

Treasury issues regulations addressing use of LLCs to disguise beneficial ownership

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On December 12 2016 the Internal Revenue Service (IRS) issued final regulations requiring foreign-owned, single-member limited liability companies (LLCs) to disclose to the IRS their beneficial owners by obtaining a US tax identification number and in many circumstances filing annual returns. Wealth advisers and their clients should be aware that failure to comply could result in significant civil penalties and, if wilful, potential criminal penalties under US law.

The final regulations seek to address a loophole in US tax filing requirements that allowed foreign non-resident aliens to avoid disclosure of certain types of investment in the United States. This comes at a time when the US government has been flexing its enforcement muscle globally against US taxpayers hiding assets abroad and pressuring other countries to implement the Foreign Account Tax Compliance Act, which requires foreign financial institutions to report to the IRS regarding accounts with direct or indirect US beneficial ownership.

At the same time, the United States is vulnerable to arguments that the country itself serves as a tax haven for non-US nationals. For example, there is no legislation that requires US banks to collect and disclose reciprocal information to foreign countries and the US government has not adopted the more wide-reaching Common Standard on Reporting and Due Diligence for Financial Account Information proposed in 2014 by the Organisation for Economic Cooperation and Development. Additionally, 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 US corporations to file Form 5472 disclosing the identity of their foreign owners and reporting certain related-party transactions, and 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. However, the requirement previously did not apply to US LLCs electing to be disregarded for federal income tax purposes. Such LLCs were not required to file Form 5472 or otherwise disclose, to US tax authorities, their foreign owners. This gap allowed foreign investors to make investments through US LLCs without concern that US tax information would come to the attention of the investors' home countries.

The new regulations address this concern by extending the Form 5472 filing requirement to all foreign-owned, single-member LLCs, even if they are not otherwise treated as corporations for US tax purposes. Such LLCs will be required to obtain a US tax identification number and to report the identity of their foreign owners to the IRS, even if they own no US assets and generate no US source income. The regulations will thus apply where a foreign national purchases real estate in the United States through a single-member, foreign-owned LLC or holds non-US financial assets not reported in his or her home country in the name of a US LLC.

The reporting of related-party transactions by such LLCs will go well beyond what is required of

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other foreign-owned US 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.

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 US income tax or information filing requirement; otherwise, the LLC's taxable year is deemed to be the calendar year.

Failing to file 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 persistent refusal to comply with the filing requirement could result in a significant penalty. Also, a wilful failure to file could constitute a criminal offence under US law. An equal penalty applies for failure to maintain records required by Section 6038A of the Internal Revenue Code.

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