

CHANGES TO U.S FOREIGN OWNED SINGLE MEMBER LLC'S – THE SERVICE'S ENFORCEMENT NET GROWS WIDER

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Recently enacted final regulations (TD 9796) will treat domestic disregarded entities, which are wholly owned, directly or indirectly, by foreign persons, as domestic corporations solely for purposes of making them subject to the reporting requirements under Internal Revenue Code, Section 6038A that apply to 25% foreign-owned domestic corporations. These changes are intended to provide 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.

EXECUTIVE SUMMARY

Effective December 13, 2016 for tax years beginning in 2017, Limited Liability Companies (LLCs) formed in the United States or the District of Columbia whose sole member is a foreign person (nonresident alien) and such person does not make an “entity classification election” (on Form 8832, also called “Check The Box”) to be treated as corporations for US tax purposes, the LLC will become subject to new Internal Revenue Service (“IRS”) reporting requirements which include, among others:

- An LLC with a sole foreign member will be required to obtain an Employer Identification Number (“EIN”) from the Internal Revenue Service (“IRS”) through Form SS-4, which requires the designation of a “Responsible Party” in the respective application;
- The LLC which would be treated as a disregarded entity owned by a foreign single member will thus be treated as a domestic (US) corporation requiring the annual filing of Form 5472 which

generally applies to 25% foreign-owned domestic corporations and such entity's reportable transactions;

- Although the sole foreign member LLC will be required to prepare and file Form 5472 for informational reporting purposes, the LLC itself will continue to be treated as an entity disregarded for tax and legal purposes, notwithstanding the informational reporting requirement.

BACKGROUND

At present, IRS Regulations classify a business entity with two or more members as either a corporation or a partnership, while a business entity with a single owner can be as either a corporation or an entity disregarded as separate from its owner ("disregarded entity"). Certain domestic business entities, such as limited liability companies ("LLCs"), are classified by default as partnerships (if they have more than one member) or as disregarded entities (if they have only one owner) but are eligible to elect for federal tax purposes to be classified as corporations should such decision be reached.

Entities that are disregarded, such as single member LLC's, are generally not subject to US tax filing requirements, which means they also generally do not need to obtain an Employer Identification Number ("EIN") unless they are filing an entity classification election to change its classification from that of a disregarded entity to a corporation for tax purposes by means of executing Form 8832, Entity Classification Election, also referred to as the "check the box" form. Although single member LLC's are not required to file a tax return, other entity types, such as domestic corporations and partnerships, as well as foreign corporations engaged in a trade or business in the US, must file annual US income tax returns. In order to file a tax return in the US or apply for a change of entity classification, an entity must obtain an EIN by filing Form SS-4, Application for Employer Identification Number.

Generally speaking, because a domestic single-member LLC is classified as a disregarded entity by default rather than by election and has no separate federal tax return filing requirements, there is typically no federal tax requirement for it to obtain an EIN¹ since a disregarded entity is not subject to a separate income or information return filing. This is so because the single member owner is treated as owning directly the entity's assets and liabilities and any information available with respect to the disregarded entity would depend solely on the single member's own return filings, if any. A disregarded entity that is formed in the US and owned by a nonresident alien individual, foreign corporation or foreign partnership, generally does not have to file a U.S. income or information return if neither the disregarded entity nor its single member owner received any U.S. source income or was engaged in a U.S. trade or business during any taxable year. Moreover, if a disregarded entity only receives certain types of U.S. source income, such as portfolio interest, or U.S. source income that is fully withheld upon at source, its owner may not have a U.S. return filing requirement².

¹ Other applicable federal or state laws may require an entity to obtain an EIN. For example, pursuant to federal law, banks and financial institutions in the United States generally require an entity to have an EIN to open an account. See 31 CFR 1020.220(a)(1)(i)(A)(4).

² Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, is used by banks and financial institutions to report tax withholdings on income accounts maintained by non-US persons. With the implementation of the Form, no additional reporting is required from the non-US account holder with respect to such tax withholdings.

On the other hand, Internal Revenue Code Section 6601 states, in part, “. . . every person liable for any tax imposed by the Code, or for the collection thereof, shall keep such records . . . make such returns and comply with such rules and regulations as the Secretary may from time to time prescribe, and that . . . the Secretary . . . may require any person . . . to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax”. Thus, the US Treasury and the IRS have broad authority under the Code to make regulations to require the keeping of records and the reporting of information by persons who may be liable for any tax. The Code also requires various types of persons, whether individual or corporate, to file return, even if no tax is owed in a given tax year. As an example, domestic partnerships referred to previously, are required to file annual tax informational forms which identifies the partners³. Similarly, domestic corporations that are owned by at least 25% non-US shareholders are also subject to informational reporting and record maintenance requirements pursuant to Internal Revenue Code Section 6038A, requiring the filing of Form 5472, Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business, with respect to “reportable transactions” undertaken with any “related party”, which includes its owner. NOTE: The Form 5472 is an information form only; it is not a tax form triggering the payment of any tax obligation.

SUMMARY REGULATORY PROVISIONS

Accordingly, in May 2016, the Department of the Treasury and the IRS published a notice of proposed rulemaking (see, REG-127199-15; 81 FR 28784) under sections 6038A and 7701 (the proposed regulations). These regulations would treat a single member LLC (or other similar disregarded entity) owned wholly by a non-US person as a domestic corporation separate from its owner for the limited purposes of the reporting and record maintenance requirements that would normally apply to 25 percent foreign-owned domestic corporations under the previously referred IRC Section 6038A. As a result, these entities must file Form 5472, and maintain related records for reportable transactions with the entities’ foreign owners or other foreign-related parties and to maintain adequate books and records to track any payments or transfers of money, property or other reportable transactions between the disregarded entity and its sole member, whether such transactions are direct or indirect. A reportable transaction is defined 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.”⁴

In order to file the Form 5472, an EIN must be obtained from the IRS by the filing of the previously referred Form SS-4. This, in itself, may be problematic due to the time it takes for the IRS to process the application process in obtaining an EIN for a non-US person. Caution should be taken here for readers to take the form of future planning to obtain the EIN prior to the first due date for the 5472 form which will be due in 2018 for reporting of tax year 2017 reportable activities.

As a final note, the requirement by the IRS of a single member LLC in being recognized as a domestic corporation thus triggering the reporting which is specified above, does not affect the continued disregarded nature of the LLC. In other words, although the execution of Form 5472 as an information

³ See IRS Reg. §1. 6031(a)-1

⁴ IRS Reg §1.482-1(i)(7)

return will be required for an affected single member LLC, the LLC will continue be treated as a disregarded entity for all legal and tax purposes.

In conclusion, the Department of Treasury makes clear their rationale for such changes regarding foreign owned single member LLC's through the following,

“Although ownership and accounting information is generally available under the reporting requirements established by the U.S. federal tax system with respect to many types of domestic entities, **the absence of specific return filing and associated recordkeeping requirements for foreign-owned, single-member domestic entities hinders law enforcement efforts and compliance with international standards of transparency and cooperation in the area of tax information exchange.”⁵(emphasis added).**

Readers need to be mindful of the increased workload that the new regulations could place upon them, and must consider thought as to what changes to their internal processes may be completed to comply with the informational reporting. It is fully anticipated that revised instructions for Form 5472 along with final amended regulations would be forthcoming as guidance would be needed to navigate these changes in the tax landscape.

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⁵ 81 FR 28784 at 28785