Treasury Issues Final Regulations to Address Use of U.S. LLCs to Disguise Beneficial Ownership

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On December 12th, the IRS issued final regulations requiring foreign-owned, single-member LLCs to disclose to the IRS their beneficial owners by obtaining a U.S. tax identification number ("TIN") and in many circumstances, filing annual returns. ***Wealth advisors and their clients should be aware that failure to comply could result in significant civil penalties and, if willful, potential criminal sanctions under U.S. law.***

The final regulations seek to address a loophole in U.S. tax filing requirements that has allowed foreign non-resident aliens to avoid disclosure of certain types of investments in the U.S. This comes at a time when the U.S. has been flexing its enforcement muscle around the world against American taxpayers hiding assets abroad and pressuring other countries to implement the Foreign Account Tax Compliance Act ("FATCA"), which requires foreign financial institutions to report to the IRS regarding accounts with direct or indirect U.S. beneficial ownership. At the same time, the U.S. is vulnerable to arguments that the U.S. itself serves as a tax haven for non-U.S. persons. For example, the U.S. has not enacted legislation that would require American banks to collect and disclose reciprocal information to foreign countries, and it has refused to adopt the more wide-reaching Common Standard on Reporting and Due Diligence for Financial Account Information proposed in 2014 by the OECD. Also, laws in states such as Delaware permit LLCs to register without disclosing their beneficial ownership. The final regulations purport to address these concerns – their preamble states that the information collected "will enhance the United States' compliance with international standards of transparency and exchange of information for tax purposes and will strengthen the enforcement of U.S. tax laws."

The new regulations address a very specific concern. Section 6038A of the Internal Revenue Code requires certain foreign-owned U.S. corporations to file a Form 5472 disclosing the identity of their foreign owners and reporting certain related-party transactions, and also requires reporting corporations to maintain detailed records of such transactions. The filing requirement generally applies where more than 25% of the voting power or value of all classes of stock of the corporation are owned by a single foreign owner. The requirement previously did not apply, however, to U.S. LLCs electing to be disregarded for U.S. federal income tax purposes. Such LLCs were not required to file a Form 5472 or otherwise disclose, to U.S. tax authorities, their foreign owners. This gap allowed foreign investors to make investments through U.S. LLCs without concern that U.S. tax information would come to the attention of the investors' home countries.

The new regulations address this concern by extending the 5472 filing requirement to all foreign-owned, single-member LLCs, even if they are not otherwise treated as corporations for U.S. tax purposes. This will require any such LLC to obtain U.S. TINs and to report the identity of its foreign owners to the IRS, even if it owns no U.S. assets and generates no U.S.-source income. The regulations will thus apply to the classic situation where a non-

U.S. person purchases real estate in the U.S. through a single member, foreign-owned LLC or holds non-U.S. financial assets not reported in their home country in the name of a U.S. LLC.

The reporting of related-party transactions by such LLCs will go well beyond what is required of other foreign-owned U.S. entities that are required to file Form 5472, and will include virtually any transaction with the LLC's foreign owner. For example, such LLCs must report contributions by and distributions to the foreign owner(s).

The new regulations take effect for taxable years beginning after December 31, 2016. For this purpose, an LLC is deemed to have the same taxable year as its foreign owner if the owner has a U.S. income tax or information filing requirement; otherwise, the LLC's taxable year is deemed to be the calendar year.

Failing to file the Form 5472 can result in monetary penalties. If the failure to file continues for more than 90 days after notification by the IRS, a $10,000 penalty is assessed. An additional $10,000 penalty is assessed for every subsequent 30-day period during which the failure to file continues. There is no cap on the total penalty, so a persistent refusal to comply with the filing requirement could result in significant penalties. Also, a willful failure to file could constitute a criminal offense under U.S. law. An equal penalty applies for failing to maintain records required by Code section 6038A.

The new regulations are consistent with other steps taken by the U.S. toward enhanced enforcement and increased transparency as to foreign investors who have relied upon more relaxed federal or state laws to conceal beneficial ownership. For example, the U.S. Financial Crimes Enforcement Network ("FinCEN") recently adopted rules that now require the identification of beneficial owners in all cash purchases of high-end real estate in a number of U.S. cities, and that soon will require U.S. banks to engage in greater "Know Your Customer" due diligence in ascertaining beneficial ownership. Wealth advisors and private client professionals around the world should be mindful of these U.S. efforts and of the U.S.'s now clear intention to collect and share information about foreign investors with other tax authorities. Moreover, U.S. advisors and practitioners should be increasingly diligent about foreign clients transferring assets into the U.S., as the Justice Department has longstanding power to charge Americans with criminal fraud or even money laundering if they knowingly facilitate the evasion of foreign tax.

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