State Law & State Taxation Corner

By Thomas E. Rutledge

Requiring Disclosure of Business Entity Ownership: Proposed New Laws are Burdensome, But With the Benefit of Being Ineffective

A trio of proposals is currently pending that purport to answer the question of how law enforcement may access information on the identities of owners of business entities that are or may be being used for nefarious purposes. The Uniform Law Enforcement Access to Entity Information Act (ULEA),[1] the Incorporation Transparency and Law Enforcement Act (S. 569)[2] and a recent proposal from the Treasury Department all aim to address the asserted connection between the utilization of business entities for money laundering, terrorism support and similar activities and asserted needs of law enforcement to access names and other identifying information with respect to the beneficial owners[3] of those business entities.[4] As asserted by the financial action task force:[5]

> In recent years, the Financial Action Task Force (FATF) has noted increasingly sophisticated combinations of techniques, such as the increased use of legal persons to disguise the true ownership and control of illegal proceeds, and an increased use of professionals to provide advice and assistance in laundering criminal funds. In furtherance of these objectives, the FATF has issued forty (40) general and nine (9) special recommendations. At an evaluation performed in 2006, the United States was found to be noncompliant with a number of these recommendations, including those that attorneys be obligated to conduct client due diligence to avoid doing business with money launderers,[6] that company formation agents be obligated to report suspicious activities to law enforcement[7] and that in order to preclude the

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unlawful use of business entities for illegal purposes, law enforcement be provided access to beneficial ownership information.[8] Since then, Congress has been involved in these activities.[9]

Currently there are at least three models in circulation that, to various degrees, respond to the FATF recommendations as to information on beneficial ownership. Which of them, if any, will be ultimately enacted into law remains to be seen. In the meantime, it is perhaps best to appreciate their similarities and distinctions.

Definition of Beneficial Owner

The three proposals have taken different approaches to identifying the persons whose identities may need to be disclosed. ULEA takes the broadest approach, including any shareholder, member or partner irrespective of their degree of control over the entity.[10] In contrast, S. 569 and the Treasury Proposal are focused upon voting control over the organization irrespective of the right to share, as owners, in the economic fruits thereof.[11] Obviously, who are the beneficial owners that may be subject to any ultimate reporting regime is going to be a crucial question. As to issues of "control" of a legal entity, distinctions as to matters in the ordinary course versus extraordinary transactions are going to be challenging. Does a limited partner whose consent is necessary for an organic transaction but who otherwise has only a minority voting right, or a special member whose consent is necessary to file a voluntary bankruptcy but who otherwise is without voting rights, going to be treated as exercising "control"?

Types of Entities that Must Comply

The three proposals take radically different approaches to the entities subject to the reporting requirements. S. 569 was limited by its terms to corporations and LLCs.[12] The Treasury Proposal would reach corporations, LLCs, LLPs, LPs and any non-U.S. entity qualified to transact business in any state.[13] ULEA extends its scope to business corporations, LLCs, LLPs, LPs, limited cooperative associations, statutory trusts and any other entity authorized by the state that is incorporated into the state's adoption of ULEA that has less than fifty beneficial owners.[14]

Obviously, the scope of the new law will be an important consideration. The more types of structures that are involved, the greater the overall compliance cost. At the same time, by leaving particular forms of organization off the subject list, there is also the risk that, being exempt, they will be treated as the "inappropriate" forms and their legitimate use may be prejudiced. The Treasury Proposal's inclusion of any structure organized outside the United States that is qualified to transact business in a state is an innovative mechanism for addressing non-U.S. entities that may not have a domestic equivalent.

Person Charged with Compliance

S. 569 charges the "formation agent" with compliance. This position is defined to include only those persons compensated with respect to the organization of a business venture.[15] In contrast, the Treasury Proposal uses the term "documentation agent," a category that may exist irrespective of whether the individual at issue is compensated for services rendered. In addition, there is a subset of the "documentation agent," namely a "licensed documentation agent," defined as an attorney or other person licensed by the state for that particular purpose.[16] ULEA uses a "records contact" concept, a person who holds or has access to the information on ownership.

What Is Required for Compliance

The three proposals take different, albeit to a certain degree overlapping, approaches to what information must be maintained for purposes of compliance. Under S. 569, there must, at the time of formation, be submitted a list setting forth the names and addresses of each beneficial owner of the business organization.[17] If any of those business owners is itself another business entity, the beneficial owners of that entity must be provided.[18] This information must be updated whenever the state's applicable annual filing fee is due or, in those states in which an annual fee is not required, the list must be updated each time there is a change in beneficial ownership.[19]

With respect to ULEA, those business organizations that, at the time of organization, do not have more than fifty beneficial owners[20] are required to separately submit an "information statement."[21] That "information statement" needs to set forth (a) the

name and address of the "Records Contact," being the person charged to maintain the organization's information as to its beneficial owners and certain other required information,[22] (b) the name and address of the "Responsible Individual," being a person generally familiar with the business who is directly or individually participating in management,[23] which information statement must be signed on behalf of the company by the Records Contact and the Responsible Individual.[24] The Records Contact is required to maintain custody of, and the Responsible Individual must be able to provide a copy of, the Responsible Individual's government-issued photo I.D. or, if the responsible individual is not a U.S. citizen, their passport.[25] Upon request, the Records Contact is required to provide the name and address of each beneficial owner, the name and address of each person to whom the business entity has otherwise been directed to transmit distributions, and the name and address of each current transferee of an interest in the entity.[26] Additional disclosure obligations relate to the identity of all foreign owners and the jurisdiction governing each,[27] the name and address of each person having management responsibility over the entity[28] as well as copies of, with respect to each of those managers, their government-issued I.D. and records as to how managers are selected.[29] Last, records must be maintained and made available as to how the relative voting power of each owner is determined[30] and the name of the person responsible for providing this information to the Records Contact.[31]

The Treasury Proposal takes a bifurcated approach to the records that must be maintained. For entities using a "Documentation Agent," there must be provided to the state at the time of formation: the names and addresses of each beneficial owner; identification information with respect to the documentation agent and a certification of compliance signed (with the signatures notarized) by the documentation agent and each beneficial owner.[32] Alternatively, where the entity utilized a "Licensed Documentation Agent," there must be identified to the state of formation the name and address of that Licensed Documentation Agent and a statement of compliance with the requirements of the Statute.[33] Regardless of whether a Documentation Agent or a Licensed Documentation Agent is utilized, an entity is obligated to update its list of beneficial owners within sixty days of any change therein. Also, each LDA or DA must maintain a photocopy of the government issued I.D. of each beneficial owner.[34]

> Attorneys need to pay particular attention to S. 569 as it would make them subject to the Bank Secrecy Acts, anti-money laundering rules and the obligation to file suspicious activity reports.

Special Rules for Foreign (Non-U.S. Citizen or Permanent Resident) Owners

Each of the three proposals contains particular rules dealing with owners who either are not U.S. citizens or permanent residents. For example, both S. 569 and the Treasury Proposal require the maintenance of a photocopy of the foreign beneficial owner's passport.[35] ULEA requires the entity to maintain a photocopy of the passport of each foreign manager and a statement from each foreign owner that identifies that owner's Responsible Person.

Confidentiality/Who May Request Information

The information with respect to beneficial owners must be provided to federal and state authorities as well as certain international organizations afforded that right through treaty, typically by means of a subpoena.[36] While the ULEA does direct that the information, once conveyed to the law enforcement officers, be maintained as confidential, neither S. 569 nor the Treasury Proposal contains an equivalent directive.

Penalties for Noncompliance

Across all the proposals, the primary penalty for noncompliance is either judicial or administrative dissolution of the entity.[37] In addition, both the Treasury Proposal and S. 569 provide a civil penalty of up to $10,000 and a prison sentence of not more than three years for intentionally failing to provide beneficial owners information when requested.[38] The Treasury

Proposal includes a "no tipping" provision; the entity and its owners are not to be told that the ownership information has been sought by law enforcement.

Exemptions

Each of the acts identifies certain categories of businesses that will be exempt from its provisions. For example, both S. 569 and the Treasury Proposal exempt entities whose securities are registered pursuant to section 12 of the Securities Act of 1935.[39]

Retroactivity

As would be expected, each of the proposals has its own formula for addressing its effective date and retroactivity. For example, the Treasury Proposal requires compliance within two years after its effective date, and goes on to provide that if a person has caused there to be created ten or more entities prior to the statute's enactment, the initial transfer of an ownership interest in any of those entities after the statute's effective date will be treated as the formation of a new entity that must, as of that time, satisfy the statute's requirements.[40]

Conclusion

Irrespective of the form of the ultimate legislation that results from these efforts,[41] we should expect that significant additional costs will be incurred in the business entity formation process, the formation process will be delayed, attorneys and other professionals involved in the formation of business entities could face additional liabilities and exposures, and additional compliance costs are going to be imposed upon our clients. Attorneys need to pay particular attention to S. 569 as it would make them subject to the Bank Secrecy Acts, anti-money laundering rules and the obligation to file suspicious activity reports.[42] At the same time, whether these efforts actually will be successful in thwarting terrorist funding, money laundering and other nefarious activities is open to significant question; persons in those industries will no doubt have few scruples in submitting false information as to beneficial ownership.

Endnotes

1 This product of the National Conference of Commissioners of Uniform State Laws (NCCUSL) has not to date been promulgated for adoption by the states.

2 The Incorporation Transparency and Law Enforcement Assistance Act (S. 569) was introduced in the U.S. Senate on Mar. 11, 2009 (155 Cong. Rec. S3026–S3030); Committee on Homeland Security and Government Affairs, Hearings Held (Nov. 5, 2009).

3 While ULEA requires disclosure of record, as contrasted with beneficial ownership, this discussion will use throughout the term beneficial ownership.

4 *See also* Marcia Coyle, *Feds Want More Corporate Data*, Nat'l Law J. 1 (Jan 11, 2010).

5 The Financial Action Task Force (FATF) was organized subsequent to the G-7 Summit in 1989 as an inter-governmental body charged with the development and promotion of national and international policies intended to combat money laundering and terrorist financing. *www.fatf-gafi.org.*

6 FATF recommendation 12.

7 FATF recommendation 16.

8 FATF recommendation 33.

9 *See, e.g.,* Senate Committee on Homeland Security & Governmental Affairs Permanent Subcommittee on Investigations Hearing, "Failure to Identify Business Owners Impedes Law Enforcement," Tuesday, November 14, 2006 at 2:30 p.m. (*http://hsgac.senate.gov/public/audio_video/111406pvideo.ram*). *See also* Senate Committee on Homeland Security & Governmental Affairs Hearing, "Examining State Business Incorporation Practices: A Discussion of the Incorporation Transparency and Law Enforcement Assistance Act," Thursday, June 18, 2009 at 2:30 p.m. (*www.senate.gov/fplayers/l2009/urlPlayer.cfm?fn=govtaff061809&st=975&dur=9650*)

10 ULEA §2(11).

11 *See* S. 569, §3(a)(1)(e)(1); Treas. Prop. §3(a)(2).

12 S. 569, §§3(e)(2), 3(a)(1)(B).

13 Treas. Prop. §§3(a)(3), 3(a)(7).

14 ULEA §17.

15 Treas. Prop. §3(a)(1)(e)(3).

16 Treas. Prop. §§3(a)(4), 3(a)(8).

17 S. 569, §3(a)(1)(a)(1)(A).

18 *Id.*

19 S. 569, §3(a)(1)(a)(1)(B).

20 "Yes, we have no bananas."

21 ULEA §§3(a), (b).

22 ULEA §4(a)(2).

23 ULEA §49(a)(3); *id.* §2(a)(20).

24 ULEA §4(b).

25 ULEA §4(j).

26 ULEA §7(a)(1).

27 ULEA §7(a)(2).

28 ULEA §7(a)(3); *id.* §2(9).

29 ULEA §7(a)(5).

30 ULEA §7(a)(6).

31 ULEA §7(a)(7).

32 Treas. Prop. §3(b)(1)(a)(i).

33 Treas. Prop. §3(b)(1)(b).

34 Treas. Prop. §3(b)(1)(C).

35 S. 569, §3(a)(1)(2)(B); Treas. Prop. §3(b)(1)(C).

36 S. 569, §3(a)(1)(a)(1)(D); ULEA §15; Treas. Prop. §3(a)(1).

37 *See, e.g.,* ULEA §8; Treas. Prop. §3(b)(3)(F).

38 *See* S. 569, §3(a)(1)(a)(1)(D); Treas. Prop. §4.

39 S. 569, §3(e)(2)(B); Treas. Prop. §3(e)(2)(A).

40 Treas. Prop. §3(b)(1)(E); *id.* §(3)(b)(1)(G).

41 It is nearly a foregone conclusion that some sort of legislation will be enacted; it is rather difficult both to lobby against and for our elected representatives to vote against proposals cloaked in the public policy of thwarting terrorist funding and money laundering.

42 S. 569 §4 (amending 31 U.S.C. §5312(a)(2)).