

# Tips for Preparing the Form 5471 for Controlled Foreign Corporations

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It may be a cliché that the world is getting smaller, but it is true that interaction among people around the globe has become much easier, faster, and far less expensive than even a dozen years ago. Thanks to these changes, and with the help of a variety of international trade agreements, an increasing number of U.S. businesses are expanding into other countries.

However, the U.S. income tax system is generally based on assumptions about a relatively closed society that were made as far back as the introduction of the modern income tax nearly a century ago.<sup>1</sup> The United States is the only major industrial country that imposes income and estate tax on its citizens without regard to where they reside.<sup>2</sup> All other industrial nations that have an income tax system use a territorial approach in which only residents are subject to the income tax.

Because of the unique approach to the taxation of citizens and entities based in the United States, any U.S. person<sup>3</sup> that ventures offshore potentially can be taxed by two countries on the same income. This has resulted in the introduction of numerous tax code provisions designed to avoid the potential for double taxation. Over the past 95 years, Congress has also seen fit to introduce an assortment of rules to prohibit tax avoidance through the use of foreign entities.

For those who do not work extensively in the niche of international taxation, these rules are novel and involve unfamiliar code sections, regulations, tax forms, instructions, and challenges. Some of the obstacles that a preparer may encounter include:

- Constructive ownership is a pervasive problem in international tax law.
- Tax returns for U.S. and foreign entities may involve the application of treaty benefits.
- Clients may be subject to a combination of passthrough and tax-deferred earnings.
- U.S. and foreign tax withholding regimes can be complex.
- Sec. 482 controlled group allocations and transfer pricing may require the engagement of a specialist.
- Multiple reporting of foreign bank accounts is possible.
- The inadvertent creation of a permanent establishment in a nonresident

1 The current income tax system is the third in the history of the United States. The first was introduced during the Civil War and was repealed a few years after the end of that conflict (Internal Revenue Act of 1862, ch. 119, 12 Stat. 432). The second was introduced and passed in 1894, but the Supreme Court struck it down as unconstitutional (*Pollock v. Farmers' Loan and Trust Co.*, 158 U.S. 429 (1895), *aff'd* on rehearing,

158 U.S. 601, striking down the Wilson-Gorman Tariff of 1894, ch. 349, 28 Stat. 570).

2 Many other major countries do impose a worldwide income tax on their permanent residents, but that burden can be overcome by a change in permanent residence.

3 Sec. 7701(a)(1) defines a person as including individuals, trusts, estates, partnerships, and corporations.

country can cause extremely undesirable tax results.

- Foreign accounting methods often substantially differ from U.S. methods.
- There are complex foreign tax credit limitations.
- There are special rules for oil, insurance, securities, and exporting.
- There may be traps for the uninformed or the unwary, including complex tax election requirements (e.g., foreign tax credit, check-the-box elections, and Sec. 362(e)(2)(C) basis elections in certain Sec. 351 transactions).
- Accounting records may require conversions of multiple currencies.
- Extensive details are required for any intercompany transactions and for ownership and ownership changes.
- Larger U.S. companies may have complex transfer pricing problems.
- Larger U.S. companies must report the impact for foreign taxes on earnings per share as well as FIN 48 accounting application standards.

## Form 5471

### Who Must File Form 5471

Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, is designed to report the activities of the foreign corporation and to function as a roadmap for the IRS on transfer pricing. The first problem the practitioner encounters with Form 5471 is determining whether a client is required to file the form. The IRS instructions identify the categories<sup>4</sup> of filers based on various ownership percentages or changes in ownership of the corporation. Practitioners are also often confused because the form is not actually limited to the U.S. owners of a *controlled* foreign corporation.<sup>5</sup> In some instances, an officer or director who is not an owner is required to file Form 5471.

Another common source of confusion can arise from the treatment of a foreign limited liability company as a foreign

corporation in the absence of an entity classification election to be treated as either a foreign partnership (multiple owners) or a foreign disregarded entity (one owner). In addition, some practitioners are not familiar with the nature of an international business company, which is the same as a corporation for U.S. tax purposes. Furthermore, some practitioners are not familiar with the term “*per se* corporations,” which are certain foreign entities mandatorily treated as corporations for U.S. federal income tax purposes.<sup>6</sup>

Another complication is that ownership is based on constructive ownership among family members and attribution of ownership by entities controlled by the taxpayer. In some instances, an indirect owner may be required to file Form 5471.<sup>7</sup>

The failure to timely file Form 5471 can cause the IRS to assess significant penalties against the taxpayer. A penalty in the amount of \$10,000 can be imposed for each accounting period on each foreign corporation that fails to file and substantially complete Form 5471 on a timely basis.

The IRS recently announced that it will automatically assess penalties (subject to certain procedural rules) for late-filed Forms 1120, U.S. Corporation Income Tax Return, that contain Form(s) 5471 even if the U.S. corporation has a loss or zero earnings.<sup>8</sup>

### Information Required

Form 5471 requires more information and details than the Forms 1065, U.S. Return of Partnership Income, or 1120:

- Ownership information;
- Stock transactions (Schedules A, B, M, and O);
- Shareholder and company transactions (Schedule M);
- Foreign tax details (type of tax, amount, and tax base);
- Foreign bank and financial account information;
- Details of accumulated earnings and profits (such earnings and profits calculations can be complex); and

## EXECUTIVE SUMMARY

- Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, is designed to report the activities of the foreign corporation and to function as a roadmap for the IRS on transfer pricing.
- Form 5471 requires information and details about the corporation’s ownership, stock transactions, shareholder and company transactions, foreign taxes, foreign bank and financial accounts, accumulated earnings and profits, and currency conversions.
- Preparation of Form 5471 requires consideration of a number of issues and concepts that do not apply to domestic corporations, including subpart F income, foreign tax credits, and transfer pricing.
- Foreign corporations that are required to file Form 5471 may be required to file a number of other forms specific to foreign corporations.

- Currency conversion information.  
The preparer needs to secure information from the client for all the owners with details of any stock transactions, dividends, or other capital transactions.

4 There are five categories of filers, but the filing requirement for Category 1 filers (officers, directors, and shareholders of foreign personal holding companies) was repealed by the American Jobs Creation Act of 2004, P.L. 108-357.

5 A U.S. shareholder is defined in Secs. 951(b) and 953(c), a foreign corporation in Sec. 7701(a)(5), and a controlled foreign corporation in Sec. 957(a).

6 Regs. Sec. 301.7701-2(b)(8)(i).

7 The AICPA Practice Guide on Form 5471, Information Return of U.S.

Persons with Respect to Certain Controlled Foreign Corporations (CFCs), offers some clarifications of these issues that are not found in the IRS instructions to Form 5471.

8 For more on this subject, see Gurene, “Automatic Penalty Assertions Begin for Delinquent Forms 5471,” Tax Clinic, 40 *The Tax Adviser* 15 (January 2009). The AICPA is working with the IRS to provide further guidance for such procedures.

Even dormant foreign corporations must file Form 5471. However, certain summary elective filing procedures apply to certain dormant foreign corporations under Rev. Proc. 92-70.<sup>9</sup>

Transaction details are also required for any transactions between any shareholders of the foreign corporation and any related entity or person. An extensive list is provided in Schedule M of the Form 5471; it includes intercompany sales or purchases, compensation, rents, license fees, royalties, dividends, loans, and interest. This detail is required for the foreign corporation's transactions with 10% or greater U.S. shareholders and any entities controlled by those shareholders.

If the foreign company has paid any taxes to a foreign jurisdiction, it is necessary to know if the taxes are based on income or on gross sales and to identify the taxes paid and the income subject to the foreign tax in each jurisdiction. In many cases, the preparer will also need details of income and expenses (including interest) on a country-by-country basis if the company operates in multiple countries.

The U.S. officers and directors and certain U.S. shareholders may be required to report all the bank and financial accounts of the foreign corporation on Treasury Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. That form requires information about the name, location, and account number of each foreign financial account. The form is filed with the Treasury Department separate from the corporation's income tax return.

Unlike Form 1120, Form 5471 includes Schedule J, Accumulated Earnings and Profits (E&P) of Controlled Foreign Corporation, which reconciles the accumulated earnings and profits from the beginning of the year to the end of the year and isolates earnings and profits for different categories of income.

If the foreign corporation keeps its records in a non-U.S. currency, it must convert the values to U.S. dollars. However, in the income statement, the corporation must report items of income and deductions

in both the functional (local) currency and U.S. dollars.

## Accounting Issues

Form 5471 presents return preparers with a number of novel accounting issues that they do not encounter in working with Form 1120.

The regulations and instructions to Form 5471 state that certain parts of the return must be prepared in accordance with U.S. GAAP, even if the foreign corporation does not otherwise keep U.S. GAAP books and records. Although the AICPA is working to encourage the IRS to accept IFRS statements in lieu of U.S. GAAP, the IRS has not yet announced that any deviation is permitted.

Currency conversions complicate the preparation of the financial data required to prepare the Form 5471. A corporation is required to present the income statement and statement of taxes paid in the local (functional) currency and in U.S. dollars. Balance sheet data are shown only in U.S. dollars. Special rules apply when a foreign corporation is doing business in a country with hyperinflation.

Various deductions permitted for businesses in the United States are either not allowed (such as Sec. 179) or are limited (such as depreciation, which must be on a straight-line basis for foreign assets) for foreign corporations.

Dividends received from foreign subsidiaries may be treated as active trade or business income rather than as passive investment income by looking through the dividends of the subsidiary to its earnings. If the dividend is a distribution to the parent of earnings from an active trade or business, the dividend will not be treated as passive income and thereby subject to current tax by the U.S. shareholders.

## Foreign Corporation Tax Concepts Encountered on Form 5471

A practitioner preparing Form 5471 will encounter many tax concepts that are not encountered when preparing returns for

domestic corporations. Some of the most important of these are discussed below.

## Subpart F Income

The primary legislative purpose of the controlled foreign corporation (CFC) tax rules is to prevent the avoidance of U.S. taxes on what is perceived to be easily portable income. Prior to 1962, U.S. corporations and investors could transfer assets to a foreign corporation that could then invest those funds on a tax-deferred basis. Or, in the case of a U.S. business, profits could be easily diverted to a corporation in a low or zero tax country by overpricing goods or services sold to a foreign subsidiary or underpricing goods or services purchased from a foreign subsidiary.

To prevent this type of tax deferral, Congress passed the subpart F tax rules, which essentially imposed a tax on certain U.S. shareholders of CFCs.<sup>10</sup> Even though the U.S. shareholders receive no distribution from the foreign company, they are subject to tax on their share of the CFC's subpart F income. This category of income includes:

- Passive investment income;
- Related-party sales income;
- Related-party services income; and
- Certain insurance and oil-related income.

By default, if the CFC has non-subpart F income from an active trade or business in a foreign country, the tax on that net income is deferred until the profits are repatriated to the U.S. owners. Consequently, a CFC may have all its income subject to current tax, all its income tax deferred, or some infinite combination of the two.

## Tax Credits

Because the United States imposes a tax on the worldwide income of its citizens, permanent residents, and legal entities, the tax law provides for a credit against U.S. taxes for income taxes paid to foreign countries on the same income.<sup>11</sup> However, generally only corporate owners of foreign entities that are treated as corporations for U.S. tax purposes are allowed to claim a credit for taxes paid by a subsidiary corporation. Absent a check-the-box

<sup>9</sup> Rev. Proc. 92-70, 1992-2 C.B. 435.

P.L. 87-834, §12).

<sup>10</sup> Subpart F, Secs. 951-965 (originally enacted by the Revenue Act of 1962,

<sup>11</sup> Sec. 901.

election, where the foreign corporation is owned by an individual or unincorporated entity, the foreign taxes paid reduce the earnings in the same way as other expenses but cannot be claimed as a tax credit. In addition, where the income subject to foreign taxation is not currently distributed to the U.S. owners, the tax credit (for a corporate owner) is also deferred until the income is repatriated to the United States.

## Transfer Pricing

The regulations under Sec. 482 provide a complex set of detailed guidelines for the application of Sec. 482 to a variety of related-party transactions. These transactions can include loans and advances, services, use of intangibles, cost-sharing agreements, and intercompany sales of tangible personal property. Generally, under these regulations, the taxpayer is required to employ the “best method,” which is the method that produces the most accurate results among the following:<sup>12</sup>

1. The comparable uncontrolled price method;
2. The resale price method;
3. The cost-plus method;
4. The comparable profits method;
5. The profit-split method; and
6. Other methods indicated for specific cases.<sup>13</sup>

The IRS also issued temporary services regulations on August 4, 2006, that are generally effective for tax years beginning after December 31, 2006 (certain retroactive election of these regulations is permitted).<sup>14</sup> These regulations provide rules for specific methodologies for services, a services cost method, treatment of high-value services and embedded intangibles, a benefits test, rules regarding contractual relationships, stock-based compensation, financial guarantees, shared services arrangements, and Sec. 6662 documentation requirements.

Practitioners should take great care in advising their clients how to deal with these complex transfer pricing rules. Failure to properly document and calculate transfer

prices (including the issuance of invoices for such related-party transactions) at the time of the filing of the tax return can result in severe penalties to the taxpayer.

Practitioners should also be aware that Sec. 1059A provides rules that generally prohibit the cost basis of inventory purchased by a foreign related party from exceeding the value declared for U.S. customs purposes (subject to certain modifications).

## Common Tax Traps for Foreign Corporations

As all experienced tax preparers are aware, the abundant traps and pitfalls in the Code can prove costly to the client (and therefore to the preparer) if they are overlooked. However, because many of the rules for foreign corporations do not apply to domestic corporations, the problems are generally harder to discover and more likely to occur. Here are a few traps that were not mentioned above, but this is far from an exhaustive list.

**Qualified dividend treatment:** Qualification for the reduced tax rate on qualified dividends is subject to a number of special rules when the payor is a foreign corporation. A detailed discussion of these rules is beyond the scope of this article.<sup>15</sup>

**Loss of long-term gain treatment:** In general, any gain from the sale of stock in a CFC will be treated as ordinary income to the extent of any accumulated earnings and profits.<sup>16</sup> The Sec. 1248 amount is generally qualified dividend income if the CFC is in a treaty country.<sup>17</sup>

**PFIC status for start-up and liquidation years:** A form of foreign entity not discussed previously is a passive foreign investment company (PFIC), which is essentially a foreign mutual fund.<sup>18</sup> But the definition of this entity can encompass operating corporations that are temporarily idle and have cash or temporary investments during a period of organization or liquidation. The PFIC rules can impose a harsh tax treatment on U.S. persons who own stock in the foreign corporation.

## Other Tax Forms That May Be Required

In addition to Form 5471, there are a number of other tax forms that may need to be filed.

- SS-4, Application for Employer Identification Number;
- W-8 series forms—certificates of certain foreign status—to claim certain reductions or zero withholding on U.S. source income payments received by a foreign corporation;
- Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation;
- Form 1042 series, annual withholding tax returns for U.S. source income of foreign persons;
- Form 1118, Foreign Tax Credit for Corporations;
- Form 1120, Schedule N, Foreign Operations of U.S. Corporations;
- Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business;
- Form 5713, International Boycott Report;
- Form 8275, Disclosure Statement;
- Form 8275-R, Regulation Disclosure Statement;
- Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund;
- Form series 8804, 8805, and 8813, Section 1446 withholding tax based on U.S. effectively connected income allocable to foreign partners;
- Form 8832, Entity Classification Election;
- Form 8833, Treaty Based Return Positions;
- Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities;
- Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnership;
- Form 8883, Asset Allocation Statement Under Section 338;
- Form 8886, Reportable Transaction Disclosure Statement; and

12 Regs. Sec. 1.482-1(c).

13 Regs. Sec. 1.482-3(a).

14 T.D. 9278.

15 For a discussion of this topic in the context of the foreign tax credit, see Vermeer, Korb, and Sigler, “How Reduced Rates for Capital Gains and Qualified

Dividends Affect the FTC,” 37 *The Tax Adviser* 414 (July 2006).

16 Sec. 1248.

17 Sec. 1(h)(11)(C)(i)(II).

18 Sec. 1297.

## Foreign Income

- Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts.

### Conclusion

Tax practitioners who are not specialists in international taxation but who have business clients with subsidiary corporations in foreign countries or individual clients with a significant ownership interest in a foreign corporation may find themselves faced with having to prepare Form 5471.

This article gives an overview of the issues faced by practitioners when preparing Form 5471 and can serve as a roadmap to the potential problems and traps for the unwary. The IRS instructions for the form may be somewhat confusing, if not overwhelming.<sup>19</sup> For practitioners who want more detail, the AICPA's International Tax Technical Resource Panel has produced a detailed practice guide on Form 5471.<sup>20</sup>

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### Editor Notes

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<sup>19</sup> The instructions can be found at [www.irs.gov/pub/irs-pdf/i5471.pdf](http://www.irs.gov/pub/irs-pdf/i5471.pdf).

<sup>20</sup> *AICPA Practice Guide on Form 5471*. A copy of the 50-page guide is available free to members of the AICPA Tax Section at <http://tax.aicpa.org/Resources/International/Tools+and+Aids/Practice+Guide+for+Form+5471.htm>. Preparers of Form 5471 may also find the AICPA International Tax Planning Checklist helpful in preparing Form 5471 (<http://tax.aicpa.org/Resources/International/AICPA+International+Tax+Planning+Guide.htm>).