3. Decision Tree Pertaining to Form 5472 Penalties

As indicated earlier in this article, most Form 5472 penalties must be resolved by IRS personnel not by applying the standards contained in other tax provisions (such as accuracy-related penalties under Code Sec. 6662, delinquency penalties under Code Sec. 6651, estimated tax penalties under Code Sec. 6654, and information-return penalties under Code Sec. 6721), and not by applying the general standards contained in the IRS’s Penalty Handbook and regulations, but rather by applying the “Decision Tree” for Form 5472 penalties. This “Decision Tree,” found exclusively in the recesses of the Internal Revenue Manual, features standards that are much more stringent than those located elsewhere. Indeed, many of the standards in the “Decision Tree” are contrary to abatement criteria established by the IRS, by the regulations, and, in certain cases, by the U.S. Supreme Court. The following examples from the “Decision Tree” demonstrate that attaining abatement of Form 5472 penalties can be significantly more challenging than normal.

- If the taxpayer claims that it was unaware of the Form 5472 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 5472 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 5472, 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 relies on challenges in obtaining the necessary foreign data as the excuse for late Forms 5472.

- The “Decision Tree” demands imposition of penalties if the reason for the delinquent Forms 5472 is that the person with sole authority to file Form 5472 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 5472 within two weeks of when the absence ended.

- The IRS will not waive Form 5472 penalties under the “Decision Tree” if the taxpayer neglected to file a Form 7004 (Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns) to secure an automatic six-month extension to file a Form 1120 or Form 1120-F.

- The “Decision Tree” also denies abatement where the taxpayer hired a third-party (such as an accounting firm) to prepare returns and erroneously believed that such third-party has filed a Form 7004 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 a U.S. resident, resided outside the United States but failed to even retain U.S. tax representation, or claims that it was unaware of the obligation to file U.S. tax returns.

- 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 5472, the tax professional advised the taxpayer that it was not required to file Form 5472, 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 5472
penalties will not be abated) if the taxpayer did not take reasonable steps to independently investigate or the taxpayer did not get a second opinion.

The last aspect of the “Decision Tree” is particularly remarkable because it is directly contrary to the legal precedent established by the U.S. Supreme Court approximately 30 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.

**E. Willful Blindness and Constructive Knowledge of Form 5472**

As explained in various places in this article, corporations that file late or inaccurate Forms 5472 have a chance to mitigate penalties if they can persuade the IRS that reasonable cause existed for the violations. This defense, seemingly raised by every taxpayer in every penalty case, has become more difficult to advance in the context of Form 5472 in recent years. Here’s another reason why.

The Form 5472 filing duty applies to two main types of entities, certain U.S. corporations that are at least 25 percent foreign owned and foreign corporations operating a trade or business in the United States. The former files a Form 1120, while the latter files a Form 1120-F. Both of these tax returns and the related guidance from the IRS contain data that undermines a reasonable cause defense by corporations, as explored below.

- The IRS’s Instructions to Form 1120 contain this guidance about Forms 5472: “Requirement to file Form 5472. If the corporation checked “yes” [in response to Question 7 to Schedule K of Form 1120], it may have to file Form 5472 ... Generally, a 25 percent-foreign-owned corporation that had a reportable transaction with a foreign or domestic related party during the tax year must file Form 5472. See Form 5472 for filing instructions and penalties for failure to file.”

- Question M on Page 1 of Form 1120-F presents the following question about Form 5472: “Did the corporation have any transactions with related parties? If “Yes,” Form 5472 may have to be filed (see instructions). Enter number of Forms 5472 attached.”

- The IRS’s Instructions for Form 1120-F significantly expand on the Form 5472 filing obligation, containing the following directions: “A foreign corporation may have to file some of the following forms and schedules. See the form or schedule for more information. For a list of additional forms the corporation may need to file (most notably, forms pertaining to the reporting of various types of income, and any related withholding, to U.S. persons, foreign persons, and the IRS), see Pub. 542, Corporations ... Form 5472 ... This form is filed by or for a foreign corporation engaged in a U.S. trade or business that had certain reportable transactions with a related party. See the Instructions for Form 5472 for filing instructions and information for failure to file and maintain records.”

The IRS and the courts recently have been pointing to similar types of data, in different contexts, in order to impose large penalties on taxpayers engaged in international tax noncompliance. The best example of this involves failures to file Forms TD F 90-22.1, which are now called FinCEN Forms 114. These forms are both commonly referred to as foreign bank account reports (FBARs). Congress enacted new FBAR penalty provisions in 2004. Now, the IRS may impose a civil penalty on any person who fails to file an FBAR when required, period. In the case of nonwillful or unintentional violations, the maximum penalty is $10,000. Higher maximum penalties exist, though, where willfulness exists. In situations where a taxpayer “willfully” failed to file an FBAR, the IRS may assert a penalty equal to $100,000 or 50 percent of the balance in the account at the time of the violation, whichever amount is larger. Many undisclosed foreign accounts have large balances, and the IRS applies the FBAR penalty on a per-account-per-year basis. This means that FBAR penalties, particularly those for “willful” violations, can be astronomical.
The U.S. government has won several high-profile FBAR cases in the past few years. For purposes of this article, these FBAR cases are only interesting for one reason: They demonstrate how the IRS and the courts are interpreting the concepts of “willfulness” and “willful blindness.” For example, the IRS took the position in a recent case, McBride, that the taxpayer had “willfully” failed to file his FBARs. The IRS raised various arguments in support of its position, including that the taxpayer should be considered “willful” because he had constructive knowledge of the FBAR filing requirement (i.e., he should have known about it), even if he lacked actual knowledge of the requirement. After meandering considerably in its legal opinion, the court ultimately delivered some remarkably clear, though perhaps questionable, reasoning with respect to the concept of constructive knowledge as it applies to FBARs:

Knowledge of the law, including knowledge of the FBAR requirements, is imputed to McBride. The knowledge of the law regarding the requirement to file an FBAR is sufficient to inform McBride that he had a duty to file an FBAR for any foreign account in which he had a financial interest. McBride signed his federal income tax returns for both the tax year 2000 and 2001. Accordingly, McBride is charged with having reviewed his tax return and having understood that the federal income tax return asked if at any time during the tax year he held any financial interest in a foreign bank or financial account. The federal income tax return contained a plain instruction informing individuals that they have the duty to report their interest in any foreign financial or bank accounts held during the taxable year. McBride is therefore charged with having had knowledge of the FBAR requirement to disclose his interest in any foreign financial or bank accounts, as evidenced by his statement at the time the returns were filed. Under penalty of perjury, that he read, reviewed, and signed his own federal income tax returns for the tax years 2000 and 2001, as indicated by his signature on the federal income tax returns for both 2000 and 2001. As a result, McBride’s willfulness is supported by evidence of his false statements on his tax returns for both the 2000 and the 2001 tax years, and his signature, under penalty of perjury, that those statements were complete and accurate.

The Tax Court came to a similar conclusion in an earlier, obscure case involving Forms 5472 (and not FBARs). It observed the following regarding the claim of ignorance by the taxpayers about the need to file Forms 5472:

The Federal tax forms specifically requested information about related parties. [Taxpayers] failed to disclose all of the required information and to file the appropriate Forms 5472. Taxpayers cannot hide behind a claim that they were not aware of the need to provide the information because they did not read their returns. The voluntary failure to read a return and blind reliance on another for the accuracy of a return are not sufficient bases to avoid liability for negligence additions to tax.

The IRS, like the Tax Court, has shown its willingness to uphold Form 5472 penalties where there is evidence of “willful blindness” and constructive knowledge by the taxpayer. For instance, the IRS stated the following in FSA 33314918:

[R]egardless of the identity of the 25-percent foreign shareholder, both the tax preparer and taxpayer, as indicated by the Forms 1120, knew that taxpayer constituted a reporting corporation under Section 6038A and may be responsible for filing Forms 5472. This knowledge is demonstrated by the fact that taxpayer reported on its Forms 1120 [that a significant portion of its stock was owned] by a nonresident alien.

As shown above, the U.S. government has experienced some success lately in asserting FBAR and Form 5472 penalties based on the argument that the taxpayers were “willfully blind.” Given the fact that Form 1120, Instructions to Form 1120, Form 1120-F, and Instructions to Form 1120-F all specifically raise the issue of the possible need to file Forms 5472, one would expect the IRS to continue presenting this position in the future when asserting Form 5472 penalties and challenging claims by taxpayers of reasonable cause.

F. Various IRS Rulings Regarding Form 5472 and Reasonable Cause

When the IRS decides not to assert Form 5472 penalties or agrees to abate such penalties administratively, written tax/legal precedent generally is not created. It makes sense, then, that most published IRS rulings would be unfavorable to taxpayers. Keeping this in mind, it is still worthwhile to review the few IRS rulings that exist regarding Form 5472.

1. Field Service Advisory 200026005

Field Service Advisory 200026005 dealt with the issue of whether the taxpayer could avoid penalties thanks to the
substantial-compliance defense to Form 5472 penalties. The IRS, in concluding that the Form 5472 was indeed substantially complete, provided the following list of facts and circumstances that the IRS might consider in making this determination: (i) The magnitude of the unreported transactions in relation to reported transactions and whether the reporting corporation had other reported transactions with the same related party; (ii) The magnitude of the unreported transactions in relation to the reporting corporation’s volume of business and overall financial situation; (iii) The significance of the unreported transactions to the reporting corporation’s business in a broad, functional sense; (iv) Whether the unreported transactions occurred in the context of a significant, ongoing transactional relationship with the related party; and (v) Whether the unreported transactions were reflected in the determination and computation of the reporting corporation’s taxable income in the relevant year.

2. Chief Counsel Advisory 10223

In Chief Counsel Advisory 10223, the IRS asserted penalties for not filing Forms 5472. The taxpayer, a domestic corporation, submitted a written statement arguing that reasonable cause existed for the following reasons: (i) It was unaware of the need to file a Form 5472; (ii) The foreign ownership was adequately disclosed to the IRS on its Form 1120 anyway; (iii) The failure to attach Form 5472 was an “inadvertent omission;” (iv) The corporation relied on professional advisors for compliance advice; and (v) The corporation had historically complied with the Form 5472 filing requirement. The IRS rejected the reasonable cause arguments for two main reasons. First, the IRS explained that reliance on substantive advice from an informed, qualified professional is reasonable, but reliance on a professional to carry out a ministerial duty (such as timely filing a return) is not reasonable. The IRS concluded that filing a Form 5472 is “a ministerial act for which the taxpayers cannot be excused of responsibility.” Second, the IRS explained that, even if filing a Form 5472 were a substantive act, the taxpayer failed to show acceptable reliance. The IRS pointed to the fact that the taxpayer filed Forms 5472 in previous years; therefore, the existence of Form 5472 and the need to analyze whether Forms 5472 needed to be filed for the year in question should have been apparent to the taxpayer and/or its accountant.

3. Chief Counsel Advisory 11537

The taxpayer in Chief Counsel Advisory 11537 failed to file various Forms 5472, got audited by the IRS, and claimed that it had “reasonable cause” for the violations. With respect to Forms 5472 related to domestic corporations, the taxpayer claimed that it did not file because the IRS’s Instructions to Form 5472 were “ambiguous and confusing.” Surprisingly, the IRS conceded that the Instructions in existence back in 1999 were ambiguous, and recognized that the regulations were equally murky. Thus, the IRS agreed that “reasonable cause” existed to abate the penalties.

Regarding Forms 5472 related to foreign corporations, the taxpayer argued that the violation was attributable to an “inadvertent administrative error” because the parent company had many affiliates all over the world, many of the affiliates are not known to the taxpayer, and it is very difficult to keep track of all the different transactions between them. The IRS rejected claims of reasonable cause for two reasons, the primary of which was that the foreign corporations should have done additional due diligence, particularly since they had previously filed Forms 5472. The IRS stated the following regarding efforts at full tax compliance:

In two instances, [the taxpayer] failed to file Forms 5472 with respect to related parties for which it had filed Forms 5472 in prior taxable years. In our view, any person making a reasonable effort to comply with the requirements of I.R.C. Section 6038A would, as part of the process of determining whether Forms 5472 are required to be filed in any given taxable year, look at prior years’ filings. There is no evidence that [the taxpayer] did so. [This] apparent failure to do so negates any possible finding that the failure to file was based on an honest misunderstanding that was reasonable in light of [the taxpayer’s] experience.

4. Field Service Advisory 33314918

The taxpayer in Field Service Advisory 33314918 filed a timely Form 1120, which included a Schedule K (Other Information) indicating that foreign persons owned a significant percentage of its stock. The taxpayer attached a Form 5472 to the Form 1120 for an earlier year. Then, for later years, the taxpayer entered “0” in Schedule K about the number of Forms 5472 to be filed. The same accounting firm prepared all the returns for all years, and the same accountant/partner signed the returns each year as the preparer. The taxpayer was audited by the IRS, and it became evident that many required Forms 5472 had not been filed. The Revenue Agent demanded that the taxpayer file all missing Forms 5472, the taxpayer did so, the Revenue Agent proposed a $10,000 penalty for each
violation, and the taxpayer requested penalty abatement.

The taxpayer gave the following justifications for abatement: (i) It had a long history of federal and state compliance since inception of business; (ii) It changed outside accountants at some point during the relevant years, and there was confusion by internal personnel and new outside accountants about the identity of the ultimate foreign owners; (iii) The returns were filed in good faith, even though they were wrong; (iv) The taxpayer was not aware of the errors until the IRS audit began; (v) The taxpayer intended to file Forms 5472 but relied “on a good-faith determination” that it was not necessary; (vi) The taxpayer made best efforts to comply with demands by the Revenue Agent in terms of quickly filing Forms 5472; and (vii) The taxpayer instituted changes such that violations would not occur in the future.

The IRS upheld the Form 5472 penalties for several reasons, the three most important of which are addressed here. First, the IRS determined that the taxpayer failed to provide sufficient proof of reliance on a qualified tax professional. In doing so, the IRS set forth a stringent standard, reflective of the IRS’s narrow view of reasonable cause in the context of Form 5472, as discussed earlier in this article in the section about the “Decision Tree.”

[T]he regulations provide that reliance on professional advice is only one factor to consider among the totality of the facts. The reliance must be reasonable. The person relied upon must be knowledgeable in the particular issues. The person relied upon should expressly provide advice on whether Forms 5472 should be filed, and taxpayer should document such reliance. Moreover, the reliance should generally relate to a technical tax issue, not matters such as filing deadlines which require no special training or effort to ascertain and make sure they are met. Generally, a taxpayer is presumed to be charged with knowledge of the contents of its own tax return. Hence, the ultimate responsibility for a correct return lies with the taxpayer who must furnish the necessary information to the agent who prepared the return. Reliance upon expert advice will not exculpate a taxpayer who supplies the expert, e.g., return preparer, with incomplete and inaccurate information. Thus, a taxpayer may not escape a penalty by simply blaming its tax return preparer. An important factor in determining reasonable cause is the extent of a taxpayer’s effort to assess his or her proper tax reporting obligations. [In this case], there is no evidence of reasonable reliance upon taxpayer’s tax preparer. Taxpayer merely states that the mistaken identity [of the 25-percent foreign shareholder] was shared by its preparer. Taxpayer does not indicate what information was reviewed by taxpayer and its tax preparer to cause the mistake. Taxpayer does not provide any evidence of the advice, if any, given by its tax preparer in this regard. Taxpayer also does not specifically state what, if any, problems it had in identifying the related party transactions, which should have been recorded on its books and records. Accordingly, the [IRS] may conclude that a bare statement claiming reliance is not sufficient proof of the existence of expert advice or reasonable reliance thereon.

Second, as it did in earlier IRS rulings, the IRS indicated that the ignorance-of-the-law argument is seriously weakened, if not fatally wounded, where the taxpayer properly filed Forms 5472 in previous years. The IRS announced the following in this regard: “If a Form 5472 for a previous tax year was filed, it would be normally difficult for the taxpayer to show reasonable cause unless taxpayer had a reasonable belief that it was no longer owned by a 25-percent foreign shareholder or no related party transactions occurred during the taxable year.”

Third, without stating it expressly, the IRS put considerable stock in the position that the IRS will not abate penalties in situations with evidence that the taxpayer was “willfully blind” of the Form 5472 filing requirement. The IRS held that the explicit cross-reference in Form 1120 to the possible need to file Form 5472 undermines a taxpayer’s ignorance-of-the-law argument.

G. Effect of Late Forms 5472 on Assessment Periods

Sure, the standard penalty of $10,000 per year per violation can hurt a corporation, and the continuing-violation penalty of an additional $10,000 per month can be even more painful. The most significant consequence of not filing or of late filing Forms 5472 has nothing to do with money, though. It concerns time, i.e., 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 5472 (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 5472 relates until three years after the taxpayer ultimately files Form 5472. Consequently, if a corporation fails to file Forms 5472 for a particular year or set of years, it is unable to run out the clock with the IRS, because bygones are never bygones as a result of Code Sec. 6501(c)(8)(A).
V. Conclusion

As this article demonstrates, important issues concerning Form 5472 can be complicated, difficult to find, and slanted in favor of the IRS. Taxpayers, therefore, often find themselves at a real disadvantage when it comes to challenging Form 5472 penalties. The situation is exacerbated by the fact that the IRS now automatically/systematically assesses penalties, Form 5472 violations often are deemed ineligible for the first-time-penalty-abatement policy, the rigid “Decision Tree” used in connection with Form 5472 infractions significantly reduces opportunities for abatement, the IRS is now raising (and some courts are now accepting) willful blindness arguments when rejecting requests for abatement of Form 5472 penalties, and unfiled Forms 5472 cause the assessment period to remain open indefinitely with respect to any tax return, tax event, or tax period to which the Forms 5472 relate. In light of this reality, taxpayers attempting to comply with the tricky Form 5472 filing requirements or facing Form 5472 penalties would be wise to seek assistance from specialized tax professionals with considerable experience in the area.

ENDNOTES

5 Code Sec. 6038A(a); Reg. §1.6038A-1(c)(1).
6 Code Sec. 6038A(c)(1); Reg. §1.6038A-1(c)(2),(3).
7 Reg. §1.6038A-1(f).
8 Code Sec. 6038C(a); Reg. §1.6038A-1(c)(1).
9 Reg. §1.6038A-1(c)(1).
10 Code Sec. 6038A(a); Reg. §1.6038A-1(c).
11 Code Sec. 6038A(c)(2); Reg. §1.6038A-1(c)(d). For purposes of determining whether a domestic corporation is considered a “reporting corporation” because it has a 25-percent foreign shareholder and whether a person is considered a “related party,” the regulations modify the constructive ownership rules of Code Sec. 318, further complicating the analysis. See Reg. §1.6038A-1(e)(1).
12 Reg. §1.6038A-1(d)(3).
13 Reg. §1.6038A-2(a)(2), (b)(3), (4), (5).
14 Reg. §1.6038A-2(a)(2).
15 Reg. §1.6038A-1(e)(2).
16 Reg. §1.6038A-2(g).
17 Reg. §1.6038A-1(m), Example 2.
18 Reg. §1.6038A-1(m), Example 3.
19 Reg. §1.6038A-1(m), Example 1.
20 Reg. §1.6038A-1(m), Example 5.
21 Reg. §1.6038A-2(a)(1).
22 Code Sec. 6038A(a); Reg. §1.6038A-3(a).
23 Reg. §1.6038A-3(g) and (i).
24 Reg. §1.6038A-1(h) and (i).
25 Reg. §1.6038A-1(h) and (i). The regulations clarify that “[s]uch a corporation, however, remains subject to the information reporting requirements of Treas. Reg. §1.6038A-2 and the general record maintenance requirements of Section 6001.”
26 Code Sec. 6038A(d)(1); Reg. §1.6038A-4(a)(1).
27 Reg. §1.6038A-4(a)(1). This regulation states that “[t]he filing of a substantially incomplete Form 5472 constitutes a failure to file Form 5472.”
28 Code Sec. 6038A(d)(1); Reg. §1.6038A-4.
29 Code Sec. 6038A(d)(2); Reg. §1.6038A-4(d)(1), (f), Example 1.
31 Code Sec. 6038A(d)(3); Reg. §1.6038A-4(b)(1).
32 Reg. §1.6038A-4(b)(1).
33 Reg. §1.6038A-4(b)(2)(ii).
34 Reg. §1.6038A-4(b)(2)(i).
36 Reg. §1.6038A-2(b)(6)(i).
37 Reg. §1.6038A-2(b)(6)(ii).
38 Reg. §1.6038A-2(b)(6)(i).
39 Reg. §1.6038A-2(b)(7).
40 Reg. §1.6038A-2(b)(7).
41 Reg. §1.6038A-2(b)(7).
43 48 FR 56076-01 (Dec. 19, 1983).
46 Supra note 36.
47 T.D. 8353, 1991-2 CB 402. The proposed regulations were previously issued in December 1990. See 55 FR 50706-01.
52 Id.
54 REG-114942-14, Preamble.
55 T.D. 114942-14, Preamble.
58 Supra note 55.
59 Please note that this strategy has been used by foreign-owned U.S. corporations, not by foreign corporations with a U.S. trade or business. This is because filing late Forms 1120-F has significantly more consequences than filing a late Form 1120. Specifically, filing late Forms 1120-F could deprive the foreign corporation of its ability to claim U.S. tax deductions and/or credits with respect to its U.S. operations. See Code Sec. 882(c)(2); Reg. §1.882-4; Swallows Holdings, Ltd., 126 TC 96, Dec. 56,417 (2006). Swallows Holdings, Ltd., CA-3, 2008-1 unse 150,188, 515 F3d 162.
60 IRM §21.8.2.20.1 (Oct. 1, 2014).
62 Id., at 1-2.
63 Id., at 2.
64 Id., at 7-8.
66 Id., at 1.
67 Id., at 1.
68 Id., at 2.
69 Id., at 5.
70 Id., at 7-8.
71 IRM §201.3.6.1(7) (Aug. 5, 2014).
72 Id.
73 Id.
74 IRM §201.3.6.1(8) and (9) (Aug. 5, 2014).
75 IRM §21.8.2.20.2 (Oct. 1, 2014).
76 IRM §21.8.2.20.2(2) (Oct. 1, 2014). The Internal Revenue Manual clarifies that this is not a sure thing for taxpayers: “First-Time Abate determination for the related Form 1120 doesn’t result in an automatic abatement of the Form 5472 penalty ... The taxpayer must also have no prior Form 5472 penalty.”
77 IRM §21.8.2.20.3(3) and (4) (Oct. 1, 2014).
78 Code Sec. 6662(a).
79 Code Sec. 6664(c).
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).
81 IRM §20.11.3.1.2 (Aug. 20, 1998).
82 Reg. §1.6664-4(b)(1).
83 IRM §20.11.3.1.2.1 (Aug. 20, 1998).
84 Id.
85 Id. §1.6664-4(c)(1).
86 Id. §1.6664-4(c)(2).
87 IRM Exhibit 21.8.2-2—Failure to File or Late-Filed Form 5472—Decision Tree.
89 Form 1120 (2014), Schedule K Other Information.
90 Instructions for Form 1120 (2014), at 20.
91 Form 1120-F (2014), at 1.
92 Instructions for Form 1120-F (2014), at 5.
98 Medieval Attractions N.V., 72 TCM 924, Dec. 51,592(M), TC Memo. 1996-455, at *60.
99 Research also identified one court case that focused on Form 5472 penalties, Seating Concepts, Inc., DC-CA, Case No. 02CV-0774, 002 WL 32692233 (2002). This case was settled before trial, with the taxpayer and the U.S. Department of Justice each conceding 50 percent of the issue/penalty.
100 McBride, 110 AFT T2d, 6600, U.S. District Court for the District of Utah Central Division, Case No. 2:09-cv-378 (Nov. 18, 2012).
101 Medieval Attractions N.V., 72 TCM 924, Dec. 51,592(M), TC Memo. 1996-455, at *60.
102 Reg. §1.6664-4(c)(1).
103 Id. at 38–39 (internal citations omitted).
104 Medieval Attractions N.V., 72 TCM 924, Dec. 51,592(M), TC Memo. 1996-455, at *60.
105 Reg. §1.6664-4(c)(2).
106 Id. §1.6664-4(c)(2).
107 Id. at 38–39 (internal citations omitted).
109 Id. at 38–39 (internal citations omitted).
110 Medieval Attractions N.V., 72 TCM 924, Dec. 51,592(M), TC Memo. 1996-455, at *60.
111 Medieval Attractions N.V., 72 TCM 924, Dec. 51,592(M), TC Memo. 1996-455, at *60.