

# BACKGROUND

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## Beneficial Ownership Reporting Regime Targets Small Businesses and Religious Congregations

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### Abstract

*The 115th Congress is seriously considering imposing a beneficial ownership reporting regime on American businesses and other entities—including charities and churches. The legislation would create a large compliance burden on businesses with 20 or fewer employees (the only non-exempt category) and would create as many as one million inadvertent felons. Religious organizations, charities, and other exempt entities and their employees would be subject to fines and imprisonment unless they file the proper certification of exemption with the Financial Crimes Enforcement Network. The rules are easily and lawfully avoided by the sophisticated—and would do virtually nothing to achieve their stated aim of protecting society from terrorism or other forms of illicit finance. Furthermore, the vast majority of the information that the proposed reporting regime would obtain is already provided to the Internal Revenue Service (IRS). Allowing the IRS to share this information with the Treasury Department's Financial Crimes Enforcement Network would better meet the needs of law enforcement by providing more comprehensive information and better enforcement than would the proposed reporting regime.*

### Introduction

The 115th Congress is seriously considering imposing a beneficial ownership reporting regime on American businesses and other entities, including charities and churches. Two House subcommittee chairmen recently released a discussion draft of legislation,<sup>1</sup> and legislation has been introduced in both the House<sup>2</sup> and the Senate.<sup>3</sup> Hearings have been held in both houses.<sup>4</sup> In addition, both the Organization for Economic Co-operation and Development (OECD),<sup>5</sup> of

### KEY POINTS

- Congress is considering imposing a beneficial ownership reporting regime on all American businesses and other entities—including charities and churches.
- The legislation would create a large compliance burden on businesses with 20 or fewer employees (the only non-exempt category) and would create as many as one million inadvertent felons.
- Religious organizations, charities, and their employees would be subject to fines and imprisonment unless they file the proper forms with the Financial Crimes Enforcement Network.
- The rules are easily and lawfully avoided by the sophisticated—and would do virtually nothing to achieve their stated aim of protecting society from terrorism or other forms of illicit finance.
- Furthermore, the vast majority of the information that the proposed reporting regime would obtain is already provided to the Internal Revenue Service, which Congress could authorize to share with the Financial Crimes Enforcement Network.

This paper, in its entirety, can be found at <http://report.heritage.org/bg3289>

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which the U.S. is a member, and the European Union are pushing member governments to adopt such a regime.<sup>6</sup>

The discussion draft and the House and Senate bills are very similar proposals that share three salient characteristics. First, they would impose a large compliance burden on the private sector, primarily on small businesses, charities, and religious organizations. Second, they create hundreds of thousands—potentially more than one million—inadvertent felons out of otherwise law-abiding citizens. Third, they do virtually nothing to achieve their stated aim of protecting society from terrorism or other forms of illicit finance. The proposals make lawful avoidance and unlawful evasion quite easy.

Furthermore, the creation of this expensive and socially damaging reporting edifice is unnecessary. The vast majority of the information that the proposed beneficial ownership reporting regime would obtain is *already* provided to the Internal Revenue Service. Simply creating a database based on information provided to the IRS and allowing the IRS to share this information with the Treasury Department’s Financial Crimes Enforcement Network (FinCEN)<sup>7</sup> would better meet the needs of law enforcement by providing more comprehensive

information and better enforcement than would the proposed beneficial ownership reporting regimes.

This *Backgrounder* (1) explains the various proposed beneficial ownership reporting regimes (with a primary focus on the discussion draft); (2) explores the adverse effects they would have; (3) explains the highly limited effectiveness such a regime would have on terrorism, money laundering, and other illicit finance; (4) discusses the FinCEN Customer Due Diligence Requirements for Financial Institutions rule (effective May 11, 2018); (5) explains how limited the reduction in financial institution costs may be under the discussion draft; (6) examines the impact on financial privacy; (7) examines briefly the experience with beneficial ownership reporting in other countries; and (8) proposes in detail a much less expensive and less socially damaging alternative that would also provide law enforcement with better, more comprehensive, and more reliable information.

## A Description of the Pearce Proposed Beneficial Ownership Reporting Regime

There are three similar proposals in Congress to establish a beneficial ownership reporting regime in the United States. The Corporate Transparency Act of 2017 has been introduced in the House by Rep-

1. Counter Terrorism and Illicit Finance Act, Discussion Draft, 115th Congress, 1st Sess., <https://financialservices.house.gov/uploadedfiles/bills-115hr-pih-ctifa.pdf> (accessed February 21, 2018).
2. The Corporate Transparency Act of 2017, H.R. 3089, 115th Congress, 1st Sess., <https://www.congress.gov/bill/115th-congress/house-bill/3089/text> (accessed February 21, 2018). Representative Carolyn Maloney (D-NY) and Senators Ron Wyden (D-OR) and Marco Rubio (R-FL) have introduced a companion bill in the Senate (S. 1717). See news release, “Wyden, Rubio Unveil Bill to Increase Transparency, Crack Down on Illicit Financial Crimes,” Senate Finance Committee, August 3, 2017, <https://www.finance.senate.gov/ranking-members-news/wyden-rubio-unveil-bill-to-increase-transparency-crack-down-on-illicit-financial-crimes-> (accessed February 21, 2018).
3. The True Incorporation Transparency for Law Enforcement Act or TITLE Act, S. 1454, 115th Congress, 1st Sess., <https://www.congress.gov/bill/115th-congress/senate-bill/1454/text> (accessed February 21, 2018).
4. Joint Hearing, *Legislative Proposals to Counter Terrorism and Illicit Finance*, Subcommittee on Financial Institutions and Consumer Credit and Subcommittee on Terrorism and Illicit Finance, Committee on Financial Services, U.S. House of Representatives, 115th Congress, 1st Sess., November 29, 2017, <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402691> (accessed February 21, 2018), and Hearing, *Beneficial Ownership: Fighting Illicit International Financial Networks Through Transparency*, Judiciary Committee, U.S. Senate, 115th Congress, 2nd Sess., February 6, 2018, <https://www.judiciary.senate.gov/meetings/beneficial-ownership-fighting-illicit-international-financial-networks-through-transparency> (accessed February 21, 2018).
5. Specifically, the OECD’s Financial Action Task Force (FATF) which, among other things, blacklists jurisdictions it deems insufficiently compliant with FATF’s dictates.
6. The Financial Action Task Force, “International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation,” §§ 10-13 and 24-25, November 2017, <http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf> (accessed February 21, 2018); Journal of the European Union, §§ 10-13 (Customer Due Diligence) and §§ 24-25 (Transparency and Beneficial Ownership of Legal Persons and Arrangements); and Directive 2015/849 of the European Parliament and of the Council, May 20, 2015, Article 14, effective June 26, 2017, [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L\\_0003&from=ES](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_0003&from=ES) (accessed February 21, 2018) (the “Fourth Anti-Money Laundering Directive”).
7. FinCEN, “What We Do,” <https://www.fincen.gov/what-we-do> (accessed February 21, 2018).

representative Carolyn Maloney (D-NY).<sup>8</sup> The True Incorporation Transparency for Law Enforcement Act (or TITLE Act) has been introduced by Senator Sheldon Whitehouse (D-RI) in the Senate.<sup>9</sup> Representative Stevan Pearce (R-NM), Chairman of the Terrorism and Illicit Finance Subcommittee of the House Financial Services Committee, and Representative Blaine Luetkemeyer (R-MO), Chairman of the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee, recently released a discussion draft of legislation called the Counter Terrorism and Illicit Finance Act.<sup>10</sup> Representative Pearce is the lead sponsor. Section 9 of the discussion draft would create a beneficial ownership reporting regime that is the focus of the discussion in this section. However, analogous provisions in the Whitehouse and Maloney bills are cited in the footnotes.

The discussion draft would require all newly formed corporations and limited liability companies to report to FinCEN the beneficial ownership of the firm and, among other things, the driver's license or passport numbers of those owners.<sup>11</sup> The firm would be required to update this information within 60 days of any change.<sup>12</sup> All *existing* firms would be subject to these requirements within two years.<sup>13</sup> Failure to comply would result in fines of up to \$10,000 or three years in prison.<sup>14</sup>

The proposed regime would then "exempt" from the beneficial ownership reporting regime those firms most able to engage in money launder-

ing activities or otherwise facilitate illicit finance. Those exempt include: (1) public companies, (2) government-sponsored enterprises, (3) banks and credit unions, (4) broker-dealers, (5) exchanges and clearing houses, (6) investment companies, (7) insurance companies, (8) commodities firms, (9) public accounting firms, (10) utilities, (11) most tax-exempt organizations, and (12) firms with more than 20 employees and gross receipts greater than \$5 million.<sup>15</sup>

Even these exempt entities, however, would be required to file a certification with FinCEN explaining why they are exempt.<sup>16</sup> Otherwise they would be in non-compliance, subject to fines or imprisonment. In other words, because the exemptions are not self-effectuating, even exempt firms are not truly exempt and must file with FinCEN. They would not, however, be required to report their beneficial ownership. The only firms subject to the full reporting regime are corporations and Limited Liability Companies (LLCs) with 20 or fewer employees or receipts under \$5 million.

The reporting requirements do not define beneficial owner consistent with normal legal principles or an ordinary person's conception of ownership. Under the proposed regime, beneficial owners would include someone who (1) "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise exercises substantial control over a corporation or limited liability company" or (2) "receives substantial economic benefits from the assets of a

8. The Corporate Transparency Act of 2017. A companion bill (S. 1717) has been introduced in the Senate by Senators Ron Wyden and Marco Rubio.

9. The Corporate Transparency Act of 2017, and The True Incorporation Transparency for Law Enforcement Act are extremely similar but not identical.

10. Counter Terrorism and Illicit Finance Act.

11. Counter Terrorism and Illicit Finance Act, proposed § 5333(a)(1)(A); The True Incorporation Transparency for Law Enforcement Act, proposed § 531(a)(1)(A); and The Corporate Transparency Act of 2017, proposed § 5333(b)(1)(A).

12. Counter Terrorism and Illicit Finance Act, proposed § 5333(a)(1)(B); The True Incorporation Transparency for Law Enforcement Act, proposed § 531(a)(1)(B)(i); and The Corporate Transparency Act of 2017, proposed § 5333(b)(1)(B)(i).

13. Counter Terrorism and Illicit Finance Act, proposed § 5333(a)(3)(B); The True Incorporation Transparency for Law Enforcement Act, proposed § 531(a)(3)(B); and The Corporate Transparency Act of 2017, proposed § 5333(b)(4)(B).

14. Counter Terrorism and Illicit Finance Act, proposed § 5333(c); The True Incorporation Transparency for Law Enforcement Act, proposed § 531(b)(2); and The Corporate Transparency Act of 2017, proposed § 5333(c)(2).

15. Counter Terrorism and Illicit Finance Act, proposed § 5333(d)(2)(C), and The True Incorporation Transparency for Law Enforcement Act, proposed § 5333(d)(2)(C). Unlike The Corporate Transparency Act of 2017, The True Incorporation Transparency for Law Enforcement Act (proposed § 531(d)(2)(B)) also requires the firm to have more than 100 shareholders.

16. Counter Terrorism and Illicit Finance Act, proposed § 5333(a)(3)(A) and § 5333(a)(3)(B). See also The True Incorporation Transparency for Law Enforcement Act proposed § 531(a)(3) and The Corporate Transparency Act of 2017, proposed § 5333(b)(4), except that the certification is to be filed with the state rather than FinCEN.

corporation or limited liability company.”<sup>17</sup> A person is treated as receiving substantial economic benefit if that person has “an entitlement to the funds or assets of the corporation or limited liability company that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the corporation or limited liability company.”<sup>18</sup>

The proposal contains poorly drafted “look-through” rules, both explicit<sup>19</sup> and implied, but the application of these rules is not clear. In the absence of such rules, the entire reporting regime could be easily avoided through the simple expedient of having a corporation or LLC own a corporation or LLC. The discussion draft rules presumably require corporations and LLCs with owners that are also corporations or LLCs to report on the beneficial ownership (as defined) of the corporation or LLC that has: (1) ownership interest in, (2) directly or indirectly exercises substantial control over, or (3) receives substantial economic benefit from the reporting corporation or LLC.

Thus, for example, a non-exempt firm that had an investment from a venture capital fund would presumably have to obtain information and report on the beneficial ownership of the venture capital fund and report any changes to the venture capital fund’s ownership. How the entrepreneurial firm would be able to secure regular updates from its venture capital fund investor so as to make new filings with FinCEN within the required 60 days regarding change of ownership in the venture capital firm is left unexplained—even though failure to do so would be a felony. The entrepreneur would have no legal means of compelling compliance by the venture capital fund. It is particularly unclear how this would be accomplished if the investing corporation (the venture cap-

ital firm, for example) is exempt and not required to report its beneficial ownership. In fact, exempt firms may not even *know* their beneficial ownership (as defined in the legislation).

Most of the reporting obligations are imposed on “applicants,” but this term is not defined, and who is actually to be treated as the applicant is quite unclear. Under state law, the person who forms a business entity is typically known as an incorporator, organizer, or authorized person, and that person often has no continuing role in the business and does not exercise any degree of control or receive any economic benefit. For ongoing reporting purposes, it is even more unclear who would be responsible as the applicant.

The most important difference between the discussion draft and Whitehouse and Maloney bills is that the discussion draft contemplates FinCEN playing the primary administrative role while the latter contemplate the states playing the primary administrative role (and would provide federal funding to the states).<sup>20</sup> Because most state laws treat corporate filings as public, the Whitehouse and Maloney bills would effectively make beneficial ownership reports public.<sup>21</sup> The FinCEN database in the discussion draft would not be accessible by the public. The Maloney bill also contemplates the licensing of “formation agents.”<sup>22</sup> Fines of up to \$1 million are permitted in the Whitehouse bill.<sup>23</sup>

### **The Problems the Proposed Beneficial Ownership Reporting Regime Would Cause**

The primary burden created by the proposed reporting regime is on firms with 20 or fewer employees or less than \$5 million in gross receipts. These are the firms least able to absorb yet another increase

17. Counter Terrorism and Illicit Finance Act, proposed § 5333(d)(1)(A); The True Incorporation Transparency for Law Enforcement Act, proposed § 531(d)(1); and The Corporate Transparency Act of 2017, proposed § 5333(d)(1).

18. Counter Terrorism and Illicit Finance Act, proposed § 5333(d)(1)(C); The True Incorporation Transparency for Law Enforcement Act, proposed § 531(d)(1); and The Corporate Transparency Act of 2017, proposed § 5333(d)(1).

19. Counter Terrorism and Illicit Finance Act, proposed § 5333(a)(3)(C). See also The True Incorporation Transparency for Law Enforcement Act, proposed § 531(d), and The Corporate Transparency Act of 2017, proposed § 5333(d).

20. See The True Incorporation Transparency for Law Enforcement Act, proposed § 531(a)(1) and § 3(b), and The Corporate Transparency Act of 2017, proposed § 5333(b) and § 3(b). Each would authorize a maximum of \$40 million annually in payments to the states.

21. National Association of Secretaries of State, “State Incorporation: Collection of Company Ownership Info,” <http://www.nass.org/initiatives/state-incorporation-collection-company-ownership-info> (accessed February 21, 2018) (“Entity information filed with the state business registry is public information, thus beneficial ownership information filed with the state would be public information.”).

22. The Corporate Transparency Act of 2017, proposed § 5333(b)(2).

23. The True Incorporation Transparency for Law Enforcement Act, proposed § 531(b)(2)(A).

in the regulatory burden imposed by the federal government. As should be evident from the brief description in the section above, determining who is and is not a “beneficial owner” under the proposal is complex, highly ambiguous, and would often require hiring counsel or a compliance expert. In fact, it would probably take a decade or more of prosecutions and litigation before the meanings of “beneficial owner,” “substantial control as a practical matter,” “substantial economic benefit,” “an entitlement to the funds or assets,” and “directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise” are reasonably well established. Defending these cases would be expensive and would in many cases economically destroy the small business and business owner who must defend themselves against the federal government.

Even “exempt” entities, however, must file a certification with FinCEN establishing why they are exempt and providing specified information.<sup>24</sup> Otherwise they would be non-compliant and subject to fines and imprisonment. Large firms and governments have the resources to know how to comply and to accurately file these certifications with FinCEN. Small charities and religious congregations do not. The typical church treasurer or pastor<sup>25</sup> does not keep up with the latest anti-money-laundering laws and regulations any more than does the local baker, restaurateur, or Main Street store owner.

Once two years has elapsed, the requirements would apply to all existing corporations and LLCs.

Thus, for example, a local church or charity that is incorporated (most are) would be required to file with FinCEN a certification establishing that it was exempt by asserting the exemption provided in proposed section § 5333(d)(2)(C)(xii). Churches and most other religious organizations do not have to file a Form 990 annually with the IRS. But they would be required to file an exemption certification with FinCEN and update the relevant personnel changes within 60 days or face fines or imprisonment. It is extremely unclear who would be treated as an “applicant” for existing incorporated churches, since the term applicant is not defined and is not a legal concept under state corporate or association law.

Every small business in America would need to either file the beneficial ownership report or, if the business is in an exempt category, file a certification with FinCEN asserting the exemption. Most would not be exempt. In the case of small firms that have other entities as investors, the reporting burden may be quite high. An entire army of compliance experts and lawyers would develop to explain these rules and how to file with FinCEN.

According to the IRS Statistics of Income, there are about 5.9 million corporate tax returns (about 5.6 million of which had gross receipts under \$5 million),<sup>26</sup> 4.3 million S-corporation returns,<sup>27</sup> and 2.4 million LLC tax returns filed annually.<sup>28</sup> About 200,000 501(c)(3) organizations<sup>29</sup> filed Form 990s.<sup>30</sup> In addition, there are other tax-exempt organizations and about 350,000 religious congregations<sup>31</sup> that are not required to file

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24. Counter Terrorism and Illicit Finance Act, proposed § 5333(a)(3)(A). See also The True Incorporation Transparency for Law Enforcement Act, proposed § 531(a)(3), and The Corporate Transparency Act of 2017, proposed § 5333(b)(4).
  25. It is not clear which would be deemed the “applicant” for reporting purposes, especially continuing reporting.
  26. Internal Revenue Service, “Corporate Income Tax Returns, Tax Year 2013,” <https://www.irs.gov/pub/irs-soi/13CorporateReturnsOneSheet.pdf> (accessed February 21, 2018), and Internal Revenue Service, “Returns of Active Corporations: Table 5, Selected Balance Sheet, Income Statement, and Tax Items, by Sector, by Size of Business Receipts, Tax Year 2013,” <https://www.irs.gov/pub/irs-soi/13co05ccr.xls> (accessed February 21, 2018).
  27. Internal Revenue Service, “Returns of Active Corporations, Form 1120S, Table 1, S-Corporations: Total Receipts and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Major Industry Tax Year 2013,” <https://www.irs.gov/pub/irs-soi/13co01s.xls> (accessed February 21, 2018).
  28. Internal Revenue Service, “Partnership Returns, 2014,” <https://www.irs.gov/pub/irs-soi/14PartnershipsOneSheet.pdf> (accessed February 21, 2018).
  29. Internal Revenue Code, § 501(c)(3) provides a tax exemption for organizations “operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.” Contributions to these organizations are generally tax deductible under Internal Revenue Code § 170(c)(2).
  30. Internal Revenue Service, “Form 990 Returns of 501(c)(3) Organizations: Balance Sheet and Income Statement Items, by Asset Size, Tax Year 2014,” <https://www.irs.gov/pub/irs-soi/14eo01.xls> (accessed February 21, 2018).
  31. U.S. Religion Census, “2010: Summary Findings, Association of Statisticians of American Religious Bodies,” May 1, 2012, [http://www.usreligioncensus.org/press\\_release/ACP%2020120501.pdf](http://www.usreligioncensus.org/press_release/ACP%2020120501.pdf) (accessed February 21, 2018).
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annual information returns.<sup>32</sup> Therefore, roughly, 12 million corporations or LLCs are likely to be subject to the new reporting regime. If even only *10 percent* are unaware of this new requirement and fail to file with FinCEN, two years after enactment there would be over one million small business owners, religious congregations, and charities in non-compliance, subject to fines and imprisonment.

These figures also give a sense of the scale of the compliance industry that would develop and the costs that would be incurred. Assuming, probably heroically, that a small business owner can, on average, read and become familiar with these rules and file the relevant form in one hour, then the number of compliance hours would be 12 million hours. Monetized at \$50/hour (which is a very low, fully burdened rate for management), the compliance costs would be \$600 million. If, more realistically, you assume a greater compliance time or a higher hourly rate or that one engages outside counsel or compliance experts (which is likely for many, given the ambiguities discussed above), then the likely cost would be well over \$1 billion annually and quite likely many billions of dollars.

### **The Limited Effectiveness of the Proposed Beneficial Ownership Reporting Regime**

Successful money launderers are typically sophisticated. They can lawfully avoid the requirements of the proposed reporting regime quite easily. It does not apply to partnerships (general partnerships, limited partnerships, limited liability partnerships) and business trusts. Therefore, to avoid the application of these rules, they need only form a partnership or a business trust instead of a corporation or LLC. Alternatively, they could buy a business that meets one of the exemption requirements (e.g., gross receipts over \$5 million and/or 21 or more employees) and file a certification of exemption with FinCEN and lawfully not report. As discussed above,

the look-through rules applicable when entities own entities are opaque, extremely unclear, potentially unworkable, and highly burdensome. But if it is ultimately determined that a non-exempt entity can have another entity own it without reporting on the beneficial ownership of the owning entity, then the requirements could be lawfully avoided by simply having a two-tier corporate structure.

Money launderers and others could also illegally evade the system rather easily by simply filing partial but false beneficial ownership reports—or not filing at all. Unless FinCEN is going to start routinely auditing firms (expending a great many federal tax dollars and imposing large costs on law-abiding firms), then this is a low-risk evasion strategy. The maximum of \$40 million in funding contemplated in the legislation is vastly too low to support non-trivial audit rates on roughly 12 million entities.

In fiscal year 2016, the Internal Revenue Service audited 21,136 C-corporation tax returns and 30,514 partnership or S-corporation tax returns.<sup>33</sup> The IRS audit rate for C corporations was 1.1 percent and for pass-through entities less than 0.4 percent.<sup>34</sup> The IRS has an enforcement budget of approximately \$4.7 billion, although only a portion of this relates to business tax returns.<sup>35</sup> The contemplated \$40 million budget is less than one percent of the IRS enforcement budget, and the bulk of the \$40 million would not be spent on enforcement but on simply administering the system and maintaining the database. Thus, unless the FinCEN budget is dramatically increased, the chance of FinCEN detecting inaccurate filings would be extremely low.<sup>36</sup>

To the author's knowledge, there is no actual evidence (as opposed to bare assertions or anecdotes) that the beneficial ownership reporting regimes in other countries have had any material effect on money laundering or terrorism. But the relevant question is not whether they have had *any* impact but whether they have improved non-tax law enforcement in a cost-effective manner. Since the tax infor-

32. Internal Revenue Code, § 6033(a)(3). See also Internal Revenue Service, "Annual Exempt Organization Return: Who Must File," <https://www.irs.gov/charities-non-profits/annual-exempt-organization-return-who-must-file> (accessed February 21, 2018).

33. Internal Revenue Service, *2016 Data Book*, "Table 9a: Examination Coverage: Recommended and Average Recommended Additional Tax After Examination by Type and Size of Return, Fiscal Year 2016," <https://www.irs.gov/pub/irs-soi/16databk.pdf> (accessed February 21, 2018).

34. *Ibid.*

35. Internal Revenue Service, *2016 Data Book*, "Table 28: Costs Incurred by Budget Activity, Fiscal Years 2015 and 2016," <https://www.irs.gov/pub/irs-soi/16databk.pdf> (accessed February 21, 2018).

36. The same would be true with respect to state authorities in the case of the Maloney or Whitehouse bills.

mation is already available to the IRS (to the extent firms are compliant with the U.S. tax-reporting requirements),<sup>37</sup> the only gain to be had for the U.S. from the proposed regime is with respect to non-tax law enforcement.

The existing anti-money-laundering (AML) regime is extraordinary expensive. The AML regime costs an estimated \$4.8 billion to \$8 billion annually.<sup>38</sup> Yet this AML system results in fewer than 700 convictions annually, a substantial proportion of which are simply additional counts against persons charged with other predicate crimes. It costs *at least* \$7 million per conviction and potentially many times that.<sup>39</sup> There is a need to engage in a serious cost-benefit analysis of the AML regime and its constituent parts before adding yet another poorly conceived requirement that burdens the smallest businesses in the country. Yet a serious cost-benefit analysis of the AML has *never* been undertaken by the U.S. government.<sup>40</sup>

### **FinCEN's Customer Due Diligence Requirements for Financial Institutions**

In 2016, FinCEN finalized its “Customer Due Diligence Requirements for Financial Institutions” rule with which covered financial institutions must comply by May 11, 2018.<sup>41</sup> Covered financial institutions must identify and verify the identity of the major beneficial owners of all legal entity customers (other than those that are excluded; generally, other financial institutions and public accounting firms) at the time a new account is opened.<sup>42</sup> Thus, unlike the congressional proposals, it would apply only to new accounts. The identification and verification procedures for beneficial owners are very similar

to existing rules for individual customers under a financial institution's customer identification program. Financial institutions may generally satisfy this requirement by having the customer fill out a form specified in FinCEN regulations.<sup>43</sup>

One of the stated reasons for the proposed beneficial ownership reporting regime is to alleviate the burden on financial institutions caused by the FinCEN Customer Due Diligence (CDD) regulation. The objective is to shift the costs imposed on financial institutions caused by this rule onto small firms and, to a lesser extent, government.<sup>44</sup> The desirability of this policy objective is questionable. The discussion draft, for example, would accomplish this objective by suspending the CDD rule until it is revised to be consistent with the new law.

The FinCEN rule is problematic for many of the same reasons that the discussion draft and the Maloney and Whitehouse bills are. Instead of simply shifting those problems from banks to small firms and tax-exempt organizations, policymakers should target the source of the problem—the FinCEN rule. A moratorium should be placed on the implementation of the rule by Congress, and the Trump Administration should withdraw the rule.

### **The Failure of the Proposal to Substantially Reduce the Compliance Burden on Financial Institutions**

The only definite cost savings for financial institutions from Section 9 of the discussion draft is from the temporary suspension of implementation of the CDD rule until a revised rule is promulgated.<sup>45</sup> Beyond that, the magnitude of savings to financial

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37. If the corporation or LLC is non-compliant with the tax law, there is no reason to believe they would be compliant with a beneficial ownership reporting regime that has vastly fewer enforcement resources.

38. David R. Burton and Norbert J. Michel, “Financial Privacy in a Free Society,” Heritage Foundation *Backgrounder* No. 3157, September 23, 2016, <http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf>.

39. Burton and Michel, “Financial Privacy in a Free Society.”

40. To the author's knowledge, “Financial Privacy in a Free Society” provides the first quantitative estimates of the aggregate cost of the U.S. AML regime.

41. “Customer Due Diligence Requirements for Financial Institutions,” Final Rules, Department of the Treasury, Financial Crimes Enforcement Network, *Federal Register*, Vol. 81, No. 91 (May 11, 2016), pp. 29398–29453.

42. 31 CFR § 1010.23(b)(1).

43. *Ibid.*, “Appendix A: Certification Regarding Beneficial Owners of Legal Entity Customers,” [https://www.fincen.gov/sites/default/files/shared/CDD\\_Rev6.7\\_Sept\\_2017\\_Certificate.pdf](https://www.fincen.gov/sites/default/files/shared/CDD_Rev6.7_Sept_2017_Certificate.pdf) (accessed February 21, 2018).

44. See Lalita Clozel, “Banks Seek Government Help to Track Money Laundering: Industry, Anticorruption Groups Support Creating a Treasury-Run Database of Corporations and their Owners,” *Wall Street Journal*, January 9, 2018.

45. Counter Terrorism and Illicit Finance Act, § 9(a)(3)(B).

institutions would be a function of what FinCEN chooses to do in its revised rule. The legislation requires the Treasury Department to “revise the final rule...as necessary to conform with this Act, the amendments made by this Act, and the regulations issued under paragraph (2),” which in turn requires the Treasury Department to “issue regulations to carry out this Act and the amendments made by this Act.”<sup>46</sup> Given FinCEN’s history, a minimal consideration of private costs incurred is to be expected as the regulation is revised.<sup>47</sup> The justified concern about the costs and inadequate benefits of the FinCEN rule could better be addressed simply by placing a permanent moratorium on the rule. Countering FinCEN’s overreach does not require imposing large costs on small firms and civil society.

### Financial Privacy Concerns

Privacy, both financial and personal, is a key component of life in a free society. Unlike in totalitarian or authoritarian regimes, individuals in free societies have a private sphere free of government involvement, surveillance, and control. The United States Constitution’s Bill of Rights, particularly the Fourth, Fifth, and Ninth Amendments, together with structural federalism and separation of powers protections, is designed to further that end by protecting individual rights.

In general, individuals should have control over who has access to information about their personal and financial lives. Individuals should be free to lead their lives unmolested and unsurveilled by government—unless there is a reasonable suspicion that they have committed a crime or conspired to commit a crime.

Many government agencies, in both the U.S. and other countries, are currently involved in collecting and disseminating private individuals’ information for the purpose of conducting their national security, law enforcement, and tax administration functions. The unique requirements for fulfilling each of these purposes dictate certain policy choices for

designing an optimal financial-privacy regime. The current U.S. framework is overly complex and burdensome, and its *ad hoc* nature has likely impeded efforts to combat terrorism, enforce laws, and collect taxes. The proposed beneficial ownership reporting regime would add substantially to the complexity and burden of the existing AML and tax information-reporting regime. It would, however, do little to further law enforcement objectives.

Financial privacy is especially vital because it can be the difference between survival and systematic suppression of an opposition group in a country with an authoritarian government. Many businesses, dissidents, and human rights groups maintain accounts outside the countries where they are active for precisely this reason. Any information-sharing regime must include serious safeguards to protect the privacy of individuals and businesses. There are no meaningful privacy rights protections in the congressional proposals, and if the information were shared with hostile or corrupt foreign governments, it could do real harm. Given information-sharing arrangements that the U.S. government is currently contemplating (and that the Executive Branch supports), this is entirely possible.<sup>48</sup>

### An Alternative Approach

The alternative approach would require the Internal Revenue Service to compile a beneficial ownership database based on information already provided to the agency in the ordinary course of tax administration—and to share the database information with FinCEN. The database would be compiled from information provided on six Internal Revenue Service forms:

1. SS-4 (Application for Employer Identification Number);
2. 1065 (Schedule K-1: Partner’s Share of Income, Deductions, Credits, etc.);<sup>49</sup>

46. Counter Terrorism and Illicit Finance Act, §§ 9(a)(2) and 9(a)(3).

47. Based on the author’s conversations with FinCEN personnel, there is some reason to believe that this may change under the current administration.

48. David R. Burton, “Two Little Known Tax Treaties Will Lead to Substantially More Identity Theft, Crime, Industrial Espionage, and Suppression of Political Dissidents,” Heritage Foundation *Background* No. 3087, December 21, 2015, <http://thf-reports.s3.amazonaws.com/2015/BG3087.pdf>, and Burton and Michel, “Financial Privacy in a Free Society.”

49. Form 1065 is the annual tax return filed by partnerships, including limited liability companies.

3. 1120S (Schedule K-1: Shareholder's Share of Income, Deductions, Credits, etc.);<sup>50</sup>
4. 1041 (Schedule K-1: Beneficiary's Share of Income, Deductions, Credits, etc.);<sup>51</sup>
5. 1099 DIV (Dividends and Distributions); and
6. 8822-B (Change of Address or Responsible Party: Business).

With this information, the ownership of every business in America and each business' responsible party would be available to FinCEN, with the exception of non-dividend-paying C corporations.

Specifically, line 7a of Form SS-4 requires the applicant to identify the "responsible party," which the IRS defines as "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." This, of course, is similar to one of three prongs (the substantial economic benefit prong) of the beneficial ownership definition in the proposed reporting regime. Form 8822-B requires this information to be updated. Schedule K-1s require S corporations and partnerships (including LLCs and business trusts) to report their owners and the owners' tax numbers and addresses. Any C corporation that pays dividends to shareholders must report the payment along with the shareholders' tax numbers and addresses on Form 1099-DIV.<sup>52</sup> If policymakers feel that reporting by non-dividend-paying C cor-

porations was required, such a provision could be adopted.<sup>53</sup>

This alternative approach would also enable FinCEN to look through entities that have ownership in other entities. The only exception to this would be foreign entities that own interests in U.S. entities. Tax reporting (and withholding) as well as various statutes governing foreign investments in the United States provide substantial information that could be added to the database, but policymakers, after careful consideration, may determine that this information needs to be augmented.

This approach would provide more comprehensive information to FinCEN than the proposed reporting regime. Furthermore, the social cost of this approach—creating a database based on information already provided to the IRS—would be a very small fraction of the approach contemplated in the proposed reporting regime. The increase in private compliance costs would be negligible since the information is currently reported for tax purposes,<sup>54</sup> and the alternative approach outlined here would not create a large class of inadvertent felons out of small business owners and church treasurers or pastors.

It almost certainly would reduce federal administrative costs compared to those contemplated in the discussion draft.<sup>55</sup> Reformatting and sharing existing information should require dramatically fewer resources than creating, administering, and enforcing an entirely new reporting system.

To implement this approach, Internal Revenue Code § 6103(i) ("Disclosure to federal officers or employees for administration of federal laws not relating to tax administration") would need to be amended to allow the IRS to share the information with FinCEN and to govern what FinCEN could then do with the information.<sup>56</sup>

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50. Form 1120A is the annual tax return filed by S corporations.

51. Form 1041 is the annual tax return filed by trusts.

52. There would be an issue in connection with stock held in street name by broker-dealers. 1099-DIVs provided by broker-dealers to their customers and the IRS could be made part of the database.

53. Non-dividend paying C-corporation stock held in street name by broker-dealers would have to be part of such a requirement if the aim were comprehensive coverage. Of course, under the Congressional proposals, C-corporations with more than 20 employees would be exempt.

54. Compliance costs associated with the tax system are quite high—an estimated \$409 billion annually. About two-thirds of this is borne by businesses. See Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation *Fiscal Fact* No. 512, June 2016, [https://files.taxfoundation.org/legacy/docs/TaxFoundation\\_FF512.pdf](https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF512.pdf) (accessed February 21, 2018).

55. Counter Terrorism and Illicit Finance Act, § 9(b)(3).

56. International information sharing with foreign governments is an issue of particular concern. The information should not be shared with hostile or corrupt governments or governments that maintain inadequate protection of their databases from hackers.

The revised approach should also place a moratorium on implementation of the FinCEN “Customer Due Diligence Requirements for Financial Institutions” rule. The database authorization and other changes should sunset after a specified period (e.g., five years) and require congressional reauthorization after a review of the program. Specifically, there should have to be a rigorous demonstration by FinCEN that the costs are justified by the benefits of the program before it is renewed.

### Beneficial Ownership Reporting in Other Countries

Under pressure from the OECD’s Financial Action Task Force (FATF) and the EU, most OECD countries are moving to either a financial institution customer due diligence requirement, similar to the FinCEN CDD rule discussed above, or a beneficial ownership reporting regime—or sometimes both.<sup>57</sup> There is little information available as to their effectiveness.

The United Kingdom is one of the few countries where the information in the beneficial ownership database is publicly available.<sup>58</sup> In Canada, federal and provincial finance ministers, in a press release dated December 11, 2017, announced an “Agreement to Strengthen Beneficial Ownership Transparency” which was, in effect, an agreement to agree in the future.<sup>59</sup> Canada does have CDD rules.<sup>60</sup>

### Conclusion

Any of the currently proposed beneficial ownership reporting regimes would create a large compliance burden on businesses with 20 or fewer employees and would create as many as one million inadvertent felons. Even “exempt” entities are not really exempt. Religious organizations, charities, other exempt entities, and their employees would be subject to fines and imprisonment unless they file the proper certification of exemption with the FinCEN. Finally, the rules can be easily and lawfully avoided, so they would do virtually nothing to achieve their stated aim of helping law enforcement.

The vast majority of the information that the proposed reporting regime would obtain is already provided to the IRS. Creating a database of this information and allowing the IRS to share this information with the Treasury Department’s FinCEN would impose vastly lower costs on businesses and civil society. It would also better meet the needs of law enforcement by providing more comprehensive information and better enforcement than would the proposed reporting regime.

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57. The Financial Action Task Force, “International Standards on Combating Money Laundering, §§ 10-13 and 24-25; Directive 2015/849 of the European Parliament and of The Council, May 20, 2015 (the “Fourth Anti-Money Laundering Directive”), Article 14, effective June 26, 2017, [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L\\_2015\\_141\\_R\\_0003&from=ES](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_2015_141_R_0003&from=ES) (accessed February 21, 2018); The Law Library of Congress, “Disclosure of Beneficial Ownership in Selected Countries,” July 2017, <https://www.loc.gov/law/help/beneficial-ownership/disclosure-beneficial-ownership.pdf> (accessed February 21, 2018); Netherlands Ministry of Justice and Security, “Holders of Bearer Shares No Longer Anonymous,” Netherlands Ministry of Justice and Security, November 4, 2017, <https://www.government.nl/latest/news/2017/04/11/blok-holders-of-bearer-shares-no-longer-anonymous> (accessed February 21, 2018) (“The government is following the recommendations of the Global Forum and the Financial Action Task Force [FATF].”).

58. “Companies Act, 2006,” <https://www.legislation.gov.uk/ukpga/2006/46/part/21A> (accessed February 21, 2018), and Cabinet Office, HM Revenue & Customs, and Prime Minister’s Office, “U.K. Implementation of the G-20 High Level Principles on Beneficial Ownership Transparency,” November 16, 2015, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/476748/UK\\_implementation\\_of\\_the\\_G20\\_High\\_Level\\_Principles\\_on\\_Beneficial\\_Ownership\\_Transparency\\_.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476748/UK_implementation_of_the_G20_High_Level_Principles_on_Beneficial_Ownership_Transparency_.pdf) (accessed February 21, 2018).

59. Canadian Department of Finance, “Agreement to Strengthen Beneficial Ownership Transparency,” December 11, 2017, [https://www.fin.gc.ca/n17/data/17-122\\_4-eng.asp](https://www.fin.gc.ca/n17/data/17-122_4-eng.asp) (accessed February 21, 2018) (“Ministers agreed in principle to pursue legislative amendments to federal, provincial and territorial corporate statutes or other relevant legislation to ensure corporations hold accurate and up to date [sic] information on beneficial owners that will be available to law enforcement, and tax and other authorities.”).

60. Financial Transactions and Reports Analysis Centre of Canada, “Beneficial Ownership Requirements,” Financial Transactions and Reports Analysis Centre of Canada, June 2017, <http://www.fintrac-canafa.gc.ca/guidance-directives/client-clientele/bor-eng.asp> (accessed February 21, 2018).