

The Truth about Delaware's Global Brand

BY RICHARD J. GEISENBERGER

IF AN EARLY 20TH CENTURY Delawarean could time travel to today, she might be shocked to discover that an economy built on explosives, peaches, tanneries, and shipbuilding gave way to an economy built on financial services, biotechnology, poultry and tourism. But the same time traveller would feel right at home to learn that Delaware's incorporations industry continues to thrive. The State's proverbial "golden goose" began laying eggs in 1899. Today, it generates thousands of jobs and more than 40% of Delaware's direct and indirect budgeted revenues.

More than 1.2 million legal entities are incorporated here including a remarkable 66% of the Fortune 500. On a per capita basis, the number of Delaware entities outpaces the average U.S. state by a factor of 20.

There are many reasons companies choose Delaware. Our business statutes are widely recognized as the most advanced and flexible in the nation. Our Court of Chancery is a unique, centuries-old business court that, along with the Delaware Supreme Court, has authored most of the modern U.S. corporate case law. The State's legal service community has unparalleled expertise in the application of our statutes and receives strong, bi-partisan support for recommended improvements to our laws. The Delaware Division of Corporations provides prompt, friendly and professional service to customers around the world.

Many corporate lawyers, venture capital firms, and investment bankers in the U.S. consider it "malpractice" if they fail to ensure that their clientele incorporate in Delaware. The state's reputation as the "Corporate Capital of the USA" increasingly attracts businesses from around the world that are seeking footholds in the Western Hemisphere and access to global capital.

THE PANAMA PAPERS

Delaware's expansion into international corporate markets has not come without misunderstandings and criticism. So it came as little surprise this April when Delaware found itself in the center of a media storm around the release of the so-called "Panama Papers" – more than 11.5 million financial and legal records of 214,000 "offshore" legal entities formed by the Panamanian law firm Mossack Fonseca. The massive leak of documents to a consortium of investigative journalists highlighted the many lawful uses of companies to manage international business risks. But it also exposed how corrupt individuals can misuse the global incorporation process to hide criminal activity and ownership information from law enforcement officials.

Mossack Fonseca reportedly formed more than 1,000 legal entities in

several U.S. states – though none have been linked to Delaware as of the date of this writing. Still, a search of the words "Delaware Tax and Secrecy Haven" and "Panama Papers" yields more than 1,100 search results in the Google news portal. Delaware has spent more than a century building its brand and ignores the label "tax and secrecy haven" at its peril. Why exactly has Delaware attracted this unwanted attention?

THE TAX AND SECRECY HAVEN MYTH

First, there is the myth that Delaware is an "onshore" tax haven. Delaware has a corporate income tax. But it exempts firms that derive all of their income from passive activities, such as licensing of intangible assets. This exemption helps the State attract multi-state enterprises to locate operations in Delaware.

Less than one percent of Delaware legal entities are holding companies and that number is declining.

Why? Because 24 U.S. states use a "combined reporting" tax system that blocks multi-state corporations from shifting income between states. Many other states have regulatory "add-back" authority enabling tax authorities to disallow deductions for intercompany transactions designed to avoid paying state taxes.

Yet, some high-tax states have chosen to not implement these strategies. A company in these states may be allowed to make interest or royalty payments to a holding company from Delaware or elsewhere and record expenses that reduce state taxable income. Delaware's tax laws are then attacked by politicians in those states because it is easier than facing the consequences of eliminating allowable tax deductions in their own states – which of course they are free to do.

Second, there is the myth that Delaware is an "offshore" tax haven. But comparisons between Delaware and sovereign nations such as the Cayman Islands are unfair. Delaware companies are subject to the same U.S. tax laws as companies formed in other states. Some suggest that the U.S. is a tax haven because non-U.S. income of overseas affiliates is normally only taxed when it is repatriated. Also, IRS rules enable non-U.S. members of limited liability companies (LLCs) to avoid U.S. taxation on non-U.S. income. But these are functions of American tax law and have nothing to do with state corporate or tax laws.

Third, there is the myth that Delaware uniquely lacks transparency of company ownership information. But in America, information regarding a company's owners, partners, officers and other responsible persons is collected

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through tax authorities. No U.S. state collects and verifies the names of beneficial owners – the natural persons who ultimately own, control or derive benefits from a company – during the incorporation process.

There are things Delaware has done to combat these myths. For example, Delaware has statutorily prohibited the issuance of anonymous bearer shares, provided law enforcement with a clear path to access the name and contact information of a communications contact person for every company, and required every LLC to retain ownership information. Delaware has tightened the standards to become a registered agent, deterred the promotion of shell companies and anonymity, and created penalties for businesses that violate these requirements.

THE ISSUE

Regrettably, legal entities are used to commit crimes. Where wrongdoing is discovered and reported to state officials, the Division of Corporations fully cooperates with law enforcement authorities and will act swiftly to suspend or terminate the entity's status. But, ultimately the key to policing international financial crimes is strong enforcement by federal law enforcement agencies, ensuring that existing "know your customer" regulations for U.S. financial institutions are working, and strengthening enforcement in countries with weak financial regulatory systems. But more can be done in the U.S. to strengthen the hand of federal law enforcement while protecting privacy rights of law-abiding businesses and individuals.

One Congressional proposal to address this issue, the proposed Incorporation Transparency and Law Enforcement Assistance Act ("ITLEAA"), would require states to collect and verify beneficial ownership information during the incorporation process. Ironically, its proponents have billed ITLEAA as a "federal" solution. Proposed in each of the last five Congresses, ITLEAA would be a costly, duplicative and ineffective approach to the problem creating 50 different "state" solutions for businesses to navigate. The bill is opposed by the American Bar Association, U.S. Chamber of Commerce, National Conference of State Legislatures and the National Association of Secretaries of State.

The truth is that the federal government already collects ownership information on tax forms and when businesses apply for and maintain their Employer Identification Number (EIN). The U.S. Treasury also requires U.S. financial institutions to identify and verify the identity of the beneficial owners of their legal entity customers and requires U.S. legal entities to report the ownership and control of overseas financial accounts.

The problem is not a lack of ownership information, it's who can access it and how. In meetings with law enforcement officials and their advocates, several challenges emerge that lend themselves to solutions everyone should be able to agree upon.

THE SOLUTION

First, there is frustration over the inability of federal agencies to communicate and share information that they already have. Even the criminal division of the IRS can't easily access ownership information collected by its own agency that would be helpful in financial crime investigations.

Second, federal officials want to close loopholes that allow certain legal entities formed in the U.S. to avoid ownership reporting requirements – particularly entities controlled by foreign individuals or that don't have U.S. financial accounts.

Third, law enforcement needs strong federal laws that criminalize the act of lying or falsifying information that is collected. This creates the leverage law enforcement ultimately needs to get the information required in an investigation.

Some simple federal reforms can significantly improve the ability of law enforcement to do its job and Delaware is helping to lead the way. In July 2016, Senator Tom Carper along with Senator Chris Coons and Senator Dean Heller (R-NV), introduced S. 3268, the Closing Loopholes Against Money-laundering Practices Act or the "CLAMP Act".

First, the CLAMP Act would require every U.S. legal entity to apply for an EIN number. This would ensure that the U.S. Treasury has the name of a responsible party (i.e., the owner/controlling person) for every U.S. entity.

Second, the CLAMP Act would provide limited discretion to the Secretary of Treasury to share responsible party information upon written request from federal law enforcement officials directly involved in a money laundering or terrorist financing investigation.

Third, the CLAMP Act would create a felony for willfully failing to obtain an EIN in order to hide the existence of an entity or the identity of its responsible party.

For law enforcement, the bill closes the loopholes and lowers the barriers preventing investigators from accessing critical information they need to combat major financial crimes.

For the business community, the CLAMP Act creates no additional filing burdens for the vast majority of U.S. businesses that are already required to get an EIN. It leverages an existing system where businesses can secure an EIN online in minutes. And it preserves important privacy protections enjoyed by law-abiding businesses and individuals – setting clear, reasonable and narrow standards for law enforcement to access confidential ownership information.

For states like Delaware, the bill avoids a costly and unworkable expansion of state government red tape while ensuring a level playing field for all U.S. legal entities.

Within days of its introduction, the National Association of Secretaries of State released a statement supporting the overall policy direction of the CLAMP Act. Hopefully, other groups will support this simple and common sense solution so that full Congressional action becomes possible.

GOING FORWARD

We can't begin to imagine the Delaware industries of the 22nd century. But there's every reason to believe Delaware's incorporations industry can be standing strong in 100 years. It requires a continual focus on what Delaware does best – providing businesses and their investors with predictability, fairness and efficiency. And it requires collaboration with our federal partners to maintain America's position as an attractive place to raise global capital. This simple and yet exceedingly complex recipe for success has worked well for more than 100 years and will continue to move our State ever closer to becoming the "Corporate Capital of the World." ■



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