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International Tax ADVISORY ■

MAY 16, 2016

Through the Looking Glass: Reporting by Foreign-Owned Disregarded Entities

Generally, a disregarded entity is not subject to U.S. tax or information reporting, so the IRS is limited to gleaning information from tax filings by an entity's owner. But foreign owners of disregarded entities often do not have U.S. tax reporting obligations themselves, meaning information about such entities and their owners may never cross the IRS's radar screen.

In the wake of the massive "Panama Papers" leak, the IRS and Treasury are understandably concerned that the lack of information about foreign-owned disregarded entities "hinders law enforcement efforts and compliance with international standards of transparency and cooperation in the area of tax information exchange."

On May 6, the IRS and Treasury announced proposed regulations that would treat a U.S. disregarded entity wholly owned by a foreign person as a separate corporation for certain reporting and recordkeeping purposes. Specifically, Code Section 6038A, which requires U.S. corporations to report information about 25% foreign owners and the corporation's transactions with such owners (and other related parties), would apply to foreign-owned domestic disregarded entities.

Background

The entity classification regulations, by default, classify U.S. business entities (such as LLCs) as partnerships if they have at least two members or as disregarded if they have only one member. An entity may elect out of its default classification to be treated as a corporation for U.S. tax purposes. The classification regulations provide special rules whereby a disregarded entity will not be disregarded for certain excise and employment tax purposes. Thus, an otherwise disregarded entity may be required to get an employer identification number (EIN), file returns and maintain related records for those purposes.

Various Code sections oblige certain categories of persons to file tax or information returns. For example, Section 6012 requires all foreign corporations engaged in business in the U.S., as well as all domestic corporations, to file tax returns. Under Section 6031, domestic partnerships must file information returns, including statements identifying their partners. Section 6038A requires a domestic corporation that is at least 25% foreign-owned to report certain information and maintain records, including information about transactions between the corporation and its 25% foreign owners and other related parties. The IRS and Treasury have broad power under Section 6001 to devise regulations requiring information reporting and recordkeeping by persons who may be liable for any tax under the Code.

An entity (including a disregarded entity) must have an EIN to elect to change its default classification or to file any required return with the IRS. Importantly, the EIN application, Form SS-4, requests information about an entity's "responsible party," defined as "the individual who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual … to control, manage, or direct the entity and the disposition of its funds and assets." An entity must report any subsequent changes in the responsible party.

In sum, federal tax law does not require a domestic entity, such as a single-member LLC, that is treated as disregarded by default and not subject to any special rules to obtain an EIN (though other federal or state laws may require it, for example, to open an account as a U.S. financial institution). Many disregarded entities fall into this category, so the IRS receives little, if any, information about these entities unless their owners are subject to U.S. tax reporting. For a disregarded entity owned by a foreign person, no U.S. tax reporting is required if neither the entity nor the owner received U.S. source income or was engaged in business in the U.S. during the year. Further, if the disregarded entity receives only certain types of U.S. source income, such as portfolio interest or U.S. source income that is fully withheld upon at source, the owner still may have no U.S. tax filing requirement. Even if a disregarded entity has an EIN and its owner files a return, associating income with the entity based solely on the owner's return can be challenging.

Proposed Regulations

The proposed regulations would amend Section 301.7701-2 to treat a domestic disregarded entity wholly owned by a foreign person as a domestic corporation for purposes of the reporting and recordkeeping requirements of Section 6038A. Similar to the special rules for excise and employment taxes, the proposed rules would not affect the entity classification framework or a disregarded entity's general treatment for U.S. tax purposes.

Because a foreign-owned domestic disregarded entity is treated as a domestic corporation under the proposed rules, it would have to file Form 5472 for "reportable transactions" between the entity and foreign related parties, including its foreign owner. Due to this filing obligation, the entity would have to obtain an EIN by filing Form SS-4, identifying its responsible party. The entity would also be required to maintain adequate records to establish the accuracy of the information return and the proper U.S. tax treatment.

A reportable transaction is any type of transaction described in Section 1.6038A-2 of the regulations, including sales and purchases, borrowings and loans, and rents, interest, royalties, service fees, commissions or other amounts paid or received in transactions between the corporation and a foreign related party. A "related party" is any direct or indirect 25% shareholder, any person related to the corporation or a 25% shareholder within the meaning of Section 267(b) or 707(b)(1), and any other person related to the corporation within the meaning of Section 482 and regulations thereunder.

In addition, the proposed regulations would provide that any transaction within the meaning of Section 1.482-1(i)(7) is a reportable transaction. That provision defines "transaction" to mean "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." The proposed regulations indicate that such transactions include amounts paid or received in connection with forming, dissolving, acquiring or disposing of the entity, as well as contributions to and distributions from the entity.

These rules would be effective for tax years ending on or after the date 12 months after final regulations are published.

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