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Looking for hidden wealth: in search of beneficial owners

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BY

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Fallout from the so called 'Panama Papers' and concerns about tax evasion, the hiding of funds from illegal activities, and loopholes in US federal and state reporting obligations have drawn scrutiny to US laws that allow shell companies to be formed for the benefit of an undisclosed foreign beneficial owner.

The US has received widespread criticism regarding the ability for shell companies to incorporate under US state law and hide assets. The US is viewed as an attractive haven as it minimises geopolitical risk, is stable, has a somewhat predictable legal system and relatively strong economy. Recent US initiatives have targeted this perception that the US has become a haven for non-US persons to hide money.

In May 2016, the US Department of the Treasury announced three new efforts to address these concerns: (i) proposed tax regulations imposing reporting requirements for foreign-owned disregarded entities; (ii) amendments to the Bank Secrecy Act regulations to clarify and strengthen customer due diligence requirements for certain financial institutions; and (iii) proposed beneficial ownership legislation that the Treasury is sending to Congress to require companies to report beneficial ownership information at the time of a company's creation.

New tax regulations for foreign-owned disregarded entities

US limited liability companies (LLC) can be formed in many states, and ownership is not a matter of public record. An LLC can be established by an 'incorporator', who can be a lawyer, accountant, paralegal or other person who has no interest in the company and no obligation to disclose the owners. For US tax purposes, US LLCs are deemed to be partnerships if they have two or more members and are deemed to be 'disregarded entities' if they have only one member. A non-resident alien can form an LLC and if it invests solely in assets that do not have income that is 'effectively connected' with a US trade or business or US source income, it is not required to file a US income tax return, nor is it required to obtain an employer identification number (EIN). Under current US law, there is a limited ability to obtain information about the ownership of these entities, their assets and activities.

The proposed new tax regulations would require foreign owned disregarded entities formed in the US to file information reporting returns. The new rules are intended to provide the IRS with improved access to information to satisfy its obligations under tax treaties and tax information exchange agreements, as well as to strengthen the enforcement of US tax laws. The proposed regulations will amend Treasury Regulations Section 301.7701-2(c) to treat a domestic disregarded entity wholly owned by a foreign person as a domestic corporation separate from its owner for the limited purpose of the reporting and record maintenance requirements under IRC Section 6038A, including the requirement of obtaining an EIN. This change will not affect the treatment of single member LLCs as disregarded entities for substantive tax purposes.

An entity obtains an EIN by filing a Form SS-4 (Application for Employer Identification Number), which requires the identification of the responsible party. The SS-4 instructions define a responsible party for an entity as "the individual who has a level of control over, or entitlement to, the funds or assets in that 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". Under the Section 6038A reporting requirements, transactions that must be reported include any sale, assignment, lease, licence, loan, advance or other transfer of any interest in or a right to use any property or money; the performance of any services for the benefit of, or on behalf of, another taxpayer; and amounts paid or received in connection with the formation, dissolution, acquisition and disposition of the entity, including contributions to and distributions from the entity.

Customer due diligence regulations

Unlike many other countries, the US has not previously required the collection of beneficial ownership information for

entities. On 11 May 2016, the US Financial Crimes Enforcement Network (FinCEN) published a 'customer due diligence final rule', which amends existing Bank Secrecy Act regulations and adds a new requirement that covered financial institutions identify and verify the identity of natural persons who are the beneficial owners of a legal entity customer for all new accounts going forward from the date of implementation of the rule.

Under the new regulations, an individual is a 'beneficial owner' if the individual meets the definition of one of two tests set forth in the regulations – an ownership test and a control test. Under the ownership test, a beneficial owner is "[e]ach individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer". Under the control test, a beneficial owner is defined as "[a] single individual with significant responsibility to control, manage, or direct a legal entity customer", which would potentially include an executive officer or senior manager, such as the chief executive officer, the chief financial officer, the chief operating officer, a managing member, a general partner, the president, the vice president, the treasurer, or "[a]ny other individual who regularly performs similar functions".

Proposed beneficial ownership legislation

The US Treasury Department has submitted to Congress legislation that would amend the Bank Secrecy Act to require the reporting of beneficial ownership information for entities formed in the US legislation requiring the disclosure of beneficial ownership information has been introduced in the past, but never enacted, and has been opposed by states, because of the costs involved and because a number of these states generate significant revenue from incorporation fees.

The proposed legislation would amend the Bank Secrecy Act to require any entity formed in the US to maintain records and file reports on the beneficial owners of the US entities, including the names, addresses and unique identifying numbers (such as social security, tax identification, passport and driver's licence numbers) of the beneficial owners, as well as the identity of the individual who is submitting the report. Both the entity and any beneficial owner whose identity the entity was required to disclose may be liable for a civil monetary penalty for violating the reporting requirement.

The new regulations that apply to covered financial institutions and the proposed beneficial ownership legislation work together. The regulations focus on financial institutions knowing who their legal entity customers are, regardless of where those entities are formed, as part of due diligence at the

time of account opening. The information provided may not be reliable, though, and may be impossible to verify given the lack of requirements for states to maintain reliable, verified and up-to-date corporate formation information. The proposed legislation focuses on ensuring that legal entities formed in the US are more transparent to law enforcement regardless of where they conduct their financial activity.

This continues to be an area of focus for the Treasury and FinCEN, with FinCEN issuing a proposed rule on 25 August 2016 to extend customer identification requirements and beneficial ownership requirements to banks that are not federally regulated and therefore not currently subject to these requirements. These new rules plug longstanding loopholes in US reporting requirements for the reporting of the real or beneficial owners, including tax reporting and reporting under the Bank Secrecy Act. The proposed legislation on beneficial ownership (given its history) may not become reality, but the new tax reporting regulations and new Bank Secrecy Act regulations for financial institutions will require more robust reporting of the beneficial owners of US entities. Failing to comply with these new requirements will result in exposure to substantial civil penalties under the Internal Revenue Code and Bank Secrecy Act for failure to comply, as well as potential criminal sanctions for intentional failures.

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