

Proposed Regulations on Foreign-Owned U.S. Disregarded Entities

On May 10, 2016 the Internal Revenue Service (the "**IRS**") published proposed regulations that, if finalized, will treat a domestic disregarded entity wholly owned (directly or indirectly) by a foreign person as a corporation for the limited purposes of the reporting, record maintenance and associated compliance requirements imposed on certain domestic corporations with foreign owners under Section 6038A of the Internal Revenue Code of 1986, as amended (the "**Code**"). The IRS explained that the collection of information under the proposed regulations "is required in order to provide the IRS with improved access to information that it needs to satisfy its obligations under U.S. tax treaties, tax information exchange agreements, and similar international agreements, as well as to strengthen the enforcement of U.S. tax laws." The following provides a general summary of the proposed regulations.

Affected entities

The proposed regulations apply to a domestic disregarded entity if one foreign person has direct or indirect sole ownership of the entity (such entity, an "**affected entity**"). Indirect sole ownership means ownership by one person entirely through one or more disregarded entities or through grantor trusts, regardless of whether such entities or trusts are domestic or foreign.

Requirement to file Form 5472

Under the proposed regulations, an affected entity would be required to file an annual information return – IRS 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 information about "reportable transactions" with a "related party" during the taxable year.

Related party

A related party would include the sole foreign owner of the affected entity, as well as any person related to the entity or the foreign owner under certain provisions of the Code.

Reportable transactions

Reportable transactions include various categories of commercial transactions already enumerated in the applicable Treasury regulations, including, but not limited to, sales or purchases of inventory, interest paid or received, and consideration for services or transfers of properties. With respect to affected entities, the list of reportable transactions already in the Treasury regulations is expanded under the proposed regulations to include an additional category of reportable transactions; specifically, any transaction within the meaning of Treasury Regulation Section 482-1(i)(7) would be a reportable transaction to the extent not covered by another reportable category. For example, amounts paid or received in connection with the formation, dissolution, acquisition and disposition of the entity, including contributions to and distributions from the entity, would be considered reportable transactions.

The proposed regulations would require the filing of Form 5472 even if the foreign owner already has an obligation to report the income from the reportable transaction on a U.S. federal income tax return (*e.g.*, because the transaction results in income effectively connected with the conduct of a U.S. trade or business).

Requirement to obtain an EIN

Because affected entities would be subject to the filing requirements of Section 6038A, the entities would be required to obtain an employer identification number (“**EIN**”) by filing a Form SS-4, *Application for Employer Identification Number* (“**Form SS-4**”). The SS-4 requires the entity to identify a “responsible party” for the entity, which for any entity that is not traded on a public exchange or registered with the Securities and Exchange Commission is defined in the form instructions 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, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets.”

Requirement to maintain and keep records

The affected entity also would be required to keep permanent books of account or records as required by Section 6001 that are sufficient to establish the correctness of the federal income tax or information return of the entity, 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.

Under the proposed regulations, the exceptions to the record maintenance requirements for small corporations and de minimis transactions would not apply to affected entities.

Penalties

Penalties for failing to file Form 5472 and comply with the Section 6038A record maintenance provisions would apply to affected entities under the proposed regulations. In general, unless an entity affirmatively shows that its failure was due to reasonable cause, the IRS could assess a penalty of \$10,000 on any entity that fails to file Form 5472 when due and in the manner prescribed or that fails to maintain records as described above. Additional penalties could apply if the failure remains uncorrected after notification by the IRS.

Effective date and request for comments

The proposed regulations will be effective for taxable years ending on or after the date that is 12 months after the date the regulations are published as final regulations in the *Federal Register*. Comments must be received by the IRS by August 8, 2016. The proposed regulations are available here: <https://www.gpo.gov/fdsys/pkg/FR-2016-05-10/pdf/2016-10852.pdf>.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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