THE LAST DAYS OF DUMMY COMPANIES

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INTRODUCTION

The use of anonymous shell companies or "dummy companies" that may be availed of to conceal the true identities of the ultimate beneficial owners is viewed by financial regulators as a tool to facilitate money laundering and the financing of terrorism. Their existence may soon become a thing of the past. The globalization of world trade and finance has meant that law enforcement agencies and other competent authorities must be able to identify the responsible individuals whenever dummy corporations are used in criminal activity, be it terrorism, drug trafficking, arms dealing, or corruption of government officials. Recently international governmental authorities have promoted the concept of beneficial ownership transparency as a major component in combatting bad actors that hide behind shells.

F.A.T.F. RECOMMENDATON 24

Following enactment of Corporate Transparency Act ("C.T.A.") and the proposed regulations published by the Financial Crimes Enforcement Network of the I.R.S. ("FinCEN") seeking to implement identification rules for determining beneficial ownership information ("B.O.I."), the Financial Action Task Force ("F.A.T.F.") adopted amendments to its Recommendation 24 on beneficial ownership earlier this month. The revisions are designed to help address the lack of beneficial ownership information that is vital for money laundering investigations.

In General

The F.A.T.F. is the intergovernmental policymaking body whose purpose is to establish international standards, and to develop and promote policies designed to combat fraud, money laundering, and the financing of terrorism. The F.A.T.F. works to generate the political will necessary to bring about national legislative and regulatory reforms to combat these international corrupt and criminal acts. There are currently 37 member countries in the F.A.T.F., including the United States, and two regional organizations – the European Commission and the Gulf Cooperation Council. The F.A.T.F. sets the global anti-money laundering standards through its 40 recommendations. More than 200 countries and jurisdictions are committed to implementing those regulations, and failure to adhere to them can have serious consequences. Countries that are black-listed or grey-listed may have challenges in accessing the global financial system.

Recommendation 24 states that countries should ensure that competent authorities such as law enforcement, financial intelligence units, and tax agencies have access to adequate, accurate, and up-to-date information on the true owners of companies operating in their country.

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According to the F.A.T.F., the amendments to Recommendation 24 are in response to evolving money laundering risks and widely publicized failures to prevent misuse of legal entities. The amendments seek to strengthen the international standards on beneficial ownership of legal entities to ensure greater transparency about their ultimate ownership and control and to mitigate the risks of their misuse. One of the concrete goals in this regard is to create an up-to-date, efficient beneficial ownership register that would be accessible to competent authorities.

Amendments

Specifically, the F.A.T.F. recommended the following action steps.

Countries should

- require companies to obtain and maintain adequate, accurate and up-to-date information on their own beneficial ownership;
- make such information available to competent authorities in a timely manner; and
- require beneficial ownership information to be held by a public authority or body functioning as beneficial ownership register or may use an alternative mechanism that provides competent authorities efficient and timely access to accurate information.

In implementing the action steps, countries should apply any supplementary measures that are deemed necessary to ensure the determination of beneficial ownership of a company. One example is the maintenance of a beneficial ownership information database using information obtained by regulated financial institutions and professionals or held by regulators or stock exchanges.

The amendments include measures to prevent legal entities from misusing bearer shares and nominee arrangements by prohibiting the issuance of new bearer shares and bearer share warrants and the conversion or immobilization of the existing ones, while setting out stronger transparency requirements for nominee arrangements.

Centralized Registers

The amended Recommendation 24 says countries should create a centralized register of the beneficial owners of companies using a public authority, but it falls short of an explicit mandate. Instead, countries may consider alternative mechanisms if those provide efficient access by competent authorities. One would be hard-pressed to come up with an effective alternative to a centralized register. the use of a wide variety of mechanisms among participating countries could impair the effectiveness of the global database of beneficial ownership information.

Risk-Based Approach for Selection of Legal Entities Subject to Reporting

Both domestic legal entities and foreign entities with sufficient links to a country should be included in assessing whether registration is required. The risk-based approach recommendation to determine which legal entities should be required to report beneficial ownership information will allow countries the flexibility to exempt certain entities from any reporting requirements.

Public Procurement

The revisions also require public authorities to collect beneficial ownership information of legal entities for purposes of public procurement. Since the U.S. federal government is the largest purchaser of goods and services in the world, this could potentially be one of the largest sources of beneficial ownership information.

Prohibiting New Bearer Shares

Bearer shares and nominee shareholder arrangements are some of the instruments used to move, hide, and launder illicitly acquired assets. Bearer shares are company shares that exist in certificate form. Whoever is in physical possession of the bearer shares is deemed to be the owner. Since the transfer of shares requires only delivery of the certificate from one individual to another, they permit anonymous transfers of control and create a serious impediment to investigations of financial crime.

The revised Recommendation 24 states that countries should prohibit the issuance of new bearer shares, as their ownership is essentially unverifiable. However, the revisions do not explicitly require the official identification of holders of existing bearer shares.

A nominee shareholder refers to the holder of shares on behalf of another person, or a beneficial owner, or the original holder of shares. The revisions call for stronger transparency requirements for nominee arrangements.

BENEFICIAL OWNER FOR C.T.A. PURPOSES

While there is no single beneficial ownership definition in F.A.T.F. Recommendation 24, the C.T.A. defines a "beneficial owner" as a natural person who

- exercises substantial control over a company,
- owns at least 25% of a company's ownership interests, or
- receives substantial economic benefits from a company's assets.

The proposed regulations from FinCEN clarify elements inherent in "substantial control." See Proposed 31 CFR 1010.380(d)(1).

The beneficial owner is the individual that exercises substantial control and receives substantial economic benefits from a company's assets. The proposed FinCEN regulations define "substantial control" using three specific indicators:

- Senior officer of a reporting company
- Authority over any officer or dominant majority of the board of directors of a reporting company
- Substantial influence over the management of any principal assets, significant contracts, major expenditures, and investments and compensation schemes for senior officers

Additionally, the proposed regulations include a "catch-all" provision to make clear that substantial control can take additional forms not specifically listed in the regulations and to prevent individuals from evading identification by hiding behind formalisms.

RESPONSIBLE PARTY FOR E.I.N. PURPOSES

The increased governmental effort to mandate corporate transparency can also be found in the changes made by the I.R.S. in connection with the term "responsible party" for purposes of obtaining an Employer Identification Number ("E.I.N."). In comparison to the meaning of the term "substantial control," the I.R.S. form adopts the term "responsible party." The terms are not identical, but they appear to be defined in similar ways.

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Definition in Instructions

According to the instructions for the current revision of Form SS-4, *Application for Employer Identification Number (EIN)*, the I.R.S. defines the term "responsible party" as follows:

> **Responsible party defined.**
>
> The "responsible party" is the person who ultimately owns or controls the entity or who exercises ultimate effective control over the entity. The person identified as the responsible party should have a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets. **Unless the applicant is a government entity, the responsible party must be an individual (that is, a natural person), not an entity.**
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> - For entities with shares or interests traded on a public exchange, or which are registered with the Securities and Exchange Commission, "responsible party" is (a) the principal officer, if the business is a corporation, (b) a general partner, if a partnership. The general requirement that the responsible party be an individual applies to these entities. For example, if a corporation is the general partner of a publicly traded partnership for which Form SS-4 is filed, then the responsible party of the partnership is the principal officer of the corporation.

Definition on I.R.S. Website

However, the I.R.S. website[1] provides an enhanced definition of the term "responsible party" which approaches the definition of the term "beneficial owner" for purposes of the C.T.A. by emphasizing that a nominee cannot be a responsible party.

> **Nominees**
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> A "nominee" is someone who is given limited authority to act on behalf of an entity, usually for a limited period of time, and usually during the formation of the entity. The "principal officer, general partner," etc., as defined by the IRS, is the true "responsible party" for the entity, instead of a nominee. The "responsible party" is the individual or entity that controls, manages, or directs the entity and the disposition of the entity's funds and assets, unlike a nominee,

[1] See here.

who is given little or no authority over the entity's assets.

The Internal Revenue Service has become aware that nominee individuals are being listed as principal officers, general partners, grantors, owners, and trustors in the Employer Identification Number (EIN) application process. A nominee is not one of these people. Rather, nominees are temporarily authorized to act on behalf of entities during the formation process. The use of nominees in the EIN application process prevents the IRS from gathering appropriate information on entity ownership, and has been found to facilitate tax non-compliance by entities and their owners.

The IRS does not authorize the use of nominees to obtain EINs. All EIN applications (mail, fax, electronic) must disclose the name and Taxpayer Identification Number (SSN, ITIN, or EIN) of the true principal officer, general partner, grantor, owner or trustor. This individual or entity, which the IRS will call the "responsible party," controls, manages, or directs the applicant entity and the disposition of its funds and assets.

To properly submit a Form SS-4, the form and authorization should include the name, Taxpayer Identification Number and signature of the responsible party. Third party designees filing online applications are reminded of their obligation to retain a complete signed copy of the paper Form SS-4 and signed authorization statement for each entity application filed with the IRS. Nominees do not have the authority to authorize third party designees to file Forms SS-4, and should not be listed on the Form SS-4.

CONCLUSION

Overall, the amendments made to Recommendation 24 significantly strengthen the F.A.T.F. standards, and in so doing, enables competent authorities in countries and territories to tackle money laundering and terrorist financing around the world. As the U.S. faces new national security threats and increased focus on Russian ownership of shell companies, and the real property and other assets owned by overseas entities, there is renewed political urgency to act against anonymous ownership of companies. The likelihood of success for the F.A.T.F. recommendations will depend on how effectively and timely they are implemented. The details, the method of enforcement, are all hugely important, and are yet to be worked out.

In the U.S., significant steps have been taken towards implementation through the proposed FinCEN regulations on beneficial owner and the I.R.S. website advising that the responsible party for E.I.N. purposes will be the same person who is considered the beneficial owner for C.T.A. purposes. The definitions and specific indicators of substantial control under the proposed FinCEN regulations means that a person who exercises substantial control and receives substantial economic benefits from a company's assets is likely the proper person to be the responsible party for purposes of obtaining an E.I.N. Nominees are not welcome.