

RELATED PARTY TRANSACTIONS: REQUIREMENTS US TAX AUTHORITIES

I. Introduction

Many taxpayers and tax professionals are not aware that a corporation doing business in the US may have to report its related party transactions to the Internal Revenue Service, the penalties for failure to report are severe and substantial.

The transactions maybe monetary or non-monetary such as the use of company property for personal use or advances of funds at below market rates or conditions.



II. Reporting Requirements

Internal Revenue Code (IRC) Sections 6038A and 6038C require reporting of related party transaction by a “reporting corporation” on its US tax returns. Failing to timely file *Form 5472* or maintain proper records results in a \$25,000 penalty, with an additional \$25,000 penalty for failing to rectify the deficiency within 90 days of IRS notification. Filing a substantially incomplete *Form 5472* constitutes a failure to file.

III. Corporations Required to Report

A Reporting corporations may be a US corporation or a foreign corporation. Generally, two categories must report:

1. 25% foreign-owned U.S. corporations, or
2. Foreign corporations engaged in a trade or business inside the United States.

The first category applies when a corporation has at least one foreign shareholder owning at least 25% of the total voting power of all classes of voting stock, or 25% of the total value of all classes of stock.

IV. Transactions Required to Report

All monetary and non-monetary transactions are reportable transactions, this means that even if no consideration is a paid or exchanged. Reportable monetary transactions are listed in Part IV of Form 5472 (e.g., sales, rents, commissions, interest, etc.) between reporting corporations and foreign related entities. Reportable non-monetary transactions (e.g. use of company property, interest free loans) are non-monetary consideration, or the exchange of less than the full amount of consideration, are reportable under Part VI of the form. A reporting corporation that engages in a monetary or non-monetary reportable transaction with a foreign or domestic related party is required to file Form 5472 with its income tax return.

V. Related Party Defined

A related party maybe a foreign person or a US person related to the reporting corporation. Furthermore, related parties are 25% foreign shareholders of the reporting corporation, or any persons related to:

1. the reporting corporation,
2. a 25% foreign shareholder of the reporting corporation, or
3. any other person related to the reporting corporation.

VI. Exemption to Reporting

A taxpayer may claim an exemption to reporting in certain circumstances. Some exemptions from filing Form 5472 my include:

- No reportable transactions for the tax year.
- A U.S. person controlling the foreign related corporation files Form 5471.
- They are foreign corporations with no permanent establishment in the U.S. under any income tax treaty, and they file Form 8833.
- The reporting corporation and the related party are not U.S. persons, and the transactions will not generate either gross income from sources in the U.S., or any expense, loss, or other deductions allocable or apportionable to such income.

VII. Disregarded Entities- Limited Liability Companies

Many foreign investors use a disregarded limited liability companies (LLC) to invest or do business in the US without knowing they also have significant filing and reporting requirements. A disregarded LLC that is wholly owned by a foreign person cannot claim an exception from filing Form 5472, it must file Form 5472 with a pro forma Form 1120.

VIII. Conclusion

In conclusion, taxpayers and tax professionals must be aware and understand the reporting obligations of related party transactions of a reporting corporation, as defined above, failure to do so may cause significant penalties. If you have failed to report and are concerned about how to correct and report the failure, the IRS does have some special reporting programs to catch-up and get things in order. We can help you comply with all the applicable tax laws and reporting obligations.

We hope this alert has been informative to you.

As always, we strive to provide our clients the highest quality of legal and tax representation in the complex area of tax law. This alert has provided only general information and specific factual scenarios may change any conclusions that would apply. Please call to discuss your specific situation with our legal and tax advisors.

Should you need additional information it will be our pleasure to assist you.

Sincerely,

Ruben Flores, Attorney & CPA

Disclaimers

This alert contains general information and should not be used as supporting document in any case of any particular case. We recommend that you contact your Attorney or Tax Advisor for your specific situation. If you need additional information, we can gladly schedule a conference call.

As requirement of the United States Treasury Regulations, you should be conscious of the fact that this notice has not been written to be used and it should not be used by the recipient to prevent penalties that could be imposed by U.S. Federal Law.