Obtaining Relief From Form 1120-F Deficiency Penalties: Filing Protective Returns and Seeking Reasonable Cause Waiver

TUESDAY, FEBRUARY 14, 2017, 1:00-2:50 pm Eastern

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Obtaining Relief From Form 1120-F Deficiency Penalties

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Stanley Barsky, Partner
Fox Rothschild, New York
sbarsky@foxrothschild.com

Jennifer E. Benda, Partner
Fox Rothschild, Denver
jbenda@foxrothschild.com

Alison N. Dougherty, J.D., LL.M., Director
Aronson, Rockville, Md.
adougherty@aronsonllc.com

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Fox Rothschild LLP
ATTORNEYS AT LAW

Filing Protective Form 1120-F

Stanley Barsky, Esq.

sbarsky@foxrothschild.com

212-878-7949

Filing Protective Form 1120-F

- Circumstances indicating a protective return
- Claiming treaty-based return position on Form 8833 with a protective return
- Permanent establishment tests under which the IRS may assert filing requirements

Circumstances Indicating A Protective Return

Circumstances Indicating A Protective Return

- Foreign corporations are taxed at graduated rates on income that is effectively connected with the conduct of a trade or business in the United States ("effectively connected income" or "ECI"). Code section 882(a).
- Deductions and credits reduce ECI only if a foreign corporation files a tax return. Code section 882(c).
- The return is required to be made on Form 1120-F. The return is required if a foreign corporation has income subject to federal income tax, or takes a positon that income is reduced or exempt under a tax treaty. Treas. Reg. sections 1.6012-2(g)(1)(i), 301.6114-1.
  - A return is generally not required if the foreign corporation is not engaged in a US trade or business, does not claim a treaty-based position, and its federal income tax liability is fully satisfied by withholding of tax at source. Treas. Reg. section 1.6012-2(g)(2).

Circumstances Indicating A Protective Return

- Form 1120-F Instructions discussion of protective returns is consistent with the above authorities:
  - If a foreign corporation conducts limited activities in the United States in a tax year that the foreign corporation determines does not give rise to ECI, the foreign corporation should file a protective return to safeguard its right to receive the benefit of the deductions and credits attributable to that income if it is subsequently determined that the original determination was incorrect.
  - A foreign corporation should also file a protective return if it determines initially that it has no U.S. tax liability under the provisions of an applicable income tax treaty (for example, because its income is not attributable to a permanent establishment in the United States).

Circumstances Indicating A Protective Return

- What is a foreign corporation?
  - Certain foreign entities are always classified as corporations. Treas. Reg. section 301.7701-2(b)(8).
  - Other entities are eligible to be classified either as (A) corporations, or (B) (i) disregarded entities if they have a single owner, or (ii) partnerships if they have multiple owners. Treas. Reg. section 301.7701-3(b)(2).
  - The default classification for a foreign eligible entity is a corporation if all members have limited liability.
    - This is different from the default classification for domestic eligible entities, which are classified as partnerships or disregarded entities unless they elect to be classified as corporations. Treas. Reg. section 301.701-3(b)(1).

Circumstances Indicating A Protective Return

- Certain considerations for foreign corporations operating in the US through lower-tier entities.
  - Foreign corporations operating in the US through an entity classified as a disregarded entity for US federal tax purposes are treated as directly engaging in the US operations. Treas. Reg. section 301.7701-2(a).
  - Foreign corporations operating in the US through an entity classified as a partnership for US federal tax purposes are treated as directly engaging in the US operations of the partnership. Code section 875(1) (US trade or business); Rev. Rul. 90-80, 1990-2 C.B. 170 (permanent establishment).
    - Sales of partnership interests can also expose a foreign corporation to ECI. Rev. Rul. 91-32, 1991-1 C.B. 107.

Circumstances Indicating A Protective Return

- United States Trade or Business – General Overview:
  - A US trade or business generally exists when a foreign person engages in profit-oriented activities in the United States that are considerable, continuous, and regular. *See, e.g.*, *Pinchot v. Comm'r*, 113 F.2d 718 (2d Cir. 1940).
    - An agent's activities are attributable to a foreign person for purposes of determining whether the foreign person is engaged in a U.S. trade or business. *See*, *e.g.*, *De Amodio v. Comm'r,* 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962).

Circumstances Indicating A Protective Return

- United States Trade or Business – General Overview:
  - Trade or business examples:
    - Contracting to purchase property, entering into leases, and collecting rents, paying bills, and arranging for property repairs. *Pinchot.*
    - Signing and counter-signing insurance policies and settling losses arising from policies. Rev. Rul. 80-255.
  - Taxpayer can elect to treat income from US real estate (including rents and gains) as effectively connected with a US trade or business, even if such income would not otherwise be treated as effectively connected income. Section 882(d).
    - If this election is made, a foreign corporation may not rely on Treas. Reg. section 1.6012-2(g)(2) to avoid filing Form 1120-F.
  - The IRS will not "ordinarily" rule on whether a foreign person is engaged in a US trade or business. Rev. Proc. 2017-7 Section 4.01(4).

Circumstances Indicating A Protective Return

- United States Trade or Business – General Overview:
  - Managing one's own investments in securities does not constitute a US trade or business. *See, e.g.*, *Higgins v. Comm'r*, 312 U.S. 212 (1941).
    - "Investing" generally focuses on the long term growth potential of the investment.
    - The IRS concluded that a taxpayer was not engaged in a trade or business, where the taxpayer was a foreign corporation that entered into a factoring agreement with related U.S. corporations. Pursuant to the factoring agreement the taxpayer purchased a certain amount of the U.S. corporations' accounts receivable, and held them until they were either satisfied or written off. The taxpayer did not acquire the receivables until after they were acquired by the U.S. companies. A related U.S. company handled collections and managed the accounts. FSA 2002-24-003 (June 14, 2002).
  - Trading securities for one's own account generally does not constitute a US trade or business. Section 864(b)(2)(A).

Circumstances Indicating A Protective Return

- United States Trade or Business – General Overview:
  - Consider the following example addressing managing own investments, Treasury Regulations section 1.864-3(b) *Example 2*.
    - R, a foreign holding company, owns all of the voting stock in five corporations, two of which are domestic corporations. All of the subsidiary corporations are engaged in the active conduct of a trade or business. R has an office in the United States where its chief executive officer, who is also the chief executive officer of one of the domestic corporations, spends a substantial portion of the taxable year supervising R's investment in its operating subsidiaries and performing his function as chief executive officer of the domestic operating subsidiary. R is not considered to be engaged in a trade or business in the United States during the taxable year by reason of the activities carried on in the United States by its chief executive officer in the supervision of its investment in its operating subsidiary corporations. Accordingly, the dividends from sources within the United States received by R during the taxable year from its domestic subsidiary corporations are not effectively connected for that year with the conduct of a trade or business in the United States by R.

Circumstances Indicating A Protective Return

- United States Trade or Business – General Overview:
  - Trading securities for one's own account generally does not constitute a US trade or business. Section 864(b)(2)(A).
    - The trading safe harbor applies to (i) a wide variety of instruments, including stocks and any evidence of indebtedness, (ii) a wide variety of transactions, including buying, selling, short-selling and trading, and (iii) trading effected with borrowed proceeds, including trading "on margin," "obtaining credit" for the purpose of effectuating the trading, and any other activity closely related to trading. Treas. Reg. section 1.864-2(c)(2)(i).
  - Loan origination is considered to be a trade or business. AM 2009-010 (Sept. 22, 2009).
  - Section 897(i).

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

- If a taxpayer takes a return position that any treaty of the United States (including an income tax treaty) overrules or modifies any provision of the Internal Revenue Code, the taxpayer must disclose the position on Form 8833 and attach it to the tax return. Treas. Reg. section 301.6114-1(a)(1)(i).
- If a return is not otherwise required, claiming a treaty-based position nevertheless requires the taxpayer to file a return that includes the taxpayer's name, address, and taxpayer identifying number; and the return must be signed under penalties of perjury (as well as the subject disclosure). The taxpayer's taxable year shall be deemed to be the calendar year (unless the taxpayer has previously established, or timely chooses for this purpose to establish, a different taxable year). Treas. Reg. section 301.6114-1(a)(1)(ii).

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

- A taxpayer is deemed to adopt a "return position" when the taxpayer determines its tax liability with respect to a particular item of income, deduction or credit. To determine whether a return position is a "treaty-based return position" so that reporting is required the taxpayer must compare: (A) the tax liability (including credits, carrybacks, carryovers, and other tax consequences or attributes for the current year as well as for any other affected tax years) to be reported on a return of the taxpayer, and (B) the tax liability (including such credits, carrybacks, carryovers, and other tax consequences or attributes) that would be reported if the relevant treaty provision did not exist. If there is a difference (or potential difference) in these two amounts, the position taken on a return is a treaty-based return position that must be reported. Treas. Reg. section 301.6114-1(a)(2).

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

  - For example, assume that X, a Country A corporation, claims the benefit of a provision of the income tax treaty between the United States and Country A that modifies a provision of the Code. This position does not result in a change of X's U.S. tax liability for the current tax year but does give rise to, or increases, a net operating loss which may be carried back (or forward) such that X's tax liability in the carryback (or forward) year may be affected by the position taken by X in the current year. X must disclose this treaty-based return position with its tax return for the current tax year. Treas. Reg. section 301.6114-1(a)(3) Example 1.

- What if the taxpayer concludes that the same result would be reached under both a treaty provision and the domestic tax law? A return position is a treaty-based return position unless the taxpayer's conclusion that no reporting is required has a substantial probability of successful defense if challenged.

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

- Disclosure of a treaty-based position is required unless expressly waived by the regulations. The regulations expressly list certain items in the context of requiring disclosure (a non-exhaustive list). Treas. Reg. section 1.6114-1(b). These items include positions that:
  - A treaty exempts from tax, or reduces the rate of tax on, interest or dividends paid by a foreign corporation that are from sources within the United States by reason of section 861(a)(2)(B) or section 884(f)(1)(A).
  - Income that is effectively connected with a U.S. trade or business of a foreign corporation is not attributable to a permanent establishment or a fixed base of operations in the United States and, thus, is not subject to taxation on a net basis.

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

- The regulations expressly waive disclosure with respect to certain items. Treas. Reg. section 1.6114-1(c). These items include:
  - Items with respect to positions that are disclosed by a partnership, trust, or estate that has the taxpayer as a partner or beneficiary on its information return (and that must otherwise be disclosed by the taxpayer).
  - Items received by a foreign corporation that receives amounts of income that have been properly reported on Form 1042-S, that do not exceed $500,000 in the aggregate for the taxable year and that are not received through an account with an intermediary, or with respect to interest in a flow-through entity.
    - Certain exceptions are listed in the instructions to Form 8833, including for foreign corporations that are residents in a foreign jurisdiction whose tax treaty with the United States is invoked, as well as in another foreign jurisdiction that has a tax treaty with the first foreign jurisdiction. *See* Rev. Rul. 2004-76, 2004-2 C.B. 111.

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

- Information reported on Form 8833:
  - Taxpayer's name, address, and tax identification number.
  - Tax treaty relied on (including the article) and the Code provisions that the treaty overrules or modifies.
  - Name, US address and tax identification number (if available) of the payor of income (if FDAP).
    - FDAP income means all fixed or determinable, annual or periodic items.

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

- Information reported on Form 8833:
  - Treaty's limitation on benefits article provisions the taxpayer relies on to claim the treaty benefits. The limitation on benefits tests generally include:
    - Publicly-traded companies and their subsidiaries
    - Stock ownership and base erosion
    - Active business
    - Derivative benefits
    - Discretionary determination
  - Whether an item is specifically required to be disclosed under Treas. Reg. section 1.6114-1(b).

Claiming Treaty-Based Return Position On Form 8833 With A Protective Return

- Information reported on Form 8833:
  - A statement explaining the treaty-based position, the relevant facts, and nature and amount (or reasonable estimate) of income or other items for which a treaty benefit is claimed.
    - For purposes of determining the nature and amount, if a taxpayer takes (and discloses) a position that it does not have a permanent establishment, it does not need to separately report its payment of actual or deemed dividends or interest exempt from tax by reason of a treaty (or any liability for branch profits tax).
    - Certain amounts may be aggregated and treated as single payment or income item.

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Treaties generally provide that profits of a foreign corporation are not subject to tax in the United States unless they are attributable to the foreign corporation's permanent establishment situated in the United States. *See* 2016 Model Tax Treaty, Art. 7 p. 1.
- IRS must successfully assert that profits it seeks to tax are "attributable" to a foreign corporation's "permanent establishment."

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Permanent Establishment. *See* 2016 Model Tax Treaty, Art. 5.
  - A fixed place of business through which the business of an enterprise is wholly or partly carried on
  - Includes:
    - a place of management
    - a branch
    - an office
    - a factory
    - a workshop
    - a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Permanent Establishment
  - A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of the sea bed and its subsoil and their natural resources, situated in one of the Contracting States constitutes a permanent establishment only if it lasts, or the activities of the rig or ship lasts, for more than twelve months.
    - The twelve-month period includes greater-than-thirty-day periods during which connected activities carried on at the same building site or construction or installation project by one or more enterprises that are related persons.

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Permanent Establishment:
  - If a person other than an independent agent acts on behalf of a foreign corporation and has and habitually exercises in the US an authority to conclude contracts that are binding on the foreign corporation, the foreign corporation has a permanent establishment in the US in respect of any activities that the person undertakes for it, unless the activities of such person are limited to those that, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Permanent establishment does not include:
  - the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise
  - the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery
  - the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise
  - the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Permanent establishment does not include:
  - the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character
  - the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) through (e) of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Permanent establishment:
  - The fact that a foreign corporation controls or is controlled by a domestic corporation, or another foreign corporation that carries on business in the US (whether through a permanent establishment or otherwise), shall not be taken into account in determining whether the foreign corporation has a permanent establishment in the US.

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Permanent Establishment Example:
  - Foreign corporation X manufactures widgets and is a resident of a treaty jurisdiction. X wants to open US sales office to act as a distributor for its widgets in the US.

Permanent Establishment Tests Under Which The IRS May Assert Filing Requirements

- Profits attributable to permanent establishment:
  - The profits the permanent establishment might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

Stanley Barsky, Esq.
sbarsky@foxrothschild.com
212-878-7949

Fox Rothschild LLP
ATTORNEYS AT LAW

Penalties and Other Consequences of Failure to File a Required Form 1120-F

Jennifer E. Benda, Esq.

- Disallowance of deductions
- Penalties
- Partnership Interests

DISALLOWANCE OF DEDUCTIONS

Consequences of Failure to File

- Treas. Reg. § 1.882-4(a)(4) states IRS will:
  - Cause a return to be made
  - Include on return all income of that corporation from all sources from which is has information
  - Assess tax and collect it from U.S. sources without any allowance for any deductions (other than section 170) or credits (other than 33, 34, 852(b)(3)(D)(ii))

IRS Enforcement Initiatives

- Prior Campaign: Notice 2003-38 provided for voluntary compliance
- On January 31, 2017, IRS LB&I announced 13 campaigns to be rolled out
- Form 1120-F Non-Filer Campaign
  - Foreign companies doing business in the U.S. are often required to file Form 1120-F. LB&I has data suggesting that many of these companies are not meeting their filing obligations. In this campaign, LB&I will use various external data sources to identify these foreign companies and encourage them to file their required returns. The treatment stream for this campaign will involve soft letter outreach. If the companies do not take appropriate action, LB&I will conduct examinations to determine the correct tax liability. The goal is to increase voluntary compliance by foreign corporations with a U.S. business nexus.

18-Month Deduction Disallowance Window

- Return was filed for immediately preceding taxable year or it is the first taxable year of the corporation
  - Return must be filed within 18 months of due date
    - For calendar year taxpayer, tax year xxx1, due date for foreign corporations with no office of place of business in the U.S. is June 15, xxx2 (April 15, xxx2 if office in U.S.)
    - So, 18 months after due date is December 15, xxx3 (October 15, xxx3 if office in U.S.)
- No return was filed for immediately preceding taxable year
  - Return due date is the earlier of 18 months after the due date or before IRS notice

18-Month Deduction Disallowance Window

- Generous rule, because not required to file by original or extended due date to obtain deductions
- In addition, additional relief is provided in Treas. Reg. § 1.882-4(a)(3)(ii), discussed later

PENALTIES

Penalties

- Failure to File
- Failure to Pay
- Substantial Understatement

Penalties

- Failure to File (Late Filing)
  - Generally, failure to file penalty is 5% of the tax required to be shown on the return, per month, for a maximum of 5 months (25% maximum penalty)
  - Fraudulent failure to file penalty may be imposed, increasing the penalty to 25% of the tax required to be shown on the return, per month, for a maximum of 3 months (75% maximum penalty)
  - Excused if reasonable cause exists

Penalties

- Failure to Pay (Late Payment)
  - Late payment penalty is applied in addition to failure to file penalty
  - Late payment penalty is .5% of the tax required to be shown on the return, per month, for up to 25 months
  - Late filing penalty is reduced to 4.5% per month in months where both failure to file and failure to pay penalties apply
  - Thus, the maximum penalty for failure to file and failure to pay combined is 47.5% of the tax required to be shown on the return for failures which exist for 25 months or more
  - Excused if reasonable cause exists

Example

	Return Filed after due date but within 18 months	Return Filed after 18 months or IRS Notice
Gross Income	100,000	100,000
Deductions	90,000	-0-
Net Income	10,000	100,000
Tax (35%)	3,500	35,000
FTF (25%)	875	8,750
FTF (fraud – 75%)	2,625	26,250

Penalties

- Substantial Understatement - applies to filed returns
  - Penalty equal to 20% of underpayment attributable to:
    - Negligence - failure to make a reasonable attempt to comply with the Code or disregard (careless, reckless or intentional) of rules and regulations
    - Substantial understatement – numeric test, if understatement exceeds the greater of 10% of tax required to the shown on the return or $5,000

Example

	Timely Filed Return	After IRS Adjustment
Gross Income	100,000	100,000
Deductions	100,000	80,000
Net Income	-0-	20,000
Tax (35%)	-0-	7,000
Substantial Understatement Penalty (20%)		1,400

Penalties

- Substantial understatement penalty does not apply if
  - There is substantial authority for the tax treatment of the item or
  - There is (a) reasonable basis and (b) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return

Substantial Authority

- Treas. Reg. § 1.6662-4(d) “objective standard involving an analysis of the law and the application of the law to the relevant facts”
- To determine whether substantial authority is present, you must evaluate the type(s) of relevant authorities and determine their relevance and persuasiveness
- There can be substantial authority for more than one position

What is Authority?
Treas. Reg. § 1.6662-3(d)(3)(iii)

- Code
- Proposed, temporary and final regulations
- Revenue rulings
- Revenue Procedures
- Tax treaties
- Treasury Department Treaty Explanations
- Court cases
- Congressional intent
- Blue Books
- PLRs/TAMs issued after October 31, 1976
- AODs
- GCMs
- IRS information and press releases
- Other IRS publications included in the IRB

What is Good Authority?

- Need to make sure an authority has not been overruled on appeal, or by statute or regulation
- Tax Court Rulings only overruled by Court of Appeals opinions if the case at issue could be appealed to the Court of Appeals in question or if the Tax Court adopts the position of a Court of Appeals
- *See* Treas. Reg. § 1.6694-2(b)(4) – Court of Appeals decisions

Weight of Authority

- Substantial authority exists if weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment
- The weight accorded an authority depends on its relevance and persuasiveness and the type of document
- Treas. Reg. § 1.6662-4(d)(3)(iii) – conclusions reached in treatises, legal periodicals or opinions rendered by tax professionals are not authority

Reasonable Basis

- Treas. Reg. § 1.6662-3(b)(3) “significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard”

Risk of Audit Irrelevant

- Treas. Reg. § 1.6662-4(d)(2) “The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or reasonable basis standard) is satisfied.”

Disclosed Positions

- Treas. Reg. § 1.6662-4(f):
  - Form 8275 or 8275-R or in accordance with annual Revenue Procedure
  - Treas. Reg. § 1.6662-4(f)(2) provides IRS ability to dictate method of disclosure for certain items
  - Rev. Proc. 2016-13 gives specific method for disclosing certain categories of items including items allocated to ECI and Treaty-Based Return Positions reported on Form 8833
  - Qualified amended returns can also be used to make adequate disclosure (*See* Treas. Reg. § 1.6664-2(c))
- Tax Shelters: generally can't disclose your way out of penalties, Treas. Reg. § 1.6664-2(g)

Reasonable Cause

- Facts and circumstances test, considering taxpayer's efforts to properly assess the tax liability
- Reliance on tax professional's advice is reasonable if you disclosed all facts to the tax professional, hired a competent tax professional, and reasonably relied on the tax professional
- Special reasonable cause rules for failure to file Form 1120-F are included in Treas. Reg. § 1.882-4(a)(3)(ii), discussed later

REPORTING PARTNERSHIP INTERESTS

Reporting Partnership Interests

- When a foreign corporation owns an interest in a partnership that generates income that is effectively connected with a trade or business of the corporation, it must make income method or asset method election to determine how it will compute its outside basis
- Election must be made on a timely filed return
  - Amended returns do not qualify
  - 9100 relief not available

Reporting Partnership Interests

- A protective election may be filed with a protective tax return filed under Treas. Reg. § 1.882-4(a)(3)(vi) to avoid the situation where no election has been made and it is later determined partnership's income should be included in ECI
- If election not timely made, IRS may make election on behalf of corporation and such election is binding on the corporation
  - Further, the consent of the commissioner is required to change an election that has been in place for less than 5 years

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Alison N. Dougherty **February 14, 2017**

http://blogs.aronsonllc.com/fedpoint/2012/06/28/international-tax-series-know-the-basics-of-entity-classification-and-check-the-box-when-forming-or-acquiring-a-foreign-company/

http://blogs.aronsonllc.com/tax/new-u-s-international-tax-reporting-disclosures-required-on-2016-u-s-federal-form-1065-partnership-tax-return/

http://blogs.aronsonllc.com/tax/us-companys-should-process-with-caution-when-filing-tax-returns-with-international-interest/

Allowance of Deductions and Credits to Foreign Corporations

- U.S. Treas. Reg. § 1.882-4
- Foreign corporations engaged in a U.S. trade or business with ECI are allowed to claim deductions properly allocated and apportioned to ECI and credits attributable to ECI.
- Foreign corporations must file a U.S. Federal Form 1120-F to claim deductions and credits.
- Foreign corporations are only entitled to deductions and credits if U.S. Federal Form 1120-F is filed timely.

Timely Filed U.S. Federal Form 1120-F

- Form 1120-F must be filed within 18 months of the original due date (3/15 for calendar year filers) if Form 1120-F was filed for the prior year or if the current year is the first year that return is required to be filed.
- Form 1120-F must be filed within 18 months of the earlier of the original due date or the date when the IRS mails a notice to the foreign corporation if no prior year Form 1120-F was filed.

Protective Filing of U.S. Federal Form 1120-F

- U.S. Treas. Reg. § 1.882-4(a)(3)(vi)
- Foreign corporation has limited U.S. activities and zero gross ECI
- Foreign corporation can file protective Form 1120-F to protect its right to receive the benefit of deductions and credits attributable to ECI if it is determined later that it does have ECI and the original determination that it did not have ECI was incorrect.
- If part of the foreign corporation's activities give rise to U.S. ECI and part does not, then Form 1120-F must be filed timely.

Waiver of U.S. Federal Form 1120-F Filing Deadlines

- U.S. Treas. Reg. Section 1.882-4(a)(3)(ii)
- Relief from Form 1120-F filing deadlines
- IRS can waive filing deadlines if the foreign corporation establishes to the satisfaction of the IRS Commissioner that the foreign corporation acted reasonably and in good faith in failing to file a U.S. tax return including a protective tax return.
- It is not good faith if the foreign corporation knew that it was required to file a U.S. tax return and it chose not to file.

Claiming Relief under U.S. Treas. Reg. § 1.882-4(a)(3)(ii)

- Foreign corporation must cooperate with the IRS in the process of determining its U.S. Federal income tax liability for the tax year for which the Form 1120-F was not filed.

Claiming Relief under U.S. Treas. Reg. § 1.882-4(a)(3)(ii)

- The IRS shall consider the following factors in considering whether the foreign corporation acted reasonably and in good faith in failing to file the U.S. income tax return.
  1. Whether the foreign corporation voluntarily identifies itself to the IRS as having failed to file before the IRS discovers it
  2. Whether the foreign corporation did not become aware of its ability to file a protective return by the deadline for filing
  3. Whether the foreign corporation had not previously filed a U.S. income tax return

Claiming Relief under U.S. Treas. Reg. § 1.882-4(a)(3)(ii)

- The IRS shall consider the following factors in considering whether the foreign corporation acted reasonably and in good faith in failing to file the U.S. income tax return.
  4. Whether the foreign corporation failed to file a U.S. income tax return because after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the corporation was unaware of the requirement to file a return
  5. Whether the foreign corporation failed to file its U.S. tax return because of intervening events beyond its control
  6. Whether other mitigating or exacerbating factors existed

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- Example 1. Foreign corporation discloses its own failure to file. In Year 1, FC became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, FC incurred losses with respect to its U.S. partnership interest. FC's foreign tax director incorrectly concluded that because it was a limited partner and had only loss from its partnership interest, FC was not required to file a U.S. income tax return. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before.

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- Example 1. Foreign corporation discloses its own failure to file. (Continued—Part 2) In Year 5, FC began realizing a profit rather than a loss with respect to its partnership interest and, for this reason, engaged a U.S. tax advisor to handle its responsibility to file U.S. income tax returns. In preparing FC's U.S. income tax return for Year 5, FC's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4.

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- Example 1. Foreign corporation discloses its own failure to file. (Continued—Part 3) Therefore, with respect to those years for which applicable filing deadlines were not met, FC would be barred from claiming any deductions that otherwise would have given rise to net operating losses on returns for those years, and that would have been available as loss carryforwards in subsequent years. At FC's direction, its U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard for waiver of any applicable U.S. Federal Form 1120-F filing deadlines.

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- Example 2. Foreign corporation refuses to cooperate. Same facts as in Example 1, except that while FC's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, FC refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because FC did not cooperate in determining its U.S. tax liability for the taxable years for which an income tax return was not timely filed, FC is not granted a waiver of any applicable U.S. Federal Form 1120-F filing deadlines.

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- Example 3. Foreign corporation fails to file a protective return. Same facts as in Example 1, except that in Year 1 through Year 4, FC's tax director also consulted a U.S. tax advisor, who advised FC's tax director that it was uncertain whether U.S. income tax returns were necessary for those years and that FC could protect its right subsequently to claim the loss carryforwards by filing protective returns. FC did not file U.S. income tax returns or protective returns for those years. FC did not present evidence that intervening events beyond FC's control prevented it from filing an income tax return, and there were no other mitigating factors. FC has not met the standard for waiver of any applicable U.S. Federal Form 1120-F filing deadlines.

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- Example 4. Foreign corporation with effectively connected income. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. FC had minimal business or tax experience internationally, and no such experience in the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC, however, did not file U.S. income tax returns for Year 1 or Year 2. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In January of Year 4, FC engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed FC's U.S. activities and advised FC that it should have filed U.S. income tax returns for Year 1 and Year 2. FC immediately engaged a U.S. tax advisor who, at FC's direction, promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described for waiver of any applicable U.S. Federal Form 1120-F filing deadlines.

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- *Example 5.* IRS discovers foreign corporation's failure to file. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. However, FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. Despite FC's extensive experience conducting similar business activities in other countries, it made no effort to seek advice in connection with its U.S. tax obligations. FC failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In January of Year 4, an Internal Revenue Service examiner asked FC for an explanation of FC's failure to file U.S. income tax returns. FC immediately engaged a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing a return, and there were no other mitigating factors. FC has not met the standard for waiver of any applicable U.S. Federal Form 1120-F filing deadlines.

U.S. Treas. Reg. § 1.882-4(a)(3)(iii) Examples

- *Example 6.* Foreign corporation with prior filing history. FC began a U.S. trade or business in Year 1. FC's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with FC's U.S. trade or business. In Year 7, FC replaced its tax advisor with a tax advisor unfamiliar with U.S. tax law. FC did not file a U.S. income tax return for any year from Year 7 through Year 10, although it had effectively connected income for those years. FC's management was aware of FC's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted FC and asked its chief financial officer for an explanation of FC's failure to file U.S. income tax returns after Year 6. FC immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing a return, and there were no other mitigating factors. FC has not met the standard for waiver of any applicable U.S. Federal Form 1120-F filing deadlines.

Other Points to Consider

- Factors for reasonable cause standard and prior examples apply to open years for which a request for a waiver is filed.
- Foreign corporation with U.S. permanent establishment per U.S. income tax treaty is subject to the filing deadlines.
- IRS can create its own U.S. tax return for the foreign corporation with gross basis taxation and without allowance for deductions and certain credits if a U.S. tax return is not filed.
- IRS can request that foreign corporation furnish information to verify that it is entitled to deductions and credits claimed on the U.S. tax return.

ALISON N. DOUGHERTY
DIRECTOR, TAX SERVICES
ARONSON LLC

Direct (301) 231-6290
Main (301) 231-6200
Email: adougherty@aronsonllc.com
805 King Farm Blvd, Third Floor
Rockville, MD 20850
Washington, DC Metro Area

Alison N. Dougherty provides tax services as a Director at Aronson LLC. Alison specializes in international tax reporting, compliance, consulting, planning and structuring as a subject matter leader of Aronson's international tax practice. She has extensive experience assisting clients with U.S. tax reporting and compliance for offshore assets and foreign accounts. She provides outbound U.S. international tax guidance to U.S. individuals and businesses with activities in other countries. She also provides inbound U.S. international tax guidance to nonresident individuals and businesses with activities in the United States. She has worked extensively in the area of U.S. international tax reporting and compliance with the preparation of the U.S. Federal Forms 5471, 926, 8865, 8858, 5472, 1042, 1042-S, 8621, 8804, 8805, 8813, 8288, 8288-A, 8288-B, 1116, 1118, 1120-F, 1040-NR, 3520, 3520-A, 2555, 5713, 8832, 8833, 8840, 8843, 8854, 8938 and FBAR. She has counseled U.S. taxpayers regarding the outbound formation, capitalization, acquisition, operation, reorganization and liquidation of foreign companies. She has significant experience with U.S. Federal nonresident tax withholding, foreign partner tax withholding and FIRPTA withholding. She works closely with nonresident individuals and businesses regarding inbound U.S. real property investment. She often assists U.S. taxpayers with IRS amnesty program disclosures of offshore assets and foreign accounts.

Alison completed the LL.M. (Master of Laws) in Securities and Financial Regulation in 2004 with academic distinction at Georgetown University Law Center. She completed the LL.M. (Master of Laws) in Taxation in 2000 and the Juris Doctor in 1999 at the University of Denver College of Law. She completed a Bachelor of Arts degree in Foreign Language in 1995 at Virginia Commonwealth University.