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memorandum**

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subject: Reasonable Cause Relief for Small Corporations under Treas. Reg. § 1.6038A-4(b)(2)(ii)

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

ISSUES

Section 6038A(d) of the Code establishes a monetary penalty for the failure to furnish information or to maintain records as required by § 6038A and related regulations. Certain failures, including failures to timely file an information return on Form 5472 as required under Treas. Reg. § 1.6038A-2 and to maintain records as required under Treas. Reg. § 1.6038A-3, may be excused for reasonable cause. Treas. Reg. § 1.6038A-4(b)(2)(ii) provides a special rule stating that relief for reasonable cause shall be applied “liberally” in the case of a small corporation meeting certain requirements (“small-corporation provision” or “SCP”). When does a corporation qualify for liberal application of the reasonable cause exception under the SCP, and what does it mean to “apply the reasonable cause exception liberally” in this context?

LEGAL BACKGROUND

Code

Section 6038A requires certain corporations to report certain related-party transactions and maintain relevant records. Specifically, § 6038A(a) provides:

If, at any time during a taxable year, a corporation (hereinafter in this section referred to as the “reporting corporation”)—

(1) is a domestic corporation, and

(2) is 25-percent foreign-owned,

such corporation shall furnish, at such time and in such manner as the Secretary shall by regulations prescribe, the information described in subsection (b) and such corporation shall maintain (in the location, in the manner, and to the extent prescribed in regulations) such records as may be appropriate to determine the correct treatment of transactions with related parties as the Secretary shall by regulations prescribe (or shall cause another person to so maintain such records).

Section 6038A(d)(1) provides for a penalty of \$25,000 for the failure to furnish such information¹ or maintain such records, and § 6038A(d)(2) provides for an additional \$25,000 penalty for each 30-day period (or fraction thereof) that the failure continues beyond 90 days from IRS notice of the failure to the taxpayer.²

Section 6038A(d)(3) provides an exception to these penalties for “reasonable cause.” This exception is structured as extending the corporation’s time to comply before the penalty applies:

For purposes of this subsection, the time prescribed by regulations to furnish information or maintain records (and the beginning of the 90-day period after notice by the Secretary) shall be treated as not earlier than the last day on which (as shown to the satisfaction of the Secretary) reasonable cause existed for failure to furnish the information or maintain the records.

Regulations

Pursuant to Treas. Reg. § 1.6038A-1(b), the reportable information is to be furnished on Form 5472 annually.

¹ A failure to furnish such information includes failure to file a Form 5472 as well as the filing of a substantially incomplete Form 5472. See Treas. Reg. § 1.6038A-4(a).

² “Taxpayer” includes a reporting corporation, regardless of whether it owes any taxes in any particular year.

Treas. Reg. § 1.6038A-4 provides rules for application of the monetary penalty for noncompliance with the reporting and record maintenance requirements of § 6038A. Treas. Reg. § 1.6038A-4(a)(1) provides that, in general:

If a reporting corporation fails to furnish the information described in §1.6038A-2 within the time and manner prescribed in § 1.6038A-2(d), fails to maintain or cause another to maintain records as required by § 1.6038A-3, or (in the case of records maintained outside the United States) fails to meet the non-U.S. record maintenance requirements within the applicable time prescribed in § 1.6038A-3(f), a penalty of \$25,000 shall be assessed for each taxable year with respect to which such failure occurs.

Under Treas. Reg. § 1.6038A-4(b), the reasonable cause exception applies only if an affirmative showing is made that (i) the taxpayer acted in good faith and (ii) there is reasonable cause for a failure that results in the assessment of the monetary penalty. The affirmative showing is required of all reporting corporations and must be made “to the satisfaction of the Secretary” pursuant to § 6038A(d)(3). The requisite showing is further described in Treas. Reg. § 1.6038A-4(b)(2).

Treas. Reg. § 1.6038A-4(b)(2)(i) provides that “the reporting corporation must make an affirmative showing of all the facts alleged as reasonable cause for the failure in a written statement containing a declaration that it is made under penalties of perjury.” Under Treas. Reg. § 1.6038A-4(b)(2)(iii), the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. The regulation goes on to provide:

Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer. Isolated computational or transcriptional errors generally are not inconsistent with reasonable cause and good faith. Reliance upon an information return or on the advice of a professional (such as an attorney or accountant) does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable.

In determining whether a taxpayer acted with reasonable cause, Treas. Reg. § 1.6038A-4(b)(2)(ii) provides rules in the case of “small” corporations, a subset of reporting corporations. Treas. Reg. § 1.6038A-4(b)(2)(ii) provides as follows:

The District Director shall apply the reasonable cause exception liberally in the case of a small corporation that had no knowledge of the requirements

imposed by section 6038A; has limited presence in and contact with the United States; and promptly and fully complies with all requests by the District Director to file Form 5472, and to furnish books, records, or other materials relevant to the reportable transaction. A small corporation is a corporation whose gross receipts for a taxable year are \$20,000,000 or less.

This rule for small corporations mirrors nearly verbatim a relevant passage from the legislative history of § 6038A (at the time, the predecessor to the current versions of §§ 6038A and 6038C), which states:

The committee expects that such reasonable cause exceptions will be allowed liberally in cases of small corporations that (1) had no knowledge of the requirements imposed by section 6038A, (2) have limited presence in and contact with the United States, and (3) promptly, fully and completely comply with all IRS requests (including requests to the corporation on behalf of any related foreign party) to furnish books, records, and other data that may be relevant or material to any reportable transaction.

H.R. REP. 101-247, 101st Cong., 1st Sess. at 729 (1989); *see also* S. PRT. 101-56, 101st Cong., 1st Sess. at 117 (1989).

ANALYSIS

You have asked (1) how a taxpayer qualifies for the SCP and (2) what it means to apply the reasonable cause exception “liberally” in the case of a qualifying small corporation per Treas. Reg. § 1.6038A-4(b)(2)(ii).

1. Whether a Taxpayer Qualifies for the Small-Corporation Provision

For a taxpayer to receive reasonable cause relief utilizing the SCP, the Secretary must first determine that the requirements of the SCP described in Treas. Reg. § 1.6038A-4(b)(2)(ii) are met. We expect that this determination typically would be made on the basis of a written statement signed under penalties of perjury, as described in Treas. Reg. § 1.6038A-4(b)(2)(i), and the interactions between the taxpayer and the IRS. The existence of reasonable cause for a corporation’s failure to furnish the information or to maintain the necessary records must be shown “to the satisfaction of the Secretary.” I.R.C. § 6038A(d)(3).

There are four prerequisites for the SCP, which, conforming to the standard of proof under section 6038A(d) generally, should be established to the satisfaction of the Secretary before the reasonable cause relief may be applied “liberally.” First, a taxpayer must have overall gross receipts of \$20,000,000 or less for the taxable year.³

³ Treas. Reg. § 1.6038A-4 does not explain how to calculate a taxpayer’s gross receipts for this purpose. There is a different “small corporation exception” under Treas. Reg. § 1.6038A-1(h), which applies only to

Second, the taxpayer must establish lack of knowledge of section 6038A requirements. Third, the taxpayer must establish limited presence in and contact with the United States. Fourth, the taxpayer must establish full and prompt compliance with IRS requests to file Form(s) 5472 and to provide materials relevant to the reportable transaction(s). A corporation that lacked knowledge of the requirements imposed by § 6038A may not be aware of the existence of the SCP. Nonetheless, the taxpayer may have the ability to meet the requirements, even if unaware of them. Where a taxpayer establishes that it has met the four prerequisites, then the SCP applies, and the IRS shall accordingly apply the reasonable cause exception liberally.⁴

In determining whether the taxpayer established a lack of knowledge of the section 6038A requirements, the IRS could consider factors including, but not limited to, whether any Forms 5472 had been previously filed by the taxpayer and whether any party that owned or controlled the taxpayer at the time the Form 5472 was due owned or controlled any other entity that had filed a Form 5472.

In determining whether the taxpayer's presence in and contact with the United States was limited, the IRS could consider factors including, but not limited to, the experience and location of the taxpayer's corporate officers and managers, the number and size of transactions with customers located in the United States, and the degree to which the taxpayer's operations involved interactions with individuals, businesses, and federal, state, and local governments in the United States.

In determining whether the taxpayer's corrective measures are satisfactory, the IRS could consider factors including, but not limited to, how timely the taxpayer responded to requests by the IRS to file Forms 5472 and to furnish the relevant materials, how complete the responses were, whether there was a need to follow up multiple times to receive necessary details, and whether information supplied was consistent or any changes were adequately justified.

If a taxpayer seeks relief under the SCP but fails to satisfy all of its prerequisites—and thus is not entitled to “liberal” application of the reasonable cause exception—the IRS should consider whether the taxpayer nevertheless satisfies the general reasonable cause standard described in Treas. Reg. § 1.6038A-4(b).

certain reporting corporations having “U.S. gross receipts” less than \$10,000,000 but which has no effect on the reasonable cause rules, instead exempting such a reporting corporation from Treas. Reg. § 1.6038A-3 record-maintenance and Treas. Reg. § 1.6038A-5 authorization-of-agent requirements. Treas. Reg. § 1.6038A-1(h) provides limited guidance for measuring “U.S. gross receipts” in the context of determining that exception's applicability (*e.g.*, aggregation of gross receipts of related reporting corporations). Note, however, that the SCP looks to overall gross receipts, not just U.S. gross receipts.

⁴ The IRS may consider adopting a policy of inquiring about the facts needed to evaluate application of the SCP if the facts and circumstances of the case indicate the SCP may be relevant, even where the taxpayer does not initially or formally raise the provision as a basis for relief. Such facts and circumstances should be duly corroborated before relief is provided.

2. “Liberal” Application of the Reasonable Cause Exception

A “liberal” application of the reasonable cause exception has bearing on the IRS’s level of scrutiny in considering a taxpayer’s request for reasonable cause relief. In an ordinary case, the requisite showing in support of reasonable cause relief under Treas. Reg. § 1.6038A-4(b)(1) has two components that the taxpayer must establish to the satisfaction of the Secretary: (i) a showing that the taxpayer acted in good faith; and (ii) a showing that reasonable cause existed for the failure that would otherwise result in the imposition of a monetary penalty. In the case of a taxpayer that has established the SCP factors, the IRS ordinarily would be justified in finding that it is appropriate to grant reasonable cause relief. Although the SCP does not eliminate the requisite showing requirements under Reg. § 1.6038A-4(b)(1), qualifying for the SCP makes it easier for a taxpayer to establish that reasonable cause relief should be granted.

As provided in § 6038A(d)(3), a finding of reasonable cause (whether under the general standard or under the SCP) has the effect of extending the taxpayer’s deadline to furnish information described in § 6038A(b) or to maintain records as required by § 6038A(a) without a penalty. It does not excuse the taxpayer from the requirement to file Form 5472 or maintain records, nor from IRS requests for information. In other words, the “liberalness” of the SCP relates only to whether reasonable cause relief is applicable in the particular case, and not, for example, to the level of compliance that is ultimately required.⁵

There is no Code definition of the word “liberally,” but the pertinent dictionary definition of “liberal” includes “marked by generosity: openhanded,” and “not strict or exact.” *Merriam-Webster.com Dictionary*, <https://www.merriam-webster.com/dictionary/liberal> (accessed October 22, 2024).⁶

Applying this plain-language definition, the IRS would be justified in concluding that a small-corporation taxpayer had reasonable cause (and, accordingly, removing associated section 6038A(d) penalties) if the taxpayer promptly and fully cooperated in filing Forms 5472 and furnished relevant information on request and if the taxpayer’s written submission (signed under penalties of perjury) establishes the other factors described in Treas. Reg. § 1.6038A-4(b)(2)(ii) to the satisfaction of the Secretary. This does not mean, however, that it would be appropriate for the IRS to grant relief based upon a conclusory submission by the taxpayer with no supporting factual representations or evidence, or to ignore known facts that cast doubt on the veracity or completeness of the taxpayer’s written statement or on the taxpayer’s good faith. Absent such problems, the IRS would generally be justified in determining that

⁵ The SCP also does not address the amount of the penalty that would apply if reasonable cause relief is not granted. Nor does the SCP apply to other penalty regimes, such as “accuracy-related” penalties under section 6662, although the underlying facts and circumstances of the case may be relevant to abating various penalties.

⁶ The Black’s Law Dictionary (12th ed. 2024) entries for “liberal” and “liberal interpretation” are broadly consistent with this meaning.

reasonable cause relief could be granted on the basis of the taxpayer's submission(s) without further inquiry or investigation.

Please call (202) 317-4382 (Michelle Philips) or (202) 317-5457 (Anand Desai) if you have any further questions.