Cross-Border Ownership Structures:
Lessons Learned Under Tough IRS Scrutiny
Complying With Forms 5471, 5472, 1120F and 926

WEDNESDAY, JUNE 18, 2014, 1:00-2:50 pm Eastern

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Cross-Border Ownership Structures

June 18, 2014

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Juan Carlos Ferrucho, Alvarez & Marsal Taxand LLC

INTERNATIONAL TAX TOPICS
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- Today’s Program:
  - Purpose of Form 5472
  - Parts I, II and III - Who is required to file?
  - Parts IV and V - What is required to be reported?
  - When and where to file
  - Penalties and Statute of Limitations
  - Sample Form 5472
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- Form 5472 is required to be filed only where there is a *reportable transaction* between a *reporting corporation* and any foreign or domestic “related party”
  - **Reporting Corporation** - 25% foreign owned US corporation (by vote or value), or a foreign corporation with a US trade or business (this is a commonly missed filing requirement). Parts I and II.
  - **Related Party** - Broad definition with a Section 482 catch-all provision. Part III.
  - **Reportable Transaction** - Any transaction listed on the form for which monetary consideration was received, and any transaction listed on the form for which part of the consideration was non-monetary or less than full consideration was paid or received. Parts IV and V.
Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

- Related Parties - Definition is far reaching for the purposes of Form 5472
  - Any direct or indirect 25% shareholder of the reporting corporation
  - Any person who is related (more than 50%) to the reporting corporation
  - Any person who is more than 50% related to a 25% foreign shareholder of the reporting corporation, and
  - Any person who is related within the meaning of Section 482
Exceptions: A reporting corporation is not required to file Form 5472 if any of the following apply:

- It had no reportable transactions
- A US Person in control of the foreign related corporation files Form 5471 for the tax year to report information pursuant to Schedule M. Such schedule shows all reportable transactions between the reporting corporation and the related party (commonly referred as the “overlap rule”)
- The related corporation qualifies as a foreign sales corporation and files Form 1120-FSC
- A FC, which otherwise would be required to file, does not have a permanent establishment in the United States under an applicable income tax treaty and timely files Form 8833
Exceptions: A reporting corporation is not required to file Form 5472 if any of the following apply (continued):

- A FC whose gross income is exempt from taxation under Section 883 and timely and fully complies with the reporting requirements
- Both the reporting corporation and the related party are not US Persons and the transactions will not generate in any tax year:
  - US source gross income or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, or
  - Any expense, loss, or other deduction that is allocable or apportionable to such income
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- **Consolidated Reporting**
  - If a reporting corporation is a member of an affiliated group filing a consolidated income tax return then it can satisfy the regulations by filing a consolidated Form 5472.
  - The common parent must attach a schedule stating which members of the US affiliated group are reporting corporations, and which of those members are joining in the consolidated filing of Form 5472.
  - The schedule must show the name, address, and employer identification number of each member who is including transactions on form 5472.
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- **Transactions Reported**
  - Inventory and non-inventory tangible property transactions
  - Rents and royalties
  - Sales, leases, licenses, royalties, etc. of intangible property
  - Compensation for different types of services
  - Commissions
  - Amounts loaned or borrowed
  - Interest
  - Premiums
  - Platform contribution transactions
  - Cost sharing transactions
  - Other amounts
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- Part V - non-monetary and less than full consideration transactions.
  - Attach a schedule with a description of transaction sufficient to determine the nature and approximate monetary value of the transaction or group of transactions.
  - Should include a reasonable estimate of the value
- The terms “paid” and “received” include accrued payments and accrued receipts.
- The form is required to be filed if there are reportable transactions between two related US entities that are not in the same consolidated group, however, amounts for such transactions need not be reported on Part IV of the Form
- No reporting is required for transactions within a US consolidated tax group
Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

- When and where to File?
  - File by the due date of the reporting corporation’s income tax return (including extensions)
  - A separate 5472 must be filed for each foreign or domestic related party with which the reporting corporation had a reportable transaction
  - Unless the income tax return is not timely filed, the final regulations do not require a duplicate copy to be filed. (Final Regulations issued by the IRS on June 5, 2014).
  - Newly proposed regulations remove a current provision that allows for the timely filing of Form 5472 separately from an income tax return that is filed late. The Proposed Regulations require a Form 5472 to be filed in all cases only with the taxpayer’s income tax return for the tax year by the due date (including extensions) of that return.
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- Agency rules for IRS information requests
  - The IRS can request documentation for transactions between a reporting corporation and a foreign related party; if the documentation is held by the foreign related party, either the reporting corporation must furnish the information or obtain such information from the foreign related party.
  - It can be difficult to convince the foreign parties to agree to turn over the requested information without a limited agent authorization.
  - If the IRS is not provided the requested documentation from the foreign party, the IRS is permitted to determine the amount paid for or incurred by the reporting corporation and the cost of any property acquired by the reporting corporation with regard to the questioned transactions based on its own knowledge.
  - It can be assumed that if this situation arises, the IRS will deny deductions of the reporting corporation due to a lack of documentation.
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- **Failure to File Penalties**
  - Failure to file a substantially complete return or maintain records carries a $10,000 penalty per Form 5472.
  - Failure to timely respond to an IRS notice for more than 90 days carries an additional $10,000 penalty and continues for each 30-day period.
  - If consolidated filing is an option, each separate reporting entity within the consolidated group is subject to a separate $10,000 penalty.
  - Open statute of limitations on the entire return, unless reasonable cause.
  - Offshore Voluntary Disclosure Program (FAQ #18)
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

- Common Mistakes and Issues:
  - Failure to properly classify the categories of intercompany transactions
  - Getting taxpayers to reveal their intercompany transactions
  - Reference IDs
  - Getting foreign taxpayers to disclose the owners of U.S. corporation, particularly when there are many tiers of ownership
  - Substantially incomplete forms
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

Comprehensive Example:

- Ferrucho Industries, Ltd. ("Ferrucho") wholly owns Pajama Manufacturing, Ltd. ("Pajama"), which manufactures pink velour snuggle-suits
- Both entities are incorporated in the Republic of Flores
- Pajama sells several of its snuggle-suits to Valentine Retail, Inc. ("Valentine"), its wholly-owned subsidiary in the U.S., which then resells snuggle-suits in the United States
  - Valentine purchase $1,000,000 of snuggle-suits from Pajama
- Valentine also performs market research in the U.S. to determine whether their customers are fully satisfied with the softness of the snuggle-suits, and Pajama pays Valentine arm’s length compensation for performing the research
  - Valentine is paid $500,000 for the services
Comprehensive Example:

- In Part I, Valentine lists its name and address on Line 1a, its EIN on Line 1b, and the total assets being reported by Valentine on Line 1c.
- On Line 1h and 1i, Valentine lists its country of incorporation and the country under whose laws Valentine is filing a return as a resident of (USA).
- In Part II, Valentine lists the name and address of its 25 percent direct shareholder (Pajama) on Line 1a, and the name and address of its 25 percent indirect shareholder on Line 3A (Ferrucho).
- Part IV will report the $1,000,000 of cost of goods purchased from Pajama on Line 12, Purchases of stock in trade (inventory), and the $500,000 of compensation for market research services on Line 5, Consideration received for technical, managerial, engineering, construction, scientific, or like services.
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

**Part I - Reporting Corporation** (see instructions). All reporting corporations must complete Part I.

<table>
<thead>
<tr>
<th>Name of reporting corporation</th>
<th>Employer identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td>VALENTINE RETAIL, INC</td>
<td>20-0101010</td>
</tr>
<tr>
<td>123 MAIN STREET</td>
<td></td>
</tr>
<tr>
<td>ANYTOWN, USA 99999</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Principal business activity</th>
<th>Principal business activity code</th>
</tr>
</thead>
<tbody>
<tr>
<td>WOMEN'S CLOTHING STORE</td>
<td>448120</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total value of gross payments made or received (see instructions) reported on this Form 5472 filed for the tax year</th>
<th>Total number of Forms 5472 filed for the tax year</th>
<th>Total value of gross payments made or received (see instructions) reported on all Forms 5472</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,500,000</td>
<td>1</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Check here if this is a consolidated filing of Form 5472</th>
<th>Country of incorporation</th>
<th>Country(ies) under whose laws the reporting corporation files an income tax return as a resident</th>
<th>Principal country(ies) where business is conducted</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>USA</td>
<td>USA</td>
<td>USA</td>
</tr>
</tbody>
</table>

*Note.* Enter all information in English and money items in U.S. dollars.

For tax year of the reporting corporation beginning **JAN**, 20X1, and ending **DEC**, 20X1.
Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

<table>
<thead>
<tr>
<th>Part II</th>
<th>25% Foreign Shareholder (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a</td>
<td>Name and address of direct 25% foreign shareholder</td>
</tr>
<tr>
<td>PAJAMA MANUFACTURING, LTD., 555 RUE ST. PAUL, CITTABLELA, REP. OF FLORES</td>
<td></td>
</tr>
<tr>
<td>1c</td>
<td>Principal country(ies) where business is conducted</td>
</tr>
<tr>
<td>REP. OF FLORES</td>
<td></td>
</tr>
<tr>
<td>1d</td>
<td>Country of citizenship, organization, or incorporation</td>
</tr>
<tr>
<td>REP. OF FLORES</td>
<td></td>
</tr>
<tr>
<td>1e</td>
<td>Country(ies) under whose laws the direct 25% foreign shareholder files an income tax return as a resident</td>
</tr>
<tr>
<td>1b(1)</td>
<td>U.S. identifying number, if any</td>
</tr>
<tr>
<td>FOREIGNUS</td>
<td></td>
</tr>
<tr>
<td>1b(2)</td>
<td>Reference ID number (see instructions)</td>
</tr>
<tr>
<td>PML001</td>
<td></td>
</tr>
</tbody>
</table>

| 2a      | Name and address of direct 25% foreign shareholder |
| FERRUCHO INDUSTRIES, LTD., 555 RUE ST. PAUL, CITTABLELA, REP. OF FLORES |
| 2c      | Principal country(ies) where business is conducted |
| REP. OF FLORES |
| 2d      | Country of citizenship, organization, or incorporation |
| REP. OF FLORES |
| 2e      | Country(ies) under whose laws the direct 25% foreign shareholder files an income tax return as a resident |
| 2b(1)   | U.S. identifying number, if any |
| FOREIGNUS |
| 2b(2)   | Reference ID number (see instructions) |
| PML002  |

| 3a      | Name and address of ultimate indirect 25% foreign shareholder |
| 3c      | Principal country(ies) where business is conducted |
| REP. OF FLORES |
| 3d      | Country of citizenship, organization, or incorporation |
| REP. OF FLORES |
| 3e      | Country(ies) under whose laws the ultimate indirect 25% foreign shareholder files an income tax return as a resident |
| 3b(1)   | U.S. identifying number, if any |
| 3b(2)   | Reference ID number (see instructions) |
Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

### Part III  Related Party (see instructions)

Check applicable box: Is the related party a ☑ foreign person or ☐ U.S. person?

All reporting corporations must complete this question and the rest of Part III.

<table>
<thead>
<tr>
<th>1a</th>
<th>Name and address of related party</th>
</tr>
</thead>
<tbody>
<tr>
<td>PAJAMA MANUFACTURING, LTD., 555 RUE ST. PAUL CITIBELLA, REP. OF FLORES</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1b</th>
<th>U.S. identifying number, if any</th>
</tr>
</thead>
<tbody>
<tr>
<td>FOREIGNUS</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1b(2)</th>
<th>Reference ID number (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PML001</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1c</th>
<th>Principal business activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>WOMEN'S CLOTHING MANUFACTURING</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1d</th>
<th>Principal business activity code</th>
</tr>
</thead>
<tbody>
<tr>
<td>315230</td>
<td></td>
</tr>
</tbody>
</table>

| 1e | Relationship—Check boxes that apply: ☑ Related to reporting corporation ☐ Related to 25% foreign shareholder ☑ 25% foreign shareholder |

<table>
<thead>
<tr>
<th>1f</th>
<th>Principal country(ies) where business is conducted</th>
</tr>
</thead>
<tbody>
<tr>
<td>REP. OF FLORES</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1g</th>
<th>Country(ies) under whose laws the related party files an income tax return as a resident</th>
</tr>
</thead>
<tbody>
<tr>
<td>REP. OF FLORES</td>
<td></td>
</tr>
</tbody>
</table>
Form 5472, **Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business**

### Part IV

Monetary Transactions Between Reporting Corporations and Foreign Related Party

(see instructions)

**Caution:** Part IV must be completed if the “foreign person” box is checked in the heading for Part III.

If estimates are used, check here □

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Sales of stock in trade (inventory)</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Sales of tangible property other than stock in trade</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Platform contribution transaction payments received</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Cost sharing transaction payments received</td>
<td></td>
</tr>
<tr>
<td>5a</td>
<td>Rents received (for other than intangible property rights)</td>
<td></td>
</tr>
<tr>
<td>5b</td>
<td>Royalties received (for other than intangible property rights)</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Sales, leases, licenses, etc., of intangible property rights (e.g., patents, trademarks, secret formulas)</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Consideration received for technical, managerial, engineering, construction, scientific, or like services</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Commissions received</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Amounts borrowed (see instructions)</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Interest received</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Premiums received for insurance or reinsurance</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Other amounts received (see instructions)</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td><strong>Total.</strong> Combine amounts on lines 1 through 12</td>
<td>1,000,000</td>
</tr>
<tr>
<td>14</td>
<td>Purchases of stock in trade (inventory)</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Purchases of tangible property other than stock in trade</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Platform contribution transaction payments paid</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Cost sharing transaction payments paid</td>
<td></td>
</tr>
<tr>
<td>18a</td>
<td>Rents paid (for other than intangible property rights)</td>
<td></td>
</tr>
<tr>
<td>18b</td>
<td>Royalties paid (for other than intangible property rights)</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Purchases, leases, licenses, etc., of intangible property rights (e.g., patents, trademarks, secret formulas)</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Consideration paid for technical, managerial, engineering, construction, scientific, or like services</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Commissions paid</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Amounts loaned (see instructions)</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Interest paid</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Premiums paid for insurance or reinsurance</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Other amounts paid (see instructions)</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td><strong>Total.</strong> Combine amounts on lines 14 through 25</td>
<td></td>
</tr>
</tbody>
</table>
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FORM 5471 EXPERIENCES
Definition of Terms

• **U.S. person**: Includes a citizen or resident of the U.S., a domestic partnership, a domestic corporation, and an estate or trust that is not a foreign estate or trust

• **Controlled foreign corporation (CFC)**: Any foreign corporation in which 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 the stock, is owned directly, indirectly or constructively by U.S. shareholders on any day during the taxable year

• **U.S. Shareholder**: A U.S. person who owns 10% or more (directly, indirectly or constructively) of the total combined voting power of all classes of stock entitled to vote in a foreign corporation
Definition of Terms

- Control: A U.S. person has control of a FC if, at any time during the person’s tax year, it owns stock possessing:
  - More than 50% of total value of all classes of stock, or
  - More than 50% of the combined voting power of all stock entitled to vote.
Income earned by a foreign company is generally deferred.

- **Sub-part F Income = Anti-deferral**
  - Foreign Personal Company Holding Company Income
    - Dividends, interest royalties, rents, annuities; net gains from the disposition of property that produces this type of income
  - Foreign Base Company Sales Income
  - Foreign Base Company Services Income, and
  - Foreign Base company Oil-Related Income

- *De minimis* rule
- Full inclusion rule
- High tax exception
Form 5471: Who Must File?

Category 1 Filers (pre-2005 years)
• Repealed

Category 2 Filers (IRC 6046)
• U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person (not necessarily such officer or director) has acquired:
  - 10% of a FC’s stock (by vote or value), or
  - An additional 10% of the outstanding stock of FC (by vote or value)
• The statute strongly suggest it refers to natural persons and not legal entities although it’s not conclusive
• U.S. officers/directors are excused from filing under Category 2 with respect to a deemed acquisition by a constructive owner (not excused in the case of an actual acquisition by the actual owner)
Category 2 Filers (Cont.)

- A category 2 filer is excused from filing if both conditions are met:
  - The acquiring U.S. person must file as a Category 3 filer, and
  - Immediately after the acquisition, 3 or fewer US persons own at least 95% by value of the corporation.
- Triggers the filing of Schedule O
- The filings related to this category are often missed
Form 5471: Who Must File? (Cont.)

Category 3 Filers (IRC 6046)

• U.S. person who acquires stock in FC which, when added to the stock already owned, meets the 10% stock ownership requirement

• U.S. person who acquires stock which, without regard to stock already owned, meets the 10% stock ownership requirement

• A person who becomes a U.S. person while meeting the 10% stock ownership requirement

• U.S. person who disposes of sufficient stock in the FC to reduce the ownership to less than 10% (may include corporate liquidations)

• A person who is treated as a U.S. shareholder under IRC Sect. 953(c) related to captive insurance companies

• Often applies to formations, acquisitions, mergers, restructuring or dispositions

• Triggers the filing of Schedule O
Category 3 Filers (Cont.)

- Constructive ownership rules apply
- Category 3 filers need to attach a statement that includes amount and type of indebtedness the FC has with:
  - Any U.S. person owning 5% or more in value of its stock, or
  - Any other FC owning 5% or more in value of the outstanding stock of the FC, provided that the shareholder filing the return owns 5% or more in value of the outstanding stock of such other FC
- Provide information of each shareholder or entity
- Category 3 filers should keep in mind these filing requirements when the FC is sold, because it may be difficult for the seller to comply with these filing requirements if the sharing of the information is not agreed beforehand in the SPA.
Form 5471: Who Must File? (Cont.)

Category 4 Filers (IRC 6038)

• This includes a U.S. person who had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation.
  – Definition of U.S. person under Category 4 also includes non-resident aliens for whom an election is in effect under Sect. 6013(g) to be treated as a resident of the US., for the purpose of filing a joint return; and
  – An individual for whom an election is in effect relating to non-resident aliens who become residents of the U.S. during the tax year and are married at the close of the tax year to a citizen or resident of the U.S.

• For this purpose, control is transitive (e.g. if A controls B and B controls C, then A controls C)

• A U.S. person can be a Category 4 filer with respect to a foreign corporation if he owns more than 50% of the value of such corporation, even if he does not have any voting shares.
Form 5471: Who Must File? (Cont.)

Category 5 Filers (IRC 6038)

• A U.S. shareholder (10% owner) who owns stock in a FC that is a CFC for an uninterrupted period of 30 days or more during any tax year of the FC, and who owned that stock on the last day of the CFC’s year
Form 5471: Filing Requirements For Categories Of Filers

<table>
<thead>
<tr>
<th>Required Information*</th>
<th>Category of Filer</th>
</tr>
</thead>
</table>
| The identifying information on page 1 (the information above Schedule A)—see Specific Instructions | 1     
|                                                                                      | 2     
|                                                                                      | 3     
|                                                                                      | 4     
|                                                                                      | 5     |
| Schedule A                                                                           | ✓     
| Schedule B                                                                           | ✓     
| Schedules C, E, and F                                                                | ✓     
| Schedule G                                                                           | ✓     
| Schedule H                                                                           | ✓     
| Schedule I                                                                           | ✓     
| Separate Schedule J                                                                  | ✓     
| Separate Schedule M                                                                  | ✓     
| Separate Schedule O, Part I                                                         | ✓     
| Separate Schedule O, Part II                                                        | ✓     |

*Required Information includes specific instructions provided in the form itself.
Form 5471: Exceptions For Filing

Multiple Filers of Same Information

• Form 5471 allows the filer of the form to file on behalf of another person with similar filing requirements.

• For Category 3 filers, the required information may only be filed by another person having an equal or greater interest (by vote or value).

• Page 1, item D must be completed to provide the necessary information about the person on whose behalf they are filing.

• If Form 5471 has been filed on the taxpayer’s behalf, then a statement must be attached to such taxpayer’s federal tax return providing information of the person filing Form 5471.

• A separate Schedule I and M must be submitted for each person who is being filed on behalf of. **This is commonly missed in practice.**

• It is prevalent in the private equity space to have multiple filers of the same information and multiple service providers, which can be confusing and cause missed filings.
Form 5471: Exceptions For Filing (Cont.)

Constructive Ownership

• Form 5471 is not required for categories 3 and/or 4 filers, if the U.S. person does not own a direct interest in the FC and it is only required to furnish information because of his constructive ownership; and if the filing requirement is satisfied by an indirect shareholder.

• Category 4 and 5 filers are not required to file Form 5471 if they do not own a direct or indirect interest in the FC, and the filing is required because of constructive ownership from a non-resident alien.
Form 5471: Additional Information

When and Where to File

• Form 5471 is due when the U.S. filer’s federal income tax return is due, including extensions.

• Form 5471 needs to be filed with the US filer’s income tax return (electronically or in paper form).
**Form 5471: Dormant Foreign Corporations**

**Dormant Foreign Corporations**

- Rev. Proc. 92-70 provides a summary filing procedure for filing Form 5471 for a dormant foreign corporation which satisfies the reporting requirements of 6038 and 6046.

- If you elect the summary procedure, then you only need to complete page 1 of Form 5471 for each dormant foreign corporation as follows:
  - The top margin of the summary return must be labeled “Filed Pursuant to Rev. Proc. 92-70 for Dormant Foreign Corporation.”
  - Include filer information such as name and address, items A through C, and tax year
  - Include corporate information such as the dormant corporation’s annual accounting period (below the title of the form) and Items 1a, 1b, 1c and 1d
Dormant Foreign Corporations (Cont.)

- A FC is a dormant foreign corporation if:
  - (1) The FC conducted no business and owned no stock in any other corporation other than another dormant foreign corporation.
  - (2) No shares of the FC were sold, exchanged, redeemed or otherwise transferred; and nor was the FC a party to a reorganization.
  - (3) No assets of the FC were sold, exchanged or transferred.
  - (4) The FC received or accrued no more than $5,000 of gross income or gross receipts.
  - (5) The FC paid or accrued no more than $5,000 of expenses.
  - (6) The value of the FC’s GROSS assets determined under U.S. GAAP (i.e. not reduced by any mortgages or other liabilities) did not exceed $100,000.
A FC is a dormant foreign corporation if:

- (7) No distributions were made by the FC, and
- (8) The FC either had no current or accumulated E&P or had only *de minimis* changes in its beginning and ending accumulated E&P balances, by reason of income or expenses specified in (4) or (5) above.
Form 5471: Stock of the FC

Schedule A: Stock of the FC

• Categories 3 and 4
• List each class of stock and the amount outstanding at the beginning and end of the year
  – Changes in stock may indicate the need for a Category 2 or 3 filing
  – A person has acquired stock if he has received an unqualified right, even if was not actually issued.
Form 5471: Income Statement

Schedule C: Income Statement

- Categories 3 and 4
- The left column shows FC’s income statement in its functional currency, and the right shows it in USD; information reported should be in accordance with U.S. GAAP.
  - Translation is done using the average rate for the FC’s tax year, in accordance with U.S. GAAP rules.
  - Special rules for hyperinflationary currencies (DASTM)
- Line 20 taxes: Includes income taxes only and should equal taxes paid or accrued on Schedule E
- Lines 4, 5, and 6: Potential Subpart F income
- In the case of a parent-sub, where both companies are CFCs, the parent’s income statement is presented on a stand-alone basis under the *equity method* of accounting (i.e., presenting equity earnings on the P&L and investment in sub account on the balance sheet).
Form 5471: Subpart F Income

Schedule I: Summary of Shareholder’s Income From Foreign Corporation

- Categories 4 and 5
- The total income on Line 6 is included in the U.S. shareholder’s tax return (Form 1120, Schedule C; Form 1040 Schedule B)
- Include the exchange gain or loss of distribution of previously taxed income as “other income” in Form 1120, Line 10

Schedule J: Accumulated E&P

- Categories 4 and 5
- All amounts are entered in functional currency
- Shows foreign company’s E&P from inception through the end of the year
- Reports the running balance of previously taxed income (Subpart F income and Sect. 956)
Form 5471: Related Party Transactions

Schedule M: Related-Party Transaction

- Category 4 only
- Every U.S. person must file a separate Schedule M.
- If the shareholder is a member of a consolidated group, the name of the filer should be the common parent.
- Determine with whom the CFC had transactions and place the totals in the appropriate column
- If the FC uses the accrual method of accounting, FC must report payment/receipts under such method.
- Note that dividends paid or received do not include those previously taxed under Subpart F
Schedule M: Related-Party Transaction (Cont.)

- Amounts borrowed and loaned (lines 19 and 20) should be shown as the highest amount during the year, not beginning or ending balances.
  - Be sure not to report accounts payable as loans
- Schedule M should include all transactions between disregarded entities that are owned by the CFC with other entities in the controlled group, in addition to the activities of the CFC itself.
  - Information that is included on Form 8858 also needs to be included on Schedule M, unless there are branch-to-branch transactions where the branches are owned by the same CFC.
- Do not leave Schedule M blank; if there is no activity for the year, zeros should be entered.
Form 5471: Schedule O

Schedule O: Organization or Reorganization of FC and Acquisition and Disposition of its Stock

- Category 2 files Part I
- Category 3 files Part II
- This applies to organizations and reorganizations, and acquisitions or dispositions of stock.
- Certain tax-free transactions require Schedule O reporting, even though there is no potential tax impact.
  - F & E reorganizations
- If an entity has an increase in U.S. ownership that requires a Schedule O to be filed, then the U.S. officers and directors of that entity have a filing requirement.
Schedule O: Organization or Reorganization of FC and Acquisition and Disposition of its Stock (Cont).

• Section F additional information
  – A chart must be attached showing chains of ownership, if any.
  – A statement is necessary if the CFC or a predecessor U.S. corporation filed a U.S. tax return.
  – Date of any reorganization within the last 4 years while the filer held 10% or more of the corporation’s stock

• Practical rule of thumb
  – If the transaction is taxable, then report it in sections B, C and D.
  – If the transaction is tax-free, then report it in Section E.
Form 5471: Schedule O

Additional filing requirements

• Sect. 338 election
  – A purchaser (or its U.S. shareholder) must attach a copy of Form 8883, *Asset Allocation Statement*.
  – A seller (or its U.S. shareholder) must attach a copy of Form 8883 to the final Form 5471 of the FC.
Form 5471: Penalties

Penalties for Failure to File Forms 5471, Schedule M, O

- A $10,000 penalty for each annual accounting period that a FC fails to provide the required information within the time prescribed.
  - An additional $10,000 in penalties can be assessed for failure to respond to IRS notices within the time provided (90 days), up to $50,000 for each failure.

- Reduction of up to 10% of the creditable foreign taxes under sections 901, 902 and 960 (not applicable for failure to file Schedule O)
  - Additional reductions for failure to respond to IRS notices in the prescribed period of time may be imposed (5% reduction for each three-month period).

- Any persons required to file Forms 5471 and schedules J, M, or O, and who agree to have another person file the form on their behalf are subject to the same penalties.

- Penalties may be imposed for undisclosed foreign financial assets understatements.
Form 5471: Audit and Notices

Increase in enforcement

- Audits with cross-border structures/transactions have an international auditor assigned automatically.
- Penalties are automatically imposed when failure to file is discovered.
- Penalties have been imposed even when the taxpayer completes the necessary forms and informs the auditor of the failure to file prior to IRS discovery of the issue.

Automatically Generated Notices

- Notices are automatically being generated for blank schedules and for items where “available upon request” was used instead of actual information.
- When statements are required for income statement and balance sheet items, and such statements are not attached, notices are now being generated.
Form 5471: Statute of Limitations

In the case of a U.S. person who does not file a *complete* Form 5471, the statute of limitations with respect to any tax return, event or period to which the information not filed relates, is extended to 3 years after the missing information is provided unless failure is due to reasonable cause and not willful neglect.
FORM 1120-F
Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*

**Purpose of Form 1120-F**

- Report the income, gains, losses, deductions, credits, and to figure the U.S. tax liability of a foreign corporation
- Claim any refund that is due
- Calculate and pay a foreign corporation’s branch profits tax liability and tax on excess interest, if any, under Section 884
- Transmit Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*
Effectively Connected Income

• A foreign corporation engaged in a U.S. trade or business is generally subject to U.S. taxation on income earned that is effectively connected with the conduct of that U.S. trade or business (“ECI”).

• ECI includes all of the U.S.-source income of a foreign corporation engaged in a U.S. trade or business, other than U.S. source non-business income.
  
  — FDAP (fixed, determinable, annual, or periodic) income is generally subject to 30% withholding tax.

• Common types of ECI includes income derived from a U.S. branch’s sale of inventory or provision of services in the U.S.

• A foreign corporation may offset income and gains with expenses, losses and other deductions that are directly related to effectively connected gross income, as well as a ratable portion of any deductions that are not definitely related to any specific item of gross income.

• For foreign corporations organized in treaty countries, taxation may be limited to income attributable to a permanent establishment.
Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*

**U.S. Trade or Business**

- Generally, a U.S. trade or business is deemed to exist when a foreign person engages in profit-oriented activities in the U.S. that are regarded as “considerable, continuous and regular.”
  - Must be more than just incidental to the taxpayer’s principal business and the activities cannot be merely routine and clerical functions.

**Permanent Establishment (“PE”)**

- Generally defined as a fixed place of business in which the business of a foreign enterprise is wholly or partly carried on.
  - May include a place of management, a branch, an office, a factory, a workshop, a mine or quarry, a building and certain construction sites.
  - Recent tax treaties may also include a “service PE” clause that may trigger a PE when the foreign corporation’s personnel perform services in the U.S. for a specified period of time.
FDAP or ECI?

- FDAP income is generally taxed at a flat rate of 30% withholding; however, ECI overrides withholding on any U.S. source income that is effectively connected to a U.S. trade or business.
  
  For example, interest, dividends, royalties, and other types of non-business income are treated as ECI if derived from the assets used in or held for use in the conduct or a U.S. trade or business, or
  
  Business activities of the U.S. trade or business are a material factor in the realization of the income.

- Example:
  
  ForCo maintains manages portfolios of stock and bonds
  
  U.S. company pay ForCo U.S. source dividends
  
  Because the dividends are related to the business activities of ForCo, they will be regarded as ECI and are exempt from withholding.
FDAP or ECI?

- A passive foreign investor may make an election to treat income derived from real property as ECI.
  - Enables the foreign investor to offset the ECI with deductions such as depreciation, depletion, and interest.
Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*

**Expense Allocation, in General**

- Expenses of a foreign corporation other than interest are generally allocated and apportioned between ECI and non-ECI under gross income principles.

**Interest Expense**

- All allocations and apportionments of interest expense must generally be made on the basis of assets, rather than gross income (fungibility principle).
  - May utilize fair market value or tax book value.
  - Affiliated groups are treated as a single corporation.

- Three exceptions requiring direct allocation
  - Qualified nonrecourse indebtedness
  - Integrated financial transactions
  - Investments in related controlled foreign corporations (excess related-person indebtedness)
Branch Profits Tax was introduced to ensure that the taxation of a U.S. branch will be equal to that of a U.S. subsidiary corporation by imposing a tax equal to 30% of a foreign corporation’s dividend equivalent amount for the taxable year (subject to applicable treaty reductions).

The dividend equivalent amount is an estimation of the amount that a U.S. branch remits to the foreign corporation during the year.

Similar to the application of 30% gross withholding on a U.S. subsidiary’s dividend distributions to its foreign parent.

The calculation of the dividend equivalent amount is computed in a two-step procedure that hypothetically treats the branch as a U.S. subsidiary.
Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

- **Dividend Equivalent Amount** = Current Earnings & Profit ("E&P")
  + Decrease in U.S. net equity
  - Increase in U.S. net Equity

**Example:**
(a) Current Yr E&P = $400,000
(b) End of Yr Net Equity = $800,000
(c) Beginning of Yr US Net Equity = $500,000

- The dividend equivalent amount equals $100,000, calculated as Current Year E&P of $400,000 less the $300,000 ($800,000 - $500,000) increase in U.S. net equity.
- The logic behind the calculation is that if $400,000 is earned during the year, U.S. net equity should increase by that amount, and any excess of Current Year E&P over the increase is therefore deemed to be a distribution.
Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

Branch Interest Tax

- Similar to the Branch Profits tax, Branch Interest Tax was introduced to reduce the disparity between the taxation of a U.S. branch and a U.S. subsidiary corporation.
- Pursuant to the rules, any interest paid by a foreign corporation’s U.S. branch is treated as if it were paid by a domestic corporation.

Branch Interest Allocation

- The U.S. tax authority’s position is that, in general, money is fungible and therefore interest expense should be attributable to all activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.
- Because interest expense is attributable to all activities and property of a taxpayer, the interest deduction is apportioned to gross income in proportion to the values of the assets used by the taxpayer to generate such income.
Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*

**Branch Interest Allocation (cont.)**

- The proportion compares the relative value of assets used to produce foreign source income to the value of assets that produce U.S. source income. For the purpose of these rules, a taxpayer may not net interest income against interest expense.

**Branch Tax on Excess Interest**

- A corporate-level tax at 30% is imposed on the excess of the amount of interest deductible by a foreign corporation (determined by Branch Interest Allocation) over the amount of interest paid by the U.S. trade or business.
  
  - In the event that interest deductions are greater, the “excess interest” deducted over interest paid is taxable as if there had been a deemed loan by the foreign corporation to its U.S. branch.
Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

When to File

• A foreign corporation that maintains an office or place of business in the United States must either:
  — File Form 1120-F by the 15th day of the 3rd month after the end of its tax year, or
  — Get an extension of time to file.

• If the foreign corporation does not maintain an office or place of business in the United States, it must:
  — File Form 1120-F by the 15th day of the 6th month after the end of its tax year, or
  — File Form 7004 to request a 6-month extension of time to file. The extension does not extend the time for payment of tax. If the tax is paid after the 15th day of the 6th month after the end of its tax year, the corporation must pay interest on the late payment and a penalty for late payment of tax may apply.
Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*

**Protective Filing**

- Does not report income or deductions.
- Contains a statement that the return is being filed to preserve the taxpayer’s rights to claim deductions and credits if it is determined to have ECI.
- Foreign corporations that do not file Form 1120-F lose the right to take deductions and credits against ECI.
- A foreign corporation that files a protective return within 18 months of the due date will, however, preserve its rights to deductions and credits if it is later determined that it did have ECI.
- The filing of a protective return is generally considered when:
  - The foreign corporation has only limited activity in the U.S. that does not rise to the level of a U.S. trade or business or income effectively connected thereto.
Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

Form 8883, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)

• Discloses treaty based return positions resulting in reduced or no U.S. tax liability.
• Common treaty articles include:
  — Article 4 - Residency
  — Article 5 - Permanent establishment
  — Article 7 - Business profits
  — Article 10 - Dividends
  — Article 11 - Interest
  — Article 14 - Independent services (self-employment)
  — Article 15 - Dependent services (salary)
• Limitation on Benefits Article must be considered.
  — May grant or eliminate treaty benefits by factors such as ownership, publicly traded, or active trade or business status.
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Kristina Dautrich Reynolds, Alvarez & Marsal Taxand LLC

FORM 926
Form 926: Purpose

- Meets the filing requirements of IRC Sect. 6038B
- Reports certain transfers of tangible and intangible property to a foreign corporation
- Contains information very similar to Form 5471, Schedule O, but is still required
- Commonly missed filing by taxpayers, particularly in the partnership context
Form 926: Important Points

Important Points

• All information is to be reported in U.S. dollars, even if the transfer was made in a different currency.

• If the transferor is a member of consolidated group, then the name of the parent company should be listed in 1c, and the form should be filed with the consolidated return.

Part I: U.S. Transferor Information

• Line 2 - If the transferor was a partnership, and the partnership is completing this filing, then the name of the partnership that was the actual transferor is entered here.

Part II: U.S. Transferee Information

• Line 7 - This is how the entity is treated for local country purposes (i.e., corporation, partnership, trust).
Form 926: Important Points (Cont.)

Part III: Information regarding the transfer of property

- Column (a) - Date title, rights or possession passed to the foreign corporation for U.S. tax purposes
- Column (b) - Description of the property
- Column (c) - Fair market value (on the date of transfer)
- Column (d) - Cost basis (adjusted basis of the property)
- Column (e) - Gain recognized on transfer
- Supplemental information - Description of a wider transaction that this contribution was part of, if applicable
Form 926: Important Points (Cont.)

Part IV: Additional Information Regarding the Transfer of Property

• Line 10 - State the IRC section that covers this contribution, if applicable.
• Line 11 - If a gain recognition agreement was required, in addition to answering yes to the appropriate question, a statement must be attached that describes the transfer and the amount of the gain that was recognized.
• Line 12 - If a check-the-box election was filed, and there was a deemed transfer rather than an actual transfer, indicate such here. Form 926 filings are commonly missed in these circumstances.
• Line 17a - If marked yes, a statement must be attached pursuant to 1.6038B-1T(d).
Who Must File?

• U.S. citizen or resident, a domestic corporation, or a domestic estate or trust to report transfers described in:
  – 6038B(a)(1)(A)
  – 367(d), or
  – 376(e).
Form 926: Important Points (Cont.)

Who Must File? (Cont.)

• Partnership transferor
  – If a transfer is made by a partnership (either domestic or foreign), then the domestic partners of the partnership have the filing requirement, not the partnership itself.
  – Each partner is considered the transferor of its proportionate share of the transfer.
  – When provided - the information is typically footnoted on a K-1 so that partners know a filing is required.
  – However, it is frequently not provided, or the individual does not know what the information means or that he has a Form 926 filing requirement.
Who Must File? (Cont.)

• Cash transfers
  – Must be reported if:
    – Immediately after the transfer, the person holds directly or indirectly at least 10% of the total voting power or the total value of the foreign corporation; OR
    – Amount of cash transferred by filer to the foreign corporation during the 12-month period ending on date of the transfer exceeds $100,000. NOTE: NOT $100,000 during the calendar year.

• Check-the-box election is filed
  – If a taxpayer checks the box (files Form 8832) to treat an entity that was already in existence as a corporation, for U.S. tax purposes, then the deemed transfer of assets to the newly formed corporation is required to be reported on Form 926.
Form 926: Important Points (Cont.)

Information Provided on Schedule O

- Depending up on the facts of the transaction, Schedule O may contain almost all the same information that is required to be reported on Form 926.
  - Formation of an entity
    - Schedule O requires the name of the transferor, date of the transfer, the FMV and basis of the property transferred, and a description of the property transferred.
    - Form 926 requires this same information plus asks additional questions. Even though Schedule O contains a good amount of the pertinent information, Form 926 is still required.
Information Provided on Schedule O (Cont.)

- Cash transfer of $500,000 to a 100% owned subsidiary
  - Schedule O reporting is not required if there was no acquisition or disposition of stock by the U.S. shareholder.
  - Form 926 is still required to be completed entirely, since more than $100,000 was transferred within the 12-month period ending on the date of the transfer, and the U.S. person held 10% or more of the entity immediately afterward. If either requirement was met, Form 926 would have to be filed.
Form 926: Additional Information

When and Where to File?

• Form 926 is due when the U.S. filer’s federal income tax return is due, including extensions.

• Form 926 needs to be filed with the U.S. filer’s income tax return (electronically or in paper form).
Penalties for Failure to File Forms 926

- If a Form 926 is not properly filed, then the penalty accessible by the IRS is 10% of the fair market value of the property at the time of the transfer.
  - Maximum penalty is $100,000 unless there is intentional disregard for the requirement.
  - There is a reasonable exception to the application of the penalty.
  - Abatement requests for reasonable cause may be filed but can be difficult to obtain.
  - An additional 40% penalty may be imposed on any underpayment resulting from a failure to properly report on Form 926

- The period of limitation for assessment of tax upon transfer of that property is extended to three years from the date Form 926 is provided.