YEAR-END US REGULATIONS

Canadian Tax Highlights
February 2017

Originally published in Canadian Tax Highlights, *Volume 25, Number 2, February 2017. Reprinted with permission.*

At the end of 2016, the Treasury and the IRS published various regulations that may affect both a US person that invests in a Canadian company and a Canadian person that owns a US entity that is disregarded for US income tax purposes (typically, a single-member limited liability company). New passive foreign investment company (PFIC) regulations affect a US shareholder of a PFIC; new disregarded entity (DRE) regulations require the filing of an annual form with the IRS by a Canadian (or another non-US person) that owns at least 25 percent of a US entity that is disregarded for US income tax purposes.

New PFIC regulations. The new PFIC regulations provide
(1) some clarifications to the definitions of "shareholder" and "indirect shareholder" in the PFIC context, and (2) clarification of and additional exceptions to form 8621 ("Information Re- turn by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund") reporting.
(1) *Definitions*.
The final regulations adopt the 2013 temporary regulations' definition of "shareholder," and they revise and clarify the term "indirect shareholder." First, they provide that a US person is not treated as a PFIC shareholder to the extent that such a person owns PFIC stock through a tax-exempt organization or account.

Second, the new regulations include a non-duplication rule to ensure that the prior regulations are not interpreted so as to create overlapping ownership in a PFIC (which is taxable under section 1291) by two or more US persons. Thus, solely for the purposes of determining whether a person owns at least 50 percent of the stock value of a foreign corporation that is not a PFIC, a person that directly or indirectly owns at least 50 percent in value of a domestic corporation's stock is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the domestic corporation. However, the non-duplication rule states that a US person is not treated as owning the stock of a PFIC that is directly owned or considered owned indirectly by another US person.

Third, the new PFIC regulations revise the prior regulations in relation to when a US person is considered to be an indirect shareholder as a result of attribution through a domestic corporation.

Finally, the new PFIC regulations make two additional clarifications with respect to the rules discussed above. One clarification is that the attribution rules do not apply to stock owned directly or indirectly through an S corporation; the second clarification is that the domestic-corporation attribution

rule applies for all PFIC purposes, not just to a PFIC that is taxable under section 1291.

(2) *Reporting (filing) requirements*.
Unless an exception applies, a direct PFIC shareholder must file form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund." The reporting rules for an indirect shareholder depend on whether the shareholder owns the PFIC through foreign or domestic entities.

The new regulations provide several exceptions to reporting, followed by specifics for filing form 8621. Eight general categories of exceptions exist: (1) if a shareholder is a tax-exempt entity; (2) if the aggregate value of the shareholder's PFIC stock is no more than US$25,000 or if the value of the shareholder's indirect PFIC stock is no more than US$5,000; (3) for PFIC stock marked to market other than under section 1296; (4) for PFIC stock held through certain foreign pension funds; (5) for certain shareholders who are dual-resident taxpayers; (6) for certain domestic partnerships; (7) for certain short-term ownership of PFIC stock (30 days or less); and (8) for certain bona fide residents of certain US territories.

Form 8621 must be filed whether or not the shareholder files a US federal income tax return. The statute of limitation period to assess additional tax does not begin to run on the failure to file the form. Importantly, a protectively filed form 8621 does not trigger the beginning of the limitation period to assess additional tax. The Treasury relies instead on reasonable- cause statements to provide relief. Moreover, if a shareholder holds interests in multiple PFICs, the shareholder must file a separate form 8621 for each PFIC and cannot consolidate the forms for filing purposes.

New DRE regulations. An entity, such as a US LLC, that has a single owner and is not classified as a corporation is generally a DRE and disregarded as separate from its owner under other regulations. A DRE is generally not subject to US tax-filing requirements and thus generally does not need to obtain an employer identification number (EIN) unless it files an entity classification election. If an entity must obtain an EIN, it should file form SS-4, "Application for Employer Identification Number," and therein identify a responsible party (generally, the individual with control over, or entitlement to, the entity's assets); this method applies unless the sole reason for applying for an EIN is to make an entity classification election and the entity is foreign-owned.

A domestic corporation, a domestic partnership, and a foreign corporation engaged in a trade or business in the United States must—unlike a DRE—file an annual income tax return. A domestic corporation that is at least 25 percent foreign-owned has additional information-reporting and record-maintenance requirements, including the filing of an annual return on form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," for each related party with which it had any "reportable transactions." These corporations must also keep records sufficient to establish

the accuracy of the return, including any relevant information regarding related parties.

Generally, a foreign-owned US DRE does not have US reporting obligations unless it is engaged in a US trade or business or has certain types of US-source income. However, solely for the purposes of the reporting requirements, a US DRE that is wholly owned by one foreign person is treated under the new DRE regulations as a domestic corporation separate from its owner: thus, such a DRE is subject to the reporting and record- keeping requirements currently applicable to a 25 percent foreign-owned US corporation.

For the purposes of the new DRE regulations, a foreign person is considered to wholly own a domestic DRE if the foreign person has direct or indirect sole ownership of the entity. To that end, indirect sole ownership means "ownership by one person entirely through one or more other [DREs] or through one or more grantor trusts, regardless of whether any such [DRE] or grantor trust is domestic or foreign."

The new DRE regulations do not affect an entity's classification for other purposes. Consequently, the DRE must file IRS form 5472 and maintain related records for reportable transactions with the entity's foreign owners or other foreign related parties. To complete this filing, an entity must also obtain an EIN by filing a form SS-4 with responsible-party information, including the responsible party's social security number, and the party's individual taxpayer identification number (ITIN) or EIN.