Baker & McKenzie

Client Alert

IRS Issues Proposed Regulations Altering Compliance Requirements of Wholly Foreign Owned U.S. Domestic Disregarded Entities

The U.S. Internal Revenue Service ("IRS") has issued proposed regulations altering the reporting requirements of certain disregarded entities that are wholly owned by a foreign person or a foreign entity. The regulations create reporting and record maintenance requirements for such entities similar to those that already apply to 25%-or-more foreign owned domestic corporations on IRS Form 5472. Once finalized, these proposed regulations would create a significant burden and raise privacy concerns but would assist the U.S. Treasury in providing reciprocal information automatically to foreign tax authorities under Model 1 FATCA intergovernmental agreements, tax information exchange agreements and tax treaties.

1. Current Rules

The U.S. Treasury Regulations contain rules for classifying a business entity as either a corporation, a partnership or an entity disregarded separate from its owner (i.e. disregarded entities) for tax purposes. U.S. corporations and partnerships have many reporting requirements. In contrast, U.S. wholly owned disregarded entities are not obligated under current regulations to file a U.S. tax return or obtain an employer identification number ("EIN"). Any income earned by such entities is passed directly to the owner who may then be required to report the income.

In the context of a U.S. disregarded entity wholly owned by a foreign corporation, foreign partnership or non-resident alien individual ("wholly foreign owned disregarded entity"), the current regulations have allowed for limited reporting to the IRS by the disregarded entity or its owner. If the disregarded entity (1) did not receive U.S. source income or received such income subject to proper withholding (if applicable) or (2) was not engaged or treated as engaged in a U.S. trade or business (such as via U.S. real property investments), then the entity and its owner do not need to file a U.S. income tax return, information return, or apply for an EIN.

2. Proposed Changes

The IRS proposes to amend the regulations to require such wholly foreign owned disregarded entities to be subject to the reporting and record keeping requirements. These requirements exist currently for U.S. corporations that are 25% or more foreign owned. The wholly foreign owned disregarded entity would be required to do the following:

- file IRS Form 5472 information return and disclose certain reportable transactions between the entity and its foreign owner or other foreign related parties;

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- maintain sufficient records to establish the accuracy of the information return and the correct U.S. tax treatment of such filing obligations;

- obtain an EIN and disclose information that includes identifying the responsible party.

The list of reportable transactions referenced above would include 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 impose these additional filing and record keeping obligations even if the foreign owner already has an obligation to report the income resulting from any of the reportable transactions. Failure to comply with these additional reporting requirements may result in penalties assessed by the IRS.

3. Impact and Next Steps

The IRS has solicited comments with respect to these regulations so additional changes may be forthcoming. However, if implemented as final in their current form, the regulations would impose significant burdens on wholly foreign owned disregarded entities, such as LLCs, and on service providers. Such entities will need to put systems in place to comply with this new reporting regime. In addition, each entity and its beneficial owner must be prepared to suffer a loss of privacy as its transactions and the responsible party of the entity will be reported to the IRS.

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