Treasury Increases Focus on Offshore Tax Evasion as New Leaks Emerge from the Panama Papers

May 11, 2016

Summary

Just before a major development in the Panama Papers document leak, the United States Treasury Department announced a series of initiatives signaling an increased regulatory focus on offshore tax evasion. On May 5, the Treasury Department issued proposed regulations designed in part to target foreign persons using U.S. non-operating entities to hold financial assets. The proposed regulations, described in greater detail below, would increase disclosure and reporting requirements for certain foreign-owned limited liability companies ("LLCs"), which have allegedly been used as offshore vehicles by non-U.S. individuals seeking to evade tax obligations in their home jurisdictions.

In a letter to Congress dated the same day, Treasury Secretary Jack Lew outlined the new proposed regulations and issued additional proposals for Congress's consideration designed to combat money laundering and offshore tax evasion. These initiatives include new customer due diligence rules for financial institutions and proposed legislation regarding identification of beneficial ownership of accounts. Moreover, Secretary Lew emphasized the United States' commitment to "live up to its end of the bargain on foreign tax reporting," and encouraged Congress to enact legislation requiring full reciprocity with other jurisdictions under the U.S. Foreign Account Tax Compliance Act ("FATCA").

Treasury's initiatives became public shortly before the International Consortium of Investigative Journalists released an online, searchable compendium of approximately 200,000 records detailing offshore accounts held by clients of Panamanian law firm Mossack Fonseca.

These announcements by Treasury indicate an increased commitment by the United States to identify foreign individuals who are using U.S.-based legal structures and accounts to manage assets, and could signal broader cooperation by the United States with respect to sharing tax-related information with foreign governments. This renewed focus on U.S. outbound information exchange is an opportunity for financial institutions to review their control functions in advance of possible future statutory and regulatory developments.

Background

Governments are cracking down on international tax evasion by increasing the amount of information that is available to tax authorities about international banking relationships. The United States led this charge by enacting FATCA, which compels foreign banks to identify accounts that may be controlled by U.S. persons. The United Kingdom followed suit by establishing a similar regime for financial institutions within its jurisdiction (referred to as the U.K. Crown Dependencies and Overseas Territories, or "UK CDOT"). Several other countries have entered into bilateral agreements that provide for automatic information exchanges along the lines of FATCA and UK CDOT. However, the bespoke nature of these agreements has resulted in information exchange gaps. In an effort to coordinate these somewhat disparate efforts, the Organization for Economic Co-operation and Development (the "OECD") has established its Automatic Exchange of Information Common Reporting Standard ("CRS"), which provides a comprehensive multilateral framework for ratifying countries to exchange tax information. To date, however, the United States has not agreed to initiatives such as CRS that would provide for the automatic exchange of information from the United States to several other countries. Further, while the United States has committed to bilateral exchange of information with multiple countries under FATCA, few steps have been taken in that direction to date. The Treasury Department's latest actions may signal an increase in U.S. cooperation with foreign tax regulators.

These efforts dovetail with a campaign by journalists and others to increase public awareness of offshore asset structuring. In early April 2016, more than ten million documents detailing offshore accounts that received services from Mossack Fonseca, a Panama-based law firm and corporate service provider, were leaked to media outlets around the globe. The documents, known as the "Panama Papers," provide information on hundreds of thousands of offshore holding companies and their owners over the period from 1977 through late 2015. Among others, the papers identify twelve current and former world leaders and numerous politicians, wealthy individuals, celebrities, and athletes.

Overview of the Proposed Regulations

The regulations proposed by Treasury, if finalized and adopted, would require many U.S. limited liability companies ("LLCs") that have a single foreign owner (a "reporting entity") to file information tax returns with the U.S. Internal Revenue Service to identify their owners and report certain transactions (including contributions and distributions). In addition, the proposed regulations would require a foreign owner to authorize the LLC to act as its agent for certain U.S. tax purposes.

The proposed regulations would apply to U.S. business entities, including LLCs, if they are disregarded as separate from their owner for U.S. tax purposes, and are wholly owned by a foreign person, either directly or indirectly through other disregarded entities or trusts. Such an entity would generally be required to file IRS Form 5472 with the U.S. Internal Revenue Service if, at any point during the prior year, the entity engaged in any transfer to or from its foreign owner (including a contribution or distribution) or with a foreign affiliate. The Form would include detailed information regarding the entity's owner, the transactions being reported, and the party involved in the transaction. If an entity is required to file Form 5472, it would also be subject to certain recordkeeping requirements.

As a consequence, a reporting entity would be required to obtain an Employer Identification Number ("EIN"), which it must have to file the required Form 5472. To obtain an EIN, the reporting entity would be required to identify an individual who is the "responsible party" for the entity. Current rules define the "responsible party" for these entities as the individual who has effective control over the entity. The entity would also be required to update the form if there were any change in the "responsible party."

In addition to the reporting and recordkeeping requirements, the foreign owner of a reporting entity would be required to authorize the entity to act as the owner's agent for the purpose of receiving summons from the IRS to examine records or witnesses. Civil and criminal penalties could apply for failure to comply with these rules.

Next Steps

Whether or not these particular regulations are adopted, there will likely be greater scrutiny of U.S.-based financial institutions' control systems with respect to cross-border tax compliance in the near future. The announcement of these proposals provides financial institutions with an opportunity to evaluate and, if appropriate, enhance their onboarding, KYC, AML, sanctions, and tax-compliance policies and procedures. Financial institutions should also consider determining whether relevant information regarding the identity and tax residency of individuals associated with an account is being collected in a manner that is consistent with these proposed regulations.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Neil Barr	**212 450 4125**	**neil.barr@davispolk.com**
Luigi L. De Ghenghi	**212 450 4296**	**luigi.deghenghi@davispolk.com**
Avi Gesser	**212 450 4181**	**avi.gesser@davispolk.com**
Jennifer G. Newstead	**212 450 4999**	**jennifer.newstead@davispolk.com**
John B. Reynolds, III	**202 962 7143**	**john.reynolds@davispolk.com**
Margaret E. Tahyar	**212 450 4379**	**margaret.tahyar@davispolk.com**
Mario J. Verdolini	**212 450 4969**	**mario.verdolini@davispolk.com**