Handling Audits of Delinquent International Information Returns

by Steven L. Walker

Steven L. Walker is an attorney in the Law Offices of Steven L. Walker PLC in San Jose, California, and an adjunct professor of law at the University of San Francisco School of Law in the LLM (taxation) program.

In this article, Walker examines strategies for handling an IRS investigation of international information returns, and he recommends ways to improve audits, foster taxpayer compliance, and uphold taxpayers' rights.

I. Introduction

The IRS has been pushing for compliance in the offshore area for some time. It began over 10 years ago with the launch of the offshore voluntary disclosure program in 2009. The IRS offered modified versions of the OVDP in 2011, 2012, and 2014 as more taxpayers came forward to handle their offshore issues from countries around the world. The programs were designed for taxpayers with exposure to potential criminal liability or substantial civil penalties because of a willful failure to report foreign financial assets and pay all tax due on those assets.[1]

In 2014 the IRS launched the streamlined filing compliance procedures for taxpayers whose failure to report foreign financial assets and pay all tax due on those assets did not result from willful conduct. Many eligible taxpayers participated in the streamlined procedures, which offered more taxpayer-friendly terms to handle compliance issues than the OVDP did. There is at least one reported case in which the government indicted an individual for willfully filing a false Form 14654, "Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures."[2] The case is an important reminder that taxpayers should be careful about executing Form 14654 because it's a written declaration made under penalty of perjury, and the IRS scrutinizes them for false statements.

On September 28, 2018, the IRS closed the OVDP. It later issued a memorandum dated November 20, 2018,[3] setting forth updated procedures for all voluntary disclosures (domestic and offshore). The program is no free lunch, but it provides a workable solution for taxpayers with criminal exposure. In the past, taxpayers could make a voluntary disclosure in exchange for filing six years of amended tax returns and typically paying an accuracy-related penalty of 20 percent under section 6662. The reduced penalty was viewed as a carrot to encourage compliance. However, the revised procedures changed the calculus by imposing a civil fraud penalty of 75 percent under section 6663 and asserting willful foreign bank account report penalties under IRS penalty guidelines.[4] Nevertheless, the voluntary disclosure practice provides the best path toward compliance for taxpayers concerned that their conduct is willful or fraudulent and may rise to the level of a tax crime.

II. Offshore Compliance Options to Avoid Audit

As things now stand, a taxpayer has five options to handle offshore compliance issues:

1. IRS streamlined compliance procedures;

[1] *See* IRS website, "Offshore Voluntary Disclosure Program" (archived).

[2] Superseding Indictment, *United States v. Booker*, No. 19-cr-60152 (S.D. Fla. 2019) (involving a violation of section 7206(1)).

[3] LB&I-09-1118-014, "Updated Voluntary Disclosure Practice" (Nov. 20, 2018).

[4] Internal Revenue Manual sections 4.26.16 and 4.26.17.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

2. the delinquent FBAR submission procedures;
3. the delinquent international information return procedures;
4. filing amended or past-due tax returns; and
5. voluntary disclosure practice.

Taxpayers would be wise to take advantage of one of these programs and avoid the risk of an audit.

III. The Cat-and-Mouse Game

Despite the available avenues for relief, there remain taxpayers who have not handled their offshore issues. The IRS is aware of this compliance problem, and practitioners have seen an increase in the number of civil examinations in which the IRS probes for unreported foreign-source income and seeks to impose steep information return penalties.[5]

IRS information return audits are like no other. The investigations begin as a hide-and-seek game in which the agent has information allegedly linking the taxpayer to an undisclosed foreign entity or foreign financial account but will not reveal the legal or factual basis for the IRS's position. The agent often will not provide the name of the foreign entity, the identity of the country where the entity is organized (for example, Switzerland or Israel), or the source of the alleged information linking the taxpayer to the entity. With significant civil penalties at stake, taxpayers question whether they are afforded their rights under the Taxpayer Bill of Rights.[6]

The cases are frustrating and exhausting for both sides. Taxpayers who maintain that they never had any ownership interest in the foreign entity are forced to act and prove a negative ("I don't own it") or run the risk of penalties.[7] Other taxpayers who do have an ownership interest find themselves under a tight timeline as they rush to gather the financial records from overseas and produce them to their U.S. accountant to prepare delinquent forms, which may date back many years. If the agent has issued a penalty notice, all of this must be done in 90 days, or else the taxpayer faces a much larger continuation penalty that can amount to $50,000 per form per year.[8]

If reasonable cause exists for the failure to furnish the information, the taxpayer may submit a reasonable cause statement made under penalty of perjury.[9] The examiner has the discretion to accept or reject the statement.[10] Although an entire section of the Internal Revenue Manual is devoted to penalty relief, some agents take a narrow view of the law and deny relief, leaving taxpayers to wonder what facts would constitute reasonable cause.

The cases are complex and fast-paced. If the agent rejects the taxpayer's request for penalty relief, the case is closed in the field, and a Notice CP15, "Notice of Penalty Charge," is generated and sent to the taxpayer.[11] If the taxpayer wishes to appeal the penalty assessment, he must submit a formal written protest within 30 days from the date of the notice.[12] Small font on the backside of the CP15 notifies the taxpayer of the right to appeal. The language is easy to overlook.

The stakes are high in significant-dollar-penalty cases because of the limited options to resolve the matter before collection. The deficiency procedures do not apply for the assessment or collection of the penalties.[13] For assessable penalties, there is no 30-day letter, no

[5] *See* sections 6038 (information reporting regarding foreign trusts and partnerships), 6038B (notice of transfers to foreign persons), 6039F (notice of large gifts received from foreign persons), 6048 (information regarding foreign trusts), and 6679 (failure to file returns, etc., regarding foreign corporations or foreign partnerships).

[6] IRS website, "Taxpayer Bill of Rights" (Feb. 18, 2020).

[7] A penalty of $10,000 per failure is imposed for each year dating back to the formation of the entity under sections 6036(b) and 6679(a)(1). If the taxpayer fails to file the information return within 90 days after the date the agent issues a penalty notice (*e.g.*, a failure-to-file Form 5471 letter), an additional $10,000 penalty will be imposed for each 30-day period (or fraction thereof) until the complete information return has been filed, but in an amount not to exceed $50,000. The penalty applies to each year of failure. Section 6679(a)(2).

[8] Section 6679(a)(2).

[9] Reg. sections 1.6038-2(k)(3)(ii) and 301.6679-1(a)(3); and IRM section 20.1.9.3.5.

[10] IRM section 20.1.1.

[11] IRM section 20.1.9.3.2.

[12] Section 6679(b) (deficiency procedures not to apply).

[13] IRM section 20.1.9.1.1(2) ("Assessable penalties are paid upon notice and demand.").

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

agreement form, and no notice requirements before assessment. Also, the taxpayer cannot file a petition in the Tax Court and contest the penalty in a prepayment forum, as one can in a routine audit. Practically speaking, the taxpayer must try to resolve the case with the auditor, and if this is not fruitful, file an administrative appeal.

The IRS can assess both an initial $10,000 penalty and a continuation penalty dating back to when the entity was formed. The IRS's position, which may be litigated at some point, is that there is no statute of limitations for assessment.[14] The cumulative effect can be a substantial balance owed in penalties without the government ever informing the taxpayer of the basis for its position (that is, why the IRS contends that the taxpayer has an ownership interest in the foreign entity, or why it rejected the taxpayer's reasonable cause statement). Taxpayers are left wondering what happened to due process of law and the Taxpayer Bill of Rights.

IV. Hypothetical

This article draws from the following example: Assume Mr. Apple receives a letter from the IRS informing him that his 2018 federal income tax return has been selected for examination. The revenue agent issues an information document request and schedules a taxpayer interview at the office of Apple's accountant. Two IRS agents (the revenue agent assigned to the case and her group manager) attend the meeting, and instead of asking questions about the information reported on the tax return, they probe whether Apple has an ownership interest in a foreign entity or any foreign financial accounts. Apple, who is nervous and unsure about where this is going, cautiously denies owning a foreign entity or any offshore accounts. The agents persist but do not reveal the alleged foreign entity's name or the country where the entity is allegedly organized. The accountant, who believes that she prepared an honest and accurate return, eventually refers the matter to tax counsel because the case does not appear to be a routine audit.

V. Understand Where the IRS Is Going

Cases like the one in the hypothetical are anything but routine audits. Typically, the revenue agent working the case is from the special enforcement program (SEP). According to the IRM, "SEP is a specialized compliance program within the IRS and is directed to taxpayers that derive substantial income and intentionally understate their tax liability."[15]

In some instances, the agent may have reasonable indications that unreported income exists before any contact with the taxpayer.[16] The IRS may receive this information from informants or whistleblowers; the Criminal Investigation division; banks filing suspicious activity reports; federal, state, or local law enforcement; or the IRS's information reporting program.[17]

Taxpayers should think twice about trying to "talk their way out" of the problem during an IRS interview. There are no "off the record" conversations; the agents prepare a memorandum, and if the taxpayer makes misstatements, it all gets documented. Inaccurate or false statements during an IRS interview can be challenging to unwind later in the case.

VI. What to Expect

There are behind-the-scenes activities going on, and the agent will not share this information with the taxpayer. Unlike a typical audit in which the agent is focused on unreported income or false deductions, the agent here is investigating three distinct cases, and this can make the case complex and confusing to the uninformed. The agent is trained to work in the following areas simultaneously:

- an income tax examination under title 26 probing for unreported income (income that the taxpayer should have reported and paid tax on);
- an FBAR investigation under title 31 that focuses on whether the individual has failed to report foreign financial accounts (there is

[14] IRM section 20.1.9.1.1(3).

[15] IRM section 4.16.1.1(1).

[16] *Id.*

[17] *Id.*

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

a $10,000 threshold reporting obligation); and

- an information return investigation (for example, Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations"; Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships"; Form 8938, "Statement of Specified Foreign Financial Assets"; Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts"; and Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation") that looks at whether the individual has a reportable interest in a foreign entity.

The cases are not worked serially in the sense that the agent issues a summons and waits to get the records, and then issues a second summons; the examination team moves forward on multiple fronts. The IRS uses all its enforcement tools — the taxpayer is asked for an interview, which is typically followed up with a summons. The IRS will interview tax return preparers, as well as spouses, business partners, and other third parties.

The proper approach is to assume that the government knows a lot of information about the case, and if the taxpayer decides to talk, he must be truthful. Agents don't like false statements.

These cases could have been avoided (and resolved) through making a voluntary disclosure, filing amended returns, or participating in the IRS streamlined procedures. Nevertheless, there are strategies that taxpayers can use to try to minimize or avoid potentially substantial penalties and reach a field closure with a favorable result.

VII. Common-Sense Strategies, Pitfalls to Avoid

A. Interview the Taxpayer Early in the Case

The person who knows the most about the case is the taxpayer. Counsel should interview the taxpayer to fully understand the facts of the case, especially the taxpayer's offshore activities. The interview should be witnessed by at least one other attorney and memorialized in a written memorandum to the file.

The IRS forms and instructions for the information returns provide an excellent source to prepare an outline before the interview. The taxpayer's counsel can walk through each of the common forms with the taxpayer to ascertain whether there was a filing obligation (for example, forms 5471, 8938, 3520, and 926). A *Kovel* accountant[18] with experience in preparing and filing the forms can be quite useful in this process. Expect the agent to be investigating the taxpayer's compliance with the forms behind the scenes, so counsel should be investigating them too. Don't get caught off guard later in the case if, for example, the agent seeks to impose a penalty for an unexpected information return, such as Form 926. Manage the situation and stay one step ahead of the agent.

Practice tip: If the IRS has interviewed the taxpayer, he or she should prepare a written statement protected by the attorney-client privilege detailing who said what during the interview. A taxpayer's memory may fade over time, and a reliable statement can be a useful document to review as the case progresses. This is especially true if the agent later asserts that the taxpayer made false statements during the IRS interview to support the imposition of a civil fraud penalty under section 6663.

B. Interview Client's Accountant, Get File Copy

Expect the agent to serve an administrative summons seeking a copy of the return preparer's file and an interview. The agent wants to know what the taxpayer said (or did not say) about his foreign assets and accounts. Did the taxpayer conceal the existence of unreported foreign-source income or a foreign corporation? Why was the revenue not reported on the return? Who knew what, and when? What documents did the taxpayer provide (or not provide) to the accountant to prepare the tax return? The agent may rely on the accountant's answers and the documents in the file in developing a fraud case.[19]

Tax counsel should stay one step ahead of the agent and obtain a copy of the accountant's file (including the tax organizer), review the information, and then interview the accountant.

[18] *See United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

[19] IRM section 25.1.2.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Determine if the taxpayer's recollection of the events lines up with the accountant's testimony.

Practice tip: The taxpayer should have no "off the record" conversations with the accountant. Although return preparers are often trusted advisers, it is not advisable for the taxpayer to discuss the case with the accountant, even if they have a close relationship. There is no attorney-client privilege, and the agent may ask if the accountant spoke with the taxpayer, and if so, what was said. Conversations with the accountant can only muddy the case.

C. Obtain Entity Formation Documents

Suppose the IRS is investigating the taxpayer regarding Company A located in Country X. The taxpayer may adamantly claim that she has no ownership interest in Company A and has never heard of the entity. Although the taxpayer's testimony may appear credible, tax counsel should proceed with caution, because the IRS likely has some information or a document in the file linking her to the foreign entity. Consequently, the taxpayer's position of "I don't own it," standing alone, may be insufficient to resolve the matter.

The best move is to produce documentary evidence to corroborate the taxpayer's testimony. The taxpayer could sign an affidavit under penalty of perjury and attach, as exhibits, the supporting documents to substantiate the case. There is risk in producing a signed affidavit, and the information should be carefully vetted to avoid any false statements.

The taxpayer's counsel may need to work with local counsel in the foreign country or with third-party contacts to obtain documents *from the foreign country* regarding the formation and ownership of the entity. The core documents should indicate the date that the entity was established, the owner(s) of the entity, and any changes in ownership status (for example, transfer or purchase of shares). Tax counsel may need to have someone search the public records in the foreign country and contact third parties to ask for the records. Each foreign country has its own unique set of documents. Examples of the documents include the following:

- articles of incorporation or association;
- director resolutions;
- register of members and share ledger; and
- purchase or sale documents.

Practice tip: The foreign documents should be carefully reviewed and assembled before being presented to the agent. In complex cases involving holding companies and multiple entities, the taxpayer's counsel may need to draft and produce a legal memorandum to the agent explaining the significance of the documents.

D. Obtain Translated Foreign Documents

It is not enough to simply obtain the documents from the foreign country and turn them over to the agent. If the documents are in a foreign language, the taxpayer should obtain certified translated copies. Although this may be an added expense, if the taxpayer wants to prevail during the audit, the documents should be produced in a format that the agent can readily understand. Make it easy for the agent to rule in the taxpayer's favor and schedule an in-person meeting with the agent to review the foreign documents.

Practice tip: A taxpayer should produce both the original document and a certified translated copy to the agent and provide the contact information of the translator if the agent has questions. Otherwise, the agent may take the position that the foreign documents are not reliable and disregard them, especially if the documents are produced late in the audit and after the agent has asked the taxpayer for his records with little success.

E. Investigate Taxpayer's Acquisition of Interest

The taxpayer may have been one of the original founders of the foreign entity, or the taxpayer may have acquired an ownership interest through purchase or gift years after the entity was formed. Investigate the facts surrounding how and when the taxpayer acquired an ownership interest and obtain the supporting documents. Don't assume that the taxpayer had an ownership interest dating back to the date of formation. This is typically the IRS's default position in a Form 5471 investigation.

Example: Assume Company X was established in 2007, and that the taxpayer purchased Company X from a third party in 2014. The taxpayer should produce the transfer of shares document, director resolutions, and other corporate documents showing the date that she

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

acquired an interest in Company X. Otherwise, the IRS may take the position that Forms 5471 must be filed dating back to 2007.

F. Understand the Foreign Law

The law is the law. Some foreign laws forbid individuals who are noncitizens or nonresidents from having an ownership interest in an entity, such as a limited liability company, partnership, or corporation. Taxpayers should check the foreign law and understand the extent to which a foreigner is legally allowed to own an entity. Foreign law typically can be found online through an internet search. Especially in developing countries, taxpayers should not assume that the law allows them to own the entity.

Practice tip: The foreign law may prove to be the best defense in the case. The taxpayer's counsel should prepare a written memorandum analyzing the foreign law and produce a copy of it to the agent.

G. Review the Client's Domestic Bank Statements

A taxpayer dealing with a foreign entity will at some point want to repatriate the profits. For instance, the taxpayer may want to spend the money or use it to invest in another business venture. One way to repatriate the funds is through a direct wire transfer from a foreign financial account to the taxpayer's domestic bank account. The IRS agent knows to look for inbound wire transfers and will summons the taxpayer's banks to obtain the bank statements for a thorough review. The statements usually reveal inbound and outbound wire transfers, the dollar amount, the date of the transaction, and often the identity of the foreign bank or foreign entity transmitting the funds.

If the taxpayer has received several sizeable wire transfers from a foreign entity or financial institution, the bank may have reported the information to the IRS in a suspicious activity report under the Bank Secrecy Act. Accordingly, the agent may know about the wire transfers, and this may have been a trigger for the IRS investigation.

Practice tip: Obtain the bank statements for the years at issue and perform a careful and tedious review of them. The bank deposit analysis should look for both unexplained deposits (unreported income) and wire transfers. Reviewing the bank statements is a critical step in individual international audits and a way to stay one step ahead of the agent. If large amounts of unreported income are discovered, a strategy call should be made on whether to disclose the issue before the agent discovers it.

H. Search Online for Taxpayer, Foreign Entity

There are websites on which a person can enter the taxpayer's name or the name of a foreign entity and obtain search results. Run an electronic search of the taxpayer's name and the name(s) of any suspected business entities. The taxpayer's name may appear as a director or officer of a foreign corporation. The search results may be surprising and provide insight into why the IRS selected the case for examination in the first place. The search results also may provide important follow-up questions to ask the taxpayer. Agents run the taxpayer's name on databases, and so should the taxpayer's counsel.

I. Inquire Whether the Agent Is Assigned to SEP

If the agent is assigned to the SEP, this indicates that the case will involve not merely a title 26 income tax case probing for unreported income, but also potentially information return penalties and suspected FBAR violations. This can help manage the taxpayer's expectations about the audit and formulate a defensible plan.

J. Timely Respond to IDRs and Summonses

To the extent possible, a taxpayer should timely respond to the agent's requests for information in IDRs and summonses. Further, the taxpayer's response should be documented in a cover letter to the agent. Examiners have discretion whether to assert penalties, and a taxpayer's cooperation during the examination is a factor the agents consider when mitigating penalties.[20] Agents don't like a taxpayer who they view as uncooperative or nonresponsive.

[20] IRM section 4.26.16.6.7(3)(d).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

K. File Delinquent Tax and Information Returns

A U.S. citizen may move overseas for work and unfortunately fall behind on tax reporting obligations. Nevertheless, if a taxpayer has unfiled tax returns for the years at issue in an audit, he should work with an accountant and prepare and file the returns on an expedited basis. Time is of the essence to maintain a good relationship with the agent and help mitigate any penalties.

If the case involves delinquent information returns (for example, form 5471, 8865, or 8938), the agent will issue a penalty letter, such as a "Failure to File Form 5471." The letter informs the taxpayer of the delinquent filing and gives him a limited time (90 days) to submit the delinquent returns or face a continuation penalty. The maximum amount of the continuation penalty is $50,000 per required Form 5471 or Form 8865 — the penalties can stack up.[21]

Practice tip: Once the agent issues a penalty letter, the clock begins to run on the 90 days to submit the delinquent returns. This may prove to be a tight schedule if the information to prepare the returns is located overseas. Consequently, it's advisable to begin preparing the delinquent forms early to avoid a fire drill.

L. Submit a Reasonable Cause Statement

To avoid penalties for late-filed or delinquent information returns, the taxpayer may submit a reasonable cause statement under penalty of perjury. Reg. section 1.6038-2(k)(3) states:

> To show that reasonable cause existed for failure to furnish information as required by section 6038 and this section, the person required to report such information must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement containing a declaration that it is made under the penalties of perjury.

To establish that reasonable cause exists, the person required to report information must be in compliance with all open reporting years (not on extension).[22] For example, the agent will not consider a taxpayer's reasonable cause statement for a delinquent Form 5471 if the taxpayer has unfiled tax returns for years under examination.

A Treasury regulation provides that, to demonstrate reasonable cause, a taxpayer filing a late return must show that he "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time."[23] The IRS Penalty Handbook sets forth various grounds for penalty relief and is worth reviewing when formulating a reasonable cause defense.[24]

The leading case interpreting the terms "reasonable cause" and "willful neglect" in section 6651(a) is *Boyle*.[25] The IRS relies on *Boyle* in penalty relief cases, but some practitioners question whether *Boyle* is still good law in the age of electronic filings and information returns.

Practice tip: There are only a handful of published cases dealing with late-filed information returns because this is a developing area of the law. It is advisable to "Shepardize" *Boyle* to determine the latest developments in the case law before preparing a reasonable cause statement.

M. Issue a FOIA Request

In cases in which it's not clear where the investigation is headed, one option is to obtain a copy of the taxpayer's administrative file (the audit file) by making a request under the Freedom of Information Act. The agency will produce a redacted copy of the file under section 6103. The administrative file should contain a copy of the agent's case activity log, which includes her detailed notes of the audit. The file also should contain a copy of the agent's notes from the taxpayer interview. Both are extremely helpful and provide insight into the inner workings of the case.

Practice tip: Include in any FOIA request an executed Form 2848, "Power of Attorney and Declaration of Representative," for the taxpayer and any related parties or entities at issue in the

[21] IRM section 20.1.9.3.4 ("The maximum continuation penalty for IRC 6038(b) is $50,000 per required Form 5471 or Form 8865.").

[22] IRM section 20.1.9.3.5.

[23] Reg. section 301.6651-1(c)(1).

[24] IRM section 20.1.1.

[25] *United States v. Boyle*, 469 U.S. 241 (1985).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

investigation. Otherwise, the IRS may withhold portions of the administrative file under the disclosure rules. FOIA requests can take several months to process, and it can be frustrating to receive only part of the file because of a missing power of attorney.

N. Schedule Meeting, Present Solid Proof Package

Once the documents are gathered, translated, and assembled, schedule a meeting with the agent and the group manager to present the information in a concise and organized manner. The goal is to reach a field closure, if possible. No case is perfect, and the taxpayer may want to come checkbook in hand and make a reasonable offer to close the case. Resolving the case at the exam level is generally in everyone's best interest.

O. File IRS Appeals Protest Within 30 Days

If a case cannot be resolved with the auditor, a timely written protest should be filed with the IRS Office of Appeals. IRS Publication 5, "Your Appeal Rights and How to Prepare a Protest if You Don't Agree," provides helpful guidance.

VIII. The IRS's Legal Theories in Form 5471 Cases

There are at least two arguments that the IRS may advance in a Form 5471 or Form 8865 investigation to support a finding that the individual had a filing obligation. A taxpayer should anticipate the arguments and be prepared to respond.

A. Constructive Stock Ownership (Indirect)

Even if the taxpayer does not directly own stock in a foreign corporation, the IRS may take the position that the taxpayer indirectly owns the stock through a family member under the code's constructive stock ownership rules.

An individual has a Form 5471 filing obligation when the foreign corporation is a controlled foreign corporation and the individual, who is a U.S. shareholder, directly or indirectly owns more than 50 percent of its stock.[26] Three code sections come into play to determine constructive stock ownership:

- section 957 (CFCs, U.S. persons);
- section 958 (rules for determining stock ownership); and
- section 318 (constructive ownership of stock).

Essentially, section 957(a) defines the term "controlled foreign corporation." It means any foreign corporation if more than 50 percent of the total combined voting power of all classes of its stock or the total value of the stock "is owned . . . or is considered owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation."

Section 958(b) provides rules for determining stock ownership. It states that for purposes of section 957, section 318(a) (concerning constructive ownership of stock) shall apply to the extent that the effect is to treat any U.S. person as a U.S. shareholder within the meaning of section 951(b).

Finally, section 318(a)(1) sets forth the constructive stock ownership rules. It provides that an individual is considered as owning the stock owned, directly or indirectly, by or for specific family members (his spouse, children, grandchildren, or parents).

Practice tip: For the constructive stock ownership rules to apply, the individual holding legal title to the stock must be a family member, as defined under section 318(a)(1). Look to see if this relationship exists, and if not, present a substantiation package to the agent.

B. Nominee Theory

The agent may take the position that the individual holding legal title to the foreign entity is the taxpayer's nominee or agent. Presumably, the government has the burden of proof in establishing a nominee relationship and cannot assert it based on mere suspicion or belief. "A nominee is one who holds bare legal title to property for the benefit of another."[27]

Because the entity under investigation is organized in a foreign country, there may be a threshold legal question about what law applies

[26] Reg. section 1.957-1 (definition of a CFC).

[27] *Fourth Investment LP v. United States*, 720 F.3d 1058, 1066 (9th Cir. 2013) (quoting *Scoville v. United States*, 250 F.3d 1198, 1202 (8th Cir. 2001)).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(that is, whether the nominee doctrine should be governed by foreign law, federal common law, or state law).

For purposes of discussion, California law recognizes nominee ownership. In *Fourth Investment*,[28] the Ninth Circuit set forth the following six-factor test for district courts to consider when applying California nominee law:

1. whether inadequate or no consideration was paid by the nominees;
2. whether the properties were placed in the nominees' names in anticipation of a lawsuit or other liability while the transferor remains in control of the property;
3. whether there is a close relationship between the nominees and the transferor;
4. whether there was a failure to record the conveyances;
5. whether the transferor retained possession; and
6. whether the transferor continues to enjoy the benefits of the transferred property.

"Because no one factor is dispositive, courts are to weigh all of the factors to determine the ultimate issue of 'whether the taxpayer exercised active or substantial control over the property,'" the court stated.[29]

When faced with a nominee argument, the taxpayer should demonstrate that he or she did not retain "the benefit, use, or control over property that was allegedly transferred to a third party."[30] The taxpayer's counsel may have to interview the holder of legal title, fully understand the taxpayer's relationship with the individual, and possibly obtain a supporting affidavit signed under penalty of perjury. The individual may need to be made available for a telephonic interview to support the taxpayer's case.

Trace any flow of the funds from the foreign entity to the taxpayer and investigate:

1. whether the taxpayer received a share of the profits or corporate distributions;
2. whether the audited financial statements show that the taxpayer maintained a capital account or profits interest; and
3. whether the bank statements for the foreign entity show that the taxpayer received funds.

Examples of foreign documents to obtain and review include:

- audited financial statements of a foreign entity;
- foreign bank statements; and
- documents showing the relationship between the taxpayer and the individual who holds legal title.

IX. Recommendations

Information return cases are difficult for both the agents and the taxpayer. There are ways in which the audits can be improved so that the agent can obtain the needed information while not overly burdening the taxpayer and respecting the taxpayer's rights. The Taxpayer Bill of Rights includes:

- the right to be informed;
- the right to challenge the IRS's position and be heard; and
- the right to a fair and just tax system.[31]

See the following suggestions and comments for improving the investigations.

A. Disclose Foreign Entity, Country of Origin First

In many instances, the IRS will not disclose the name of the foreign entity, its country of origin, or the document(s) or other information it has that link the taxpayer to the entity. The first time the taxpayer learns of the entity is when the IRS issues a penalty notice letter. A better course of action is to disclose the entity information upfront in the audit so both sides can work together to resolve the case efficiently.

[28] *Id.* at 1070.

[29] *Id.* (citations omitted). *See also Prompt Staffing Inc. v. United States*, 321 F. Supp. 3d 1157 (C.D. Cal. 2018) (court applied the six-factor test of *Fourth Investment* and held that corporations acted as nominees for the taxpayer's benefit).

[30] IRM section 5.17.14.1.4.

[31] *See* IRS, *supra* note 6.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

B. IRS Should Disclose the Basis of Its Position

The IRS maintains that it can issue a Form 5471 or Form 8865 penalty notice, trigger the running of the 90 days for the imposition of the continuation penalty, and never tell the taxpayer the legal or factual basis for its position. The taxpayer is thus left in the lurch, having to take rapid protective measures to avoid the penalty. The IRS should be required to provide in writing the basis for its position; the process should not be a "shotgun approach" in which the IRS issues one or more penalty letters based on suspicion or belief and without ever allowing a taxpayer to respond to the evidence at hand.

C. Allow Filing of Forms 5471, 8865 Under Protest

Taxpayers may find themselves in a Catch-22 situation if the agent has issued a penalty notice giving the taxpayer 90 days to submit the Form 5471 or Form 8865 or face continuation penalties. The taxpayer has a choice: One option is to file the form to prevent the imposition of continuation penalties, but the IRS may view the filing as an admission. A second option is to not file the form, but the taxpayer runs the risk of owing penalties if the case is unsuccessful. Neither option is good. There should be a procedure to allow a taxpayer to file a protective Form 5471 or Form 8866 under protest in response to a penalty notice.

D. IRS Should Disclose Basis for Rejection

If the IRS rejects the taxpayer's reasonable cause statement and the taxpayer must file a written protest, the IRS should provide the taxpayer with a legal and factual basis supporting its position. Otherwise, how does the taxpayer know what arguments to respond to on appeal? For example, in a routine audit, the agency issues a revenue agent report setting forth the agent's adjustments to income and a written narrative with supporting schedules. The agency's position is clear. This is not the case with information return penalty cases, in which little information is provided.

E. Failure-to-File Penalties Shouldn't Be Automatic

The civil penalties imposed in information return cases for not filing the required forms are substantial, and in many cases punitive. The penalties can drive a taxpayer into bankruptcy or force the taxpayer to sell significant assets, such as a family home.

The agents should be willing to consider a taxpayer's reasonable cause statement and understand that many taxpayers, especially individuals who are not from this country, are unaware of the filing obligation and make mistakes.[32]

F. Penalties Shouldn't Date Back to Formation

The IRS often seeks to impose penalties in a Form 5471 or Form 8865 case dating back to when the entity was formed. The penalties can date back 10 or even 20 years. The dollar amount of the penalties can be substantial. This should be done only in extraordinary cases.

X. Parting Thoughts

In many instances, taxpayers facing complex information return penalty cases simply want to correct the issue, cooperate with the agent, and close the case. As outlined in the updated voluntary disclosure practice memorandum, penalties for the failure to file information returns should not be automatically imposed, and the examination team should exercise discretion.[33] These same rules should apply to field audits. A taxpayer's rights under the Taxpayer Bill of Rights are infringed when the IRS:

1. fails to provide the legal and factual basis for its position that the taxpayer has a filing obligation; or
2. rejects the taxpayer's reasonable cause statement without providing its position in writing for purposes of filing an administrative appeal.

There are easy solutions to the issues raised in this article, and implementing them can foster taxpayer cooperation during the audit, future compliance, and field closure. A civil examination should be a cooperative effort to reach the correct result, not a battlefield. A copy of this article has been provided to the national taxpayer advocate. ■

[32] IRM section 20.1.1.3.2.2.6 ("Reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances.").

[33] LB&I-09-1118-014.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2020 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.