Regulating Foreign Disregarded Entities with Proposed Form 8858: Try, Try Again
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TABLE OF CONTENTS
INTRODUCTION
EVOLUTION OF ENTITY CLASSIFICATION
    Brief Overview
    The Enron Scandal — Genesis of Proposed Form 8858
PROPOSED FORM 8858
    Components of Proposed Form 8858
    Merely One Piece of the Enforcement Puzzle
COMMENTS ABOUT PROPOSED FORM 8858
    Proposed Form 8858 Lacks Instructions

The Information Requested on Proposed Form 8858 Is Duplicative
Proposed Form 8858 Is Costly and Burdensome for Taxpayers and the IRS
Confusion Regarding Who Must File Separate Schedule M
Proposed Form 8858 Is Contrary to the Policy of Simplification and Efficiency
Is Proposed Form 8858 Tax Law Enforcement or a Fishing Expedition?
Penalties for Non-Compliance Are Unclear
Mandatory Organizational Chart
Schedule C
Schedule C-1
Schedule F
Schedule G
Schedule H
Separate Schedule M

RECOMMENDATIONS
CONCLUSION

INTRODUCTION
Tenacity is generally a laudable trait. Indeed, as many of us are taught during childhood, if at first you don’t succeed, try, try again. This lesson was not missed by the U.S. Internal Rev-
EVOLUTION OF ENTITY CLASSIFICATION

Brief Overview

Until 1997, the classification of business entities for U.S. tax purposes was predicated on a so-called corporate resemblance test. Under this test, an entity was classified as an association (i.e., a corporation) if it exhibited a majority of various corporate characteristics, including the presence of associates, a business objective and profit motive, continuity of life, centralized management, limited liability, and free transferability of interests. Determining classification based on these factors was, to put it lightly, a complex process. In the words of tax practitioners, both the IRS and taxpayers found themselves spending inordinate amounts of time (and therefore money) obsessing over abstruse points of state and foreign law... Counting the corporate characteristic angels dancing on classification pinheads was nearly a meaningless exercise that caused increasing frustration among taxpayers and within the government... The pointlessness of it all was underlined by the general conviction that, with enough high-priced tweaking of the organizing documents, most taxpayers were able to achieve the classification they desired most of the time.3

Cognizant of this boondoggle, the IRS introduced the check-the-box regulations in 1997 with the express aim of simplifying the entity-classification procedure. In the preamble to the check-the-box regulations, the IRS acknowledged that the former regulations were based on historical differences under local law between corporations and partnerships, and that such rules had become “increasingly formalistic.”4 The IRS therefore introduced the check-the-box regulations, which, it believed, constituted a “much simpler approach.”5

The advent of these new rules may have made entity classification simpler, but definitely not less controversial. Under the check-the-box regulations, taxpayers generally could choose the classification of their liking by completing Form 8832 (Entity Classification Election). In the case of certain foreign entities having only one owner, taxpayers could decide to have the IRS disregard the entity for U.S. tax purposes. More precisely, the foreign entity would be

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1 See pre-1997 Regs. §301.7701-2(a); Morrissey v. Comr., 296 U.S. 344 (1935); U.S. v. Kintner, 216 F.2d 418 (9th Cir. 1954). All section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), and the regulations thereunder, unless otherwise stated.


5 Id.
treated as a “tax nothing,” a “fiscally transparent entity,” a “flow-through,” or a “disregarded entity.” Irrespective of the nomenclature, the tax effect was the same: the FDE would be treated as a mere extension of its owners, and for U.S. tax purposes the IRS viewed the two (i.e., the FDE and its owner) as merely one.

The advantages for taxpayers of using FDEs, particularly in the international context, are plentiful. As the saying goes, beauty is in the eye of the beholder—what many taxpayers saw as attractive tax benefits, the IRS viewed as tax abuses.

In hindsight, it is clear that the IRS always feared that the use of FDEs could undermine the U.S. international tax system. Upon announcing its intention of issuing the check-the-box regulations, the IRS recognized that [an] elective approach could expand the potential that exists under the current classification regulations for hybrid structures. The [IRS] and Treasury are considering whether it is appropriate to address inconsistent classification in any rules to be proposed and are also considering how the tax benefits or detriments that may result from inconsistent classification can be addressed through the tax treaty process.7

The IRS expressed a similar sentiment when it officially released the check-the-box regulations shortly thereafter. According to the IRS, in light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.8

True to their word, Treasury and the IRS took action approximately one year after introducing the check-the-box regulations by issuing Notice 98-11 to combat perceived abuses of Subpart F.9 Notice 98-11 explained that taxpayers were using FDEs in arrangements designed to undermine the policies and rules of Subpart F, which was enacted to limit deferral of U.S. taxation of certain types of income earned outside the United States by controlled foreign corporations (“CFCs”). The following arrangement was identified in Notice 98-11 as being inconsistent with Subpart F (§§951 through 964). CFC1 owns all of the stock of CFC2. CFC1 and CFC2 are both incorporated in Country A. CFC1 has a branch (“Branch1”) in Country B which is an FDE. Under the tax laws of Country A and Country B, CFC1, CFC2 and Branch1 are all classified as separate taxable entities. CFC2 earns only non-Subpart F income and uses a substantial part of its assets in a trade or business in Country A. Branch1 makes a transfer to CFC2 that the tax laws of both Country A and Country B recognize as a “loan” from Branch1 to CFC2. CFC2 then makes interest payments to Branch1 pursuant to this loan. Country A allows CFC2 to deduct the interest paid from its taxable income. For its part, Branch1 pays little or no tax to Country B when it receives the interest payments. Since Branch1 is an FDE, for U.S. tax purposes the loan is regarded as being made by CFC1 to CFC2 and the interest is regarded as being paid by CFC2 to CFC1. Interest received by a CFC is normally considered Subpart F income under §954(c); however, because Branch1 is an FDE, the same-country exception of §954(c)(3) applies and operates to exclude the interest from Subpart F income. On the other hand, if Branch1 were considered to be a CFC instead of an FDE, then this interest payment would be between two CFCs located in different countries. In such a case, there would be Subpart F income because the same-country exception under §954(c)(3) would not apply. According to Treasury and the IRS, if CFC1 is permitted to use an FDE in this situation, the U.S. parent of CFC1 can lower its foreign tax on deferred income and has a significant incentive to invest abroad rather than in the United States.10 Notice 98-11 announced that Treasury and the IRS planned to issue regulations to halt such perceived abuses of Subpart F.

Within weeks of issuing Notice 98-11, the much-anticipated proposed regulations were issued.11 These regulations essentially recharacterized non-Subpart F income as Subpart F income in situations involving certain payments between a CFC and its FDE, or among multiple FDEs of the CFC. Over the next few years the IRS issued, and subsequently withdrew under intense criticism, several notices and regulations designed to eliminate perceived tax abuses concerning

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7 Notice 95-14, 1995-1 C.B. 297.
10 Id. at Ex. 1.
FDEs, including the short-lived Notice 98-11.\textsuperscript{12} Despite these efforts, the use of FDEs, as well as the IRS’s frustration therewith, has persisted.

**The Enron Scandal — Genesis of Proposed Form 8858**

Perhaps the clearest evidence of this reality was the notorious Enron scandal. Pursuant to a report by the U.S. Joint Committee on Taxation, Enron’s worldwide operations included over a thousand foreign companies, many of which were FDEs.\textsuperscript{13} The report found that Enron “deliberately and aggressively” used these FDEs to engage in numerous transactions that had little or no business purpose in order to obtain favorable tax treatment.\textsuperscript{14} The study further stated that Enron’s activities demonstrated a need for “stronger measures” to combat tax-motivated transactions that satisfy the technical legal requirements, yet violate the spirit of the law.\textsuperscript{15} One such measure was the imposition of annual information reporting requirements on FDEs.

According to the U.S. Joint Committee on Taxation, although the IRS is alerted of the existence and classification of each FDE at the time that the entity election is made on Form 8832, current law does not require ongoing information reporting with respect to FDEs. Consequently, the IRS faces great difficulty in keeping track of the FDEs in a company’s structure and monitoring how the FDEs are used in transactions.\textsuperscript{16} On the one hand, the lack of annual reporting makes sense given that FDEs are supposed to be “disregarded” for U.S. tax purposes. On the other hand, the application of the check-the-box regulations in the international context raises a multiplicity of issues, such as the use and regulation of hybrid entities. After weighing these considerations, the U.S. Joint Committee on Taxation concluded that a regime of annual information reporting with respect to FDEs “would significantly enhance the IRS’s ability to administer the international tax rules and to identify and address specific issues that arise in applying the [check-the-box] regulations in the international arena.”\textsuperscript{17} Proposed Form 8858 was thus born.

\textsuperscript{12} Click, “Treasury Withdraws Extraordinary Check-the-Box Regulations,” 2003 Tax Notes Today 194-35 (10/7/03).


\textsuperscript{14} Id. at 16, 377-380.

\textsuperscript{15} Id. at 16-17, 25.

\textsuperscript{16} Id. at 387.

\textsuperscript{17} Id. at 32.

**PROPOSED FORM 8858**

**Components of Proposed Form 8858**

In January 2004, the IRS issued Announcement 2004-4, which contained proposed Form 8858.\textsuperscript{18} According to the IRS, proposed Form 8858 was created to allow the IRS to more efficiently administer U.S. tax law with respect to U.S. persons that own FDEs directly, indirectly or constructively.\textsuperscript{19} The IRS recognized that the introduction of the check-the-box regulations facilitated the use of FDEs in international investments and operations.\textsuperscript{20} As a result of this frequent usage of FDEs and the outdated nature of the existing reporting requirements related thereto, the IRS claimed to have encountered “significant difficulties” in governing certain U.S. international tax provisions.\textsuperscript{21} More specifically, the IRS was concerned that the current information reporting requirements under U.S. tax law were instituted at a time when entity classification rules failed to even contemplate FDEs. According to the IRS, this disparity between current international business and investment practices, on one hand, and the outdated nature of addressing FDEs, on the other, has hindered its ability to identify potential compliance issues efficiently and effectively.\textsuperscript{22} The IRS therefore introduced proposed Form 8858 with the goals of reducing the length of the corporate examination process, improving the credibility of such examinations, identifying tax issues more efficiently, and ensuring the effective allocation of IRS resources.\textsuperscript{23}

Proposed Form 8858 consists of three main parts: an introductory section, five schedules (i.e., Schedules C, C-1, F, G and H), and a separate Schedule M. The introductory section requires certain identifying information, including the name and contact information of several persons, such as the filer, the FDE, and the tax owner and/or direct owner of the FDE. The introductory section mandates disclosure of additional data related to the FDE, including its date of organization, location and description of its principal business activity, effective date of becoming an FDE, and its functional currency.\textsuperscript{24} The five schedules request various types of information regarding the FDE. In particular, the FDE must provide an abbreviated income statement (Schedule C), information relating to the foreign currency rules under §987 that are applicable to FDEs (Schedule C-1), a condensed balance sheet (Schedule F), answers to six specific “yes/no” questions (Schedule G), and summary information regard-


\textsuperscript{19} Id.

\textsuperscript{20} Id.

\textsuperscript{21} Id.

\textsuperscript{22} Id.

\textsuperscript{23} Id.

\textsuperscript{24} Id.
ing taxable income or earnings and profits (Schedule H).\(^{25}\) Finally, the separate Schedule M demands information regarding related party transactions involving FDEs owned by a controlled foreign partnership ("CFP") or a controlled foreign corporation ("CFC").\(^{26}\)

Proposed Form 8858 indicates that it must generally be filed by U.S. persons considered tax owners of FDEs, as well as by U.S. persons that own certain interests in foreign tax owners of FDEs. In the context of proposed Form 8858, the term "tax owner" means the person that is treated under U.S. tax law as owning the assets and liabilities of the FDE.\(^{27}\) Proposed Form 8858 sets forth different filing requirements for five distinct types of taxpayers.

- First, U.S. persons that are tax owners of FDEs must complete the *entire* Form 8858, *but not* separate Schedule M.\(^{28}\)
- Second, U.S. persons that are Category 4 filers of Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations) with respect to a CFC that is the tax owner of an FDE must complete the entire Form 8858, *plus* Schedule M.\(^{29}\)
- Third, U.S. persons that are Category 5 filers of Form 5471 (i.e., noncontrolling shareholders) must complete only the introductory section, Schedule G and Schedule H.\(^{30}\)
- Fourth, U.S. persons that are Category 1 filers of Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships) with respect to a CFP that is a tax owner of an FDE must complete the *entire* Form 8858, *plus* Schedule M.\(^{31}\)
- Finally, U.S. persons that are Category 2 Filers of Form 8865 (i.e., non-controlling partners) must complete *only* the introductory section, Schedule G and Schedule H.\(^{32}\)

With respect to administrative matters, proposed Form 8858 would be due on the date that the taxpayer’s federal income tax return or information return is due (including extensions), and would be submitted as an attachment thereto.\(^{33}\) In terms of timing, proposed Form 8858 indicates that it must be filed for annual accounting periods of tax owners of FDEs beginning on or after January 1, 2004.\(^{34}\)

**Merely One Piece of the Enforcement Puzzle**

The issuance of proposed Form 8858 constitutes just one part of a multifaceted effort by the U.S. Treasury Department and the IRS to deter perceived abuses. In fact, in December 2003 these organizations issued four items of administrative guidance as a part of their continuing efforts “to halt abusive tax avoidance transactions and maximize effective use of IRS audit resources.”\(^{35}\) The four specific actions consisted of issuing (i) proposed changes to Circular 230 that set higher standards for the tax advisors and firms that provide opinions supporting tax-motivated transactions, (ii) final regulations that will increase the cost of failing to disclose abusive tax avoidance transactions, (iii) revised final regulations clarifying that the disclosure of confidential transactions on a return is limited to transactions for which a promoter has imposed confidentiality on a taxpayer to protect the promoter’s tax strategies from disclosure, and (iv) proposed Form 8858.\(^{36}\)

According to Pam Olson, Assistant Secretary of the Treasury for Tax Policy at the time, these actions represent “another significant step to end the proliferation of abusive tax avoidance transactions that has undermined confidence in our tax system.”\(^{37}\) Olson clarified that the government’s need for data is not restricted to abusive tax avoidance transactions; rather, appropriate information reporting requirements focus the IRS’s audit resources designed to protect the in-

\(^{25}\) Id.

\(^{26}\) Id.

\(^{27}\) Id.

\(^{28}\) Id.

\(^{29}\) Id. See also IRS Instructions for Form 5471, Categories of Filers, pp. 1-2 (Dec. 2003). A Category 4 Filer includes a U.S. person that had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation.

\(^{30}\) Announcement 2004-4. See also IRS Instructions for Form 5471, Categories of Filers, p. 2 (Dec. 2003). Category 5 filers include U.S. shareholders that own stock on the last day of any taxable year in a foreign corporation that is a CFC for an uninterrupted 30-day period or more during that taxable year.

\(^{31}\) Announcement 2004-4. See also IRS Instructions for Form 8865, Categories of Filers, p. 2 (Feb. 2004). A Category 1 Filer is a U.S. person that controlled the foreign partnership at any time during the partnership’s taxable year.

\(^{32}\) Announcement 2004-4. See also IRS Instructions for Form 8865, Categories of Filers, p. 2 (Feb. 2004). A Category 2 Filer is a U.S. person who at any time during a taxable year of the foreign partnership owned at least a 10% interest in such partnership while the partnership was controlled by U.S. persons each owning at least 10% interests.


\(^{34}\) Announcement 2004-4.


\(^{36}\) Id.

\(^{37}\) Id.
tegrity of the U.S. tax system. Olson further stated that proposed Form 8858 would enhance the transparency of offshore entities, thereby allowing the IRS to better allocate its resources and improve taxpayer compliance.

COMMENTS ABOUT PROPOSED FORM 8858

At the end of Announcement 2004-4, the IRS requested comments concerning three issues: (i) proposed Form 8858 in general, (ii) matters that should be addressed in the instructions to proposed Form 8858, and (iii) current Forms 5471 and 8865 as to whether any modifications thereto are necessary in light of proposed Form 8858 to ensure that the information requested on the existing forms is necessary to the administration of tax law and is not duplicative of the information required by proposed Form 8858. Comments were due by March 1, 2004, and international tax practitioners had no doubts that the comments would “prove interesting.” The comments received by the IRS regarding proposed Form 8858 — many of which are indeed interesting — are examined in detail below.

Proposed Form 8858 Lacks Instructions

Proposed Form 8858 contains numerous explicit references to the instructions. For starters, the arrow under the title of the form indicates that taxpayers should “see separate instructions.” Express references to the instructions appear at least seven more times throughout proposed Form 8858. Despite this, the proposed instructions have not yet been released, and, based on Announcement 2004-4, it appears that this omission was intentional — the IRS announced that it was “particularly interested in receiving comments on matters that should be addressed in the instructions to Form 8858.”

To its credit, the IRS may consider it prudent and cost-effective to await public comments on proposed Form 8858 before drafting the corresponding instructions. This opinion, however, clearly is not universal. Certain banking associations noted the difficulty in providing the IRS “constructive feedback” in the absence of proposed instructions. Likewise, members of corporate tax departments maintained that, without detailed instructions, the IRS’s expectation that taxpayers understand and accurately complete proposed Form 8858 for the 2004 tax year is “unreasonable.” Finally, some major accounting firms have suggested that the lack of instructions hinders the ability of taxpayers to correctly interpret particular items on proposed Form 8858 and to make necessary judgments.

The Information Requested on Proposed Form 8858 Is Duplicative

The IRS has repeatedly announced its intention to avoid making the information required on proposed Form 8858 duplicative of that already requested on existing tax forms. In Announcement 2004-4, for example, the IRS revealed its plan to review Form 5471 and Form 8865 to ensure that the information requested on these forms (i) enables the IRS to effectively administer the tax law applicable to U.S. owners of CFCs and CFPs, (ii) is necessary to the administration of the tax law, and (iii) is not duplicative of information required on proposed Form 8858 or other...
forms. Lest there be any confusion on this issue, Announcement 2004-4 later states that each item of information requested on proposed Form 8858 has been evaluated to ensure that it is not duplicative of information already required to be reported elsewhere. Despite the IRS’s stated intentions on this point, Announcement 2004-4 contains a statement that seems somewhat contradictory. In particular, the document states that “[a]lmost all of the items of information requested from U.S. persons on proposed Form 8858 with respect to an FDE are currently required to be reported by such U.S. persons on an aggregate basis on, for example, Form 5471 (in the case of FDEs of CFCs) or Form 8865 (in the case of FDEs of CFPs).”

Even a cursory review of the comments reveals the generalized perception that the information requested by proposed Form 8858 is indeed duplicative. Certain accounting firms argue that the majority of the financial information requested on proposed Form 8858 is already required to be reported (on an aggregate basis) on Form 1120, Form 5471 and/or Form 8865. Because FDEs are disregarded as separate entities from their owners for U.S. tax purposes, all income, deductions, assets, liabilities, etc. are passed through to and reported by the owners. Reporting this information again on Form 8858, therefore, would be “duplative and unnecessary.” Certain special interest groups of the same opinion provided the IRS with concrete examples of information requested on proposed Form 8858 that is duplicative. For example, they indicated that question 1a (i.e., name and address of the FDE), question 1b (i.e., U.S. identifying number) and question 1c (i.e., country under whose laws the FDE was organized and the FDE’s classification under local tax law) in the introductory section of proposed Form 8858 are already answered on Form 5471 (Schedule G, question 3), Form 8865 (Section G, question 6) and Form 1120 (Schedule N, question 1).

Given these requests for duplicative information, certain commentators suggest that the IRS simply add another column to Schedule M of Form 5471 (in the case of FDEs indirectly owned by U.S. persons through CFCs) and to Schedule N of Form 8865 (in the case of FDEs indirectly owned by U.S. persons through CFPs), as opposed to requiring taxpayers to complete proposed Form 8858. If a taxpayer reports any information in these new columns, then the IRS could require that an organizational chart be submitted. In this manner, the IRS could still identify the transactions that it desires to target while eliminating the need to file proposed Form 8858.

Proposed Form 8858 Is Costly and Burdensome for Taxpayers and the IRS

Upon introducing proposed Form 8858, the IRS stated that in order to “ensure that taxpayer burden is minimized” it had determined that each item of information requested was necessary to the administration of tax law, not duplicative of any existing tax form, and minimally intrusive because only the minimum information needed to identify the items attributable to an FDE are required. Nearly all commentators disagreed with the IRS’s assessment, claiming that proposed Form 8858 would impose tremendous compliance burdens. Certain tax experts explain that the number of existing FDEs is already “astronomical” and that the figure is probably “multiplying rapidly.” The sheer magnitude of the paperwork involved, both for the IRS and taxpayers, is therefore a primary concern. Other commentators support this position, stating that the increased compliance burden “cannot be over-emphasized” because U.S. multinational companies commonly have hundreds of FDEs. Multinationals already devote a significant amount of resources to tax compliance in the form of system design and maintenance, employee

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49 Id.
50 Id.
51 See, e.g., Letter dated March 1, 2004, from Jeffrey P. Neubert, President and CEO, New York Clearing House Association, to the IRS Tax Products Coordinating Committee, available at <www.nyche.org>; Fuller, “IRS Proposes New Form for Foreign Disregarded Entities,” 33(4) Tax Notes Int’l 375-376 (1/26/04); Letter dated Jan. 16, 2004, from Michael J. McGrath, Tax Director, Technitrol, to IRS, obtained through an FOIA request and on file with author. According to Mr. McGrath, “[t]he information reported on proposed Form 8858 approximates, if not duplicates, that required on the current Form 5471 and thus creates additional burden, cost and complexity associated with the taxpayer’s information reporting process.”
52 Letter dated March 1, 2004, from Ernst & Young LLP to IRS, obtained through an FOIA request and on file with author.
53 Id.
54 Letter dated March 1, 2004, from the American Petroleum Institute to IRS, obtained through an FOIA request and on file with author.
55 Id.
60 Id. Mr. Tillinghast states that “[i]t’s anyone’s guess what exactly the administrative problems are that the IRS thinks justify this major increase in the paperwork load.”
61 Letter dated March 1, 2004, from American Petroleum Institute to IRS, obtained through an FOIA request and on file with author.
training, etc. Imposing additional tax compliance burdens on these companies will, some special interest groups argue, further place these enterprises at a competitive disadvantage to their foreign rivals. The introduction of proposed Form 8858 and the compliance burdens that it generates comes at a particularly inopportune moment for some. According to the tax department of one major company, the reporting requirements of proposed Form 8858, along with the appreciable regulatory burdens imposed by the Sarbanes-Oxley Act of 2002, would create “undue hardship” for the company and its tax department. Certain industry representatives also expressed concern about proposed Form 8858, describing themselves as “frankly perplexed” by the IRS’s justification for imposing such additional work and effort on taxpayers. Although these commentators claim to appreciate the IRS’s desire to gather data on FDEs and better utilize its limited resources, they are “unsure how going through hundreds of additional forms containing information [that is] already available on required tax returns and reports or through audit information requests is a solution.”

Along with generally criticizing the added compliance burdens, certain organizations have focused on the need to utilize U.S. generally accepted accounting principles (“GAAP”) when reporting on proposed Form 8858. Schedule C of proposed Form 8858 requires taxpayers to provide a brief income statement, reporting all information in functional currency “in accordance with U.S. GAAP” and reporting each amount in U.S. dollars translated from functional currency “using GAAP translation rules.” Similarly, Schedule F of proposed Form 8858 requires a balance sheet, which generally must be completed by reporting all amounts in U.S. dollars computed in functional currency and translated in dollars “in accordance with U.S. GAAP.” Commercial banking associations explain that FDEs operating abroad must adhere to local accounting norms; therefore, forcing them to convert such financial data on an FDE-by-FDE basis will lead to increased costs. Agreeing with this argument, certain tax practitioners explain that the data required on proposed Form 8858 is in some cases kept on a general ledger accounting system located outside the United States, which is not maintained in accordance with U.S. GAAP. Filling out proposed Form 8858, therefore, will constitute “a significant administrative burden.”

Confusion Regarding Who Must File Separate Schedule M

As a preliminary (yet extremely important) matter, commentators expressed confusion regarding exactly who is required to complete separate Schedule M (Transactions Between Foreign Disregarded Entity of a Foreign Tax Owner and the Filer or Other Related Entity). This uncertainty derives from inconsistent statements issued by the IRS. On the one hand, Announcement 2004-4 states that U.S. persons that are Category 4 filers of Form 5471 with respect to a CFC that is the tax owner of an FDE must complete the entire Form 8858, plus Schedule M. Similarly, Announcement 2004-4 provides that U.S. persons that are Category 1 filers of Form 8865 with respect to a CFP that is a tax owner of an FDE must complete the entire Form 8858, plus Schedule M. On the other hand, commentators point out that the text following the word “Important” on Schedule M implies that it must be filed by the tax owner of any CFC or CFP. This apparent inconsistency has triggered uncertainty.

Proposed Form 8858 Is Contrary to the Policy of Simplification and Efficiency

As discussed above, before the check-the-box regulations were implemented, the IRS utilized a corporate-resemblance test to determine how entities would be classified. Under this test, an entity was classified as a corporation if it exhibited a majority of certain corporate characteristics, including the presence of associates, a business objective and profit motive, continuity of life, centralized management, lim-

62 Letter dated March 26, 2004, from Philip Kerstein, Vice President of Taxes, Pfizer Inc. to IRS, obtained through an FOIA request and on file with author.
63 Letter dated March 1, 2004, from American Petroleum Institute, to IRS, obtained through an FOIA request and on file with author.
65 Letter dated Jan. 8, 2004, from Michael J. Setzenfand, Vice President and International Tax Manager, Mellon, to IRS, obtained through an FOIA request and on file with author.
67 Letter dated Jan. 8, 2004, from Michael J. Setzenfand, Vice President and International Tax Manager, Mellon, to IRS, obtained through an FOIA request and on file with author.
68 Id.
70 Announcement 2004-4, General Questions About Form 8858, Who Will Be Required to File Form 8858?, “Comments Requested on New Form for U.S. Owners of FDEs,” 2003 Tax Notes Today 249-7 (12/30/03); see also IRS Instructions for Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships), Categories of Filers, p. 2 (Feb. 2004). For purposes of Form 8865, a “Category 1 Filer” is a U.S. person that controlled the foreign partnership at any time during the partnership’s taxable year.
71 Letter dated Feb. 24, 2004, from Donald C. Alexander, Esq., to IRS, obtained through an FOIA request and on file with author.
72 Id.
Classifying entities in this manner was troublesome for both taxpayers and the IRS, and the IRS “found itself spending significant resources on published and private classification rulings and pondering the likelihood of classification litigation over obscure points of state and foreign nontax law.”\(^{74}\) One of the primary rationales for introducing the check-the-box regulations in 1997 was to create a system that was less “formalistic” and “simpler.”\(^{75}\)

According to various groups, proposed Form 8858 is completely inconsistent with the IRS’s stated goals. For instance, commentators point out that the check-the-box regulations significantly facilitated U.S. tax law and lessened the administrative burden on both taxpayers and the IRS. Lamentably, with the recent issuance of proposed Form 8858, “much of that simplification threatens to be lost because of the need to accumulate sufficient information to complete this form.”\(^{76}\) This opinion is shared by others who fear that the IRS is “simply trying a new tack in expressing its long-held unease with the [check-the-box] provisions.”\(^{77}\) Indeed, according to one tax expert, requiring higher levels of information for FDEs (through proposed Form 8858) than for CFCs is both “counterintuitive” and “antithetical” to the spirit of the check-the-box regulations.\(^{78}\) Certain special interest groups expressed a similar view. Citing several authorities issued by the IRS in the last few years that generated little (if any) success in limiting the tax benefits of FDEs, one industry group suggests that proposed Form 8858 is merely a horse of a different color; that is, the IRS is simply pursuing the same objective with a new instrument.\(^{79}\) From this group’s perspective, such veiled and recurrent attempts are “contrary to an overall Treasury policy of compliance simplification.”\(^{80}\)

**Is Proposed Form 8858 Tax Law Enforcement or a Fishing Expedition?**

The international tax community also appears confused as to the underlying rationale for proposed Form 8858. In Announcement 2004-4, the IRS acknowledged that it has encountered significant difficulties in administering the tax law related to FDEs because the current information-reporting requirements were introduced before the entity classification rules even contemplated the use of FDEs.\(^{81}\) The IRS stated that proposed Form 8858 would overcome these difficulties by improving its ability to identify potential compliance issues and by enabling it to more effectively administer the provisions of U.S. tax law related to FDEs.\(^{82}\)

Certain accounting firms understand the IRS’s desire to understand and more efficiently address FDE issues; however, they criticize the IRS on three fronts. The IRS states that it desires to improve the administration of “the relevant provisions of the tax law,” yet it never specifically identifies these provisions.\(^{83}\) Moreover, the IRS has not yet issued instructions to proposed Form 8858, which “perhaps would have shed some light on what the IRS intends to accomplish.”\(^{84}\) In the opinion of one major firm, knowing the particular purposes that the IRS intends the information reported on the Form 8858 to serve would help taxpayers interpret the questions and use their discretion.\(^{85}\) Finally, it is suggested that if the IRS fails to fully and candidly identify the rationale for proposed Form 8858, then the public will be incapable of determining whether the IRS is overstepping its bounds. In other words, some companies wonder whether the IRS is truly trying to obtain only the information that it needs to more effectively administer particular provisions of the Code (which is acceptable) or whether the IRS is really conducting a survey of the extent to which U.S. taxpayers carry on business through FDEs (which would be an “inappropriate” data-gathering expedition under §6038, the authority upon which proposed Form 8858 was issued).\(^{86}\)

**Penalties for Noncompliance Are Unclear**

Announcement 2004-4 states that the reporting of information on proposed Form 8858 will be required under the authority of §6011 (General Requirement of Return, Statement, or List), §6012 (Persons Required to Make Returns of Income), §6031 (Return of Partnership Income) and §6038 (Information Reporting with Respect to Certain Foreign Corporations and Partnerships).\(^{87}\) Also, since question 1(f) of the introductory section of proposed Form 8858 asks if ben-

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\(^{73}\) See fn. 2.

\(^{74}\) Walser & Culbertson, “Encore Une Fois: Check-the-Box on the International Stage,” 97 Tax Notes Today 139-71 (7/21/97).


\(^{78}\) Id.

\(^{79}\) Letter dated March 1, 2004, from American Petroleum Institute to IRS, obtained through an FOIA request and on file with author.

\(^{80}\) Id.


\(^{82}\) Id.

\(^{83}\) Letter dated March 1, 2004, from Steven R. Lainoff, Partner-in-Charge, International Corporate Services, KPMG, to IRS, obtained through an FOIA request and on file with author.

\(^{84}\) Id.

\(^{85}\) Id.

\(^{86}\) Id.

benefits under a U.S. tax treaty were claimed with respect to the income of the FDE, this information may have to be reported under §6114 (Treaty-Based Return Positions). While some of the aforementioned provisions contain penalties, certain accounting firms suggest that the IRS should be more specific concerning potential penalties for noncompliance with proposed Form 8858. Simply put, “[t]hese matters should be addressed in additional guidance.”

**Mandatory Organizational Chart**

Question 5 of the introductory section of proposed Form 8858 requests that the taxpayer provide an organizational chart identifying the name, placement, percentage of ownership and tax classification of all entities in the chain between the tax owner and the FDE, as well as all entities in which the FDE has at least a 10% ownership interest. Tax practitioners explain that providing such an organizational chart represents an onerous task because the information required greatly exceeds that necessary for Form 5471 and “many companies don’t keep [such data] on a constantly updated basis.”

Concurring with this position, a group of corporate tax managers suggests that this requirement be satisfied in one of two ways. Taxpayers could submit one organizational chart that includes all FDEs that roll up into a single CFC or CFP. Alternatively, taxpayers could submit a single organizational chart that includes all reporting FDEs within a U.S. person’s legal structure. This way, the reporting burden will be reduced by permitting U.S. persons to attach their existing organizational charts.

Other critics argue that forcing taxpayers to include an organizational chart would be inconsistent with existing law. They point out that the Internal Revenue Restructuring and Reform Act of 1998 established a long-term goal for the IRS of having at least 80% of all federal tax returns filed electronically by 2007 and obligated the IRS to establish a 10-year plan to eliminate impediments to electronic filing. The requirement of an organizational chart like the one described in proposed Form 8858 could violate this legislatively mandated obligation. Furthermore, the IRS’s recent decision that transactions are generally accounted for in the taxpayer’s “functional currency,” which, in the international context, often is a foreign currency. Complications arise from the fact that all U.S. tax liabilities consistent with the policy underlying the IRS’s electronic filing initiative.

**Schedule C**

Schedule C of proposed Form 8858 requires an abbreviated income statement. In completing this income statement, taxpayers must report all information in functional currency in accordance with U.S. GAAP and report each amount in U.S. dollars translated from functional currency using GAAP translation rules. This requirement has raised criticisms from various groups. For example, while some major tax firms concede that certain items that must be reported in Schedule C may be relevant to determining U.S. tax liability, they fail to comprehend why such figures must be maintained and reported to the IRS in accordance with U.S. GAAP, especially when doing so would generate significant compliance costs.

**Schedule C-1**

Transactions are generally accounted for in the taxpayer’s “functional currency,” which, in the international context, often is a foreign currency. Complications arise from the fact that all U.S. tax liabilities consistent with the policy underlying the IRS’s electronic filing initiative.
must be calculated and paid in U.S. dollars. Therefore, when taxpayers invest and/or conduct business using foreign currencies, the gains or losses must be converted into U.S. dollars before dealing with the IRS. In addition, taxpayers must account for any gain or loss resulting from the change of relative values of the U.S. dollar and the foreign currency while the taxpayer owns or has a position denominated in a foreign currency. Sections 985 through 989 and the corresponding regulations contain the rules for making currency conversions, calculating gains and losses in foreign currencies, and identifying the rates to be used in making such conversions and calculations.101

For its part, §987 provides that if a taxpayer has one or more qualified business units ("QBUs") that operate in a functional currency other than the U.S. dollar, then the taxpayer’s taxable income must be determined by computing the taxable income or loss separately for each QBU in its functional currency, by converting the income or loss separately for each QBU at the appropriate exchange rate, and by making appropriate adjustments for transfers of property between the taxpayer’s QBUs using different functional currencies.102 The term QBU means a "separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records."103 Every corporation (foreign or domestic) is a QBU, even if its activities do not rise to the level of a trade or business.104 Furthermore, a particular activity of a corporation is considered a QBU if (i) such activity constitutes a trade or business and (ii) a separate set of books and records is kept for such activity.105

Schedule C-1 of proposed Form 8858 solicits several items of information, including the amount of any remittances from the FDE in the foreign currency, the amount of any §987 gain or loss incurred by the recipient of any remittance, whether the remittances were reported on the books of the direct owner of the FDE, and whether the tax owner changed its accounting method for §987 gain or loss with respect to the remittances from the FDE during the tax year.106 According to certain major tax firms, the information included in Schedule C-1 generally would allow the IRS to determine if a taxpayer complied with §987 and, if not, “there is substantial risk that such non-compliance may result in an IRS examination.”107

The IRS originally issued proposed regulations regarding §987 in 1991. After over a decade of virtual inactivity in this area, the IRS recently announced that it planned “to review and possibly replace” these proposed regulations for two main reasons.108 First, the IRS is concerned that the proposed regulations may not have reached their goal of providing rules that are both administrable and result in the appropriate recognition of gains and losses concerning foreign currencies.109 Second, the IRS is worried about certain abusive transactions aimed at creating an inappropriate acceleration of foreign currency losses.110 In light of the impending modification of the §987 regulations and the uncertainty surrounding it, several groups have argued that forcing taxpayers to complete Schedule C-1 at this time would be “unreasonable.”111 Claiming that issuing Schedule C-1 at this point would be premature, a number of commentators recommend that the IRS coordinate (both in substantive and procedural terms) the information required in Schedule C-1 and the new guidance on §987. They further argue that the Schedule C requirement should not become effective until after the new proposed regulations are finalized.112

Schedule F

Schedule F of proposed Form 8858 requires an abbreviated balance sheet in which all amounts must be reported in U.S. dollars computed in functional currency and translated into U.S. dollars in accordance with U.S. GAAP.113 Some tax practitioners claim that the limited number of asset and liability categories in Schedule F make it look relatively benign. However, upon closer observation, it is apparent that the requirements in Schedule F are even more onerous than those for Schedule C (which requires the abbreviated income statement) because U.S. GAAP rules would potentially require taxpayers to restate historical asset information due to acquisition accounting rules, differences in depreciation, amortization or capitaliza-

102 §987.
103 §989(a).
104 Regs. §1.989(a)-1(e), Ex. (5).
105 Regs. §1.989-1(b)(2)(ii).
tion rules, equity accounting in subsidiary provisions, etc. According to one tax expert, large multinational companies would neither have this information readily available for the majority of their foreign subsidiaries nor have any need for the information other than to comply with proposed Form 8858. As evidence of his befuddlement, this practitioner stated that he cannot “imagine any tax abuse which the production of this information would enable the IRS to uncover. Perhaps I’m not thinking creatively enough.” Also critical of Schedule F, certain major tax firms explain that the current proposed regulations under §987 already require taxpayers to maintain records about the assets of the FDE for purposes of determining the source of a §987 gain or loss.

Schedule G

Schedule G of proposed Form 8858 contains six “yes/no” questions. According to certain commentators, the purpose of most of these questions is apparent. For instance, Question 3 (i.e., Were substantially all of the assets of the FDE sold, exchanged, transferred or otherwise disposed of during the tax year?) deals with check-and-sell transactions. Such transactions occur when a taxpayer makes an election under the check-the-box regulations to treat a foreign corporate entity as an FDE for U.S. tax purposes, shortly after which the domestic parent disposes of the stock of the FDE and treats the sale as an asset sale, rather than a stock sale, which is not subject to the anti-deferral rules of Subpart F. For its part, Question 4 (i.e., If the FDE made its election to be treated as such during the taxable year, did the tax owner claim a loss with respect to stock or debt of the FDE as a result of the election?) addresses whether a taxpayer claimed a worthless stock loss under §166(b) or a bad debt deduction under §166 in connection with an election under the check-the-box regulations. Question 5 (i.e., If the FDE is owned directly or indirectly by a domestic corporation and the FDE incurred a net operating loss for the taxable year, is the FDE a separate unit as defined in Regs. §1.1503-2(c)(3) and (4)?) attempts to identify whether a taxpayer used a dual consolidated loss for the tax year, and, if so, to indicate the need for the proper filing of the requisite certifications and agreements. Question 6 (i.e., If the tax owner of the FDE is a CFC, were there any intra-company transactions between the FDE and the CFC or any other branch of the CFC during the taxable year in which the FDE acted as a manufacturing, selling or purchasing branch?) is aimed at determining whether the taxpayer is subject to the branch rules under Subpart F.

Although the rationale for the four aforementioned questions is relatively clear, members of the international tax community seem baffled by the purposes of the remaining questions in Schedule G. In particular, they argue that the purpose for Question 1 (i.e., During the taxable year, did the FDE own an interest in any trust?) and Question 2 (i.e., During the taxable year, did the FDE own at least a 10% interest, directly or indirectly, in any foreign partnership?) is unclear. Furthermore, the information requested in Question 2 might be redundant in that it would already be included in Form 8865. Along with highlighting the uncertainty regarding motives, practitioners are concerned that Schedule G is a veritable Pandora’s box because the list of questions may grow as the IRS’s worries increase about the check-the-box regulations and perceived abuses thereof.

Schedule H

Schedule H of proposed Form 8858 demands that taxpayers report the current earnings and profits or taxable income of the FDE. A key element of an FDE is that it is “disregarded” for U.S. tax purposes — hence the letter “D.” An FDE is treated as a mere extension of its owners, and all income, losses, deductions, etc. pass through the FDE to its owners (as if the FDE did not exist as a separate and distinct entity). Therefore, certain tax practitioners are confused as to why Schedule H asks for the current earnings and profits or taxable income of the FDE when, by definition, an FDE does not have any earnings and profits or taxable income. Tax experts have labeled Schedule H a “mystery” for other reasons. For in-

115 Id.
116 Id.
117 Letter dated March 1, 2004, from Ernst & Young LLP to IRS, obtained through an FOIA request and on file with author.
121 Id.
122 Id.
124 Fuller, “IRS Proposes New Form for Foreign Disregarded Entities,” 33(4) Tax Notes Int’l J. 375-376 (1/26/04)
stance, it instructs taxpayers on three occasions to “see instructions,” which, as discussed above, were never issued by the IRS.\textsuperscript{128} Moreover, Schedule H requires a taxpayer to calculate “net additions” and “net subtractions,” but does not specify what these terms mean.\textsuperscript{129} Finally, based on the assumption that the IRS is attempting to design something similar to a branch-equivalent earnings and profits amount, some practitioners warn that the complexity of the calculation would be “enormous.”\textsuperscript{130}

## Separate Schedule M

Detailed information concerning transactions between the FDE and persons related to a CFC or CFP is requested in Schedule M. This particular reporting requirement has raised concerns within the international tax community for numerous reasons. According to a group of corporate tax executives, Schedule M will simply disaggregate, on an FDE-by-FDE basis, the information that is already reported on Form 8865 (in the case of a CFP) and on Form 5471 (in the case of a CFC). As a result, Schedule M will place an enormous tax-reporting burden on companies that have adopted a regional holding-structure model.\textsuperscript{131} Certain practitioners acknowledge that disaggregated information of this nature might permit the IRS to focus on transactions involving low-tax jurisdictions; however, they criticize the IRS for using Schedule M to gather information on transactions by or among FDEs that it cannot otherwise obtain in light of the extended dormancy of Proposed Regs. §1.954-9, dealing with “hybrid transactions.”\textsuperscript{132} In the words of one tax expert, “[a] somewhat more paranoid view might be that the IRS is attempting to collect information on FDEs in order to curtail their use.”\textsuperscript{133} Other tax practitioners dislike the duplicative nature of Schedule M, which, they argue, demands essentially the same related-party transaction information that is already requested of a CFC on Form 5471.\textsuperscript{134} Given this redundancy, they conclude that Schedule M constitutes a step in the wrong direction; that is, it would be the equivalent of reverting to virtually full Form 5471 filing obligations as if the entities had never made the check-the-box election to be treated as FDEs.\textsuperscript{135}

### RECOMMENDATIONS

From the comments examined in the previous section, many suggestions regarding proposed Form 8858 can be identified. In particular, the international tax community has recommended that the IRS (i) enhance the existing Forms 5471 and 8865 instead of issuing a new information reporting form,\textsuperscript{136} (ii) not require the financial information in Schedule C and Schedule F to be reported utilizing U.S. GAAP,\textsuperscript{137} (iii) identify with precision which taxpayers are obligated to complete separate Schedule M,\textsuperscript{138} (iv) clarify the potential penalties for noncompliance with proposed Form 8858,\textsuperscript{139} (v) consolidate or eliminate the requirement for an organizational chart,\textsuperscript{140} (vi) coordinate the information requirements in Schedule C-1 and the upcoming revised proposed regulations regarding §987,\textsuperscript{141} and (vii) eliminate some of the yes/no questions in Schedule G.\textsuperscript{142} Along with these proposals, numerous other ideas have been expressed. For example, citing the fact that...
the instructions to proposed Form 8858 have not yet been issued, various commentators have requested that the IRS postpone the effective date of the new form. While there is widespread agreement regarding the need to delay filing of Form 8858, the appropriate time for imposing the information reporting requirement is still disputed. Some corporate tax managers ask that the effective date of Form 8858 be deferred for one year, thereby making it applicable to tax years beginning on or after January 1, 2005. Other suggestions of the effective date being pushed back to tax years beginning on or after January 1 of the year after which both Form 8858 and its instructions are finalized. In support of their position, Form 8858 opponents explain that major modifications to computer systems, budget and time constraints, competing projects, and the difficulty in coordinating the accounting, data-processing and tax departments of a multinational company will make complying with Form 8858 “extremely onerous.” They also claim that complying with an earlier deadline would be virtually impossible because multinational companies tend to send information-request packets to their foreign affiliates (including their FDEs) approximately nine months before the tax and/or information returns are due. Thus, “[o]nly after the instructions to the Form [8858] are prepared will taxpayers be able to begin to gather the data necessary to complete the Form [8858].” The most zealous opponents of Form 8858 take the argument one step further, arguing that Form 8858 should be delayed indefinitely. According to certain special interest groups, because nearly all of the information requested on proposed Form 8858 is already provided to the IRS via existing forms and schedules, and because auditors already have the authority to review particular issues involving FDEs that concern them, proposed Form 8858 is pointless and redundant. Stated succinctly, “we recommend avoidance of duplication by avoiding the requirement for a proposed Form 8858 in the first place.”

Other tax practitioners acknowledge both the directive contained in the Enron report for annual information reporting for FDEs and the legitimate need for a certain degree of information on FDEs; nevertheless, they believe that proposed Form 8858 “goes way too far.” Accordingly, some suggest that Form 8858 be reduced to one page (instead of three), and only require the identity of each FDE and the tax owner, as well as abbreviated local currency, local book balance sheet and profit and loss information. This short-en form would save the taxpayers time and money, while simultaneously permitting the IRS to determine where the FDEs are in a group and to develop an audit checklist relevant to each one.

With respect to the requirements of Schedule C (requiring an abbreviated income statement), Schedule F (requiring a shortened balance sheet) and Schedule H (requiring current earnings and profits or taxable income), certain corporate tax managers suggest that these be satisfied by providing tabular schedules that set forth the required line items for all FDE members of a CFC or CIP. Such tabular schedules, they argued, are equivalent to the detail supporting the computation of taxable income on Form 1120 in a consolidated return and will substitute for multiple presentations of the data on separate Forms 8858. Moreover, this approach is similar to the tabular schedule found on Form 8873 (Extraterritorial Income Exclusion), which explicitly permits taxpayers to supply such schedules in place of filling out the form in some circumstances.

To avoid burdening relatively small businesses, some groups urge the IRS to adopt a de minimis filing requirement, whereby Form 8858 would not need to be filed by an FDE with annual gross income of less than $1 million. According to proponents of this suggestion, narrowing the type of taxpayers required to file Form 8858 would permit the IRS to concentrate on material issues while at the same time minimizing the administrative burden on smaller FDEs.

CONCLUSION

In view of the creative and frequent use of flow-through entities since the introduction of the check-the-box regulations, the IRS’s tenacity with respect to FDEs may be warranted. Regulating such entities in a haphazard manner, however, is not. Extensive comments and recommendations regarding proposed

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148 Id.
150 Id.
152 Id.
153 Id.; Letter dated March 26, 2004, from Philip Kerstein, Vice President of Taxes, Pfizer Inc. to IRS, obtained through an FOIA request and on file with author. Mr. Kerstein suggests that Form 8858 should be required only with respect to FDEs with gross income over $1 million annually and/or gross assets over $2 million.
Form 8858 provided by members of the international tax community should be useful to the IRS. Nevertheless, this public feedback should represent merely the first step. Although the publication of Form 8858 in draft form for public comment thereon has proven helpful thus far, prudence dictates that the IRS now make appropriate modifications, publish instructions, hold a hearing, and analyze additional public comments before finalizing proposed Form 8858.