

Practice Update

New Reporting Requirements for Foreign-Owned Disregarded Entities Have Taken Effect

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The final regulations enacted in late 2016 that impose new reporting requirements on foreign-owned disregarded entities have now taken effect, bringing changes that will add significant complexity for many taxpayers this tax filing season.

Prior to 2016, a foreign-owned U.S. corporation was required to file Form 5472 only to report certain related-party transactions between the U.S. corporation and its foreign shareholder. This filing requirement extended only to “reportable transactions” such as related party loans, sales or rents.

However, in December 2016, the IRS finalized regulations under Section 6038A of the Code, generally effective for tax years beginning on or after January 1, 2017, which extended the Form 5472 reporting requirement to *U.S. disregarded entities with a single foreign owner*, and, in doing so, greatly expanded the scope of the reporting requirement for such entities. For disregarded entities, the requirement to report “reportable transactions” includes amounts paid or received in connection with the formation, dissolution, acquisition or disposition of the entity, including contributions to or distributions from the entity.

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Accordingly, under the new regulations, a disregarded entity with a single foreign owner is required to file Form 5472 to report every capital contribution (however *de minimis*) and every distribution from the disregarded entity. The provision applies to disregarded entities owned by a single foreign person, including individuals and certain entities and trusts. In effect, this broad provision extends to U.S. disregarded entities that do not conduct an operating business, if an initial capital contribution has been made.

Further, the provision imposes a burdensome filing requirement on disregarded entities that traditionally are *not* required to file U.S. income tax returns. The new requirements may even require an application for an EIN where one was not previously required and where one is not easily obtained (because the foreign owner lacks a taxpayer identification number). The IRS recently published a revised version of Form 5472 and its instructions to take into account these new requirements for disregarded entities. The instructions explain that while a foreign-owned disregarded entity is not ordinarily required to file a U.S. income tax return, it is now required to do so in order to satisfy the requirements of these new regulations. Thus, foreign-owned U.S. disregarded entities will need to file a pro forma Form 1120 in order to attach Form 5472.

Moreover, in addition to this new onerous filing requirement, one of the other changes buried in the recently enacted Tax Cuts and Jobs Act is a significant increase in the penalty for failure to file a timely Form 5472. For tax years after December 31, 2017, the penalty increases from \$10,000 to \$25,000 for each return required to be filed. These penalties can add up quickly, since a Form 5472 must be filed for each related party with respect to which there is a reportable transaction (which, for disregarded entities, includes capital contributions and distributions). The penalty can be abated if the taxpayer can demonstrate reasonable cause.

This expanded reporting requirement has flown under the radar as a consequence of all of the other recent changes to the Code, but it is one of the few changes effective for this current tax filing season. Thus, it is imperative to evaluate the ownership structures of cross-border arrangements before filing 2017 tax returns to ensure that all reporting requirements are met.

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