

## US IRS finalizes regulations requiring reporting by foreign-owned US disregarded entities

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### Executive summary

The United States (US) Treasury Department (Treasury) and Internal Revenue Service (IRS) have issued final regulations ([TD 9796](#)) that treat domestic disregarded entities wholly owned, directly or indirectly, by foreign persons as domestic corporations solely for purposes of making them subject to the reporting requirements under Internal Revenue Code<sup>1</sup> Section 6038A that apply to 25% foreign-owned domestic corporations.

No comments were submitted on the underlying proposed regulations (REG-127199-15),<sup>2</sup> published in May 2016. The final regulations, effective 13 December 2016, are substantially similar to the proposed regulations, but reflect a few changes.

### Detailed discussion

#### Background

Under US tax regulations, an entity, such as a US limited liability company (LLC), that has a single owner and is not classified as a corporation is generally disregarded as separate from its owner (a disregarded entity). These disregarded entities are generally not subject to US tax filing requirements, which means they also generally do not need to obtain an employer identification number (EIN) unless they are filing an entity classification election. Entities that do need

to obtain EINs do so by filing Form SS-4, on which they must identify a responsible party (generally the individual with control over, or entitlement to, the entity's assets) unless the sole reason for applying for an EIN is to make an entity classification election and the entity is foreign-owned.

Unlike disregarded entities, domestic corporations and partnerships, as well as foreign corporations engaged in a trade or business in the US, must file annual income tax returns. Domestic corporations that are 25% or more foreign-owned are subject to additional specific information reporting and record-maintenance requirements under Section 6038A, including filing an annual return on Form 5472, *Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business*, for each related party with which the corporation has had any "reportable transactions." These corporations must also keep records sufficient to establish the accuracy of the return, including information relating to related parties to the extent relevant. Generally no US reporting obligations apply to foreign-owned US disregarded entities unless the entity is engaged in a US trade or business or has certain types of US-source income.

### General provisions of final regulations

The final regulations treat US disregarded entities wholly owned by one foreign person as a domestic corporation separate from its owner solely for purposes of Section 6038A, making these otherwise disregarded entities subject to the reporting and record-keeping requirements that currently apply to 25% foreign-owned US corporations. The regulations do not affect the entity's classification for other purposes. As a result, these entities must file Form 5472, and maintain related records, for reportable transactions with the entities' foreign owners or other foreign-related parties. To complete this filing, entities also need to obtain EINs by filing a Form SS-4 with responsible-party information, including the responsible party's social security number (SSN), individual taxpayer identification number (ITIN) or EIN.

For purposes of the regulations, a foreign person will be considered to wholly own a domestic disregarded entity if the foreign person has direct or indirect sole ownership of the entity. To that end, indirect sole ownership means "ownership by one person entirely through one or more other [disregarded entities] or through one or more grantor trusts, regardless of whether any such disregarded entity or grantor trust is domestic or foreign."

The final regulations add to the category of reportable transactions any transaction within the meaning of Reg. Section 1.482-1(i)(7), including 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. Penalty provisions apply to failures to file Form 5472 or maintain adequate records. Further, no exceptions apply to record-maintenance requirements for small corporations to *de minimis* transactions.

### Limited changes from proposed regulations

Revised exceptions. The preamble to the final regulations notes that Treasury and the IRS continue to believe that "the generally applicable exceptions to the requirements of [S]ection 6038A should not apply to a domestic disregarded entity that is wholly owned by a foreign person." Although the proposed regulations provided that small corporations (Reg. Section 1.6038A-1(h)) and *de minimis* transactions (Reg. Section 1.6038A-1(i)) are not excepted from the record-maintenance requirements, the proposed regulations did not address two other exceptions to these requirements. Specifically, a reporting corporation is not required to:

1. File Form 5472 for a foreign corporation when a US person controlling the related foreign corporation files a Form 5471, *Information Return of US Persons with Respect to Certain Foreign Corporations*, containing required information on reportable transactions between the reporting corporation and the related foreign corporation for the tax year (Reg. Section 1.6038A-2(e)(3))
2. File Form 5472 for a related foreign corporation qualifying as a foreign sales corporation for a tax year for which it files Form 1120-FSC, *U.S. Income Tax Return of a Foreign Sales Corporation* (Reg. Section 1.6038A-2(e)(4))

Consistent with the scope and intent of the proposed regulations, the final regulations apply without regard to the exceptions under Reg. Section 1.6038A-2(e)(3) and (4).

*Tax year clarification.* The preamble explains that, to facilitate reporting corporations' compliance with Section 6038A requirements, including the requirement to file Form 5472, the final regulations specify that reporting corporations are deemed to have: (1) the same tax year as their foreign owner if the foreign owner has US return filing obligations; and (2) a calendar-year tax year if the foreign owner does not have US return filing obligations.

*Applicability date.* The final regulations apply to tax years of entities beginning on or after 1 January 2017, and ending on or after 13 December 2017. (In contrast, the proposed regulations simply would have applied to tax years ending on or after 13 December 2017.)

## Implications

Whereas some disregarded entities and their foreign owners may not have obligations to file a tax return or obtain an EIN currently, the final regulations impose new filing requirements as well as obligations to maintain sufficient records. Such disregarded entities must now, for example, file Form 5472. To complete such filing, these entities also need to obtain EINs by filing a Form SS-4 with responsible-party information, including the responsible party's SSN, ITIN or EIN, which

may require the ultimate individual owner to obtain an ITIN, a potentially time-consuming and burdensome process. Because these changes become effective for entities' tax years beginning on or after 1 January 2017, and ending on or after 13 December 2017 (meaning the earliest Forms 5472 required under the final regulations would be due in early 2018), and obtaining an ITIN can often take several months, taxpayers should begin determining who the ultimate responsible party is and, if that person does not already have an ITIN, begin the application process. Taxpayers should also be mindful of the increased burden that these regulations could place upon them, and consider what changes to their internal processes may be required to comply with the additional reporting. Presumably, new instructions for Form 5472 are forthcoming with specific guidelines related to the final regulations.

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## Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. See EY Global Tax Alert, *US issues proposed rules that would require reporting by foreign-owned US disregarded entities*, dated 11 May 2016.

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