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Practice Update

Disregarded Entity Regs Confirm Global Transparency Push

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Last year, the Treasury Department proposed new reporting requirements for domestic disregarded entities with one foreign owner. The proposed regulations, issued May 10, 2016, greatly expanded the scope of Section 6038A of the 1986 Internal Revenue Code. As of Dec. 13, 2016, the Treasury adopted most of them in its final rules.

Consistent with the preamble to the proposed regulations, the primary purpose of the final regulations remains to enable the Treasury Department to collect information about taxpayers, which it can then exchange with other governments under tax treaties, taxpayer information exchange agreements and other inter-governmental agreements. The U.S. government also intends to use this information to enforce the U.S. tax laws, as well as to prevent money laundering and similar activities.

The focus of the final regulations is on reporting for domestic disregarded entities. A “disregarded entity” is a company (other than a corporation formed under state law) with a single owner that is not treated as an entity separate from its owner for United States federal tax purposes.

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In other words, a disregarded entity is generally nonexistent from a substantive U.S. federal tax perspective.[i] A single-member limited liability company formed under U.S. state law is classified by default (e.g., no election of corporate status is made) as a disregarded entity.[ii]

Prior to the final regulations, a domestic disregarded entity with a single foreign owner often had no tax reporting obligation to the Internal Revenue Service.

Reporting Obligations in General

Section 6038A requires a domestic corporation which is at least 25 percent foreign-owned to furnish certain information to the IRS with regard to reportable transactions.[iii]

The regulations extend this obligation to a foreign, non-U.S. corporation that is 25 percent foreign-owned and engaged in trade or business within the United States. [iv] Attribution rules apply to determine whether a person owns such portion of a corporation.[v]

In the above instances, reportable information includes the name, principal place of business, nature of business, country of organization or residency of each foreign person that is a related party and had a reportable transaction with the corporation during its taxable year, and information about reportable transactions.[vi]

Related parties include any shareholder who owns 25 percent or more of the voting power or value of the corporation (also based on ownership attribution rules).[vii] Reportable transactions include transactions such as sales of certain types of property, payments of commissions and loans.[viii]

Information required to be reported under Section 6038A must be furnished to the IRS annually on Form 5472, Information Return of a 25 Percent 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).[ix]

These corporations are also required to maintain books and records that are sufficient to establish the accuracy of the information.[x] A monetary penalty of $10,000 may be assessed on any corporation that fails to file Form 5472 when due, or that fails to maintain the required books and records.[xi]

Criminal penalties may also apply for failure to submit the required information or for filing false or fraudulent information.[xii]

Proposed Regulations

The proposed regulations extended information reporting under Section 6038A to domestic disregarded entities with a single foreign owner by employing a fiction that treats such disregarded entities as domestic corporations for this limited purpose.[xiii]

In addition, the Treasury also proposed to expand the category of reportable transactions applicable to these domestic disregarded entities to include "any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented."[xiv]

Hence, under the proposed regulations, a foreign person's contributions to, and distributions from, a domestic disregarded entity would be reportable transactions, even though such events would not otherwise be treated as a transaction for tax purposes and transfer pricing rules would not apply. [xv]

Under the proposed regulations, a domestic disregarded entity with a single foreign owner that

has a reportable transaction would be required to apply for and obtain an Employer Identification Number for purposes of satisfying its reporting obligations on Form 5472. The proposed regulations provided the exceptions from the record maintenance requirements for small corporations and de minimis transactions would not apply to domestic disregarded entities.

Final Regulations

The Treasury's final regulations leave unchanged nearly all of the substantive provisions of the proposed regulations, while adding several important modifications.

First, they specifically provide that two of the exceptions from Form 5472 filings for corporations which are contained in Treas. Reg. 1.6038A-2(e)(3) (based on an overlap with Form 5471 reporting) and Treas. Reg. 1.6038A-2(e)(4) (based on foreign sales corporation reporting on Form 1120-FSC) shall not apply with regard to a domestic disregarded entity that is treated as a domestic corporation under Section 6038A.[xvi]

Second, the final regulations provide that the taxable year of a domestic disregarded entity subject to Section 6038A will be the same as the taxable year of its sole foreign owner if such foreign owner has a U.S. income tax or information filing obligation for its taxable year.[xvii]

If the foreign owner does not have a U.S. income tax or information filing obligation for such taxable year, the taxable year of the domestic disregarded entity will be the calendar year unless otherwise published in forms, instructions or other guidance. The Treasury added these provisions to facilitate compliance with Section 6038A and for ease of tax administration.

Third, the final regulations also now specify how amounts loaned and borrowed are to be reported,

providing that such amounts shall be "reported as monthly averages or outstanding balances at the beginning and end of the taxable year, as the form shall prescribe. ..."[xviii] This change applies to both traditional corporations as well as domestic disregarded entities treated as domestic corporations under Section 6038A.

In addition, the final regulations further tighten Section 6038A reporting for domestic disregarded entities by shutting off the exclusion for reportable transaction reporting that generally would be available if neither party to the transaction is a U.S. person and the transaction will not generate U.S. source income, income effectively connected with a U.S. trade or business, or an expense allocable to such income.[xix]

Lastly, the final regulations apply to taxable years of such entities beginning after Dec. 31, 2016 and ending on or after Dec. 31, 2017.[xx]

Comment

The final regulations notably take Section 6038A reporting to a more rigorous standard than their proposed version in several important respects. Further, they impose a higher reporting standard on domestic disregarded entities, as compared to reporting of foreign-owned corporations and foreign corporations engaged in a U.S. trade or business, which were the original targets of Section 6038A.

The Treasury Department reported that it did not receive a single written comment to its proposed regulations and, as a result, no public hearing was requested or held. It is thus not surprising that the agency's final regulations carry forward nearly all the provisions from its former proposal, in nearly identical language.

The new additions and changes serve mainly to clarify how reporting is to be performed and reinforce the overarching substance of the reporting

regime. The latter requires tax and non-tax practitioners to seek appropriate guidance to address this new reporting framework.

[i] One notable exception is for employment tax purposes. Treas. Reg. 301.7701-2(c)(iv).
[ii] Treas. Reg. 301.7701-3.
[iii] Code Section 6038A.
[iv] Treas. Reg. 1.6038A-1(c)(1).
[v] Code Section 6038A(c)(5); Treas. Reg. 1.6038A-1(e).
[vi] Treas. Reg. 1.6038A-2(b).
[vii] Treas. Reg. 1.6038A-1(d); Code Section 6038A(c)(5); Treas. Reg. 1.6038A-1(e).
[viii] Treas. Reg. 1.6038A-2(b).
[ix] Treas. Reg. 1.6038A-2(a).
[x] Treas. Reg. 1.6038A-3.
[xi] Treas. Reg. 1.6038A-4(a).
[xii] Treas. Reg. 1.6038A-4(e).
[xiii] Prop. Reg. 301.7701-2(c)(2)(vi); Prop. Reg. 1.6038A-1(c)(1).
[xiv] Prop. Reg. 1.6038A-2(b)(3)(xi).
[xv] Prop. Reg. 1.6038A-2(b)(9).
[xvi] Treas. Reg. 1.6038A-2(e)(3) and (4).
[xvii] Treas. Reg. 301.7701-2(c)(2)(iv)(C).
[xviii] Treas. Reg. 1.6038A-2(b)(3)(vii).
[xix] Treas. Reg. 1.6038A-2(a)(2).
[xx] Treas. Reg. 1.6038A-1(n).

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