



NEW YORK
CITY BAR

COMMITTEE ON
TAXATION OF
BUSINESS ENTITIES

September 23, 2013

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The Honorable Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Daniel I. Werfel (or successor)
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: New York City Bar Report Offering Proposals to Eliminate
Duplicative or Otherwise Unnecessary Filing Requirements for
Certain Interests in Foreign Corporations and Foreign Partnerships

Dear Assistant Secretary Mazur and Commissioner Werfel (or successor):

On behalf of the New York City Bar, as reported by the Committee on Taxation of Business Entities, I am pleased to submit this report offering proposals to eliminate duplicative or otherwise unnecessary filing requirements for certain interests in foreign corporations and foreign partnerships.

United States persons who own (or are deemed to own) certain specified interests in foreign corporations and foreign partnerships are subject to special reporting requirements including the obligation to file IRS Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, or IRS Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*. The rules pertaining to such filing requirements can be counterintuitive and can result in numerous persons, including persons who do not directly or indirectly own any interest in a foreign entity, all being required to file Form 5471 or 8865 with respect to that same entity.

The penalties and other consequences attendant to a failure to file such forms when required can be quite severe, even where there is little or no unpaid tax, and even if the interests required to be disclosed on such forms are otherwise reported to the IRS, e.g., on new IRS Form 8938. Moreover, over the last few years, the IRS appears to have departed from its prior (more measured) policy to impose penalties for late-filed Forms 5471 and 8865 as a matter of course. Under these circumstances, the elimination of duplicative or otherwise unnecessary filing obligations seems particularly appropriate.

Accordingly, while we are keenly aware of the Government's interest in gathering the information needed to adequately enforce the tax laws, we offer several proposals for alleviating certain of the overly burdensome reporting obligations imposed on taxpayers. Our proposals are as follows:

- A. A U.S. person who does not directly or indirectly own any stock of the foreign corporation should be exempt from reporting under category 4 (U.S. person in control of foreign corporation) and category 5 (U.S. shareholder of controlled foreign corporation ("CFC")) of Form 5471.
- B. The limitation on attribution from a nonresident alien that applies for purposes of determining United States shareholder status, under Code section 951(b), and CFC status under Code section 957, should also apply to the determination of whether a U.S. person has "control" for purposes of category 4 of Form 5471.
- C. A U.S. person that does not directly or indirectly own an interest in the foreign partnership should be exempt from reporting under category 1 (U.S. person in control of foreign partnership) and category 2 (U.S. person owning 10% interest in U.S.-controlled foreign partnership) of Form 8865.

We are pleased to discuss any questions you may have. Please feel free to contact the undersigned at (212) 903-8757 or via e-mail at mmiller@rhtax.com.

Very truly yours,



Michael J. Miller
Chair

Enclosure

cc: Danielle Rolfes, International Tax Counsel
Treasury Department
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Internal Revenue Service

NEW YORK CITY BAR

REPORT OFFERING PROPOSALS TO ELIMINATE DUPLICATIVE OR OTHERWISE UNNECESSARY FILING REQUIREMENTS FOR CERTAIN INTERESTS IN FOREIGN CORPORATIONS AND FOREIGN PARTNERSHIPS

As Reported by the Committee on Taxation of Business Entities

September 23, 2013

This report, which is submitted on behalf of the New York City Bar, by its Committee on Taxation of Business Entities, considers various circumstances in which the obligation to disclose certain interests in foreign corporations and foreign partnerships appears overbroad. The report proposes certain limitations on the current reporting requirements.¹

I. Introduction

United States persons² who own (or are deemed to own) certain specified interests in foreign corporations and foreign partnerships are subject to special reporting requirements including the obligation to file IRS Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, or IRS Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*. As discussed below, the rules pertaining to such filing requirements can be counterintuitive and can result in numerous persons, including persons who do not directly or indirectly own any interest in a foreign entity, all being required to file Form 5471 or 8865 with respect to that same entity.

The penalties and other consequences attendant to a failure to file such forms when required can be quite severe, even where there is little or no unpaid tax, and even if the interests required to be disclosed on such forms are otherwise reported to the IRS, *e.g.*, on new IRS Form 8938. Moreover, over the last few years, the IRS appears to have departed from its prior (more measured) policy to impose penalties for late-filed Forms 5471 and 8865 automatically. Under these circumstances, the elimination of duplicative or otherwise unnecessary filing obligations seems particularly appropriate.

¹ The report was prepared by the Committee on Taxation of Business Entities of the New York City Bar. The author of the report is Michael J. Miller. Helpful comments were provided by John P. Barrie and Abraham Leitner.

² For the definition of United States person ("U.S. person"), *see* IRC § 7701(a)(30). Unless otherwise indicated, all "section" and "IRC §" references are to the Internal Revenue Code of 1986, as amended, and all "Treasury Regulation section" and "Treas. Reg. §" references are to the Treasury regulations promulgated thereunder.

II. Proposals

- A. A U.S. person who does not directly or indirectly own any stock of the foreign corporation should be exempt from reporting under category 4 (U.S. person in control of foreign corporation) and category 5 (U.S. shareholder of controlled foreign corporation ("CFC")) of Form 5471.
- B. The limitation on attribution from a nonresident alien that applies for purposes of determining United States shareholder status, under section 951(b), and for purposes of determining CFC status under section 957, should also apply to the determination of whether a U.S. person has "control" for purposes of category 4 of Form 5471.
- C. A U.S. person that does not directly or indirectly own an interest in the foreign partnership should be exempt from reporting under category 1 (U.S. person in control of foreign partnership) and category 2 (U.S. person owning 10% interest in U.S.-controlled foreign partnership) of Form 8865.

III. Description of Reporting Requirements Under Current Law

A. Statutory Provisions

Pursuant to section 6038(a)(1), every U.S. person that controls a foreign business entity must furnish such information as the IRS may prescribe, including:

(A) the name, the principal place of business, and the nature of business of such entity, and the country under whose laws such entity is incorporated (or organized in the case of a partnership);

(B) in the case of a foreign corporation, its post-1986 undistributed earnings (as defined in section 902(c));

(C) a balance sheet for such entity listing assets, liabilities, and capital;

(D) transactions between such entity and—

(i) such person,

(ii) any corporation or partnership which such person controls, and

(iii) any United States person owning, at the time the transaction takes place—

(I) in the case of a foreign corporation, 10 percent or more of the value of any class of stock outstanding of such corporation, and

(II) in the case of a foreign partnership, at least a 10-percent interest in such partnership; and

(E) (i) in the case of a foreign corporation, a description of the various classes of stock outstanding, and a list showing the name and address of, and number of shares held by, each United States person who is a shareholder of record owning at any time during the annual accounting period 5 percent or more

in value of any class of stock outstanding of such foreign corporation, and

(ii) information comparable to the information described in clause (i) in the case of a foreign partnership.

Section 6038(a)(4) provides that the IRS may require any United States shareholder of a CFC to furnish the same information set forth in section 6038(a)(1).

Section 6038(a)(5) provides that in the case of a foreign partnership that is controlled by U.S. persons holding at least 10% interests (but not by any one U.S. person), the IRS may require each such U.S. person to furnish information relating to such partnership, including information relating to such partner's ownership interests in the partnership and allocations to such partner of partnership items.

Section 6038(d) provides that, if two or more U.S. persons would otherwise be required to furnish information under section 6038(a) with respect to the same foreign business entity for the same period, the Secretary may by regulations provide that only one person is required to provide such information. To the extent practicable, the determination of which U.S. person must furnish the information shall be made on the basis of actual ownership of stock.

Section 6038(e) provides several key definitions. Pursuant to section 6038(e)(1), a foreign business entity is a foreign corporation and a foreign partnership.

Pursuant to section 6038(e)(2), a person is in "control" of a corporation if such person 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 such corporation. Furthermore, if a person is in control (as so defined) of an upper-tier corporation that in turn is in control of a lower-tier corporation, then such person shall be treated as in control of such lower-tier corporation. For purposes of determining control, the constructive ownership rules of section 318(a) apply, except that (A) the rules of section 318(a)(3)(A), (B), and (C) shall not be applied so as to consider a U.S. person as owning stock owned by a non-U.S. person, and (B) in applying section 318(a)(2)(C), the phrase "10 percent" shall be substituted for the phrase "50 percent."

Pursuant to section 6038(e)(3)(A), a person is in control of a partnership if such person owns directly or indirectly more than a 50% interest in such partnership. Pursuant to section 6038(e)(3)(B), a 50% interest in a partnership is (i) an interest equal to 50% of the capital interest, or 50% of the profits interest, in such partnership, or (ii) to the extent provided in regulations, an interest to which 50% of the deductions or losses of such partnership are allocated. For this purpose, constructive ownership rules "similar to the rules" of section 267(c) (other than section 267(c)(3)) apply.

Pursuant to section 6038(e)(3)(C), a 10% interest in a partnership is an interest that would be described in section 6038(e)(3)(B) if "10 percent" were substituted for "50 percent" each place it appears.

Section 6046(a)(1) requires a return (meeting the requirements of section 6046(b)) to be filed by:

(A) each United States citizen or resident who becomes an officer or director of a foreign corporation if a United States person (as defined in section 7701(a)(30)) meets the stock ownership requirements of paragraph (2) with respect to such corporation,³

(B) each United States person——

(i) who acquires stock which, when added to any stock owned on the date of such acquisition, meets the stock ownership requirements of paragraph (2) with respect to a foreign corporation, or

(ii) who acquires stock which, without regard to stock owned on the date of such acquisition, meets the stock ownership requirements of paragraph (2) with respect to a foreign corporation,

(C) each person (not described in subparagraph (B) who is treated as a United States shareholder under section 953(c) with respect to a foreign corporation, and

(D) each person who becomes a United States person while meeting the stock ownership requirements of paragraph (2) with respect to stock of a foreign corporation.

Section 6046(c) provides that for purposes of applying section 6046(a), stock owned directly or indirectly by a person (including, in the case of an individual, stock owned by members of such individual's family) shall be taken into account. For this purpose an individual's family includes only the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

A person meets the stock ownership requirements of section 6046(a)(2) if such person owns 10% or more of—

(A) the total combined voting power of all classes of stock of such corporation entitled to vote, or

(B) the total value of the stock of such corporation.

Section 6046(b) provides that the returns required under section 6046(a) shall be in such form and shall set forth, in respect of the foreign corporation, such information as the Secretary prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws, except that in the case of persons described only in section 6046(a)(1)(A) the information required shall be limited to the names and addresses of the U.S. persons described in section 6046(a)(1)(B) or (C).

Section 6046A(a) provides that, except as otherwise provided in regulations, a return is required to be filed by any U.S. person:

(1) who acquires any interest in a foreign partnership, if such U.S. person directly or indirectly holds at least a 10% interest in the partnership either before or after the acquisition;

³ In the case of a foreign corporation with respect to which any person is treated as a United States shareholder under section 953(c), the flush language at the end of section 6046(a)(1) provides that section 6046(a)(1)(A) is treated as including a reference to each U.S. person who is an officer or director of such corporation.

- (2) who disposes of any portion of his interest in a foreign partnership, if such U.S. person directly or indirectly holds at least a 10% interest in the partnership either before or after the disposition; and
- (3) whose proportional interest in a foreign partnership changes substantially, if the change is equivalent to at least a 10% interest in such partnership.

Section 6046A(d) provides that for purposes of section 6046A(a), a 10% interest in a partnership is an interest described in section 6038(e)(3)(C).

B. Form 5471

a. Overview

U.S. persons required to file form 5471 are divided into four separate categories, with different information and schedules required from different categories. Category 1 no longer exists.⁴ Category 2 applies to a U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired stock meeting a specified threshold. Category 3 applies to U.S. persons who acquire or dispose of stock of a foreign corporation meeting a specified threshold, to persons who become U.S. persons while owning stock meeting a specified threshold, and to U.S. persons treated as United States shareholders under section 953(c). Category 4 applies to U.S. persons who are in control (or deemed to be in control) of a foreign corporation for an uninterrupted period of 30 days during the foreign corporation's annual accounting period. Category 5 applies to U.S. shareholder who owned stock in a foreign corporation that is a CFC for an uninterrupted period of 30 days during the taxable year of the CFC and who owned that stock on the last day of that year. The focus of this report is on categories 4 and 5, so these are explained in further detail below.

b. Category 4

Implementing section 6038(a)(1), the category 4 filing requirement applies to U.S. persons who control a foreign corporation for an uninterrupted period of 30 days or more during the foreign corporation's annual accounting period.⁵ A U.S. person is in control of a corporation for this purpose if such person owns stock possessing (a) more than 50% of the total combined voting power of all classes of stock entitled to vote, or (b) more than 50% of the total value of shares of all classes of stock of the corporation.⁶

As indicated above, pursuant to section 6038(e)(2), the constructive ownership rules of section 318(a) apply, with certain modifications. Under the general rules of section 318, an individual is treated as owning stock that is owned, directly or indirectly, by or for his or her

⁴ Category 1 was repealed by Jobs Creations Act of 2004 (P.L. 108-357, October 22, 2004).

⁵ See also Treas. Reg. § 1.6038-2(a).

⁶ IRC § 6038(e)(2); Treas. Reg. § 1.6038-2(b). In addition, if a U.S. person is in control of an upper-tier foreign corporation that is in control of a lower-tier foreign corporation, such U.S. person will also be considered to be in control of the lower-tier foreign corporation.

spouse, children, grandchildren and parents.⁷ Notably, the family attribution rules of section 318 do not proscribe "inbound" attribution from a nonresident alien family member to a U.S. citizen or resident alien. A proscription on such "inbound" family attribution applies for purposes of the CFC rules under section 958(b)(1), but this limitation does not apply for purposes of determining "control" under section 6038 and the category 4 filing requirement.

c. Category 5

Implementing the authority granted under section 6038(a)(4), the category 5 filing requirement generally applies to any U.S. person who is a "United States shareholder" of a CFC for an uninterrupted period of 30 days or more during the CFC's taxable year and who owned that stock on the last day of that year.

d. Reporting exceptions

The instructions to Form 5471 provide several exceptions to the reporting requirements that otherwise apply. Only the exceptions relevant to categories 4 and 5 are described here.

i. *Multiple filer exception*

The instructions to Form 5471 provide that one person may file Form 5471 and the applicable schedules for other persons who have the same filing requirements. Thus, for example, if several persons are required to file under category 4 or 5 with respect to a foreign corporation, one of them may file on behalf of the others.⁸

The instructions further provide, however, that the person filing Form 5471 "must complete Item D on page 1 of the form" which item indicates the other persons on whose behalf the form is filed. They also provide that all of the persons identified in Item D "must attach a statement to their tax returns" with certain information as to who filed Form 5471 on their behalf. While not expressly stated in the instructions, it appears that performance of these *musts* is a prerequisite to application of the multiple filer exception.

ii. *Member of consolidated group exception*

The instructions to Form 5471 provide that a category 4 filer is not required to file Form 5471 for a corporation described in section 1504(d) that files a consolidated return for the year.

iii. *Constructive Ownership Exceptions*

The instructions to Form 5471 provide two exceptions whereby a U.S. person that constructively owns stock of a foreign corporation may be relieved of the obligation to file Form 5471 under category 4 or 5. Each is addressed separately below.

⁷ IRC § 318(a)(1). Stock constructively owned by an individual by reason of family attribution will not be treated as actually owned by such individual for purposes of then re-attributing ownership from such individual to another family member by reason of family attribution. IRC § 318(a)(5)(B).

⁸ See also Treas. Reg. § 1.6038-2(j)(1) (exception for return jointly filed).

(A) *U.S.-to-U.S. constructive ownership exception*

Under the "U.S.-to-U.S. constructive ownership exception,"⁹ a U.S. person that is otherwise required to file under category 4 or 5 with respect to a foreign corporation is relieved of such obligation to file if each of the following requirements is satisfied:

- The U.S. person does not own any direct interest in the foreign corporation.
- The U.S. person is required to file under category 4 or 5 solely because of constructive ownership from another U.S. person.
- The U.S. person through which the indirect shareholder constructively owns an interest in the foreign corporation files Form 5471 to report all of the required information.¹⁰

(B) *Inbound constructive ownership exception*

Under the "inbound constructive ownership exception,"¹¹ a U.S. person that is otherwise required to file under category 4 or 5 with respect to a foreign corporation is relieved of such obligation to file if both of the following requirements are satisfied:

- The U.S. person does not own any direct or indirect interest in the foreign corporation.
- The U.S. person is required to file under category 4 or 5 solely because of constructive ownership from a nonresident alien.

C. Form 8865

a. Overview

U.S. persons required to file Form 8865 are divided into four separate categories, with different information and schedules required for different categories. Category 1 applies to a U.S. person who controlled the foreign partnership at any time during the partnership's taxable year. Category 2 generally applies to U.S. person who, at any time during the foreign partnership's taxable year, owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons owning at least 10% interests. Category 3 applies to a U.S. person who contributed property to the partnership, if certain requirements are satisfied. Category 4 applies to a U.S. person that had a reportable event, generally speaking involving certain acquisitions, dispositions, or changes in proportional interest in the partnership. The focus of this report is on categories 1 and 2, so these are explained in further detail below.

⁹ This term is used herein for convenience. It appears nowhere in Form 5471 or the instructions thereto.

¹⁰ See also Treas. Reg. § 1.6038-2(j)(2)(i). This exception (which also applies for category 3 purposes) was recently extended to cover category 5.

¹¹ This term is used herein for convenience. It appears nowhere in Form 5471 or the instructions thereto.

b. Category 1

Implementing section 6038(a)(1), the category 1 filing requirement applies to a U.S. person that controlled the foreign partnership at any time during the partnership's taxable year.¹² A U.S. person is in control of a foreign partnership for this purpose if such person owns more than a "50% interest" in the partnership.¹³ A "50% interest" is defined as an interest possessing 50% of the capital, 50% of the profits, or 50% of the deductions or losses.¹⁴

As indicated above, pursuant to section 6038(e)(3)(C), constructive ownership rules similar to the rules of section 267(c) (other than section 267(c)(3)) apply for this purpose. Thus, an interest owned by a corporation, partnership, estate, or trust, generally is considered to be owned proportionately by its shareholders, partners, or beneficiaries, and an individual generally is considered to own any interest owned (or considered to be owned) by his or her family, consisting of the individual's spouse brothers, sisters, ancestors, and lineal descendants. However, an interest will not be attributed from a nonresident alien individual under such family attribution rules unless the person to whom the interest would be attributed owns a direct or indirect interest in the foreign partnership under section 267(c)(1) or (5).¹⁵

c. Category 2

Implementing the authority granted under section 6038(a)(5), the category 2 filing requirement generally applies to a U.S. person that, at any time during the partnership's taxable year, owned a 10% or greater interest in the foreign partnership while it was controlled by U.S. persons each owning 10% or greater interests; provided that if the partnership had a category 1 filer at any time during the year, no person will be considered a category 2 filer.

A "10% interest" is defined as an interest possessing 10% of the capital, 10% of the profits, or 10% of the deductions or losses.¹⁶ The same attribution rules described above with respect to category 1 apply for purposes of category 2 as well.

d. Reporting exceptions

The instructions to Form 8865 provide several exceptions to the reporting requirements that otherwise apply. Only the exceptions relevant to categories 1 and 2 are described here.

i. *Multiple category 1 filer exception*

The instructions to Form 8865 provide for a multiple filer exception with respect to category 1 that is very similar to the multiple filer exception described above in connection with Form 5471.

¹² See also Treas. Reg. § 1.6038-3(a)(1).

¹³ IRC § 6038(e)(3)(A); Treas. Reg. § 1.6038-3(b)(1).

¹⁴ IRC § 6038(e)(3)(B); Treas. Reg. § 1.6038-3(b)(2).

¹⁵ Treas. Reg. § 1.6038-3(b)(4).

¹⁶ IRC § 6038(e)(3)(C); Treas. Reg. § 1.6038-3(b)(3).

The instructions to Form 8865 provide that, if more than one person qualifies as a category 1 filer, only one of them need file Form 8865.¹⁷ The single Form 8865 must include all of the information that would have been required if each category 1 filer had submitted a separate Form 8865. Furthermore, the Form 8865 must provide certain information (from Items B, C, and D on page 1, and Schedule A on page 2) for each category 1 filer that does not file the form and on whose behalf such Form 8865 is submitted. In addition, a category 1 filer not filing Form 8865 must attach a statement entitled "Controlled Foreign Partnership Reporting" to that person's income tax return setting forth, among other things, the name and address of the person filing Form 8865 on such person's behalf. While not expressly stated in the instructions, it appears that performance of these *musts* is a prerequisite to application of the multiple filer exception.

ii. *Constructive Ownership Exception*

The instructions to Form 8865 provide an exception whereby a U.S. person that constructively owns an interest in a foreign partnership may be relieved of the obligation to file Form 8865 under category 1 or 2 if each of the following requirements is satisfied:

- The U.S. person (the "indirect U.S. partner") does not own any direct interest in the foreign partnership.
- The obligation to file Form 8865 arises solely because of constructive ownership from a U.S. person.
- The U.S. person through which the indirect shareholder constructively owns an interest in the foreign partnership files Form 8865 (or, if such U.S. person is also an indirect partner, such U.S. person separately meets the requirements for the constructive ownership exception).
- The indirect U.S. partner files a statement entitled "Controlled Foreign Partnership Reporting" with its income tax return setting forth, among other things, the names and addresses of the U.S. persons whose interests in the foreign partnership are constructively owned by such indirect U.S. partner.¹⁸

iii. *Member of consolidated group exception*

The instructions to Form 8865 provide that, if two or more members of an affiliated group of corporations filing a consolidated return qualify as category 1 or 2 filers for a particular foreign partnership, the common parent corporation may file a single Form 8865 on behalf all of the members of the group required to report.¹⁹ The Form 8865 generally must include all of the information that would have been required to be submitted if each group member had filed its own Form 8865.

¹⁷ See also Treas. Reg. § 1.6038-3(c)(1).

¹⁸ See also Treas. Reg. § 1.6038-3(c)(2).

¹⁹ See also Treas. Reg. § 1.6038-3(c)(3).

iv. *Certain retirement trusts*

Certain trusts relating to state and local government employee retirement plans are not required to file Form 8865.²⁰

v. *Form 1065 overlap rule*

If a foreign partnership files Form 1065 or Form 1065-B, category 1 and 2 filers may use a copy of the completed Form 1065 or Form 1065-B schedules in place of the corresponding schedules of Form 8865.²¹

D. Penalties and Other Consequences for Failure to File

Pursuant to section 6038(b)(1), a U.S. person that fails to timely provide information with respect to a foreign corporation pursuant to category 4 or 5 of Form 5471, or with respect to a foreign partnership pursuant to category 1 or 2 of Form 8865, is subject to a penalty of \$10,000 for each annual accounting period with respect to which such failure exists.²² Section 6038(b)(2) provides that if such failure continues for more than 90 days after the day on which the Secretary mails notice of such failure to such U.S. person, additional penalties of \$10,000 for each 30-day penalty (or fraction thereof) during which such failure continues following the expiration of such 90-day period are imposed, provided that such additional penalties shall not exceed \$50,000. In addition, the amount of foreign taxes for which such U.S. person may claim a credit under section 901 may be reduced, pursuant to section 6038(c).

The failure to timely file Form 5471 or Form 8865 also has adverse effects with respect to the statute of limitations. Section 6501(c)(8) provides that, in the case of any failure to provide the information required under section 6038 (or certain other provisions), the time for assessment of any tax imposed under the Internal Revenue Code with respect to any return, event, or period to which such information relates shall not expire before the date that is three years after the date on which such information is reported. Unless the taxpayer can demonstrate that such failure is due to reasonable cause, and not willful neglect, this keeps the applicable return open with respect to all items, not simply the items relating to the foreign entity that should have been disclosed on Form 5471 or Form 8865, as the case may be.

²⁰ See also Treas. Reg. § 1.6038-3(d).

²¹ See also Treas. Reg. § 1.6038-3(j).

²² Such penalty does not apply if the U.S. person can establish reasonable cause for the failure to file. IRC § 6038(c)(4)(B); Treas. Reg. §§ 1.6038-2(k)(3) and 1.6038-3(k)(4).

IV. Discussion

A. Form 5471

1. *Domestic Attribution Problem: Duplicative Filing Obligations*

As discussed below, the applicable attribution rules result in a potentially limitless number of filing obligations with respect to the same stock.

Example 1: A, a U.S. citizen, owns 100% of the stock of two foreign corporations, F1 and F2. Both of A's parents, B and C, are living and are U.S. citizens. A has five children: D, E, F, G, and H, all of whom are U.S. citizens. D owns 100% of the stock of five domestic corporations: I, J, K, L, and M. M owns 100% of the stock of three domestic subsidiaries: N, O, and P. Nether A nor anyone else files Form 5471 with respect to F1 or F2 for 2008, 2009, 2010, or 2011.

Under the applicable attribution rules, 100% of the stock of F1 and F2 is considered to be owned by both of A's parents, each of A's five children, and the eight domestic corporations directly and indirectly owned by D. Accordingly, at least 15 U.S. persons (in addition to A) are considered to have control, and to be United States shareholders, of both F1 and F2. Accordingly, unless an exception applies, all of them are required to file Form 5471, under both categories 4 and 5.

Unfortunately, neither the multiple filer exception nor the U.S.-to-U.S. constructive ownership exception applies, since A failed to file.²³ Thus, each of the other 15 U.S. persons referenced above may be subject to a \$10,000 penalty for each failure to file, giving rise to a total exposure of \$1,200,000.²⁴ And each such U.S. person may be subject to a perpetually open statute of limitations under section 6501(c)(8).

In our view, such exposure to duplicative (and extremely harsh) penalties for persons who do not directly or indirectly own any stock of the foreign corporations, and who therefore could not in any circumstance have an inclusion of income under Subpart F, is not warranted.²⁵

Example 2: The facts are the same as in Example 1, except that the five domestic corporations, I, J, K, L, and M (which owns the three domestic subsidiaries N, O, and P), are owned by A instead of D.

Since the eight domestic corporations are directly and indirectly owned by A, the U.S. person who owns the stock of F1 and F2, and who is fundamentally responsible for the failure to file Forms 5471, we can envision that the IRS may be more reluctant to expand the constructive

²³ As noted above, additional requirements would also apply in the case of the multiple filer exception.

²⁴ $15 * \$10,000 * 2 * 4 = \$1,200,000$. This does not include the penalties payable by A, who actually owns the stock of F1 and F2. Note also that the potential penalties would increase if more years were at issue. In light of section 6501(c)(8), there is no limit to the number of years that may be open.

²⁵ We understand that penalties potentially might be avoided through a demonstration of reasonable cause in certain circumstances, but in our view this is too doubtful a remedy.

ownership exception in this scenario. Nevertheless, we are of the view that subjecting A and his corporations to duplicative filing obligations with respect to the same interests in F1 and F2, so as to impose unduly harsh and duplicative penalties in the event of a failure to file, is arbitrary and inappropriate.²⁶ In our view, subjecting A to the applicable penalties for failing to file Forms 5471 should suffice to advance the Government's enforcement objectives.

2. *Inbound Attribution Problem*

Example 3: A, a nonresident alien, directly owns 99% of the stock of F, a foreign corporation. A's son B has moved to the United States and is currently a U.S. resident. B directly owns 1% of the stock of F. B fails to file Form 5471 for 2008, 2009, 2010, and 2011.

In this example, B is considered to have "control" of F, under the family attribution rules of sections 318 and 6038(e)(2). The inbound constructive ownership exception does not apply, because B directly owns a small interest in F. Accordingly, B, a 1% shareholder, must file under category 4 of Form 5471 by reason of being considered to possess "control" of F. Since B has failed to file for four years, he may be subject to penalties of \$40,000. He may also be subject to a perpetually open statute of limitations under section 6501(c)(8).

The fact that B is deemed to have reportable control of F may come as a huge surprise,²⁷ since B is not a United States shareholder of F, within the meaning of section 951(b), and F is not a CFC under section 957. Pursuant to section 958(b)(1), the family attribution rules do not apply to treat a U.S. person as the constructive owner of stock owned by a nonresident alien for such Subpart F purposes.

In our view, this is an unnecessary and undesirable trap for the unwary.

3. *Proposals*

The primary purpose of category 4 and 5 reporting, as we understand it, is to help ensure reporting of Subpart F income by U.S. persons subject to Subpart F.²⁸ Accordingly, we would suggest that the scope of reporting under categories 4 and 5 be narrowed with this in mind.

²⁶ For example, we are not aware of any policy that would support subjecting a U.S. person who fails to file Form 5471 to an increased monetary penalty of \$90,000 per violation (in lieu of \$10,000 per violation) based on the mere happenstance of that U.S. person owning eight domestic corporations.

²⁷ We have heard "through the grapevine" of certain accounting firms that do not report under category 4 in this situation, but we do not know what authority, if any, supports this position.

²⁸ In our view, such supposition is supported by (i) the requirement for category 4 status that control be maintained for an uninterrupted period of at least 30 days, (ii) the requirement for category 5 status that the foreign corporation be a CFC for an uninterrupted period of at least 30 days, and (iii) the requirement for category 5 status that the reporting U.S. person owned stock of the CFC on the last day of the foreign corporation's taxable year. It appears to be by design that these requirements closely parallel the requirements for inclusion of Subpart F income under section 951(a). Pursuant to section 951(a), a United States shareholder must include in income its pro rata share of a CFC's Subpart F income only if the foreign corporation was a CFC for an uninterrupted period of at least 30 days during its taxable year and only if the United States shareholder owned stock of the foreign corporation on the last day during such year on which it was a CFC.

Our first proposal is to expand the constructive ownership exception so that a U.S. person who does not directly or indirectly own any stock of the foreign corporation is exempt from reporting under categories 4 and 5 of Form 5471, regardless of whether the U.S. person or persons that actually owns stock of the foreign corporation fulfill their Form 5471 filing obligations.²⁹ Pursuant to this proposal, the litany of individuals and corporations who are deemed in Examples 1 and 2 above to own stock of F1 and F2 solely by reason of attribution from A would be exempt from the Form 5471 filing requirement. We would think this would be acceptable to the Government since none of them are subject to Subpart F, and the U.S. person who is subject to Subpart F, *i.e.*, A, would still be required to file. We do not believe that the incremental benefit to the Government of requiring A's entire family, and each of their domestic corporations, to file is warranted in light of the burden and outsized penalty exposure imposed upon them.³⁰ Imposition of the filing requirement on the U.S. person that directly or indirectly owns such stock should be sufficient to protect the Government's interests.³¹

We acknowledge that, if this first proposal is accepted, the result may be that no one is required to file Form 5471 with respect to certain stock of a foreign corporation. For example, if two U.S. sisters each own 5% of a CFC, and the remaining 90% is owned by an unrelated U.S. person, neither sister is required to file Form 5471; but as things stand now their U.S. parents (if living) would be required to file, since they would each be considered United States shareholders, and thus category 5 filers, under the family attribution rules. If the parents are relieved of this filing obligation pursuant to our first proposal, no Form 5471 reporting would be required with respect to the CFC stock owned by the sisters. Inasmuch as neither sister could have any Subpart F inclusions, we would still support expansion of the constructive ownership exception as proposed above. In our view, the Government's interest in receiving information with respect to stock held by persons who are not United States shareholders is insufficient to justify placing the burden of Form 5471 reporting (and the resulting penalty exposure for failing to report) on persons who do not directly or indirectly own any stock of the foreign corporation. Moreover, we note that if either sister's 5% interest has sufficient value (along with any other specified foreign financial assets she may own) she will in any case be required to disclose such interest on new Form 8938.

Our second proposal is that the limitation on attribution from a nonresident alien that applies for purposes of determining United States shareholder and CFC status under sections 951(b) and 957 should also apply to the determination of whether a U.S. person has "control" for purposes of category 4 of Form 5471.

Under this proposal, B in Example 3, who directly owns only a 1% interest in F, and who is subject to category 4 reporting solely because of inbound family attribution, would no longer be required to file Form 5471. We would think this would be acceptable to the Government, since B cannot be subject to Subpart F. Moreover, if B's 1% interest has sufficient value (along

²⁹ For this purpose, "indirect" ownership would be through foreign entities, within the meaning of section 958(a).

³⁰ For example, we do not believe it is reasonable to place upon all U.S. citizens and resident aliens a duty to investigate what interests in foreign corporations may be owned by each of their family members.

³¹ As indicated above, we are aware that the U.S.-to-U.S. constructive ownership exception was recently expanded to apply for purposes of category 5 as well as category 4. In our view, this is clearly a step in the right direction, and we appreciate the IRS's efforts to reassess the proper balance between the burdens imposed on taxpayers and the Government's need to gather the information needed to adequately enforce the tax laws.

with any other specified foreign financial assets he may own) B will in any case be required to disclose such interest on new Form 8938. In our view, this should be sufficient to protect the Government's interests.

With respect to the authority issue, we note that, pursuant to section 6038(a)(1), a U.S. person who is in control of a foreign corporation must only provide "such information as the Secretary *may* prescribe" with respect to certain specified items.³² Similarly, pursuant to section 6038(a)(4), "the Secretary *may* require" a U.S. shareholder of a CFC to provide the same information.³³ In each case, the statute provides the IRS and the Treasury Department with ample discretion to determine that reporting is not required in a given instance.

B. Form 8865

1. *Domestic Attribution Problem: Duplicative Filing Obligations*

Just as in the case of Form 5471, the applicable attribution rules result in a potentially limitless number of duplicative filing obligations with respect to the same interests.

Example 4: A, a U.S. citizen, owns an 80% interest in two foreign partnerships, P1 and P2. Both of A's parents, B and C, are living and are U.S. citizens. A has five children: D, E, F, G, and H, all of whom are U.S. citizens. D owns 100% of the stock of five domestic corporations: I, J, K, L, and M. M owns 100% of the stock of three domestic subsidiaries: N, O, and P. Neither A nor anyone else files Form 8865 (or Form 1065 or 1065-B) with respect to P1 or P2 for 2008, 2009, 2010, or 2011.

Under the applicable attribution rules, A's 80% partnership interests in P1 and P2 are considered to be owned by both of A's parents, each of A's five children, and the eight domestic corporations directly and indirectly owned by D. Thus, each of these 15 U.S. persons (as well as A) is considered to have control under category 1.³⁴ Accordingly, unless an exception applies, all 16 of them are required to file Form 8865.

Unfortunately, none of the exceptions described above would apply. The constructive ownership exception does not apply because, among other things, A failed to file. Thus, each of the 15 other U.S. persons referenced above may be subject to a \$10,000 penalty for each failure to file, giving rise to a total exposure of \$1,200,000.³⁵ And each such U.S. person may be subject to a perpetually open statute of limitations under section 6501(c)(8).

In our view, such exposure to duplicative (and extremely harsh) penalties for persons who do not directly or indirectly own any interests in the foreign partnerships, and who therefore

³² Emphasis added.

³³ Emphasis added.

³⁴ Each is also considered to own a 10% or greater interest, but as noted above, since there is a category 1 filer, no person is considered a category 2 filer.

³⁵ $15 * \$10,000 * 2 * 4 = \$1,200,000$. This does not include the penalties payable by A, who actually owns the 80% interests in P1 and P2. Note also that the potential penalties would increase if more years were at issue. In light of section 6501(c)(8), there is no limit to the number of years that may be open.

could not in any circumstance have an inclusion of income earned through such partnerships, is not warranted.³⁶

2. *Proposal*

The primary purpose of category 1 and 2 reporting, as we understand it, is to help ensure that U.S. persons who own significant interests in foreign partnerships (directly or through other foreign entities) will report the income earned through such partnerships. Accordingly, we would suggest that the scope of reporting under categories 1 and 2 be narrowed with this in mind.

Our third proposal is that a U.S. person who does not directly or indirectly own any interest in a foreign partnership should be exempt from reporting under categories 1 and 2 of Form 8865.³⁷ Pursuant to this proposal, the litany of individuals and corporations who are deemed in Example 4 above to own interests in P1 and P2 solely by reason of attribution from A would be exempt from the Form 8865 filing requirement. We would think this would be acceptable to the Government, since none of them are taxable on the income of P1 or P2, and the U.S. person who is subject to such tax, *i.e.*, A, would still be required to file. We do not believe that the incremental benefit to the Government of requiring A's entire family, and each of their domestic corporations, to file is warranted in light of the burden and outsized penalty exposure imposed upon them.

With respect to the authority issue, our observations are similar to those made above with respect to categories 4 and 5 of Form 5471. Pursuant to section 6038(a)(1), a U.S. person who is in control of a foreign partnership must only provide "such information as the Secretary *may* prescribe" with respect to certain specified items.³⁸ Similarly, pursuant to section 6038(a)(5), "the Secretary *may* require" U.S. persons holding at least 10-percent interests in a foreign partnership that is controlled by such U.S. persons to provide information relating to such partnership.³⁹ In each case, the statute provides the IRS and the Treasury Department with ample discretion to determine that reporting is not required in a given instance.

³⁶ We understand that penalties might potentially be avoided through a demonstration of reasonable cause in certain circumstances, but in our view this is too doubtful a remedy.

³⁷ For this purpose, "indirect" ownership would be through foreign entities, under the principles of section 958(a).

³⁸ Emphasis added.

³⁹ Emphasis added.