Recent Tax Court Case Reveals Rare Use of Form 5471 Penalty Defenses

*By Hale E. Sheppard**

I. Introduction

They say that a little knowledge is a dangerous thing. This is true in many contexts, including international tax. U.S. persons living, investing or conducting business abroad often form corporations in the local country for legitimate reasons. The problem is not establishing the foreign entities, but rather maintaining full compliance with the U.S. Internal Revenue Service ("IRS") in terms of taxes and information reporting. Varying levels of ignorance about foreign corporation matters, by both taxpayers and their advisors, frequently trigger taxes, penalties, expanded audits, and other unpleasantries. Many derive from a failure to file proper Forms 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*).

This article explains circumstances in which taxpayers must file Forms 5471, stringent standards that the IRS and courts apply when considering potential abatement of penalties, obscure manners in which Form 5471 violations extend assessment periods to the detriment of taxpayers, places where taxpayers can and cannot dispute Form 5471 penalties, and a new Tax Court case, *M.R. Kelly*, which features several of the key issues.[1]

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II. Overview of International Duties

To appreciate this article, one must have a basic understanding of the obligations commonly triggered when U.S. individuals hold foreign assets. Here are just a few. They must disclose on Schedule B (Interest and Ordinary Dividends) to Form 1040 (*U.S. Individual Income Tax Return*) the existence and location of foreign accounts, as well as certain actions related to foreign trusts. Moreover, they must declare on Form 1040 all income obtained from all sources around the globe. They also must report foreign assets on Form 8938 (*Statement of Specified Foreign Financial Assets*). In addition, they must electronically file a FinCEN Form 114 (*Report of Foreign Bank and Financial Accounts*) to provide details about foreign financial accounts. Finally, if they hold interests in, or have certain other links to, foreign corporations, they must file Forms 5471.[2]

Taxpayers file Forms 5471 as an attachment to their federal income tax returns.[3] If taxpayers file late, inaccurate, or substantially incomplete Forms 5471, then the IRS may assert a penalty of $10,000.[4] This penalty increases on a monthly basis, to a maximum of $50,000, if the problem persists after notification by the IRS.[5] The IRS will not impose penalties, however, if there was "reasonable cause" for the violation.[6]

III. Stringent Penalty Standards

Too many taxpayers and their advisors are unaware of the unique and stringent standards applied in the context of Form 5741 penalties. This segment of the article examines just a few of the authorities demonstrating the hyper-critical lens through which the IRS and courts often view matters.

A. International Practice Unit

The IRS trains its personnel in various ways, one of which is issuing them so-called International Practice Units ("IPUs"). They do not constitute legal precedent, but many IRS auditors, called Revenue Agents, give IPUs considerable weight in conducting audits, determining whether penalties apply, *etc*.[7] The IRS released an IPU in late 2015 focused on penalties for Form 5471 violations by certain categories of U.S. persons.[8] It contains a significant amount of data about the circumstances under which the IRS will consider a Form 5471 to be "substantially incomplete" and thus subject to penalties. The IPU divides defective Forms 5471 into two main categories, facially income returns and less obvious non-compliance.

1. Facially Incomplete Returns

The IPU contains a list of items that represent incompleteness on the face of Form 5471. These include the following: (i) failure to identify on Page 1 the category (or categories) into which the taxpayer falls, without which the IRS cannot determine which Schedules to Forms 5471 the taxpayer must complete; (ii) inclusion of partial data about the identity and location of the foreign corporation, which the IRS needs in order to expand an audit to cover related entities and individuals; (iii) failure to complete required Schedules; (iv) stating that certain information required by Form 5471 will be provided by the taxpayer only upon express request from the IRS; (v) use of computer-generated Forms 5471 that have not been approved by the IRS; and (vi) failure to provide proper financial statements for the foreign corporations.[9] According to the IPU, these constitute "conspicuous" errors that front-line workers at IRS Service Centers should immediately detect, and then either mark the related tax return for audit or send a notice to the taxpayer threatening penalties and/or demanding corrections.[10]

2. More Subtle Problems

In a section called "beyond their face," the IPU cites various IRS pronouncements and cases that shape the IRS's position regarding Forms 5471 and the "substantially complete" defense. These items, on which many Revenue Agents likely will base their actions, are examined below.

a. Chief Counsel Advice 200645023. The taxpayer was the parent of a group that conducted global operations through numerous foreign subsidiaries. It filed timely Forms 5471, but they did not include all required Schedules, they failed to report certain items in U.S. dollars, and U.S. generally accepted accounting principles ("GAAP") were not always used. The IRS penalized the taxpayer.

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

With respect to the "substantially complete" issue, the IRS stated that certain Schedules must be in GAAP, other Schedules must be in U.S. dollars, and functional currencies are "significant pieces of required information" for purposes of Form 5471. The IRS then acknowledged that high administrative costs might be a defense, but only if the task at hand would cause "undue hardship" for the taxpayer.[11] The term "undue hardship" means more than a mere inconvenience; the taxpayer must show that it would suffer a substantial financial loss if it were required to complete the relevant tax duty.[12] As one might expect, from the IRS's perspective, a taxpayer rarely confronts a financial hardship significant enough to warrant penalty abatement.[13]

The IRS then characterized a seemingly positive fact for the taxpayer as a negative. Specifically, the taxpayer contended that its filing of complete, timely Forms 5471 in past years should mitigate penalties for deficient Forms 5471 in the present. The IRS rolled out its standard you-should-have-known-better position, as follows:

> [T]he fact that [the taxpayer] has a strong compliance history in filing Forms 5471 for its non-U.S. affiliates indicates that the failure to file complete Forms 5471

in this case was not inadvertent because [the taxpayer] was familiar with the proper manner in which to complete Forms 5471 for its non-U.S. affiliates.

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

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

> A taxpayer that under-reports, or over-reports, a particular transaction in a substantial amount frustrates the [IRS's] efforts to audit that taxpayer. A taxpayer's error may also compel the [IRS] to conduct a more intensive investigation than would have been necessary had the taxpayer correctly reported the transaction on the Form 5472. *Accordingly, it is the error itself, as opposed to whether the error involves an under-reporting or over-reporting, which undermines the ability of the [IRS] to rely upon a taxpayer's reporting of related party transactions*.

The IRS also explained that it applies a seven-factor test in determining whether a particular error or omission makes an international information return "substantially incomplete." These factors consist of the following: (i) the magnitude of the overstated or understated amounts compared to the actual amounts that should have been reported; (ii) whether the taxpayer had other reportable transactions with the same party and correctly reported such transactions; (iii) the size of the erroneously reported transaction in relation to all other reportable transactions that were correctly reported; (iv) the amount of the unreported transactions in relation to the taxpayer's volume of business and overall financial situation; (v) the significance of the unreported transactions to the taxpayer's business in a broad, functional sense; (vi) whether the unreported transactions occurred in the context of a significant, ongoing transactional relationship with a related party; and (vii) whether the unreported transactions affect the taxpayer's taxable income in the relevant year.

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

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

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iv. Fourth Situation—Small Net Change. The taxpayer over-reported one amount and then under-reported another amount on the same Form 5472. Specifically, the taxpayer disclosed purchases of inventory of $1,000 instead of $500 and then showed commissions paid of $1,200 instead of $1,600. The net effect was an error of $100. The IRS determined that each of these errors separately, and the two errors together caused the Form 5472 to be "substantially incomplete."

c. 2002 IRS NSAR 20167, 2002 WL 32167873. The taxpayer in this case filed timely tax returns and enclosed Forms 5471; however, they were missing several Schedules. Nearly every page of the Forms 5471 stated

that the taxpayer would be willing to furnish additional information upon request. The IRS penalized the taxpayer for filing "substantially incomplete" Forms 5471.

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

d. 1997 WL 33381431 Field Service Advisory. The taxpayer was a large multinational manufacturer that filed timely Forms 5471. The IRS discovered as part of an audit that some of the Forms 5471 contained incomplete or inaccurate information with respect to certain items, such as sales with related companies and intercompany loans. The IRS penalized the taxpayer, and the taxpayer disagreed. The taxpayer defended itself on various theories, the principal one being that it filed timely and substantially complete Forms 5471.

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

B. Automatic Penalty Assessment

A critical but little known aspect of Form 5471 is that the IRS has been *automatically* imposing penalties for several years. Since 2009, if a U.S. tax return is filed after the deadline and Forms 5471 are attached, then the IRS automatically assesses a $10,000 penalty and starts the collection process. This is true regardless of whether the taxpayer includes an eloquent, thorough, and persuasive statement of "reasonable cause" with the late Form 5471.[14] Lest any doubt remain about the IRS's rigidity on this point, the IPU described above states the following: "For Form 1120s filed late after December 31, 2008, the [IRS] automatically assesses an initial penalty of $10,000 for each Form 5471 attached. *It is assessed even when a request for reasonable cause is submitted with the Form 1120*."[15]

C. First-Time Abate Policy Does Not Apply

The good news is that the IRS has a general first-time-penalty-abatement policy, and taxpayers facing large Form 5471 penalties often cite this policy in seeking relief.[16] This policy states that the IRS will grant abatement, with respect to virtually all delinquency penalties in situations where a taxpayer has not been required to file a certain return before, or the taxpayer has no prior penalties.[17] If the taxpayer meets these criteria, then the IRS generally issues a letter to the taxpayer confirming it is granting abatement solely because of the first-time-penalty-abatement policy, not because the taxpayer demonstrated that it had reasonable cause for the violation.[18]

The first-time-penalty-abatement policy is bittersweet, though, because it does *not* apply to (i) "returns with an event-based filing requirement" and (ii) "information reporting that is dependent on another filing, such as various forms that are attached [to an income tax return]."[19] The IRS often denies requests for abatement of Form 5471 penalties based on these exclusions from the first-time-penalty-abatement policy.

D. The "Decision Tree" Bears Little Positive Fruit

If taxpayers do not know the rules of the game, it is unlikely that they will triumph. This holds true in the area of penalty disputes with the IRS. For many years, the IRS did not resolve Form 5471 penalties by applying normal standards, but rather by utilizing an obscure guide. The so-called "Decision Tree," found in the depths of the Internal Revenue Manual, featured standards that are much more stringent than those located elsewhere.[20] The following insight from the "Decision Tree" shows that attaining abatement of Form 5471 penalties can be exceptionally challenging:

- If the taxpayer claims that it was unaware of the Form 5471 filing requirement, the "Decision Tree" instructs the IRS to deny abatement because "ordinary business care and prudence requires taxpayers to determine their tax obligations when establishing a business in a foreign country."
- The "Decision Tree" mandates that penalty abatement be denied where the taxpayer seeks clemency because of financial problems.
- The "Decision Tree" further indicates that the IRS will show no mercy in situations where a taxpayer states that Form 5471 was late because the transactions, tax laws, or business structure was complicated.
- If the taxpayer claims that multiple layers of ownership prevent the taxpayer from obtaining all the data necessary to file a timely Form 5471, the "Decision Tree" instructs the IRS not to abate penalties.
- Rejection of the penalty-abatement request will also occur, according to the "Decision Tree," when the taxpayer cites challenges in obtaining the necessary foreign data as the excuse for late Forms 5471.
- The "Decision Tree" demands imposition of penalties if the reason for late Forms 5471 is that the person with sole authority to file Forms 5471 was absent for a reason other than death or serious illness. Moreover, even if the taxpayer demonstrates death or serious illness of the sole responsible person, the IRS will only accept this justification if (i) the taxpayer can provide tangible proof, such as insurance claims, police reports, hospital bills, or newspaper clippings confirming the illness or death, (ii) the absence was not foreseeable, (iii) the absence occurred before and in close proximity to the filing deadline, and (iv) the taxpayer filed the Forms 5471 within two weeks of when the absence ended.
- The IRS will not waive penalties under the "Decision Tree" if the taxpayer personally neglected to submit a filing-extension request for the tax return to which the Form 5471 was attached.
- Likewise, the "Decision Tree" denies abatement where the taxpayer hired a third party (such as an accounting firm) to prepare returns and believed, erroneously, that such party submitted a filing-extension request on behalf of the taxpayer.
- The IRS will also reject abatement requests under the "Decision Tree" if the taxpayer relies on the ignorance-of-the-law defense and the taxpayer was either a U.S. resident or lived outside the United States but failed to hire and get advice from a U.S. tax professional.
- For purposes of seeking penalty abatement, the "Decision Tree" clarifies that reliance on an accountant or attorney might be appropriate in certain situations, but reliance by a taxpayer on the following types of people is not reasonable: Bookkeeper, financial advisor, business associate, information in a tax plan or promotion, and person assisting in establishing the corporation.
- Finally, the "Decision Tree" indicates that the IRS 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, the tax professional specifically advised the taxpayer that it was not required to file Form 5471, the taxpayer has tangible evidence to prove the preceding facts, and, in the opinion of the IRS, the taxpayer's reliance was reasonable. The "Decision Tree" goes on to state that the taxpayer's reliance will be considered unreasonable (and thus Form 5471 penalties will not be abated) if the taxpayer did not take reasonable steps to independently investigate or get a second opinion. This aspect of the "Decision Tree" is remarkable because it is contrary to the legal precedent established by the U.S. Supreme Court years ago on this exact point, in *Boyle*.[21]

IV. More Audit Time Is Money

The normal Form 5471 penalty of $10,000 per year, per violation can hurt a taxpayer. Perhaps the most significant consequence has nothing to do with money, though. It concerns time, specifically the period that the IRS has to audit the relevant issues.

The general rule is that the IRS has three years from the time a taxpayer files a tax return to identify it as problematic, conduct an audit, offer all required administrative procedures, and issue a final notice proposing adjustments, such as tax increases, penalties, and interest charges.[22] There are various exceptions to the normal three-year rule. One exception, found in Code Sec. 6501(c)(8), applies to situations where a taxpayer fails to file information returns regarding foreign entities, transfers, or assets.[23] This tax provision states the following:

> In the case of any information which is required to be reported [to the IRS pursuant to various

> international tax provisions], the time for assessment of any tax imposed by this title *with respect to any tax return, event, or period to which such information relates* shall not expire before the date which is 3 years after the date on which the [IRS] is furnished the information required to be reported ….[24]

Congress and the IRS adopted a broad interpretation of "related" tax returns, events, and periods from the outset. For instance, the legislative history indicates that amounts asserted by the IRS during the extended assessment period facilitated by Code Sec. 6501(c)(8) are *not* limited related to the items that should have been reported on an international information return, like Form 5471.[25]

Given the importance of this issue, the IRS issued a memorandum to its staff clarifying the scope of Code Sec. 6501(c)(8). It contained the following example:

> The taxpayer filed the [Form 1120 for 2005] on March 15, 2006. During the taxable year 2005, the taxpayer acquired more than 10% of the outstanding stock of a foreign corporation, but failed to file a Form 5471 … as required to be filed to report the stock acquisition as prescribed by IRC §6046. Normally, the period of time for assessment would have expired on March 15, 2009 [*i.e.*, three years after the time that the Form 1120 for 2005 was filed]. Since the taxpayer failed to report the information required to be reported by IRC §6046, the period of time for assessment would not expire on March 15, 2009, but [rather] would expire three years after the required information is actually reported by the taxpayer. *The clarifying amendment to IRC §6501(c)(8) makes it clear that the open assessment statute applies to the entire return and not only to the tax deficiency attributable to the information which was not reported, unless the failure to provide the required information is due to reasonable cause and not willful neglect*. If it is determined that reasonable cause for failing to report the information exists, the period of time for assessment is only open for the deficiency attributable to the information not reported under IRC §6046, in this example.[26]

The IPU regarding Form 5471 penalties examined earlier in this article sheds additional light on this issue. It provides IRS personnel with specific instructions in situations where Form 5471 violations are present: "As you identify Forms 5471 that were required, but not filed, for the exam year(s), consider reviewing whether those forms were required, but not filed, in earlier tax years."[27] Moreover, the IPU underscores that Code Sec. 6501(c)(8) holds the assessment period open indefinitely, not only when a taxpayer fails to file a Form 5471, but also in instances where a taxpayer filed a timely but "substantially incomplete" one. The IPU emboldens IRS personnel to advance the argument that "[t]he statute of limitations for assessing and collecting penalties … expires three years after a substantially complete Form 5471 is filed."[28]

V. Places Where Taxpayers Can and Cannot Fight

Form 5471 sanctions are "assessable" penalties. This means that, unlike penalties related to tax liabilities, taxpayers effectively get no opportunity to challenge Form 5471 penalties *before* they are "assessed." In other words, these penalties are not addressed in an income tax Examination Report, and the IRS will not include them in a Notice of Deficiency, such that taxpayers cannot quarrel over Forms 5471 penalties with the Tax Court at the same time they challenge tax increases.[29]

A. Where Fighting Is Acceptable

Given their unique character, taxpayers often find themselves challenging Form 5471 penalties in one or more of the following manners. First, upon receipt of the initial penalty notice, many taxpayers file a penalty-abatement request. Second, if the IRS rejects this penalty-abatement request, which is frequently the case, then taxpayers administratively appeal by filing a Protest Letter. Third, while awaiting an audience with the Appeals Office in response to the Protest Letter, the IRS often continues to take collection actions to recoup the Form 5471 penalties, including, but not limited to, filing a Notice of Federal Tax Lien and/or issuing a pre-levy notice. When either of these occurs, taxpayers can file a request for a collection due process ("CDP") hearing. Fourth, in situations where the Appeals Office disagrees with the taxpayer's position during the CDP hearing, he will issue a Notice of Determination concluding that the IRS's collection actions were justified. In response to the Notice of Determination, taxpayers can file a Petition with the Tax Court, arguing that the Appeals Office abused its discretion. Fifth, certain taxpayers choose to avoid the preceding procedures, opting instead to pay the Form 5471 penalties under duress, file an administrative claim

for refund, and, if the IRS fails to respond to the claim within six months or issues a Notice of Disallowance, then taxpayers can initiate a refund lawsuit in federal court.

B. Where Fighting Is Unacceptable

As explained immediately above, at least five possible venues for challenging Form 5471 penalties exist. Some taxpayers continue their attempts to dispute them elsewhere, such as during a Tax Court trial over revocation of a passport.

In a recent case, *Ruesch*, the IRS assessed penalties of $160,000 against the taxpayer not filing Forms 5471.[30] The taxpayer did not pay such penalties voluntarily. Therefore, the IRS sent her a pre-levy notice, she filed a request for a CDP hearing, the IRS then filed a Notice of Federal Tax Lien, she responded with another timely request for a CDP hearing, the IRS somehow failed to grant the CDP hearings, and the IRS ultimately certified the taxpayer as having a seriously delinquent tax debt ("SDTD") under Code Sec. 7345. The taxpayer then filed a Petition with the Tax Court asking it to rule that she did not owe the Form 5471 penalties, the IRS erred in issuing her a certification in the first place, and the IRS further erred by not decertifying her later.

After Tax Court litigation had started, the IRS realized its mistake in not granting the taxpayer her CDP hearings, decertified her, and notified the State Department accordingly. The IRS then filed a Motion of Lack of Jurisdiction, arguing that the Tax Court is not empowered under Code Sec. 7345 to address the question of whether the underlying Form 5471 penalties were accurate.

The Tax Court explained that Code Sec. 7345(e) creates narrow jurisdiction in passport revocation cases: The only determination it can make is whether the SDTD certification was erroneous, and the only relief that it can provide is ordering the IRS to notify the State Department that a certification was erroneous. The Tax Court explained that "[t]here is nothing the text of Section 7345 that authorizes us to redetermine [a taxpayer's] underlying liability for the penalties the IRS has assessed."

The Tax Court then offered some *dicta* about the limited circumstances under which it could ever decide the appropriateness of "assessable" penalties related to international information returns, like Form 5471. The Tax Court explained that such matters fall outside of its deficiency jurisdiction, meaning that these would not be part of a Tax Court trial triggered by the IRS issuing a Notice of Deficiency to a taxpayer. The Tax Court then indicated that this leaves two options for taxpayers. First, they can wait for the IRS to issue a Notice of Federal Tax Lien or pre-levy notice, file a request for a CDP hearing, and, if the Appeals Office issues an unfavorable Notice of Determination, they can file a Petition with the Tax Court. Second, they can pay the penalties, file an administrative Claim for Refund, and if the IRS either disallows it or ignores it for more than six months, then they can file a Suit for Refund in the proper District Court.

VI. Recent Case Highlighting Form 5471 Issues

A recent Tax Court case, *Kelly*, shows an atypical role of Form 5471 penalty issues.

The facts in this case are extensive, dense, and largely irrelevant to the main issue in this article. Here is all that readers need to know. The taxpayer ran many businesses, which often shifted funds back and forth, depending on availability. The taxpayer generally characterized these amounts as loans to affiliated entities, adhering to the bookkeeping and accounting practices implemented by various outside accountants and internal officers. As his operations grew and diversified, the taxpayer formed a considerable number of domestic single-member limited liability companies, treated as disregarded entities for tax purposes. Thus, instead of filing separate tax returns for such domestic entities, each was reported on a separate Schedule C (Profit or Loss from Business) attached to the taxpayer's annual Form 1040.

In 2008, the taxpayer formed a corporation in the Cayman Islands ("Cayman Corporation") for purposes of buying a commercial yacht from a distressed seller at a discounted price. The taxpayer was the sole owner of the Cayman Corporation. The business plan consisted of renovating the yacht and then selling it at a profit or chartering it to generate an income stream. It appears that this was the only foreign entity owned by the taxpayer.

The taxpayer had a longstanding professional relationship with an outside, independent accounting firm, working with it since 2000 ("Accounting Firm"). The Controller for various companies owned by the taxpayer timely sent to the Accounting Firm all tax-related data, including that about the Cayman Corporation. In doing so, the Controller sent an email to the Accounting Firm expressly stating that the Cayman Corporation was a

foreign entity, the taxpayer was the sole owner, he was unsure about which U.S. filing requirements applied and how items flowed to the taxpayer's Form 1040, and the Cayman Corporation would need to be addressed starting in 2008. Despite this email, the Accounting Firm treated the Cayman Corporation as a domestic disregarded entity, reporting it on a Schedule C, and did not file a Form 5471 disclosing the Cayman Corporation to the IRS.

The IRS started an audit of the taxpayer's Form 1040 for 2010, identified potential problems in multiple years, issued a Notice of Deficiency in 2016 proposing adjustments all the way back to 2007, and raised various theories for ignoring the normal three-year assessment period. Among them was that the unfiled Forms 5471 in earlier years related to the Cayman Corporation allowed the IRS to reach back nearly a decade.

The Tax Court, fortunately, was not receptive to the IRS's arguments on this issue. It acknowledged that the taxpayer did not file timely Forms 5471 for 2008 and 2009, but warned that the IRS could only make adjustments related to the Cayman Corporation (and not related to anything else on the Forms 1040) if there was "reasonable cause" for the taxpayer's non-compliance. The Tax Court then turned to the standards, explaining that neither Code Sec. 6501(c)(8) nor the corresponding regulations define the concept of "reasonable cause." However, it pointed out, both the Supreme Court and Tax Court have previously accepted reasonable reliance on tax professionals as "reasonable cause" under certain circumstances.[31]

The Tax Court emphasized the following facts: the Accounting Firm had been preparing the taxpayer's Forms 1040 since 2000, including Schedules C for his many companies; the relevant accountants at the Accounting Firm have no prior adverse disciplinary actions or IRS penalties; the accountants have decades of experience preparing Forms 1040; the taxpayer timely notified the Accounting Firm about the Cayman Corporation, its foreign status, and its ownership; the Accounting Firm did not have a conflict of interest; and the situation did not involve some tax or financial result that was "too good to be true."

The IRS urged the Tax Court to believe that the taxpayer's actions were not enough. Specifically, the IRS argued that not only did the taxpayer need to inform the Accounting Firm about the existence, location, and ownership of the Cayman Corporation, but he also needed to expressly tell the Accounting Firm that it had to file a Form 5471.

The Tax Court held in favor of the taxpayer, ruling that he had "reasonable cause" for not filing timely Forms 5471 for 2008 and 2009, and the IRS could only make proposed adjustments about the Cayman Corporation for such years. In reaching this decision, the Tax Court referenced the list of facts described in the preceding paragraphs. It did some less obvious, but more important things, too. Namely, it explained that the Accounting Firm's complete lack of prior experience with Forms 5471 before 2008 was not detrimental to the taxpayer's reasonable reliance position. It also clarified, citing to Supreme Court precedent, that taxpayers do not need to question advice they receive from tax professionals, do not need to obtain second opinions, and do not need to monitor the advice received from the professionals. Moreover, the Tax Court recognized that the taxpayer could have done more to ascertain his filing duties related to the Cayman Corporation, but it was reasonable for him to rely on the Accounting Firm to do so for him. Lastly, with respect to timing, the Tax Court alluded to unclean hands, or perhaps hypocrisy, in noting that the IRS itself failed to advise the taxpayer of his Form 5471 problems until 2019, which was nearly a decade after the audit started and three years after the Tax Court litigation began.

VII. Conclusion

This article demonstrates that assisting taxpayers with foreign corporation issues involves a lot more than simply raising the need to file Forms 5471; that is just a small part of it. To be effective, tax advisors must possess a deep understanding of the complex rules associated with Form 5471 filings, the harsh standards that the IRS and courts utilize in considering penalty abatement, how submitting late, inaccurate or substantially incomplete Forms 5471 allows the IRS to expand audit periods, the places in which taxpayers can and cannot dispute penalties, and how Form 5471 disputes can indirectly affect income tax litigation before the Tax Court. Tax audits will increase in the near future, with Congress significantly enlarging the IRS's budget, the IRS hiring thousands of new personnel, and the IRS Commissioner leading a strong enforcement charge. The "compliance campaigns" announced by the IRS confirm that many of these audits will focus on international tax matters, including foreign corporations. Under these circumstances, taxpayers would be wise to hire advisors steeped in *all aspects* of Form 5471.

ENDNOTES

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[1] *M.R. Kelly*, 121 TCM 1561, Dec. 61,888(M), TC Memo. 2021-76.

[2] Code Sec. 6038; Reg. §1.6038-2; Code Sec. 6046; Reg. §1.6046-1; Code Sec. 6679; Reg. §301.6679-1; Instructions to Form 5471. Four categories of U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations must file annual Forms 5471 with the IRS. A Category 2 filer is a U.S. individual who is either an officer or director of a foreign corporation in which a U.S. person has acquired during the relevant year (i) stock in the foreign corporation that meets the "10-percent ownership test," or (ii) an additional 10 percent or more of the stock of the foreign corporation. For these purposes, the "10-percent ownership test" is met if the U.S. person owns 10 percent or more of the foreign corporation, by vote or value. A Category 3 filer encompasses several types, including any U.S. person who acquires stock in a foreign corporation, and when such stock is added to any stock that the U.S. person already owns, he meets the "10-percent ownership test" described above. A Category 4 filer is a U.S. person who had "control" of a controlled foreign corporation ("CFC") for an uninterrupted period of 30 days during the relevant year, which means that such U.S. person held more than 50 percent of the stock of a CFC, by vote or value. For these purposes, a "CFC" is a foreign corporation that has "U.S. shareholders" who/that own (directly, indirectly, or constructively) more than 50 percent of the total voting power or stock value of the foreign corporation on any day of the relevant year. A Category 5 filer is a "U.S. shareholder" who/that owns stock in a foreign corporation that is a CFC for at least 30 uninterrupted days during the relevant year and who/that held the stock on the last day of the relevant year. In this context, the term "U.S. shareholder" means any U.S. person who/that owns (directly, indirectly, or constructively) 10 percent or more of the foreign corporation, by vote or value.

[3] Code Sec. 6038(a)(2); Reg. §1.6038-2(i).

[4] Code Sec. 6038(b)(1); Reg. §1.6038-2(k)(1)(i); Code Sec. 6046(f); Reg. §1.6046-1(k).

[5] Code Sec. 6038(b)(2); Reg. §1.6038-2(k)(1)(ii); Code Sec. 6046(f); Reg. §1.6046-1(k).

[6] Reg. §1.6038-2(k)(3)(i).

[7] Jasper L. Cummings, Jr., *LB&I International Practice Units*, Tax Notes 1077 (Nov. 23, 2015); Kristen A. Parillo and Jaime Arora, *IRS Plans to Release International Training Materials*, Tax Notes 1317 (Mar. 24, 2014).

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

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

[10] *See* IRS News Release, IR-90-58, Mar. 29, 1990.

[11] Reg. §301.6651-1(c)(1); Reg. §1.6161-1(b).

[12] Reg. §301.6651-1(c)(1); Reg. §1.6161-1(b).

[13] For guidance about the meaning of "undue hardship" in the tax context, *see e.g.*, *C.E. Wolfe*, DC-MT, 85-2 USTC ¶9476, 612 FSupp 605; *Rogers*, DC-MI, 66 AFTR2d 90-5831; *In re Upton Printing Company*, DC-LA, 186 BR 904, 76 AFTR2d (1995); *In re Sykes & Sons, Inc.*, DC-PA, 188 BR 507, 76 AFTR2d 95-7419; *In re Frederick Savage, Inc.*, DC-FL, 179 BR 342, 75 AFTR2d 95-1967 (1995); *Bostar Foods, Inc.*, DC-KY, 79 AFTR2d 97-1041 (1997); *Van Camp & Bennion*, CA-9, 2001-1 USTC ¶50,446, 251 F3d 862; *Fran Corp.*, CA-2, 99-1 USTC ¶50,208, 164 F3d 814; *Diamond Plating Company*, CA-7, 2005-1 USTC ¶50,107, 390 F3d 1035; *Harvey & Sons, Co.*, DC-MA, 94 AFTR2d 2004-7258; *Burt, Inc.*, DC-IN, 99 AFTR2d 2007-1856 (2007).

[14] IRM §21.8.2.20.1 (Oct. 1, 2014).

[15] *Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty*, International Practice Unit (updated as of Oct. 7, 2015); *see also* U.S. Treasury Inspector General for Tax Administration, *Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement*, Report 2013-30-111 (Sept. 25, 2013).

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

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

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

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

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

[21] *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 251, 105 SCt 687 (1985).

[22] Code Sec. 6501(a).

[23] Code Sec. 6501(c)(8).

[24] P.L. 111-147 (Mar. 18, 2010), Title V, Subtitle A, Parts I through V, Code Sec. 511(b) (emphasis added).

[25] U.S. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment to the House Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010*, JCX-46-10, August 10, 2010, at 36 (emphasis added); *see also* U.S. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act,"* JCX-4-10, February 23, 2010, at 66 (emphasis added).

[26] IRSIG SBSE-25-0312-022 (Mar. 9, 2012) (emphasis added).

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

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

[29] The IRS's internal guidance confirms this, stating that "[d]eficiency procedures under Subchapter B of Chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) do *not* apply to penalties discussed in this section." IRM §20.1.9.2 (Apr. 22, 2011); IRM Exhibit 20.1.9-4; for details about collection freezes and the right to post-assessment, pre-payment review, *see* IRM §21.8.2.20.2 (Oct. 01, 2013).

[30] *Ruesch*, 154 TC 289 (2020).

[31] *Kelly*, 121 TCM 1561, Dec. 61,888(M), TC Memo. 2021-76, at 48–49 (referencing *Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 246, 105 SCt 687), *E.S. Flume*, 113 TCM 1097, Dec. 60,822(M), TC Memo. 2017-21, and *Neonatology Associates, P.A.*, 115 TC 43 (2000), *aff'd*, CA-3, 2002-2 USTC ¶50,550, 299 F3d 221.