UNITED STATES

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Renewed IRS focus on foreign corporations' US tax return obligations

Mark Martin and Thomas Bettge of KPMG in the US review recent Internal Revenue Service enforcement efforts regarding foreign corporations' US income tax returns, and discuss the waiver process for taxpayers with untimely returns.

If a foreign corporation has a US trade or business, it is required to file a US income tax return – Form 1120-F – reporting the income effectively connected with that trade or business. Figuring out whether a US trade or business exists is not always easy, and even when it is, the foreign corporation may be unaware that its US activities give rise to a filing obligation.

For instance, if a bilateral tax treaty exempts the income from US taxation, this does not mean the foreign corporation does not need to file a US return; rather, the Form 1120-F must be accompanied by another form (Form 8833) or a statement detailing the treaty position. It is therefore not surprising that some entities that are required to file Form 1120-F do so late, or not at all.

Enforcement efforts

Right now, Form 1120-F issues are a focus of Internal Revenue Service (IRS) attention. The IRS Large Business & International (LB&I) division has four active enforcement campaigns related to Form 1120-F.

Two touch on substantive issues: refunds for withholding at the source, and claims for certain deductions.

One is aimed at non-filers: LB&I is using external data sources to identify foreign corporations with likely filing obligations, and sending out soft letters before initiating examinations.

The fourth Form 1120-F campaign deals with delinquent filings, and, in particular, the ability of a delinquent filer to claim deductions and credits to offset against the income effectively connected with its US trade or business.

Under Section 882(c)(2) of the Internal Revenue Code, a foreign corporation can only claim deductions and credits against its effectively connected income if it files a US return. Treas. Reg. § 1.882-4(a)(3) adds a timeliness requirement: the return must be filed by 18 months after the due date (or, for corporations that were required to file a US return in the preceding year and failed to do so, by the date the IRS contacts the taxpayer regarding the current year's missing return).

In *Adams Challenge (UK) Ltd. v. Commissioner*, which KPMG discussed in a prior article, the Tax Court articulated another timing rule, which it found implicit in the statute: a taxpayer can no longer file a return claiming deductions after the IRS prepares a substitute for return in lieu of the missing filing.

Waiver process

Fortunately for taxpayers, Treas. Reg. § 1.882-4(a)(3)(ii) permits the IRS to waive the timeliness requirement if it considers the taxpayer to have acted reasonably and in good faith, a determination that is made based on several criteria (for example, whether the taxpayer exercised reasonable due diligence but was unaware a filing obligation existed).

In 2018, the IRS adopted procedures for determining whether a waiver is appropriate, and in July 2022, it released a practice unit that instructs LB&I examiners on the waiver process.

In the case of an untimely Form 1120-F filing, the LB&I exam team is directed to provide the taxpayer with information on the waiver process. The taxpayer can choose whether to request a waiver (which requires that it cooperate with the IRS' efforts to accurately determine its US tax liability).

The exam team recommends acceptance or denial of the waiver, but the ultimate decision is made by the relevant IRS director of field operations for Cross Border Activities, sometimes in consultation with a Waiver Committee that helps to ensure consistency across determinations.

Considerations for foreign corporations

The IRS enforcement focus on Form 1120-F issues should serve as a reminder for all foreign corporations with US activities to evaluate whether those activities may give rise to US income and a US filing obligation.

When US trade or business status is uncertain, it is generally advisable to file a protective Form 1120-F reporting no income, as the protective filing will entitle the taxpayer to claim the benefit of deductions and credits, should the IRS later determine that US trade or business income exists.

The protective filing also starts the statute of limitations period and allows the company to avoid failure-to-file penalties. For taxpayers that come under IRS audit for a delinquent return, consideration should be given in suitable cases to requesting a waiver. Engaging with the IRS in a cooperative manner can be particularly important where overlooked filings are an issue for successive years as well.

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