

**The moneylaundering.com**  
**and Money Laundering Alert**  
**12<sup>th</sup> Annual International**  
**Conference and Exhibition**  
**Monday-Wednesday, March 19-21, 2007**  
**The Westin Diplomat Resort & Spa • Hollywood, Florida USA**

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**INSTITUTION:** Morgan, Lewis & Bockius LLP (Until January 2007, U.S. Internal Revenue Service Deputy Commissioner)

**BENEFICIAL OWNERS OF CORPORATIONS AND ACCOUNTS**  
**-- A Law Enforcement Perspective**

Background/Summary

U.S. law enforcement agencies have struggled for decades to penetrate the surreptitious ownership and control structures of foreign business entities and financial accounts situated in so-called bank secrecy jurisdictions. Typically, these foreign jurisdictions operate under legal regimes that make it difficult and time-consuming (at best) for U.S. law enforcement authorities to access information that is critical to on-going investigations. Although the United States has entered into treaties with certain jurisdictions that provide for expedited information exchange processes, the challenge of obtaining information from these jurisdictions has not been alleviated since implementation and oversight of such treaties is often poor. In addition, dramatic advances in financial globalization, including internet on-line account openings and transactions, have rapidly made law enforcement's task even more difficult. To make matters worse from a law enforcement perspective, when U.S. financial institutions began scrutinizing offshore shell corporations, criminals realized that they could obtain the same benefits at home by establishing domestic shell corporations that take advantage of lax state incorporation requirements. Then, these criminals began exploiting the apparent legitimacy of U.S. corporations by opening accounts and engaging in financial transactions abroad.

The dilemmas above have been the subject of a four-year investigative program by the Senate Permanent Subcommittee on Investigations ("PSI") (lead by U.S. Senators Carl Levin (D-MI) and Norm Coleman (R-MN)), with assistance from other investigative entities, including the Government Accountability Office. This investigation has resulted in a series of detailed reports, and now, just as this paper is being written, the introduction of legislation by Senators Levin, Coleman and Barack Obama (D-IL) that is designed to bolster law enforcement access to key financial and ownership data. Beneficial ownership of corporate entities, both domestic and foreign, promises to be the subject of considerable Congressional attention this year.

U.S. Senate Permanent Subcommittee on Investigations

The PSI has been engaged in a four-year investigation of initially offshore and now domestic obstacles to law enforcement's efforts to investigate money laundering, tax and securities violations. Significantly, PSI concluded that money laundering, tax and securities violations are often related to each other and the financial veils thrown up against law

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enforcement by secrecy practices have benefited violators in each of these areas. The Committee's 400-page August 2006 Report, "Tax Haven Abuses: The Enablers, The Tools, and Secrecy" (available at <http://www.senate.gov/~levin/newsroom/supporting/2006/PSI.taxhavenabuses.080106.pdf>) uses six case histories to describe the factual basis for the committee's findings.

The Committee's first five findings are key:

"1. Control of Offshore Assets. Offshore 'service providers' in tax havens use trustees, directors, and officers who comply with client directions when managing offshore trusts or shell corporations established by those clients; the offshore trusts and shell corporations do not act independently.

2. Tax Haven Secrecy. Corporate and financial secrecy laws and practices in offshore tax havens make it easy to conceal and obscure the economic realities underlying a great number of financial transactions with unfair results unintended under U.S. tax and securities laws.

3. Ascertaining Control and Beneficial Ownership. Corporate and financial secrecy laws and practices in offshore tax havens are intended to make it difficult for U.S. law enforcement, creditors, and others to learn whether a U.S. person owns or controls an allegedly independent offshore trust or corporation. They also intentionally make it difficult to identify the beneficial owners of offshore entities.

4. Offshore Tax Haven Abuses. U.S. persons, with the assistance of lawyers, brokers, bankers, offshore service providers, and others, are using offshore trusts and shell corporations in offshore tax havens to circumvent U.S. tax, securities, and anti-money laundering requirements.

5. Anti-Money Laundering Abuses. U.S. financial institutions have failed to identify the beneficial owners of offshore trusts and corporations that opened U.S. securities accounts, and have accepted W-8 forms in which offshore entities represented that they beneficially owned the account assets, even when the financial institutions knew the offshore entities were being directed by or were closely associated with U.S. taxpayers."

These findings establish the predicate for the "Stop Tax Haven Abuse Act" introduced in February by Senators Levin, Coleman and Obama (described below).

#### Most Recent Issue – U.S. State Incorporation Laws

The use and abuse of U.S. corporate entities for money laundering has recently come to the forefront of Congressional attention. The paucity of information required to form a

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U.S. corporation in most states was the subject of an April 2006 GAO report (available at <http://www.gao.gov/new.items/d06376.pdf>) and the focus of hearings in November 2006 before the PSI. As Senator Levin noted in his opening statement:

“In most cases, our states have no idea who is behind the companies they have incorporated. A person who wants to set up a U.S. company typically provides less information than is required to open a bank account or get a driver’s license. In most cases they don’t have to provide the name, address, or proof of identification of a single owner of the new company. That’s because our states have been competing with each other to set up new companies faster than ever, at less cost, and with greater anonymity for the company’s owners.

Most U.S. states offer electronic services that incorporate a new company, and many will set up a new company in less than 24 hours. The median fee is less than \$100. In Delaware and Nevada, for an extra \$1,000, an applicant can set up a company in less than an hour. Colorado, which incorporates about 5000 new companies each month, told the Subcommittee that it now sets up 99% of its companies by computer, without any human intervention or review of the information provided.”

U.S. Associate Deputy Attorney General Stuart Nash put it even more directly at the hearing: “In sum, a person from within or outside of the United States, without any verification of identification, can submit the appropriate paperwork to form a corporation, and establish a corporation within as little as five minutes. The corporation is then a legal entity that can engage in business and open a bank account.” The testimony at this hearing and in relevant reports focused on certain U.S. states that allow nominee shareholders or bearer shares. In both instances, yet another layer of concealment is placed between law enforcement and the ultimate owners of the accounts and funds at issue.

The use of third party formation agents complicates law enforcement’s task even further by adding yet another layer of unverified identities. Even if the state system requires a local address for an agent for service of process or for a formation agent, these addresses are not verified. Moreover, even if located, the formation agents may have little or no information concerning the owners themselves. Law enforcement sources admitted to GAO that cases have simply been closed due to roadblocks at the beneficial ownership stage.

This state of affairs also operates in reverse to frustrate foreign investigative efforts that involve these U.S. shell corporations. The U.S. Justice Department’s Office of International Affairs (“OIA”) receives requests for assistance from foreign law enforcement authorities seeking ownership information for U.S. corporations engaged in financial transactions within their borders. OIA then seeks and receives from the relevant state authorities only the corporate records on file with the state agency. In most cases, these records do not identify the beneficial ownership of the account. Moreover, law enforcement

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representatives have testified that it is not uncommon for the corporations to be inactive and file required annual reports. Because of this lack of information, the foreign investigation hits a dead end in the U.S.

The number of requests for information from foreign law enforcement continues to increase. From 2004 to 2005, legal assistance requests to the Justice Department from Eastern Europe involving U.S. shell corporations rose from 122 to 143, annually. In most instances, OIA responded that it could not obtain the information necessary to identify the owners of the companies.

The U.S. Internal Revenue Service ("IRS") suffers from the same fate when it receives requests for assistance through tax treaties. It likewise is receiving increasing numbers of requests each year from foreign law enforcement for information about the ownership of U.S. corporations, predominately from Russia and Eastern European countries. An IRS witness at the November PSI hearing testified that "[t]he IRS is generally unable to determine the 'beneficial owner' of these U.S. shell companies."

This circumstance is embarrassing to the U.S. government, which has aggressively argued through international bodies like the Financial Action Task Force ("FATF") for all countries to enact more comprehensive anti-money laundering protections. Now, FATF itself has called attention to the relatively lax standards state incorporation standards in the U.S., by giving the U.S. four "non-compliant" ratings in a peer review last year, two of which relate to legal entities and beneficial ownership. The U.S. government must file an update with FATF by June 2008 describing the corrective actions it is taking.

#### Current Issues for Law Enforcement

Given the relatively lax standards for corporate formation in most U.S. states and the availability of internet-based account opening, there is no longer any bright line between "foreign" and "domestic" money laundering cases. Mr. Nash testified that "[v]irtually every major 'domestic' investigation involving an organized criminal group has an international dimension, and many major 'foreign' cases, if nothing else, involve the transfer of funds through the U.S. financial system."

U.S. law enforcement reports that U.S. shell companies are increasingly popping up in U.S. and foreign investigations. One current trend utilizes domestic corporate entities to access the U.S. financial system through foreign banks. It appears that criminal elements have probed for the weakest links in the system, as usual, and adjusted their schemes accordingly. In the most recent variant, criminals exploit the relatively weak scrutiny involved in creating a U.S. corporation and then avoid the relatively more robust standards for opening a U.S. bank account by going offshore. They open a bank account offshore in the name of the new U.S. corporation – again exploiting the perceived aura of legitimacy of the U.S. corporation abroad. Once the account is open, given the availability of correspondent banking relationships, the criminal elements use the foreign bank account for

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easy access back into the U.S. financial system. Even if U.S. law enforcement personnel detect suspicious activity, the U.S. correspondent bank typically only knows the identity information for the foreign bank itself, not the identity of the sub accounts within the foreign bank. Under these circumstances, law enforcement witnesses testified it is “nearly impossible” for U.S. law enforcement authorities to determine the ownership or source of funds moving through the U.S. banking system – estimated to be in the billions of dollars each year.

### Law Enforcement's New Tools

The law enforcement community has not stood still as the criminals became more creative and aggressive. There have been advances (from a law enforcement perspective) in their ability to detect and investigate money laundering, including the tracing of ownership. Some examples in just the last few years include:

- Law enforcement has significantly improved its computerized modeling and link analysis skills and programs. The FBI and FinCEN are developing and enhancing link analysis software systems that will visualize financial patterns, connect relevant criminal activities and display the links in detailed charts designed to reveal relationships that would otherwise never be detected manually.
- U.S. Immigration and Customs Enforcement (ICE) continues to expand its projects concerning bulk cash smuggling and trade-based money laundering and is engaged in multi-agency efforts and task forces targeting unlicensed MSBs, cross-border trading anomalies indicative of money laundering and foreign political corruption and its attendant money laundering.
- The IRS Criminal Investigation Division has implemented projects to better exploit SAR and BSA data. The IRS has 41 Suspicious Activity Review teams, complimented with a software system designed to make connections and detect patterns in the SAR data.
- Government agencies continue to benefit from the development and expansion of task force approaches that share data and resources. In 2005, the Justice Department, Homeland Security and the Treasury Department established a multi-agency fusion center in the Organized Crime Drug Enforcement Task Force program that targets and shares drug and financial intelligence.
- The Treasury Executive Office for Asset Forfeiture continues to focus on “high impact” cases – those resulting in \$100,000 or more of forfeited assets -- generating hundreds of millions of dollars in revenue each year.
- The National Drug Intelligence Center created a money laundering unit in 2005.
- Law enforcement has been aided by the gradual expansion of the segments of the economy subject to BSA reporting requirements, further adding to the data available for data mining and research.

Another mechanism that allows law enforcement to develop leads that otherwise might never have been developed is provided for in Section 314(a) of the USA PATRIOT Act

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of 2001. This law permits FinCEN to contact over 27,000 U.S. financial institutions on behalf of other law enforcement agencies and request information and documentation relating to accounts or transactions of persons potentially involved in money laundering or terrorist financing. According to FinCEN's February 2007 fact sheet, over the last four and a half years, these requests have identified over 2,200 accounts and over 3,200 new transactions and lead to 112 indictments.

Section 319(a) of the Patriot Act allows the U.S. government to forfeit a foreign bank's interbank account in the United States as a substitute for a foreign deposit if the deposit of funds in the foreign bank outside the U.S. is subject to forfeiture. Significantly, there is no requirement that assets seized in the U.S. be traced to the deposit abroad. But in practice, this section appears to have been used sparingly and has operated more as a deterrent and an incentive to cooperate – both for U.S. and foreign banks.

These new tools and mechanisms have helped law enforcement not lose more ground than it would have in the face of globalized and on-line financial systems, but they are not enough to satisfy law enforcement's stated needs.

#### "Stop Tax Haven Abuse Act"

In February, just as this paper was being written, Senators Levin, Coleman and Obama introduced comprehensive legislation designed to correct the perceived deficiencies in the current system. The senators focused attention on the approximately \$100 billion in taxes lost each year to the U.S. Treasury through offshore and domestic schemes, many of which rely on the secrecy afforded by foreign and U.S. state laws and practices. This lengthy bill includes provisions designed to leverage the tax code and securities law in furtherance of more transparency in the system – both domestically and abroad. It imposes various presumptions under the tax code concerning the control or ownership of assets that attempt to deny the potential tax benefits of certain abusive practices involving placing assets offshore. For instance, U.S. persons who directly or indirectly form foreign corporations or trusts in certain foreign jurisdictions and/or send assets to those entities would be presumed to control those assets for tax purposes. The bill also directs the Secretary of the Treasury to issue regulations requiring hedge funds and company formation agents to establish anti-money laundering programs.

Most directly on point for this topic, however, is Section 104 of the bill. That section requires U.S. financial institutions that "directly or indirectly" open a foreign account or create a foreign entity in certain jurisdictions for a U.S. client to report that fact and identifying information to the IRS, along with the initial balance deposited into the account. And correspondingly, if a U.S. financial institution learns that the beneficial owner of a foreign entity is a U.S. taxpayer, the U.S. financial institution must again inform the IRS of the income in the account via a Form 1099.

The Administration has not issued its position on this legislation yet. But given the increasing attention to the annual "Tax Gap" (the funds owed, but not paid to the Treasury

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each year), now estimated at approximately \$350 billion each year, this bill seems certain to receive significant attention and debate this year. The further development of this bill (or not) will be a significant bell weather for the future of beneficial ownership issues from law enforcement's perspective.