

# National Association of Secretaries of State (NASS) Company Formation Task Force



## Report and Recommendations on Assisting Law Enforcement in Fighting the Misuse of Corporate Entities

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## **I. Introduction: The NASS Approach to Company Formation Issues**

Since 2008, the members of the National Association of Secretaries of State (NASS) have been urging federal leaders to focus on tracking corporate entity ownership information through federal tax filings and customer due diligence efforts by financial institutions. The goal is to assist law enforcement in gaining access to information on criminals who attempt to hide behind front companies and shell entities, without a dramatic and costly restructuring of the state business formation processes and related laws which govern the creation of private corporations in the U.S.

During the past five years, NASS has worked in cooperation with the American Bar Association (ABA), the Uniform Law Commission (ULC), the National Conference of State Legislatures (NCSL), the U.S. Chamber of Commerce, and various other stakeholders to identify workable, alternative solutions to federal proposals that would require state business filing agencies to collect "beneficial ownership" information at the time of company formation. The task of identifying a company's beneficial owners is a complex undertaking, and policymakers have yet to agree on the details for gathering such data.

NASS opposes federal legislation that aims to radically transform the company formation process in the U.S., the Incorporation Transparency and Law Enforcement Assistance Act, largely because the federal government is already collecting information on corporate entity ownership. With its murky designations for state collection of beneficial ownership information, the bill threatens to create sweeping changes that will result in expensive, unworkable regulatory and compliance burdens for states and legitimate businesses. As Congress and multiple other domestic and international organizations consider various proposals to collect information that will help law enforcement unmask beneficial owners who are misusing corporate entities, this report reiterates state objections to federal approaches that will upend the business creation process in the U.S. and saddle states with costly, unnecessary mandates. It also highlights the progress that has been made in collecting entity ownership information that can assist law enforcement, and what can be done moving forward. This effort is a follow-up to the 2007 NASS Company Formation Task Force Report and Recommendations, which were left to expire in July 2012 because of significant changes that have occurred during the past few years.

Originally, the NASS Company Formation Task Force's recommendations focused on requiring the disclosure of a person responsible for a business entity's recordkeeping. To state officials, this was a far more practical approach to accessing disclosures on company ownership, and one that could be just as effective in satisfying the needs of law enforcement.

Now, there are new federal agency tax reporting requirements and proposed customer due diligence (CDD) rules for financial institutions that have rendered obsolete the need for a state role in gathering such information. Secretaries of State advocate for the collection of ownership entity information via the best paper trail that already exists at no additional cost to taxpayers or businesses, which includes the following:

- [Internal Revenue Service \(IRS\) Revised Form SS-4](#) submissions
- [U.S. Treasury Department "FBAR" \(Report of Foreign Bank and Financial Accounts\)](#) disclosures
- [U.S. Treasury Department customer due diligence \(CDD\) requirements for financial institutions](#)

With company ownership data readily available to federal law enforcement via federal agencies and U.S. financial institutions, they are best-situated to take on the costly, legally intricate task of collecting and verifying beneficial ownership information. Therefore, readers will have a clear understanding of why federal legislation is unnecessary in light of existing practices.

### **Background and Recent Developments**

Secretaries of State became aware that several federal agencies were examining the issue of ownership information collection by state governments at the beginning of 2006, just before the U.S. Government Accountability Office (GAO) released its April 2006 report on the topic.<sup>1</sup> The GAO concluded that the laws of incorporation in most states allow company owners varying degrees of anonymity and privacy, which opened up a conversation in Washington about how the process was being used by criminals to avoid detection by law enforcement. A separate report released by the U.S. Treasury and other agencies had already raised concerns about limited beneficial ownership information.<sup>2</sup>

In November 2006, Senator Carl Levin (D-MI) chaired a hearing in the Senate Homeland Security Committee's Permanent Subcommittee on Investigations, featuring testimony from federal officials who discussed the findings of these reports, along with the state corporate division directors from Massachusetts, Delaware, and Nevada. During the hearing, Senator Levin expressed concern about a Financial Action Task Force (FATF) report that found the U.S. to be non-compliant with Recommendation 33, the FATF standard calling on countries to ensure that law enforcement has access to the beneficial ownership information of legal entities. Senator Levin indicated that the lack of any U.S. standard requiring companies to disclose their beneficial owners made it difficult for law enforcement to conduct investigations and cooperate with international requests. He warned that more aggressive action was needed to improve the process, mentioning several possible solutions to the issue, including federal legislation that would require states to collect beneficial ownership information, or revised state model incorporation laws to include this requirement.<sup>3</sup>

In early 2007, North Carolina Secretary of State and then-NASS Business Services Committee Chair Elaine Marshall sent a letter to Senator Levin on behalf of NASS, requesting that he hold off on introducing federal legislation until the association had an opportunity to convene a special task force that would try to address what he saw as inadequate practices. The letter stated that the group would be tasked with developing meaningful recommendations for federal and state consideration.

Shortly afterwards, in February 2007, the NASS Company Formation Task Force was established. The bipartisan group, led by Secretary Marshall and Nebraska Secretary of State John Gale, held frequent meetings and conference calls during the five months that followed. After conducting a comprehensive

review of state company formation practices and discussing all options for addressing the perceived shortcomings in the process, the group released its report and recommendations in July 2007. These recommendations included the following:

- A request that the ABA and ULC develop language to amend model and uniform business entity laws to require that businesses file a periodic report with the name and address of a natural person in the United States who has responsibility for providing access to the list of owners of record for the business entity. The name would be part of the public record, and thus, available to law enforcement without a subpoena.<sup>4</sup>
- A ban of bearer shares and interests in bearer form.

As a result of the task force's deliberations, many Secretaries of State also took a closer look at their individual state statutes and practices related to company formation. They began to conduct state reviews and called for changes to their laws. Most of the states that were scrutinized in those early federal government reports moved forward on their own, strengthening their processes and closing perceived loopholes.<sup>5</sup>

Despite state attempts to proactively address the issues, Senator Levin expressed dissatisfaction with the NASS approach and shared his intent to introduce federal legislation that would set minimum standards for beneficial ownership disclosure.<sup>6</sup> In May 2008, Senator Levin, along with then-Senators Barack Obama (D-IL) and Norm Coleman (R-MN), introduced S. 2956, the Incorporation Transparency and Law Enforcement Assistance Act, which would have required states to collect beneficial ownership information from corporations and limited liability companies (LLCs).<sup>7</sup>

In July of that year, NASS adopted a resolution renewing the Company Formation Task Force and expanding its mission. This time around, the group was tasked with building collaborations with other stakeholder organizations to identify workable, state-based solutions as an alternative to federal legislation. In the following months, the ABA, NCSL, and ULC all expressed opposition to S. 2956 and began to work with NASS on this subject matter.

In March 2009, Senator Levin reintroduced the Incorporation Transparency and Law Enforcement Assistance Act in the 111<sup>th</sup> Congress as S. 569, co-sponsored by Senators Charles Grassley (R-IA) and Claire McCaskill (D-MO).<sup>8</sup> In June, the Senate Homeland Security and Government Affairs Committee held a hearing to examine the potential impact of the legislation.<sup>9</sup> In addition to testimony by NASS Company Formation Task Force Co-Chair and North Carolina Secretary of State Elaine Marshall, the hearing included a discussion of the Uniform Law Enforcement Access to Entity Information Act, the alternative state law proposal drafted by the ULC at the request of the NASS Company Formation Task Force. Under that Act, businesses would be required to provide states with the names and addresses of

individuals who could provide law enforcement with information about the control and ownership of the business.<sup>10</sup>

The ULC formally approved the Act just a month later, but by that time, it was clear that Senator Levin found the Act to be another insufficient solution.<sup>11</sup> NASS, along with the ABA, ULC, NCSL, and the U.S. Chamber of Commerce, continued to advocate for a state-based approach while opposing S. 569 as an unfunded federal mandate that would create an unnecessary bureaucracy for states and businesses.<sup>12</sup>

In November 2009, the Senate Homeland Security and Government Affairs Committee held yet another hearing on S. 569.<sup>13</sup> No state recordkeeping officials testified, but U.S. Treasury Department officials notably indicated that they would be drafting a legislative proposal to address their concerns with S. 569, including the bill's ambiguous definition of the term "beneficial owner."

The U.S. Treasury Department released its proposal in the spring of 2010, with additional revisions released in June and September of that year.<sup>14</sup> Between February and July 2010, several markups were scheduled for S. 569, but all were eventually cancelled before a markup could take place. It is important to note that the definition of "beneficial ownership" continued to be a sticking point for negotiations on all of the bills that had been introduced, as well as the various U.S. Treasury Department proposals.

Meanwhile, in July 2010, NASS learned that the Internal Revenue Service (IRS) was contacting state business filing offices to ask for help in promoting IRS Revised Form SS-4 (Application for Employer Identification Number), which requires applicants to disclose the same company ownership information required by S. 569. Later that month, at the annual NASS Summer Conference in Rhode Island, Secretaries of State adopted a resolution asserting that federal proposals and legislation requiring states to develop costly and elaborate procedures to collect beneficial ownership would be unnecessary and redundant in light of the fact that the IRS had begun collecting company ownership information through Revised Form SS-4.<sup>15</sup>

NASS members were encouraged by the federal government's common-sense approach, which allows for the collection of the ownership information within an existing process, at no additional expense to taxpayers or businesses. The updated SS-4 instructional form even indicates that information provided to the IRS may be shared with federal law enforcement agencies, if warranted. Despite the revisions to IRS Form SS-4, Representative Carolyn Maloney (D-NY) introduced H.R. 6098 as a companion bill to S. 569 in August 2010, without any clear explanation as to why the legislation was still necessary.<sup>16</sup>

Around the same time, NASS staff learned that the U.S. Treasury Department was amending its reporting requirements to add a new item with major significance regarding ownership entity information. In March 2011, the agency began requiring individuals and legal entities in the U.S. to file annual disclosures, called "FBARs" (Report of Foreign Bank and Financial Accounts), on all foreign bank and financial accounts.<sup>17</sup> This change effectively closed the loophole on the one existing exception to

the SS-4 filing requirement: single member LLCs that do not conduct business in the U.S. and have no U.S. bank accounts. Treasury's new requirement also affects entities with foreign ownership, as it mandates the disclosure of a U.S. taxpayer identification number (TIN) or foreign identification.

According to the IRS, the ownership information collection procedures that were added via Revised Form SS-4 and FBAR disclosures were put in place to deter criminal activity and aid law enforcement. The IRS website explicitly states,

The FBAR is a tool to help the United States government identify persons who may be using foreign financial accounts to circumvent United States law. Investigators use FBARs to help identify or trace funds used for illicit purposes or to identify unreported income maintained or generated abroad."<sup>18</sup>

Considering the fact that the new IRS and U.S. Treasury Department reporting requirements could easily provide the ownership information trail that law enforcement was seeking for investigating crimes such as money laundering and tax evasion, NASS members were surprised to learn that Senator Levin reintroduced the Incorporation Transparency and Law Enforcement Assistance Act in August 2011. This time, S. 1483 was a more complex version of the previous iteration of the bill, with many of the same aspects of the Treasury Department's 2010 proposal included.

Shortly thereafter, Representative Maloney introduced H.R. 3416, a companion bill to S. 1483. This version of the legislation contains a number of similarities to S. 1483, with an additional provision requiring the U.S. Treasury Department to collect beneficial ownership information if states do not implement the bill. It also contains major differences compared to the Senate bill, most notably its legal definition of beneficial owner.

There have been no hearings on S. 1483 or H.R. 3416.<sup>19</sup> However, during this lull in bill activity on Capitol Hill, several related developments are worth briefly noting:

- The Obama Administration released its [Open Government Partnership National Action Plan](#) in September 2011, which declared the White House's support for increased transparency of legal entities formed in the U.S. through the adoption of federal legislation. The report states that the Administration, "will advocate for legislation that will require the disclosure of meaningful beneficial ownership information for corporations at the time of company formation."<sup>20</sup>
- FATF released some [clarifications on implementation of its recommendations](#) in February 2012, noting that countries can use any one of a number of channels to make company ownership information available to authorities, including a tax authority like the IRS, or financial institutions. Soon thereafter, the U.S. Treasury Department proposed the creation of

prescriptive rules to strengthen customer due diligence (CDD) requirements for financial institutions in obtaining the beneficial ownership information of legal entities.

- In May 2012, a new coalition of grassroots, consumer, and labor organizations called the FACT (Financial Accountability & Corporate Transparency) Coalition kicked off a coordinated campaign to lobby Congress on the importance of transparency and international regulatory efforts through, among other things, the collection of business ownership information. Along with an affiliated international organization called Global Witness, the group issued a letter to Congress urging support for the Incorporation Transparency and Law Enforcement Act.<sup>21</sup>

In July 2012, the NASS Business Services Committee allowed the 2007 Company Formation Task Force Report and Recommendations to expire and authorized the drafting of this report to more accurately reflect the significant progress made on the issue of collecting ownership information at the federal and state levels, as well as the work continuing within the financial industry. At the end of July, the U.S. Treasury Department held the first of several hearings on proposed amendments to CDD rules.<sup>22</sup>

In the fall of 2012, there were indications that Senator Levin was planning to seek a markup on S. 1483. If the 112<sup>th</sup> Congress adjourns in December 2012 without addressing S.1483, new legislation would need to be introduced in the 113<sup>th</sup> Congress.

## **II. Review of the Incorporation Transparency and Law Enforcement Assistance Act**

### **S. 1483**

The most recent version of the Incorporation Transparency and Law Enforcement Assistance Act (S. 1483) was introduced in August 2011.<sup>23</sup> The bill is co-sponsored by Senators Levin and Grassley, along with Senator Tom Harkin (D-IA). It was referred to the Senate Homeland Security and Governmental Affairs Committee.

S. 1483 would require states that receive Department of Homeland Security funding to implement the bill by October 1, 2013. Corporations and LLCs meeting certain criteria would have to file beneficial ownership information with the state at the time of forming the business, and in all annual filings. Specifically, businesses would be required to disclose the names of beneficial owners, addresses, and driver's licenses or passport numbers. The bill defines a beneficial owner as,

a natural person who, directly or indirectly exercises substantial control over a corporation or limited liability company; or has a substantial interest in or receives substantial economic benefits from the assets of a corporation or limited liability company.

The individual forming the business would also have to provide this information. However, if a business has any foreign beneficial owners, the business would have to have a formation agent certify to the state that the agent has verified the owner's identity.

S. 1483 authorizes the U.S. Secretary of the Treasury and the U.S. Secretary of Homeland Security, in conjunction with the U.S. Attorney General, to issue guidance or rules to clarify the definitions (including the definition of beneficial owner) and information verification procedures in the bill. This could include notarization requirements for filings.

Under the new law, states would have to disclose beneficial ownership information in response to a subpoena or summons from a state or federal agency or congressional committee, a written request from a federal agency on behalf of another country, or a written request by the Financial Crimes Enforcement Network of the Department of the U.S. Treasury Department. Also, each state would have to determine whether to make the beneficial ownership information it collects available to the public, per its public disclosure laws and related statutes.

As an alternative to filing beneficial ownership information with the state, S. 1483 would permit businesses to provide beneficial ownership information to a licensed formation agent, provided that the state has a licensing system in place that meets the bill's standards, including requiring formation agents to register with the state, undergo regular monitoring, and remain subject to noncompliance sanctions and background checks.

S. 1483 uses the term "exempt" to describe business entities that would not be required to comply with the bill's beneficial ownership disclosure provisions. However, these entities – banks, publicly traded corporations, insurance companies, etcetera – would be subject to other filing requirements, including having to provide the state with the name, address, and driver's license or passport number of an individual affiliated with the entity (e.g. officer or director).

As a possible funding source for implementation of the bill, S. 1483 states that the U.S. Treasury Department may make up to \$20 million available to the states, and the Department of Justice may make up to \$10 million available from their forfeiture funds.

#### **H.R. 3416**

In November 2011, Representative Maloney introduced H.R. 3416, the current companion version of the Incorporation Transparency and Law Enforcement Assistance Act.<sup>24</sup> The bill is co-sponsored by Representatives Barney Frank (D-MA) and Stephen Lynch (D-MA) and was referred to the House Financial Services Committee. H.R. 3416 would amend the Bank Secrecy Act, requiring states to implement the bill by October 1, 2013.

Many of the provisions in H.R. 3416 are identical to S. 1483, with some notable exceptions. First and foremost, this bill contains a different definition of beneficial owner, noting that the term would reference a “natural person who directly or indirectly has at least as great an ownership interest in the corporation or limited liability company as any other natural person, or has responsibility for directing the regular operations of the corporation or limited liability company.”

Additionally, H.R. 3416 stipulates that if a state fails to implement the bill by October 1, 2013, the U.S. Treasury Department must issue regulations requiring business in that state to file beneficial ownership information and exempt entity information with the U.S. Treasury Department.

### **III. State Concerns Regarding the Incorporation Transparency and Law Enforcement Assistance Act**

NASS has opposed the Incorporation Transparency and Law Enforcement Assistance Act since the first version of the bill was introduced in 2008. The legislation is a confusing, overly bureaucratic proposal that would needlessly set in motion a drastic revamping of the business incorporation process in the U.S., with questionable results. While Secretaries of State support the goal of assisting law enforcement in fighting corruption and other financial crimes, the federal government already has an existing process for collecting beneficial ownership information on business entities that are domestically formed. These IRS and U.S. Treasury-based channels are the proper means by which the federal government should be addressing such important national security and law enforcement needs, particularly those that are driven by international regulatory pressures.

Completely altering the manner in which companies are established in the U.S. is not only unnecessary, it is also not an appropriate, effective, or efficient strategy for tracking beneficial ownership information. The implementation of the Incorporation Transparency and Law Enforcement Assistance Act would require an extensive and continuous funding source that does not exist, and few states can afford to finance. With so many states and businesses still struggling during the economic recovery, it is the wrong time to be saddling taxpayers with costly, confusing new regulations, and burdens on legitimate business creation and investment. Moreover, it seems unlikely that any new business filing requirements will actually achieve the purpose of exposing criminals and terrorists.

If enacted, the Incorporation Transparency and Law Enforcement Assistance Act would bring federal rulemaking and regulatory authority into an area that has traditionally been the jurisdiction of the states, significantly blurring the lines between federal-state roles, with the following results:

#### **FINDING #1: The law would create sweeping, unnecessary changes to the business formation process in the U.S., when other viable alternatives already exist.**

Federal legislation is unnecessary because the federal government is already collecting corporate entity ownership information through federal tax filings (IRS Revised Form SS-4 and U.S. Treasury Department

Report of Foreign Bank and Financial Accounts/"FBAR" disclosures) and federally-required customer due diligence procedures for financial institutions in the U.S.

IRS Revised Form SS-4 requires ownership disclosures when applying for an Employer Identification Number (EIN). The "responsible party" request within the form adheres to the same definition used to define "beneficial owner" in the original version of the Incorporation Transparency and Law Enforcement Assistance Act.

Meanwhile, the U.S. Treasury Department requires individuals and U.S. legal entities to file an annual Report of Foreign Bank and Financial Accounts (called "FBAR" reporting) on all foreign bank and financial accounts, thereby closing the last remaining loophole for domestically-formed entities that are opening financial accounts and conducting business overseas. The FBARs also address foreign-owned entities by requiring the disclosure of a U.S. taxpayer ID number or foreign identification. These are effective tools for helping the United States government identify criminals who may be using financial accounts to circumvent the law, or identifying/tracing funds used for illicit purposes. According to the IRS, the ownership information collected on the SS-4 form and the new FBAR reporting were put in place to deter criminal activity and aid law enforcement.<sup>25</sup>

Additionally, the U.S. Treasury's Financial Crimes Enforcement Network (FinCEN) requires financial institutions to adhere to customer due diligence (CDD) requirements that include measures for identifying and verifying the beneficial owners of customers that present a high risk for money laundering and other illicit activities. This year, FinCEN announced a new rulemaking proposal that would tighten these requirements under the Bank Secrecy Act, with the aim of adding to the federal government's available data on corporate beneficial ownership.

With all of this data available to law enforcement agencies for investigations related to criminal or terrorist activities at no additional cost to taxpayers or businesses, these IRS and U.S. Treasury-based channels are the most effective means by which the federal government can achieve its stated goals of assisting law enforcement and bringing the U.S. into greater compliance with international regulatory standards for financial disclosures.

**FINDING #2: The law would require a significant and costly expansion of state government oversight.**

The Incorporation Transparency and Law Enforcement Assistance act would impose indeterminate compliance costs and bureaucratic obligations on state governments and legitimate businesses (both exempt and non-exempt, as they must file forms with the state regardless of their classification).

Without any clear administrative rules, trying to calculate any of the costs would be an inaccurate undertaking. However, state recordkeeping offices will clearly have to create new forms, develop and implement new filing and licensing procedures, create new databases, and develop a host of associated

business rules to bring them into compliance with a host of as-of-yet undetermined federal regulations. The legislation would also require states to dedicate additional staff time and resources to collect, process, and maintain the data collected through multiple new filings. Data storage and archiving costs will increase exponentially, along with significant public outreach and education costs to ensure compliance.

To be clear, the federal mandates in the bill involve more than adding one line to an existing form. The legislation sets in motion at least ten possible scenarios where additional information must be filed with the state, including identification documentation updates, and various certifications. All states will need to establish formal licensing procedures for company formation agents, who are required to keep beneficial ownership information. Recordkeeping offices will need to collect certifications from the agents holding the information, with rigorous vetting processes and background checks. They will need to establish new processes to ensure that licensed agents meet certain standards and undergo regular monitoring. They would also need to impose sanctions for non-compliance and create outreach programs to publicize new licensing and filing requirements. Even the various corporations and LLCs which are “exempt” from the new disclosure requirements will be required to provide the state with contact information and a certification as to why they are considered exempt.

**FINDING #3: The law would place yet another federal government unfunded mandate on financially overburdened states and businesses.**

With no guaranteed source of federal funding to ensure that states can implement the law, federal officials will determine whether states ultimately get any of the \$30 million that is referenced in federal legislation. There is no telling what amount, if any, will actually be distributed to states.

Even if it is the full amount, states are doubtful that \$30 million will sufficiently fund such a significant overhaul to state company formation processes in the U.S., and they have concerns about the source of the funding. With the funding coming from DOJ and Treasury Department forfeiture funds, the law would put state recordkeeping offices in direct competition against law enforcement for unobligated federal funding. Secretaries of State do not want recordkeeping offices to be put in a position where they are potentially seen as taking away from the vital services that police agencies provide, particularly when it comes to their front-line role in protecting against corruption and terrorism.

**FINDING #4: The law would impose unworkable regulatory and compliance burdens on states and legitimate businesses, many of which are struggling economically right now, with questionable results.**

A major concern for states is the federal legislation's ill-defined approach to collecting beneficial ownership information, which would leave state filing offices to unravel the complexities of the law while having to rely upon the federal government for as-of-yet undetermined clarifications and rulemaking. There are no guarantees that the U.S. Treasury Department, the Department of Homeland

Security, and the Department of Justice will be able to reach a clear and workable consensus on the vague and often confusing provisions outlined in the Incorporation Transparency and Law Enforcement Assistance Act. States and potentially millions of businesses would have to spend time and money trying to interpret the law, determining who is considered a beneficial owner. The law will burden these stakeholders with huge document filing duties and additional fees during this difficult economic environment.

Meanwhile, the relatively small number of bad actors who are abusing the system for criminal purposes will likely provide false information, ignore the requirements altogether, or find some other way to skirt the new regulations. Instead, the law will create a large number of non-compliant businesses entities that must hire a lawyer, or some kind of legal advisor, to assist them with these new federal requirements and avoid steep penalties. With more than two million new business entities formed in the U.S. each year, the majority of which are legitimate businesses that are small in size with modest budgets, the number of businesses in this camp will be much larger and more common than the number of terrorists and money launderers that the law might actually help to expose.

The law also raises many privacy issues that remain unanswered. For example, information collected by the states is usually classified as public record. States will have to determine how they will handle this new data seeking to identify corporate beneficial owners, making it likely that laws will need to be changed and states will need to be prepared to handle litigation on this issue. The result may be that states will have to establish and maintain costly parallel systems – one public and one protected.

In short, the Incorporation Transparency and Law Enforcement Assistance Act has failed to gain support from major state government organizations or business advocacy organizations. NASS joins the National Conference of State Legislatures (NCSL), the Uniform Law Commissioners (ULC), the American Bar Association (ABA), and the U.S. Chamber of Commerce, among others, in opposing this legislation.

#### **IV. Recommendations for Continued Progress**

Thanks to the adoption of new reporting requirements by the IRS and the U.S. Treasury, there is no longer a justified need for federal legislation that would require persons to divulge the beneficial owners of a company or legal entity to state agencies at the time of its formation. This section of the report takes a closer look at the new federal agency requirements and explains why they are practical solutions.

**RECOMMENDATION #1: The federal government should focus its attention on collecting beneficial ownership information for corporate entities through IRS SS-4 and FBAR reporting, as well as through customer due diligence (CDD) requirements for U.S. financial institutions.**

Any legal entity that opens an account with a U.S. financial institution is required to have an employer identification number (EIN). When the IRS revised Form SS-4 (Application for Employer Identification

Number) in 2010, it precluded the use of a nominee individual (someone with limited authority to act on behalf of the entity) and instead required that legal entities identify a “responsible party.”<sup>26</sup> The definition of “responsible party” includes “the person who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets.”<sup>27</sup> This definition is the one used in S. 569, and is very similar to the definition contained in S. 1483, with the notable exception that Revised Form SS-4 is asking for only one name.

Additionally, U.S. Treasury Department regulations require a person to file an annual Report of Foreign Bank and Financial Account (FBAR), disclosing any interest in a foreign financial account that exceeds \$10,000. In 2011, the U.S. Treasury Department issued revised regulations expanding the definition of persons required to submit an FBAR to include legal entities, including corporations and LLCs.<sup>28</sup> The FBAR also applies to foreign companies doing business in the U.S. All entities required to file the FBAR must provide an EIN, or taxpayer identification number (TIN), and a foreign-owned entity that does not have one of these identifiers is required to provide identification information from an official foreign government document.

IRS Revised Form SS-4 and FBAR reporting requirements provide government authorities, including law enforcement, with access to company ownership information. These requirements were highlighted in a 2011 report by the Organization for Economic Cooperation and Development (OECD), which found U.S. tax reporting and disclosure obligations to be an effective means for obtaining this information.<sup>29</sup> The report also provides a positive review of U.S. tax information exchange programs with other countries.<sup>30</sup>

As part of a Customer Identification Program (CIP), U.S. financial institutions are required to obtain the address and EIN of each legal entity that opens an account. Financial institutions are also required to institute a customer due diligence (CDD) program that includes measures for identifying and verifying the beneficial owners of customers that present a high risk for money laundering and other illicit activities.<sup>31</sup> Guidance issued by the U.S. Treasury Department’s Financial Crimes Enforcement Network (FinCEN) in 2010 identified certain types of business entities as customers that may pose a heightened risk. Treasury also emphasized the importance of obtaining beneficial ownership information on these entities in order to detect suspicious activity and provide useful information to law enforcement.<sup>32</sup> In March 2012, FinCEN issued a notice of proposed rulemaking that would require financial institutions to identify the beneficial owners of all customers, and verify the beneficial ownership information pursuant to a risk-based approach.<sup>33</sup>

The anti-money laundering policies of U.S. financial institutions provide authorities with yet another effective mechanism for obtaining company ownership information. In a recent comment letter to FinCEN concerning the proposed new CDD requirements, Senator Levin highlighted the effectiveness of

existing financial institution procedures for identifying, maintaining, and disclosing the beneficial owners of specific accounts, stating:

The Subcommittee has often asked U.S. financial institutions to identify the beneficial owners of specific accounts, especially accounts opened in the name of offshore or domestic shell corporations. Our experience has been that virtually all large U.S. financial institutions already have policies and procedures in place requiring their personnel to know who the beneficial owners are of accounts opened by high risk entities, such as shell corporations. In addition, when the Subcommittee asks for the names of the beneficial owners, in the vast majority of cases, the financial institutions have the information.<sup>34</sup>

While Senator Levin's letter expressed concern over the lack of a standardized method for tracking beneficial ownership information, focusing on ways to address those specific concerns would seem to be more efficient than implementing complex federal legislation that requires another 50 layers of bureaucracy on top of existing federal government and financial industry processes.

**RECOMMENDATION #2: Federal and state officials should acknowledge that the federal government's corporate ownership information collection efforts adhere to revised Financial Action Task Force (FATF) Recommendations.**

One of the driving factors in the discussions on beneficial ownership disclosures in the U.S. has been a 2006 report by the Financial Action Task Force (FATF) that found the U.S. to be out of compliance with the international organization's regulatory recommendations.

In June 2011, FATF issued a Consultation Paper as part of a review of its recommendations. FATF stated that a "generally low level of compliance" with Recommendation 33, which calls on countries to provide authorities with access to information on the beneficial ownership of legal persons, had signaled "some problems implementing the requirements."<sup>35</sup> The report also indicated that FATF was considering an interpretive note to clarify what countries should do to comply with Recommendation 33, and what was considered adequate beneficial ownership information.

In September 2011, NASS submitted a comment letter in response to the FATF Consultation Paper.<sup>36</sup> The letter expressed the concern that the body's definition of beneficial owner is overly vague and ambiguous.<sup>37</sup> The letter also called on FATF to recognize federal tax filings and anti-money laundering provisions as effective mechanisms for obtaining company ownership information in compliance with Recommendation 33.

In February 2012, FATF released revised recommendations, including an interpretive note for Recommendation 33 (renumbered as Recommendation 24). It indicates that there a number of ways in

which beneficial ownership information for companies can be made available to a country's authorities, including through a tax authority, financial institutions, or a company holding the information. The note reflects what NASS pointed out in a 2011 comment letter to FATF: the U.S. already has adequate methods in place for complying with Recommendation 24.<sup>38</sup>

Another recent FATF interpretive note, which addresses Recommendation 10 customer due diligence issues, states that financial institutions should be required to identify the beneficial owners of customers that are legal entities and take reasonable measures to verify the identity of such persons. It also includes clarification on the definition of beneficial owner.<sup>39</sup> The specifics of this note closely mirror FinCEN's recently proposed rulemaking efforts on CDD requirements.

Considering these clarifications and existing federal government data collection practices, the U.S. has clearly moved into compliance with FATF recommendations. Federal government authorities should promote this achievement and ensure that international regulatory organizations are aware of the progress that has been made in this regard.

**RECOMMENDATION #3: If federal legislative approaches continue to be pursued, Congress should request a General Accountability Office (GAO) study to determine the law's financial impacts on states and businesses.**

Secretaries of State believe that it would be helpful for the GAO to investigate the costs and methods for collecting ownership information and evaluating their effectiveness. Revamping the business formation process in the U.S. is no small undertaking, and it should not be done without a thorough assessment of potential impacts on the stakeholders who are on the front lines of the process - state recordkeeping offices and U.S. businesses.

#### **IV. Conclusion**

This report is part of an effort to convey state and federal agency success in tackling the complex challenges related to the business formation process in the U.S., while at the same time reiterating some of the serious concerns that are driving NASS opposition to federal legislation that would require states to collect beneficial ownership information. From the beginning, NASS members have been committed to finding practical, cost-effective solutions to combat the misuse of front companies and shell entities. States that were often scrutinized in early federal government reports and hearings have implemented substantive legal and procedural enhancements that strengthened their corporate formation processes.

In addition, in the five years since the first NASS Company Formation Task Force Report and Recommendations were released, the federal government has made significant progress in fighting financial crimes by expanding efforts to collect company ownership information, which they are uniquely positioned to share with law enforcement. These efforts include adoption of IRS Revised Form

SS-4 and new U.S. Treasury Department FBAR disclosures have significantly enhanced the government's ability to share ownership information with law enforcement authorities when financial wrongdoing is suspected. Combined with the work that is currently taking place to refine the Customer Due Diligence (CDD) requirements implemented by financial institutions for collecting and verifying ownership information, there is no compelling reason for the adoption of federal legislation that would create expensive, sweeping changes to the business formation process in the U.S.

While Secretaries of State enthusiastically support the goal of assisting law enforcement in its mission to identify criminal acts using corporate entities to access the U.S. financial system, state officials strongly believe that federal proposals to require states to collect beneficial ownership information are unnecessary, as well as unlikely, to be effective. Since states will not be verifying the company information that is submitted to them, it seems unlikely that criminals will file truthful and accurate statements. NASS continues to urge federal policymakers to focus on strengthening the various federal agency methods that are already in place for obtaining company ownership information and, when properly warranted, sharing that information with law enforcement.

In closing, NASS members remain staunchly committed to ensuring that legitimate businesses can thrive in their state, particularly during this time of economic challenge. The vast majority of the estimated two million new companies formed in this nation each year are created by law abiding citizens for legitimate purposes. These companies serve as the backbone of our state and federal economies. NASS will not support steps to impose unworkable regulatory and compliance burdens on states and legitimate businesses when other viable alternatives already exist.

## Endnotes

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<sup>1</sup> See U.S. Government Accountability Office, [Company Formations: Minimal Ownership Information Is Collected and Available](#) (Nov. 2006); U.S. Department of the Treasury, [U. S. Money Laundering Threat Assessment](#) (Dec. 2005).

<sup>2</sup> U.S. Department of the Treasury, [U. S. Money Laundering Threat Assessment](#) (Dec. 2005).

<sup>3</sup> See Sen. Subcomm. on Investigations, *Failure to Identify Company Owners Impedes Law Enforcement*, 109<sup>th</sup> Cong. (Nov. 14, 2006) ([statement of Senator Levin](#)); also see Financial Action Task Force, [Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism: United States of America](#) (June 2006).

<sup>4</sup> National Association of Secretaries of State, [Company Task Force Report and Recommendations](#) (July 2007). Note: at the time the report and recommendations were developed the Uniform Law Commission was referred to as the National Conference of Commissioners on Uniform State Laws (NCCUSL).

<sup>5</sup> For example, Nevada amended its state laws in 2007 to require that companies maintain a list of record owners at a registered office or principal place of business, file the name of the custodian of the list with the Secretary of State's office, and make the list available to law enforcement in the course of a criminal investigation. See Nevada Model Registered Agents Act ([NRS 77.310](#)), [Chapter 77. Sec. 010-270](#).

<sup>6</sup> Letter from Senator Carl Levin to NASS Company Formation Task Force Co-Chairs, [Response to Company Formation Task Force Recommendations](#) (Nov. 13, 2007).

<sup>7</sup> [Sen. 2956](#), 110<sup>th</sup> Cong. (2008). The bill defined a beneficial owner as "an individual who has a level of control over, or entitlement to, the funds or assets of a corporation or limited liability company that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the corporation or limited liability company."

<sup>8</sup> [Sen. 569](#), 111<sup>th</sup> Cong. (2009).

<sup>9</sup> Sen. Comm. on Homeland Security and Government Affairs, [Examining State Business Incorporation Practices: A Discussion of the Incorporation Transparency and Law Enforcement Assistance Act](#), 111<sup>th</sup> Cong. (June 18, 2009).

<sup>10</sup> See Uniform Law Commission, [Uniform Law Enforcement Access to Entity Information Act](#) (2009).

<sup>11</sup> Sen. Comm. on Homeland Security and Government Affairs, *Examining State Business Incorporation Practices*, 111<sup>th</sup> Cong. [6-7](#) (June 18, 2009) (statement of Senator Levin).

<sup>12</sup> Letter from NASS Company Formation Task Force Co-Chairs to Senator Joseph Lieberman, Chairman, Senate Committee on Homeland Security and Governmental Affairs, [NASS Opposition to S. 569](#) (Nov. 3, 2009).

<sup>13</sup> Sen. Comm. on Homeland Security and Government Affairs, [Business Formation and Financial Crime: Finding a Legislative Solution](#), 111<sup>th</sup> Cong. (Nov. 5, 2009).

<sup>14</sup> The Treasury Department's proposal, which was never formally introduced, defined a beneficial owner as "a natural person who, directly or indirectly exercises substantial control over a legal entity or has a substantial interest in or receives substantial economic benefits from such legal entity."

<sup>15</sup> National Association of Secretaries of State, [Resolution on the Collection of Ownership Information in the Company Formation Process](#) (July 2010).

<sup>16</sup> [H.R. 6098](#), 111<sup>th</sup> Cong. (2010). The bill defines a "beneficial owner" as "a natural person who, directly or indirectly exercises substantial control over a corporation or limited liability company or has a substantial interest in or receives substantial economic benefits from the assets of the corporation or limited liability company."

<sup>17</sup> See Internal Revenue Service, [Form TD F 90-22.1: Report of Foreign Bank and Financial Account](#); also see Internal Revenue Service, [FAQs Regarding Report of Foreign Bank and Financial Accounts \(FBAR\) - Filing Requirements](#).

<sup>18</sup> Internal Revenue Service, [Report of Foreign Bank and Financial Accounts \(FBAR\)](#).

<sup>19</sup> In 2012, the Senate Foreign Relations Committee held a hearing entitled "Ivory and Insecurity: The Global Implications of Poaching in Africa," where S. 1483 was mentioned, but it was not a hearing on S. 1483.

<sup>20</sup> The White House, [The United States Releases its Open Government National Action Plan](#) (Sept. 20, 2011); The Open Government Partnership, [National Action Plan for the United States of America](#) (Sept. 2011).

<sup>21</sup> See FACT Coalition Press Release, [Civil Society, Business Groups Call on Congress to Support Incorporation Transparency, Ban Anonymous U.S. Shell Companies](#) (May 2012).

<sup>22</sup> Samuel Rubinfeld, [FinCEN Holds Hearing on Beneficial Ownership Rule](#), Wall Street Journal (August 1, 2012).

<sup>23</sup> [Sen. 1483](#), 112th Cong. (2011). See the [NASS Company Formation Task Force webpage](#) for a detailed summary of the bill.

<sup>24</sup> [H.R. 3416](#), 112<sup>th</sup> Cong. (2011). See the [NASS Company Formation Task Force webpage](#) for a detailed summary of the bill.

<sup>25</sup> See Internal Revenue Service, [Report of Foreign Bank and Financial Accounts; Use of Nominees in the EIN Application Process](#).

<sup>26</sup> Organization for Economic Cooperation and Development, [Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: United States 2011](#) 19 (2011).

<sup>27</sup> Internal Revenue Service, [Responsible Parties and Nominees](#).

<sup>28</sup> [Amendment to the Bank Secrecy Act Regulations](#), 76 Fed. Reg. 10234 (Feb. 24, 2011).

<sup>29</sup> Organization for Economic Cooperation and Development, [Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: United States 2011](#) 8, 19, 20, 23 (2011).

<sup>30</sup> *Id.* at 8, 73, 79, 86.

<sup>31</sup> Treasury Department regulations concerning Customer Due Diligence programs define a beneficial owner of an account as "an individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the account. The ability to fund the account or the entitlement to the funds of the account alone, however, without any corresponding authority to control, manage or direct the account (such as in the case of a minor child beneficiary), does not cause the individual to be a beneficial owner." [31 C.F.R. 103.175\(b\)](#).

<sup>32</sup> FinCEN, [Guidance on Obtaining and Retaining Beneficial Ownership Information](#) (March 2010).

<sup>33</sup> [Customer Due Diligence Requirements for Financial Institutions](#), 77 Fed. Reg. 13046 (March 5, 2012).

<sup>34</sup> Letter from Senator Levin to James H. Fries, Director, FinCEN, [Comments on Proposed CDD Rules](#) (June 1, 2012).

<sup>35</sup> Financial Action Task Force, [The Review of the Standards: Preparation for the 4th Round of Mutual Evaluation](#) (June 2011).

<sup>36</sup> Letter from NASS Company Formation Task Force Co-Chairs to John Carlson, Principal Administrator, FATF, [Comments to the Consultation Paper on Review of the FATF Standards](#) (Sept. 16, 2011).

<sup>37</sup> See Financial Action Task Force, [Glossary of the FATF Recommendations](#). The FATF definition of beneficial owners states the following:

Beneficial owner refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement. Reference to "ultimately owns or controls" and "ultimate effective control" refer to situations in which ownership/control is exercised through a chain of ownership or by means of control other than direct control.

<sup>38</sup> Financial Action Task Force, [The FATF Recommendations](#), 59-61, 83-85 (Feb. 2012).

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<sup>39</sup> The FATF interpretive note to Recommendation 24 states that beneficial ownership information for legal persons is the information described in the interpretive note to Recommendation 10, which states:

For legal persons:

(i.i) The identity of the natural persons (if any – as ownership interests can be so diversified that there are no natural persons (whether acting alone or together) exercising control of the legal person or arrangement through ownership) who ultimately have a controlling ownership interest\*\*in a legal person; and

(i.ii) to the extent that there is doubt under (i.i) as to whether the person(s) with the controlling ownership interest are the beneficial owner(s) or where no natural person exerts control through ownership interests, the identity of the natural persons (if any) exercising control of the legal person or arrangement through other means.

(i.iii) Where no natural person is identified under (i.i) or (i.ii) above, financial institutions should identify and take reasonable measures to verify the identity of the relevant natural person who holds the position of senior managing official.

\*Measures (i.i) to (i.iii) are not alternative options, but are cascading measures, with each to be used where the previous measure has been applied and has not identified a beneficial owner.

\*\* A controlling ownership interest depends on the ownership structure of the company. It may be based on a threshold, e.g. any person owning more than a certain percentage of the company (e.g. 25%).