

FOREIGN-OWNED U.S. DISREGARDED ENTITIES MUST NOW FULFILL IRC § 6038A'S REPORTING AND RECORD MAINTENANCE REQUIREMENTS



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At the end of 2016, the Treasury Department ("Treasury") finalized Treasury Regulations that now require a foreign-owned U.S. disregarded entity to be treated as a corporation for the limited purpose of the reporting and record maintenance requirements that apply to a 25-percent foreign-owned domestic corporation under Internal Revenue Code¹ ("IRC") section 6038A. Effective December 13, 2016, the final regulations are substantially similar to the proposed regulations published by Treasury on May 10, 2016. Before the enactment of the final regulations, a foreign-owned domestic disregarded entity generally did not have any U.S. tax reporting obligations. As a result, the Internal Revenue Service ("IRS") and foreign jurisdictions did not have information about the owners of these disregarded entities effectively sheltering foreign owners from potential U.S. and foreign tax liabilities.

The final regulations require a foreign-owned U.S. disregarded 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 ("Form 5472") to report certain transactions with related parties and to maintain records sufficient to establish the accuracy of the information reported. Consequently, these disregarded entities are now required to obtain an Employer Identification Number ("EIN") and provide information about their responsible party. This information will increase transparency and allow the IRS to determine whether there is any tax liability. In addition, Treasury hopes this information will enhance U.S. compliance with international standards

of transparency and the exchange of information with foreign tax authorities.

REPORTING AND RECORD MAINTENANCE REQUIREMENTS UNDER IRC § 6038A FOR 25% FOREIGN-OWNED U.S. CORPORATIONS

Pursuant IRC section 6038A, a U.S. corporation that is 25-percent foreign-owned at any time during the taxable year, or a foreign corporation that is 25-percent foreign-owned and engaged in a trade or business within the U.S. (a "reporting corporation"), must report certain information to the IRS that relates to transactions between itself and a related party.² A related party is a 25-percent foreign shareholder of the reporting corporation, a person related to such a shareholder under IRC section 267(b) or IRC section 707(b)(1), or any other person who is related within the meaning of IRC section 482 (a "related party").³ In addition, a reporting corporation must maintain certain records necessary to determine the correct treatment of certain transactions with related parties.⁴

According to the Joint Committee on Taxation, the 1982 enactment of IRC section 6038A addressed concerns that transactions between a U.S. parent and its foreign subsidiaries as well as transactions between a foreign parent and its U.S. subsidiaries were not at arm's length prices.⁵ Under prior law, a U.S. parent corporation was required to report transactions with its foreign affiliates and transactions between its foreign affiliates, but no such reporting was required for transactions between a U.S. subsidiary of a foreign corporation and its foreign affiliates.⁶ As a result, Congress believed that requiring

the reporting of such transactions would reduce transfer pricing abuses and similar abuses and would place foreign controlled U.S. entities on equal footing with U.S. corporations controlled by U.S. persons.⁷

Transactions between the reporting corporation and related parties that must be reported generally include (i) sales of inventory; (ii) sales of other tangible property; (iii) rents and royalties paid; (iv) sales and payments for the use of intangible property; (v) payments for certain services; (vi) commissions paid; (vii) certain loans; (viii) interest payments; (ix) premiums for insurance; (x) and other amounts that affect the reporting of the corporation's taxable income ("reportable transactions").⁸ The amount of each such transaction, as well as the total amount of such transactions must be reported on form 5472.⁹ If a reporting corporation cannot determine the actual amounts in the related party transactions then it must make a reasonable estimate.¹⁰ If a transaction involves nonmonetary consideration, or less than full consideration, the corporation must report the approximate monetary value of the transaction.¹¹

As stated above, the amount of each reportable transaction and the total amount of such transactions must be reported on Form 5472.¹² A separate Form 5472 must be filed annually by each reporting corporation for each related party with which it conducted any reportable transactions during the taxable year.¹³ In addition to providing information for the reportable transactions on Form 5472, the reporting corporation must furnish specific information about itself and each related party. The reporting corporation must provide (i) its name, address, and U.S. taxpayer identification number; each country in which the reporting corporation files an income tax return as a resident under the tax laws of that country; its country or countries of organization, and incorporation; its total assets; the places where it conducts its business; and its principal business activity; (ii) the name, address, and U.S. taxpayer identification number, if applicable, of all its direct and indirect 25-percent foreign shareholders; each country in which each 25-percent foreign shareholder files an income tax return as a resident under the tax laws of that country; the places where each 25-percent shareholder conducts its business; and the country or countries of organization, citizenship, and incorporation of each 25-percent foreign shareholder; and (iii) the number of Forms 5472 filed for the taxable year and the aggregate value in U.S.

dollars of gross payments made for all foreign related-party transactions reported on all Forms 5472.¹⁴

The reporting corporation must also provide information on Form 5472 about each related party, whether foreign or domestic, with which the reporting corporation had a reportable transaction during the taxable year including (i) the name, U.S. taxpayer identification number, if applicable, and address of the related party; (ii) the nature of the related party's business and the principal place or places where it conducts its business; (iii) each country in which the related party files an income tax return as a resident under the tax laws of that country; and (iv) the relationship of the reporting corporation to the related party.¹⁵

A reporting corporation does not have to file Form 5472 if (i) it does not have a reportable transaction with a related party; (ii) all of its reportable transactions are with domestic reporting corporations; (iii) the transactions are with a related foreign corporation that is controlled by a U.S. person who files Form 5471 reporting the otherwise reportable transactions; or (iv) the transactions are with a foreign sales corporation.¹⁶

In addition to furnishing information regarding related party transactions, a reporting corporation must maintain records appropriate to determine the correct treatment of transactions with related parties.¹⁷ A reporting corporation must keep the permanent books of account or records as required by IRC section 6001 that are sufficient to establish the correctness of the federal income tax return of the corporation, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties.¹⁸ The records must be permanent, accurate, and complete, and must clearly establish income, deductions, and credits.¹⁹ A reporting corporation should keep the required records for as long as they are relevant.²⁰

A small reporting corporation that has less than \$10 million in U.S. gross receipts for a taxable year generally does not have to maintain records for that taxable year.²¹ A reporting corporation also does not have to satisfy the record maintenance requirements if the aggregate value of all gross payments that the reporting corporation makes to, and receives from, foreign related parties in related party transactions in a taxable year does not exceed \$5 million and is less than 10 percent of its U.S. gross income.²² However, even if a

corporation is not required to maintain records under IRC section 6038A, it remains subject to the requirements for filing Form 5472 on an annual basis and must meet the general record maintenance requirements under IRC section 6001.

If a reporting corporation fails to report the information or maintain the records required by IRC section 6038A, the IRS may assess a penalty of \$10,000 for each taxable year in which the failure occurs.²³ If a reporting corporation has more than one related party with which it engaged in reportable transactions, the penalty may be assessed against the reporting corporation for each related party for which the failure occurs.²⁴ Further, if the IRS notifies the reporting corporation of the failure, the IRS may assess an additional penalty of \$10,000 for each thirty day period (after ninety days) during which the failure continues.²⁵ This additional penalty can be assessed again if there is another failure by the reporting corporation and such failure exists for more than ninety days after notice by the IRS.²⁶ In addition to monetary penalties, criminal penalties may also result.²⁷

NEW REPORTING AND RECORD MAINTENANCE REQUIREMENTS UNDER IRC § 6038A FOR FOREIGN-OWNED DOMESTIC DISREGARDED ENTITIES

Generally, the check-the-box regulations permit an unincorporated business entity with two or more owners to elect to be treated as either an association taxable as a corporation or as a partnership for federal tax purposes.²⁸ An entity with a single owner may be treated as an entity disregarded as separate from its owner or as a corporation.²⁹ If an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner (as a pass-through).³⁰ Accordingly, an owner of a disregarded entity is treated as directly owning the entity's assets.

A disregarded entity does not have a tax identity separate from its owner (no separate taxable year and no separate tax attributes). Typically, there is no federal tax requirement for a single-member LLC classified as a disregarded entity to obtain an EIN. Generally, a disregarded entity must use its owner's taxpayer identification number for federal tax purposes and not the EIN of the disregarded entity.³¹

The final regulations require a domestic business entity wholly owned by one foreign person that is otherwise

disregarded to be treated as a domestic corporation separate from its owner for the limited purpose of the reporting and record maintenance requirements that apply to 25-percent foreign-owned domestic corporations under IRC section 6038A.³² The final regulations do not affect the entity's classification for other purposes. An entity is disregarded as separate from its owners and classified as a corporation under IRC section 6038A if (i) the entity is a domestic entity and (ii) one foreign person has direct or indirect sole ownership of the entity.³³ Indirect sole ownership means ownership by one person entirely through one or more other entities disregarded as separate from their owners or through one or more grantor trusts, regardless of whether any such disregarded entity or grantor trust is domestic or foreign.³⁴ Accordingly, a domestic disregarded entity wholly owned by a foreign person is now required to file Form 5472 with respect to reportable transactions, including transactions between the entity and its foreign owner³⁵ or other foreign related parties, and maintain records sufficient to establish the accuracy of the information return and the correct U.S. tax treatment of such transactions.³⁶ In addition, because these entities now have a filing obligation, they are required to obtain an EIN by filing a Form SS-4 which requires information about the entity's responsible party, including the responsible party's social security number, individual taxpayer identification number ("ITIN") or EIN.³⁷

According to Treasury, it is difficult for the U.S. to carry out the obligations it has committed to in its tax treaties, tax information exchange agreements and similar international agreements to provide other jurisdictions with relevant information on U.S. entities with owners that are tax resident in partner jurisdictions.³⁸ The final regulations are intended to provide the IRS with improved access to information that will increase U.S. compliance with international standards of transparency, escalate the exchange of information for tax purposes, and strengthen the enforcement of U.S. tax laws.³⁹ In addition, Treasury believes that these regulations will primarily affect a small number of foreign-owned domestic disregarded entities that do not otherwise have a U.S. return filing requirement, and that the requirement to file a return for these entities will not impose a significant burden on them.⁴⁰

However, under the final regulations, there are some differences to the reporting requirements for a U.S. corporation that is a 25-percent foreign-owned domestic

disregarded entity. Under the final regulations, another category of reportable transactions was added and is specifically applicable to a foreign-owned domestic disregarded entity. The new required reportable transactions include any transaction as defined by Treasury Regulation section 1.482-1(i)(7), such as amounts paid or received in connection with the formation, dissolution, acquisition and disposition of the entity, including contributions to and distributions from the entity.⁴¹ Under Treasury Regulation section 1.482-1(i)(7), a transaction means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented as well as the performance of any services for the benefit of, or on behalf of another taxpayer.⁴² As a result, a transaction between a disregarded entity and its foreign owner or another disregarded entity with the same owner (including contributions and distributions) is considered a reportable transaction even though it generally would not be considered a transaction under general U.S. tax principles.⁴³

In addition, the final regulations provide that a foreign-owned domestic disregarded entity is not entitled to the exceptions from reporting for transactions with (i) a related foreign corporation that is controlled by a U.S. person who files Form 5471 reporting the otherwise reportable transactions,⁴⁴ and (ii) a foreign sales corporation.⁴⁵ Moreover, the exceptions to the record maintenance requirements for small corporations and related party transactions of de minimis value, discussed above, do not apply to these entities.⁴⁶ Nonetheless, the penalties for the reporting and record maintenance requirements under IRC section 6038A apply.

To facilitate compliance with the requirements of IRC section 6038A, the final regulations provide that a foreign-owned domestic disregarded entity has the same tax year as its foreign owners if the foreign owner has a U.S. return filing obligation.⁴⁷ If the foreign owner does not have a U.S. return filing obligation, the final regulations provide that the tax year is the calendar year unless otherwise provided in forms, instructions, or published guidance.⁴⁸

The final regulations are applicable to entities with tax years beginning on or after January 1, 2017, and ending on or after December 31, 2017.⁴⁹ The earliest Forms 5472 will be due in early 2018.

IMPLICATIONS

Until the enactment of the final regulations, a foreign-owned domestic disregarded entity did not have any U.S. tax reporting obligations unless the entity engaged in a U.S. trade or business or had certain types of U.S. source income. Such an entity generally did not need to obtain an EIN disclosing responsible-party information. As a result, the IRS lacked information about the disregarded entity potentially shielding its foreign owner from U.S. and foreign tax liabilities. Many foreign jurisdictions view such disregarded entities as tax havens allowing foreign persons to hide assets in the U.S.

However, under the final regulations these entities must now obtain an EIN by filing Form SS-4 where they must identify a responsible party, which is generally the individual with control over the entity's assets. In filing Form SS-4, the entities must include the responsible party's social security number, ITIN, or EIN, which may require the ultimate individual owner to obtain an ITIN.

The reporting and record maintenance requirements will largely affect foreigners investing in the U.S. through domestic disregarded entities and will allow the IRS to obtain information about these entities that was previously unreported for purposes of determining whether there is any tax liability and the amount of the liability. Additionally, this information will enhance U.S. compliance with international standards of transparency and will increase the exchange of information with foreign tax authorities.

Finally, with the increased compliance burden, foreign-owned disregarded entities will have to make changes to their internal processes to ensure compliance. Going forward, since these entities have compliance obligations whether or not they incorporate in the U.S., foreign investors may consider using a U.S. corporation for such investments so they can deduct and capitalize expenses. 📌

Notes

- 1 The Internal Revenue Code of 1986, as amended.
- 2 Treas. Reg. § 1.6038A-1(c)(1).
- 3 IRC § 6038A(c)(2); Treas. Reg. § 1.6038A-1(d).
- 4 IRC § 6038A(a).
- 5 Staff of Joint Comm. on Tax'n 97th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at 250 (Comm. Print 1982).
- 6 Id.
- 7 Id.
- 8 Treas. Reg. § 1.6038A-2(b)(3).
- 9 Id.
- 10 Id. An amount will be considered a reasonable amount if it is at least 75-percent and not more than 125-percent of the actual amount. Treas. Reg. § 1.6038A-2(b)(6)(i).
- 11 Treas. Reg. § 1.6038A-2(b)(4).
- 12 Treas. Reg. § 1.6038A-2(b)(3).
- 13 Treas. Reg. § 1.6038A-2(a)(1).
- 14 Treas. Reg. § 1.6038A-2(b)(1).
- 15 Treas. Reg. § 1.6038A-2(b)(2).
- 16 Treas. Reg. § 1.6038A-2(e).
- 17 IRC § 6038A(a).
- 18 Treas. Reg. § 1.6038A-3(a)(1).
- 19 Id.
- 20 Treas. Reg. § 1.6038A-3(g).
- 21 Treas. Reg. § 1.6038A-1(h).
- 22 Treas. Reg. § 1.6038A-1(i).
- 23 IRC § 6038A(d)(1); Treas. Reg. § 1.6038A-4(a)(1).
- 24 Treas. Reg. § 1.6038A-4(a)(3).
- 25 IRC § 6038A(d)(2).
- 26 IRC § 6038A(d)(2); Treas. Reg. § 1.6038A-4(d).
- 27 IRC § 6038A(f).
- 28 Treas. Reg. § 301.7701-2(a); Treas. Reg. § 301.7701-3(a).
- 29 Id.; A domestic LLC has the flexibility to be classified as either a partnership, an association taxable as a corporation, or a disregarded entity.
- 30 Treas. Reg. § 301.7701-2(a).
- 31 Treas. Reg. § 301.6109-1(h)(2)(i).
- 32 Treas. Reg. § 1.6038A-1(c)(1).
- 33 Treas. Reg. § 301.7701-2(c)(2)(vi).
- 34 Treas. Reg. § 301.7701-2(c)(2)(vi)(B)(1).
- 35 These transactions are otherwise disregarded under general U.S. tax principles.
- 36 Treas. Reg. § 1.6038A-2(a); Treas. Reg. § 1.6038A-3(a).
- 37 Id. at § 1.6038A-2(b)(1).
- 38 Preamble to Prop. Reg., 81 Fed. Reg. 28784 (May 10, 2016).
- 39 Preamble to T.D. 9796, 81 Fed. Reg. 89849 (Dec. 13, 2016).
- 40 Id.
- 41 Treas. Reg. § 1.6038A-2(b)(3)(xi).
- 42 Treas. Reg. § 1.482-1(i)(7).
- 43 Preamble to Prop. Reg. supra.
- 44 Treas. Reg. § 1.6038A-2(e)(3).
- 45 Treas. Reg. § 1.6038A-2(e)(4).
- 46 Treas. Reg. §§ 1.6038A-1(h) and (i).
- 47 Treas. Reg. § 301.7701-2(c)(2)(vi)(C); Preamble to T.D. 9796, 12/12/2016, supra.
- 48 Id.
- 49 Treas. Reg. § 301.7701-2(e)(9); Treas. Reg. § 1.6038A-1(n)(1) and (2).



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