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Treasury Proposes New Regulations on Disregarded Entities Owned by Nonresident Aliens

If you ask the typical American tax administrator to name a notorious tax haven they would probably name the Cayman Islands or the British Virgin Islands or some other small nation that makes a disproportionate amount of its budget by accommodating international tax structures. Ask the same question of a European tax administrator and the answer will likely be Delaware or Nevada.

The ease and rapidity with which a U.S. Limited Liability Company (LLC) can be formed in these jurisdictions is a matter of wonder to many Europeans. More ominous, in their eyes, is the fact that the ownership of U.S. LLCs is not a matter of public record. Indeed, even the states in which the entities are formed generally do not have that information. An LLC can be established by an “incorporator,” who can be a lawyer, accountant, paralegal, or other person who has no interest in the company and no obligation to disclose the owners.

For tax purposes, these domestic LLCs are deemed to be partnerships if they have two or more members and are deemed to be disregarded entities if they have only one member.¹

A nonresident alien can form a Delaware LLC and if it invests solely in assets that do not have income that is effectively connected with a U.S. trade or business (*e.g.*, it holds foreign bonds or Afghanistan opium fields), it is not required to file a U.S. income tax return, nor is it required to obtain an employer identification number (EIN). The result is that there is no way to obtain information about the ownership of these entities or their assets and activities. The new rules are “intended to provide the IRS with improved access to information that it needs to satisfy its obligations under U.S. tax treaties and tax information exchange agreements, as well as to strengthen the enforcement of U.S. tax laws.”²

The proposed regulations will amend Treasury Regulations (Treas. Reg.) Section 301.7701-2(c) to treat a domestic

¹ Treasury Regulations Sections 301.7701-1 through 301.7701-3 set forth the entity classification; there are voluntary elections that permit an LLC to choose to be taxed as a corporation.

² Explanation of Provisions ([REG-127199-15](#))

disregarded entity that is wholly owned by a foreign person as a domestic corporation separate from its owner for the limited purpose of the reporting and record maintenance requirements under Section 6038A. This change WILL NOT AFFECT THE TREATMENT OF SINGLE MEMBER LLCs AS DISREGARDED ENTITIES FOR SUBSTANTIVE TAX PURPOSES – however, it will change the record reporting and record keeping rules in the following ways:

- 1) A wholly owned LLC (*i.e.*, an entity that is treated as a disregarded entity for U.S. tax purposes) will be treated as a domestic corporation separate from its owner for the limited purpose of the reporting and record maintenance under Internal Revenue Code (Code) Section 6038A, and therefore all such disregarded entities will now be required to obtain an Employer Identification Number (EIN).³
- 2) An entity obtains an EIN by filing a form SS-4 (*Application for Employer Identification Number*), which requires the identification of the responsible party. The SS-4 instructions define a responsible party for an entity (including a disregarded entity) not traded on a public exchange or registered with the Securities and Exchange Commission as “the individual who has a level of control over, or entitlement to, the funds or assets in that 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 entity must also report any subsequent change of the responsible party.⁴

Under these new regulations, disregarded entities wholly owned by nonresident aliens will be treated as foreign owned domestic corporations for the reporting purposes of Section 6038A and they will be required to file [Form 5472](#) (Information Return) with respect to reportable transactions between the entity and its owner. Transactions required to be reported are those specified in Form 5472, as well as certain other transactions specified in Treasury Regulations under Section 482. Reportable transactions thus include any sale, assignment, lease, license, loan, advance, or other transfer of any interest in or a right to use any property or money, the performance of any services for the benefit of, or on behalf of another taxpayer, and amounts paid or received in connection with the formation, dissolution, acquisition, and disposition of the entity, including contributions to and distributions from the entity.⁵ Thus any contributions or distributions between the disregarded entity and its owner or between the disregarded entity and another disregarded with the same owner will be a reportable transaction.

The penalty for failing to file a Form 5472 for each reportable transaction is \$10,000 and the failure to maintain records is a violation under Section 6038(a) and is subject to a similar \$10,000 penalty.⁶ If the failure continues for more than 90 days after notification by the IRS, an additional penalty of \$10,000 will apply for each 30-day period (or part of a 30-day period) during which the failure continues after the 90-day period ends. Criminal penalties also apply for failure to submit information or for filing false or fraudulent information.

Effective Date

The regulations are proposed to be applicable for taxable years ending on or after the date that is 12 months after the date these regulations are published as final regulations in the Federal Register.

There is a continuing effort by the taxing authorities of the Organisation of Economic Co-operation and Development (OECD) to determine the ultimate beneficial owners of passthrough entities such as partnerships, LLCs, and trusts. It is the expectation that these efforts will continue in the months and years ahead and that this may be the first of many efforts by the U.S. Treasury and IRS to force transparency with respect to the ownership of both U.S. and foreign entities.

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³ Code Section 6038A.

⁴ Treas. Reg. §301.6109-1(d)(2)(ii).

⁵ Treas. Reg. §§1.6038A-2(3)(xi); 1.482-1(i)(7).

⁶ Code Section 6038(b).

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