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Expanded Reporting Obligations for Financial Institutions in the New World of Tax Transparency

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From the Editor

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This issue of the *Journal of Taxation and Regulation of Financial Institutions* begins with an examination of an important new framework used by the Office of the Comptroller of the Currency (OCC) to assess civil money penalties. Authors Frank A. Mayer III, John E. Bowman, Richard M. Berman, Jonathan L. Levin, and Adrienne C. Beatty discuss the OCC's revisions to its civil money penalty framework that both lower the thresholds for triggering sanctions against financial institutions and institution-affiliated parties for operational and compliance failures and raise the penalties.

In our second article, Alan Appel explores rules from the Treasury Department's Financial Crimes Enforcement Network that are intended to curb foreign investors' efforts to hide the proceeds of their illegal activities in U.S. assets through the use of shell companies with hidden owners. Mr. Appel covers general requirements relating to anti-tax-avoidance measures, opening new accounts, and high-end real estate purchases made with cash.

Christopher G. Brown discusses recent developments in foreclosure law in our third article. Focusing on Connecticut, Mr. Brown discusses cases that seem to indicate a pro-borrower trend in the areas of dual tracking, predatory lending, and lien stripping for loss mitigation.

Our fourth article turns to the nationwide trend of encouraging investment through tax credits. David D. Ebersole discusses angel investments in general and focuses on Georgia's angel tax credit in particular as an example of trend. As in other states, to qualify for the Georgia credit the investor must be sufficiently sophisticated, the business must be small and maintain its business in the state, and the investment structure must be common or preferred stock or qualified subordinated debt.

Compliance with the Foreign Account Tax Compliance Act (FATCA) as it applies to investment funds is the subject of the next article, by John P. Dombrowski. Mr. Dombrowski first gives an overview of the FATCA regime and then explains how it applies to the documentation of an investment fund structured with offshore accounts.

In our sixth article, Arturo J. Aballi, Megan E. Campos, and Gustavo Oliveira discuss the tax-exempt status of U.S. investments made by foreign high-net-worth individuals through a non-U.S. corporation owned by a trust. The issues raised by such investments are relevant to financial institutions with private client divisions that work with international or cross-border families and must be cognizant of the FATCA reporting requirements involved.

This issue concludes with a state and local column by John P. Barrie. Mr. Barrie discusses the October 13, 2016, Section 385 final and temporary regulations—and finds the overall news to be good for financial institutions.

—Houman Shadab
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Expanded Reporting Obligations for Financial Institutions in the New World of Tax Transparency

The U.S. government has been focusing its attention on foreign investors who may be investing proceeds of illegal activity into U.S. entities without identifying the natural persons who are the beneficial owners of the equity interests in such entities. There is great concern that the U.S. has allowed itself to be used as a tax haven due to the lack of transparency in certain states' laws, which do not require the disclosure of entity ownership. This article looks at FinCEN's current anti-tax-avoidance measures, including the new account opening requirements, along with the requirements relating to cash purchases of high-end real estate with which title insurance companies and U.S. lenders must comply. Additionally, this article discusses the Treasury Department's expanded requirements for reporters of bank deposit interest to foreign tax authorities.

ALAN I. APPEL

Earlier this year, the German newspaper *Süddeutsche Zeitung* enlisted the help of the International Consortium of Investigative Journalists (ICIJ) to investigate a significant number of documents detailing financial and attorney-client information for more than 214,488 offshore entities, which were used for various, including illegal, purposes. The ICIJ published the so-called "Panama Papers," a report focusing on the practices of the Panamanian law firm and corporate service provider, Mossack Fonseca, which had orchestrated the use of these offshore entities, which put a spotlight on the secrets of the international "offshoring" industry, through which the world's rich and powerful hide assets and avoid tax and other laws. This is accomplished through a simple and low-cost process of registering shell corporations or nontransparent entities in foreign jurisdictions that do not require entities to disclose their beneficial owners. Included among the Panama Papers-listed jurisdictions were the U.S. states of Wyoming, Nevada, and Delaware.

In response to the Panama Papers' revelations, the U.S. government has focused its attention on foreign investors who may be investing proceeds of illegal activity into U.S. entities without identifying the natural persons who are the beneficial owners of the equity interests in such entities. The U.S. government wants the beneficial owners to be disclosed, and to that end is implementing new federal reporting requirements to identify these natural persons. The purpose of the disclosure is to thwart unlawful offshoring, to prevent illegal use of U.S. bank accounts, and to uncover financial criminal activities, including tax avoidance or evasion practices.

The United States Treasury Department's Financial Crimes Enforcement Network (FinCEN) is primarily responsible for uncovering tax-avoidance and financial crime activities. Financial institutions are already exercising due diligence and complying with know-your-customer (KYC) requirements to identify the source and nature of their clients' funds being invested in the United States.[1] Nevertheless, FinCEN

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[1] The statutory basis for KYC requirements is the Bank Secrecy Act or Anti-Money Laundering Law (BSA/AML). Under BSA/AML, financial institutions are required to thoroughly review new customers before accepting their business. The purpose of the KYC requirements is to reduce the potential misuse of the financial institution for money laundering, terrorist financing, and/or other illegal activities. Clients' funds are individual client funds and funds of sole proprietorships invested in the United States. Under the FinCEN rules, client funds do not include funds from unincorporated associations. See 31 C.F.R. 1020.220.

is implementing new customer due diligence rules, which mandate that the non-U.S. beneficial owners of legal entities be disclosed when they open new accounts in the U.S. Certain banks and financial institutions (i.e., "covered financial institutions," (defined below), must comply with the new legal landscape.

This article discusses (1) the current FinCEN measures, including the new account opening requirements, along with the compliance requirements relating to cash purchases of high-end real estate with which title insurance companies and U.S. lenders must comply, and (2) the Treasury Department's expanded requirements for reporters of bank deposit interest to foreign tax authorities.[2]

Covered financial institutions must comply with finalized Customer Due Diligence Rules by May 11, 2018.

THE ANTI-AVOIDANCE LAW UNDER FINCEN

FinCEN is the primary agency of the U.S. government focused on anti-money-laundering (AML) compliance and enforcement controls governing corporate entities that conduct business with bank and other financial institutions.[3] FinCEN's rules have been issued in response to the recent domestic AML initiatives targeting certain activities of non-U.S. persons, including the opening of financial accounts in the United States and the all-cash purchasing of high-end real estate.

New Customer Due Diligence Rules. Currently, covered financial institutions (CFIs) are under no obligation to verify the identity of beneficial owners of legal entities. "Beneficial owners"[4] are the individuals who own or control the institutions' "legal entity customers" under the current AML regulations. FinCEN issued the final version of Customer Due Diligence Rules on May 11, 2016, and the Final Rules became effective July 11, 2016, but compliance by covered financial institutions with finalized Customer Due Diligence Rules is not required until May 11, 2018.[5]

[2] Treas. Reg. §§ 1.6049-4(b)(5) and 1.6049-8, as revised by T.D. 9584, and Rev. Proc. 2012-24, updated by Rev. Proc. 2015-50 [hereinafter the "Treasury Regulations and Procedures"].

[3] 81 Fed. Reg. 29397; 31 C.F.R. 1010, 1020, 2023, 1024, and 1026.

[4] All terms used but not otherwise defined herein have the meaning set forth in C.F.R., ch. X, tit. 31.

[5] See 31 C.F.R. Parts 1010, 1020, 1023, er al. (2016).

The Final Rules codify the four "core elements" that must be included in a CFI's AML compliance program:

1. Customer identification and verification;
2. Beneficial ownership identification and verification;
3. Understanding the nature and purpose of customer relationships to develop a customer risk profile and
4. Ongoing monitoring for reporting suspicious transactions and, on a risk-basis, maintaining and updating customer information.[6]

The second core element listed, which is the new core element, is identifying the beneficial ownership of legal entity customers. To do this, CFIs are required to regularly monitor and update corporate borrowers' information, specifically, the legal entity's beneficial ownership. This discussion addresses the types of bank accounts for which beneficial owners will be required to be identified, and the terms "covered financial institutions" and "legal entity customers," and will also explain the criteria for determining the identity of beneficial owners, with respect to the "ownership prong" or "control prong"; the non-compliance penalties; exempted financial institutions; and potential issues arising from the Final Rules.

Types of Accounts for Which Beneficial Owners Must Be Identified. The FinCEN rules require that a CFI identify the beneficial owners of entities when they open a new:

- Deposit account;
- Transaction or asset account;
- Credit account;
- Any other extension of credit;
- Safety deposit box or other safekeeping service;
- Cash management service;
- Custodial service; or
- Trust and fiduciary service.

The Final Rules specify that any formal contractual relationship between a CFI and a legal entity is an account.

"Covered Financial Institutions" and "Legal Entity Customers" Defined. "Covered financial institutions" include bank and non-bank financial institutions[7]:

- Banks, specifically foreign banks doing business in the United States[8];

[6] See 31 U.S.C. § 5318(h).

[7] 31 C.F.R. 1010.230(b)(2). See also 31 C.F.R. 1010.605.

[8] Id. See also 31 C.F.R. 1020.220(a)(2).

- Savings associations and credit unions[9];
- Brokers or dealers in securities[10];
- Mutual funds[11]; and
- Futures commission merchants.[12]

CFIs must identify the beneficial owners who own or control certain "legal entity customers" when a new account is opened. "Legal entity customers" include (1) corporations, (2) limited liability companies, or other entities, such as (3) partnerships, (4) limited partnerships, and (5) limited liability partnerships, created by the filing with a State Secretary of State or similar officer, and include (6) foreign country chartered corporate entities doing business in the United States. The entity creation by public filing is the filing of a public document with an appropriate state office. A general partnership and any similar entity formed under the laws of a foreign jurisdiction are also a part of the other entities group.

Criteria for Identification of Beneficial Owners. The requirement to report the identity of the beneficial owners of legal entities applies to new accounts as set forth in the Final Rules. Under the beneficial ownership requirements, there are two distinct prongs for determining the beneficial owner of a legal entity: (1) the "ownership prong" and (2) "control prong." When a legal entity customer opens a new account, the CFI must:

- *Under the Ownership Prong:* Identify each individual beneficial owner, if any, who directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise, owns 25 percent or more of the equity interests of the legal entity customer; or

- *Under the Control Prong:* Identify a management official—i.e., a single individual who exercises control, manages, or directs a legal entity customer. This includes an executive officer or senior manager, such as a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer, or any other individual who performs similar functions on a regular basis.[13]

If the beneficial owner does not meet the 25 percent threshold under the ownership prong, CFIs are only required to collect beneficial ownership information and are not required to identify an individual with "significant managerial control," as under the control prong. However, the CFI is still responsible for assessing risk associated with the entity.

The number of individuals satisfying the definition of "beneficial owner" may vary and, therefore, must be identified and verified. Under the control prong, the CFI must identify at least one individual as a beneficial owner for each legal entity customer. Under the ownership prong, depending on the legal entity's ownership structure, the CFI may identify zero to four individuals.

Under the control prong, the CFI must identify at least one individual as a beneficial owner for each legal entity customer. Under the ownership prong, depending on the legal entity's ownership structure, the CFI may identify zero to four individuals.

Ongoing Monitoring. The CFI should obtain a legal entity's beneficial ownership and control information when an account is opened and should continue to monitor the account to develop a risk-based profile of the legal entity opening the account. This should be a process of analyzing the account relationship, and conducting a continual monitoring program to identify and report suspicious transactions through filing Suspicious Activity Reports (SARs).[14] If the account activity is not within the established parameters of the assigned risk profile, a CFI is required to flag the account and determine whether filing an SAR is necessary.

It is the CFI's responsibility to update any change in beneficial ownership with the legal entity's management and to update its customer due diligence for such legal entity, or recertify the beneficial owners of a legal entity, and keep the account current. This means the CFI must regularly review the account relationship with the legal entity and make any necessary updates and changes on the legal entity's beneficial ownership.

Recordkeeping. The CFI must retain the customer due diligence compliance beneficial ownership data for five years from the date the record was created.[15]

[9] 31 C.F.R. 1020.220.

[10] 31 C.F.R. 1023.210. Refer also to Appendix D ("Statutory Definition of Financial Institution") for guidance.

[11] 31 C.F.R. 1024.210. Refer also to Appendix D ("Statutory Definition of Financial Institution") for guidance.

[12] 31 C.F.R. 1026.210. Refer also to Appendix D ("Statutory Definition of Financial Institution") for guidance.

[13] See 31 C.F.R. Parts 1010, 1020, 1023, et al. (2016).

[14] 31 C.F.R. 1024.320.

[15] 31 C.F.R. 1010.230(i)(2).

If the CFI decides to keep the data for a longer period of time, this is likely to burden the servers where the data is kept. Furthermore, the voluminous data will need to be backed up, which will likely burden the CFI's information technology operations.

Implementation. With KYC and AML obligations already in place, FinCEN believes the new customer due diligence obligations are already in effect. Additionally, FinCEN indicated federal banking regulators are authorized to impose more stringent requirements on regulated banks. Thus, the new customer due diligence obligations will need to be implemented sooner than the May 11, 2018, date.

Foreign banks will likely turn to their home country regulator to assume compliance with the FinCEN beneficial ownership Final Rules.

Non-Compliance Penalties. Under the law, a CFI that knowingly makes a false statement with respect certifying the legal entities' beneficial ownership under the aforementioned two prongs will face substantial penalties:

> Whoever knowingly makes any false statement or report . . . to any institution the accounts of which are insured by the Federal Deposit Insurance Corporation, a branch or agency of a foreign bank . . . or a mortgage lending business . . . upon any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, loan, or insurance agreement or application for insurance or a guarantee, or any change or extension of any of the same, by renewal, deferment of action or otherwise . . . shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.[16]

Exempted Financial Institutions. Other financial institutions, foreign banks, and CFIs that use third parties to perform the customer due diligence procedure on their behalf are exempted from the FinCEN Final Rules and will not be obliged to identify and verify the beneficial owners when new accounts are opened or new contractual agreements are made with these financial institutions.

Other Financial Institutions. The other eight (out of 16) financial institutions that are exempted[17] from the new rules are:

[16] 18 U.S.C. § 1014.

[17] 31 C.F.R. 1010.230(e)(2).

1. Financial institutions regulated by a state or federal functional regulator[18];
2. Foreign financial institutions from jurisdictions where the regulator maintains beneficial ownership information regarding the said institution[19];
3. Bank holding companies[20];
4. Publicly traded and SEC-registered companies[21];
5. Registered investment companies[22];
6. Registered investment advisors[23];
7. Exchanges or clearing agencies[24]; and
8. Other similar exemptions.[25]

Foreign Banks. The foreign bank exception in the Final Rules provides that it may be necessary for a foreign bank CFI with a branch in the U.S. to obtain confirmation that the foreign bank regulator has established ownership and control rules, thus satisfying the requirements of the Final Rules. Consequently, foreign banks will likely turn to their home country regulator to assure compliance with the FinCEN beneficial ownership Final Rules.

Third Parties Doing Due Diligence on Behalf of a CFI. A CFI with a third-party financial institution or affiliate performing the customer due diligence with respect to any legal entity customer opening a new account is exempted under the following circumstances[26]:

- There is reasonable reliance between the parties[27];
- The third party or affiliate is subject to FinCEN's AML regulations and a federal functional regulator controls the customer due diligence procedure as mandated by the Final Rules[28]; and
- The third party or affiliate is under contract to annually certify an effective AML program and its AML compliance program follows FinCEN's Final Rules.[29]

POTENTIAL ISSUES FOR CFIS GOING FORWARD

The FinCEN Final Rules align current KYC procedures of CFIs, AML initiatives, and similar FinCEN

[18] 31 C.F.R. 1010.230(e)(2)(i).

[19] 31 C.F.R. 1010.230(e)(2)(xiv).

[20] 31 C.F.R. 1010.230(e)(2)(x).

[21] 31 C.F.R. 1010.230(e)(2)(vii).

[22] 31 C.F.R. 1010.230(e)(2)(iv).

[23] 31 C.F.R. 1010.230(e)(2)(v).

[24] 31 C.F.R. 1010.230(e)(2)(vi).

[25] 31 C.F.R. 1010.230(e)(2).

[26] 31 C.F.R. 1010.230(j).

[27] 31 C.F.R. 1010.230(j)(1).

[28] Subject to a rule implementing 31 U.S.C. § 5318(h).

[29] 31 C.F.R. 1010.230(j)(2).

and federal laws. The FinCEN Final Rules are likely to create additional issues that CFIs will need to consider in their daily operations. These issues include:

- It is possible that banking regulators will expand the scope of the minimum beneficial ownership standards for customer due diligence in the Final Rules, which would require CFIs to devote resources and time to the development of a comprehensive compliance program.
- An earlier implementation and roll-out of the CFI's compliance program will likely be required and a concentrated effort with other CFI operation groups, such as information technology, underwriting, and documentation policies and procedures, will probably be implemented.
- It is not clear how a contract with a third party to outsource a CFI's certification of the legal entities' beneficial owners in the third party's AML program will be treated. Thus, the indemnification of the CFI to make a certification through another party is at issue, especially if the CFI may face criminal liability.[30]
- The CFIs will have to comply with all of the different laws used to identify beneficial ownership interests that are enforced under the Final Rules; the Internal Revenue Code of 1986, as amended; and state and foreign reporting requirements. In other words, for certain purposes filing of information returns is required if threshold ownership equals 25 percent, while for purposes other than federal tax information reporting the threshold may be less than 25 percent.

From a practical perspective, the new rules have been criticized for having significant gaps. The rules do not sufficiently identify the persons who control a non-transparent company because the definition of control fuses together the legal entity's senior management and executive officers with beneficial owners. There is a chance that officials in leadership positions are representatives with real control, effectuated in other ways. Also, although the rules do not extend the requirement to collect beneficial ownership information to accounts established before the applicability date, the missing information creates a major gap in information collected. Lastly, the beneficial owner of a trust under the ownership prong is the trustee, who is typically only the legal, rather than the beneficial owner, of the trust's assets.

[30] Under 12 U.S.C. § 1014.

HIGH-END REAL ESTATE TRANSACTIONS REPORTABLE BY TITLE INSURANCE COMPANIES

Geographic Targeting Orders. Since March 2016, FinCEN has issued six geographic targeting orders (GTOs). The GTOs require title insurance companies to disclose the beneficial ownership—i.e., the identification of the actual persons—of entities purchasing properties at threshold amounts in six GTOs. The GTOs initially focused on Manhattan, one of five boroughs of New York City,[31] and Miami-Dade County, Florida. FinCEN expanded the GTOs, which now effectively cover all-cash real estate transactions in (1) all boroughs of New York City; (2) Miami-Dade, Broward, and Palm Beach Counties, Florida; (3) Los Angeles County, California; (4) San Francisco,

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San Mateo, and Santa Clara Counties, California; (5) San Diego County, California; and (6) Bexar County, Texas. The GTOs are effective as of August 28, 2016, and extend the effective period to all boroughs of New York City and Miami-Dade County for 180 days, through February 23, 2017.

Beneficial Ownership Disclosure: Form 8300. Title insurance companies must complete Form 8300 and e-file it through the Bank Secrecy Act E-filing system within 30 days of the closing of a Covered Transaction. The title insurance companies must also comply with the FinCEN's GTOs by:

- Identifying the Purchaser's or entity's beneficial owners, specifically, each individual who owns an equity interest of 25 percent or more;
- Retaining a copy of each beneficial owner's identification document, such as a passport, or driver's license;
- If the customer is an LLC, providing each LLC member's name, address, and taxpayer identification number; and
- Providing details about the transaction: the property's address, purchase price, and the transaction's closing date.

[31] The Manhattan GTO is available online at https://www.fincen.gov/sites/default/files/shared/Real_Estate_GTO-NYC.pdf. The Miami-Dade GTO is available online at https://www.fincen.gov/sites/default/files/shared/Real_Estate_GTO-MIA.pdf.

The disclosure of beneficial ownership under FinCEN's new Customer Due Diligence Rules not only affects title insurance companies, but extends to the daily operations of covered financial institutions, including the procedure of a client opening a new account.

REPORTING INTEREST ON CERTAIN DEPOSITS

In April 2012, the Treasury Department and IRS required the annual reporting of U.S. deposit interest that is paid to nonresident alien individuals on or after January 1, 2013.[32] If the nonresident alien individual is a resident of a listed country, the U.S. agrees to reciprocate such information under tax information exchange agreements (TIEAs).[33]

Previously, such reporting was required only on interest paid to U.S. persons or to a nonresident alien individual who was a resident of Canada. However,

Treasury has also proposed new measures requiring certain domestic disregarded entities to disclose their beneficial owners, to combat U.S. states from being used as tax havens.

the list of jurisdictions with mutual reported has grown apace. Revenue Procedure 2014-64 lists (under Section 3) the countries with which the U.S. has a TIEA between the listed countries' taxing authority and the Treasury Secretary or delegate and (under Section 4) those countries with which the U.S. Treasury and IRS have determined that an automatic exchange of deposit interest information was appropriate. More recently, Revenue Procedure 2015-50 added 16 countries to the list previously provided in the Revenue Procedure 2014-64 Section 4 list: Brazil, Czech Republic, Estonia, Gibraltar, Hungary, Iceland, India, Latvia, Liechtenstein, Lithuania, Luxembourg, New Zealand, Poland, Slovenia, South Africa, and Sweden.

Thus, for any calendar year, payors must report interest on deposits maintained at a U.S. branch office, if:

1. Interest is paid to a nonresident alien individual;
2. As of December 31 of the prior calendar year, the individual is a resident of a country identified in the revenue procedures; and
3. The identified country is a listed country with which the United States has, in effect, an information exchange agreement.

Relying on TIEAs as the remedy for the offshore tax information deficit, in practice, often provides little useful information. The TIEA is typically a slow procedure, for the most part, ineffectual, and takes a lot of resources to process and obtain requested tax information.

The Treasury Department has also established new measures to disclose beneficial owners of certain domestic entities.[34] On December 13, 2016, the Treasury Department promulgated these final regulations to combat U.S. states from being used as tax havens by requiring certain domestic disregarded entities to disclose their beneficial owners. For example, a Delaware LLC owned by foreign persons will be treated as a domestic corporation for the limited purpose of reporting and record maintenance requirements of Internal Revenue Code Section 6038A. This reporting would effectively identify the foreign owners of the entity and their related transactions with the Delaware LLC, which would deter non-U.S. persons from carrying on illegal activities through U.S. entities. Since these entities would have a filing obligation, they would be required to obtain an Employer Identification Number (EIN) by filing a Form SS-4 with the Internal Revenue Service to report the responsible party's information. The EIN can be shared with FinCEN and other federal enforcement agencies to promote the U.S. government's transparency efforts and deter tax-avoidance schemes.

CONCLUSION

The FinCEN Final Rules are a part of the U.S. government's goal to increase transparency of enigmatic partnerships created by state filings, where foreign investors may be investing proceeds of their illegal activity into

[32] Under the "Treasury Regulations and Procedures," supra note 2. It should be noted that the U.S. has entered into agreements with many countries for the exchange of information is the tax-related information for tax administration and enforcement purposes. Exchanges of tax-related information between countries generally occur under the provisions of international tax information sharing agreements, including through income tax treaties and tax information exchange agreements (TIEAs). While tax treaties are intended to prevent double taxation of international economic activity or income in two jurisdictions, the Treasury Department mandate on reporting interest on certain deposits is related to TIEAs. The sole purpose of TIEAs is to create reciprocal agreements between parrner countries to exchange tax-related information. See also Treas. Reg. §§ 1.6049-4(b)(5) and 1.6049-8, as revised by T.D. 9584, and issued Rev. Proc. 2012-24.

[33] As defined in IRC § 6103(k)(4).

[34] T.D. 9796, Treatment of Certain Domestic Entities Disregarded as Separate From Their Owners as Corporations for Purposes of Section 6038A.

U.S. entities. This is not just a U.S. problem, but an international issue. To increase the transparency and mitigate the use of the U.S. as a tax haven, the FinCEN Final Rules are part of a goal to create a stronger anti-avoidance program. However, the effect of the regulations, whether the deterrence is successful, and how the rules will affect the business of CFIs in the United States is unknown. So long as there is a way to create transparency and uncover the true identity of the beneficial owners of obscure legal entities, such AML compliance programs are likely to be successful in deterring the laundering of dirty money in the United States. ■