Panama Papers and US initiatives to identify entity beneficial owners

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Introduction

In early April 2016 files leaked from a large Panama-based law firm (known as the 'Panama Papers') brought to the attention of many the ways in which offshore companies and structures can be used to obscure the identity of beneficial owners, some of whom have used such entities to avoid paying tax in their country of tax residence. Offshore structures are not inherently illegal and the use of offshore companies and trusts can provide for the smooth management and transition of wealth from one generation to the next. Unfortunately, the same entities can be misused by criminals, including tax evaders and money launderers. Non-US financial institutions have already identified and reported numerous US individuals as the beneficial owners of non-US accounts as a result of the Foreign Account Tax Compliance Act (FATCA). Now the Internal Revenue Service (IRS) and US financial institutions will begin gathering information identifying beneficial owners of certain entities in response to the heightened awareness of abuse resulting from the disclosure of the Panama Papers, although the United States has not yet committed to exchanging such information under FATCA or the Common Reporting Standard (CRS).

Identification of non-US persons owning US LLCs

Limited liability companies (LLCs) established under the law of a US state are classified by default as disregarded entities if they have only one owner. Many of these LLCs need not file a US tax return or obtain a tax identification number. Thus, the IRS may not possess any information on US entities with owners that are tax resident in a jurisdiction with which the United States has a tax treaty or tax information exchange agreement.

On May 23 2016 the US Treasury released proposed regulations that, if they become effective, will require US domestic LLCs that are wholly owned, directly or indirectly, by a non-US person, to obtain a US tax identification number and file an annual return (Form 5472) reporting transactions between the LLC and its foreign owner. In addition, the LLC must maintain permanent books of account or records sufficient to establish the accuracy of the return. These proposed regulations would not alter the existing default disregarded entity classification. Instead, they are intended to provide the IRS with the information that it needs to satisfy US obligations under tax treaties, tax information exchange agreements and the like.

The term 'transaction' in the proposed regulations is defined to include any sale, assignment, lease, license, loan advance, contributions or other transfer of any interest in or a right to use any property or money, as well as the performance of any services for the benefit, or on behalf, of another taxpayer. Contributions to and distributions from the LLC would be considered reportable transactions. Penalties for failure to file the required return or maintain records will apply. A revised Form 5472 has not yet been released, but LLCs will likely be required to report:

- the name, address and tax identification number, if any, of its non-US owner;
- each country in which the owner is tax resident;
- places where the owner conducts its business; and
- the country or countries of organisation, citizenship, or incorporation of the owner.

'Indirect sole ownership' means ownership by one person entirely through one or more entities disregarded as separate from their owners or through trusts that are classified as 'grantor trusts' under the US grantor trust rules, regardless of whether any such disregarded entity or grantor trust is domestic or foreign. Thus, the proposed regulations will affect the US-based foreign grantor trust structure often used for succession planning purposes where the matriarch and patriarch are non-US persons but the children or grandchildren are US persons. In that situation, a non-US settlor can establish a trust under the law of a US state (eg, South Dakota or Delaware) that is nevertheless classified as a foreign trust for US tax purposes. That trust can be the single member of an LLC, the director of which can open an investment account and manage the portfolio. Historically, no US income or information return needed to be filed provided that neither the LLC nor the trust received any US source income or engaged in any US trade or business during the taxable year. However, once the proposed regulations become effective the requirement for the LLC to file Form 5472 will provide the IRS with information regarding the non-US trust settlor. The IRS can then exchange information with the tax authorities of the settlor's country of tax residence, although it is not currently obligated to do so.

The proposed regulations are intended to fill a gap in information collection that was hindering the IRS from complying with international standards of transparency and cooperation with tax information exchange agreements. They also put the US-based trust in the aforementioned structure on equal footing with offshore trusts established in a jurisdiction that is implementing the CRS and which will require the trustee to report information regarding a settlor who is tax resident in a CRS participating jurisdiction.

Beneficial owners identified under FinCEN enhanced customer due diligence rules

New customer due diligence rules issued by the Financial Crimes Enforcement Network (FinCEN) are already in effect. Under these rules certain US financial institutions (defined as 'covered financial institutions') must now identify the beneficial owner of a legal entity customer at the time a new account is opened. Covered financial institutions include banks, federally regulated trust companies, securities broker-dealers and mutual funds.

Legal entity customer

For purposes of the FinCEN rules, a 'legal entity customer' means:

- a corporation;
- an LLC;
- another entity that is created by filing a public document with a secretary of state or similar office (which might include a limited partnership);
- a general partnership; and
- any similar entity formed under the laws of a non-US jurisdiction.

The FinCEN rules specifically provide that a legal entity customer does not include, among other things, a pooled investment fund that is operated or advised by an investment company, an investment adviser that is registered with the Securities and Exchange Commission (SEC) or a non-US financial institution established in a jurisdiction where the regulator of such institution maintains beneficial ownership information regarding such institution.

Beneficial owner identifying information required

The FinCEN rules include a form of certification which the financial institution can use to obtain the required information from the individual opening the account on behalf of the legal entity customer. The financial institution may rely on such information regarding the identity of the entity's beneficial owner or owners, provided the financial institution has no knowledge of facts that would reasonably call into question the reliability of such information.

The financial institution is required to identity:

- up to four individuals who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, own 25% or more of the equity interest of the legal entity customer; and
- a single individual with significant responsibility to control, manage or direct a legal entity customer, such as an executive officer or senior manager (referred to in the rules as the 'control prong').

Two types of legal entity are subject to only the control prong identification requirement:

- a pooled investment vehicle that is operated or advised by an investment company or investment adviser that is not excluded from the definition of a 'legal entity customer'; and
- any legal entity that is established as a non-profit corporation or similar entity and has filed its organisational documents with the appropriate state authority as necessary.

The individual opening the account must provide the name, address, date of birth and social security number (or passport number or other similar information, in the case of a non-US person) for each beneficial owner. The financial institution is required to maintain updated information on the beneficial owners as such information changes. The financial institution's records are subject to government subpoena in connection with law enforcement investigations. The FinCEN regulations will not result in a national register of beneficial owner information for entities because the relevant financial institution will retain the collected information and only disclose it to the US government upon specific request.

Private trusts

A legal entity customer does not include a private trust, whether established under the trust laws of a US state or non-US jurisdiction. Thus, a trustee opening a bank account for a trust will not be required under the FinCEN rules to provide information on the trust's settlor or beneficiaries. Regardless, financial institutions already gather information under their customer identity protocols and often request a copy of the trust instrument. Moreover, trustees themselves are answerable to law enforcement in appropriate circumstances as regards the settlor and beneficiaries of trusts for which they act as fiduciary.

Where the legal entity customer is owned by another entity rather than individuals, the FinCEN rules require the financial institution to look through all entity owners until individual beneficial owners are identified, with the exception of a trust that owns 25% or more of the equity interests, in which case the trustee will be the beneficial owner. Thus, in the common situation where a trust owns an LLC and the LLC opens a financial account, the FinCEN rules will require the LLC officer opening the account to provide identifying information on the trustee of the trust that owns the LLC and on the individual officer, but the due diligence inquiry should stop there.

Regardless of the specifics of the FinCEN rules, it is important to note that a covered financial institution may also identify additional individuals as part of its customer due diligence if it deems appropriate on the basis of risk. For example, a financial institution's risk assessment guidelines may cause the account manager or compliance department to ask for information on the settlor, the investment adviser or other persons with authority to direct the trustee.

Comment

Advisers to international families must be able to explain to family members why banks and other financial institutions are asking for increased identifying information when opening accounts for a family entity. The traditional desire for privacy of family affairs must be balanced against the abuses allegedly illuminated in the Panama Papers (and similar prior disclosures) and the desire of governments to impede terrorist financing and money laundering. Whether specifically affected by the Panama Papers or not, given the seemingly endless efforts of governments to require increased transparency, beneficial owners and their advisers should review family structures to identify and mitigate potential underreporting in jurisdictions where the beneficial owner is tax resident. The increased gathering of information by the IRS and US financial institutions begins to pave the way for the exchange of that information under FATCA or the CRS.

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