Treasury Proposes New Reporting Rules for Foreign-Owned Disregarded Entities

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On May 5, 2016, the United States Treasury ("Treasury") issued proposed regulations containing new reporting rules for foreign-owned disregarded entities. The proposed regulations would treat a domestic disregarded entity wholly owned by a foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting, record maintenance and associated compliance requirements that apply to 25 percent foreign-owned domestic corporations.

Foreign-owned domestic disregarded entities represent a narrow class of foreign-owned U.S. entities that have generally had no obligation to report information to the IRS or to get a tax identification number, and thus can be used to shield the foreign owners of non-U.S. assets or non-U.S. bank accounts. According to a Treasury press release, the proposed rules will "strengthen the IRS's ability to prevent the use of these entities for tax avoidance purposes, and will build on the success of other efforts to curb the use of foreign entities and accounts to evade U.S. tax."

Background

Certain domestic business entities, such as limited liability companies ("LLCs"), are classified by default as partnerships (if they have more than one member) or as disregarded entities (if they have only one owner) but are eligible to elect for U.S. federal tax purposes to be classified as corporations. When an entity, such as an LLC, is classified as a corporation or a partnership for tax purposes, general ownership and accounting information is available to the IRS because such entities are generally required to obtain a U.S. Employer Identification Number ("EIN") and file U.S. tax returns. An entity

obtains an EIN by filing Form SS-4, *Application for Employer Identification Number*, in which the entity must identify a responsible party (typically the individual that owns or controls the entity).

A disregarded entity ("DRE") is generally not subject to separate income or information return filing requirements. Its owner is treated as owning directly the entity's assets and liabilities, and the information available with respect to the DRE depends on the owner's own return filings, if any are required. For a DRE that is formed in the United States and wholly owned by a foreign corporation, foreign partnership, or nonresident alien individual, generally no U.S. income or information return must be filed if neither the DRE nor its owner received any U.S. source income or was engaged in a U.S. trade or business during the taxable year.

Treasury has stated that the absence of specific return filing and associated recordkeeping requirements for foreign-owned DREs hinders law enforcement efforts and compliance with international standards of transparency and cooperation in the area of tax information exchange. These issues have been noted in reviews of the U.S. legal system by international organizations, including the Financial Action Task Force and the Global Forum on Transparency and Exchange of Information for Tax Purposes, which is affiliated with the Organisation for Economic Cooperation and Development ("OECD").

Currently, section 6038A of the Internal Revenue Code imposes reporting and recordkeeping requirements (together with certain procedural compliance requirements) on domestic corporations that are 25-percent foreign-owned. They are required to file an annual 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* (under sections 6038A and 6038C of the Internal Revenue Code), with respect to each related party with which the reporting corporation has had any "reportable transactions." These corporations must also keep the permanent books of account or records as required by section 6001.

Proposed Regulations

The proposed regulations would amend Treas. Reg. 301.7701-2(c) to treat a domestic DRE that is wholly owned by one foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting and record maintenance requirements (including the associated procedural compliance requirements) under Code section 6038A. The proposed regulations would not alter the framework of the existing entity classification regulations, including the treatment of certain entities as disregarded.

Because the proposed regulations would treat the affected domestic entities as foreign-owned domestic corporations for the specific purposes of section 6038A, and because such entities are foreign-owned, they would be "reporting corporations" within the meaning of Code section 6038A. Consequently, they would be required to file the Form 5472 information return with respect to reportable transactions between the entity and its foreign owner or other foreign related parties (transactions that would have been regarded under general U.S. tax principles if the entity had been, in fact, a corporation for U.S. tax purposes). These entities would also be required to maintain records sufficient to establish the accuracy of the information return and the correct U.S. tax treatment of such transactions. In addition, because these entities would have a filing obligation, they would be required to obtain an EIN by filing a Form SS-4 that includes responsible party information.

These regulations would specifically require all foreign-owned single-member DREs to report all transactions with related parties (with such entities being treated as separate taxpayers for the purpose of identifying transactions and being subject to requirements under section 6038A) to the extent not already covered by another reportable category. The term "transaction" is defined in Treas. Reg. 1.482-1(i)(7) to include any sale, assignment, lease, license, loan, advance, contribution, or other transfer of any interest in or a right to use any property or money, as well as the performance of any services for the benefit of, or on behalf of, another taxpayer. Accordingly, a transaction between such an entity and its foreign owner (or another disregarded entity of the same owner) would be considered a reportable transaction for purposes of the section 6038A reporting and record maintenance requirements, even though, because it involves a disregarded entity, it generally would not be considered a transaction for other purposes, such as making an adjustment under section 482. The proposed regulations would also provide that the exceptions to the record maintenance requirements in Treas. Reg. 1.6038A-1(h) and (i) for small corporations and *de minimis* transactions will not apply to these entities.

The proposed regulations would impose a filing obligation on a foreign-owned DRE for reportable transactions it engages in even if its foreign owner already has an obligation to report the income resulting from those transactions - for example, transactions resulting in income effectively connected with the conduct of a U.S. trade or business. Treasury is seeking comments on possible alternative methods for reporting the disregarded entity's transactions in such cases.

The regulations are proposed to be applicable for taxable years ending on or after the date that is 12 months after the date the regulations are published as final regulations in the Federal Register.

Concluding Thoughts

The proposed regulations under Code section 6038A are consistent with recent initiatives that seek to improve cross-border transparency and international information exchange. They were likely issued in response to international criticism of state business laws that allow domiciled LLCs to withhold the identity of beneficial owners. This criticism may be related in part to the United States' refusal to join more than 90 countries that have adopted the OECD's common reporting standard.

The new reporting requirements may be difficult to enforce because state governments may not know when entities organized in their states are foreign-owned meaning IRS investigators may not have a basis to monitor compliance. If the proposed regulations are adopted, foreign-owned DREs will be required to maintain detailed records regarding related-party transactions - records they may not be currently generating or retaining given that such transactions are ignored for most U.S. tax purposes.

Failure to obtain an EIN and file Form 5472 could result in failure to file penalties and an indefinite suspension of the limitations period under section 6501(c)(8). Assets held by the DRE could also be subject to attachment.