

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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date: September 8, 2006

to: Marsha Stayer  
Revenue Agent

from: David Rakonitz  
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(Large & Mid-Size Business)

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subject: Form 5471 Filing and Penalty for Failure to File

EIN:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Buyer =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Number 1 =

Number 2 =

Taxpayer =

Year 1 =

### ISSUES

1. Is Taxpayer liable for penalties for its failure to file Number 1 Forms 5471 for its short tax year ending Date 3?
2. Should the Internal Revenue Service request that Taxpayer provide Forms 5471 that would accompany its short tax year ending Date 3?

### CONCLUSIONS

1. No. The Treasury Regulations, the Year 1 Instructions to Form 5471 and the statute itself impose limits on section 6038's reporting requirements. Taxpayer must file Forms 5471 for the CFCs with tax years that end with or within Taxpayer's tax year. Since Taxpayer has no CFCs with tax years that end with or within its short tax year, Taxpayer is not legally required to file the Forms 5471 for its short tax year and should not be subject to a penalty under section 6038(b). As explained in the discussion section, none of the CFCs will have tax years that end with or within Taxpayer's shortened tax year.
2. Yes. The Service should request that Taxpayer provide Forms 5471 that would accompany its short tax year ending Date 3. Taxpayer may provide the Forms 5471 that it filed for its previous tax year; it has no legal obligation to file a partial year Form 5471 for the CFC.

### FACTS

Taxpayer, a U.S. corporation, owns 100% of Number 1 foreign corporations that are Controlled Foreign Corporations (the "CFCs") under section 957(a) of the Internal Revenue Code of 1986, as amended.<sup>1</sup> These CFCs qualify as specified foreign corporations under section 898. Taxpayer's tax year goes from Date 1 through Date 2.

On Date 3, Buyer, a U.S. corporation, acquired 100% of the stock of Taxpayer. Buyer's tax year goes from Date 4 through Date 5. Before this acquisition, the CFCs' tax year ended on Date 2. Taxpayer timely filed a final U.S. Corporation Income Tax Return for the short tax year beginning on Date 6 and ending on Date 3. Taxpayer did

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<sup>1</sup> All section references are to the Internal Revenue Code of 1986, as amended.

not include any Forms 5471 with its final return. Taxpayer included a statement entitled "Controlled Foreign Corporations" with a listing of each of the CFCs and taxpayer identification numbers where known. After the acquisition, Taxpayer became part of Buyer's consolidated group.

Buyer filed Forms 5471 for the CFCs with its Year 1 tax return.

In a letter dated Date 7, the Internal Revenue Service notified Taxpayer that it had failed to file Forms 5471 for the tax year ending Date 3. The Internal Revenue Service gave Taxpayer a Notice of Proposed Adjustment dated Date 8 for its failure to file Forms 5471. On Date 9, Taxpayer submitted a response that disagreed with the proposed adjustment.

### LAW AND ANALYSIS

A review of section 6038, the Treasury Regulations, and the instructions for Form 5471 shows that Taxpayer should not be subject to a penalty for failing to file the Forms 5471 because it did not have a legal obligation to file any Forms 5471 with its short year tax return. Taxpayer does not have a legal obligation to file Forms 5471 for its final tax year because the tax years of the CFCs do not end with or within Taxpayer's shortened tax year. Section 6038, its regulations and the instructions for Form 5471 govern when Taxpayer must file a Form 5471. Section 6038(a)(2) states that, "The information required under [section 6038(a)(1)] shall be furnished for the annual accounting period of the foreign business entity ending with or within the United States person's taxable year. The information so required shall be furnished at such time and in such manner as the Secretary shall provide." This language also appears in the regulations and the instructions for Form 5471.

As discussed below, the regulations for section 6038 specifically reference and incorporate Form 5471. This memorandum first examines the relevant statute and regulations and then examines the instructions for Form 5471.

#### A. Statute and Regulations

Section 6038 sets out in broad terms the type of information that the Internal Revenue Service may request from a person controlling one or more foreign corporations or foreign partnerships. Treas. Reg. section 1.6038-2(f) and Treas. Reg. section 1.6038-2(g) specifically reference Form 5471 when describing what should be included on the Form 5471 and what information a taxpayer should include with the Form 5471. Under these regulations, a taxpayer must look to Form 5471 to determine the form and manner of providing the required information to the Internal Revenue Service.

Treas. Reg. section 1.6038-2(e) states in part, "The information required under [Treas. Reg. section 1.6038-2(f) and Treas. Reg. section 1.6038-2(g)] with respect to a foreign corporation shall be furnished for the annual accounting period of the foreign

corporation ending with or within the United States person's taxable year." This sentence imposes certain limits on which foreign corporations a taxpayer places on a Form 5471. Unless another rule applies, a foreign corporation will not be included on a Form 5471 if its tax year does not end with or within the U.S. person's taxable year. Taxpayer has not sold its interests in the CFC and should not be subject to the rules governing the sales of controlled foreign corporations. In order for Taxpayer to be subject to a penalty, a CFC's annual accounting period must end with or within Taxpayer's short tax year in order for Taxpayer to have a requirement to file a Form 5471.

Under Treas. Reg. section 1.6038-2(e), a foreign corporation's annual accounting period is the annual period which the foreign corporation uses regularly to compute its income in keeping its books. For specified foreign corporations, such as the CFCs, their taxable year is treated as their annual accounting period. The regulation specifically permits CFCs to have short tax years but effectively directs the reader to section 898 to determine when the taxable year for a specified foreign corporation begins and ends.

Before Buyer acquired Taxpayer, the CFCs had taxable years ending Date 2, the same as Taxpayer, because section 898(c)(1)(A)(i)<sup>2</sup> requires that specified foreign corporations have the same tax year as the majority U.S. shareholder. Section 898(c)(1)(C) defines the majority U.S. shareholder year. On the testing day, one determines whether the tax year of the specified foreign corporation should change. Section 898(c)(1)(C)(ii) provides that testing days are a) the first day of the specified foreign corporation's taxable year determined without reference to section 898 and b) "the days during such representative period as the Secretary may prescribe." If Date 10 was not a testing day, the CFC's taxable years would not change and would continue to end on Date 2. Taxpayer's short year goes from Date 6 through Date 3. If left unchanged, the CFCs' tax year ends on Date 2 which is outside of Taxpayer's short year. Accordingly, there would be nothing to report for the short year, and Taxpayer would not need to file any Forms 5471. If the proposed regulations for section 898 were effective, the proposed regulations would treat Date 10 as a testing day; that discussion is below.

#### 1. Proposed Section 898 Regulations

Proposed Treas. Reg. section 1.898-3(a)(5)(iii) states in part that "a specified foreign corporation must determine its majority U.S. shareholder year on each day . . . on which a substantial change occurs in the United States ownership of the stock of the specified foreign corporation." This occurs when there is a new more than 50 percent United States shareholder of the foreign corporation. Section 898(b)(3) references section 951(b) for the meaning of the term "United States shareholder." Under section 951(b), a

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<sup>2</sup> This version of section 898(c)(1) applies to the tax year in question. P.L. 108-357 amended section 898(c) for tax years of foreign corporations beginning after December 31, 2004 and to tax years of U.S. shareholders with or within which such tax years of foreign corporations end. The modification to section 898(c) is not substantive for the purposes of this memorandum.

United States person includes a U.S. corporation. Section 958(b) provides that constructive ownership rules of section 318 shall generally apply to section 951(b). Treas. Reg. section 1.958-2(c)(1)(iii) states in part:

If 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. . . .

Buyer accordingly constructively owns all the CFCs, which are 100% owned by Taxpayer. Under Treas. Reg. section 1.958-2(c)(1)(iii), Buyer will be treated as the new majority shareholder of the CFCs for the purposes of section 951(b) and by extension section 898. Taxpayer became part of the consolidated group on Date 10, the day after the acquisition. Date 10 is, thus, a testing date under the proposed regulations, and the CFCs must identify the majority shareholder in order to determine their taxable year.

Since Buyer is the new more than 50 percent United States shareholder and Date 10 is the testing date, the CFCs should adopt its Date 5 tax year as their own. Under the proposed regulations, the CFCs' tax years ending Date 5 would again be outside of Taxpayer's short year and Taxpayer would have nothing to report for the short tax year. One could argue that Taxpayer, not Buyer, remains the majority shareholder at the moment that it files its final return. There is no issue of two majority shareholders because Buyer has not acquired Taxpayer at the moment that Taxpayer is filing its return. The problem with this approach is that it ignores the tax year of the new majority shareholder who is responsible for triggering the testing date, and there is no legal basis to ignore Buyer. Another problem with this argument is that it is based on proposed regulations that are not yet effective. Accordingly, since there is no other support for this approach, the better position is that Buyer is the new majority shareholder, and the CFCs should use its tax year.

#### B. Instructions for Form 5471

At first glance, the instructions for Form 5471 seem to require Taxpayer to file Form 5471. Taxpayer clearly qualifies as a Category 4 Filer, which includes domestic corporations that control a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation. The Year 1 instructions for Form 5471, however, have a comparable sentence to the language in Treas. Reg. section 1.6038-2(e). The instructions state, "Except for information contained on Schedule O, report information for the tax year of the foreign corporation that ends with or within your tax year."<sup>3</sup> The instructions shed no light on who is the majority shareholder and what is the tax year of the CFCs. Taxpayer is not a Category

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<sup>3</sup> A taxpayer uses Schedule O to report the organization or reorganization of a foreign corporation and the acquisition or disposition of its stock.

3 Filer because it has not disposed of any of the CFC stock and remains the owner of the CFCs.

In light of this analysis, Taxpayer should not be penalized for failing to file the Forms 5471. We recommend that you withdraw the Notice of Proposed Adjustment that imposes a \$ Number 2 penalty on Taxpayer for failing to file Form 5471s with its short year tax return. We, however, believe that Taxpayer should submit to you the Forms 5471 from its last year.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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