Mastering Form 5471 for Interests in Foreign Entities: Determining Ownership Share and Correct Filing Status

WEDNESDAY, FEBRUARY 12, 2014, 1:00-2:50 pm Eastern

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• Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides and the Official Record of Attendance for today’s program.

• Double-click on the PDF and a separate page will open.

• Print the slides by clicking on the printer icon.
Mastering Form 5471 for Interests in Foreign Entities: Determining Ownership Share and Correct Filing Status

Feb. 12, 2014

Bill Leary, Doereen Mayhew
leary@doeren.com
Form 5471

Generally

- Although Form 5471 is an information return, accurate completion is important. The basis for the Form is found in IRC §§ 6038 and 6046. The Form dates back to the early 80s, when it replaced several outdated information returns.

- Form 5471 is an important IRS tool for determining entities that need to be audited and establishing an audit work plan. Most recently, we have seen Form 5471 being used in connection with transfer pricing reviews.

- The Form is also useful in determining whether a foreign entity is generating subpart F income or has undergone a taxable restructuring or changes of ownership. The Form can also be used to alert the IRS of a possible IRC § 956 inclusion.

- The current version of the form was revised in December 2012. New instructions were issued on December 2013.

- The government estimates that recordkeeping burden for this form approaches 130 hours and preparation takes on average 27 hours.
Form 5471 Issues

- Is information presented consistently year-to-year?
- Are creditable foreign taxes and earnings and profits being calculated?
- Is currently taxable income, such as subpart F income and Sec. 956 investments in U.S. property, being included in U.S. shareholder’s income and are amounts being computed accurately?
- Does it appear that other income currently taxable to the foreign corporation’s shareholders is being overlooked?
- Do transactions between related parties raise transfer pricing issues?
- Have stock sales or reorganizations been accounted for properly?
- Does the tax return include all forms required to report on foreign operations? Consider the questions included in Schedule G (Other Information) & the related “reminders” included in the Instructions to the Form.
Penalties for failure to file Form 5471 can be steep. A minimum $10,000 penalty can be assessed for each form that is not filed. In addition, 10% or more of the filer’s FTC for the year can be eliminated.

A penalty of $10,000 can be automatically assessed for each Form 5471 that is filed after the due date of the income tax return, including extensions, and also for Forms that do not include complete and accurate information. In addition, the penalty can increase up to $50,000 per Form per year in the event of failure to comply after notice by the IRS.

Penalties for incomplete or inaccurate Form 5471s will be controlled by the examining agents reviewing these returns.

Generally, taxpayers can file penalty abatement requests based on reasonable cause.
Form 5471
Penalties

• Section 6501(c)(8) can apply when information is required to be reported under Sections 6038, 6038A, 6038B, 6046, 6046A or 6048 and is not made available. Failure to comply with these reporting rules can extend the statute of limitation related to information required to be disclosed under these reporting rules.
Form 5471
Points to Keep in Mind

• A separate Form 5471 must be filed for each foreign corporation for each tax year of the foreign corporation ending during the shareholder’s tax year.

• U.S. accounting methods apply, but Form 5471 is not a mechanism for accounting method elections.

• Filing on behalf of a U.S. consolidated group is permissible. Filing on behalf of others may be possible.

• U.S. translation rules apply. Specific rules apply to hyperinflationary currencies.

• E&P adjustments need to be considered. Virtually all foreign corporations require adjustments to reconcile U.S. GAAP books to U.S. E&P.
Form 5471
Points to Keep in Mind

• Attachments - Required schedules should be completed on the form itself. Penalties can apply for non-compliance. Certain attachments are mandated by the instructions, e.g., for partnership investments, when shares are acquired or disposed of and when a Section 338 election is made (Form 8883). Category 3 Filers must also attach a separate statement on certain debt and subscribed shares.

• U.S. individuals, partnerships, trusts, estates, and corporations can have filing obligations and some may apply to indirect owners as well.

• Special rules apply to captive insurance companies and dormant companies.
Form 5471
Filing Categories

- A Category 2 Filer is a U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired the requisite shares (10% vote or value) in one or more transactions.

- A Category 3 Filer is a U.S. person who acquires the requisite shares in the foreign corporation, a person who becomes a U.S. person while meeting the requisite ownership requirements, or a U.S. person that disposes of the requisite shares. For example, a U.S. shareholder that directly or indirectly disposes of sufficient shares in the foreign corporation to fall below a 10% threshold is a Category 3 Filer.

- A Category 4 Filer is a U.S. person (and certain nonresident aliens) who had “control” of a foreign corporation for an uninterrupted period of at least 30 days during the accounting period of the foreign corporation. (A Category 4 File can also be a Category 5 Filer.)
Form 5471
Filing Categories

- A Category 5 Filer is a “U.S. shareholder” that owns stock in a foreign corporation that is a CFC for 30 days or more during any tax year of the foreign corporation and that owned that stock on the last day of the year.
  - A “U.S. Shareholder” as defined in IRC § 951(b) is a 10% owner that directly or indirectly or constructively owns a controlled foreign corporation.
  - A Category 5 Filer can also be a Category 3 Filer in a year shares of a CFC are sold or the company is reorganized or liquidated.
- Category 4 & 5 Filers may be required to file Form 8858 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) for disregarded entities.
- Special rules apply to captive foreign insurance companies as Category 3 and 5 Filers under IRC § 953(c) rules.
**Form 5471**

**Filing Requirements**

<table>
<thead>
<tr>
<th>Required Information*</th>
<th>Category of Filer</th>
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<tbody>
<tr>
<td>The identifying information on page 1 of Form 5471 above Schedule A, see Specific Instructions</td>
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<tr>
<td>Schedule A</td>
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<td>Schedule B</td>
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<td>Schedules C, E, and F</td>
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<td>Separate Schedule J</td>
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<td>Separate Schedule M</td>
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<td>Separate Schedule O, Part I</td>
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<td>Separate Schedule O, Part II</td>
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Form 5471
Control

• IRC §6038 generally requires all U.S. persons (including corporations, S corporations, partnerships, trusts and individuals) having either direct or indirect “control” of a foreign corporation for 30 days or more during the year to file Form 5471 annually unless a specific exception applies.

• Under the regulations, a person shall be deemed to be in control of a foreign corporation if at any time during that person's taxable year it owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of shares of all classes of stock of the foreign corporation.
Form 5471

Control

- A person in control of a corporation which, in turn, owns more than 50% of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as being in control of such other corporation.
  - A U.S. partnership controls a foreign corporation through ownership control of it by a U.S. C Corporation.
  - A U.S. C corporation is a 51% owner of the U.S. corporate joint venture and the joint venture entity controls a foreign corporation. As a result, the C corporation controls the foreign corporation.
  - A U.S. company owns 80% of an unconsolidated U.S. C corporation which, in turn, controls a foreign corporation. As a result, the U.S. company also controls the foreign corporation.

- Contrast this with control vis-à-vis attribution. See Reg. § 1.6038-2(b) & Reg. § 1.6038-2-2(c).
Form 5471
Attribution

• For the purpose of determining control of domestic or foreign corporations the constructive ownership rules of IRC § 318(a) (to family members, partners, shareholders & beneficiaries) shall apply, except that:
  
  • Stock owned by or for a partner or a beneficiary of an estate or trust shall not be considered owned by the partnership, estate, or trust when the effect is to consider a United States person as owning stock owned by a person who is not a United States person;
  
  • A corporation will not be considered as owning stock owned by or for a 50 % or more shareholder when the effect is to consider a United States person as owning stock owned by a person who is not a United States person; and
  
  • If 10 % or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, IRC § 318(a)(2)(C) shall apply.
  
  • Section 318(a)(2)(C) provides that if 50 % or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.
A U.S. person described in Category 3 or 4 does not have to file Form 5471 if all of the following conditions are met:

- The U.S. person does not own a direct interest in the foreign corporation,
- The U.S. person is required to furnish the information requested solely because of constructive ownership (as determined under Regulations §1.6038-2(c) or 1.6046-1(i)) from another U.S. person, and
- The U.S. person through which the U.S. person constructively owns an interest in the foreign corporation files Form 5471 to report all of the required information.

The new instructions permit Category 5 Filers to rely on this exception and clarify that no statement is required to be attached to the returns of persons relying on this constructive ownership exception. By expanding the scope of this exception, unnecessary duplicative filing can be avoided.
Form 5471
Filing Exceptions

• A Category 2 Filer does not have to file Form 5471 if:
  • Immediately after a reportable stock acquisition, three or fewer U.S. persons own 95% or more in value of the outstanding stock of the foreign corporation and the U.S. person making the acquisition files a return for the acquisition as a Category 3 Filer or
  • The U.S. person(s) for which the Category 2 Filer is required to file Form 5471 does not directly own an interest in the foreign corporation but is required to furnish the information solely because of constructive stock ownership from a U.S. person and the person from whom the stock ownership is attributed furnishes all of the required information.
Form 5471
Filing Exceptions

- A Category 4 or 5 Filer does not have to file Form 5471 if the shareholder:
  - Does not own a direct or indirect interest in the foreign corporation and
  - Is required to file Form 5471 solely because of constructive ownership from a nonresident alien
Form 5471  
Applicable Foreign Corporations

- What is an association taxable as a corporation ("corporation")? Consider the check-the-box regulations.
  - If we are dealing with a per se corporation, it is a corporation for U.S. tax purposes.
  - On the other hand if we are permitted to elect whether or not a foreign entity is a corporation, partnership, or branch, it is usually important that the Form 8832 election has been made. Form 5471 does not perfect a foreign entity’s status, but it may preclude “9100” relief.
  - Designating the foreign legal form of the entity can be useful, e.g., SA or SrL
- Remember that a separate 5471 is required for each foreign entity even if it is included in a foreign consolidated group, e.g., a German “Organschaft.”
- Name changes are subject to special disclosure requirements.
Form 5471
Applicable Foreign Corporations

- When reviewing the foreign corporations that must complete Form 5471, it is always a good practice to have a log of those entities that filed returns in the prior year for better control over the current year’s filing. Generally speaking if a return is not needed for the current year or there is a new entity in the group Schedule O is frequently required.

- If you realize that you failed to complete a required return for the prior year, that oversight should be corrected immediately.

- If it is determined that a filed Form 5471 contained incorrect information, it can be amended. Technically, the amended Form should be filed with an amended U.S. tax return.
Form 5471
Applicable Foreign Corporations

- Sometimes we find non-U.S. persons that own foreign businesses, becoming U.S. taxable residents (e.g., securing a “Green Card.”) As a result, they are now required to file Form 5471, as well as consider the U.S. taxable consequences associated with their foreign operations, e.g., subpart F.

- Dormant foreign corporations.
  - The IRS permits an abbreviated Form 5471 filing with respect to certain dormant foreign corporations. See Rev. Proc. 92-70.
  - Filers, however, must verify each year that a foreign corporation meets the requirements for dormant company status.
Form 5471
Applicable Year-End

• Regardless of the foreign corporation’s year-end in its home country, Form 5471 must be completed based upon the entity’s U.S. tax year. Thus., one must consider IRC § 898.

• For many foreign subsidiaries IRC § 898 requires that for U.S. tax purposes the foreign corporations tax year-end must be the same as its majority U.S. shareholder.

• A question often arises as to what is required in the year of foreign entity is sold or liquidated.
  • In the case of a sale, the full year’s results regardless of ownership changes needs to be reported.
  • In the case of liquidation, results are reported up through the date of liquidation. The balance sheet should reflect results through that date. In either case, a Schedule O is required.
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Form 5471
Basic Information

• Generally, the Form should be completed just as the U.S. group is described on page 1 of Form 1120, e.g. “XYZ and Affiliates.”

• A filer’s reference ID is now permitted, and the foreign entity’s EIN should be included.

• In the preliminary sections of the Form, it asks for the category (categories) of the filer. Depending on what category the filer falls into will determine what schedules must be completed.

• “Persons on Whose Behalf This Information Return isFiled”
  • Certain indirect and constructive owners may have a filing obligation as well, and their obligation can be met by another person filing on their behalf. Exceptions apply for multiple filers of the same information, provided the return is filed by a person subject to the same or greater filing requirements.
  • The person on whose behalf the return is filed must include a statement in their income tax return indicating who filed Form 5471 on their behalf. If the return is not filed or if an incomplete return is filed, the party may be jointly liable.
Form 5471
Stock Information

- Schedule A (Stock of Foreign Corporation)
  - When indicating the shares issued and outstanding, consider whether the change was due to a taxable event or whether disclosure needs to be included in the return, e.g., capitalization of debt under IRC §108 or an election under IRC § 108(i) as described in Rev. Proc. 2009-37.

- Schedule B (U.S. Shareholders of Foreign Corporation)
  - Once again, the tax effect if any of changes in shares held during the year needs to be considered. What do we do about foreign shareholders? For example, assume 30% of the entity is owned by a non-U.S. person.
  - Presumably disclosure applies to beneficial owners.
Form 5471
Schedule C (Income Statement)

• Results need to be reported in accordance with U.S. GAAP and the translation also follows U.S. GAAP rules (e.g., FAS 52). As under U.S. GAAP, special translation rules apply to operations in hyperinflationary jurisdictions. See Reg. § 1.985-3.

• Remember that amounts reported on the income statement become the basis for determining earnings and profits (E&P).

• Also be mindful that the Form distinguishes between non-income taxes (line 15) and the provision for income taxes (line 20).

• In addition, some of the categories indicated will carry over to Schedule M.

• The schedule requires statements to support other income and deductions. In developing these statements, be mindful of materiality when breaking-out the detail.
Form 5471
Schedule E (Income Taxes Paid or Accrued)

- Income-Type taxes (creditable foreign taxes) need to be broken out by taxing jurisdictions.
- Amounts must be translated generally under the IRC § 986 rules.
- Amounts reported need to be considered when preparing Form 1118; the U.S. dollar amount of taxes will become a part of the foreign corporation’s tax pool.
- Differences in the translation of accrued taxes and the rate applicable to amounts when paid should also be considered when preparing tax pool information.
Form 5471
Schedule F (Balance Sheet)

• As with schedule C, amounts reported in accordance with U.S. GAAP.
  • The various categories are broken down to facilitate a review of earnings and profits, as well as amounts reported on Schedule M.
  • Stock or share information (Lines 18 & 19) should be reconcilable with amounts included on Schedule A.
  • Line 5 (Loans to Shareholders and Other Related Persons) may indicate a possible IRC § 956 inclusion. Compare it to what appears on Schedule M.
  • Line 2 (Trade Notes and Accounts Receivable) may be important for assessing whether the appropriate amount of interest is being charged.
  • Consider the U.S. tax implications of changes in accounting methods.
  • Significant current assets may indicate TD 90-22.1 (Report of Foreign Bank and Financial Accounts) and/or Form 8938 (Statement of Specified Foreign Financial Assets) need to be filed.
Form 5471
Schedules H & I

• Schedule H (Current Earnings & Profits). This schedule must be completed using the foreign entity’s functional currency amounts.
  • The items listed in Lines 2(a) - (h) reflect typical E&P adjustments. At a minimum one would expect to see an adjustment for taxes (line 2(g)).
  • Special rules apply to the depreciation under IRC § 312, and UNICAP needs to be considered.
  • Functional currency amounts reported on the schedule (Line 5) will affect the company’s earnings and profits pools for foreign tax credit purposes, and will flow into Schedule J (Accumulated Earnings and Profits (E&P) of Controlled Foreign Corporations).

• Schedule I (Summary of Shareholder’s Income From Foreign Corporation). This schedule produces succinct summary of the income (and previously taxed income (“PTI”) withdrawn) on a shareholder-by-shareholder basis. Amounts included on the schedule are translated into U.S. dollars under the applicable tax rules, and amounts should be reconcilable with Forms 1118. The new instructions require the disclosure of names and identifying numbers of Category 4 and 5 Filers.
Form 5471
Schedule J (Accumulated Earnings and Profits)

- This schedule produces comprehensive analyses of:
  - Pre-87 E&P layers, post 86 pool amounts, and
  - A comprehensive analysis of the various IRC § 959(c)(1)& (c)(2) balances (related to subpart F and IRC § 956 inclusions, distributions and reclassifications).

- Although Column B refers to pre-87 E&P, it also applies to post-86 E&P generated prior to establishing an E&P pool for the entity (e.g., pre-acquisition amounts).

- Support schedules detailing the various layers composing pre-87 E&P balances should be maintained.

- It is not unusual that filers forget to include this schedule with Form 5471.

- The schedules included in the Instructions to the Form provide very helpful worksheets applicable to Schedules I & J.

- Amounts reported on this schedule should be reconcilable with Form 1118.
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This schedule is a critical document when it comes to transfer pricing, but it is also very helpful to the IRS in reviewing items that could give rise to either subpart F income or IRC 956 inclusions.

- Columns (b), (c), & (e) apply to domestic persons and are frequently useful to identify non-deferral transactions.

- Column (d) (any other foreign corporation or partnership controlled by U.S. person filing this return) is also helpful identifying subpart F type transactions.

- The schedule reports amounts in U.S. dollars, translated at the average exchange rate for the foreign corporation’s taxable year. See IRC § 989(b). (The exchange rate must be disclosed on the schedule.)

- Although it is advisable, few filers develop comprehensive schedules to reconcile paid and received amounts reported by other related foreign corporations.

- If the foreign corporation uses the accrual method of accounting, amounts reported must included the accrued amounts.
Form 5471
Schedule M (Related Party Transactions)

- Questions 1 through 12 on the schedule look to amounts received by the foreign corporation. So, for example, if royalties are being paid by a U.S. person and reported on line 8, two questions result: (1) Was U.S. withholding due? and (2) Does the payment result in U.S. source subpart F income?

- Similarly, if fixed indeterminable annual and periodic type amounts are being paid between foreign related persons, does it result in subpart F income.

- The adequacy of interest paid and received and the rate at which it is charged are frequent questions pursued by IRS agents.

- Insurance amounts (lines 11 and 23) might indicate that an excise taxes due if U.S. risks are being insured and there is not a treaty override.

- Amounts borrowed and loaned (lines 25 and 26) are not only important for transfer pricing analysis, but may indicate an IRC § 956 inclusion if a controlled foreign corporation is lending money to a U.S. person or that interest amounts are understated.
Form 5471
Schedule O (Structural Changes)

• If this is the first year that a Form 5471 is filed for a foreign corporation, it is very likely that this schedule is required to report the organization or acquisition of the stock either directly or indirectly (or constructively) (Section C).

• Schedule may also be required when the U.S. company acquires another U.S. company with CFCs.

• When CFC stock is sold, there is a question as to whether an IRC § 1248 event has occurred.

• Completion of section D, reporting dispositions, should be closely reviewed since the section considers constructive dispositions, a sale of a U.S. company holding CFCs probably requires the completion of a Schedule O. Remember, a disposition also includes a gift of shares.
Section E of the Form considers organizations (e.g., IRC § 351 transfers) and reorganizations.

The focuses on whether an IRC § 367 event has occurred and whether a gain recognition agreement is required. (Remember as well that certain types of restructuring may trigger gain recognition agreements.)

Transfers such as those under IRC § 351 require additional disclosure detailed in Reg. Section 1.351 - 3.

In some cases, Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation) may be required, related to certain outbound transfers.

Section E also request information on the fair market value and adjusted basis of assets transferred. This information may be important if the IRS construes the transaction as a taxable event.
Form 5471
Schedule O (Structural Changes)

- Section F (Additional Information) may require a chart indicating the corporation’s position in the chain of ownership as well as information on stock ownership. Few filers remember to include this information.
- When reviewing foreign-to-foreign cross-chain sales be alert to potential an IRC § 304 events.
- The question on prior reorganizations within the past four years may be used by the IRS to evaluate the current transactions impact on prior reorganizations.
Form 926 Reporting Requirements

• U.S. persons, domestic corporations or domestic estates or trusts must file Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, to report any exchanges or transfers of property described in Section 6038B(a)(1)(A) to a foreign corporation. The form is filed with their income tax return for the tax year that includes the date of the transfer.

• A person could be subject to a penalty for failure to file equaling 10% of the fair market value of the property at the time of the exchange/transfer if the taxpayer fails to comply with the filing requirement. The penalty is limited to $100,000 unless the failure to comply was due to intentional disregard.

• The period of limitations for assessment of tax upon the exchange/transfer of that property is extended to the date that is 3 years after the date on which the information required to be reported is provided.
Form 926
Reporting Requirements

• Cash transfers - A U.S. person that transfers cash to a foreign corporation must file Form 926 if
  • Immediately after the transfer the person holds directly or indirectly at least 10% of the total vote or value of the foreign corporation, or
  • Cash transferred within the past 12 months exceeds $100,000
• Is a gain recognition agreement required (Form 8838)?
• Recapture might be required for:
  • Depreciation
  • Section 904 recapture
  • Dual consolidated losses
  • Unrealized exchange gain