

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

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to: Jeffrey Johnson, International Technical Advisor
LM:PFT:I

from: Elizabeth Beck, Branch Chief
CC:INTL:BR6

subject: I.R.C. 6038A - Form 5472

This Technical Assistance responds to your memorandum dated March 10, 2004 requesting advice on the reporting requirements under I.R.C. § 6038A and attendant regulations. Technical Advice does not relate to a specific case and is not binding on Examination or Appeals. This advice is not to be used or cited as precedent.

ISSUES:

Under each of the four circumstances presented, whether taxpayer's timely-filed Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) is "substantially incomplete" within the meaning of Treas. Reg. § 1.6038A-4(a)(1) and, if so, whether the section 6038A(d) monetary penalty for failure to furnish information should be imposed.

CONCLUSIONS:

Our analysis of the facts given in each of the described circumstances shows that the Forms 5472 are likely to be "substantially incomplete" within the meaning of Treas. Reg. § 1.6038A-4(a)(1). However, there is insufficient information to determine whether the penalty should be excused under the reasonable cause provisions of section 6038A(d)(3) and Treas. Reg. § 1.6038A-4(b).

FACTS:

All of the scenarios assume that taxpayer:

- 1) Is a reporting corporation as defined in Treas. Reg. § 1.6038A-1(c) and not a "small corporation" as defined in Treas. Reg. § 1.6038A-4(b)(2)(ii);
- 2) Timely filed Forms 5472 for transaction(s) during its taxable year with its parent, a

- foreign corporation;
- 3) Included all information required by Treas. Reg. § 1.6038A-2(b)(1) and (2) on the Forms 5472; and
 - 4) Did not use estimated amounts on its Forms 5472 because the actual amount of each of the reportable transactions was “determinable” as that term is used in Treas. Reg. § 1.6038A-2(b)(3).

Additional facts that are assumed regarding the transactions in each scenario are:

- 1) The amount of each type of reportable transactions is larger than \$50,000;
- 2) The amounts reported on the Forms 5472 are identical to the amounts reported for U.S. customs purposes;
- 3) The magnitude of the erroneous transaction is substantial in relation to all other reportable transactions as correctly reported; and
- 4) The magnitude of the erroneous transaction is substantial in relation to the reporting corporation’s volume of business and overall financial situation.

DISCUSSION:

Section 6038A – In General

Before addressing each specific question, a general overview of section 6038A and its attendant regulations is appropriate.

In 1987, in order to permit the Internal Revenue Service (“Service”) to obtain information necessary to audit transactions between certain foreign-owned U.S. companies (“reporting corporations”) and other related parties, Congress enacted section 6038A which expanded various reporting and record-keeping requirements of these reporting corporations. Staff of Joint Committee on Taxation, 99th Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1986 (JCS-10-87) at 1053-1054 (J.Comm. Print 1987). Later, in 1989, Congress significantly revised section 6038A to provide the Service with additional tools for auditing transactions between foreign-owned U.S. corporations and their non-U.S. parent corporations. Congress believed these changes were necessary because the lack of clear jurisdiction for enforcement of summonses coupled with inadequate foreign standards for record-keeping and preservation of documents had “substantially interfered” with the Service’s ability to effectively audit the foreign-owned U.S. companies. As part of the revisions, reporting, record-keeping and document-preservation requirements were expanded and monetary penalties for non-compliance with these requirements increased from \$1,000 to \$10,000 per incident. H.R. Rep. No. 101-386, 101st Cong., 1st Sess., at 1296-1297 (1989).

Under section 6038A and attendant regulations, each “reporting corporation” must file a separate annual information return on Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) with respect to each “related party” with which the reporting corporation had any “reportable transaction” during the taxable year, even though the required

information may not affect the amount of any tax due under the Code. Treas. Reg. § 1.6038A-2(a)(1). The definition of “reporting corporation” includes a domestic corporation that is 25-percent foreign-owned, or a foreign corporation that is 25-percent foreign-owned and engaged in a trade or business within the United States. Treas. Reg. § 1.6038A-1(c)(1). A “related party” includes any person who is related to the reporting corporation or a 25-percent foreign shareholder of the reporting corporation. I.R.C. § 6038A(c)(2); Treas. Reg. § 1.6038A-1(d).

“Reportable transactions” consist of foreign related party transactions involving: 1) monetary consideration paid or received by the reporting corporation; or 2) non-monetary consideration or less-than-full consideration. Treas. Reg. § 1.6038A-2(b). With respect to transactions involving solely monetary consideration, Treas. Reg. § 1.6038A-2(b)(3) provides:

If the related party is a foreign person, the reporting corporation must set forth on Form 5472 the dollar amounts of all reportable transactions for which monetary consideration (including U.S and foreign currency) was the sole consideration paid or received during the taxable year of the reporting corporation. The total amount of such transactions, as well as the separate amounts for each type of transaction described below, must be reported on the Form 5472, in the manner the form prescribes. Where actual amounts are not determinable, a reasonable estimate (as described in paragraph (b)(6) of this section) is permitted. The types of transactions described in this paragraph are:

- (i) Sales and purchases of stock in trade (inventory);
- (ii) Sales and purchases of tangible property other than stock in trade;
- (iii) Rents and royalties paid and received (other than amounts reported under paragraph (b)(3)(iv) of this section);
- (iv) Sales, purchases, and amounts paid and received as consideration for the use of all intangible property . . .;
- (v) Consideration paid and received for technical, managerial, engineering, construction, scientific, or other services;
- (vi) Commissions paid or received;
- (vii) Amounts loaned and borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph (b)(3) that arise and are collected in full in the ordinary course of business);
- (viii) Interest paid and received;
- (ix) Premiums paid and received for insurance and reinsurance; and

- (x) Other amounts paid or received not specifically identified in this paragraph (b)(3) to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting corporation.

(Emphasis added.)

In Part IV, Form 5472 requires a reporting corporation to separately categorize by type the reporting corporation's transactions with the named foreign related party by listing the amounts paid and received pursuant to Treas. Reg. § 1.6038A-2(b)(3).

A reporting corporation is required to file the Form 5472 with its income tax return for the taxable year by the due date (including extensions) of that return. Treas. Reg. § 1.6038A-2(d). Under certain circumstances, a reporting corporation must also file a duplicate Form 5472 with the Philadelphia Service Center. Treas. Reg. § 1.6038A-2(d); Temp. Treas. Reg. § 1.6038-2T(d). If a reporting corporation fails to file the Form 5472 within the prescribed deadline, the reporting corporation may be assessed a monetary penalty of \$10,000 for each taxable year for which such failure occurs. I.R.C. § 6038A(d)(1); Treas. Reg. § 1.6038A-4(a)(1). If a reporting corporation files a "substantially incomplete" Form 5472, it will be deemed to have failed to file the Form 5472. Treas. Reg. § 1.6038A-4(a)(1). A failure to include certain items not required to be reported is not a "substantially incomplete" Form 5472. *Id.* There is no other specific guidance in the regulations or case law regarding the meaning of the term "substantially incomplete" as that term is used in Treas. Reg. § 1.6038A-4(a)(1).

In addition, section 6038A(d)(3) provides that reasonable cause will postpone the time prescribed by the regulations to furnish the requisite information. More specifically, the regulations provide that the failure to timely file a Form 5472 and the corresponding monetary penalty may be excused upon taxpayer's affirmative showing that it acted in good faith and there is reasonable cause for the failure. Treas. Reg. § 1.6038A-4(b)(1). Any analysis of reasonable cause necessarily involves an inquiry into the facts and circumstances of the particular failure. A variety of facts may indicate reasonable cause, such as "an honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer" or "reliance upon the advice of a professional" if the "reliance was reasonable" under the facts and circumstances. Treas. Reg. § 1.6038A-4(b)(2)(iii). Even "isolated computational or transcriptional errors" may be consistent with reasonable cause under certain circumstances. *Id.*

In summary, in order for a monetary penalty for failure to furnish information to be imposed under section 6038A, there must be a showing that: 1) the Form 5472 was not timely filed or was "substantially incomplete"; and 2) taxpayer did not have reasonable cause for the failure to file or for filing a "substantially incomplete" Form 5472. With respect to the second showing, the facts in the questions presented below are insufficient to reach a determination. Consequently, the discussion below will only address whether the Form 5472 is "substantially incomplete."

Question 1:

Would a taxpayer's over-reporting of amounts in Part IV of Form 5472 render the Form 5472 "substantially incomplete" within the meaning of Treas. Reg. § 1.6038A-4(a)(1)?

For example, taxpayer reports on its Form 5472 Purchases of Stock in Trade in the amount of \$1,000X. Upon examination, the Service determines that the correct amount of Purchases of Stock in Trade was actually \$500X. This is the amount that should have been reported on the Form 5472. Does this over-reporting constitute a "substantially incomplete" Form 5472 pursuant to Treas. Reg. § 1.6038A-4(a)(1), and would a monetary penalty be excused in this situation?

Analysis:

Our initial inquiry here is whether the mere fact that taxpayer over-reported (as opposed to underreported) the amount of the transactions for Purchases of Stock in Trade on the Form 5472 impacts the analysis. We believe not. As explained above, section 6038A was enacted, and then later revised, in order to assist the Service in auditing foreign-owned U.S. taxpayers. Such assistance was provided in the form of imposing additional reporting and record-keeping requirements on those U.S. taxpayers. A taxpayer that underreports, or over-reports, a particular transaction in a substantial amount frustrates the Service's efforts to audit that taxpayer. A taxpayer's error may also compel the Service to conduct a more intensive investigation than would have been necessary had the taxpayer correctly reported the transaction on the Form 5472. Accordingly, it is the error itself, as opposed to whether the error involves an underreporting or over-reporting, which undermines the ability of the Service to rely upon a taxpayer's reporting of related party transactions.

With respect to the amount over-reported, Treas. Reg. § 1.6038A-2(b)(3) sets forth the reporting requirements for particular types of transactions. One interpretation of Treas. Reg. § 1.6038A-2(b)(3) is that if a taxpayer has either underreported or over-reported a particular type of transaction in any amount, then the Form 5472 is "substantially incomplete" under Treas. Reg. § 1.6038A-4(a)(1) ("Strict Interpretation"). The express language of Treas. Reg. § 1.6038A-2(b)(3) requires that the "separate amounts" for each particular transaction "must be reported" and provides that only "when actual amounts are not determinable" is a taxpayer permitted to provide a reasonable estimate instead of the correct amount. In this question, it is assumed that taxpayer did not use estimates. Since taxpayer did not use estimates, under this Strict Interpretation taxpayer's error in over-reporting Purchases of Stock in Trade by 500X would constitute a failure to report the requisite "separate amounts" for that particular type of transaction and result in the Form 5472 being "substantially incomplete." We note that this Strict Interpretation is a rigorous interpretation of the regulations and, depending on the particular circumstances, may yield a harsh result.

Another interpretation of the language of Treas. Reg. § 1.6038A-2(b)(3) is that, in a situation where a taxpayer underreported or over-reported a particular type of reportable transaction, the question of whether the Form 5472 is "substantially incomplete" under

Treas. Reg. § 1.6038A-4(a)(1) depends upon an examination of all of the relevant facts and circumstances (“Facts and Circumstances Interpretation”). This Facts and Circumstances Interpretation would allow taxpayers some leeway where the amounts are erroneously reported, but not excusable for reasonable cause. A Facts and Circumstances Interpretation also gives significance to the modifying term “substantially,” which is defined by the dictionary to mean “being of considerable importance, value, degree, amount or extent.” Webster’s II New College Dictionary 1099 (1999). Thus, under this interpretation, although the regulations require a strict reporting of amounts, the deemed failure to file for a “substantially incomplete” Form 5472 does not require the filed Form 5472 to be exact in every respect, rather some leeway in this regard is permitted. The amount of such leeway is not stated in the regulations and appears to be a matter of degree.

A Facts and Circumstances Interpretation would allow one to consider differing elements which affect that degree of acceptability. We believe that the following facts and circumstances should be considered in making this determination:

- 1) The magnitude of the underreporting, or of the over-reporting, of the erroneous reported transaction(s) in relation to the actual total amount of that reported type of transaction(s);
- 2) Whether the reporting corporation has reportable transactions other than the erroneous reported transaction(s) with the same related party and correctly reported such other transactions;
- 3) The magnitude of the erroneous reported transaction(s) in relation to all of the other reportable transactions as correctly reported;
- 4) The magnitude of the erroneous reported transaction(s) in relation to the reporting corporation’s volume of business and overall financial situation;
- 5) The significance of the erroneous reported transaction(s) to the reporting corporation’s business in a broad functional sense;
- 6) Whether the erroneous reported transaction(s) occur(s) in the context of a significant ongoing transactional relationship with the related party; and
- 7) Whether the erroneous reported transaction(s) is (are) reflected in the determination and computation of the reporting corporation’s taxable income.

When considering and applying these factors to any particular situation, it must be remembered that no one factor is necessarily more important than any other factor. The factors themselves may contain evaluative characteristics when combined with other facts to indicate the completeness of the reporting.

In applying the above seven factors to this question, taxpayer’s over-reporting of Purchases of Stock In Trade (which were reported as \$1000X but should have been reported as \$500X) will likely result in the Form 5472 being “substantially incomplete” under Treas. Reg. § 1.6038A-4(a)(1). The magnitude of this over-reporting is substantial because the overstatement is 50% of the transaction type (\$500X of \$1,000X), thus satisfying the first factor. The question assumes that the magnitude of the erroneous transaction is substantial in relation to all other reportable transactions as

correctly reported, thus satisfying the third factor. Similarly, the question assumes that the magnitude of the erroneous transaction is substantial in relation to the reporting corporation's volume of business, thus satisfying the fourth factor.

It is important to recognize that these three factors (the first, third and fourth factors) address the issue of "substantial," or as Webster's states "considerable in importance, value, degree, amount or extent," and consequently these three factors are very influential, and may even determine, the ultimate conclusion as to whether the Form 5472 is "substantially incomplete."

As to the other three factors, the question as presented does not provide sufficient information to determine: 1) whether the reporting corporation has other reportable transactions with the same related party (the second factor); 2) the significance of the erroneous reported transaction in a broad functional sense (the fifth factor); and 3) whether the erroneous transaction occurs in the context of a significant ongoing relationship (the sixth factor). If additional facts were presented regarding these factors, those additional facts could affect the determination as to whether the Form 5472 was "substantially incomplete."

Overall, the factors as applied to the facts of this question indicate that the Form 5472 is likely to be considered "substantially incomplete" pursuant to Treas. Reg. § 1.6038A-4(a)(1). Additionally, the facts presented here are insufficient to determine whether the penalty should be excused for reasonable cause.

Question 2:

In a situation where a taxpayer reports amounts of intercompany trade receivables (as defined by Treas. Reg. § 1.482-2(a)(1)(ii)(A)(2)) not specifically required to be reported on Form 5472, and later corrects the Form 5472 to remove these amounts from the Form 5472, would the originally filed Form 5472 be "substantially incomplete" within the meaning of Treas. Reg. § 1.6038A-4(a)(1)?

For example, taxpayer sells goods in the ordinary course of its business to its foreign parent for resale to unrelated persons. On its timely-filed Form 5472, taxpayer reports Amounts Borrowed in the amount of \$1,000X and the correct amount of its sales receipts from its parent. Upon examination, the Service determines that \$400X of this amount was for intercompany trade receivables (as defined in Treas. Reg. § 1.482-2(a)(1)(ii)(A)(2)) from the parent and that all of these intercompany trade receivables were due and paid during the "interest free period" as defined in Treas. Reg. § 1.482-2(a)(1)(iii) which was less than sixty days. The Service determines that the amounts of intercompany trade receivables are not required to be shown on Form 5472 as a reportable transaction. The Service also determines that taxpayer correctly reported interest for the category of Amounts Borrowed. Taxpayer submits a corrected Form 5472 to show the Amounts Borrowed to be \$600X. Does this original over-reporting constitute a "substantially incomplete" Form 5472 per Treas. Reg. § 1.6038A-4(a)(1), and would a monetary penalty be appropriate in this situation?

Analysis:

Under the Strict Interpretation of Treas. Reg. § 1.6038A-2(b)(3) described previously, taxpayer's over-reporting of Amounts Borrowed by \$400X makes the Form 5472 "substantially incomplete" because taxpayer did not accurately report the "separate amounts" for Amounts Borrowed.

Under the Facts and Circumstances Interpretation of Treas. Reg. § 1.6038A-2(b)(3), taxpayer's over-reporting of Amounts Borrowed (by including \$400X in intercompany trade receivables) will likely result in the Form 5472 being "substantially incomplete" pursuant to Treas. Reg. § 1.6038A-4(a)(1).

In applying the seven factor test, the magnitude of taxpayer's over-reporting is substantial because the overstatement is 40% of the transaction type (\$400X of \$1000X). Furthermore, the question assumes that the magnitude of the over-reporting of Amounts Borrowed is substantial in relation to all other reportable transactions as correctly reported, thus satisfying the third factor. Similarly, the question assumes that the magnitude of the over-reporting of Amounts Borrowed is also substantial in relation to the reporting corporation's volume of business, thus satisfying the fourth factor. As explained earlier, these three factors address whether the error is "substantial" or "considerable in importance, value, degree, amount, or extent" and therefore may influence, or even determine, whether the Form 5472 is "substantially incomplete."

In contrast, the seventh factor is not satisfied. Taxpayer's error in including \$400X of intercompany trade receivables will not affect taxpayer's computation of any item of income or expense, including interest expense, since the intercompany trade receivables accrue no interest, and therefore will not affect the reporting of taxpayer's taxable income.

As to the other three factors, the question as presented does not provide sufficient information to determine: 1) whether the reporting corporation has other reportable transactions with the same related party (the second factor); 2) the significance of the erroneous reported transaction in a broad functional sense (the fifth factor); and 3) whether the erroneous transaction occurs in the context of a significant ongoing relationship (the sixth factor). If additional facts were presented regarding these factors, those additional facts could affect the determination as to whether the Form 5472 as filed was "substantially incomplete."

Despite this lack of information, the factors as applied to the facts of this question indicate that the Form 5472 is likely to be considered "substantially incomplete" pursuant to Treas. Reg. § 1.6038A-4(a)(1). In addition, the facts presented here are insufficient to determine whether the penalty should be excused for reasonable cause.

Question 3:

If the amount reported on Form 5472 as the ending balance of related party loans does not match the opening balance on the next year's Form 5472 for that party, does this mismatch render the Form 5472 "substantially incomplete" within the meaning of Treas. Reg. § 1.6038A-4(a)(1)?

For example, on Form 5472 for Year 1, taxpayer chooses the outstanding balance method and reports the ending balance of loans to taxpayer's foreign parent to be \$1,000X. The Service audits and determines that this amount is the actual ending balance, rather than the average monthly balance for this loan, and that this amount is the correct ending balance for Year 1. The Service also audits and determines that interest relating to this ending balance of related party loans was properly reported on the Form 5472 for Year 1. On a timely-filed Form 5472 for Year 2, the opening balance of the same loan is incorrectly reported on the outstanding balance method to be \$600X. Taxpayer however correctly reports the amount of interest for related party loans for Year 2 on the Form 5472. Would this error in the beginning balance for Year 2 constitute a "substantially incomplete" Form 5472 per Treas. Reg. § 1.6038A-4(a)(1), and would a monetary penalty be appropriate in this situation?

Analysis:

Under the Strict Interpretation of Treas. Reg. § 1.6038A-2(b)(3) described earlier in this advice, taxpayer's underreporting of related party loans by \$400X makes the Form 5472 "substantially incomplete" since taxpayer did not accurately report the "separate amounts" for the related party loans.

In applying the seven factors described as part of the Facts and Circumstances Interpretation, taxpayer's underreporting by \$400X of the opening balance of related party loans will likely result in the Form 5472 being "substantially incomplete" under Treas. Reg. § 1.6038A-4(a)(1).

The magnitude of taxpayer's underreporting of the opening balance is substantial because it constitutes 40% of the transaction type (\$400X of \$1000X). Thus, the first factor is satisfied. The magnitude of the underreporting in relation to all other reportable transactions as correctly reported, which is the third factor, is also substantial because this fact was assumed as part of the question. Similarly, the magnitude of the underreporting in relation to the reporting corporation's volume of business, which is the fourth factor, is substantial because this fact was also assumed as part of the question. Once again, these three factors (the first, third and fourth factors) address the question of whether the error is "substantial" and are therefore very influential in determining whether the Form 5472 is "substantially incomplete." Last, the sixth factor appears to be satisfied because this loan has been in effect for at least two years and therefore constitutes part of a significant, ongoing relationship between taxpayer and the related party.

The seventh factor is not satisfied. Although taxpayer erroneously underreported by \$400X the opening balance of related party loans for Year 2, taxpayer correctly reported

interest associated with these related party loans. Consequently, taxpayer's error will not affect the computation of any item of income or expense, including interest expense, and therefore will not be reflected in the computation of the reporting corporation's taxable income in the relevant year.

The question lacks sufficient information regarding: 1) whether the reporting corporation has other reportable transactions with the same related party (the second factor); and 2) the significance of the erroneous reported transaction in a broad functional sense (the fifth factor). If additional facts were presented regarding these factors, those additional facts could affect the determination as to whether the Form 5472 as filed was "substantially incomplete."

Despite this lack of information, the factors as applied to the facts indicate that the Form 5472 is likely to be considered "substantially incomplete" pursuant to Treas. Reg. § 1.6038A-4(a)(1). Additionally, the facts presented here are insufficient to determine whether the penalty should be excused for reasonable cause.

Question 4:

Would a taxpayer's over-reporting of one amount and underreporting of another amount in Part IV of Form 5472 render the Form 5472 "substantially incomplete" within the meaning of Treas. Reg. § 1.6038A-4(a)(1)?

For example, taxpayer reports on its Form 5472 Purchases of Stock In Trade in the amount of \$1,000X. Upon audit the Service determines that the correct amount of Purchases of Stock In Trade is \$500X. On the same Form 5472, taxpayer reports Commissions Paid in the amount of \$1,200X. Upon audit, the Service determines that the correct amount of Commissions Paid is \$1,600X.

Accordingly, the correct amount of total reportable related party transactions (in the aggregate) is \$2,100X instead of the reported \$2,200X for a \$100X difference. While the \$100X aggregate difference may not be substantial, would the material changes to each reported item (50% over-reporting of purchases and 33% underreporting of commissions) constitute a "substantially incomplete" Form 5472 under Treas. Reg. § 1.6038A-4(a)(1), and would a monetary penalty be appropriate in this situation?

Analysis:

First, it is important to recognize that when a taxpayer has made several errors on a Form 5472 it is necessary to analyze each of these errors in isolation in order to determine whether the error causes the Form 5472 to be “substantially incomplete,” and to analyze the errors in the aggregate in order to determine whether the total effect of the errors causes the Form 5472 to be “substantially incomplete.” It is possible that no single error, among several on a Form 5472, would render that form “substantially incomplete.” However, the net effect of those errors, in the aggregate, may cause the Form 5472 to be considered “substantially incomplete.” For example, a taxpayer could over-report by \$100X each of the following: Purchases of Stock in Trade, Commissions Paid and Rents Paid. Although individually each of these errors may not be significant, the aggregate effect of these errors that result in over-reporting expenses by \$300X may be considered significant enough to make the Form 5472 “substantially incomplete.” Accordingly, we believe that if one of the errors in isolation or the aggregate effect of all of the errors causes the Form 5472 to be “substantially incomplete,” then the Form 5472 in its entirety is “substantially incomplete.”

Under the Strict Interpretation of Treas. Reg. § 1.6038A-2(b)(3) described earlier in this advice, each individual error would make the Form 5472 “substantially incomplete” because taxpayer did not accurately report the “separate amounts” for each of these transactions.

Relying on the Facts and Circumstances Interpretation of Treas. Reg. § 1.6038A-2(b)(3), and focusing solely on taxpayer’s over-reporting of Purchases of Stock in Trade by \$500X, the analysis would be similar to that of Question 1 above. The over-reporting of this item would likely result in the Form 5472 being “substantially incomplete.” Many of the seven factors have been satisfied (the error will have an effect on taxable income; the magnitude of the error is substantial in relation to the transaction, other reportable transactions as correctly reported and taxpayer’s overall volume of business). As to the remaining factors (other reportable transactions with the same related party, significance of error in broad functional sense, and error as part of a significant ongoing relationship), there is insufficient information to determine whether those factors have been satisfied.

Since it has been determined that one of taxpayer’s errors results in the Form 5472 being “substantially incomplete,” it is unnecessary to analyze whether taxpayer’s other error in underreporting Commissions Paid, or whether these two errors in the aggregate, cause the Form 5472 to be “substantially incomplete.” As explained above, if one of the errors, or the aggregate effect of all of the errors, cause the Form 5472 to be “substantially incomplete,” then there is a deemed failure to file the form. However, one should also determine independently whether taxpayer’s underreporting of Commissions Paid cause the Form 5472 to be “substantially incomplete” and whether the aggregate effect of both of these errors causes the Form 5472 to be “substantially incomplete.”

Focusing solely on taxpayer's error in underreporting of Commissions Paid by \$400X, the Form 5472 is again likely to be "substantially incomplete." Many of the seven factors have been satisfied (the error will have an effect on taxable income; the magnitude of the error is substantial in relation to the transaction, other reportable transactions as correctly reported and taxpayer's overall volume of business). Also, there is insufficient information to determine the status of the remaining factors (other reportable transactions with the same related party, significance of error in broad functional sense, and error as part of a significant ongoing relationship).

In considering the aggregate impact of these errors, it is uncertain whether the Form 5472 is "substantially incomplete." The first factor is arguably not satisfied since the magnitude of the error (in aggregate) does not appear to be substantial in relation to these types of transactions. The aggregate effect of the error is only \$100X (over-reporting of Purchases of Stock in Trade by \$500X less underreporting of Commissions Paid by \$400X) and constitutes only 4.7% of these transactions (\$100X error in relation to \$2100X in total transactions).

One factor, the seventh factor, is technically satisfied because these errors, in aggregate, will be reflected in the determination and computation of taxpayer's taxable income. However, once again, the aggregate effect of these errors is \$100X, and thus depending upon what amount X represents the impact on taxable income may be relatively insignificant. Similarly, although the question assumes that the third factor (*i.e.*, the magnitude of the error in relation to all of the other reportable transactions as correctly reported) and the fourth factor (*i.e.*, the magnitude of the error in relation to taxpayer's overall financial situation) have been satisfied, these assumptions appear questionable because the overall impact of the error may be relatively small.

As to the other three factors, the question as presented does not provide sufficient information with respect to the errors in aggregate to determine: 1) whether the reporting corporation has other reportable transactions with the same related party or parties (the second factor); 2) the significance of the erroneous reported transactions (as an aggregate) in a broad functional sense (the fifth factor); and 3) whether the erroneous transactions (in aggregate) occurred in the context of a significant ongoing relationship (the sixth factor). As with the other questions, it is important to note that additional facts could affect the determination as to whether the Form 5472 as filed was "substantially incomplete" under this test.

In summary, the factors indicate that each error, when considered in isolation, will likely cause the Form 5472 to be "substantially incomplete." There are not enough facts to show that the errors in aggregate result in the Form 5472 being "substantially incomplete." Such an aggregate analysis is not necessary since the Form 5472 will likely be deemed to be "substantially incomplete" because at least one of taxpayer's errors causes it to be "substantially incomplete." Additionally, the facts presented here are insufficient to determine whether the penalty should be excused for reasonable cause.

If you have any questions, please contact our branch at .

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