

## US Tax Newsletter | July 2016

*This thought leadership paper is regarding: Form 5471, information return of U.S. persons with respect to certain foreign corporations.*



Shishir Lagu  
Partner, Taxation

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Form 5471, which is the information return of U.S. persons in the context of specific foreign corporations, is one of the most complex federal forms that is designed to report the activities of the foreign corporation. This also serves as a road-map for the IRS on transfer pricing. U.S. citizens and U.S. residents who are officers, directors, or shareholders in certain foreign corporations are responsible for filing Form 5471.

### **Information required on Form 5471:**

Form 5471 is substantially complex and requires information in relation to the following.

- Ownership;
- Stock transactions (*Schedules A, B, M, and O*);
- Shareholder and company transactions (*Schedule M*). It includes inter-company sales or purchases, compensation, rents, license fees, royalties, dividends, loans and interest;
- Foreign tax details (*type of tax, amount, and tax base*). If the foreign company has paid any taxes to authorities in a foreign jurisdiction, it is necessary to know if the taxes are based on income or on gross sales and to identify the taxes paid and the income subject to the foreign tax in each such jurisdiction;
- Earnings and profits information. Schedule J reconciles the accumulated earnings and profits from the beginning of the year to the end of the year and isolates earnings and profits for different categories of income; and
- Currency conversion information. A corporation is required to present the income statement and statement of taxes paid in the local (*functional*) currency and in U.S. dollars. Balance sheet data is shown only in U.S. dollars. Special rules apply when a foreign corporation is doing business in a country with hyper-inflation.

### **Important concepts unique to Form 5471 preparation:**

There are certain concepts that tax payers encounter while preparing Form 5471, which they would have rarely come across when preparing returns for domestic corporations. Some important concepts in this context are summarized below.

#### *Sub-part F income:*

The primary legislative purpose of the controlled foreign corporation ('CFC') tax rules is to prevent the avoidance of U.S. taxes on what is perceived to be easily portable income. Prior to 1962, U.S. corporations and investors could transfer assets to a foreign corporation that could then invest those funds on a tax-deferred basis. Alternatively, in the case of a U.S. business, profits could be easily diverted to a corporation in a low or zero tax country by over-pricing goods or services sold to a foreign

subsidiary or underpricing goods or services purchased from a foreign subsidiary. To prevent this type of tax deferral, the Congress passed the sub-part F tax rules, which essentially imposed a tax on certain U.S. shareholders of CFCs. Even though the U.S. shareholders receive no distribution from the foreign company, they are subject to tax on their share of the CFC's sub-part F income. This category of income includes passive investment income, related-party sales income, related-party services income, etc.

#### Tax credits:

As a consequence of the tax on the worldwide income of its citizens (*permanent residents and legal entities*), the tax law provides for a credit against U.S. taxes for income taxes paid to relevant authorities in foreign jurisdictions on the same income.

#### Transfer pricing:

The regulations under Sec.482 provide a complex set of detailed guidelines for the application of Sec. 482 to a variety of related-party transactions. These transactions can include loans and advances, services, use of intangibles, cost-sharing agreements, and inter-company sales of tangible personal property. Form 5471 is an important tool for IRS to capture the related party transactions.

#### Earnings and profits ('E&P'):

E&P represents the corporation's economic income (*i.e. their 'economic ability' to pay dividends*) without impairing its capital. E&P (*current year E&P and accumulated E&P*) is the upper limit on the amount of dividend income a shareholder must recognize on corporate distributions and any additional distribution shall be first treated as return of capital and thereafter as capital gain. A foreign corporation is also required to compute its E&P, including electing methods of accounting for various items, under U.S. tax principles. Similar to U.S. domestic corporations, the CFC's E&P plays an important role since it determines for the U.S. shareholder the amount to be included as dividend income in their U.S. tax return.

#### **Exposure to penalties:**

Although Form 5471 is an information return and no tax is due with the form, the penalties involved can still be quite substantial. Sec. 6038(b)(1) provides for a US\$ 10,000 monetary penalty for each Form 5471 filed after the due date of the income tax return (*including extensions*). An additional penalty of US\$ 10,000 per Form 5471 per year may be assessed for every 30-day period (*or a fraction thereof*) commencing 90 days after the U.S. person was notified that a failure exists. The maximum amount of that penalty is US\$ 50,000 per Form 5471 per year. This penalty also applies if the return does not include the complete and accurate required information. In addition to the monetary penalty, Sec. 6038(c) imposes a 10% reduction of the foreign taxes available for credit under Secs. 901, 902, and 960 for a late Form 5471. A tax need not be due for the penalty under Sec. 6038(c) to apply. **It is important to note that the statute of limitation remains open on the taxpayer's entire tax return if Form 5471 is not filed, and does not expire until three years after the date on which the information required to be reported is filed and properly reported [Sec. 6501(c)(8)].**

The IRS has stringent standards to determine when a Form 5471 is substantially complete and thus not subject to the US\$ 10,000 penalty under Sec. 6038(b). Since the definition of 'substantially complete' for Form 5471 reporting is not contained in the code or the regulations, the IRS has released guidance what may be considered not substantially complete. The guidance discusses two types of errors that may cause a Form 5471 to not be substantially complete: (1) errors apparent on the face of the form; and (2) errors beyond the face of the return.

### Errors apparent on the face of Form 5471:

If a Form 5471 contains the following errors on page one of the form, it does not comply with the reporting requirements in Sec. 6038.

- If the category of filer is left blank or is incorrect, then the schedules of Form 5471 required to be completed cannot be determined;
- Total percentage of the foreign corporation's voting stock owned at the end of the annual accounting period. When Item C is omitted or incorrect, there is again no way to determine which schedules of the form must be completed;
- When the name and address of the foreign corporation is omitted, other information on the form cannot be associated with a specific foreign corporation;
- The employer identification number ('EIN') and reference ID number being omitted. When these are missing, information provided on the form cannot be associated with a specific foreign corporation; and
- Any schedule required (*based on the filing category*) is not prepared, e.g., Schedule J, accumulated E&P of CFC, or Schedule M, transactions between controlled foreign corporation and shareholders or other related persons. If a Form 5471 does not contain a required schedule, Sec. 6038 is not '*substantially complied*' with.

### Errors beyond the face of Form 5471:

Chief counsel advice ('CCA') 200429007, provides a facts and circumstances analysis for 'substantially incomplete' in contrast to a strict interpretation of the regulations that any over-reported or under-reported transaction amount meant the form was '*substantially incomplete*'.

The seven factors stated in CCA 200429007 are:

- The magnitude of the under-reporting, or of the over-reporting, of the erroneously reported transaction in relation to the actual total amount of that reported type of transaction(s);
- Whether the reporting corporation has reportable transactions other than the erroneously reported transaction(s) with the same related party and correctly reported those other transactions;
- The magnitude of the erroneously reported transactions in relation to all of the other reportable transactions as correctly reported;
- The magnitude of the erroneously reported transactions in relation to the reporting corporation's volume of business and overall financial situation;
- The significance of the erroneously reported transactions to the reporting corporation's business in a broad functional sense;
- Whether the erroneously reported transactions occur in the context of a significant ongoing transactional relationship with the related party; and
- Whether the erroneously reported transactions are reflected in the determination and computation of the reporting corporation's taxable income.

### **Conclusion:**

Form 5471 is an extremely complex and onerous form and special care needs to be taken in preparation of this form. Taxpayers should pay close attention to how Form 5471 and the related schedules are completed, including reviewing Forms 5471 from prior years. Failure to properly complete the forms and schedules can have significant penalty and perhaps other income tax

ramifications for taxpayers in the years ahead, not the least of which is the statute of limitation not expiring until the forms are filed, all of which could be difficult to resolve.

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