

PROPOSED REPORTING REQUIREMENTS FOR FOREIGN-OWNED U.S. DISREGARDED ENTITIES

Authors

Philip R. Hirschfeld
Nina Krauthamer

Tags

Code §482
Code §6038A
Code §7701
Disregarded Entity
Reporting Requirements

INTRODUCTION

On May 6, the Treasury released proposed regulations under Code §§6038A and 7701,¹ which would require foreign companies doing business in the U.S. through disregarded entities (“D.R.E.’s”) to supply the I.R.S. with information about the operations of these D.R.E.’s and comply with certain record-keeping requirements. Under the proposed regulations, U.S. D.R.E.’s owned by foreign persons would be treated as domestic corporations for purposes of Code §6038A, which imposes reporting, record-keeping, and compliance requirements on 25% foreign-owned domestic corporations. The change is a necessary enforcement measure that will be used to meet U.S. obligations under various tax treaties, tax information exchange agreements, and other international agreements.

The “check-the-box” regulations under Code §7701 generally allow a business entity with a single owner to be treated as a D.R.E. for most tax purposes. Among other things, this can result in the entity not having to file a U.S. tax return or obtain an employer identification number (“E.I.N.”). As a result, absent the new rules, the I.R.S. may lack information about the entity. This results in a loophole in the U.S. system that may allow a foreign person to hide assets in U.S. accounts.

PROPOSED §6038A REGULATIONS

The I.R.S. is proposing to use the provisions of Code §6038A to impose reporting and recordkeeping requirements on foreign-owned D.R.E.’s. Section 6038A currently requires a domestic corporation that is a 25% foreign-owned entity to annually file Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, if it has a “reportable transaction” with its foreign owner or other foreign related parties. In addition, a reporting U.S. corporation must maintain records (or cause another person to maintain records) that allows the I.R.S. to determine the correct treatment of transactions with related parties.

The proposed regulations would amend Treas. Reg. §301.7701-2(c) – part of the check-the-box regulations – to treat a domestic D.R.E. that is wholly owned by one foreign person as a domestic corporation that is separate from its owner for purposes of the §6038A reporting and record keeping requirements. The proposed regulations are not intended to otherwise alter the existing framework of the entity classification regulations. This would result in a D.R.E. having to file Form 5472 and maintain sufficient records to establish the accuracy of the information. The entity

¹ REG-127199-15.

“Under the proposed regulations, U.S. D.R.E.’s owned by foreign persons would be treated as domestic corporations for purposes of Code §6038A.”

would also have to obtain an E.I.N. by filing a Form SS-4 and provide information about its responsible party.

In order to insure that the I.R.S. obtains all pertinent information, a new category of reportable transactions is created. This new category includes any transaction within the meaning of Treas. Reg. §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. As a result, a transaction between a D.R.E. and its sole owner (or another D.R.E.) would be a transaction subject to reporting, even though it may not generally be a transaction for other purposes of the Code, such as §482.

The entity is also required to keep permanent books of account and other records under Code §6001. The exceptions to the record keeping requirements for small corporations and *de minimis* transactions will not apply to a D.R.E.

Failure to comply with these new rules can result in criminal penalties and a \$10,000 civil penalty, which can be increased if the failure continues after notification by the I.R.S.

The new rules will apply to taxable years ending on or after the date that is 12 months after the date of publication of final regulations.

CONCLUSION

Transactions conducted by D.R.E.’s normally would not be considered reportable transactions for purposes of Code §6038A. The proposed regulations result in the D.R.E. having to report a wide variety of transactions and services. These rules, once finalized, will result in additional time, effort, and expense in using a D.R.E.