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by Lee G. Zimet

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The Application of Downward Attribution To De Minimis Ownership

by Lee G. Zimet

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In this article, the author explores whether U.S. persons that may have been unintentionally or unfairly affected by the introduction of downward attribution under amended section 958(b) can use a de minimis exception to the Form 5471 filing requirement for U.S. shareholders.

The Tax Cuts and Jobs Act drastically changed the stock ownership attribution rules under section 958(b), which are generally used to determine if a foreign corporation is a controlled foreign corporation and if a U.S. person is a U.S. shareholder of a foreign corporation. Before the TCJA, downward attribution did not apply under section 958(b) to treat a U.S. person as owning stock owned by a foreign person. The TCJA eliminated that exception. As a result, downward attribution can now apply broadly and in many situations that Congress may not have anticipated. This article explores the information return filing considerations for U.S. taxpayers that may have been unintentionally or unfairly affected by the introduction of downward attribution.

Generally, a U.S. person that owns 10 percent or more of the stock of a CFC (a U.S. shareholder) is required to annually file a Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations." There is an exemption for U.S. shareholders that own none of the CFC stock directly. Does (or should) the ownership of a small amount of stock change the result? For example, if a U.S. shareholder owns 1 percent of the CFC stock because of downward attribution, must it file Form 5471? This article examines whether there is a de minimis ownership exception to the filing requirement.

The stakes are particularly high. A U.S. person that owns a small amount of stock in a foreign entity could face huge compliance costs: It might have to file foreign information disclosures for numerous foreign corporations (perhaps hundreds or thousands) and compute a deemed tax liability for each of them.

In October 2019 the IRS issued guidance (Rev. Proc. 2019-40, 2019-43 IRB 982) on the application of downward attribution. Rev. Proc. 2019-40 provides various exceptions to disclosure and other compliance requirements. However, Example 2 of the revenue procedure concludes that the compliance exceptions don't apply to a U.S. person that has a 1 percent direct interest in a foreign corporation. Thus, the IRS's position is that there is no de minimis ownership exception to the Form 5471 filing requirement.

Despite the IRS's position, there are several procedural arguments available to taxpayers to avoid some of the compliance problems caused by de minimis ownership in a foreign entity. This article discusses those potential problems, as well as related substantive tax issues, the penalties for noncompliance, and statute of limitation issues.

I. Example 2 of Rev. Proc. 2019-40

Example 2 sets out the following fact pattern:

> USI, a U.S. citizen, owns 10 percent of the stock of FP, a foreign corporation. The remaining 90 percent of the stock of FP is owned by a foreign individual who is unrelated to USI. FP owns 100 percent of the stock of FS1, a foreign corporation. FS1 owns 100 percent of the stock of USS, a U.S. corporation, and 99 percent of the stock of FS2, a foreign corporation. USS owns the remaining 1 percent of the stock of FS2.

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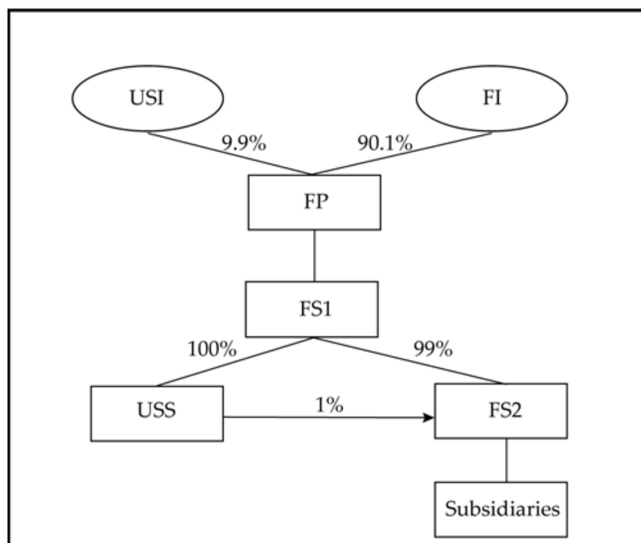
This article revises that fact pattern as follows to highlight the potential compliance burdens imposed on USS as the result of a 1 percent ownership of the FS2 stock:

> USI, a U.S. citizen, owns 9.9 percent of the stock of FP, a foreign corporation. The remaining 90.1 percent of the stock of FP is owned by a foreign individual who is unrelated to USI. FP owns 100 percent of the stock of FS1, a foreign corporation. FS1 owns 100 percent of the stock of USS, a U.S. corporation, and 99 percent of the stock of FS2, a foreign corporation. USS owns the remaining 1 percent of the stock of FS2. FS2 has 100 direct and indirect wholly owned foreign corporate subsidiaries. All the entities described in this paragraph use a calendar year as their tax year.
>
> On June 30, 2019, USS transferred the stock of FS2 to FS1 as a dividend. USS did not previously file Form 5471 for FS2 (or any of the subsidiaries thereof).

This example can be illustrated as shown in the figure below.



This article focuses on whether USS has an obligation to file the Forms 5471 for FS2 (and its subsidiaries) in 2017, 2018, and 2019. It also addresses whether USS has an obligation to include (and report) deemed distributions regarding the ownership of FS2 and identifies potential collateral consequences of failing to file the Forms 5471 (for example, penalties or extension of the statute of limitations).

This article does not address the potential effect on USI because the assumed facts take it below 10 percent ownership. However, if USI owns 10 percent (as described in the unrevised version of Example 2), it will have potential Form 5471 filing obligations that are described here for USS, plus an obligation to include subpart F amounts in gross income.

II. Executive Summary

As discussed in more detail later, it appears that there is no broad exception to the requirement to file Form 5471 when a U.S. person has only a de minimis amount of direct ownership in a CFC. However, there are good arguments that would support a position by USS (and similar taxpayers) that Form 5471 does not need to be filed.

Three code provisions might require USS to file the Forms 5471 for FS2 and its subsidiaries: sections 6038(a)(1), 6038(a)(4), and 6046. Sections 6038(a)(1) and 6046 might not apply to USS because neither provision was amended by the TCJA to provide for downward attribution. However, USS could be required to file the Forms 5471 under section 6038(a)(4) if applicable form instructions (or other IRS guidance) so require. In this case, the applicable instructions clearly purport to require USS to file the Forms 5471 in 2018 (and potentially in other tax years).

USS could base a nonfiling position on the IRS's decision to provide an exception for persons with no direct ownership but not for persons with de minimis direct ownership. A court might treat that distinction as arbitrary and capricious under the Administrative Procedure Act (APA) or find that the IRS abused its discretion under federal common law.

USS could also argue that the IRS failed to follow the APA's notice and comment procedures in deciding to provide a filing exception for persons with no direct ownership. A district court recently held in *Bullock*[1] that the notice and comment procedures apply to IRS subregulatory guidance (for example, revenue procedures). A

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[1] *Bullock v. IRS*, No. 4:18-cv-00103 (D. Mont. 2019).

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court might hold that the IRS's attempt to provide an exemption violated the notice and comment requirement and that the appropriate remedy is to remand the case to the agency for further consideration.

USS would have an additional basis for not filing the Forms 5471 for the 2017 tax year: Under section 6038(a)(3), information need not be supplied under section 6038(a) for a CFC's tax year unless the IRS has prescribed the furnishing of the information on or before the first day of that tax year. The instructions for Form 5471 that were issued before January 1, 2017 (the first day of the tax year), did not appear to require USS to file a Form 5471 or supply any information.

And for USS's 2019 tax year, the words of the applicable form instructions could support a position that USS need not file Forms 5471. Those instructions require a filing by a U.S. shareholder under section 6038(a)(4) only if the U.S. shareholder owns stock in a CFC on the last day in the tax year in which the CFC is a foreign corporation. FS2 (and its subsidiaries) were all CFCs on December 31, 2019, as a result of downward attribution. However, USS did not own any FS2 stock on that date.

Even if USS is not required to file the Forms 5471, it appears that it must include in gross income its pro rata share of any subpart F income inclusions of FS2 and its subsidiaries (at least for 2017 and 2018). It also seems that USS will be unable to apply the alternative information safe harbor in Rev. Proc. 2019-40. However, USS might be able to estimate the amount of the inclusions based on the *Cohan* doctrine,[2] which supports estimation in appropriate instances.

If USS does not file the Forms 5471 and a court determines that it was in fact required to, the statute of limitations for that tax year could be extended, and USS could be liable for penalties. The penalty and statute of limitations provisions both have reasonable cause exceptions. There are strong arguments that USS should qualify for a reasonable cause exception because its failure to file Forms 5471 was based on a good-faith position that the forms weren't required.

[2] *See Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

III. CFC Status of FS2

A. The Law

Subpart F provides special rules for CFCs and their U.S. shareholders.[3] A CFC is a foreign corporation of which U.S. shareholders own, directly or indirectly by attribution, more than 50 percent of the stock by vote or value.[4] For this purpose, a U.S. shareholder is a U.S. person that owns, directly or indirectly by attribution, 10 percent or more of the stock of a foreign corporation by vote or value.[5]

Constructive ownership rules apply in determining whether a foreign corporation is a CFC and in determining if a U.S. person is a U.S. shareholder. Section 958(a) generally provides that for subpart F purposes, a person is treated as owning the stock that it owns directly.[6] Also, section 958(a) provides for upward attribution from a foreign entity (that is, a foreign corporation, partnership, trust, or estate) to its owners. If a foreign entity directly or indirectly owns stock in a foreign corporation, the equity owner (that is, shareholders, partners, or beneficiaries) of that entity is treated as owning a proportional share of the stock. For example, a 1 percent partner is treated as owning 1 percent of the stock owned by the partnership. Stock that is attributed to another person is treated as actually owned by that person in applying the constructive ownership rules (that is, stock of a foreign corporation is continually reattributed from foreign entity to foreign entity).[7]

Section 958(b) provides constructive ownership rules that apply only for limited purposes. Those rules apply in determining whether an entity is a CFC and in determining if a person is a U.S. shareholder, but not for purposes of any of the subpart F income inclusion rules. Under section 958(b), the constructive ownership rules of section 318, with modifications, apply.

[3] Sections 951 through 965.

[4] Section 957(a) and reg. section 1.957-1(a).

[5] Section 951(b) and reg. section 1.951-1(g). For tax years of foreign corporations that begin on or before December 31, 2017, the determination is based solely on voting rights. Section 951(b) (as in effect before the enactment of TCJA section 14214(a)).

[6] Section 958(a)(1) and reg. section 1.958-1(a)(1).

[7] Section 958(a)(2) and reg. section 1.958-1.

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However, the constructive ownership rules apply only if the effect is to treat a foreign corporation as a CFC or to treat a U.S. person as a U.S. shareholder.[8] Section 318 generally consists of four constructive attribution rules: (1) attribution from entities to the owners of the entity (upward attribution); (2) attribution to entities from the owners of the entity (downward attribution); (3) family attribution; and (4) option attribution.[9]

Before 2018, section 958(b)(4) generally turned off the downward attribution rules of section 318 in some circumstances. As a result, a U.S. person was not treated as owning stock that was owned by a foreign person as a result of downward attribution.[10] Section 958(b)(4) was repealed by the TCJA. The change is effective for the last tax year of a foreign corporation beginning before January 1, 2018 (and all subsequent tax years), and tax years of a U.S. shareholder in which that tax year ends.[11]

Under the section 318 downward attribution rules, in some instances stock owned by a shareholder, partner, beneficiary, or grantor is attributed to a corporation, partnership, or trust. For a corporation, downward attribution applies if the shareholder owns 50 percent or more of the corporation (by value).[12]

This downward attribution change can have a broad application. However, Congress apparently intended that it have a limited application to end specific abuses. One stated objective was to end the practice of "decontrolling" a CFC (and similar abuses).[13] The Joint Committee on Taxation's explanation of the TCJA (the blue book) describes this as follows:

> In a common example, a new foreign parent, or another non-CFC foreign affiliate, could transfer property to a CFC in exchange for stock representing at least 50 percent of the voting power and value of the CFC. Such transactions "de-control" the CFC, thus converting former CFCs to non-CFCs, despite continuous ownership by the U.S. shareholders, and avoiding the application of subpart F provisions.[14]

The blue book also states that downward attribution applies only to attribute ownership to a U.S. person that is related (as defined later) to the foreign person. However, it is observed in a footnote that a technical correction may be needed to properly reflect the congressional intent.[15] This intent not to apply downward attribution to unrelated persons is also referenced in the conference report and in debates on the Senate floor.[16]

Near the end of the 115th Congress, Kevin Brady, outgoing chair of the House Ways and Means Committee, introduced legislation that would have reinstated the pre-TCJA version of the downward attribution law for unrelated persons.[17] Downward attribution would have applied only to attribute ownership to a related U.S. person.

Under existing rules, a person is treated as a related person for a CFC if (1) the tested person controls the CFC; (2) the CFC controls the tested person; or (3) the same person (or persons) controls both the CFC and the tested person. For this purpose, control is defined as ownership, direct or indirect by attribution, of more than 50 percent of the equity (for a corporation, by vote or value). Attribution rules that are similar to the rules described in section 958 apply (including section 958(b) and downward attribution). However, the exemption from attribution for entities that are foreign and individuals who are nonresident aliens does not apply in determining if a person is a related person.[18]

On November 19, 2019, Treasury and the IRS published final regulations (T.D. 9883) that affect the definition of related person under section 954. Under the amended rules, downward attribution does not apply in determining if a person is

[8] Section 958(b) and reg. section 1.958-2(a).

[9] Section 318(a)(1)-(4).

[10] Section 958(b)(4) (as in effect before the enactment of TCJA section 14213(a)) and reg. section 1.958-2(d)(2).

[11] TCJA section 14213(a).

[12] Sections 318(a)(3)(C) and 958(b); reg. section 1.958-2(d).

[13] Joint Committee on Taxation, "General Explanation of Public Law 115-97," JCS-1-18, at 385 (Dec. 2018) (the blue book).

[14] *Id.* at 384.

[15] *Id.* at 385 n.1761.

[16] H.R. Rep. No. 115-466, at 633 (Dec. 15, 2017) (Conf. Rep.).

[17] Tax Technical and Clerical Corrections Act section 4(jj)(1).

[18] Section 954(d)(3) and reg. section 1.954-1(f).

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related to a CFC.[19] The final regulations generally apply to tax years of CFCs ending on or after November 19, 2019 (and to tax years of a U.S. shareholder that include that tax year).[20]

B. Analysis

FS2 (and its subsidiaries) will generally be treated as CFCs if one or more U.S. persons (that meet the 10 percent ownership requirement) own more than 50 percent of the stock of the foreign corporation (taking into account the attribution rules of both section 958(a) and (b)).

USS is the only U.S. person that potentially is a U.S. shareholder. Before the enactment of the TCJA, USS was not a U.S. shareholder, because it owned only 1 percent of the stock of FS2. Downward attribution would not have applied to attribute the 99 percent owned by FS1 to USS.

If downward attribution applies, USS is treated as constructively owning 100 percent of FS2 (and its subsidiaries). In that case, FS2 and each of the subsidiaries are considered CFCs because a U.S. shareholder (USS) owns more than 50 percent of the stock (in this case 100 percent) of each subsidiary. As a result, after the enactment of the TCJA, FS2 and each of its subsidiaries are CFCs.[21]

The change to the application of the downward attribution rule applies to the last tax year of a foreign corporation beginning before January 1, 2018 (and to subsequent years).[22] As a result, the rule applies to FS2 (and each of its subsidiaries) for the 2017 tax year (and later years).

The expressed congressional intent was that the change to the CFC attribution rules be applied only to related persons. It is possible that Congress will enact a retroactive technical corrections law that would exempt unrelated persons.

However, that exemption seemingly would not affect our analysis. It appears that USS is a related person for FS2 (and each of the subsidiaries) even without the downward attribution rule. This is because the same person (FP) controls (owns more than 50 percent of the stock, taking into account upward attribution) both USS and FS2, as well as each of the subsidiaries.[23]

Based on this analysis, it appears that for the 2017 tax year and later, (1) FS and each of its subsidiaries are CFCs; (2) USS is a U.S. shareholder of each of those corporations; and (3) USS is a related person for each of those entities.

C. Stock Ownership

The conclusion that FS2 and its subsidiaries are CFCs is based on an assumption that the stock owned by USS is to be respected for U.S. income tax purposes. In many cases, a U.S. person owns a de minimis amount of stock only because foreign corporate law requires that the corporation have at least two stockholders. It does not appear that the mere fact of an intent to accommodate foreign law (as opposed to an intent to benefit from it) is sufficient to disregard shares or the ownership of them. However, if USS did not exercise the rights of ownership (economic or otherwise), it might be possible to take the position that the share or ownership can be ignored.

Stock in a corporation generally offers the owner three potentially relevant types of rights: (1) to vote the shares; (2) to receive dividends from the corporation; and (3) to receive corporate assets upon a liquidation.[24] Cases and rulings also suggest that the ability to sell or dispose of stock is an indicator of ownership.[25] An analysis of whether a U.S. person is the beneficial owner of stock would consider those factors (and perhaps others) to come to a conclusion.

Accommodation stock might be structured as so-called hook stock (that is, shares owned by a subsidiary corporation in its parent corporation). For example, USS could own a stock interest in FS1. In that case, one would need to determine

[19] Reg. section 1.954-1(f)(2)(iv)(B)(1).

[20] Reg. section 1.954-1(f)(3)(i). Taxpayers can generally rely on the proposed version of the amendment (REG-125135-15) for tax years ending on or after May 17, 2019, if they apply all the rules in the proposed regulation.

[21] Section 318(a)(2)(C), (3)(C), and (5)(A); section 958(b).

[22] TCJA section 14213(a).

[23] *See* section 954(d)(3)(B).

[24] *Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964); Rev. Rul. 85-106, 1985-2 C.B. 116; and Rev. Rul. 81-289, 1981-2 C.B. 82.

[25] *Hall v. Commissioner*, 15 T.C. 195, 200 (1950) (unfettered right to sell is an important attribute of ownership), *aff'd*, 194 F.2d 538 (9th Cir. 1952); and TAM 9612001.

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whether FS1 is a CFC and whether USS would need to file a Form 5471 for FS1. In many foreign tax jurisdictions, hook stock is not respected as stock. However, it appears that hook stock is generally respected as stock for U.S. income tax purposes.[26]

IV. Form 5471 Filing Requirement

Various provisions of the code impose disclosure requirements when a U.S. person owns stock, directly or indirectly, in a foreign corporation. Form 5471 is an information return designed to allow U.S. persons to satisfy their reporting requirements under sections 6038 and 6046 and the related regulations. To comply with the requirements, the U.S. person attaches the Form 5471 to its tax return.[27]

This section of the article discusses whether USS will be required to file Form 5471 for FS2 and its subsidiaries.

A. Section 6046

Some U.S. persons that meet a stock ownership requirement for a foreign corporation are required by section 6046(a) to file an information return to disclose specific events. A return is generally required if a U.S. person (1) first meets the stock ownership requirement during the tax year (or ceases to meet it during the tax year); (2) acquires a block of stock during the tax year that independently meets the stock ownership requirement; or (3) meets the stock ownership requirement in a tax year in which the foreign corporation reorganizes. Also, a U.S. person who is an officer or director of the foreign corporation can have an independent requirement to file an information return to report transactions described in the previous sentence.[28]

A person meets the stock ownership requirement of section 6046(a) for a foreign corporation if it directly owns, or indirectly owns by attribution, 10 percent or more of the stock of the foreign corporation by vote or value. Only upward attribution and family attribution apply for purposes of section 6046. There is no downward attribution.[29]

USS owns only 1 percent of FS2 and owns none of the stock of FS2's subsidiaries. Because USS does not meet the 10 percent stock ownership requirement, it appears that USS is not required to file Forms 5471 under section 6046.

B. Section 6038(a)(1)

Some U.S. persons that own stock in a foreign corporation are required to file an annual information return under section 6038(a)(1). An information return is required if the U.S. person directly owns, or indirectly owns by attribution, more than 50 percent of the stock of the foreign corporation by vote or value (the control requirement). If a person controls a corporation, it is also treated as meeting the control requirement for any corporation that is controlled by that corporation — that is, controlled subsidiaries also meet the control requirement.

The control requirement of section 6038(a)(1) is determined based on the attribution rules of section 318(a), as modified.[30] Thus, there are applicable attribution rules for family attribution, upward attribution, downward attribution, and option attribution.

For purposes of the section 6038(a)(1) control requirement, downward attribution is not applied to treat a U.S. person as owning stock that is owned by a foreign person.[31] Although similar to section 958(b)(4), this provision was not repealed by the TCJA. As a result, downward attribution does not apply to push ownership from FS1 to USS.

USS owns only 1 percent of FS2 (directly) and 1 percent of FS2's subsidiaries (indirectly by upward attribution). Because USS does not meet the control requirement, it appears that USS is not required to file the Forms 5471 under section 6038(a)(1).

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[26] *Commissioner v. Van Camp Packing*, 67 F.2d 596 (7th Cir. 1933) (subsidiary recognized gain or loss on sale of parent stock); Rev. Rul. 73-28, 1973-1 C.B. 187 (hook stock treated as voting stock); and LTR 201123030; *see* reg. section 1.367(b)-10 (antiabuse rule for the creation of hook stock); reg. section 1.385-1(c)(4)(vii), examples 3 and 4 (attribution of hook stock); and reg. section 1.7874-1(d) (ignored for section 7874 purposes).

[27] Reg. section 1.6038-2(a)(2) and -2(i); and reg. section 1.6046-1(a)(2), (c)(1), and (j).

[28] Section 6046(a)(1); and reg. section 1.6046-1(a)(2)(i), (c)(1), and (c)(2).

[29] Section 6046(a)(2) and (c); and reg. section 1.6046-1(i).

[30] Section 6038(a)(1) and (e)(2); and reg. section 1.6038-2(a) and (b).

[31] Section 6038(e)(2)(A); and reg. section 1.6038-2(c)(1) and (2).

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C. Section 6038(a)(4)

The IRS can require a U.S. person to file an annual information return under section 6038(a)(4) if it is a U.S. shareholder for a corporation that is treated as a CFC (for any purpose under subpart F). The required information is the same information that would have been required under section 6038(a)(1).[32] No regulations have ever been proposed or implemented under section 6038(a)(4).

As described in more detail later, the IRS has required some U.S. persons to file Form 5471 in accordance with form instructions. There is some uncertainty about whether the filing requirements of section 6038(a)(4) are self-implementing or require regulations. In at least one ruling, the IRS has taken the position that section 6038(a)(4) cannot be implemented without regulations.[33] More recently, the IRS has maintained that a requirement to file in the instructions for Form 5471 is sufficient to implement section 6038(a)(4).[34]

The applicable legislative history states that the legislation "clarifies the reporting requirements and penalties imposed by section 6038 by expressly applying those provisions to failures to provide certain information with respect to related parties, such as controlled foreign corporations of which the person subject to the requirements is a U.S. shareholder."[35] This language does not appear to settle whether the information can be required by IRS form instructions in the absence of implementing regulations.

The Form 5471 instructions that predated the enactment of section 6038(a)(4) had a category E filing status similar to the requirements for category 5 filers under current instructions.[36] Thus, Congress likely intended to give the IRS legislative authority for what it had already been doing.

D. Form 5471 Instructions

Because the only authority that implements section 6038(a)(4) is the form instructions, a detailed discussion of those instructions is warranted.

The IRS issued instructions for Form 5471 in December 2017.[37] Under those 2017 instructions, all U.S. persons described in a category must file Form 5471 for a stock investment in a foreign corporation. The 2017 instructions list the following four categories of filers that are generally required to file Form 5471 for 2018[38]:

- Category 2 filer — An individual who is a U.S. citizen or resident and an officer or director of a foreign corporation required to file Form 5471 under section 6046.
- Category 3 filer — A U.S. person that is a shareholder required to file Form 5471 under section 6046.
- Category 4 filer — A U.S. person that had control of a foreign corporation during the tax year that is required to file Form 5471 under section 6038(a)(1).
- Category 5 filer — A U.S. shareholder of a foreign corporation (that is a CFC at any time during the tax year) that owned stock in the foreign corporation on the last day in the year in which the corporation was a CFC. In determining if a U.S. person is a U.S. shareholder and if a foreign corporation is a CFC, the attribution rules of section 958(b) apply.[39]

Notice 2018-13, 2018-6 IRB 341, was issued in early 2018. It announced that the IRS intended to amend the Form 5471 instructions to provide that a category 5 filer does not have to file Form 5471 if no U.S. shareholder owns stock in the foreign corporation and if the foreign corporation is a CFC solely because one or more U.S. persons are considered to own stock under downward attribution. In determining whether the U.S. shareholder owns stock in the foreign corporation, the attribution rules of section 958(a)

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[32] Section 6038(a)(4).

[33] 1996 FSA Lexis 184.

[34] Rev. Proc. 2019-40, section 8.01; Notice 2018-13, 2018-6 IRB 341; and REG-104390-18.

[35] JCT, "Comparison of Differing Revenue Provisions of the Revenue Reconciliation Act of 1989 (H.R. 3299 as Passed by the House and Senate)," JCS-18A-89 (Oct. 24, 1989).

[36] Instructions for Form 5471, at 1 (rev. Nov. 1987).

[37] Instructions for Form 5471 (rev. Dec. 2017).

[38] There is no category 1 under the 2017 instructions.

[39] 2017 instructions, *supra* note 37, at 2.

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(but not section 958(b)) apply.[40] The filing exception described in Notice 2018-13 could be relied on by taxpayers until new Form 5471 instructions were issued.[41]

The IRS issued new instructions for Form 5471 in December 2018.[42] Under the 2018 instructions, all U.S. persons described in a category must file Form 5471 for a stock investment in a foreign corporation. The 2018 instructions include the four categories described in the 2017 instructions, plus a new filer category: category 1.

A category 1 filer is a U.S. shareholder of a foreign corporation that is a section 965 specified foreign corporation (SFC) at any time during the tax year, if the U.S. shareholder owned stock in the foreign corporation on the last day in that year on which the corporation was an SFC. In determining if a U.S. person is a U.S. shareholder and if a foreign corporation is an SFC, the attribution rules of section 958(b) apply. An SFC is a foreign corporation (including a CFC) for which at least one U.S. corporation is a U.S. shareholder.[43]

The 2018 instructions provide that a category 1 or 5 filer does not have to file Form 5471 if no U.S. shareholder owns stock in the foreign corporation and the foreign corporation is a CFC solely because one or more U.S. persons are considered to own stock as a result of downward attribution. In determining whether the U.S. shareholder owns stock in the foreign corporation, the attribution rules of section 958(a) (but not section 958(b)) apply.[44]

For 2017 and 2018, it appears that USS will be a category 5 filer (and also a category 1 filer for 2018) for FS2 and its subsidiaries. Each of those corporations was a CFC in 2017 and 2018 (taking into account section 958(b) attribution, including downward attribution). USS is a U.S. shareholder for each corporation for the same reason. Moreover, USS owned stock in each corporation, directly, or indirectly as the result of upward attribution, on the last day of the tax year.

USS cannot be a category 2 filer because it is not an individual. USS does not appear to be a category 3 filer because it is not required to file under section 6046 (as discussed earlier). It appears that USS is not a category 4 filer because it does not have control of FSS (or its subsidiaries) because of the lack of downward attribution.

USS might not be a category 5 filer in 2019 (or a category 1 filer if the forthcoming instructions include that status). Categories 1 and 5 both require that the U.S. shareholder own stock in the CFC on the last day in the tax year in which the foreign corporation was a CFC. FS2 and each of its subsidiaries were CFCs throughout 2019 as a result of downward attribution. However, USS transferred its stock in FS2 on June 30, 2019, and did not directly own any stock in FS2 on the last day of the 2019 tax year (December 31, 2019).

The 2018 instructions are silent on which rules apply to determine if a U.S. shareholder owns stock on the last day of the tax year. If the section 958(a) attribution rules apply, USS would not be a category 1 and 5 filer because section 958(a) does not provide for downward attribution. However, if the section 958(b) attribution rules apply, USS would be a category 1 and 5 filer as a result of downward attribution.

USS would not be a category 1 and 5 filer unless the section 958(b) attribution rules apply. Section 958(b) lists four specific code provisions for which it applies. As a result, it appears that section 958(b) does not apply unless a provision specifically references it. Moreover, the rules under categories 1 and 5 are similar to the rules in section 951(a). Under section 951(a), a U.S. shareholder must take into account subpart F inclusions only if it is a U.S. shareholder that owns stock in a CFC on the last day in the tax year on which the corporation is a CFC.[45] In determining whether a U.S. shareholder owns stock in a CFC for section 951(a) purposes, the section 958(a) attribution rules apply, and the section 958(b) attribution rules are not considered.[46]

[40] Notice 2018-13, section 5.02; and Notice 2018-26, 2018-16 IRB 480, section 7.

[41] Notice 2018-13, section 6.

[42] Instructions for Form 5471 (rev. Dec. 2018).

[43] *Id.* at 2-3.

[44] *Id.* at 4.

[45] Section 951(a)(1).

[46] Section 951(a)(1); and reg. section 1.951-1(a)(2).

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The 2018 instructions, on their face, are ambiguous about which rules apply to determine if a U.S. shareholder owns stock on the last day of the CFC's tax year. Based on (1) the limited application of section 958(b); (2) the fact that section 958(b) does not apply for section 951(a) purposes; and (3) the fact that section 951(a) applies rules that are similar to the category 1 and 5 filer rules, it appears reasonable for USS to take the position that the Forms 5471 are not required for 2019.

Note that the 2018 instructions provide that a category 1 or 5 filer does not have to file a Form 5471 if (1) no U.S. shareholder owns stock (within the meaning of section 958(a)) in the SFC or CFC, and (2) the foreign corporation is an SFC or CFC solely as a result of downward attribution.[47] This exception to filing may not apply to USS because it owned stock in FS2 directly, and in the subsidiaries indirectly as a result of attribution under section 958(a), during 2019 (but not at the end of the tax year). The instructions are ambiguous on whether the section 958(a) ownership is determined at the end of the year or at any time during the year.

Thus, it appears that the 2017 and 2018 instructions purport to require USS to file the Forms 5471 for 2017 and 2018 for FS2 and its subsidiaries. However, it appears that the 2018 instructions do not have a similar requirement for 2019.

E. Section 6038(a)(3)

The IRS's authority to require taxpayers to provide information on a Form 5471 is constrained by section 6038(a)(3), which limits the information that can be required to be provided under section 6038(a). Information is not required for a CFC's tax year unless the IRS has prescribed the furnishing of that information on or before the first day of the CFC's tax year.[48] Section 6038(a)(3) appears to cover information that can be required under section 6038(a)(4). I am unaware of any case or ruling that discusses the application of section 6038(a)(3).

The 2017 tax year of FS2 and its subsidiaries began January 1, 2017. Under section 6038(a)(3), it appears that USS must submit information under section 6038(a) only to the extent required by the IRS before January 1, 2017.

The 2017 instructions had not been issued by January 1, 2017 (and the TCJA had not been enacted). The applicable instructions as of January 1, 2017 (the 2016 instructions[49]) had language that was similar to the 2017 instructions. It is impossible to read the 2016 instructions as applying downward attribution in determining if a U.S. person is a category 5 filer, because the TCJA had not changed the statute at that time. As a result, USS might not be required to file the Forms 5471 for FS2 and its subsidiaries because there was no requirement in existence at the beginning of the 2017 tax year.

F. Rev. Proc. 2019-40

On October 1, 2019, the IRS issued guidance on the TCJA's repeal of section 958(b)(4) — the exception to the application of downward attribution for stock ownership by a foreign person. This guidance consisted of Rev. Proc. 2019-40 and proposed regulations. The revenue procedure sets out exceptions to the requirement to file Form 5471.

Rev. Proc. 2019-40 provides various definitions, which are important in understanding the guidance.

The guidance provides for two types of CFCs: foreign-controlled CFCs and U.S.-controlled CFCs. A foreign-controlled CFC is a foreign corporation that is a CFC solely as a result of the repeal of section 958(b)(4). A U.S.-controlled CFC is a CFC that is not a foreign-controlled CFC.

The guidance provides for two types of U.S. shareholders: section 958(a) U.S. shareholders and constructive U.S. shareholders. A section 958(a) U.S. shareholder is a U.S. shareholder that owns stock of a foreign corporation, taking into account section 958(a) attribution (but not section 958(b) attribution). A constructive U.S. shareholder is a U.S. shareholder that is not a section 958(a) U.S. shareholder.

[47] 2018 instructions, *supra* note 42, at 4.

[48] Section 6038(a)(3).

[49] Instructions for Form 5471 (rev. Dec. 2016).

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The guidance further subdivides the two categories of U.S. shareholders into related persons and unrelated persons. Related or unrelated status depends on whether the person is related to the CFC by applying the rules of section 954(d)(3). As a result, a U.S. shareholder that is a related person for a CFC can be a "related section 958(a) U.S. shareholder" or a "related constructive U.S. shareholder," and a U.S. shareholder that is not a related person can be an "unrelated section 958(a) U.S. shareholder" or an "unrelated constructive U.S. shareholder."[50]

Section 8 of Rev. Proc. 2019-40 provides exceptions from the filing requirements of Form 5471, as well as reduced filing obligations when filing is still required. The guidance states that the IRS intends to revise the Form 5471 instructions to provide that a category 5 filer is not required to file a Form 5471 for a related constructive U.S. shareholder of a foreign-controlled CFC.[51]

Rev. Proc. 2019-40 also reduces the amount of information that must be included on Form 5471 for unrelated section 958(a) U.S. shareholders and related constructive U.S. shareholders. However, a Form 5471 is still generally required for those U.S. shareholders.[52] Taxpayers are permitted to apply the exceptions (and reduced filing rules) before the revised instructions to the Form 5471 are modified.[53]

Rev. Proc. 2019-40 refers only to category 5 filers in the exception and reduced filing rules. Presumably, the coming instructions will no longer have a category 1 because it relates to section 965 and that provision applied only to tax years ending in 2017 and 2018.

The guidance does not provide any filing relief for related section 958(a) U.S. shareholders. As a result, those U.S. shareholders generally are required to file the Forms 5471 without any reduction in the information required.

Recall that in Example 2, USI, a U.S. citizen, owns 10 percent of the stock of FP, a foreign corporation, and the remaining 90 percent is owned by a foreign individual who is unrelated to USI. FP owns 100 percent of the stock of FS1, a foreign corporation. FS1 owns 100 percent of the stock of USS, a U.S. corporation, and 99 percent of the stock of FS2, a foreign corporation. USS owns the remaining 1 percent of the stock of FS2.

The IRS concludes in Example 2 that USS is a related section 958(a) U.S. shareholder of FS2 and that USI is an unrelated section 958(a) U.S. shareholder of FS2. The example also concludes that FS2 is a foreign-controlled CFC because more than 50 percent of the stock is owned by USS under section 958(b) (and not under section 958(a)).[54]

The example does not discuss the status of FP and FS1. However, neither corporation appears to be a CFC, because USI owns only 10 percent, and downward attribution does not appear to apply.

The IRS's conclusion that USS is a related section 958(a) U.S. shareholder of FS2 appears to be correct. USS owns shares of FS2 directly (1 percent) and is therefore a shareholder under section 958(a). USS is a related person for FS2 because it owns 100 percent of FS2, taking into account downward attribution from FS1 under section 958(b).

The IRS's conclusion that USI is an unrelated section 958(a) U.S. shareholder of FS2 also appears to be correct. USI owns only 10 percent of FS2, taking into account upward attribution from FP under section 958(a). USI is not a related person for FS2, because it owns only 10 percent of FS2, taking into account attribution under section 958(a) and (b), and the related-party control test requires more than 50 percent ownership.

The example discusses only the definitional status of the various parties; there is no discussion of the consequences of fitting within a definition. Based on USS's status as a related section 958(a) U.S. shareholder, USS would be required to file Form 5471 for FS2 and would be required to file the full amount of disclosures. Based on USI's status as an unrelated section 958(a) U.S. shareholder, USI would be required to file a Form 5471 for FS2 but would have a reduced level of disclosure.

[50] Rev. Proc. 2019-40, section 3.

[51] *Id.* at section 8.04.

[52] *Id.* at sections 8.02 and 8.03.

[53] *Id.* at section 10.

[54] *Id.* at section 9, examples 1(b), 1(c), and 2.

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Thus, it appears that Rev. Proc. 2019-40 does not offer USS in our fact pattern any relief from the potential obligation to file Form 5471 and does not reduce the amount of information that is otherwise required.

G. Abuse of Discretion

The IRS has provided an exception from the Form 5471 filing requirement for a U.S. shareholder that does not own any stock of the CFC (taking into account only direct ownership and the attribution rules of section 958(a)). However, it did not provide an exception for de minimis ownership (such as USS's ownership of 1 percent).

The IRS has the discretion to provide exemptions from the requirement to file particular statements, forms, and information with a tax return. More specifically, section 6038(a)(4) permits the IRS to determine, within its discretion, which persons must include information with a return and what information must be included.

Even when a decision is within the IRS's discretion, the choice made by the agency can still be reviewed by a court. The IRS abuses its discretion when it does not provide a rational basis for exempting one class of taxpayers but not another (or one class of transactions but not another). The courts have held that they can review a governmental agency's discretionary decisions.[55]

Several courts have held that the IRS has a duty to treat taxpayers consistently. The Supreme Court observed in *Kaiser* that "the Commissioner cannot tax one and not tax another without some rational basis for the difference."[56] The Second Circuit held in *Sirbo Holdings* that the IRS has "a duty of consistency toward similarly situated taxpayers" and that taxpayers "are entitled to a non-discriminatory administration of the tax laws."[57] These cases have generally been decided under federal common law.[58] In many of the cases in which the taxpayer prevailed, the court found that its conclusion was not inconsistent with the relevant statute or regulation.

It must be acknowledged that the courts have not been uniform in requiring consistency. The First Circuit held for the IRS when a taxpayer alleged that all its competitors received an exemption from tax but that it had not. The court found that the IRS had the prerogative to deny an exemption to a single taxpayer in an industry. It stated: "Despite the goal of consistency in treatment, the IRS is not prohibited from treating such taxpayers disparately. Rather than being a strict, definitive requirement, the principle of achieving parity in taxing similarly situated taxpayers is merely aspirational."[59] In many cases in which the taxpayer lost, the taxpayer was either unable to prove that the other taxpayers were similarly situated or that the IRS's treatment was not uniform.

In the Form 5471 situation, the IRS has provided a filing exemption for shareholders that own no stock but not for shareholders that own de minimis amounts of stock. This distinction could be reviewed by a court. In providing exemptions from tax, the IRS has a duty to try to be consistent.

Section 706(2)(A) of the APA allows courts to overturn government agency actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[60] Although few cases have applied the APA to IRS actions, it appears that the agency is not exempt from the APA's requirements.[61] A district court recently held that subregulatory guidance (for example, a revenue procedure) issued by the IRS is subject to

[55] *Drakes Bay Oyster Co. v. Jewell*, 747 F.3d 1073, 1082 (9th Cir. 2014); and *Pinnacle Armor Inc. v. United States*, 648 F.3d 708, 719 (9th Cir. 2011).

[56] *United States v. Kaiser*, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring).

[57] *Sirbo Holdings v. Commissioner*, 476 F.2d 981, 987 (2d Cir. 1973).

[58] *Powell v. United States*, 945 F.2d 374, 377-378 (11th Cir. 1991) (inconsistent treatment by the IRS of payments received by religious organizations); *Niles v. United States*, 710 F.2d 1391, 1393-1395 (9th Cir. 1983) (held the IRS to a "consistent and long-standing administrative practice"); *Sirbo Holdings*, 476 F.2d 981 (inconsistent IRS litigating positions in two concurrent Tax Court cases); *Vesco v. Commissioner*, T.C. Memo. 1979-369 (use of company plane not taxable based on IRS treatment of other taxpayers); *Xerox Corp. v. United States*, 656 F.2d 659 (Ct. Cl. 1981) (duty of consistency to private letter rulings).

[59] *Hostar Marine Transportation System v. United States*, 592 F.3d 202, 210 (1st Cir. 2010).

[60] 5 U.S.C. section 706(2)(A).

[61] *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44 (2011) (APA applies to IRS regulations); *Cohen v. United States*, 650 F.3d 717, 723 (D.C. Cir. 2011) (en banc) ("The IRS is not special in this regard.").

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scrutiny under the APA.[62] As a result, the APA rules seem to apply to IRS notices and form instructions.

The Supreme Court in *State Farm*[63] articulated the standards for reviewing an agency action under the arbitrary and capricious rule:

> A reviewing court may not set aside an agency rule that is rational, based on consideration of the relevant factors and within the scope of the authority delegated to the agency by the statute. The scope of review under the "arbitrary and capricious" standard is narrow and a court is not to substitute its judgment for that of the agency.[64]

State Farm essentially has stated that an agency must satisfy three requirements to avoid violating the arbitrary and capricious rule. First, the agency must engage in "reasoned decision-making." Second, the agency must "articulate a satisfactory explanation for its actions." And third, the agency must have the authority under the statute to take the action. This is frequently described as a "hard look" standard of review.

The first *State Farm* standard requires the agency to examine the relevant data and evaluate the relevant factors (that is, factors that Congress wanted the agency to consider and ignoring factors that Congress did not want it to consider). The agency's reasoning must make sense, and the conclusion must follow from the premises, which must be reasonable. A failure to consider a reasonable alternative approach could violate the reasoned decision-making standard.[65]

Under the second *State Farm* standard (satisfactory explanation), the agency must explain the basis for exercising its discretion a particular way. The explanation must be provided by the agency itself when it makes the decision (and not later by the agency's attorneys). However, no reason need be given if the reason is obvious (or can be discerned by the court, even if the clarity is less than ideal).[66] For the agency action to succeed, there must be a "rational connection between the facts found and the choice made."[67]

In applying the *State Farm* analysis, it seems clear that the IRS had the authority to determine which taxpayers are required to file Form 5471 and to provide exemptions from that filing requirement. It is less clear whether there is a reasonable basis for the distinction between indirect and de minimis ownership. It also appears that the IRS did not provide an explanation for that distinction.

There is no explanation of why the IRS provided a filing exemption for taxpayers with no section 958(a) ownership of stock but not for taxpayers with de minimis ownership. As noted, there is no requirement to state a reason if the reason is obvious (or can be discerned by a court). It appears that the reason for exempting taxpayers with no direct ownership is obvious. However, it is not obvious why a similar exemption wasn't provided for de minimis ownership. The IRS's failure to state a reason for the distinction might be grounds for a court to determine that the agency's action was arbitrary and capricious.[68]

A court may decide that the IRS should have considered providing a de minimis exception as an alternative to just providing for an exception for taxpayers with no stock. The IRS was aware of the need for some de minimis exceptions for downward attribution. It recognized that under the statute, downward attribution could apply to a de minimis amount of an equity interest in a U.S. partnership, estate, or trust.[69] This should be contrasted with the application of downward attribution to U.S. corporations, for which the provision applies only if the shareholder owns 50 percent or more of the stock of the corporation (by value).[70]

[62] *Bullock*, No. 4:18-cv-00103.

[63] *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43-52 (1983).

[64] *Id.* at 42-43.

[65] *Id.* at 43-46.

[66] *Id.* at 43-48.

[67] *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1972).

[68] *Encino Motorcars LLC v. Navarro*, 136 S. Ct. 2117 (2017) (failure to provide even a minimal level of analysis).

[69] Section 318(a)(3)(A) and (B); and reg. section 1.958-2(d)(1)(i) and (ii). The downward attribution rules do not apply if the beneficiary has a remote contingent interest in a U.S. trust (other than a grantor trust).

[70] Section 318(a)(3)(C); and reg. section 1.958-2(d)(1)(iii).

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In Notice 2018-26, the IRS and Treasury announced that they intended to promulgate regulations that would turn off the application of downward attribution for partnerships if the partner owns less than 5 percent of the partnership (by capital and profits). The change in the application of the downward attribution rules was solely for purposes of the application of section 965. The stated reason for the change was that the IRS and Treasury recognized that the application of downward attribution to de minimis partnership interest "would pose compliance difficulties for taxpayers and administrative difficulties for the IRS."[71] Taxpayers were permitted to rely on this rule before the issuance of regulations.[72] The authors of the notice did not state why similar exemptions were not needed for provisions other than section 965. The notice did not provide for a de minimis exemption for estates and trusts (or provide an explanation).

In deciding whether the IRS's action regarding the Form 5471 exemption was arbitrary and capricious, a court might consider the costs and benefits of requiring taxpayers with de minimis ownership to file. The Supreme Court in *State Farm* noted that it is reasonable for an agency to compare costs and benefits in support of a given action.[73] In the Form 5471 case, the cost of compliance by taxpayers, such as USS, is knowable. The benefit to the IRS is less concrete, but it would appear that the usefulness of the information supplied on Form 5471 for de minimis ownership would be small. It would not be surprising to find that similarly situated taxpayers would also have potentially large compliance costs.

None of the courts that have applied the APA to IRS actions have discussed how to perform a cost-benefit analysis for tax guidance. However, several cases involving challenges to IRS penalties under the Eighth Amendment's excessive fines provision have applied a cost-benefit analysis. In *Bajakajian*,[74] which involved the civil forfeiture of currency, the Supreme Court held that the potential benefit to the IRS of an information filing were outweighed by the 100 percent penalty imposed on the taxpayer.

Hosep Bajakajian tried to leave the United States without reporting that he was transporting approximately $360,000 in currency. As a result, Bajakajian was subject to forfeiture of the entire amount to the federal government. The Court held that the forfeiture was grossly disproportional to the gravity of the offense. It thus found that the forfeiture was excessive and that the taxpayer's actions did not harm the government, because the only effect of the nonreporting was that the government was deprived of the information that approximately $360,000 left the country.[75]

A court reviewing the IRS's actions regarding Form 5471 might conduct a similar analysis of the potential costs to taxpayers versus the potential benefits of the information to the IRS. For example, if the cost of preparing 100 Forms 5471 was $200,000 per year (and the taxpayer reported its estimated subpart F inclusions), a court might well say that the cost to the taxpayer was disproportionate to the benefit to the IRS of the filing.

Based on the discussion in this section, it is possible that a court would determine that the IRS did not adequately explain the reason for providing a filing exemption for no ownership but not for de minimis ownership, and that the failure to provide (or consider) an exemption for de minimis ownership was arbitrary and capricious. Further, a court might find that the exemption for no stock ownership should have been extended to de minimis owners.

There is some uncertainty about how to determine the level of ownership that would be considered de minimis. The 1 percent owned by USS would appear to be small enough to warrant an exemption. However, a taxpayer could point to Notice 2018-26, which provided a de minimis exception to a partnership attribution of 5 percent.

[71] Notice 2018-26, section 3.01.

[72] *Id*. at section 7.

[73] *State Farm*, 463 U.S. at 54; *see also EPA v. EME Homer City Generation LP*, 572 U.S. 489 (2014) (use of cost-effectiveness analysis permitted).

[74] *United States v. Bajakajian*, 524 U.S. 321 (1998).

[75] *Id*. at 337-340.

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H. Notice and Comment

Generally, before a federal agency promulgates a rule, it must notify the public of the proposed rule and give the public the right to comment on it. This is the APA's notice and comment requirement. The IRS, in providing the Form 5471 filing exemption for U.S. shareholders with no stock ownership (after ignoring downward attribution), may have violated the notice and comment requirement.

Section 706(2)(D) of the APA requires courts to "hold unlawful and set aside agency action[s]" that are promulgated "without the observance of procedure required by law."[76] Section 553 of the APA generally requires that agency proposals for rulemaking be published in the *Federal Register*. That notice must give the public the ability to comment (orally or in writing) on the proposed rule. Generally, the proposed rule must be published at least 30 days before the proposed effective date.[77]

The notice and comment requirement applies to agency "rules." The APA defines a rule as "whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency."[78] The term "rulemaking" is defined as the "agency process for formulating, amending, or repealing a rule."[79]

The APA's notice and comment requirement does not apply to interpretive rules; general statements of policy; or rules of agency organization, procedure, or practice.[80] Moreover, the requirement does not apply if the agency finds (for good cause) that the requirement is "impracticable, unnecessary, or contrary to the public interest," and the agency incorporates the finding (and a brief statement of reasons therefor in the rules issued).[81] These exceptions to notice and comment do not apply if a notice or a hearing is required by statute.[82]

A federal district court recently held that subregulatory guidance issued by the IRS can be subject to the APA's notice and comment requirement. In *Bullock*,[83] the IRS tried to provide an exemption from a filing requirement (imposed by a regulation) by issuing a revenue procedure. The revenue procedure was issued without complying with the notice and comment procedure, the court found.

At issue was the requirement under the section 6033 regulations that tax-exempt organizations provide donor information on the annual Form 990. The regulations require that the filer include the names and addresses of persons who contribute $5,000 or more (or $1,000 in some cases) during the tax year.[84]

The IRS eliminated the requirement to report donor information for many filers by issuing Rev. Proc. 2018-38, 2018-31 IRB 280, and modifying the Form 990 instructions. The revenue procedure was issued without first undergoing the notice and comment procedure. The exemption was challenged by several states (which could access the information on the returns). The court set aside Rev. Proc. 2018-38 on the basis that the IRS admittedly failed to follow the notice and comment procedures in issuing the revenue procedure. It found that the notice and comment procedural requirements generally apply to IRS subregulatory guidance (without discussion).

The notice and comment requirement does not apply to interpretive rules, however. An interpretive rule does no more than "advise the public of the agency's construction of the statute and rules which it administers."[85] The court found that the exemption from the disclosure requirement did not fit within the exemption for interpretive rules.

The court distinguished an interpretive rule (which is exempt) from a legislative rule (which is not). Applying Ninth Circuit precedent, it explained that the difference between the two is

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[76] 5 U.S.C. section 706(2)(D).

[77] 5 U.S.C. section 553(b)-(d).

[78] 5 U.S.C. section 551(4).

[79] 5 U.S.C. section 551(5).

[80] 5 U.S.C. section 553(b)(A).

[81] 5 U.S.C. section 553(b)(B).

[82] 5 U.S.C. section 553(b).

[83] *Bullock*, No. 4:18-cv-00103.

[84] Reg. section 1.6033-2(a)(2)(ii)(f) and (iii)(d).

[85] *Shalala v. Guernsey Memorial Hospital*, 514 U.S. 87, 88 (1995).

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that a legislative rule has the force of law. A rule has the force of law if (1) in the absence of the rule, there would not be an adequate basis for enforcement; (2) the agency explicitly applies legislative authority; or (3) the rule amends a prior legislative rule.

The court found that the change in the disclosure rules through a revenue procedure was an attempt to "evade the time-consuming procedures of the APA."[86] It considered Rev. Proc. 2018-38 a legislative rule because it changed the application of a regulation (under a "with or without" approach). Based on the finding that Rev. Proc. 2018-38 was a legislative rule, the court held that the guidance was unlawful and invalid.

Based on the holding and analysis in *Bullock*, the Form 5471 filing exemption that the IRS provided for U.S. shareholders with no direct stock ownership may be invalid.

The foregoing analysis assumes that the *Bullock* decision is correct. The case was decided July 31, 2019, and the IRS did not appeal the decision. Treasury and the IRS subsequently issued a proposed regulation (applying the notice and comment procedure) that would implement the filing exemption described in Rev. Proc. 2018-38.[87] It therefore appears reasonable to consider the *Bullock* decision in determining whether USS should file Form 5471.

After *Bullock*, there is still uncertainty about whether IRS subregulatory guidance is subject to the APA. The court did not discuss the basis for concluding that the revenue procedure was a rule (only why it was a legislative rule and not an interpretive rule). As noted earlier, the definition of rule in the APA includes a statement that is "designed to implement, interpret, or prescribe law or policy."[88] Based on that definition, IRS instructions and other subregulatory guidance appear to be rules for purposes of the APA.

The term "rule" is used in section 7805(a) (and nowhere else in the code) and in reg. section 301.7805(a). Together, they state that the IRS, with the approval of the Treasury secretary, has the authority to prescribe all needful rules for the enforcement of the code. "Rule" is not defined in the code or the applicable regulations. Section 7805(a) does not appear to suggest that IRS rules are exempt from the APA.

Note that the Supreme Court in *Mortgage Bankers*[89] reviewed an opinion letter issued by the Department of Labor to determine whether the notice and comment requirement applied. The Court held that it did not because the opinion letter was an interpretive rule. The Court made no suggestion that the fact that this was an opinion letter, as opposed to a regulation, avoided the application of the APA requirements. In fact, the Court treated the opinion letter as a rule interpreting a regulation.[90]

Treasury recently issued a policy statement on IRS guidance. That statement clarified the proper use of subregulatory guidance, which it defined as including only items published in the Internal Revenue Bulletin — meaning notices, announcements, revenue rulings, and revenue procedures, but not form instructions. The statement adopts a policy that subregulatory guidance is to be limited (in the future) to interpreting existing law. Treasury and the IRS will no longer argue that subregulatory guidance has the force and effect of law or is entitled to deference. And if potential guidance would have the effect of modifying existing legislative rules, it will be issued through a notice and comment procedure. However, subregulatory guidance (without the notice and comment procedure) will continue to be issued to announce a "statutorily prescribed form of relief."[91]

Based on that policy, Notice 2018-13 and the 2018 instructions may be invalid in their attempt to exempt specific persons from filing Form 5471, because that exemption constituted a legislative rule that did not conform to the notice and comment requirements of the APA. Comments were not solicited for Notice 2018-13. Although comments were solicited for the 2018 instructions, the instructions were issued in final form less than

[86] *Bullock*, No. 4:18-cv-00103 (citing *Reno-Sparks Indian Colony v. EPA*, 363 F.3d 899, 1091 (9th Cir. 2003)).

[87] Prop. reg. section 1.6033-2(a)(2)(ii)(f) and (iii)(d)(1). The IRS also announced that no penalties would be asserted for taxpayers that omitted information before the decision date of *Bullock* (July 31, 2019). Notice 2019-47, 2019-39 IRB 731.

[88] 5 U.S.C. section 551(4).

[89] *Perez v. Mortgage Bankers Association*, 135 S. Ct. 1199 (2015).

[90] *Id*.

[91] Treasury, "Policy Statement on the Tax Regulatory Process" (Mar. 5, 2019).

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30 days after being issued in draft form. The IRS did not state whether it had received any comments and, if so, why it did or did not adopt the suggestions made.

Assuming that a court ultimately concludes that Notice 2018-13 and the 2018 instructions are invalid, there is a question of the appropriate remedy. Consistent with most courts, the *Bullock* court invalidated an agency action that it found to violate the APA's notice and comment requirements. If that were the remedy here, USS still might be required to file Forms 5471. The only difference is that other unrelated parties might lose their filing exemption.

On occasion, courts have not invalidated an agency action that they held to be in violation of the APA. Instead, the courts have remanded those cases to the agency for further action in accordance with the decision. This is referred to as remand without *vacatur*.

Although unusual, remand without *vacatur* has been applied by almost all the circuit courts of appeal.[92] It should be noted that the Supreme Court has not weighed in on the issue. Moreover, remand without *vacatur* has never been applied to any challenged IRS action.

The courts generally review all the facts and circumstances in determining whether remand without *vacatur* is appropriate. However, they have focused on two factors in making that determination. First, courts examine the seriousness of the agency deficiencies and whether the agency can rehabilitate the action. Second, courts examine the potential disruptive consequences of *vacatur*.[93]

In this case, the IRS tried to provide an exemption from filing for taxpayers that own no stock in a CFC (except as a result of downward attribution). Because those taxpayers would not be required to include any amounts under the subpart F regime, it is difficult to imagine that any taxpayer or commentator would object to the exemption.

The only apparent defects are that the IRS failed to follow the notice and comment procedures and failed to consider whether the exemption should be expanded to cover de minimis ownership. As a result, it appears that the defects are not serious and could be remedied on remand. For example, the IRS could request comments on the exemption and then determine if modifications are necessary.

It also appears that *vacatur* would be disruptive. Taxpayers might be required to amend returns to file Form 5471 and might have to accrue penalties for financial accounting purposes. As a result, it appears likely that if a court found that the IRS's actions violated the APA, it would remand the case to the agency to remedy the procedural defects.

V. Income Inclusion

As discussed earlier, USS has good arguments for not filing the Forms 5471. A question arises whether similar arguments can apply to avoid including USS's pro rata share of subpart F income for FS2 and its subsidiaries.

A. The Law

U.S. persons that are U.S. shareholders of a foreign corporation that is considered a CFC are subject to several potential tax inclusion regimes. Under those regimes, the U.S. shareholder can be required to include amounts in gross income based on activities of the CFC. These include regimes for (1) subpart F income; (2) investments in U.S. property under section 956;[94] (3) the section 965 transition amount (effective for the last tax year of a CFC that begins before January 1, 2018); and (4) global intangible low-taxed income (effective for tax years of a CFC beginning after December 31, 2017).[95]

If an amount must be included in gross income by the U.S. shareholder of a CFC, that shareholder includes a pro rata amount based on stock ownership in the CFC. For this purpose, only stock ownership under section 958(a) is

[92] Stephanie J. Tatham, "The Unusual Remedy of Remand Without Vacatur," Administrative Conference of the United States, Executive Summary (Jan. 3, 2014) (application in D.C., Federal, First, Third, Fifth, Eighth, Ninth, and Tenth circuits).

[93] *Allied-Signal Inc. v. Nuclear Regulatory Commission*, 988 F.2d 146, 150 (D.C. Cir. 1993).

[94] Generally repealed for corporate shareholders for tax years of a CFC beginning after December 31, 2017. Reg. section 1.956-1(a)(2) and (g)(4).

[95] Sections 951(a)(1), 951A(a), 956(a), and 965(a); TCJA section 14201(a).

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taken into account; stock ownership under section 958(b) is ignored. As a result, a U.S. person that is considered to own 10 percent or more of the stock of a CFC for purposes of determining U.S. shareholder status may be treated as owning less than 10 percent of the stock (and possibly zero) for purposes of determining the amount to include in gross income.[96]

The federal income tax on amounts that must be included under the subpart F regime can be offset by foreign tax credits. U.S. shareholders that are corporations (or individuals who make a section 962 election) that take into account income under the subpart F regime are deemed to have paid the foreign income taxes of the CFC (for FTC purposes) that are properly attributable to the income inclusion amount. These deemed-paid foreign income taxes are treated as received as dividends from the CFC if the taxpayer chooses to benefit from the FTC regime for that tax year.[97]

B. Analysis

As previously discussed, it appears that USS is a U.S. shareholder of FS2 (and each of the subsidiaries).

For the 2017 and 2018 tax years, USS's pro rata share of any subpart F inclusions would seem to be 1 percent. For this purpose, section 958(b) and downward attribution is not taken into account. Instead, USS would take into account CFC stock owned directly (1 percent of FS2) and CFC stock owned indirectly through a foreign corporation (1 percent of each of FS2's subsidiaries).[98]

For the 2019 tax year, it appears that USS's pro rata share of any subpart F inclusions would be zero. The pro rata share is determined on the last day of the tax year in which the corporation is a CFC. FS2 and each of its subsidiaries were CFCs on December 31, 2019 (the last day of the 2019 tax year), because of downward attribution. However, USS transferred its interest on June 30, 2019. As a result, it does not seem that USS will be required to include any of the subpart F inclusions for 2019. Instead, USS will recognize a gain under section 1248(a), which will be treated as a dividend to the extent of the combined accumulated earnings and profits of FS2 and its subsidiaries.

For 2020 and later tax years, FS2 and its subsidiaries will be CFCs. However, USS's pro rata share of those companies will be zero. So it appears that no amounts will be taken into income in those tax years.

As stated earlier, USS may have to include its pro rata share of any subpart F inclusions for 2017 and 2018. It is anticipated that USS will have a section 965 inclusion in 2017 and a GILTI inclusion in 2018, as well as any actual subpart F income.

To comply with the subpart F income inclusions rules, USS would be required to attach to its 2018 return Form 965 (including schedules A through H) and Form 965-B to compute the tax owed on the section 965 inclusions.[99] USS would also be required to attach to its 2018 return Form 8992 (including Schedule A) to compute the income inclusion under the GILTI rules.

As described earlier, USS has various arguments for not filing Form 5471 for FS2 and its subsidiaries. There appear to be no similar arguments to avoid filing forms 965, 965-B, and 8992. Form 5471 is an information return with its own set of filing rules and requirements, whereas forms 965, 965-B, and 8992 are designed to help taxpayers and the IRS determine the correct amount of tax. The requirement to file the latter forms appears to be authorized by section 6011(a), which provides that a person that is required by regulations to file a tax return or statement must include in the filing any information required by those forms or regulations.[100]

Because USS has to include only 1 percent of the taxable income and E&P of FS2 and each of the subsidiaries, a question arises as to whether USS can use alternative methods to estimate the amount to be included in income. This assumes that the amount included would be a de minimis amount.

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[96] Section 951(a)(1)(A) and (2); and section 956(a).

[97] Sections 78 and 960.

[98] Section 958(a).

[99] The applicable forms to compute the tax owed under section 965 were not available during the 2017 tax return filing season. As a result, the applicable forms must be attached to the 2018 return, even if the amounts relate to 2017. IRS, "Questions and Answers About Tax Year 2018 Reporting and Payments Arising Under Section 965," Q&A 6 (posted Mar. 11, 2019).

[100] *See also* reg. section 1.6011-1(a); and *Deutsche Bank v. United States*, 742 F.3d 1378, 1382-1383 (Fed. Cir. 2014) (IRS had authority to require forms 8805 and 1042-S to be attached to Form 1120F).

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The IRS in Rev. Proc. 2019-40 has given some taxpayers the ability to use alternative information to compute the amount of any subpart F income, section 965 transition amount, or GILTI inclusion. Alternative information cannot be used to determine the foreign income taxes that were paid or accrued by a CFC for deemed FTC purposes.

The ability to use the alternative information safe harbor for subpart F income and GILTI inclusion purposes is limited to a foreign-controlled CFC for which there is no related section 958(a) U.S. shareholder. Alternative information can be used if the necessary information is not readily available to the unrelated section 958(a) U.S. shareholder. In that instance, the unrelated section 958(a) U.S. shareholder can choose to use the alternative information to determine the amount of any subpart F income or GILTI inclusion.[101]

The revenue procedure lists eight sources of information that can qualify as alternative information. They include separate-entity financial statements for the CFC (audited or unaudited) that are prepared under U.S. generally accepted accounting principles, international financial reporting standards, or local-country GAAP; or separate-entity records used by the CFC for tax reporting, internal management controls, or regulatory or similar purposes. There are ordering rules for which source can be used.[102]

The IRS in Rev. Proc. 2019-40 also provided an alternative information safe harbor for determining the amount of any section 965 inclusion (or the related deduction). This safe harbor is unavailable for U.S.-controlled CFCs and foreign-controlled CFCs for which there is a related section 958(a) U.S. shareholder.

Under the safe harbor, alternative information can be used if the necessary information is not readily available to the section 958(a) U.S. shareholder and the information is reported on a return that is both due and filed on or before October 1, 2019 (or a return that is both due and filed after October 1, 2019). In that case, the unrelated section 958(a) U.S. shareholder can choose to use the alternative information to determine the amount of any subpart F income or GILTI inclusion.[103]

The IRS concluded in Example 2 of Rev. Proc. 2019-40 that USS (in that example) is a related section 958(a) U.S. shareholder of FS2 and that FS2 is a foreign-controlled CFC. Because USS is not an unrelated section 958(a) U.S. shareholder, it cannot use either of the alternative information safe harbors.

Note that the alternative information procedures do not allow taxpayers to use consolidated or combined financial statements to determine subpart F inclusions. The forms in question would require USS to provide separate information for FS2 and for each of the 100 subsidiaries. Some taxpayers in this situation might simplify the reporting by providing a combined amount (and using a consolidated or combined financial statement to determine the amounts). It is unclear if there are any legal consequences or penalties for simplifying the reporting. However, based on the agency's positions in Rev. Prov. 2019-40, it is apparent that the IRS would not approve of such combined calculations or reporting.

Taxpayers might be allowed to estimate the amounts (even when the alternative information safe harbors don't apply). Under the *Cohan* doctrine,[104] taxpayers that do not keep adequate records have been permitted by the courts to estimate the proper amount of a tax item. In that case, all benefits of the doubt must inure to the government (to avoid rewarding a taxpayer for "inexactitude[s] . . . of his own making.").[105] The doctrine was recently applied by the Tax Court in *Moore*[106] to allow deductions for commission expenses.

The IRS and the courts have not issued clear guidance on when taxpayers can use estimates.

[101] Rev. Proc. 2019-40, section 5.

[102] *Id.* at section 3.01.

[103] *Id.* at section 6.

[104] *Cohan*, 39 F.2d 540. In the case, entertainer George M. Cohan did not keep receipts for business expenses. He was able to prove that he did in fact incur expenses, and he was then allowed to estimate the amount.

[105] *Id.* at 544. *Vaughn v. Commissioner*, T.C. Memo. 1986-578 (estimate of cash labor costs reduced based on uncertainty and lack of substantiation); *see also* reg. section 1.274-5T(c)(4) and (5) (alternate means permitted when records are lost or in exceptional circumstances); and AM 2009-006.

[106] *Moore v. Commissioner*, T.C. Memo. 2019-100.

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The American Institute of CPAs has issued such guidance to its members. The AICPA's professional standards allow CPAs to rely on taxpayer estimates in preparing a tax return (unless prohibited by statute or rule). The CPA must determine that the estimates are reasonable based on the facts and circumstances and professional judgment. The guidance specially mentions that estimates are generally appropriate when dealing with small amounts.

The AICPA's professional standards require CPAs to disclose the use of estimates only in unusual circumstances (for example, death of the taxpayer, failure to receive information returns, litigation affecting the availability of information, and loss of pertinent records).[107] Taxpayers that use estimates of separate, consolidated, or combined amounts should consider disclosing the fact that estimates were used.

VI. Statute of Limitations

A question arises whether a failure by USS to attach the Forms 5471 to its tax return will affect the statute of limitations on assessment of tax, interest, and penalties for that year. As a general rule, the IRS can assess an income tax only within three years after a tax return is filed.[108]

If no return is filed, the IRS can assess the tax at any time.[109] If USS does not attach the Forms 5471 to its return, the IRS might assert that USS has not filed an income tax return. If that position is successful, the statute of limitations on the returns would never start to run.

The Tax Court in *Beard*[110] established a four-part test for determining whether a valid return was filed: (1) did the document purport to be a return; (2) was it executed under penalties of perjury; (3) did it contain sufficient data to allow the IRS to calculate the tax; and (4) "there must be an honest and reasonable attempt to satisfy the requirements of the tax law."[111] This is sometimes referred to as the substantial compliance standard.

The IRS's position, based on the *Beard* standard, appears to be that a return that is filed without a required entry, form, schedule (or missing information or documentation) is still a valid return.[112] Further, the Tax Court has treated a return with a single frivolous schedule (Schedule C showing a $100 billion loss) to be a valid return.[113] Thus, it appears that an income tax return of USS would be treated as a valid return if the only missing entries, returns, or schedules are the Forms 5471.

If information is required to be reported under section 6038 or 6046 (among other provisions), the time for assessment is extended until three years after the IRS receives the information.[114] If the failure to furnish the information is attributable to reasonable cause and not willful neglect, the assessment period is not extended (except for items that should have been timely disclosed).[115]

Even if USS's return is a valid return, the statute of limitations on assessment will not start to run if the Forms 5471 are required to be attached under section 6038(a)(4).[116] If the failure to attach the Forms 5471 is attributable to reasonable cause, the statute of limitations will generally start to run when the return is filed. If the reasonable cause exception is met, the only allowable adjustments after the original three-year period are (1) adjustments made to the tax consequences shown on the return for transactions that are the subject of the information return; (2) adjustments to the extent affected by the transaction, even if unrelated to the transaction (for example, an adjustment to a limitation); and (3) interest and penalties that relate to the transaction or an adjustment made to the tax consequences.[117]

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[107] AICPA, Statement on Standards for Tax Services, No. 4, Use of Estimates.

[108] Section 6501(a); and reg. section 301.6501(a)-1(a).

[109] Section 6501(c)(3); and reg. section 301.6501(c)-1(c).

[110] *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986).

[111] *Beard*, 82 T.C. at 777.

[112] PMTA 01947 (Sept. 2, 2008).

[113] *Steines v. Commissioner*, T.C. Memo. 1991-588, *aff'd*, 12 F.3d 1101 (7th Cir. 1993).

[114] Section 6501(c)(8)(A).

[115] Section 6501(c)(8)(B).

[116] Section 6501(c)(8)(A).

[117] Section 6501(c)(8)(B); and JCT, "Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010," JCX-46-10, at 37 (Aug. 10, 2010).

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As a result, it appears that USS could have liability after the three-year period for (1) the income tax (plus interest and penalties) related to the activities of the CFCs (that is, subpart F income, section 965 income, and GILTI), and (2) the potential penalties for failure to timely file the Forms 5471. This assumes that reasonable cause can be established.

The IRS has not issued any general guidance on the reasonable cause exception. It has indicated in a ruling that the determination "depends on all the facts and circumstances."[118] The applicable legislative history indicates that to meet the reasonable cause exception, the "taxpayer must establish that the failure was objectively reasonable (i.e., the existence of adequate measures to ensure compliance with rules and regulations) and in good faith."[119]

As noted earlier, there are good arguments available that would allow USS to take the position that it doesn't need to attach the Forms 5471 to its tax returns. This would appear to allow USS to establish that there was reasonable cause for not filing the forms and that the failure was not attributable to willful neglect.

As a result, it is likely that any extension of the statute of limitations would be limited to adjustments to taxable income that relate to items that would have been disclosed on the form (for example, penalties for not filing and income inclusions under section 965 and GILTI).

VII. Penalties

The code provides various penalties for failure to file a Form 5471 on time (or with complete information). The penalties can generally be waived if the taxpayer's failure is attributable to reasonable cause.

A. The Law

Various penalties are provided for failures to meet the filing requirements of section 6038(a)(1). A penalty of $10,000 per form is provided for a failure to fully meet the filing requirements on a timely basis.[120] This penalty is on a per-form, per-year basis. So if five forms are due in a year, the penalty could be $50,000 if the forms are filed late or are incomplete (or are not filed at all). The penalties increase if a failure to file continues after the IRS sends the taxpayer a notice of noncompliance.[121] In addition to the monetary penalties, any FTC allowable for the CFC's activities are subject to reduction if the applicable forms are filed late or are incomplete.[122]

If the IRS finds that there is reasonable cause for a late filing under section 6038(a)(1), the time for filing the information return is extended until the last day on which reasonable cause existed.[123]

Penalties are also provided for failures to meet the filing requirements of section 6046(a). A penalty of $10,000 per form is provided for a failure to fully meet the filing requirements on a timely basis.[124] This penalty is on a per-form, per-year basis. The penalties increase if a failure to file continues after the IRS sends the taxpayer a notice of noncompliance.[125] A penalty for late filing under section 6046(a) can be waived by the IRS if there is reasonable cause for the late filing.[126]

Section 7203 provides for criminal penalties if a taxpayer willfully fails to file a tax return or information return (including Form 5471). If convicted, that taxpayer would be guilty of a misdemeanor and subject to a fine of up to $100,000 (for a corporation), in addition to any applicable civil penalties.[127]

B. Analysis

As discussed, the code provides for a $10,000 per-form penalty for Form 5471 failures under section 6038(a)(1) or 6046. It seems that neither section applies to USS because neither provision applies downward attribution.

If USS has an obligation to file Form 5471, it is under section 6038(a)(4). There are no statutory provisions that specifically provide for penalties for noncompliance with section 6038(a)(4).

[118] ILM 201206014.

[119] *Id.*

[120] Section 6038(b)(1); and reg. section 1.6038-2(k)(1)(i).

[121] Section 6038(b)(2); and reg. section 1.6038-2(k)(1)(ii).

[122] Section 6038(c); and reg. section 1.6038-2(k)(2).

[123] Section 6038(c)(4)(B); and reg. section 1.6038-2(k)(3).

[124] Section 6679(a)(1); and reg. section 301.6679-1(a)(1).

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

[126] Section 6679(a)(1); and reg. section 301.6679-1(a)(3).

[127] Section 7203; *see also* sections 6038(f)(1) and 6046(f).

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It is possible that there are no civil penalties for noncompliance with section 6038(a)(4). The penalties described in section 6038(b) specifically reference section 6038(a)(1). However, there is some ambiguity because a taxpayer that is required to file under section 6038(a)(4) can be required by the IRS to furnish the information required under section 6038(a)(1).[128]

In at least one ruling, the IRS has treated a failure to file under section 6038(a)(4) as subject to the penalty under 6038(a)(1).[129] However, in other situations, the IRS has treated the filing obligations under section 6038(a)(1) and 6038(a)(4) as separate obligations.[130]

The Tax Court in a nonprecedential memorandum opinion recently upheld penalties imposed by the IRS on a taxpayer for a failure to file a Form 5471 under section 6038(a)(4).[131] It appears that the taxpayer did not raise the argument that there are no penalties for noncompliance with section 6038(a)(4) filing requirements.

Based on this analysis, there are good arguments for the position that there are no civil penalties for a failure to comply with the filing requirements of section 6038(a)(4).

Even if the section 6038(b) penalty applies to noncompliance with section 6038(a)(4), the reasonable cause exception might apply. For purposes of the section 6038(b) penalty, the due date for filing information on Form 5471 is extended until the last day on which reasonable cause existed for the noncompliance. To meet that exception, reasonable cause must be shown to the satisfaction of the IRS.[132]

The applicable regulations do not define the meaning of reasonable cause for purposes of section 6038(b). However, the term "reasonable cause" is used frequently in connection with exceptions to other penalties.

The Internal Revenue Manual states that the IRS will grant reasonable cause relief from a penalty "when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but nevertheless is unable to comply with those obligations."[133] The regulations under the accuracy penalties of section 6662 state that reasonable cause is determined on a case-by-case basis, taking into account all the facts and circumstances. The most important factor is the extent of the taxpayer's efforts to resolve the issue. Reasonable cause includes "an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer."[134] Note that the penalty under section 6662 can be waived only if the taxpayer acted in good faith, in addition to having reasonable cause. The exception to the section 6038(b) penalty does not appear to require the taxpayer to have acted in good faith, although that may well be a distinction without a difference.

If USS doesn't file the Forms 5471 based on a view that the filing was not required, the reasonable cause exception might be met. If the law is uncertain when a taxpayer decides to take a position on a return, that fact can be considered in determining whether reasonable cause exists.[135]

However, the IRS has taken the position that the mere existence of an uncertain state of law is alone insufficient to support a finding of reasonable cause. In the IRS's view, an uncertain state of law should be a factor only if the taxpayer made a proper contemporaneous investigation of the state of the law and, if appropriate, consulted with a competent professional.[136] So a taxpayer maintaining that a Form 5471 filing isn't required would be well advised to have the position documented in writing before the applicable return is filed.

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[128] Section 6038(a)(4).

[129] AM 2014-002.

[130] Rev. Proc. 92-70, 1992-2 C.B. 435 (Form 5471 procedures for dormant foreign corporations).

[131] *Flume v. Commissioner*, T.C. Memo. 2017-21.

[132] Section 6038(c)(4)(B); and reg. section 1.6038-2(k)(3)(i).

[133] IRM section 20.1.1.3.2(1) (Nov. 21, 2017).

[134] Reg. section 1.6664-4(b) and (c); *see also* reg. section 1.6038A-4(b)(2)(iii).

[135] *Patel v. Commissioner*, 138 T.C. 395, 416-417 (2012) (charitable deduction). *But see DJB Holding Corp. v. Commissioner*, 803 F.3d 1014, 1030-1031 (9th Cir. 2015) (*Patel* not applied because law was settled); and AOD 2012-05 (announcing that the IRS won't acquiesce in the part of the *Patel* decision holding that the uncertain state of the law, without a finding of a taxpayer's efforts to determine the state of the law, is a factor in determining whether a taxpayer acted with reasonable cause and good faith for purposes of avoiding accuracy-related penalties).

[136] AOD 2012-05.

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Thus, there are good arguments available that even if the penalty under section 6038(b) applies, it can be waived under the reasonable cause exception. Remember, however, that reasonable cause extends the filing deadline for penalty purposes only as long as reasonable cause exists. If the law later becomes settled such that the requirement to file was clear, the penalties could become nonwaivable.

VIII. Conclusion

Based on Example 2 of Rev. Proc. 2019-40, it seems clear that the IRS does not believe that taxpayers that have small-percentage stock interests in a CFC are exempt from filing Forms 5471. However, taxpayers may be able to challenge this position on grounds that the IRS violated the APA in providing for an exemption for taxpayers who only have a stock interest in a CFC if downward attribution applies. The basis for the challenge could be that (1) the failure to provide a similar filing exemption for taxpayers with small stock interests was arbitrary and capricious, or (2) the IRS violated the notice and comment provisions in providing the existing filing exemption. Further, taxpayers may be able to avoid filing Forms 5471 for the 2017 tax year because the applicable forms and regulations did not provide for any filing requirements related to downward attribution before the beginning of the tax year, as required by section 6038(a)(3).

It will be interesting to see if any of the issues described in this article are ever litigated. We will have to wait and see how IRS auditors handle situations in which a Form 5471 filing may be required as the result of downward attribution. ■

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