

Clients & Friends Memo

In the Wake of the Panama Papers, Treasury Proposes New Reporting Requirements for Foreign-Owned Legal Entities

May 18, 2016

On May 10, 2016, the Treasury Department issued proposed regulations that, if approved, will require business entities formed in the United States that are owned by a single foreign person to obtain an employer identification number ("EIN"), maintain adequate records of certain transactions, and file information returns with the Internal Revenue Service ("IRS").¹ While the proposed regulations will not change the tax treatment of these entities, they will supply the IRS with additional information about the entity, its foreign owner, and other foreign related parties. Together with enhanced customer due diligence requirements recently issued by the Financial Crimes Enforcement Network,² the proposed regulations are a further effort by the Obama Administration to increase global transparency and require reporting by anonymous foreign-owned entities, particularly in light of the recent release of the "Panama Papers."³

Public comments on the proposed regulations may be submitted through August 8, 2016. If approved, the proposed regulations will become effective twelve months after they are published as final in the Federal Register.

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- ¹ See U.S. Department of the Treasury, Internal Revenue Service, Notice of Proposed Rulemaking, Treatment of Certain Domestic Entities Disregarded as Separate From Their Owners as Corporations for Purposes of Section 6038A, 81 Fed. Reg. 28784 (May 10, 2016), <https://www.gpo.gov/fdsys/pkg/FR-2016-05-10/pdf/2016-10852.pdf> [hereinafter "proposed regulations"].
- ² See Cadwalader Clients & Friends Memorandum, "FinCEN Issues Final Rules for Customer Due Diligence Requirements" (May 13, 2016), <http://www.cadwalader.com/resources/clients-friends-memos/fincen-issues-final-rules-for-customer-due-diligence-requirements>.
- ³ Press Release, The White House, Fact Sheet: Obama Administration Announces Steps to Strengthen Financial Transparency, and Combat Money Laundering, Corruption, and Tax Evasion (May 5, 2016), <https://www.whitehouse.gov/the-press-office/2016/05/05/fact-sheet-obama-administration-announces-steps-strengthen-financial>. The announcement included (i) final regulations requiring stronger customer due diligence by financial institutions, (ii) proposed legislation that would require reporting of the "beneficial ownership" of corporations, (iii) legislative proposals to make it easier for law enforcement to pursue transnational corruption, (iv) a call for the United States Senate to approve eight pending tax treaties, and (v) a call for Congress to enact legislation providing full reciprocal reporting of information in connection with implementation of the Foreign Account Tax Compliance Act.

I. Reporting and Recordkeeping Requirements

Currently, the “check-the-box” entity classification regulations under Section 7701 of the Internal Revenue Code permit a business entity with a single owner, such as a single-member limited liability company, to be disregarded as separate from its owner (a “disregarded entity”). Unlike a domestic partnership or corporation (or a foreign corporation engaged in a trade or business in the United States), which is required to make annual filings with the IRS, a disregarded entity is exempt from having to obtain an EIN or file a tax return. Instead, any tax filing or recordkeeping responsibility resides solely with the individual owner of the disregarded entity. In addition, a disregarded entity owned by a single foreign individual is not required to maintain records or file an information report under Section 6038A, which applies to domestic corporations that are 25 percent foreign-owned.

Under the proposed regulations, a domestic disregarded entity that is wholly owned by a foreign person (directly or indirectly through one or more disregarded entities or grantor trusts) would be considered a domestic corporation for the limited purposes of making it subject to the reporting and other requirements of Section 6038A. As a result, the entity would be required to obtain an EIN by submitting a Form SS-4 (Application for Employer Identification Number) and to identify the “responsible party” who has control over, or entitlement to, the funds or assets within the entity.⁴ The entity also must report any subsequent change in the responsible party.

Going forward, such entities will be required to file 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) with respect to each foreign related party with which the entity has had any “reportable transactions.”⁵ This newly defined category of transactions would include “any sale, assignment, lease, license, loan, advance, contribution, or other transfer of any interest in a right to use any property or money” between the entity and its owner, as well as “the performance of any services for the benefit of, or on behalf of, another taxpayer.” In each instance, the entity will be required to report the name, address, and certain identifying information with respect to each foreign related party. The responsibility for a reporting entity to file this information will apply regardless of whether its foreign owner has an individual obligation to report the income resulting from these transactions.

The proposed regulations also will subject reporting entities to the recordkeeping provisions of Section 6001, which requires the collection and retention of a permanent book of accounts or other records sufficient to establish the accuracy of any reportable transaction that is disclosed in a filing to the IRS. The exceptions to the record maintenance requirements that normally apply for small

⁴ <https://www.irs.gov/pub/irs-pdf/fss4.pdf>.

⁵ <https://www.irs.gov/uac/form-5472-information-return-of-a-25-percent-foreign-owned-u-s-corporation-or-a-foreign-corporation-engaged-in-a-u-s-trade-or-business>.

corporations and *de minimis* transactions, under 26 CFR 1.6038A-1(h) and (i) respectively, will not apply to reporting entities under the proposed regulations.⁶

The penalty for failing to file a Form 5472 or for failure to maintain sufficient records is \$10,000. Additional penalties or criminal liability also may apply for failing to submit information or for submitting false information.

II. Additional Changes Likely in Response to Recently-Identified Tax Abuses

The recent public release of the Panama Papers by the International Consortium of Investigative Journalists ("ICIJ") exposed a network of offshore bank accounts and entities allegedly used to hide income and assets from U.S. and international tax authorities.⁷ Individuals involved in establishing these accounts and entities are believed to include current and former world leaders, criminals, and celebrities who engaged Panamanian law firm Mossack Fonseca & Co. to create anonymous companies in Panama, the British Virgin Islands, and other tax havens. In addition, ICIJ reportedly has identified offshore companies tied to at least thirty-six U.S. persons who have been accused or convicted of fraud or other serious financial misconduct.⁸

To date, reactions from U.S. prosecutors and regulators have been swift. The United States Attorney for the Southern District of New York, Preet Bharara, has informed ICIJ that his office has opened a criminal investigation into the Panama Papers and requested ICIJ's cooperation.⁹ The New York Department of Financial Services also has ordered several foreign banks to provide communications and records of transactions between their New York branches and Mossack Fonseca, as well as any communications with shell companies formed by the transactions.¹⁰

The Treasury Department has announced that it also is considering modifications to the current requirements for corporate, partnership, and other tax or information returns to require the filer to identify all foreign and domestic disregarded entities that it owns. These additional changes are likely future steps, as the IRS has indicated that the absence of specific identifying information

⁶ See Section 1.6038A-1(h) and (i), respectively.

⁷ On May 9, 2016, the ICIJ published a searchable database with the names of more than 360,000 people and companies behind almost 214,000 "anonymous" offshore entities. The data covers nearly 40 years up to the end of 2015 and links to people and companies in more than 200 countries and territories. Users can search the database by name, company, address or jurisdiction. See <https://offshoreleaks.icij.org/>.

⁸ Michael Hudson, Jake Bernstein, Ryan Chittum, Will Fitzgibbon and Chaterine Dunn, *Panama Papers Include Dozens of Americans Tied to Fraud and Financial Misconduct*, THE INTERNATIONAL CONSORTIUM OF INVESTIGATIVE JOURNALISTS (May 9, 2016), <https://panamapapers.icij.org/20160509-american-fraudsters-offshore.html>.

⁹ Rupert Neate, *Panama Papers: US Launches Criminal Inquiry Into Tax Avoidance Claims*, THE GUARDIAN (Apr. 19, 2016), <https://www.theguardian.com/business/2016/apr/19/panama-papers-us-justice-department-investigation-tax-avoidance>.

¹⁰ Greg Farrell, Tom Schoenberg and Katherine Chiglinksky, *New York Wants Foreign Banks to Hand Over Panama Records*, BLOOMBERG (Apr. 20, 2016), <http://www.bloomberg.com/news/articles/2016-04-20/ny-regulator-asks-banks-for-records-linked-to-panama-papers-firm>.

hinders the efforts of law enforcement and compliance with international information exchange standards.

III. Conclusion

The proposed regulations impose reporting requirements on another narrow class of foreign-owned entities formed in the United States that previously enjoyed anonymity. They represent a further step in ongoing efforts by the Treasury Department to plug tax loopholes and facilitate information exchange with foreign tax authorities.

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