Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: June 20, 2006

to: John T. Kelshaw
International Examiner
RFPH 1686
(Large & Mid-Size Business)

from: Bettie Ricca
Deputy Associate Chief Counsel, Litigation
(International)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

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ISSUES

Did B have reasonable cause for failing to file complete Forms 5471 for the non-U.S. subsidiaries of D?

CONCLUSIONS

B did not have reasonable cause for failing to file complete Forms 5471 for the non-U.S. subsidiaries of D.

FACTS

A is a Country M corporation with operations throughout the world. B is a U.S. corporation and the common parent of A's U.S. group and conducts, through numerous subsidiaries, A's U.S. operations. C is a Country M corporation that directly and indirectly conducts A's non-U.S. operations.

Pursuant to a joint tender offer agreement signed on Date 1, B and C acquired D, a Country N corporation with operations in various countries. D's U.S. businesses represented X% of its total fair market value and its non-U.S. businesses represented the remaining Y%. The acquisition was accomplished by the creation of a Country N subsidiary, E, that was owned and funded X% by B and Y% by C. E in turn formed a wholly owned tender offer subsidiary F, through which it carried out the tender offer.

The terms of the tender offer were as follows. E, through F, would acquire the stock of D using the X% of funds from B and the Y% of funds from C. As soon as practicable following the tender offer, D, E, F and various other subsidiaries would be liquidated and B would receive the U.S. operations of D and C would receive the non-U.S. operations of D. B would be responsible and indemnify C against any liabilities associated with D's U.S. operations and C would be responsible and indemnify B against any liabilities associated with D's non-U.S. operations.

All of the stock of D was acquired by F via the tender offer between Date 2 and Date 3 and the liquidations were carried out between Date 4 and Date 5, at which time, B was redeemed out of E in exchange for D's U.S. operations. Thus, B had ownership and control of the non-U.S. operations for approximately 4 months.

B was rendered tax advice by G, indicating that B should file Forms 5471 for each of the J non-U.S. subsidiaries of D because of the acquisition of D by E through F. Although B claims that B continued to believe that the Forms 5471 were not required

despite G's advice, B nonetheless decided to file the Forms 5471 for each of the non-U.S. subsidiaries of D. The Forms 5471 were filed by the due date including extensions. However, they were incomplete. B failed to attach Schedule O's to all but one Form 5471 (the Form 5471 for E) and also failed to prepare, translate and report the Forms 5471 in U.S dollars and in accordance with U.S. GAAP (except for H). Forms 5471 relating to inactive and/or dormant entities also were not properly prepared.

Although B believes it was not required to file the Forms 5471, the International Examiner has proposed to impose the penalty, under sections 6038 and 6679 of the Internal Revenue Code, for failure to file complete Forms 5471 at $10,000 per form for the initial failure to file complete Forms 5471 (see section 6038(b)(1) of the Code). B has remedied the deficiencies in the Forms 5471 and asked for a waiver of the penalty for reasonable cause.

LAW AND ANALYSIS

Section 6679(a)(1) of the Code provides, in part, that any person who fails to file a return (in this case a Form 5471, Schedule O) that is required to be filed under section 6046, or who files a return which does not show the information required pursuant to such section, shall pay a penalty of $10,000, unless it is shown that such failure is due to reasonable cause. Section 301.6679-1(a)(3) of the Treasury Regulations states, in part, that if the taxpayer exercises ordinary business care and prudence and is nevertheless unable to furnish any item of information required under section 6046 and the regulations thereunder, such failure shall be considered due to reasonable cause. Thus, B's failure to file Forms 5471 showing the required information is due to reasonable cause if B can show that it exercised ordinary business care and prudence.

Section 6038(b)(1) of the Code provides that if any person fails to furnish, within the time prescribed under section 6038(a)(2), any information with respect to any business entity required under section 6038(a)(1) (in this case a Form 5471), such person shall pay a penalty of $10,000 for each annual accounting period with respect to which such failure exists. Section 6038(c)(4)(B) provides, in part, that the time prescribed under section 6038(a)(2) to furnish information shall be treated as being not earlier than the last day on which (as shown to the satisfaction of the Secretary) reasonable cause existed for failure to furnish such information. Section 1.6038-2(k)(3)(ii) of the regulations includes an exception from the imposition of penalties for substantial compliance in cases where an incomplete return is filed, stating that "if the person who filed the return establishes to the satisfaction of the service center that the person has substantially complied with this section then the omission or error shall not constitute a failure under this section."

B relies on three arguments in explaining why it is entitled to relief under the reasonable cause exception in sections 6038(c)(4)(B) and 6679(a)(1) of the Code and sections 1.6038-2(k)(3) and 301.6679-1(a)(3) of the regulations: (1) B reasonably

believed that it was not required to file the Forms 5471, (2) B timely filed substantially complete Forms 5471, and (3) B had a strong compliance history.

I. Reasonable Belief and Reliance on Advice

B's first reason why the IRS cannot impose a failure to file penalty is because it reasonably believed that it was not required to file the Forms and that it was unclear whether B had an obligation to file the Forms 5471 in the first place. Although sections 1.6038-2(k)(3) and 301.6679(a)(3) of the regulations do not address a failure to file based upon the belief that a filing is not required, by analogy to the reasonable cause exception for accuracy related penalties contained in section 6664, the exercise of ordinary business care and prudence required B to take reasonable efforts in formulating its beliefs, and determining its filing obligations. See Treas. Reg. §1.6664-4(b)(1). Circumstances that may suggest reasonable cause include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication and education of the taxpayer. Id. The taxpayer's sophistication with respect to the tax laws, at the time the return was filed, is relevant in deciding whether the taxpayer acted with reasonable cause. See Kees v. Commissioner, T.C. Memo. 1999-41; Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 98-1 USTC ¶ 50,108 (2d Cir. 1997) (the Court was unconvinced by the claim of highly sophisticated, able, and successful investors that they acted reasonably in failing to inquire about their investment and simply relying on offering circulars and accountant, despite warnings in offering materials and explanations by accountant about limitations of accountant's investigation).

B's argument regarding a lack of clarity in the law only supports a finding of reasonable cause if B can show that it reasonably relied upon an erroneous but reasonable interpretation of the law. Here, B argues that it believed it was not required to file the Forms 5471 because, under a step transaction or substance over form analysis, B never owned the subsidiaries. However, B cites to no specific authority that would apply these doctrines to negate a filing requirement. Furthermore, B was rendered tax advice by G indicating that B should file the Forms 5471. B has therefore failed to demonstrate that it reasonably relied upon a belief that it was not required to file.

II. Substantial Compliance

B next argues that it timely filed substantially complete Forms 5471 based on the best information available to it at that time. B stated that the only substantive deficiency was that the financial statements were not stated in U.S. dollars and not converted to U.S. GAAP and that it would have been a monumental costly task for it to do so. B points to the timely filing of copies of the Forms 5471 with both the Philadelphia and Cincinnati Service Centers and the attachment to the forms of all of the financial statements that were required, with the exception of the Schedule O's on all but one Form 5471, to demonstrate that the Forms 5471 were substantially complete.

The Forms 5471 filed by B were not substantially complete, and B's statement that the conversions necessary to file substantially complete Forms 5471 would have been costly is not alone a sufficient reason to demonstrate reasonable cause for failure to file substantially complete Forms 5471. First, reporting of the Schedules C and F in accordance with U.S. GAAP and the reporting of the Schedules C and E amounts in functional and U.S. currencies are significant pieces of required information. Second, the statement that such conversions would have been a monumental costly task can constitute reasonable cause only if the exercise of ordinary business care and prudence would not have allowed B to make the conversions.

Although section 301.6679-1(a)(3) of the regulations does not address cost as a factor in finding reasonable cause for failure to file, section 301.6651-1(c) does address cost as a factor for reasonable cause for failure to pay a tax, stating that reasonable cause will be found for failure to timely pay tax if, after the exercise of ordinary business care and prudence, the taxpayer would suffer undue hardship (as described in section 1.6161-1(b)) if the tax was paid on the due date. Section 1.6161-1(a)(2)(ii), in turn, defines undue hardship by use of examples (liquidation of assets at a sacrifice price or in a depressed market in order to make payment) and by reference to what undue hardship is not (sale of property at fair market value where a market exists). In this case, B has provided no evidence that the costs involved in filing the Schedules C, E, and F would have caused B undue hardship of the sort described above. At the insistence of the IRS, B ultimately did file complete Forms 5471.

III. Compliance History

Finally, B argues that it should be entitled to relief because of its compliance history. IRM 20.1.1.3.1 provides that one factor to consider in determining if the taxpayer exercised ordinary business care and prudence is a taxpayer's compliance history. If a taxpayer makes an isolated error, it is indicative of the error being inadvertent, rather than intentional. B indicates that it has a strong compliance history and that it has timely filed complete Forms 5471 and 5472 with respect to its non-US affiliates. B admits that it once failed to file a Form 5472 with respect to one of its foreign affiliates and that this was an inadvertent oversight.

In this case, however, B filed a large number of incomplete Forms 5471 with the Service. The fact that the forms were filed, and that almost every form was incomplete, is not indicative of an isolated oversight but instead of an intentional decision to file incomplete Forms 5471. Furthermore, the fact that B 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 B was familiar with the proper manner in which to complete Forms 5471 for its non-U.S. affiliates.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3840 if you have any further questions.

By: _____
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