IRS Finalizes Form 5472 Regulations for Foreign-Owned, Domestic, Disregarded Entities

By Hale E. Sheppard

I. Introduction

Various international organizations claimed, and the IRS recently confirmed, that we may have a problem on our hands. Namely, as a result of gaps in U.S. tax law concerning international information reporting, foreigners can hide money through the United States by utilizing a domestic, single-member limited liability company (LLC), treated as a disregarded entity (DRE) for federal tax purposes. With the aim of putting a stop to this practice, the IRS issued proposed regulations in May 2016 ("Proposed Regulations") that would obligate foreign-owned, single-member, domestic DREs to file with the IRS annual Forms 5472 (Information Return of a 25-percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) and to comply with stringent record-keeping requirements.[1] Just seven months later, in December 2016, the IRS finalized and published the new rules ("Final Regulations"), featuring a few unilateral changes by the IRS.[2] This article provides context on the creation of Form 5472, explains key duties, describes penalties for violations, clarifies the IRS's rationale for change, analyzes the regulatory modifications on a provision-by-provision basis and identifies pivotal issues regarding Form 5472 of which most taxpayers and their tax advisors are unaware.

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II. Overview of the Applicable Law

To appreciate the changes introduced by the Final Regulations, one must first have some history about Form 5472 and understand the basic requirements and terminology.

A. Brief History of Code Sec. 6038A and Code Sec. 6038C

Foreign investment and foreign business activity in the United States increased significantly in the 1980s. The U.S. government, through Congress and the IRS, began taking steps to ensure that these items were properly taxed and monitored. One example of these efforts was the enactment of Code Sec. 6038A in 1982.

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The primary purpose of that legislation was to gather additional information about foreigners to prevent the manipulation of related-party transactions, the resulting decrease in (or avoidance of) U.S. tax liabilities and other "abuses."[3] The congressional rationale for passing Code Sec. 6038A was the following:

> Transactions between related parties are required to be at arms-length prices. This rule applies, for example, to transactions between a U.S. parent and its foreign subsidiaries, as well as to transactions between a foreign parent and its U.S. subsidiaries. *Under prior law, a U.S. parent corporation was required to report transactions with its foreign affiliates and transactions between its foreign affiliates, but no such reporting was required of transactions between a U.S. subsidiary of a foreign corporation and its foreign affiliates. Consequently, the existence of such transactions did not necessarily come to the attention of the Internal Revenue Service*. Congress believes that a requirement that such transactions be reported will reduce transfer price abuses and similar abuses and will place foreign controlled U.S. entities on equal footing with U.S. corporations controlled by U.S. persons.[4]

Code Sec. 6038A originally applied to domestic corporations with significant ownership by foreign persons. It was later expanded to cover foreign corporations engaged in a trade or business in the United States, irrespective of the percentage of foreign ownership.[5]

In 1990, Congress enacted Code Sec. 6038C, which essentially split the two requirements: Domestic corporations that were foreign-owned would be governed by Code Sec. 6038A, while foreign corporations with U.S. operations would be controlled by Code Sec. 6038C.[6] Despite this statutory separation, the two tax provisions share the same regulations (*i.e.*, those under Code Sec. 6038A), and corporations subject to either provision must supply the IRS with information in the same manner (*i.e.*, on Form 5472).

B. Analysis of Key Concepts and Terminology

Form 5472 generally must be filed by a "reporting corporation" in order to disclose to the IRS certain "reportable transactions" between the "reporting corporation" and "related parties." Thus, taxpayers must analyze each of these three concepts to determine if they must file Forms 5472. These concepts are terribly complicated and technical, even for tax professionals, and a detailed discussion is beyond the scope of this article. However, having a general understanding of the three key terms is important. They are summarized below.

1. What Is a "Reporting Corporation?"

The filing obligations are created by two interrelated tax provisions.

Under Code Sec. 6038A, a "reporting corporation" is a *domestic corporation* that is at least 25 percent foreign-owned.[7] A domestic corporation falls into this category if at least 25 percent of its stock is owned, directly or indirectly, by one foreign person (either an individual or entity) at any time during the relevant tax year.[8] This foreign owner is commonly known as the "25-percent-foreign shareholder."[9]

According to Code Sec. 6038C, a "reporting corporation" is also any *foreign corporation* that operates a U.S. trade or business at any time during the year at issue.[10] The regulations clarify that if a foreign corporation is a resident of a foreign country that has a tax treaty with the United States, then it will not be considered a "reporting corporation," unless it has a so-called permanent establishment in the United States.[11]

2. What Is a "Reportable Transaction?"

The term "reportable transaction" generally encompasses several items, including, but not limited to, sales and purchases of inventory and other tangible property, rents and royalties paid and received, consideration paid for use of all intangible property, consideration paid for services rendered (including technical, managerial, engineering, construction, scientific and others), commissions paid and received, certain amounts loaned or borrowed, interest paid or received, premiums received for insurance or reinsurance, and the catch-all, other amounts paid to or received from related parties that are taken into account in determining the taxable income of the reporting corporation.[12]

3. What Is a "Related Party?"

A "related party" is broadly defined to cover (i) any 25-percent-foreign-shareholder of the reporting corporation, (ii) any person who is related to the 25-percent-foreign-shareholder according to special ownership-attribution rules, (iii) any person who is related to the reporting corporation under the special ownership-attribution rules, and (iv) any entity that is owned or controlled by the same persons as the reporting corporation pursuant to the transfer-pricing rules in Code Sec. 482.[13] This wide scope notwithstanding, the term "related party" does *not* include any corporation filing a consolidated federal income tax return with the reporting corporation.[14]

C. Form 5472 Filing Requirement

1. General Duty

A reporting corporation must file a *separate* annual Form 5472 with respect to *each* related party with which it had *any* reportable transaction during the relevant year.[15] This, of course, opens the door for reporting corporations to incur numerous penalties in the same year. Notably, Forms 5472 must be filed with the IRS, even though the information they contain may not affect the amount of U.S. tax due.[16] When, where, and how a reporting corporation files Forms 5472 has changed numerous times over the years, and new rules are still pending.[17]

2. Assorted Exceptions to General Filing Duty

The regulations identify various situations in which a reporting corporation is excused from filing Forms 5472. Among these special situations are the following. First, a reporting corporation generally is not obligated to file a Form 5472 with respect to a related foreign corporation for a year during which a U.S. person that controls such foreign corporation files a Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*), providing the necessary information about the "reportable transactions."[18] Second, a reporting corporation does not need to file a Form 5472 regarding transactions with a related party that qualifies as a Foreign Sales Corporation (FSC) for the year and files Form 1120-FSC.[19]

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D. Record-Keeping Requirement

1. General Duty

In addition to filing Forms 5472, a reporting corporation normally must maintain records of reportable transactions in sufficient detail to establish the correct tax treatment of the transactions.[20] These records must be kept as long as they may be relevant or material to determining such treatment, and they must generally be kept within the United States.[21]

2. Exceptions for Small Entities and Small Transactions

There are exceptions to this special record-keeping requirement in cases of small reporting corporations (*i.e.*, those that have less than $10 million in U.S. gross receipts for a tax year) and small reportable transactions (*i.e.*, where the aggregate value of all gross payments that a reporting corporation makes to and receives from foreign related parties during a tax year does not exceed $5 million and is less than 10 percent of the reporting corporation's U.S. gross income).[22] Neither of these two record-keeping exceptions relieves a reporting corporation from its obligation to file annual Forms 5472, though.[23] Indeed, while the IRS liberates certain small items from the extra record-keeping burden, it still demands reporting of relevant transactions on Forms 5472.

E. Penalties for Form 5472 Violations

1. General Standards and Amounts

A reporting corporation that fails to file timely Forms 5472 is subject to civil penalties.[24] Likewise, a reporting corporation that files timely, yet "substantially incomplete," Forms 5472 will be punished.[25] The IRS generally may impose a penalty of $10,000 for each violation for each year, which can add-up quickly if a reporting corporation fails to file multiple Forms 5472 for an extended period.[26]

This penalty increases where the failure to file Forms 5472 continues after the IRS notifies the reporting corporation of its noncompliance. Specifically, if the reporting corporation fails to supply to the IRS the missing Forms 5472 within 90 days of notice from the IRS, then the penalty increases by $10,000 each additional month.[27]

2. Exceptions to Penalties

The regulations contain some unique rules regarding penalty mitigation, most of which are not available to taxpayers dealing with requirements other than Form 5472.

a. First Exception—Reasonable Cause Defense. If the reporting corporation acted in "good faith" and there is "reasonable cause" for not filing a Form 5472 or maintaining proper records, then the initial $10,000 penalty may be waived, and the running of the 90-day correction period may be tolled.[28] The reporting corporation must make an affirmative showing of all the relevant facts in a written statement made under penalties of perjury to demonstrate that good faith and reasonable cause existed.[29]

The IRS makes its determination of whether the reporting corporation acted reasonably and in good faith on a case-by-case basis, taking into account all the pertinent facts and circumstances.[30] The regulations provide the following guidance in this regard:

- An honest misunderstanding of fact or law by the reporting corporation may indicate reasonable cause and good faith in light of the experience and knowledge of the reporting corporation.
- Isolated computational or transcriptional errors are consistent with reasonable cause and good faith.

- Reliance by the reporting corporation on an erroneous information return, erroneous professional advice or other erroneous data constitutes reasonable cause and good faith, only if such reliance was reasonable under all the circumstances.
- A reasonable belief (*i.e.*, it does not know or have reason to know) by the reporting corporation that it is not owned by a 25-percent-foreign-shareholder.
- A foreign owner is considered a "related party" solely under the broad principles of the transfer-pricing rules in Code Sec. 482, and the reporting corporation had a reasonable belief that its relationship with the foreign owner did not meet such principles.[31]

b. Second Exception—Substantial Compliance Defense. The regulations also contemplate a "substantial compliance" defense to penalties, which is categorized as a subset of "reasonable cause." This defense only applies if the reporting corporation filed a timely Form 5472, but it was incomplete or inaccurate.[32] Upon introducing this defense in the earliest regulations, the IRS envisioned salvation for many taxpayers: "The [IRS] anticipates that the broad range of estimates and descriptions allowed in [the Section 6038A regulations] will prevent most inadvertent errors from causing a technical violation if the reporting corporation has made a reasonable effort to comply."[33]

c. Third Exception—Reasonable Estimates Defense. The regulations provide flexibility in terms of the figures reported on Forms 5472, allowing latitude of 25 percent on either side. In this regard, the regulations state that "[a] ny amount reported [on Form 5472] is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount."[34]

d. Fourth Exception—Small Amounts Defense. The regulations explain that, if any actual amount required to be reported does not exceed $50,000, then simply stating this on Form 5472 suffices. Reporting corporations are directed to write "$50,000 or less" in the pertinent places.[35]

e. Fifth Exception—Small Reporting Corporation Defense. The IRS must "liberally" apply the reasonable-cause-and-good-faith exception in cases where four factors are met: The reporting corporation (i) is a small corporation, *i.e.*, its gross receipts for the relevant year are $20 million or less; (ii) had no knowledge of the duty to file Form 5472 and/or maintain special records; (iii) has a limited presence in, and contact with, the United States; and (iv) promptly and fully complies with all requests by the IRS to file Forms 5472, and to furnish books, records or other materials relevant to reportable transactions.[36]

III. Rationale for Changes to Regulations in 2016

A. Data Received or Not Received from Foreign Persons

The IRS normally has a good deal of information about foreign persons who invest in or conduct business in the United States, either individually or through an entity, because they must file annual income tax returns with the IRS. For example, foreign corporations engaged in a U.S. trade or business generally file a Form 1120-F (*U.S. Income Tax Return of a Foreign Corporation*) enclosing a Form 5472, domestic corporations with significant foreign ownership file a Form 1120 (*U.S. Corporation Income Tax Return*) enclosing a Form 5472, partnerships file a Form 1065 (*U.S. Return of Partnership Income*) revealing information about the partners/owners on the enclosed Schedules K-1 (Partner's Share of Income, Deductions, Credits, *etc.*), and non-citizen-non-residents file Form 1040-NR (*U.S. Nonresident Alien Income Tax Return*) if they are engaged in a U.S. trade or business or have certain types of income from U.S. sources.

In addition to the data derived from income tax returns described in the preceding paragraph, the IRS obtains information about foreign persons because they often file a Form 8832 (*Entity Classification Election*) indicating to the IRS how they intend to be treated for U.S. tax purposes and/or a Form SS-4 (*Application for Employer Identification Number*) to secure their identities with the IRS, their Employer Identification Numbers (EINs). In the case of an entity, the name and identifying number of the owner must be provided to the IRS on Form 8832. The IRS's Instructions to Form 8832 explain the following regarding one-owner entities:

> If an eligible entity has only one owner, provide the name of its owner on line 4a and the owner's identifying number (social security number, or individual taxpayer identification number, or EIN) on line 4b. If the electing eligible entity is owned by an entity that is a disregarded entity or by an entity that is a member of a series of tiered disregarded entities, identify the first entity (the entity closest to the electing eligible entity) that is not a disregarded entity. For example, if the electing eligible entity is owned by disregarded entity A, which is owned by another disregarded entity B, and disregarded entity B is owned by partnership C, provide the name and EIN of partnership C as the owner of the electing eligible entity.[37]

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For its part, Form SS-4 requires data about the ultimate owner of the entity seeking the EIN. It does so by demanding information about the "responsible party." The IRS's Instructions to Form SS-4 mandate that the entity provide the full name and identifying number (*i.e.*, Social Security Number, Individual Taxpayer Identification Number or EIN) of the "responsible person." The IRS's Instructions go on to broadly define the concept of "responsible person" as follows:

> For all other entities [*i.e.*, all entities other than those whose interests or shares are traded on a public exchange, which are registered with the Securities and Exchange Commission, or which are government entities], the "responsible party" is 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. The ability to fund the entity or the entitlement to the property of the entity alone, however, without any corresponding authority to control, manage, or direct the entity (such as in the case of a minor child beneficiary), doesn't cause the individual to be a responsible party.[38]

Currently, neither Form 8832 nor Form SS-4 is required to be filed in certain situations involving DREs. The Instructions to Form 8832 state that a "new eligible entity should *not* file Form 8832 if it will be using its default classification," which, in the case of an entity with one owner, is a DRE.[39] Similarly, the current Instructions to Form SS-4 explain that a DRE only needs to file a Form SS-4 if it needs an EIN to pay employment or excise taxes, to comply with a nonfederal tax requirement (such as a state mandate), to file a Form 8832 to elect to be treated as an association/corporation instead of a DRE, or because it has acquired one or more additional owners, thereby changing its classification from a DRE to a partnership under the default rules.[40]

B. Reasons for Modifying the Regulations

With that backdrop, we now move to the supposed problems, the reasons for forcing foreign-owned, single-member, domestic DREs to file Forms 5472. The IRS identified the following issues:

- The entity-classification regulations, also known as the check-the-box regulations, located in Reg. §301.7701-1 through Reg. §301.7701-3, contain default rules that function to treat entities with just one owner as DREs, unless they file a Form 8832 with the IRS electing to be treated as an association/corporation for U.S. tax purposes.
- Many of these DREs consist of domestic LLCs owned by one foreign person.
- Persons forming DREs in certain states are required to provide little, if any, information about the ultimate owner.
- The current rules do not require the filing by a DRE of a Form 8832 (because it is accepting the default classification as a DRE) or a Form SS-4 (because it does not need to obtain an EIN).
- In situations where neither the DRE nor its owner received any U.S.-source income during a tax year and was not engaged in a U.S. trade or business, no U.S income tax returns are required to be filed.
- If a DRE receives only certain types of U.S.-source income, such as portfolio/investment interest or U.S.-source income that is subject to automatic tax withholding, then the owner of the DRE might not be obligated to file a U.S. tax return.
- The current lack of U.S. filing and record-keeping requirements for certain foreign-owned, single-member, domestic DREs makes it difficult for the IRS to ascertain whether a DRE or its owner is liable for any U.S. taxes and it hinders the ability of the U.S. government to comply with international standards concerning financial transparency and tax enforcement.
- The current weaknesses triggered by the U.S. tax rules have been highlighted by various organizations, including the Financial Action Task Force and the Global Forum on Transparency and Exchange of Information for Tax Purposes.[41]

The criticisms launched by the international organizations have been echoed by a number of respected publications, including Financial Times, Forbes, Business Week and The Economist. They all released articles addressing the inadequacy of current disclosure requirements and the hypocrisy of the United States in pressuring foreign countries and financial institutions to implement FATCA, while the United States has still not enacted the Common Reporting Standard, an international tax-information exchange initiative overseen by the Organization for Economic Cooperation and Development.[42] These articles, trying to gain readership by employing shock tactics, refer to the United States as "the biggest tax haven in the world," "the new Switzerland," "a black hole of information for other countries" and "the biggest tax loophole of all."[43] In addition to the media, major accounting firms have underscored the fact that certain elements are now labeling the United States a "tax haven" because of the

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ability of taxpayers to conceal their identities and activities through the use of foreign-owned, single-member, domestic DREs.[44] In light of this reality, the IRS issued the Proposed Regulations in May 2016. Their purpose was "to provide the IRS with improved access to information that it needs to satisfy 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."[45]

The IRS and the White House made several announcements in connection with the issuance of the Proposed Regulations and certain other measures aimed at strengthening international enforcement. One such announcement is set forth below. It derives from a "Fact Sheet" issued by the White House in May 2016, in the segment called "Closing A Loophole that Enables Foreigners to Hide Behind Anonymous Entities Formed in the United States."

> The Treasury and the IRS are issuing proposed regulations closing a loophole in U.S. laws that has allowed foreigners to hide assets or financial activity behind anonymous entities established in the United States. The rule will require foreign-owned entities that are "disregarded entities" for tax purposes, including foreign-owned single-member LLCs, to obtain an EIN with the IRS. These entities represent a narrow class of foreign-owned U.S. entities that have previously had no obligation to report information to the IRS or to get a tax identification number and thus can be used to shield the foreign owners of non-U.S. assets or non-U.S. bank accounts. The proposed rule will strengthen the IRS's ability to prevent the use of these entities for tax avoidance purposes and will build on the success of other efforts to curb the use of foreign entities and accounts to evade U.S. tax.[46]

IV. Analysis of the Prior, Proposed and Final Regulations

With the release of the Final Regulations, the IRS has now modified three existing regulations (*i.e.*, Reg. §301.7701-2, Reg. §1.6038A-1 and Reg. §1.6038A-2) in order to implement the changes affecting foreign-owned, single-member, domestic DREs and Form 5472. One of the biggest challenges in understanding regulatory modifications, like the ones here, is that often they are not adequately described. The IRS's normal methodology is to identify a long, complicated regulation, and then provide mere snippets of information to explain what will be deleted, added or altered. This makes it difficult to get the whole picture. In an effort to ensure that the modifications are clear, the following portion of the article divides matters into prior law (*i.e.*, the regulations in effect before the IRS started introducing changes in 2016), Proposed Regulations and Final Regulations.

A. Relevant Regulation One of Three—Changes to Reg. §301.7701-2

As explained above, Reg. §301.7701-2 is part of the entity-classification regulations, which are also known as the check-the-box regulations. Together, this set of regulations provides that a business entity with just one owner can choose to be treated for federal tax purposes as either an association/corporation or a DRE, as long as such entity is not forced to be classified as a corporation under the "per se corporation" rules.[47] Generally, if a domestic eligible entity with just one owner does not file a timely Form 8832, then the IRS will consider it a DRE by default.[48] Reg. §301.7701-2 was changed in the following manners.

1. Revising Last Sentence of Reg. §301.7701-2(a)

Reg. §301.7701-2(a) contains introductory information about the federal tax treatment of business entities. Under prior law, it reads as follows:

> [A] business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. But see [Treas. Reg. § 301.7701-2 (c)(2)(iv) through (v)] for special employment and excise tax rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.

The Proposed Regulations made a minor change, a slight tweak to the last sentence in order to reference the substantive change in Reg. §301.7701-2(c)(2)(vi), discussed below. The modified sentence is italicized for the convenience of the reader.

> [A] business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. *But see [Treas. Reg. § 301.7701-2(c)(2)(iii) through (vi)] for special rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.*

The Final Regulations did not further address this issue, such that the language in the Proposed Regulations now governs.

2. Adding Reg. §301.7701-2(c)(2)(vi)(A)

Reg. §301.7701-2(c)(2) contains the rules regarding one-owner-entities. It is currently divided into five parts, separately addressing the general classification standard, an exception for certain banks, parameters on the scope of disregarded status, special rules for employment tax purposes and more special rules for excise tax purposes.

The Proposed Regulations retained the existing five parts and then added one more special rule, this one related to information-reporting under Code Sec. 6038A. Specifically, the Proposed Regulations created new Reg. §301.7701-2(c)(2)(vi)(A), which generally states that an entity that is treated as a DRE under the entity-selection regulations will be classified as a corporation for purposes of Code Sec. 6038A and Form 5472 if (i) the entity is domestic, and (ii) one foreign person has direct sole ownership of the entity or has indirect sole ownership of the entity.[49]

The Final Regulations did not further address this issue, so the Proposed Regulations now apply.

3. Adding Reg. §301.7701-2(c)(2)(vi)(C)

Neither prior law nor the Proposed Regulations raised the issue of the proper tax year for foreign-owned, single-member, domestic DREs that are treated as corporations solely for purposes of Form 5472. It was broached for the first time in the Final Regulations, which added new Reg. §301.7701-2(c)(2)(vi)(C). This new guidance explains that the tax year for the DRE will be the same as that of the foreign sole owner, if such owner has a duty to file a U.S. income tax return or U.S. information returns for the relevant year. If the owner does not have such a filing duty, then the tax year for the DRE will be the calendar year, unless the IRS later provides directions to the contrary in forms, instructions or some other type of published guidance.[50] The Preamble to the Final Regulations stated that these rules regarding tax years were inserted to facilitate compliance for the DREs (and thus its foreign owners).[51]

4. Adding Reg. §301.7701-2(e)(9)

The applicability/effective date of the entity-selection regulations, or check-the-box regulations, was found under prior law in Reg. §301.7701-2(e).

The Proposed Regulations added Reg. §301.7701-2(e)(9), which says that the new Form 5472 reporting requirement for foreign-owned, single-member, domestic DREs applies to tax years ending on or after the date that is 12 months after the date that the Proposed Regulations are finalized and published in the Federal Register.

The Final Regulations were published on December 13, 2016, which would have meant, under the Proposed Regulations, that the new Form 5472 duties applied to tax years ending on or after December 13, 2017. This changed in the Final Regulations. Reg. §301.7701-2(e)(9) now states that the new Form 5472 filing requirement "applies to taxable years of entities beginning after December 31, 2016, and ending on or after December 13, 2017." The Preamble to the Final Regulations states this in a slightly clearer manner, explaining that "these regulations should apply to taxable years of entities beginning on or after January 1, 2017, and ending on or after December 13, 2017."[52]

B. Relevant Regulation Two of Three—Changes to Reg. §1.6038A-1

The Proposed Regulations made several changes to Reg. §1.6038A-1, which features the general requirements and definitions concerning Form 5472. The changes are examined below.

1. Adding Sentence to Reg. §1.6038A-1(c)(1)

Reg. §1.6038A-1(c)(1), which contains the definition of "reporting corporation," stated the following under prior law:

> For purposes of section 6038A, a reporting corporation is either a domestic corporation that is 25-percent foreign-owned as defined in [Treas. X], or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. After November 4, 1990, a foreign corporation

> engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation. See section 6038C.

The Proposed Regulations added one sentence to the end, cross-referencing the entity-selection regulations and clarifying that foreign-owned, single-member, domestic DREs would be treated as "domestic corporations" (and thus "reporting corporations") for purposes of Code Sec. 6038A. The updated version of Reg. §1.6038A-1(c)(1) reads as follows. The new language has been italicized for ease of review:

> For purposes of section 6038A, a reporting corporation is either a domestic corporation that is 25-percent foreign-owned as defined in [Treas. Reg. § 1.6038A-1(c)(2)], or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation. See section 6038C. *A domestic business entity that is wholly owned by one foreign person and that is otherwise classified under [Treas. Reg. § 301.7701-3(b)(1)(ii)] as disregarded as an entity separate from its owner is treated as an entity separate from its owner and classified as a domestic corporation for purposes of section 6038A. See [Treas. Reg § 301.7701-2(c)(2)(vi)].*

The Final Regulations did not alter the Proposed Regulations on this point.

2. Revising First Sentence of Reg. §1.6038A-1(h)

As explained earlier in this article, in addition to filing Forms 5472, a reporting corporation must maintain records of reportable transactions in sufficient detail to establish the correct tax treatment of the transactions.[53] These records ordinarily must be kept as long as they may be relevant or material to determining such treatment, and they must generally be kept within the United States.[54] Also, explained earlier in this article, there is an exception to this record-keeping rule in Reg. §1.6038A-1(h) for small reporting corporations, *i.e.*, those that have less than $10 million in U.S. gross receipts for a tax year. Reg. §1.6038A-1(h) stated the following under prior law:

> A reporting corporation that has less than $10,000,000 in U.S. gross receipts for a taxable year is not subject to [the special record-keeping requirements set forth in Treas. Reg. § 1.6038A-3 and Treas. Reg. § 1.6038A-5] for that taxable year. Such a corporation, however, remains subject to the information reporting requirements of [Treas. Reg. § 1.6038A-2] and the general record maintenance requirements of Section 6001 …

The Proposed Regulations served to make foreign-owned, single-member, domestic DREs ineligible for the small corporation exception, such that they would be required to file Forms 5472 and maintain detailed records of reportable transactions within the United States. The updated language, italicized for clarity, was as follows under the Proposed Regulations:

> A reporting corporation *(other than an entity that is treated as a reporting corporation by reason of § 301.7701-2(c)(2)(vi) of this chapter)* that has less than $10,000,000 in U.S. gross receipts for a taxable year is not subject to [the special record-keeping requirements set forth in Treas. Reg. § 1.6038A-3 and Treas. Reg. § 1.6038A-5] for that taxable year. Such a corporation, however, remains subject to the information reporting requirements of [Treas. Reg. § 1.6038A-2] and the general record maintenance requirements of Section 6001 …

No changes on this score were included in the Final Regulations; therefore, the language in the Proposed Regulations stands, and the relevant DREs cannot benefit from the small corporation exception to the special record-keeping mandates.

3. Revising First Sentence of Reg. §1.6038A-1(i)(1)

It is not only small reporting corporations that traditionally got a break from the special record-keeping requirements; corporations with small reportable transactions were relieved, too. Reg. §1.6038A-1(i)(1) read as follows under prior law:

> A reporting corporation is not subject to [the special record-keeping requirements set forth in Treas. Reg. § 1.6038A-3 and Treas. Reg. § 1.6038A-5] for any taxable year in which the aggregate value of all gross payments it makes to and receives from foreign related parties with respect to related party transactions (including monetary consideration, nonmonetary consideration, and the value of transactions involving less than full consideration), is not more than

$5,000,000 and is less than 10 percent of its U.S. gross income. Such a corporation, however, remains subject to the information reporting requirements of [Treas. Reg. § 1.6038A-2] and the general record maintenance requirements of section 6001 …

Like the waiver for small corporations, the waiver for small transactions would also disappear pursuant to the Proposed Regulations. The new language inserted by the Proposed Regulations is set forth below, with the changes italicized for emphasis:

> A reporting corporation *(other than an entity that is treated as a reporting corporation by reason of § 301.7701-2(c)(2)(vi) of this chapter)* is not subject to [the special record-keeping requirements set forth in Treas. Reg. § 1.6038A-3 and Reg. § 1.6038A-5] for any taxable year in which the aggregate value of all gross payments it makes to and receives from foreign related parties with respect to related party transactions (including monetary consideration, nonmonetary consideration, and the value of transactions involving less than full consideration), is not more than $5,000,000 and is less than 10 percent of its U.S. gross income. Such a corporation, however, remains subject to the information reporting requirements of [Treas. Reg. § 1.6038A-2] and the general record maintenance requirements of section 6001 …

The Final Regulations did not otherwise contemplate this issue, the result of which is that new language in the Proposed Regulations will apply, and the relevant DREs are now deprived of both the small corporation exception and the small transaction exception to the special record-keeping obligations.

4. Adding New Sentence to Reg. §1.6038A-1(n)

Under prior law, Reg. §1.6038A-1(n)(1) contained the effective/applicability date for all matters required by Reg. §1.6038A-1, whereas Reg. §1.6038A-1(n)(2) did the same for all matters mandated by Reg. §1.6038A-2.

The Proposed Regulations added one sentence to each of these provisions in order to make the new rules effective for future years. In particular, the Proposed Regulations stated that all the new and/or modified rules in Reg. §1.6038A-1 and Reg. §1.6038A-2 "apply to taxable years of [the relevant entities] ending on or after the date that is 12 months after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register."

The Final Regulations change the effective date of the rules for the pertinent DREs, stating that they apply to tax years of the DREs beginning after December 31, 2016, and ending on or after December 13, 2017.

C. Relevant Regulation Three of Three—Changes to Reg. §1.6038A-2[55]

1. Revising Second Sentence of Reg. §1.6038A-2(a)(2)

Reg. §1.6038A-2(a)(2), as in effect under prior law, carved-out the following situation from the broad definition of reportable transaction. A transaction was *not* considered a "reportable transaction" (and thus not required to be reported on Form 5472) if (i) neither the reporting corporation nor the related party is a U.S. person; (ii) the transaction will not generate in any year gross income from U.S. sources or income effectively connected with a U.S. trade or business; and (iii) the transaction will not generate in any year any expenses, losses or other deductions that could be allocated or apportioned to such income.[56]

This exception from the definition of reportable transaction was not addressed in the Proposed Regulations.

The Final Regulations, however, contain language that effectively renders this exception obsolete, by stating that the term "U.S. person" includes the foreign-owned, single-member, domestic DREs that are now considered domestic reporting corporations for purposes of Form 5472. Reg. §1.6038A-2(a)(2), as found in the Final Regulations, is provided below, with the new material italicized for ease of identification:

> A reportable transaction [generally] is any transaction of the types listed in [Treas. Reg. § 1.6038A-2(b)(3) or (b)(4)]. However, if neither party to the transaction is a United States person as defined in Section 7701(a)(30) *(which, for purposes of section 6038A, includes an entity that is a reporting corporation as a result of being treated as a corporation under § 301.7701- 2(c)(2)(vi) of this chapter)* and the transaction (i) will not generate in any taxable year gross income from sources within the United States or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, and (ii) will not generate in any taxable year any expense, loss, or other deduction that is allocable or apportionable to such income, [then] the transaction is not a reportable transaction.

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2. Adding New Paragraph to Reg. §1.6038A-2(b)(3)

Under prior law, Reg. §1.6038A-2(b)(3) featured a list of 10 types of monetary transactions that must be reported on Form 5472.

The Proposed Regulations added another category of reportable transaction for foreign-owned, single-member, domestic DREs by inserting new Reg. §1.6038A-2(b)(3)(xi). It would obligate disclosure of the following matters:

> With respect to [a foreign-owned, single-member, domestic DRE] that is treated as a reporting corporation by reason of § 301.7701-2(c)(2)(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.

Inadvertent violations of Form 5472 duties are commonplace now, and they undoubtedly will increase with the implementation of the Final Regulations, starting in 2017.

According to Reg. §1.482-1(i)(7), the term "transaction" is broadly defined to mean "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 [and] a transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer."

The Final Regulations had nothing to add or detract from this topic, so the expanded list of what constitutes a reportable monetary transaction found in the Proposed Regulations remains in place.

3. Adding New Reg. §1.6038A-2(b)(9)

The prior law did not offer examples of the functioning of Reg. §1.6038A-2.

Examples were added by the Proposed Regulations, as new Reg. §1.6038A-2(b)(9). It contains the following two items:

Example 1. In year 1, W, a foreign corporation, forms and contributes assets to X, a domestic LLC that does not elect to be treated as a corporation under Reg. §301.7701-3(c) of this chapter. In year 2, W contributes funds to X. In year 3, X makes a payment to W. In year 4, X, in liquidation, distributes its assets to W. In accordance with Reg. §301.7701-3(b)(1)(ii) of this chapter, X is disregarded as an entity separate from W. In accordance with Reg. §301.7701-2(c)(2)(vi) of this chapter, X is treated as an entity separate from W and classified as a domestic corporation for purposes of Code Sec. 6038A. In accordance with paragraphs (a)(2) and (b)(3) of this section, each of the transactions in years 1 through 4 is a reportable transaction with respect to X. Therefore, X has a Code Sec. 6038A reporting and record maintenance requirement for each of those years.

Example 2. The facts are the same as in Example 1 of this paragraph (b)(9) except that in year 1 W also forms and contributes assets to Y, another domestic LLC that does not elect to be treated as a corporation under Reg. §301.7701-3(c) of this chapter. In year 1, X and Y form and contribute assets to Z, another domestic LLC that does not elect to be treated as a corporation under Reg. §301.7701-3(c) of this chapter. In year 2, X transfers funds to Z. In year 3, Z makes a payment to Y. In year 4, Z distributes its assets to X and Y in liquidation. In accordance with Reg. §301.7701-3(b)(1)(ii) of this chapter, Y and Z are disregarded as entities separate from each other, W, and X. In accordance with Reg. §301.7701-2(c)(2)(vi) of this chapter, Y, Z and X are treated as entities separate from each other and W, and are classified as domestic corporations for purposes of Code Sec. 6038A. In accordance with paragraph (b)(3) of this section, each of the transactions in years 1 through 4 involving Z is a reportable transaction with respect to Z. Similarly, the contribution to Y in year 1, the payment to Y in year 3 and the distribution to Y in year 4 are reportable transactions with respect to Y. Moreover, X's funds transfer to Z in year 2 is a reportable transaction. Therefore, Z has a Code Sec. 6038A reporting and record maintenance requirement for years 1 through 4, Y has a Code Sec. 6038A reporting and record maintenance requirement for years 1, 3 and 4 and X has a Code Sec. 6038A reporting and record maintenance requirement in year 2 in addition to its Code Sec. 6038A reporting and record maintenance described in Example 1 of this paragraph (b)(9).

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The Final Regulations did not adjust or expand the two examples in any manner.

4. Adding Sentence to the End of Reg. §1.6038A-2(d)

Reg. §1.6038A-2(d) contains the rules regarding how and when to file Forms 5472. Prior law stated that Forms 5472 "must be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return."

The Proposed Regulations added unique rules for Forms 5472 filed by foreign-owned, single-member, domestic DREs, rules that apparently will only be announced by the IRS, later and separately, on Form 5472 or the IRS's Instructions thereto. The version of Reg. §1.6038A-2(d) found in the Proposed Regulations states the following, and the new language has been italicized to facilitate review.

> A Form 5472 required under this section must be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. *In the case of an entity that is treated as a reporting corporation by reason of § 301.7701-2(c)(2)(vi) of this chapter, Form 5472 must be filed at such time and in such manner as the Commissioner may prescribe in forms or instructions.*

The Final Regulations did not alter the guidance regarding Form 5472 filing procedures. Taxpayers and their advisors await clarity from the IRS.

5. Revising First Sentence of Reg. §1.6038-2(e)(3)

Reg. §1.6038A-2(e) contains exceptions to the general Form 5472 filing duty. As explained earlier in this article, prior law indicated that a reporting corporation was not required to file a Form 5472 with respect to a related foreign corporation for any year during which a U.S. person that controls the foreign related corporation files with the IRS a Form 5471 containing information about the reportable transactions between the reporting corporation and the foreign related corporation. The Proposed Regulations were silent on this topic. The Final Regulations, however, inserted one phrase that effectively served to withdraw this exception for foreign-owned, single-member, domestic DREs. Reg. §1.6038A-2(e), as set forth in the Final Regulations, is found below, with the new language italicized to highlight the changes:

> Transactions with a corporation subject to reporting under Section 6038. A reporting corporation *(other than an entity that is a reporting corporation as a result of being treated as a corporation under §301.7701-2(c)(2)(vi) of this chapter)* is not required to make a return of information on Form 5472 with respect to a related foreign corporation for a taxable year for which a U.S. person that controls the foreign related corporation makes a return of information on Form 5471 that is required under section 6038 and this section, if that return contains information required under §1.6038-2(f)(11) with respect to the reportable transactions between the reporting corporation and the related corporation for that taxable year …

6. Revising First Sentence of Reg. §1.6038-2(e)(4)

Prior law, rooted in Reg. §1.6038A-2(e)(4), established that a reporting corporation was not obligated to file Form 5472 with respect to any related corporation that qualified as an FSC for the relevant year and that filed with the IRS its Form 1120-FSC. The Proposed Regulations did not touch this issue, but the Final Regulations rendered this exception unavailable to foreign-owned, single-member, foreign DREs. The Final Regulation, with the relevant portion italicized, is set forth below:

> A reporting corporation *(other than an entity that is a reporting corporation as a result of being treated as a corporation under §301.7701-2(c)(2)(vi) of this chapter)* is not required to make a return of information on Form 5472 with respect to a related corporation that qualifies as a foreign sales corporation for a taxable year for which the foreign sales corporation files Form 1120-FSC.

V. Interesting Issues About Form 5472 and the Final Regulations

Being aware of the changes made by the Final Regulations is important, but that is just the surface. To appreciate the broader implications, one must examine other items involving Form 5472. Some questions, comments and observations can be found below.

A. Late Forms 5472 Trigger Automatic Penalties

A relatively obscure aspect of Form 5472 is that the IRS has been *automatically* imposing penalties since 2013.

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The IRS, after achieving considerable economic success by automatically sanctioning other types of international information returns, decided to implement the so-called systematic assessment mechanism for Forms 5472 in 2013. Since that time, if a Form 1120 or Form 1120-F is filed after the deadline and Forms 5472 are enclosed, then the IRS will assess a $10,000 per-violation penalty and immediately start the collection process, regardless of whether the taxpayer includes with the late Forms 5472 a statement of reasonable cause.[57] Two significant reports by the U.S. Treasury Inspector General for Tax explain how the IRS arrived at this assess-penalties-now-possibly-consider-excuses-later situation.[58]

B. First-Time-Abate Policy Might Have Limited Value

The good news is that the IRS has a first-time-penalty-abatement policy, and taxpayers facing large Form 5472 penalties often cite this policy in seeking relief.[59] The policy states that the IRS will grant penalty abatement, with respect to virtually all delinquency penalties in situations where a taxpayer has not been required to file a certain return before, or the taxpayer has no prior penalties of this type.[60] If the taxpayer meets these criteria, then the IRS generally issues a letter to the taxpayer confirming that abatement is being granted solely on the basis of the first-time-penalty-abatement policy, not because the taxpayer has demonstrated that it had reasonable cause for the violation.[61]

The bad news is that the first-time-penalty-abatement policy does *not* apply to (i) "returns with an event-based filing requirement," (ii) situations where a taxpayer filed a Form 1120 late for one of the past three years but was not penalized and (iii) "information reporting that is dependent on another filing, such as various forms [like Forms 5472] that are attached [to income tax returns]."[62] Some IRS personnel simply deny requests for waiver of Form 5472 penalties based on these exclusions from the first-time-penalty-abatement policy.

C. The "Decision Tree" for Form 5472 Penalties

The Internal Revenue Manual indicates that *all* requests by taxpayers for abatement based on reasonable cause must be analyzed in accordance with the terms of the "Decision Tree," if the Form 5472 penalties were automatically assessed by the IRS's computers, as opposed to being assessed by a Revenue Agent conducting an audit.[63] The "Decision Tree," found in the depths of the Internal Revenue Manual, features standards that are significantly more stringent than those located elsewhere.[64] The following examples, taken directly from the "Decision Tree," demonstrate that attaining abatement of Form 5472 penalties can be significantly more challenging than normal.

- If the taxpayer claims that it was unaware of the Form 5472 filing requirement, the "Decision Tree" instructs the IRS to deny abatement because "ordinary business care and prudence requires taxpayers to determine their tax obligations when establishing a business in a foreign country."
- The "Decision Tree" mandates that penalty abatement be denied where the taxpayer seeks clemency because of financial problems.
- The "Decision Tree" further indicates that the IRS will show no mercy in situations where a taxpayer states that Form 5472 was late because the transactions, tax laws and/or business structure were complicated.
- If the taxpayer claims that multiple layers of ownership prevent the taxpayer from obtaining all the data necessary to file a timely Form 5472, the "Decision Tree" instructs the IRS not to abate penalties.
- Rejection of the penalty abatement request will also occur, according to the "Decision Tree," when the taxpayer relies on challenges in obtaining the necessary foreign data as the excuse for late Forms 5472.
- The "Decision Tree" demands imposition of penalties if the reason for the delinquent Forms 5472 is that the person with sole authority to file Form 5472 was absent for a reason other than death or serious illness. Moreover, even if death or serious illness of the sole responsible person is claimed, the IRS will only accept this justification if (i) the corporation can provide tangible proof, such as an insurance claim, police report, letters or bills from hospitals, or newspaper clippings describing the event; (ii) the absence was not foreseeable; (iii) the absence occurred before and in close proximity to the filing deadline; and (iv) the taxpayer filed the Forms 5472 within two weeks of when the absence ended.
- The IRS will not waive Form 5472 penalties under the "Decision Tree" if the taxpayer neglected to file a Form 7004 (*Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*) to secure an automatic six-month extension to file a Form 1120 or Form 1120-F.
- The "Decision Tree" also denies abatement where the taxpayer hired a third-party (such as an accounting firm) to prepare returns and erroneously believed that such third-party has filed a Form 7004 on behalf of the taxpayer.

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- Abatement requests will also be rejected under the "Decision Tree" if the taxpayer relies on the ignorance-of-the-law defense and the taxpayer was a U.S. resident, resided outside the United States but failed to retain U.S. tax representation, or claims that it was unaware of the obligation to file U.S. tax returns.
- For purposes of seeking penalty abatement, the "Decision Tree" clarifies that reliance on an accountant or attorney might be appropriate in certain situations, but reliance by a taxpayer on the following types of people is not reasonable: Bookkeeper, financial advisor, business associate, information in a tax plan or promotion and person assisting in establishing the corporation.
- Finally, the "Decision Tree" indicates that it might abate penalties based on the reasonable-reliance-on-a-qualified-tax-professional defense if, and only if, (i) the taxpayer relied on an accountant or attorney, (ii) the taxpayer provided such tax professional all relevant information, (iii) the taxpayer supplied the information before the deadline for filing Form 5472, (iv) the tax professional advised the taxpayer that it was not required to file Form 5472, (v) the taxpayer has tangible evidence to prove the preceding facts and (vi) in the opinion of the IRS, the taxpayer's reliance was reasonable. The "Decision Tree" goes on to state that the taxpayer's reliance will be considered unreasonable (and thus Form 5472 penalties will not be abated) if the taxpayer did not take reasonable steps to independently investigate or the taxpayer did not get a second opinion. This aspect of the "Decision Tree" is particularly remarkable because it is contrary to the legal precedent established by the U.S. Supreme Court years ago on this exact point. In a famous tax case from 1985, *United States v. Boyle*, the highest court in the land explained that taxpayers are not required to seek a second opinion as a condition to benefitting from the reasonable-reliance-on-a-qualified-tax-professional defense because demanding this "would nullify the very purpose of seeking the advice of a presumed expert in the first place."[65]

D. Extended Assessment Periods for Late or Unfiled Forms 5472

The standard penalty of $10,000 per year, per violation, can hurt a corporation, but the most significant consequence of late/not filing Forms 5472 has nothing to do with money. It concerns time, *i.e.*, the amount of time that the IRS has to audit the relevant issues. An obscure procedural provision, Code Sec. 6501(c)(8)(A), contains a powerful tool for the IRS. It generally states that where a taxpayer fails to file a timely Form 5472 (and/or a long list of other international information returns), the assessment period remains open "with respect to any tax return, event, or period" to which the Form 5472 relates, until three years after the taxpayer ultimately files Form 5472.[66] Consequently, if a corporation fails to file Forms 5472 for a particular year or set of years, it is unable to simply run out the clock with the IRS.

For corporations required to enclose Forms 5472 with the Forms 1120 or Forms 1120-F, the threat of Code Sec. 6501(c)(8) is serious; the IRS could assert penalties of $10,000 per violation, the IRS could reach older years that would normally have been closed thanks to the statute of limitations and the IRS could audit the entire Form 1120 or Form 1120-F with which the Forms 5472 should have been enclosed and then propose tax increases, penalties and interest charges. However, because many of the entities covered by the Final Regulations (*i.e.*, foreign-owned, single-member, domestic DREs) have no duty to file income tax returns with the IRS, the hazards created by Code Sec. 6501(c)(8) might be minimal or nonexistent for them.

E. Future Obligations Concerning Disregarded Entities

More disclosure requirements are on the way, says the IRS. According to the Proposed Regulations, "the IRS is also considering modifications to corporate, partnership, and other tax or information returns (or their instructions) to require the filer of these returns to identify all the foreign and domestic disregarded entities it owns."[67]

F. Possibility of Duplicative Reporting

The IRS acknowledges that the Final Regulations may trigger duplicative reporting regarding certain international transactions, but proceeds anyway. This is noteworthy for at least a couple of reasons.

First, closely reading the Proposed Regulations and Final Regulations gives one the impression that the IRS allowed potential duplicative reporting, at least in part, because it was miffed at stakeholders for not even bothering to offer suggestions. The Proposed Regulations asked for specific comments about solutions to remedy duplication.[68] Then, in the Preamble to the Final Regulations, the IRS explained that it did not add language to address potential duplication and it decided to make foreign-owned, single-member, domestic DREs ineligible for even more filing exceptions than it originally anticipated. In doing so, the IRS seemed to insinuate that this was partially due to a lack of input from the public:

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> In addition to generally soliciting comments on all aspects of the proposed rules, the preamble to the proposed regulations specifically requested comments on possible alternative methods for reporting a domestic disregarded entity's transactions in cases in which the foreign owner of the domestic disregarded entity already has an obligation to report the income resulting from those transactions—for example, transactions resulting in income effectively connected with the conduct of a U.S. trade or business. No written comments on the proposed regulations were received, and no public hearing was requested or held.[69]

Second, the potential for duplicative reporting in the context of Form 5472 is worth mentioning because the IRS has recently taken the opposite approach when it comes to foreign asset reporting on Form 8938 (*Statement of Specified Foreign Financial Assets*). The applicable regulations under Code Sec. 6038D identify various foreign assets that are *not* required to be reported on Form 8938 because doing so would be duplicative. Specifically, the relevant U.S. persons are not required to report a foreign asset on Form 8938, provided that such persons timely reported them to the IRS on at least one of the following international information returns: Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*), Form 3520-A (*Annual Information Return of Foreign Trust With a U.S. Owner*), Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*), Form 8621 (*Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund*), Form 8865 (*Return of U.S. Persons with Respect to Certain Foreign Partnerships*), Form 8891 (*U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*) or any other international information return recognized by the IRS in later guidance.[70]

VI. Conclusion

As this article demonstrates, despite efforts to simplify, clarify and organize the recent changes to the Form 5472 rules, they remain dense. It is best, therefore, to summarize here the main effects of the Final Regulations: (i) Foreign-owned, single-member, domestic DREs will be treated as "domestic corporations" (and thus "reporting corporations") *solely* for purposes of Code Sec. 6038A; (ii) As reporting corporations, these DREs will be required to file annual Forms 5472 and comply with the rigid record-keeping requirements; (iii) Because the DREs will now have a filing requirement with the IRS (*i.e.*, Form 5472), they must also file a Form SS-4 in order to obtain an EIN, thereby giving the IRS information about the "responsible person"; (iv) The types of "reportable transactions" that must be disclosed on Form 5472 have been expanded by cross-reference to the transfer-pricing rules in Code Sec. 482; (v) Certain exceptions to the strict record-keeping requirements (that normally shield corporations with small gross incomes and/or small reportable transactions) will not be available to help the DREs; and (vi) Certain exceptions to the Form 5472 filing requirement (that ordinarily relieve duplicative reporting in cases where a Form 5471 or Form 1120-FSC has been filed) will not apply to the DREs.

Inadvertent violations of Form 5472 duties are commonplace now, and they undoubtedly will increase with the implementation of the Final Regulations, starting in 2017. This, of course, will trigger more audits, more automatic penalties of $10,000 per violation per year and more disputes with the IRS. Accordingly, all taxpayers that are subject to Form 5472 filing and record-keeping duties (*i.e.*, domestic corporations that are least 25 percent foreign-owned, foreign corporations operating a U.S. trade or business and, starting in 2017, foreign-owned, single-member, domestic DREs) should retain specialized U.S. tax professionals to provide guidance on these dynamic issues.

ENDNOTES

1. REG-127199-15 (May 10, 2016).
2. T.D. 9796 (Dec. 13, 2016).
3. Act Sec. 339(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).
4. U.S. Joint Committee on Taxation. General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), at 250.
5. Act Sec. 7403 of the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239).
6. Act Sec. 11315 of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508).
7. Code Sec. 6038A(a); Reg. §1.6038A-1(c)(1).
8. Code Sec. 6038A(c)(1); Reg. §1.6038A-1(c)(2),(3).
9. Reg. §1.6038A-1(f). In this context, "foreign persons" include an individual who is neither a U.S. citizen nor U.S. resident, an individual who is a citizen of a U.S. possession, a foreign government and any foreign partnership, association, company, corporation, trust or estate.
10. Code Sec. 6038C(a); Reg. §1.6038A-1(c)(1).
11. Reg. §1.6038A-1(c)(5)(i).
12. Reg. §1.6038A-2(a)(2); Reg. §1.6038A-2(b)(3); Reg. §1.6038A-2(b)(4); Reg. §1.6038A-2(b)(5). There are special attribution rules applicable to "reportable transactions" in which either a domestic partnership or foreign partnership engages, and the ownership interest in the partnership by the "reporting corporation" is deemed to reach 25 percent or more. These complex, special rules exceed the scope of this article. *See* Reg. §1.6038A-1(e)(2); Reg. §1.6038A-2(g).
13. Code Sec. 6038A(c)(2); Reg. §1.6038A-1(d). For purposes of determining whether a domestic corporation is considered a "reporting corporation" because it has a 25-percent-foreign-shareholder and whether a person is considered a "related party," the regulations modify the constructive ownership rules of Code Sec. 318, further complicating the analysis. *See* Reg. §1.6038A-1(e)(1).

[14] Reg. §1.6038A-1(d)(3).

[15] Reg. §1.6038A-2(a)(1). The regulations contain various exceptions whereby a reporting corporation is not required to file a Form 5472. *See* Reg. §1.6038A-2(f).

[16] Reg. §1.6038A-2(a)(1).

[17] For more information about the evolution of the Form 5472 filing deadlines and procedures, *see* Hale E. Sheppard, *Forms 5472 for Certain Foreign and Domestic Corporations: New Filing Procedures, New Automated Penalties, New Abatement Standards, and More*, 93(5) Taxes – The Tax Magazine 45–60 (2015).

[18] Reg. §1.6038A-2(e)(3).

[19] Reg. §1.6038A-2(e)(4).

[20] Code Sec. 6038A(a); Reg. §1.6038A-3(a).

[21] Reg. §1.6038A-3(g) and (f).

[22] Reg. §1.6038A-1(h) and (i).

[23] Reg. §1.6038A-1(h) and (i). The regulations clarify that "[s]uch a corporation, however, remains subject to the information reporting requirements of Treas. Reg. § 1.6038A-2 and the general record maintenance requirements of Section 6001."

[24] Code Sec. 6038A(d)(1); Reg. §1.6038A-4(a)(1).

[25] Reg. §1.6038A-4(a)(1). This regulation states that "[t]he filing of a substantially incomplete Form 5472 constitutes a failure to file Form 5472."

[26] Code Sec. 6038A(d)(1); Reg. §1.6038A-4.

[27] Code Sec. 6038A(d)(2); Reg. §1.6038A-4(d)(1); Reg. §1.6038A-4(f) Example 1.

[28] Code Sec. 6038A(d)(3); Reg. §1.6038A-4(b)(1).

[29] Reg. §1.6038A-4(b)(2)(i).

[30] Reg. §1.6038A-4(b)(2)(iii).

[31] Reg. §1.6038A-4(b)(2)(iii).

[32] Reg. §1.6038A-4(b)(2)(i).

[33] T.D. 8040, 50 FR 30160-01 (July 24, 1985), Preamble.

[34] Reg. §1.6038A-2(b)(6)(i).

[35] Reg. §1.6038A-2(b)(7).

[36] Reg. §1.6038A-4(b)(2)(ii).

[37] Form 8832 (Rev. December 2013), Specific Instructions, at 6.

[38] IRS Instructions for Form SS-4 (Rev. February 2016), at 3.

[39] Form 8832 (Rev. December 2013), General Instructions, at 4.

[40] IRS Instructions for Form SS-4 (Rev. February 2016), at 4.

[41] REG-127199-15 (May 6, 2016), Preamble.

[42] Ryan Finley, *New Regs Will Force Foreign-Owned Single-Member LLCs to Report Beneficial Owner*, 2016 Worldwide Tax Daily 63-1 (2016); The Biggest Loophole of All, The Economist, ___ (2016); Robert W. Woods, *The World's Next Top Tax Haven Is … America*, Forbes ___ (2016); Jesse Drucker, *The World's Favorite New Tax Haven Is the United States*, Bloomberg-Businessweek ___ (2016); John Dizard, *Fear and Regulatory Loathing Makes America the Top Tax Haven*, Financial Times ___ (2016).

[43] *Id.*

[44] PriceWaterhouseCoopers, LLP. Disregarded Entity Regs Could Lead to Large Penalties, PWC Says. 2016 Tax Notes Today 114-37 (2016).

[45] REG-127199-15 (May 6, 2016), Preamble.

[46] *White House Proposes Requiring EINs for Disregarded Entities*, 2016 Tax Notes Today 89-59 (2016). This language is part of the "Fact Sheet: Obama Administration Announces Steps to Strengthen Financial Transparency, and Combat Money Laundering, Corruption, and Tax Evasion." *See also Lew Urges Congress to Pass Tax Treaties, Transparency Bill*, 2016 Tax Notes Today 89-57 (2016).

[47] Reg. §301.7701-3(a).

[48] Reg. §301.7701-3(b)(1)(ii).

[49] Proposed Reg. §301.7701-2(c)(2)(vi)(A). For these purposes, the concept of "indirect sole ownership" means ownership by one person entirely through one or more entities disregarded as separate from their owners or through grantor trusts, regardless of whether any such disregarded entity/entities or grantor trusts is domestic or foreign. *See* Proposed Reg. §301.7701-2(c)(2)(vi)(B)(1).

[50] Reg. §301.7701-2(c)(2)(vi)(C).

[51] T.D. 9796 (Dec. 13, 2016), Preamble.

[52] T.D. 9796 (Dec. 13, 2016), Preamble.

[53] Code Sec. 6038A(a); Reg. §1.6038A-3(a).

[54] Reg. §1.6038A-3(g) and (f).

[55] In addition to the changes to Reg. §1.6038A-2 described in this article, there was another modification, of Reg. §1.6038A-2(b)(3)(vii). This involved a slight change to the description of the types of loans that would be considered reportable transactions. It is not discussed in detail in this article because it distracts from the main focus, *i.e.*, the new rules and procedures applicable to certain foreign-owned, single-member, domestic DREs.

[56] Reg. §1.6038A-2(a)(2). There are also special attribution rules applicable to "reportable transactions" in which either a domestic partnership or foreign partnership engages, and the ownership interest in the partnership by the "reporting corporation" is deemed to reach 25 percent or more. These complex, special rules exceed the scope of this article. *See* Reg. §1.6038A-1(e)(2); Reg. §1.6038A-2(g).

[57] IRM, pt. 21.8.2.20.1 (Oct. 1, 2014).

[58] U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006); U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (September 2013).

[59] IRM, pt. 20.1.3.6.1(7) (Aug. 5, 2014).

[60] IRM, pt. 20.1.3.6.1(7) (Aug. 5, 2014).

[61] IRM, pt. 20.1.3.6.1(7) (Aug. 5, 2014).

[62] IRM, pt. 20.1.3.6.1(8) and (9) (Aug. 5, 2014).

[63] IRM, pt. 21.8.2.20.2(3) and (4) (Oct. 1, 2014).

[64] IRM Exhibit 21.8.2-2—Failure to File or Late-Filed Form 5472—Decision Tree.

[65] *R.W. Boyle*, SCt, 85-1 ustc ¶13,602, 469 US 241, 251, 105 SCt 687(emphasis added).

[66] Code Sec. 6501(c)(8)(B) contains a limitation, stating that the assessment period will open remain only with respect to "the item or items" related to the late Form 5472 if the taxpayer can demonstrate that the delinquency was due to reasonable cause and not due to willful neglect.

[67] REG-127199-15 (May 10, 2016), Preamble.

[68] REG-127199-15 (May 10, 2016), Preamble.

[69] T.D. 9796 (Dec. 13, 2016), Preamble.

[70] Reg. §1.6038D-7(a)(1)(i).

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