By **Dina Kapur Sanna** & **Carl A. Merino**

The New Form 5472 Reporting Requirements

Are your clients ready?

Many foreign owners of U.S. disregarded entities (and their U.S. tax preparers) soon will have to contend with new reporting requirements going into effect for tax years beginning on or after Jan. 1, 2017 and ending on or after Dec. 13, 2017. Internal Revenue Service Form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," has until now applied only to U.S. corporations with foreign owners and foreign corporations engaged in a U.S. trade or business—both of which generally would already have an obligation to file a U.S. tax return. This is the first year that the obligation to file this form will apply to U.S. disregarded entities with foreign owners, many of which would otherwise have had no reason to file a tax or information return in the United States. Covered entities will need to obtain employer identification numbers (EINs) to comply. This could present further complications if the foreign owners or other responsible persons don't already have individual taxpayer identification numbers (ITINs) or Social Security numbers (SSNs).[1]

The IRS recently posted early drafts of updated Form 5472 and the accompanying instructions on its website.[2] However, as discussed below, the form instructions diverge from the regulations in a few key areas, raising questions as to whether certain types of reportable transactions are, by themselves, sufficient to trigger a reporting obligation. However, as both are still in draft and subject to Office of Management and Budget approval, they're likely to undergo further revisions before being released in final form in December.

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Potential Tax Haven?

The United States has come under fire in recent years for having lax rules that enable unscrupulous foreign individuals to use single-member limited liability companies (LLCs) as shell companies to hide their income and assets from tax authorities back home without triggering any tax liabilities or reporting obligations in the United States.[3] The particular vulnerability of the United States to such abuses stems from the interplay between: (1) the U.S. Treasury regulations governing entity classification (the "check-the-box" regulations"),[4] and (2) state laws in certain jurisdictions, such as Delaware, South Dakota, Nevada and several others, which afford a high degree of privacy to the owners of business entities and trusts and require minimal disclosure of beneficial ownership information.[5] Single-member LLCs are disregarded for U.S. federal income tax purposes under the check-the-box regulations, and so funding an LLC is a non-event for federal income tax purposes. Until recently, this wouldn't have triggered any reporting obligation. Thus, a foreign taxpayer trying to hide the proceeds of illegal activities potentially could have laundered millions of dollars by anonymously investing the proceeds in U.S. real estate through such an LLC.

The United States hasn't adopted automatic beneficial ownership registries for entities or trusts comparable to what its E.U. counterparts are putting in place, but in the past year or so, it's adopted more limited measures, including the issuance of Form 5472 reporting requirements for U.S. disregarded entities with foreign owners, as described below. On Dec. 12, 2016, the Treasury Department and the IRS announced final regulations requiring U.S. disregarded entities (such as

single-member LLCs) with foreign owners to file Form 5472 information returns identifying their foreign owners and reporting certain related party transactions.[6] These new reporting requirements went into effect this year with the first information returns due next year.

Regulatory Framework

The Form 5472 reporting requirements for foreign-owned disregarded entities were piggybacked onto the existing Form 5472 reporting obligations for 25 percent foreign-owned U.S. corporations. Internal Revenue Code Section 6038A and the accompanying Treasury regulations—on which the current Form 5472 reporting requirements are premised—originally were designed to capture transactions that could impact the income tax liability of the reporting corporation and in fact include a catch-all category for amounts received that "are taken into account in determining the taxable income of the reporting corporation." In extending the filing requirements to foreign-owned U.S. disregarded entities, the regulations also expanded the range of related party transactions and activities that would trigger a reporting obligation for a disregarded entity so as to capture transactions that would have no effect on any person's U.S. tax liability. The preamble to the proposed regulations cited the lack of any reporting or record-keeping requirements with respect to such disregarded entities as a hindrance to international law enforcement efforts and the U.S. government's ability to meet its obligations under information exchange agreements. The expansion of the reportable transaction categories was specifically intended to capture contributions to and distributions from disregarded entities that wouldn't otherwise have any income tax significance.

> While foreign-owned disregarded entities continue to be disregarded for most federal tax purposes, they'll now be "regarded" for Form 5472 reporting, record-keeping and compliance purposes.

To ensure that such entities are required to report all transactions with foreign related parties, these regulations would specify as an additional reportable category of transaction for these purposes any transaction within the meaning of Treasury Regulations Section 1.482-1(i)(7) (with such entities being treated as separate taxpayers for the purpose of identifying transactions and being subject to requirements under Section 6038A) to the extent not already covered by another reportable category. The term "transaction" is defined in Treas. Regs. Section 1.482-1(i)(7) to 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. For example, under these proposed regulations, contributions and distributions would be considered reportable transactions with respect to such entities. Accordingly, a transaction between such an entity and its foreign owner (or another disregarded entity of the same owner) would be considered a reportable transaction for purposes of the Section 6038A reporting and record maintenance requirements, even though, because it involves a disregarded entity, it generally wouldn't be considered a transaction for other purposes, such as making an adjustment under Section 482. The penalty provisions associated with failure to file the Form 5472 and failure to maintain records would apply to these entities as well.[7]

Some practitioners have questioned the authority of the IRS to issue regulations in the absence of a statutory mandate. Section 6038A applies by its terms to corporations and not disregarded entities. However, the IRS relied on broad authority under IRC Section 6001 to promulgate regulations to require the keeping of records and the reporting of information by persons who may be liable for any tax and rooted the changes in IRC Section 7701 by creating another special exception in the regulatory framework of the check-the box regulations. The IRS has already successfully carved out exceptions to disregarded entity status in the employment and excise tax context[8] and merely carved out another exception to disregarded entity status within

a regulatory framework that already expressly contemplates exceptions, rather than affirmatively extending a requirement for corporations to disregarded entities. Thus, while foreign-owned disregarded entities continue to be disregarded for most federal tax purposes, they'll now be "regarded" for Form 5472 reporting, record-keeping and compliance purposes.

Reportable Transactions

The term "reportable transaction" is defined to include a broad range of transactions between the disregarded entity and any "related party" (including the direct or indirect foreign owner and certain other foreign persons related to the owner). This can include transactions for which cash or other property is received as consideration, as well as transactions for which no monetary consideration is received or for which less than adequate consideration is paid.[9] Transactions 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. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer.[10]

Reportable transactions also include amounts paid or received in connection with the formation and dissolution of the entity, including contributions to and distributions from the entity, whether or not such amounts would otherwise be reportable.[11] This means that, at least under the regulations, a structure involving a foreign-owned disregarded entity generally can't be created or unwound without triggering a Form 5472 reporting obligation.

However, this is where the recently posted draft instructions introduce some ambiguity in light of the mechanics of the applicable regulations:

- As indicated above, Treas. Regs. Section 1.6038A-2(a)(2) generally defines the term "reportable transaction" to include any transaction of the types listed in paragraphs (b)(3) and (4). Paragraph (b)(3) lays out a laundry list of transactions for which cash consideration is received, and paragraph (b)(4) covers the same transactions by reference in situations in which less than adequate consideration is paid or only nonmonetary consideration is received.
- Treas. Regs. Section 1.6038A-2(b)(3)(xi) adds to the list: "With respect to an entity that is a reporting corporation as a result of being treated as a corporation under § 301.7701-2(c)(vi) of this chapter, any other transaction as defined by § 1.482-1(i)(7), such as amounts paid or received in connection with the formation, dissolution, acquisition and disposition of the entity, including contributions to and distributions from the entity."
- The draft form covers the additional transactions described in Treas. Regs. Section 1.482-1(i)(7) in a new Part V, which closely tracks the language of the regulations, instructing filers to "[describe] on an attached separate sheet any other transaction as defined by § 1.482-1(i)(7), such as amounts paid or received in connection with the formation, dissolution, acquisition and disposition of the entity, including contributions to and distributions from the entity, and check here."
- However, on page 2 of the instructions, under the subheading "Exceptions from filing," filers are advised that: "[a] reporting corporation is not required to file Form 5472 if any of the following apply: ... It had no reportable transactions of the types listed in Parts IV and VI of the form." Loans made and received are explicitly covered in Part IV, but this would seem to leave open the possibility that funding a disregarded entity with equity or liquidating the entity wouldn't, by itself, trigger a filing obligation if such transaction is only reported in Part V. As discussed earlier, the preamble to the proposed regulations explicitly cited such contributions and

Only transactions with foreign related parties are considered reportable transactions.

distributions as transactions that the new reporting requirements were intended to capture, so it seems odd that this would be omitted.

The omission of Part V probably wasn't intended and may be corrected when the draft form is finalized later this year. Foreign owners of disregarded entities should be prepared to have such amounts reported pending further guidance.

Related Parties

As noted, only transactions with related parties are considered reportable transactions. Related parties include direct and "indirect" 25 percent foreign owners of the LLC (by vote or value), as well as any persons related to the LLC or the owner under IRC Sections 267(b) or 707(b)(1) and persons related to the LLC under the IRC Section 482 regulations. The regulations incorporate a modified version of the existing IRC Section 318 attribution rules for purposes of determining both whether someone is an indirect owner of the LLC and whether someone is related to a direct or indirect owner.[12] Under these rules, the following persons are related:

Anyone who needs an EIN for a Form 5472 filing obligation would be well advised to apply for one months in advance.

- Spouses, ancestors, descendants and siblings of the owner.
- A corporation or partnership with a greater than 50 percent interest in the owner or reporting entity or that's either owned more than 50 percent by the owner or reporting entity or under common control.
- Certain trust fiduciaries when the trust or grantor owns a requisite interest in the underlying entity.

When the reporting entity is owned by a foreign corporation, partnership or (nongrantor) trust, the shareholders, partners or beneficiaries thereof will be considered to own their proportionate shares of the reporting entity (with a 10 percent minimum ownership threshold for attribution from a corporation). A beneficiary's share of a trust's interest in the reporting entity is based on the relative actuarial value of his beneficial interest in the trust. It's not entirely clear how a discretionary beneficiary's interest would be determined, but informal guidance in other contexts suggests one would look to the pattern of distributions, mortality assumptions and relationships among the trustees and beneficiaries.[13] When the tax owner is a foreign grantor trust, the grantor of such trust, rather than the beneficiaries, would be considered to own any shares held by the trust. Successive attribution rules apply.

Reportable Transactions

The following examples illustrate the potential scope of the new Form 5472 reporting requirements:

Example 1: U.S. LLC owned by foreign blocker. X and Y, both nonresident aliens (NRAs), each own 50 percent of the stock of a BVI corporation (BVI Co), which in turn is the sole member of a Nevada LLC. The LLC owns a condominium apartment in Aspen, Colo. that X and Y use for their annual ski vacation. BVI Co periodically advances funds to the LLC to cover maintenance and other carrying costs. Occasionally, BVI Co, X or Y will pay such expenses directly.

- Cash advances by BVI Co to the LLC would constitute reportable transactions that would trigger a Form 5472 return filing obligation.
- Further, the payment of expenses by BVI Co, X or Y on behalf of the LLC would be considered indirect contributions and thus would be similarly reportable because each of BVI Co, X and Y would be considered a related party with respect to the LLC.
- The use of the apartment by X and Y also would appear to be reportable regardless of whether X and Y pay rent. If they pay fair market rent, then their rent payments would be reportable under Treas. Regs. Section 1.6038A-2(b)(3) in Part IV of Form 5472. If they use the apartment rent-free, then their use of the apartment would seem to be covered by Treas. Regs. Section 1.6038A-2(b)(4)

and reportable in Part VI or, alternatively, in Part V as a constructive distribution from the LLC to BVI Co and from BVI Co to X and Y based on case law and IRS guidance in other areas.[14] Moreover, the Section 6038A regulations require the disclosure of a reportable transaction "however such transaction is effected, and whether or not the terms of such transaction are formally documented."

Example 2: U.S. LLC owned by foreign nongrantor trust. A foreign nongrantor trust is the sole member of a Delaware LLC that owns a townhouse in New York City. The settlor of the trust is an NRA. The settlor's wife and his three daughters are all discretionary beneficiaries, and the trust has an independent trustee. The settlor's wife and two of his daughters are NRAs, and one of his daughters has a green card. The trust doesn't have a significant distribution history, but all of the beneficiaries use the apartment from time to time without paying any rent. The trust periodically advances funds to the LLC to cover carrying costs and other expenses. Occasionally, the trust pays expenses on behalf of the LLC.

- All of the beneficiaries would likely be considered related persons. Although there's no formal distribution history to use as a proxy for determining their beneficial interests in the trust, their prior use of property indirectly owned by the trust could be seen as a distribution history of sorts.
- As illustrated in the previous example, both actual contributions to the LLC and constructive contributions (when the trust pays expenses on behalf of the LLC) would be reportable transactions.
- Similarly, although there's no corporation-shareholder context here, the rent-free use of the apartment by the non-U.S. beneficiaries would be akin to an interest-free loan (in this case, of property rather than money), which would be reportable.

Note that the daughter holding the green card would be treated for U.S. income tax purposes as receiving a potentially taxable distribution from the trust to the extent that she used the apartment without paying market rent under IRC Section 643(i), which she would be required to report on IRS Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts."

Record Maintenance Requirements

The foreign-owned disregarded entity would be required to keep permanent books and records sufficient to establish the correct U.S. tax treatment of any transactions with related parties, including information, documents and records of the foreign owner that may be relevant. The final regulations exclude domestic disregarded entities from exceptions to the record maintenance requirements for small corporations and de minimis transactions. The penalty for failure to timely file a correct Form 5472 is $10,000. If the IRS issues notice of the reporting entity's failure to file and no form is filed within 90 days of such notice, an additional $10,000 penalty will apply for each additional 30 days that the form is delinquent.

Taxpayers should be on the lookout for a revised form and instructions later this year.

Because an EIN is required for the Form 5472, a disregarded entity subject to the new reporting requirements would have to file IRS Form SS-4 to obtain an EIN. The latest draft instructions now contemplate applications obtaining EINs for Form 5472 filing purposes. The Form SS-4 instructions require the applicant to identify a "responsible party" for the entity on Line 7 and provide an ITIN or SSN for that responsible person. For an entity that isn't publicly traded, registered with the Securities Exchange Commission, a tax-exempt organization or a government entity, the draft instructions define a responsible party as "the individual (i.e., the natural person) who ultimately owns or controls the entity or who exercises ultimate effective control over the entity." The draft instructions go on to note that such individual "should have 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." In many cases, particularly with a single-member LLC, the responsible person will be the owner.

If the responsible person is an NRA who doesn't

already have an ITIN, then he'll need to apply for one by filing IRS Form W-7, along with the relevant supporting documents to establish all information on Form W-7, including the individual's identity and connection to a foreign country. Prior to the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), an alternative to mailing Form W-7 was bringing a completed Form W-7 and documentation to a designated Taxpayer Assistance Center (which can authenticate documentary evidence and forward the application for IRS processing) or an IRS office overseas. For convenience, foreign taxpayers could also use a certified acceptance agent (CAA) who's authorized by the IRS to assist taxpayers in verifying documentary evidence in addition to submitting the Form W-7.[15] If a CAA was used, the CAA would certify to the IRS that it's reviewed the documentation of the applicant's identity and alien status and that it would maintain a record of that documentation. Also, the CAA would describe the documentation and certify that, to the best of its knowledge and belief, the documentation was authentic, complete and accurate.[16] The PATH Act added new ITIN application requirements under IRC Section 6109(i).

SPOT LIGHT

Shall We Dance?

Groovin High by Faith Ringgold sold for $3,380 at Swann Auction Galleries' African-American Fine Art sale in New York City on Oct. 5, 2017. Ringgold was best known for her elaborate narrative quilts, which were the result of a collaboration with her clothing designer and seamstress mother. The quilts were her way of telling a story, as no one at the time would publish her autobiography.

Under new Section 6109(i), effective Jan. 1, 2017, individuals who reside outside the United States can only apply for an ITIN by mail or in person to an IRS employee or a designee at a U.S. diplomatic mission or consular post. This means that the overseas CAA procedure for nonresidents has been eliminated, although it still remains available for U.S. residents.[17]

The practical implication is that the process of obtaining an ITIN for a nonresident individual can take months and requires original or certified copies of the applicant's passport or other official documents confirming his identity. Only the issuing agency or a U.S. embassy or consulate can certify the documents, so nonresidents are now left with the option of either applying by mail (and sending original documents) or applying in person to an IRS employee or designee at a U.S. diplomatic mission or consular post. We note that while some taxpayers may have been able to obtain EINs for LLCs by fax without a responsible person ITIN or SSN, there's a significant risk of pushback from the IRS. Thus, anyone who needs an EIN for a Form 5472 filing obligation would be well advised to apply for one months in advance.

Filing the Form

Foreign-owned disregarded entities will now be required to file a pro forma Form 1120 with Form 5472 attached. However, the only information required to be completed on Form 1120 is the name and address of the foreign-owned U.S. disregarded entity and items B and E on the first page. "Foreign-owned U.S. DE" should be written across the top of the Form 1120. The pro forma Form 1120 and accompanying Form(s) 5472 can be submitted by mail to the address provided in the instructions or by fax (number to be provided in the final instructions), but won't be eligible for electronic filing.

Take Steps Now

As discussed above, although some questions remain as to the final contours of the form and whether certain subclasses of transactions wouldn't, by themselves, trigger a filing requirement, it's clear that a wide swath of previously unreportable transactions will have to be reported next year. Taxpayers should be on the lookout for a revised form and instructions later this year. In the meantime, foreign owners of U.S. disregarded entities and their advisors should be taking steps now to

identify and quantify potentially reportable transactions, such as payments made on behalf of such entities and uncompensated use of LLC property. Further, potential gating items, like obtaining an ITIN if one is needed, should be undertaken well ahead of time so as not to be caught short when the form is actually due.

Endnotes

1. This article expands on an alert written by the co-authors for the *Trusts & Estates* e-newsletter on Jan. 3, 2017. *See www.wealthmanagement.com/estate-planning/new-filing-requirements-foreign-owned-disregarded-entities.*
2. The draft form is available at *www.irs.gov/pub/irs-dft/f5472--dft.pdf.* The draft instructions are available at *www.irs.gov/pub/irs-dft/i5472--dft.pdf.*
3. For more color on the criticism lodged against the United States by its foreign partners, *see* Dina Kapur Sanna and Carl A. Merino, "Long Arm of the Law: The Risk to U.S. Practitioners of Prosecution for Facilitating Foreign Tax Offenses," *Trusts & Estates* (June 2017), at p. 30.
4. Under Treasury Regulations Sections 301.7701-1 through 301.7701-3, effective Jan. 1, 1997, all business entities, other than those classified as corporations for federal tax purposes (referred to as eligible entities), may elect to be taxed as pass-through entities (disregarded entities if they have one member and partnerships if they have two or more members) or as corporations.
5. For example, in Delaware, only the company name and the name and address of the registered agent typically appear on the Certificate of Formation, along with the date of filing and the company file number. No information about the members or managers is required to be listed on the Certificate of Formation, and the Delaware Division of Corporations doesn't request, obtain or store any information regarding the limited liability company's (LLC's) members and managers. The Delaware Registered Agent is required, however, to maintain a record of the contact person for the LLC, including the contact person's address, but the contact person doesn't have to be a member or manager of the LLC.
6. *See* T.D. 9796, 81 FR 89849 (Dec. 13, 2016). Note that the White House issued an Executive Order on April 21, 2017 requiring the Treasury Department to review all "significant" regulations issued on or after Jan. 1, 2016 and identify in an interim report to the President within 60 days all such regulations that: (1) impose an undue financial burden on U.S. taxpayers, (2) add undue complexity to the federal tax laws, or (3) exceed the statutory authority of the Internal Revenue Service. In Notice 2017-38 released on July 7, 2017, the IRS identified for burden reduction eight regulations that met one of the criteria identified in the executive order. Internal Revenue Code Section 6038A regulations weren't on that list. *See* Notice 2017-38.
7. Fed. Reg. Vol. 81, No. 90, p. 28784 (May 10, 2016).
8. Treas. Regs. Section 301.7701–2(c)(2)(iv) and (v). Note that disregarded entities have been treated as separate corporations for federal employment and excise tax purposes since 2009. *See* T.D. 9356, 72 F.R. 45893 (Aug. 16, 2007).
9. *See* Treas. Regs. Sections 1.6038A-2(a)(2), (b)(3) and (b)(4).
10. *See* Treas. Regs. Section 1.482-1(i)(7) (cited by the IRC Section 6038A regulations).
11. Treas. Regs. Section 1.6038A-2(b)(3)(xi).
12. Treas. Regs. Section 1.6038A-1(e).
13. *See* Private Letter Ruling 9024076 (March 21, 1990); Technical Advice Memorandum 200733024.
14. Both the IRS and the courts have held that the rent-free use by shareholders or their relatives of apartments or other property owned by a corporation would be characterized as distributions from the corporation to the shareholder (and taxed as dividends to the extent of earnings and profits). *See G.D. Parker, Inc. v. Commissioner*, T.C. Memo. 2012-327; Rev. Rul. 58-1, 1958-1 CB 173. *See also Dickman v. Comm'r*, 465 U.S. 330 (1984) (holding that when a parent grants a child rent-free indefinite use of commercial property that has a determinable rental value, there's a clear transfer of a valuable property right for gift tax purposes).
15. Treas. Regs. Section 301.6109-1(d)(3)(iv)(A); *See* Revenue Procedure 2006-10.
16. *Ibid.*
17. Some national commentators believe the unavailability of the certified acceptance agent procedure for nonresidents was an oversight and should be corrected by a future technical amendment to IRC Section 6109(i). Congress introduced legislation to correct this error, but neither the Senate nor the House have acted on the bills to date. *See https://taxpayeradvocate.irs.gov/Media/Default/Documents/2016-ARC/ARC16_Volume1_LR_09_CAAS.pdf.*

SPOT LIGHT

Gone Fishing

Untitled (Youths on a Lakeshore) by Hughie Lee-Smith sold for $93,750 at Swann Auction Galleries' African-American Fine Art sale in New York City on Oct. 5, 2017. As depicted in this painting, Lee-Smith's signature works often featured seaside landscapes and distant figures. In 1963, he became the second African-American to be elected to the National Academy of Design.