

GAO

Report to the Permanent Subcommittee  
on Investigations, Committee on  
Homeland Security and Governmental  
Affairs, U.S. Senate

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April 2006

# COMPANY FORMATIONS

## Minimal Ownership Information Is Collected and Available





Highlights of [GAO-06-376](#), a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

### Why GAO Did This Study

Companies form the basis of most commercial and entrepreneurial activities in market-based economies; however, “shell” companies, which have no operations, can be used for illicit purposes such as laundering money. Some states have been criticized for requiring minimal ownership information to form a U.S. company, raising concerns about the ease with which companies may be used for illicit purposes. In this report, GAO describes (1) the kinds of information each of the 50 states and the District of Columbia and third party agents collect on companies, (2) law enforcement concerns about the use of companies to hide illicit activity and how company information from states and agents helps or hinders investigations, and (3) implications of requiring states or agents to collect company ownership information.

### What GAO Recommends

While not making recommendations, GAO observes that if a requirement to collect company ownership information is considered, it would be useful for policymakers to consider (1) options that balance the conflicting concerns among states, agents, and law enforcement agencies; and (2) uniformly applying any such requirement to all states or agents.

[www.gao.gov/cgi-bin/getrpt?GAO-06-376](http://www.gao.gov/cgi-bin/getrpt?GAO-06-376).

To view the full product, including the scope and methodology, click on the link above. To view the results of GAO’s survey of state officials responsible for company formations, click: [www.gao.gov/cgi-bin/getrpt?GAO-06-377SP](http://www.gao.gov/cgi-bin/getrpt?GAO-06-377SP). For more information, contact Yvonne Jones at (202) 512-8678 or [jonesy@gao.gov](mailto:jonesy@gao.gov).

## COMPANY FORMATIONS

### Minimal Ownership Information Is Collected and Available

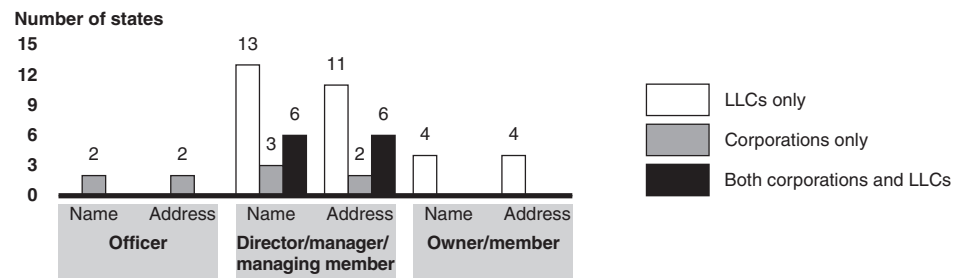
#### What GAO Found

Most states do not require ownership information at the time a company is formed, and while most states require corporations and limited liability companies (LLC) to file annual or biennial reports, few states require ownership information on these reports. With respect to the formation of LLCs, four states require some information on members, who are owners of the LLC. Some states require companies to list the names and addresses of directors, officers or managers on filings, but these persons may not own the company. Nearly all states screen company filings for statutorily required information, but none verify the identities of company officials. Third-party agents may submit formation documents to the state on a company’s behalf, usually collecting only billing and statutorily required information for formations. These agents generally do not collect any information on owners of the companies they represent, and instances where agents told us they verified some information were rare.

Federal law enforcement officials are concerned that criminals are increasingly using U.S. shell companies to conceal their identity and illicit activities. Though the magnitude of the problem is difficult to measure, officials said U.S. shell companies are appearing in more investigations in the United States and other countries. Officials told us that the information states collect has been helpful in some cases because names on the documents, such as names of directors, generated additional leads. However, some officials said that the information was limited and that cases had been closed because the owners could not be identified.

State officials and agents said that collecting company ownership information could be problematic. Some state officials and agents noted that collecting such information could increase the cost of company filings and the time needed to approve them. Some officials said that if they had additional requirements, companies would go to other states or jurisdictions. Finally, officials and agents expressed concerns about compromising individuals’ privacy because owner information disclosed on company filings would be part of the public record, which has not historically been the case for private companies.

Information Collected on Ownership and Management at Formation



Source: GAO survey of state officials responsible for company formation.

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**Abbreviations**

CIP	Customer Identification Program
DEA	Drug Enforcement Agency
DHS	Department of Homeland Security
EIN	employer identification number
EOUSA	Executive Office of the U.S. Attorneys
EPA	Environmental Protection Agency
FATF	Financial Action Task Force on Money Laundering
FBI	Federal Bureau of Investigation
FinCEN	Financial Crimes Enforcement Network
IACA	International Association for Commercial Administrators
ICE	Immigration and Customs Enforcement
ID	identification
IRS	Internal Revenue Service
IRS/CI	Internal Revenue Service, Criminal Investigations
LLC	limited liability company
LLLP	limited liability limited partnership
LLP	limited liability partnership
NAICS	North American Industry Classification System
NCCUSL	National Conference of Commissioners on Uniform State Laws
OECD	Organization for Economic Cooperation and Development
OFAC	Office of Foreign Assets Control
SAR	suspicious activity report
SDN	Specially Designated Nationals
SEC	Security and Exchange Commission
SSA	Social Security Administration
TIN	taxpayer identification number

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United States Government Accountability Office  
Washington, D.C. 20548

April 7, 2006

The Honorable Norm Coleman  
Chairman  
The Honorable Carl Levin  
Ranking Minority Member  
Permanent Subcommittee on Investigations  
Committee on Homeland Security and Governmental Affairs  
United States Senate

Companies—business entities that conduct a variety of commercial activities and hold a variety of assets—form the basis of most commercial and entrepreneurial activities in market-based economies. Companies in the United States play an essential and legitimate role in the country’s economic system. They provide a wide variety of services that range from the provision of necessary utilities and investment services to retail sales of items such as clothing and furniture. Companies can also be set up that act as “shell” companies and conduct either no business or minimal business. Shell companies are used for legitimate purposes; for example, they may be formed to obtain financing prior to starting operations. However, government and international reports indicate that shell companies have become popular tools for facilitating criminal activity in the United States and internationally and can be involved in fraud and corruption or used for illicit purposes such as laundering money, financing terrorism, hiding and shielding assets from creditors, and engaging in questionable tax practices.<sup>1,2</sup> Such schemes can conceal money movements that range from a few thousand to many millions of dollars.

Using U.S. shell companies for such activities can be appealing because of the perceived legitimacy of U.S. companies in international commerce and the potential for concealing the identity of the beneficial owners behind the legal entity. The beneficial owners are the persons who ultimately own and

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<sup>1</sup>See U.S. Departments of the Treasury, Justice, Homeland Security, et al, U.S. Money Laundering Threat Assessment Working Group, *U.S. Money Laundering Threat Assessment* (Washington, D.C., December 2005); and Organization for Economic Co-operation and Development (OECD), *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (Paris, 2001).

<sup>2</sup>Companies used to hide or facilitate illegal activity are sometimes also referred to as “front” companies and can sometimes conduct legitimate activity in addition to illegal activity. When we refer to “shell companies” in this report, we mean U.S. companies that do not conduct any legitimate activity.

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control a company.<sup>3</sup> For example, a shareholder of a corporation could be a beneficial owner. State statutes have traditionally provided for the privacy of the identities of company owners and limited liability, which protects them against lawsuits and protects their personal assets. However, shell companies can provide beneficial owners with the means to conduct illegal activities while hiding the owners' identity and involvement. Also, company formation agents who help individuals form companies may facilitate the formation of these shell companies, further shielding the identity of the individuals controlling the company. Law enforcement agencies investigating cases in which such companies may have been used for illicit purposes often need to know who the owners are in order to determine responsibility for criminal actions.

In a previous investigation of foreign individuals laundering money through U.S. corporations formed in Delaware, we found that the state required very limited information when a company is formed.<sup>4</sup> The potential paucity of the information required when forming a company in the United States has raised concerns about the ease with which companies may be used for illicit purposes, particularly since the September 11, 2001, terrorist attacks. Given these concerns, you asked us to determine what types of information are routinely obtained and made available regarding the ownership of nonpublicly traded companies formed in each state.<sup>5</sup> Specifically, this report will describe

1. the kinds of information—including ownership information—that the 50 states and the District of Columbia collect during company formation and the states' efforts to review and verify the information;

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<sup>3</sup>While definitions of beneficial ownership vary, this is the definition we developed for the purposes of this report.

<sup>4</sup>See GAO, *Suspicious Banking Activities: Possible Money Laundering by U.S. Corporations Formed for Russian Entities*, [GAO-01-120](#) (Washington, D.C.: Oct. 31, 2000).

<sup>5</sup>Our focus is on the collection and availability of ownership information of nonpublicly traded companies whose securities are not registered with the Securities and Exchange Commission (SEC) pursuant to Section 12 of the Securities Exchange Act of 1934 (SEC Act) (codified at 15 U.S.C. § 78l), because significant shareholders of publicly traded companies are subject to certain federal regulatory requirements. For instance, every beneficial owner of more than 10 percent of any class of security registered with the SEC under Section 12 must file certain disclosure statements under Section 16(a) of the SEC Act (codified at 15 U.S.C. § 78p(a)) regarding the nature of such ownership.

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2. the roles of third-party agents, such as company formation agents, and the kinds of information they collect on company ownership;
  3. the role of shell companies in facilitating criminal activity, the availability of company ownership information to law enforcement, and the usefulness of such information in investigating shell companies; and
  4. the potential effects of requiring states, agents, or both to collect company ownership information.

Individuals can choose a variety of business structures when forming a company. The scope of this report covers corporations and limited liability companies (LLC) because corporations have historically been the dominant business form and LLCs have recently grown in popularity. We refer to corporations and LLCs collectively as “companies” unless otherwise specified.

To address the objectives, we conducted a survey of officials from all of the states and the District of Columbia on their company formation and periodic reporting practices and cross-checked the responses against our review of state statutes, company formation forms, and state Web sites. Each of the 50 states and the District of Columbia responded to our survey. We also called and visited selected states to obtain further information about certain practices. In addition, we interviewed academics who have done research in the area, companies that provide filing and related services for businesses, law firms, financial institutions, state and industry associations, and state law enforcement agencies. Furthermore, we talked with officials from two jurisdictions outside of the United States that have recently implemented regulations for company formation agents.<sup>6</sup> We also spoke with officials from federal agencies in the Department of Homeland Security (DHS), including Immigration and Customs Enforcement (ICE); Department of Justice (Justice), including the Criminal Division, Drug Enforcement Agency (DEA), Federal Bureau of Investigation (FBI), and a U.S. Attorneys office and the Executive Office of the U.S. Attorneys (EOUSA); and Department of the Treasury (Treasury), including the

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<sup>6</sup>We chose to interview officials from Jersey and Isle of Man, two United Kingdom crown dependencies, because these jurisdictions have implemented regulations for companies that provide filing and related services to businesses.



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Financial Crimes Enforcement Network (FinCEN), Internal Revenue Service (IRS), and Office of Foreign Assets Control (OFAC).

We conducted our work from May 2005 through March 2006 in Arizona, Delaware, Florida, Maryland, Nevada, New York, Oregon, Virginia, and Washington, D.C., in accordance with generally accepted government auditing standards. A more extensive discussion of our scope and methodology appears in appendix I. The report also includes a glossary of terms. The survey and a more complete tabulation of state-by-state and aggregated results can be viewed at <http://www.gao.gov/cgi-bin/getrpt?GAO-06-377SP>. We provided a draft of this report to DHS, Justice, and Treasury. Justice and Treasury provided technical comments on the report that were incorporated, as appropriate.

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## Results in Brief

Most states do not require companies to provide ownership information at formation or in periodic reports. Similarly, states usually do not require information on other individuals who manage a company, including corporate officers and directors and LLC managers, on company formation documents, but most states require this information on periodic reports. However, these individuals may not be the owners of the company. States typically require basic information on company formation documents, such as the name of the company and the name and address of a contact where tax and other legal notices for the company should be sent. However, some may require other types of information, such as the company's principal office address or a statement of purpose. Almost all state officials reported that they screen filings for the presence of statutorily required information, but none reported screening names against criminal watch lists or verifying the identities of company officials provided in company formation or periodic report filings. Some officials said they do not take these steps because they do not have the legal authority or means to perform them.

Third-party agents may submit formation and other documents on behalf of a company, but the agents seldom collect ownership information or verify the information they collect. Individuals may also submit their own company filing documents. Company formation agents file required documents with a state for individuals or their representatives, while agents for service of process receive legal and tax documents on behalf of a

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company.<sup>7</sup> Although these agents provide different services, one company may serve in both capacities. Some state statutes have basic requirements regulating agents for service of process, such as state residency, but otherwise there is little oversight of either type of agent and no verification of the information they provide. For example, some states may require the agent for service of process to have a local address but do not check to see whether the address is valid. Wyoming is the one state we found that requires agents for service of process to register yearly to discourage agents from providing false information and to have the information available if the agent is under investigation. Agents generally collect billing information and the information required by state statute for company formation but generally do not collect any additional information on ownership or management of the companies they represent. Agents are generally not required to verify information from clients, although some agents we spoke with may request additional information or verify the identity of international clients by requiring copies of passports. In some circumstances, a legal firm may be the contact for a company, and the agent may not interact with anyone affiliated with the company being formed.

Law enforcement officials are concerned about the use of shell companies in the United States that enable individuals to conceal their identities and conduct criminal activity and have encountered difficulties in investigating these shell companies because they cannot determine the owners of the companies. Quantifying the magnitude of the use of shell companies used in crimes is difficult because creating a shell company is not a crime but rather can be a method for hiding criminal activity. However, law enforcement officials told us they are seeing many investigations within the United States and in other countries where individuals have used U.S. shell companies to facilitate illicit activity involving billions of dollars. Most of the law enforcement officials we interviewed said that when they need company information, they obtain some information from state Web sites and company filings, and some said they also requested information from agents. Some law enforcement officials noted that the information available from states had proven helpful because names on the documents generated additional leads. However, some officials said that the information states collected was limited in revealing who owned and

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<sup>7</sup>Agents for service of process may be known as registered agents, resident agents, statutory agents, or clerks in different states. Agents can be individuals or companies operating in one state or nationally with only a few clients to thousands of clients.

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controlled the company and that cases had been closed because of insufficient information. For example, an Immigration and Customs Enforcement (ICE) official provided an example of a Nevada-based corporation that received 3,774 suspicious wire transfers totaling \$81 million over a period of approximately 2 years. However, the case was not prosecuted because ICE could not identify the beneficial owner of the corporation.

Although law enforcement officials noted that information on owners was useful in some cases, state officials, agents, and others we interviewed said that collecting company ownership information could be problematic. For instance, if states or agents collected such information, the cost of filings and the time needed to approve them could increase, potentially slowing down business dealings or even derailing them. A few states and some agents also said they might lose business to other states, countries, or agents that had less stringent requirements, a consequence two foreign jurisdictions experienced after regulating agents and requiring collection of ownership information. Further, state officials and agents pointed out the difficulties of collecting information when companies are being formed or on periodic reports since ownership can change frequently. In addition, state officials and agents expressed concerns about maintaining privacy when making public information about legitimate businesses that historically has been protected. State officials, agents, and other experts in the field suggested internal company records, financial institutions, and the IRS as alternative sources of ownership information for law enforcement investigations. However, collecting information from these sources could present many of the same difficulties.

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## Background

States historically have had jurisdiction over the way business entities within their boundaries are formed and over reporting requirements for these entities. Statutes and requirements vary from state to state. In general, however, forming a company involves certain steps. Initially, a company principal or someone acting on the company's behalf submits formation documents to the appropriate state office—usually a division of the secretary of state's office—but in some cases to a different state

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agency.<sup>8</sup> All formation documents filed with the state are matters of public record and are available to anyone. Documents may be submitted in person, by mail or, increasingly, online. A minimal amount of basic information generally is required to form a company, although these requirements also vary from state to state. Generally, the documents must give the company's name, an address where official notices can be sent to the company, share information for corporations, and the names and signatures of the persons incorporating (see fig. 1). State officials generally check to see that the documents supply the information required by statute. Fees vary by state from \$25 to \$1,000, and the process can take anywhere from 5 minutes to 60 days.<sup>9</sup> See appendix II for more information on how formation documents are submitted and on the company formation fees in each state. Expedited services, available in some states, decrease processing times but may require an additional fee. Most states also require companies to file annual or biennial reports in order to stay in good standing, for a fee ranging from \$5 to \$500.<sup>10</sup>








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<sup>8</sup>Formation documents may be called articles of incorporation, certificates of incorporation (for corporations), or articles of organization or certificates of formation (for LLCs) in different states. In Alabama, formation documents are submitted to the probate judges at the county level. After a judge reviews and approves the documents, they are forwarded to the Secretary of State's office for review and filing.

<sup>9</sup>In Nebraska, the fees for filing articles of incorporation are based on the value of capital stock and can range from \$60 to over \$300. In New Mexico, the fees can range from \$100 to \$1,000, depending on the total amount of the authorized shares for the corporation.

<sup>10</sup>A certificate of existence or good standing shows that a company is in existence or authorized to transact business; that all fees, taxes, and penalties owed the state have been paid; that its most recent annual report has been filed; and that articles of dissolution have not been filed. States, cities, or counties may impose taxes or requirements for obtaining licenses or permits on businesses. We did not review the application or reporting requirements that businesses may have to submit to other state or local agencies in order to conduct business.

**Figure 1: How Companies Are Typically Formed**

Submission of company formation documents to state			Document processing		
Who may submit	How to submit	What is typically required	Who is responsible	What steps are taken	Possible outcomes
 Company principal   Attorney, or individual acting on behalf of the company   Other agent (e.g., company formation agent)	 In person   Mail   Fax   Online or e-mail	<input type="checkbox"/> Company name <input type="checkbox"/> Name and address of agent for service of process  <input type="checkbox"/> Number or type of shares <sup>a</sup> <input type="checkbox"/> Names, addresses, or signatures of incorporators or organizers  <input type="checkbox"/> Median fee: \$95 <sup>b</sup>	<div style="border: 1px solid black; padding: 5px; text-align: center;">State agency</div> <div style="display: flex; justify-content: space-around; margin-top: 10px;"> <div style="border: 1px solid black; width: 20px; height: 20px;"></div> <div style="border: 1px solid black; width: 20px; height: 20px;"></div> <div style="border: 1px solid black; width: 20px; height: 20px;"></div> </div> Division of secretary of state's office or a division of tax/revenue agency, or other agency	<input checked="" type="checkbox"/> Check for availability of desired company name  <input checked="" type="checkbox"/> Check for presence of all required information  <input checked="" type="checkbox"/> Process payment	<div style="border: 1px solid gray; border-radius: 15px; padding: 5px; display: inline-block;">ACCEPT</div> States accept company formation if information is complete. States provide certified articles indicating date and time of formation.  <div style="border: 1px solid gray; border-radius: 15px; padding: 5px; display: inline-block;">SUSPEND</div> States may delay company formation if information is missing. States may contact original submitter to obtain needed information.  <div style="border: 1px solid gray; border-radius: 15px; padding: 5px; display: inline-block;">REJECT</div> State may reject company formation, if for example, information is missing or not in compliance with state law.



Duration of entire process:  
5 minutes to 60 days

Sources: GAO; Art Explosion (images).

<sup>a</sup>Share information applies only to corporations.

<sup>b</sup>In two states, New Mexico and Nebraska, the filing fee for corporations was a range. The median was calculated using the lowest fee in the range.

## Types of Companies

Businesses may be incorporated or unincorporated. A corporation is a legal entity that exists independently of its shareholders—that is, its owners or investors—and that limits their liability for business debts and obligations and protects their personal assets. For example, the owners of a small store may desire limited liability protection in case a customer is accidentally injured inside the store and decides to sue. In this hypothetical case, the owners' personal assets, such as their home and retirement savings, generally would not be subject to any award if the customer won the lawsuit. Limited liability means that owners or shareholders in a business entity are personally responsible only for the amount they have invested in the business, while the corporation itself is responsible for the debts and other obligations it incurs. The exception occurs when a court "pierces the corporate veil," or disregards the legal entity that is the corporation, and holds the owners, shareholders, and sometimes the officers and directors

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responsible for the corporation's acts and obligations.<sup>11</sup> In contrast, the owners of unincorporated businesses, such as partnerships and sole proprietorships, are generally liable for all debts and liabilities incurred by their businesses. However, these types of businesses also offer tax advantages that corporations do not.<sup>12</sup>

The limited liability company (LLC) is a fairly new business form that is a hybrid of the corporation and the partnership. Wyoming passed the first law permitting formation of LLCs in 1977, and Florida followed suit in 1982. By the mid-1990s, all states had enacted LLC statutes. Like a corporation, an LLC protects its owners, which are referred to as members, from some debts and obligations; like partnerships and sole proprietorships, however, it may confer certain tax advantages.<sup>13</sup> In addition, LLCs can choose a more flexible management structure than corporations. Table 1 shows the key characteristics of the different types of U.S. businesses.

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<sup>11</sup>Piercing the corporate veil is justified only in extraordinary circumstances where a court finds that a unity of interest and ownership between an individual and a corporation exists to such an extent that recognizing a separate existence between the two would result in an injustice. In such cases, a court may disregard the corporate entity and impose personal liability on the individual. See 1 Fletcher Cyclopedia of Private Corp. §41 and 45 Am. Jur. Proof of Facts 3d 1.

<sup>12</sup>Corporations are generally subject to income taxes on the corporation's taxable income. 26 U.S.C. § 11. Shareholders are generally subject to income taxes on dividends they receive from corporations with respect to its stock. 26 U.S.C. § 61(a)(1)(7). Certain small business corporations on the other hand may elect under the federal tax code to be taxed as an S corporation, which generally allows corporate income to pass through to the shareholder level before it is subject to federal income taxation. 26 U.S.C. §§ 1361(a)(1), 1363 and 1366. Partners in business are generally liable for income tax in their separate, individual capacity rather than the partnership being liable for income tax. 26 U.S.C. § 701.

<sup>13</sup>In late 1996, the IRS issued regulations that generally allowed LLCs to elect how they will be treated for federal tax purposes—that is, as sole proprietorships (disregarded entities), partnerships, or corporations, depending on the number of members. 26 C.F.R. §§ 301.7701-2 & 301.7701-3.

**Table 1: Basic Types of U.S. Businesses**

<b>Business form</b>	<b>Key characteristics</b>
<b>Corporation</b>	An artificial construct (usually a business entity) created by law that acts as a separate and distinct legal entity apart from its owners and that has other legal rights, such as the ability to issue stock.
C corporation (for tax purposes)	Generally, any corporation that is not an S corporation.
S corporation (for tax purposes)	A small business corporation that elects to be taxed as an S corporation under the federal tax code. The taxable income of an S corporation is passed through to the shareholders and taxed at the shareholder level.
<b>Limited liability company (LLC)</b>	A company that offers its owners (members) some protection from responsibility for the company's debts and obligations. An LLC may have only one member and may be managed by its members or managers.
<b>Partnership</b>	An association of two or more persons who jointly own and conduct a business and agree to share the profits and losses of the business.
Limited partnership	A partnership consisting of one or more limited partners who contribute capital to and share in the profits of the partnership but who are responsible for the company's debts only up to the amount of their contribution and one or more general partners who control the business and are personally liable for its debts.
Limited liability partnership	A partnership in which the participants are not responsible for negligent acts committed by other partners or by employees not under the partner's supervision. Certain businesses (typically law firms or accounting firms) are allowed to register under state statutes as this type of partnership.
Limited liability limited partnership	A partnership in which general and limited partners are not responsible for the partnership's debts and obligations.
<b>Sole proprietorship</b>	A business operated by one person who owns all assets and is responsible for all of the liabilities.

Sources: Black's Law Dictionary (8<sup>th</sup> ed. 2004); Uniform Limited Liability Company Act, § 202(a) (1996); 26 U.S.C. §§ 1361, 1363 and 1366; Uniform Limited Partnership Act 2001 Refs.; and Annos., Prefatory Note (Main Vol. 2003).

## Corporations and LLCs

Historically, the corporation has been the dominant business form, but recently the LLC has become increasingly popular. According to our survey, 8,908,519 corporations and 3,781,875 LLCs were on file nationwide in 2004. That same year, a total of 869,693 corporations and 1,068,989 LLCs were formed. Figure 2 shows the number of corporations and LLCs formed in each state in 2004. Five states—California, Delaware, Florida, New York, and Texas—were responsible for 415,011 (47.7 percent) of the corporations and 310,904 (29.1 percent) of the LLCs. As shown in figure 3, Florida was the top formation state for both corporations (170,207 formed) and LLCs (100,070) in 2004. New York had the largest number of corporations on file in 2004 (862,647) and Delaware the largest number of LLCs (273,252). Data from the International Association of Commercial Administrators (IACA) shows that from 2001 to 2004, the number of LLCs formed increased

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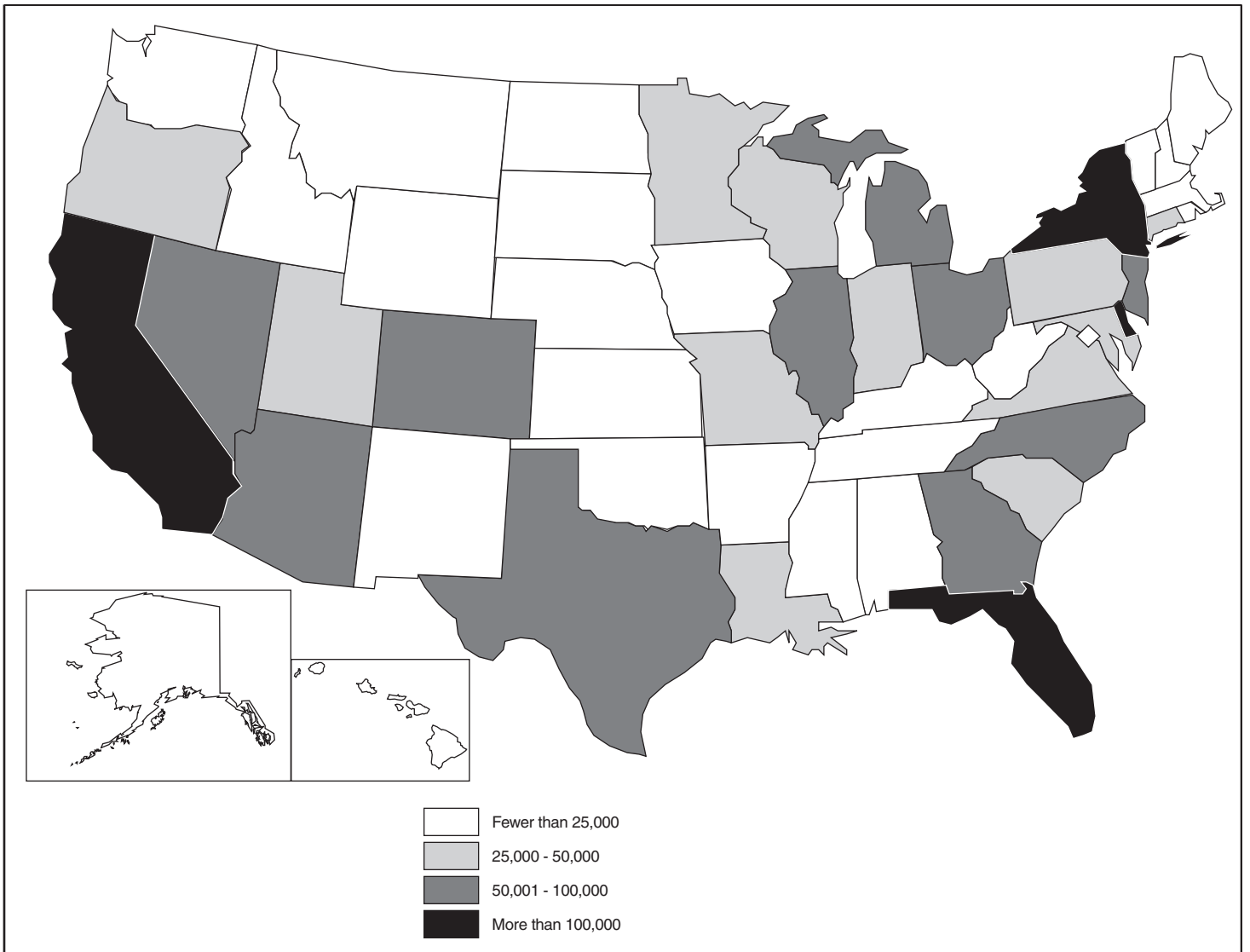
rapidly—by 92.3 percent—although the number of corporations formed increased only 3.6 percent.<sup>14</sup>

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<sup>14</sup>IACA is a professional association for government administrators of business organization and secured transaction record systems at the state, provincial, and national level in any jurisdiction. The IACA data include domestic, foreign, and professional companies. Domestic companies are those doing business in the same state in which they are incorporated or formed. Foreign companies do business in a state, but they are incorporated or formed in another jurisdiction, either in another U.S. state or a foreign country. Professional corporations may include professional services, such as those performed by doctors, dentists and attorneys. Combining figures for these different types of companies overestimates the number of companies formed under the state statutes examined in this report, which covers only domestic companies. Some states did not report data to IACA.

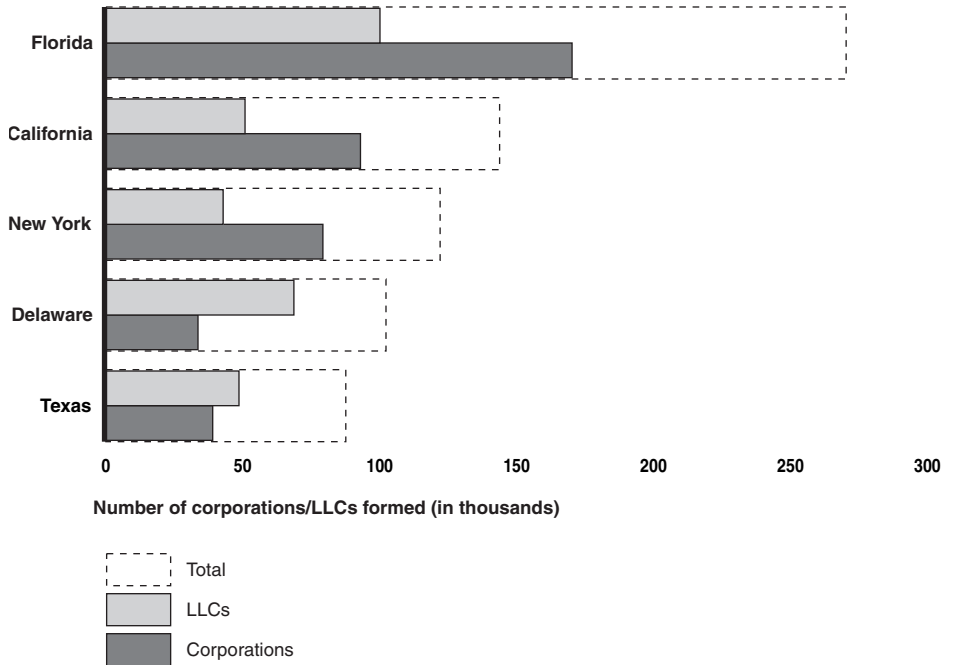


**Figure 2: Domestic Corporations and LLCs Formed in States in 2004**



Sources: GAO survey of state officials responsible for company formation (data); Art Explosion (map).

**Figure 3: Number of Domestic Corporations and LLCs Formed in the Top Five States in 2004**



Source: GAO survey of state officials responsible for company formation.

## Most States Collect Limited Information on Company Ownership and Management

Most states do not require ownership information at the time a company is formed, and while most states require corporations and LLCs to file annual or biennial reports, few states require ownership information on these reports. Similarly, only a handful of states mandate that companies list the names of company managers on formation documents, although many require managers' information on periodic reports. States may require other types of information on company formation documents, but typically they do not ask for more than the name of the company and the name and address of the agent for service of process (where legal notices for the company should be sent). Most states conduct a cursory review of the information submitted on these filings, but none of the states verify the identities of company officials or screen names against federal criminal records or watch lists.

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## Information States Collect on Company Ownership

The owners of a company are, in the case of a corporation, the shareholders of that corporation and in the case of an LLC, the members of that LLC.<sup>15</sup> According to our survey results, none of the states collect ownership information in the formation documents—articles of incorporation—for corporations (see fig. 4). State statutes generally do, however, require corporations to prepare and maintain lists of shareholders that, unlike formation documents, are not filed with the state or part of the public record.<sup>16</sup>

With respect to LLCs, states generally require a manager-managed LLC to name the designated manager instead of a member on the formation document—articles of organization. However, the manager is not necessarily an owner of the LLC.<sup>17</sup> LLCs usually prepare and maintain operating agreements that name the owners, members, and their financial interests in the company, but these operating agreements are not filed with the state or part of the public record. According to our survey results, four states—Alabama, Arizona, Connecticut, and New Hampshire—request some ownership information when an LLC is formed.<sup>18</sup> For example, in Alabama, the formation documents must list the names and mailing addresses of the initial members of an LLC. A Connecticut official said that either a member's or a manager's name was required on the articles of organization. In New Hampshire, a member or manager is required to sign the articles of organization. Arizona statutes mandate that manager managed LLCs must list on formation documents the name and address of each member owning more than a 20 percent interest and that member-managed LLCs must list all members' names and addresses. Depending on the management structure of an LLC, ownership information

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<sup>15</sup>Companies may have complex structures with multiple organizational layers—beyond the two-tier parent/subsidiary construct—of different types of business entities, and the shareholders of a corporation and members of an LLC could be individuals or other businesses. Therefore, identifying the individual who is the beneficial owner directing the company and receiving the proceeds or other advantages of the company may involve uncovering the ownership of various layers of entities.

<sup>16</sup>Unless otherwise specified, data are from our survey of state officials responsible for company formations.

<sup>17</sup>An LLC can be member managed, with the owners collectively running the business, or manager managed, with one or more persons or entities—either designated members or an outside party—taking the managerial role.

<sup>18</sup>One state did not respond to the survey question on providing names of owners of corporations, and two states did not respond to the question on the addresses of owners.

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may be included on the formation documents in more states. If an LLC is managed by its members, some states require the LLC to provide the name and address of at least one member on the formation document.

Most states require corporations and LLCs to file periodic—annual or biennial—reports, but not many states require ownership information on these reports (see fig. 4).<sup>19</sup> With respect to corporations, three states (Alaska, Arizona, and Maine) indicated on our survey that the name of at least one owner was required on corporations' periodic reports. In Alaska, any person owning more than a 5 percent interest in a corporation must be listed on the periodic report, according to a state official. An official from Arizona said the state requires that corporate periodic reports list the names and addresses of shareholders owning more than 20 percent of company stock. In Maine, statutes require that periodic reports include the names and addresses of shareholders of a corporation only if there are no directors.

With respect to LLCs, our survey showed that five states require LLCs to list at least one member on their periodic reports.<sup>20</sup> As with corporations, Alaska requires the name and address of any person owning more than a 5 percent interest in an LLC to be listed on the company's periodic report. A state official told us that LLCs in Kansas are required to list on their periodic reports the names and post office addresses of members owning at least 5 percent of the capital in the company.<sup>21</sup> Connecticut and New Hampshire require either a manager or at least one member name on their periodic reports. Maine requires the name and business or residential address of each manager, or if there are no managers, each member with a street address on the periodic report. Finally, in states that require a manager's or managing member's name on periodic reports, the reports for member-managed LLCs might include a member's name.

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<sup>19</sup>Forty-eight states require an annual or biennial report for corporations, and 37 states require an annual or biennial report for LLCs. In some states, such as Alabama, New Jersey, and Oklahoma, the annual report may be submitted to a different office, such as the department of revenue, rather than the office that handles formation filings. In addition, an Iowa official told us that as of January 1, 2006, LLCs are required to submit biennial reports.

<sup>20</sup>The five states are Alaska, Connecticut, Kansas, Maine, and New Hampshire. One state did not respond to this survey question.

<sup>21</sup>In 2004, Kansas removed a requirement that corporations list the names and post office addresses of shareholders owning at least 5 percent of capital stock in order to limit the reporting requirements for corporations.



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information requirements for company formations. For instance, our review of state statutes found that Louisiana does not require information on directors on the incorporation documents, but does require directors' names and addresses on an initial report that must be filed with the incorporation documents. We also found that Oklahoma requires the names and addresses of the directors only if the persons incorporating the company are not responsible for its operations after the incorporation documents are filed. More states require management information on LLCs. Nineteen states require the names of managers or managing members on formation documents, and 18 states require their addresses.<sup>23</sup>

Most states require the names and addresses of corporate officers and directors and of managers of LLCs on periodic reports (see fig. 5). For corporations, 47 states require the names of officers on periodic reports, and 46 states require officers' addresses. Thirty-eight states require directors' names and 37 require directors' addresses. For LLCs, 28 states require the manager's or managing member's name, and 27 states require their addresses. However, even if states require disclosure of directors' names, those listed may not be the individuals who are truly directing the company because in some cases, the individuals could be nominee directors that act only as instructed by the beneficial owner of the company.<sup>24</sup> Also, managers may or may not be owners of the LLC.

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<sup>23</sup>One state did not respond to this survey question.

<sup>24</sup>A nominee director may be an individual who is located where the business was formed and may sign for the business on behalf of the beneficial owner. Typically, the nominee director will have no knowledge of the business affairs or accounts, cannot control or influence the business, and will not act unless instructed to by the beneficial owner. We did not review state statutes on the use of nominee directors. While this mechanism may serve legitimate purposes, it can also be used to conceal identities and evade scrutiny. See Organization for Economic Co-operation and Development (OECD), *Behind the Corporate Veil, Using Corporate Entities For Illicit Purposes* (Paris, 2001); and *U.S. Money Laundering Threat Assessment* (Washington, D.C., December 2005).



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addition, a majority of the states include on their formation documents space for an individual to sign as the incorporator (in the case of a corporation) or organizer (in the case of an LLC) of the company.<sup>25</sup> The incorporator or organizer may be the agent who is forming the company on behalf of the owners or it may be an individual affiliated with the company being formed. Most states permit an individual or entity to serve as incorporator without regard to state residency or later participation in the company, but at least two states require that the incorporator be associated with the company in some way. For example, the articles of incorporation for Arkansas and California state that if a newly incorporated company has chosen initial officers or directors, one or more of them must sign as the incorporator. Otherwise, an unaffiliated individual can sign as the incorporator.

Many states require a brief statement of purpose or a principal office address in order to form a corporation or LLC.<sup>26</sup> In reviewing state statutes and state forms, we found that 20 states require a statement on the purpose of a corporation and 16 require a statement of purpose for LLCs on formation documents. In some states that ask for a statement of purpose, a general statement such as “the purpose of the corporation is to engage in any lawful act or activity...” is sufficient. Alaska requires an additional form that discloses the North American Industry Classification System (NAICS) number that most closely describes the activities of a corporation.<sup>27</sup> Fourteen states require a principal office address to form a corporation, and 23 states require a principal office address to form an LLC. The principal office generally means either the address of the company’s place of business or its mailing address. Therefore, even in states where a principal office address is required, this address may not indicate the company’s actual place of business. For example, Arizona’s form asks for a

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<sup>25</sup>Many states also ask for this individual’s address more often for corporations than for LLCs. The primary role of the incorporator is to execute and deliver the formation document to the state company formation office. Although state statutes may not require this information, states may request or require this information be included on the company formation documents.

<sup>26</sup>Some states may require this information for corporations or LLCs, but not both. Appendix II has information on each state’s information requirements for company formation documents.

<sup>27</sup>The North American Industry Classification System is a system for classifying businesses that was developed jointly by the United States, Canada, and Mexico for the collection, analysis, and publication of statistical data related to the business economy across North America.



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known place of business in Arizona, but the instructions for the form state that this address may be in care of the address of the company's agent.

Some states have unique requirements for information on newly forming companies. For example, the articles of incorporation forms for Louisiana, Rhode Island, and South Dakota must be notarized. Similarly, an attorney licensed to practice in South Carolina must sign company formation documents in that state. Private sector officials told us that more states used to require a notary's signature on company formation documents, but that most had repealed this provision. A Louisiana state official said that requiring a notary's signature was a "historical" decision and, despite an effort to change the law, was likely to remain a requirement.

A few states (Louisiana, Massachusetts, Mississippi, and Pennsylvania) also require a federal taxpayer identification number (TIN) on some company formation documents.<sup>28</sup> Kansas requests a TIN on formation documents, but it is not required by statute. Louisiana and Massachusetts state officials told us that even though a TIN is required, company formation documents are not rejected if it is not included. These states originally used the TIN as a tracking number for filings. For instance, the Kansas Department of Revenue uses the information to match companies in its database. A Massachusetts official said that the state was moving away from using TINs in all cases and now assigns a private unique identification number to each company for tracking purposes. While the requirement to include a TIN is still in place for LLCs in Massachusetts, it was recently deleted from the corporation statute because the Secretary of State's office received many complaints about this number being publicly available on filing documents.

Forty-two states reported on our survey that their information requirements for persons or entities from outside the United States forming a U.S. company were the same as for U.S. citizens. Those states that say there was a difference also said that the difference was simply that proof of the company's existence had to be included and that documents had to be translated into English. For example, Minnesota and North Carolina commented that if an entity from another country was applying to conduct

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<sup>28</sup>A taxpayer identification number is an identification number used by the Internal Revenue Service in the administration of tax laws. It can be either a Social Security number issued by the Social Security Administration (SSA) or another number, such as an employer identification number (EIN), issued by the IRS.

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business in those states, the entity must provide proof of good standing or a document certifying that the company existed in the original country.<sup>29</sup> Alaska is the only state that requires the name and address of each alien affiliate or a statement on the articles of incorporation that there are no alien affiliates. An “alien affiliate” is an individual from another country who has some ownership or control of a company or an entity controlled by an individual or a corporation from another country.<sup>30</sup> An Alaska state official said that this information was originally required to identify offshore fisheries and their owners.

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### State Officials Reported That They Generally Reviewed Documents for Basic Information but Did Not Verify the Information

Nearly all of the states reported that they reviewed filings for the required information and fees and checked to see if the proposed name was available (see table 2). In Arizona, for example, state officials said that the main reasons filings were rejected were that required information, such as the agent’s address or signature or the type of management structure of an LLC, was missing and that the company name was not distinguishable from an existing entity’s name. Other state officials said they also rejected filings because they were missing key information, the company name was not available, or the fee was not included. Many states also reported that they reviewed filings to ensure compliance with state laws.<sup>31</sup> In Virginia, for instance, filings are reviewed for more than just the required information. An attorney in the state office reviews all formation filings for substantive issues. For example, Virginia law requires that shareholders elect directors, and state officials said that they would reject a filing if the articles stated that the company’s directors would be chosen by a different method.

None of the states reported verifying the identities of incorporators or company officials or using federal criminal records or watch lists to screen names. State officials gave several reasons for not taking this step when reviewing formation documents. In interviews and on the survey, many state officials emphasized that their role was authorized by statute as only administrative, not investigative. In fact, 45 states reported that they did

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<sup>29</sup>Minnesota also commented that an agent is required for persons or entities from other countries forming a Minnesota company.

<sup>30</sup>An “alien affiliate” could also be an entity that was either created or organized in another country or whose principal place of business is located outside of the United States.

<sup>31</sup>We do not have information on the extent of this legal review in all of the states that responded that they conduct such a review.

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not have investigative authority to take action if they identified information that could indicate criminal activity, although some state officials said they can refer suspicious activity to law enforcement. Only two states—Colorado and North Carolina—reported that they did have investigative authority.<sup>32</sup> Further, two states noted that their state statutes required them to file formation documents as long as the documents contained the required information. In addition, one state official said that states did not have the resources to verify the information submitted on formation documents and other officials commented on the survey that verification would significantly increase the costs and workloads of their offices. Another stated that the staff would not know how to determine the validity of information individuals provided to verify their identity.

While states do not verify the identities of individuals listed on company formation documents, an individual may be charged with perjury in some states if law enforcement officials find in the course of an investigation that an individual submitted false information on a company filing. We found in our review of state forms that 10 states note the penalties for providing false information on their company formation documents. One state official provided an example of a case in which state law enforcement officials charged two individuals with, among other things, perjury for providing false information about an agent on articles of incorporation.

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<sup>32</sup>Four other states responded either “no response” or “do not know” to this question.

**Table 2: Steps States Take to Review Articles of Incorporation/Organization and Periodic Reports**

Processing steps	Corporations				LLCs			
	Articles only	Reports only	Both	Not performed or no response	Articles only	Reports only	Both	Not performed or no response
Review for availability of company names	47	0	3	1	45	0	2	4
Review for presence of information and fees	11	39	0	1	16	2	31	2
Determine whether submitted information is in compliance with state law	10	1	35	5	16	2	28	5
Verify with picture IDs the identities of incorporators, directors, or officers	0	0	0	51	0	0	0	51
Use federal criminal records or watch lists to screen names of incorporators, directors, or officers	0	0	0	51	0	0	0	51
Direct staff to look for suspicious activity or fraud in filings	2	0	4	45	3	0	3	45

Source: GAO survey of state officials responsible for company formation.

A few states reported that they directed staff to look for suspicious activity or fraud in company filings. For example, an official in Alabama told us that staff who reviewed filings looked for anything out of the ordinary, such as a bank from another country that wanted to form a company in Alabama but would not provide the required information. An official in Missouri said that despite not having a formal procedure or policy for reviewing filings for suspicious activity, staff were trained to look for things that were out of the ordinary. Such things might include discrepancies like two signatures of the same name with different handwriting. However, most states reported that they did not direct staff to look for suspicious information. According to an official in Alaska, the state has no formal mechanism for identifying or reporting suspicious information. The official said that staff would notice unusual fictitious names on filings, but with a filing fee of \$250 in Alaska, this type of activity was rare. Two state officials told us that when staff noticed something unusual, they typically contacted the applicant for an explanation but still usually filed the documents. If something appeared especially unusual, they referred the issue to state or local law enforcement or the Department of Homeland Security. One official said his office had

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never received a response from law enforcement about issues that had been forwarded.

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## Agents Facilitate Company Formation but Are Not Required to Collect Ownership Information or Verify Information on Clients

The roles of company formation agents and agents for service of process differ, as do the state statutes that govern them.<sup>33</sup> Company formation agents submit documents on a company's behalf, and agents for service of process receive legal and tax documents for clients. Most states do little to oversee these agents and do not verify information about them. Further, states generally do not require agents to collect information on company ownership or management or to verify the information they collect. The agents we interviewed generally collect only contact information and any information required by the states and do not verify the information. In some circumstances—primarily with international clients and clients requesting special services—some agents may verify a client's identity.

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## Company Formation Agents and Agents for Service of Process Play Different Roles

Company formation agents are firms that help individuals form companies by filing required formation documents and other paperwork with the appropriate state agencies. Although individuals may file their own formation documents directly, a company formation agent can facilitate the process. Agents for service of process can be either persons or entities that are designated to receive important tax and legal documents on behalf of businesses. For example, if a company is being sued, the agents for service of process will accept the legal paperwork and forward it to their company contacts. Historically, the role of agents was to ensure companies had a presence in each state they operated in and were able to be reached. Our review of state statutes showed that almost all states require companies to designate an agent for service of process on company formation

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<sup>33</sup>We interviewed a total of 12 third-party agent companies that provide company formation and service of process services. The companies ranged from large national companies to small companies. In this report, we refer to company formation agents and agents for service of process as simply "agents" unless otherwise specified. Some agents and state officials told us that most companies are formed by individuals who also designate themselves as the agent for service of process. Anecdotally, agents told us that they may work with up to 30 percent of the total companies formed.

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documents.<sup>34</sup> These agents may provide other services, such as filing amendments and periodic reports, assisting with mergers and acquisitions, obtaining certificates of good standing, and conducting other public record searches. Agents may also provide assistance in setting up bank accounts or providing directors, although only a couple of the 12 agents we contacted said that they would provide these services, and then only in special situations.<sup>35</sup> According to a few agents we interviewed, large companies are more likely to hire agents, especially large companies that need an agent for service of process in multiple states.

Most states have basic requirements for agents for service of process. Forty-six states indicated on our survey that they required agents for service of process to have a physical address in the state (not a post office box) where documents could be received, while seven states required agents to keep specific office hours. Individuals serving as agents for service of process generally must be state residents or have a state address, but firms acting as agents generally must be authorized to do business in the state and must have filed company formation documents. A few states have additional requirements for agents. For example, in Maine, an agent must be a natural person, while in Louisiana, a professional law corporation or partnership may serve as the agent.<sup>36</sup> In Virginia, agents for service of process must be individuals who are both a resident and an officer of the company being formed, members of the state bar, or companies authorized to do business in the state, and must specify their qualification on the company formation documents.

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<sup>34</sup>In New York, the Secretary of State serves as the designated agent but another agent may be designated. Minnesota and Pennsylvania require a registered office but the name of an agent is not required. Louisiana does not require an agent on the formation documents, but does require an agent to be listed on the initial report that is filed with the formation document.

<sup>35</sup>Typically, the nominee or dummy director is a mere figurehead and will have no knowledge of the business affairs or accounts, cannot control or influence the business, and will not act unless instructed to by the beneficial owner. Special circumstances could arise, for example, if a bank required someone independent of a corporation to serve as director for purposes of granting a loan.

<sup>36</sup>A natural person is a legal term and means a “human being.”

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## Few States Verify Information from or Otherwise Oversee Agents

We found limited incidences of state oversight of agents. A few state officials we spoke with reported checking company formation documents to ensure that agents had a local address, but in general they did not check to see whether the address was valid. One state official said the office verified addresses only in special cases. Delaware reviews its agents' addresses if several hundred transactions occur from the same address to ensure it is an actual address and not a post office box. In addition, Delaware is unique in allowing approximately 40 agents to have direct access to the state's database to enter or access company information. The state contracts with these agents, and in return they must meet certain guidelines and pay access fees. The state reserves the right to terminate these contracts at any time but thus far has not done so because of nefarious behavior. State officials in Florida and Wyoming told us that they checked their records to ensure that companies acting as agents for service of process were authorized to conduct business in the state.

Thirty-nine states said they did not track the number of agents for service of process operating in the state and 36 did not have an official listing of agents. However, a couple of states have registration requirements for operating within their boundaries. Wyoming requires agents serving more than five corporations to register with the state annually, under a law that was enacted after some agents gave false addresses for their offices, according to a state official. To register, agents must pay a \$25 annual fee and complete a form each January giving contact information, including a physical and mailing address, and indicating whether the applicant or any company principal has ever been convicted of a felony. The state official said that the office kept the information on file in case an agent was investigated. California law requires any corporation serving as an agent for service of process to file a certificate with the Secretary of State's office and to list the California address where process can be served and the name of each employee authorized to accept process. Seventeen states indicated on the survey that they provide the names of all or some agents on a Web site, and 6 states reported having some requirements for agents wanting to be listed on the Web site.<sup>37</sup> For example, Delaware requires a business to have been operating for at least 1 year, to be in good standing, and to serve more than 50 clients.

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<sup>37</sup>Seventeen states indicated on our survey that they provided the names of all or some agents. However, we were unable to verify the listing of agents for all of these states.

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Although the notion is controversial, some state officials and agents said that some level of uniform registration or certification in the industry might be desirable, for several reasons. One agent told us that the few agents who do not follow the current rules give the industry a bad name and that regulation would eliminate some of these agents. Another agent felt that registration would create some standards in the industry and provide some legitimacy for firms conducting business in international jurisdictions that require registration. However, some agents felt that regulation would be difficult if not detrimental to the industry. One agent felt that if the industry were regulated, individuals would avoid using agents and form their companies themselves. Another agent believed that the costs associated with meeting standards could be high enough to drive smaller firms out of business. In either case, both agents that supported and opposed regulation said that the industry should be involved in efforts to develop some type of registration or regulation that would affect their business.

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**Agents We Talked with Said They Generally Do Not Collect Ownership and Management Information on Companies Because States Do Not Require Them to Collect It**

Agents we spoke with generally collected only contact information and the information required by a state for company formation documents or periodic reports. This information may include contact names for billing and for forwarding service of process, annual reports, or tax notifications. These agents said they may have only one contact name for a company. According to several agents, they rarely collect information on ownership since states do not require it. In general, agents said they collect the names and addresses of officers and managers, if required, and when serving as an incorporator, agents may collect information on the company directors or shareholders, even if it is not required. This information allows agents to resign as incorporators and pass on the authority to conduct business to the new company principals. Depending on the size of the company, the directors and the officers may also be the owners, but one agent told us that he did not try to determine if they were. Several agents also told us that they do not always work directly with the principals of the company because the agents interact directly with law firms or transact a large part of their business online, and therefore may not have access to additional information not required by the state. One agent also noted that collecting ownership information was not necessary to doing his job.

Even if agents collect information such as the names of officers and directors, a few agents said that they might not keep records of the information. For example, two agents told us that their firms did not keep a database of company information, in part because company documents filed with the state are part of the public record. Because the information is



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public, one agent felt it was not necessary to bear the additional cost of storing it internally. According to our review of state statutes, some states have record retention requirements that oblige corporations to make shareholder lists or the stock ledger available at the registered office within the state (which may be the agent's office), although the requirements vary by state. For example, in Nevada, the registered office is required to keep the stock ledger or a file listing the location of the ledger, and in New Mexico, a list of shareholders must be available at a company's registered office 10 days prior to a shareholders' meeting.

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### Agents Are Not Required to Verify Information in Company Filings, but a Few Do

States generally do not require agents to verify the information collected from clients, and few agents we interviewed do. In general, agents told us they do not verify the validity of names or addresses provided, screen names against watch lists, or require picture identification of company officials. The extent of agents' verification might include checking that the minimum statutory requirements have been met, researching an address if a client's mail is returned, or comparing a credit card address to a company's address. One agent said that his firm generally relied on the information that it received and that in general did not feel a need to question the information, although another agent said that his firm might request additional information to assess risk if something about a potential client seemed suspicious.

Two agents with whom we spoke indicated that they collected additional information that could be used to verify the identity of clients, often when working with international clients, although the choice to verify information did not appear to be based on a formal risk assessment. These agents said they might check names against caller identification systems on their telephones or against the Office of Foreign Assets Control (OFAC) list of Specially Designated Nationals and Blocked Persons.<sup>38</sup> One agent said that her firm created a document to collect additional information from

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<sup>38</sup>OFAC is an office within the U.S. Department of the Treasury that administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals, as well as a master list of "Specially Designated Nationals and Blocked Persons" (SDN) that includes numerous foreign agents and front organizations, terrorists, terrorist organizations, and narcotics traffickers. See the U.S. Department of Treasury's Web site: <http://www.treas.gov/offices/enforcement/ofac/>. All U.S. persons, both individuals and entities, are responsible for ensuring they do not do business with a person or entity listed on the SDN list. Undertaking any type of business or financial transaction with a person or entity on this list is illegal under federal law.

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clients from unfamiliar countries. This agent's document was based in part on federal standards for financial institutions from the USA PATRIOT ACT.<sup>39</sup> On the document, the agent asks for a federal tax identification number (TIN); company ownership information; information from the company Web site; e-mail addresses; and, for individuals, identification, proof of occupation, and citizenship status.

Another agent we interviewed in Delaware asked for identification and used a specific agreement with certain international clients. In some cases, international agents contact the Delaware agent for assistance in forming U.S. companies for their clients in other countries. According to this agreement, international agents must verify the identity of an individual wishing to form a company through the Delaware agent by requiring their client to provide the principals' names, addresses, dates and places of birth, nationalities, and occupations, as well as certified copies of their passports, proof of address, and a reference letter from a bank.<sup>40</sup> This agent also required a client requesting mail forwarding services to provide additional information, such as a Social Security number, in addition to the information required by the U.S. Postal Service on its mail forwarding form. The agent said the firm collected this information to screen potential clients and protect the firm and that it would stop representing a client if the client generated a significant amount of service of process, complaints, or visits from investigative agents. In general, the agent felt the additional requirements were not burdensome. Another agent noted that any extra time added to the process was a result of the time required for the client to provide the information.

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<sup>39</sup>Title III of the USA PATRIOT ACT of 2001, passed after the September 11, 2001, terrorist attacks, amended U.S. anti-money-laundering laws and imposed new requirements on financial institutions. Section 326 of Title III required the Secretary of the Treasury to develop regulations establishing minimum standards for financial institutions to follow when verifying the identity of its customers in connection with the opening of an account. These regulations require financial institutions to establish a written customer identification program (CIP) that includes procedures for obtaining minimum identification information from customers that open an account with the financial institution, such as a person's date of birth, a government identification number, and physical address. The regulations stipulated that the CIP must include risk-based procedures for verifying the identification of a customer that enable the financial institution to form a reasonable belief that it knows the true identity of the customer. See *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act)* of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

<sup>40</sup>Proof of address can be satisfied by providing a utility bill, an original bank statement, or a letter from an employer.

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In addition, a few other agents said that they used the OFAC list to screen names on formation documents or on other documents required for other services provided by their company, although several agents told us they were not aware of the OFAC list. A few agents we interviewed in Delaware used commercially available software to screen client names against the OFAC list, a step strongly encouraged by the Secretary of State. However, one agent told us that his staff had never gotten a match on the list. One agent felt that running checks on the names listed on company documents could add time to the process but would likely not be a burden. Other agents found the list difficult to use and saw using it as a potentially costly endeavor. OFAC officials reported that they had also heard from agents that screening names against the OFAC list would result in increases in the time and cost of the process, which could lead to a loss in business.

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**Law Enforcement  
Officials Can Obtain  
Some Company  
Information from  
States and Agents, but  
a Lack of Ownership  
Information Obstructs  
Some Investigations**

Law enforcement officials are concerned about the use of U.S. shell companies to facilitate or hide criminal activity. Law enforcement officials we interviewed noted that they often used the information available from states in investigating shell companies that were suspected of criminal activities and said that, in some cases, the names of officers and directors on company filings had generated additional leads. However, officials also said that the information states collected was limited, noting that it could provide a place to start but that some cases had been closed because of insufficient information on beneficial owners.

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## Law Enforcement Officials Are Concerned about the Use of U.S. Shell Companies to Facilitate Criminal Activity

Law enforcement officials and other reports indicate that shell companies have become popular tools for facilitating criminal activity, particularly laundering money.<sup>41</sup> In December 2005, several agencies of the federal government, including the Departments of the Treasury, Justice and Homeland Security, issued the first governmentwide analysis of money laundering in the United States, which described, among other things, how shell companies can be used to launder money. Shell companies can aid criminals in conducting illegal activities by providing an appearance of legitimacy—for example, an artificial source of income or proof of the type of transactions legitimate companies conduct. Shell companies can also provide access to the U.S. financial system through U.S. bank accounts or offshore accounts in banks that have a correspondent relationship with a U.S. bank.<sup>42</sup> For example, in a Financial Crimes Enforcement Network (FinCEN) December 2005 enforcement action, FinCEN determined, among other things, that the New York branch of ABN AMRO, a banking institution, did not have an adequate anti-money-laundering program and had failed to monitor approximately 20,000 funds transfers—with an aggregate value of approximately \$3.2 billion—involving the accounts of U.S. shell companies and institutions in Russia or other former republics of the Soviet Union.<sup>43</sup>

Determining a precise number of criminal cases involving the use of shell companies to hide illicit activity is difficult because forming such companies is not a crime but rather is sometimes used as a method for moving money that may be associated with a crime. Therefore, the use of shell companies for illicit activities is not tracked by law enforcement or

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<sup>41</sup>Our review focuses on state information requirements when companies are formed and when they submit periodic reports. Other reports cite additional state practices that may also facilitate criminals hiding their identity such as allowing bearer shares, nominee directors, and nominee shareholders. See U.S. Departments of the Treasury, Justice, Homeland Security, et al, U.S. Money Laundering Threat Assessment Working Group, *U.S. Money Laundering Threat Assessment* (Washington, D.C., December 2005); and Organization for Economic Co-operation and Development (OECD), *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (Paris, 2001).

<sup>42</sup>A correspondent account is an account that a foreign bank opens at a U.S. bank to gain access to the U.S. financial system and to avoid bearing the costs of licensing, staffing, and operating its own offices in the United States. Many of the largest international banks serve as correspondents for thousands of other banks.

<sup>43</sup>Without admitting or denying the allegations, ABN AMRO Bank N.Y. agreed on December 19, 2005, to enter into a consent agreement to the assessment of civil money penalty.

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government agencies.<sup>44</sup> However, law enforcement officials told us they are seeing a wide range of indicators that suggest the increased use of U.S. shell companies for illicit activities.

- FinCEN officials told us they see many suspicious activity reports (SAR) filed by financial institutions that potentially implicated shell companies in the United States. For example, FinCEN reported in the U.S. Money Laundering Threat Assessment that financial institutions filed 397 SARs between April 1996 and January 2004 involving shell companies, East European countries, and correspondent bank accounts. The aggregate amount of activity reported in these SARs totaled almost \$4 billion.
- Justice officials said that law enforcement officials from other countries have asked the United States to help them track down the individuals that had formed U.S. shell companies to hide illicit activity, but the lack of ownership information is obstructing their investigations. For example, a review by Justice of requests for legal assistance in 2005 from Russia and Ukraine found 30 requests for assistance from Russian authorities and 75 requests from Ukraine authorities involving U.S. shell companies. These requests typically ask for assistance in identifying individuals associated with the U.S. companies. However, Justice's attempts to gather information in response to these requests on the companies are obstructed by the lack of information maintained by states and agents. These requests often involve serious crimes occurring in other countries but implicate a U.S. company. For example, in early 2006, one request was seeking information on a U.S. corporation allegedly used to smuggle a toxic controlled substance between two Eurasian countries because the name of the U.S. corporation was on the foreign customs papers.
- OFAC expressed concerns that shell companies can be used to facilitate transactions with targets (individuals, entities, or countries) of U.S. economic sanctions. In one example, during the period when the United States maintained sanctions against Yugoslavia (Serbia and Montenegro), a U.S. company formation agent filed incorporation papers for a Serbian entity, which then opened bank accounts in the

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<sup>44</sup>The 2005 *U.S. Money Laundering Threat Assessment* reported that the U.S. government currently does not have a systematic way of collecting data on the total amount of money laundering activity being apprehended by federal law enforcement agencies or the methods used to launder money.

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United States as a U.S. company to transfer money through the United States.

- The FBI told us they currently have over 100 ongoing cases investigating market manipulation and that the majority of these cases involve the use of shell companies. One closed case, for example, involved the sale of fraudulent private placement offerings to the investing public. The convicted individuals used U.S. shell companies to give investors the impression that they were investing in legitimate companies, but instead the individuals stole the investors' proceeds. In some cases, individuals have used shell companies to pump up the price of a stock and then sell their entire position in the stock while legitimate investors are left with worthless stock.
- The FBI has also expressed concern about the use of third-party agents to form thousands of shell companies in the United States for criminals operating in other countries; the criminals then use the shell companies to open U.S. bank accounts. The FBI believes that U.S. shell companies are being used to launder as much as \$36 billion from the former Soviet Union. An FBI analysis of the use of these third-party agents found that they often register the shell company using nominee officers to keep the foreign beneficial owner anonymous and use companies created at an earlier date—"aged shelf companies"—to give banks and regulatory authorities the impression the company has longevity.

Law enforcement officials provided us with examples of cases involving the use of U.S. shell companies. According to a Department of Justice report on Russian money movements, many of the investigations involving shell companies use common schemes to launder money and conceal money movements. In a "fictitious services" scheme, the criminals enter into a contract with a company purportedly offering an intangible service, such as consulting. The consulting company is actually a shell company owned by the criminals, so that payments for consulting services are actually payments into a bank account under their control. In one case involving a fictitious services scheme, a former public official from the Russian Federation allegedly helped to unlawfully divert international nuclear assistance funds that were intended to upgrade the safety of nuclear power plants operating in Russia and several former republics of the Soviet Union. The indictment stated that the suspects formed shell companies in Pennsylvania and Delaware that received the nuclear assistance payments and then diverted over \$15 million of this money to corporate bank accounts. Ultimately the money was allegedly transferred

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to other personal bank accounts in the United States and other countries and the transfers concealed behind fictitious business contracts. The subjects of the indictment allegedly used at least \$9 million to fund business investments and loans for their personal enrichment.

IRS investigations have also uncovered the use of U.S. shell companies in tax evasion schemes. In one tax evasion case, two co-conspirators used nominee names to open bank accounts and form U.S. corporations in Florida to hide their assets and income to avoid tax liabilities. One co-conspirator was sentenced to 10 years in prison and ordered to pay \$1.6 million in restitution. The other co-conspirator was sentenced to 25 years imprisonment for his involvement in the tax evasion scheme, as well as a related investment fraud scheme.

ICE officials also told us they have encountered the use of U.S. shell companies in their investigations. ICE officials interviewed a third-party agent who had registered approximately 2,000 companies for international clients. The registrations took place mostly in Oregon, but also in Arkansas, Colorado, Idaho, Iowa, Kentucky, Montana, South Dakota, Washington, and West Virginia. The investigation was prompted by a bank that had reported suspicious transactions in an account of one of the companies registered by this agent. This case was subsequently closed because the agent moved from the area and could not be found.

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### Information from Company Filings and Agents Is Available and Useful to Law Enforcement, but Is Often Too Limited to Solve Cases

Law enforcement officials obtain some company information from states and agents through a variety of methods. Our review of states' Web sites found that 46 states provide some company information online for free, but that states post different amounts of company information on their Web sites.<sup>45</sup> For instance, Virginia officials told us that while the name of the incorporator is on the articles of incorporation, it is not added to the on line database. In addition, Delaware lists only the company name and the name and address of the agent online, while Florida makes copies of all documents available with all of the information they contain, including names of directors and managers. Given the variations in what is available online, law enforcement officials may request paper copies of filings that could provide more information. Law enforcement officials may also

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<sup>45</sup>The states that do not provide information online for free are Arkansas, Hawaii, Maine, New Jersey, and Texas. In these states, we found that some information is available online for a fee.

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obtain company information from agents, although some law enforcement officials said they do not usually request information from agents because too little would be available, and one state law enforcement official said the agents might tell their clients about the investigation. Some agents told us they usually collect the same information as the state, but other agents and law enforcement officials indicated that agents might have additional information that could be useful in investigations, such as contact addresses and methods of payment.

While ownership information is typically not available from states or agents, some law enforcement officials said the names of officers and directors and other information on forms could be helpful in some investigations. If ownership information is not available, law enforcement officials said that the names of officers and directors—even false names—could provide productive leads. In addition, law enforcement officials said that other information, such as addresses, could be investigated and also might provide productive leads.

In other cases, though ownership information is not required, the actual owners may include personal information on the state's documents. For example, IRS investigated four people in Michigan who formed 15 shell corporations in Michigan and Indiana. Using these shell companies, the co-conspirators established 37 lines of credit at a bank and charged a number of large purchases, including real property, several luxury cars, jewelry, boats, and a motor home. The bank incurred losses of approximately \$9.6 million. The IRS investigators found key pieces of evidence, including the identity of the co-conspirators, on the articles of incorporation and annual reports maintained by the states where the corporations were formed. Two of the co-conspirators were sentenced to 45 months and 51 months in prison and ordered to pay \$327,500 and \$2.8 million in restitution, respectively. In another IRS case, a man in Texas used numerous identities and corporations formed in Delaware, Nevada, and Texas to sell or license a new software program to investment groups. He received about \$12.5 million from investors but never delivered the product to any of the groups. The man used the corporations to hide his identity and to provide a legitimate face to his fraudulent activities. He also used the companies to open bank accounts to launder the money obtained from investors. IRS investigators found from state documents that he had incorporated the companies himself and often included his co-conspirators as officers or directors. The man was sentenced to 40 years in prison.



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In some cases, law enforcement officials have evidence of a crime but cannot connect an individual to the criminal action without ownership information. For example, an Arizona law enforcement official charged with helping investigate an environmental spill that caused \$800,000 in damage said that the investigators could not prove who was responsible for the damage because the suspect had created a complicated corporate structure involving multiple company formations.<sup>46</sup> ICE officials described a subject who allegedly used an agent to establish a Nevada-based corporation that in almost 2 years received 3,774 wire transfers totaling \$81 million from locations such as the Bahamas, British Virgin Islands, Latvia, and Russia. However, ICE could not identify the suspect as the beneficial owner of the corporation because other people had handled the transactions. These cases were not prosecuted because investigators could not identify critical ownership information. Most of the law enforcement officials we interviewed said they had also worked on cases that reached dead ends because of the lack of U.S. company ownership information.

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## More Company Ownership Information Could Be Useful to Law Enforcement, but Concerns Exist about Collecting It

State officials, agents, and others we interviewed said that collecting company ownership information could be useful to law enforcement and other interested parties. As we have discussed, investigations can be closed because of a lack of information, such as the names of the beneficial owners of a company. But if states or agents collected additional information on companies, filing times could increase, and a few states worried that costs could increase and company start-ups could be deterred. Further, information collected when companies were being formed might not be complete or up to date, as officers and directors might not have been chosen and the ownership could change after the company was formed. In addition, including such information in public records could cause concerns about privacy and related issues. State officials, agents, and other experts in the field suggested internal company records, financial institutions, and the IRS as alternative sources that might already be collecting this information. However, obtaining information from these

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<sup>46</sup>Dispersing assets among as many different types of entities and jurisdictions as possible is also a way to protect assets. The goal of this approach is to create complex structures that, in effect, provide multiple protective trenches around assets, making it challenging and burdensome to pursue. See GAO, *Environmental Liabilities: EPA Should Do More to Ensure That Liable Parties Meet Their Cleanup Obligations*, [GAO-05-658](#) (Washington, D.C.: Aug. 17, 2005).

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sources also has limitations because the information may not be up to date or available.

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### States and Agents Acknowledged Benefits of Having Additional Information on Company Ownership but Raised Concerns about Collecting It

Collecting ownership information when companies are formed could have some positive impacts for law enforcement as well as members of the public searching for this information. As shown in figure 6, 21 states in our survey said that if more ownership information were collected at company formation, that additional information would be available to law enforcement and the public. And as we have discussed, law enforcement investigations can benefit from knowing who owns and controls a company. A couple of state officials said that collecting such information would also allow them to be more responsive to consumer demands they have received for this information. For example, officials in Arizona and the District of Columbia told us that they often received phone calls from the public asking for ownership information they could not provide. In addition, one agent suggested that requiring agents to collect more ownership information could discourage dishonest individuals from using agents and could reduce the number of unscrupulous individuals in the industry.

State officials and agents noted that collecting additional information could increase filing times, and a few were concerned about other negative effects. Our survey showed that 29 states reported that the time needed to review and approve formations would increase if information on ownership was collected, since more data would need to be recorded in their databases (see fig. 6). A few states calculated that they would incur additional costs in modifying their forms, databases, and online filing systems to accommodate the new requirements. One state official said the extra time that would be required to review filings would reduce the benefits of electronic filing. Agents we interviewed also said that collecting and storing ownership information would increase the time necessary to provide their services and raise costs for both themselves and their clients. Other agents said that collecting and verifying ownership information would be difficult because they may have contact only with law firms and not company officials when a company is formed. State officials and others also noted that individuals could easily provide false names if ownership information were required without being verified.

**Figure 6: Implications of All of the States Collecting Information on Company Ownership**

	Number of states that responded on the following impacts			
	Decrease ←   → Increase		Stay the same	Not applicable or no response
Time to approve company formations	0	29	15	7
Fees charged for company formations	0	8	31	12
Number of companies formed in the state	6	5	23	17
Information available to the public	0	21	17	13
Information available to law enforcement officials and courts	0	21	14	16

Source: GAO survey of state officials responsible for company formation.

Our survey results showed that in nearly half the states (23), officials thought the number of companies formed in their jurisdictions would stay about the same if all of the states collected this additional information (see fig. 6). But some state officials and others we interviewed said that if the requirements were not uniform, states with the most stringent requirements could lose business to other states or even countries, potentially losing state revenue. Some state officials noted the importance of the fees generated from company formations to state general revenue funds. For example, a Delaware official said that 22 percent of the state’s revenue comes from the company formation business. Also, Nevada and Oregon officials stated that their offices were revenue-generating offices for the state. State officials, agents, and industry experts commented that states would be unlikely to pass comparable laws because state officials have such different opinions about the amount of information that should be disclosed.<sup>47</sup> As a result, individuals could form companies in states where the requirements were easiest to follow. Agents also expressed concern that they could lose business if they collected ownership information, because individuals might be more likely to form their own companies and serve as their own agents.

<sup>47</sup>The National Conference of Commissioners on Uniform State Laws approved the Uniform Limited Liability Company Act and the American Bar Association, Committee on Corporate Laws approved the Model Business Corporation Act to serve as uniform legislation for states to consider. Various states have used these legislative proposals when adopting their state statutes for business corporations and LLCs.

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Individuals forming businesses could also be affected by new requirements for collecting company information. Some officials noted that the additional time required to review filings could slow down and might derail business dealings. One state official commented that such requirements would create a burden for honest business people who would have provided accurate information in the first place but would not deter criminals, who would provide false information in any case. According to a report on the use of companies for illicit purposes, requiring companies to disclose up front and to update ownership information may impose significant costs, particularly on small businesses.<sup>48</sup> A few state and some private sector officials noted that an increase in the time and costs involved in forming a company might reduce the number of companies formed, because entrepreneurs and investors might be less likely to take the risks involved in forming or investing in new companies.

Some state officials also noted that to change the information requirements, state legislatures would have to pass new legislation and grant company formation offices new authority. A few states indicated that collecting additional information would require higher fees that would also need to be set by their state legislatures. State officials also noted that since they are administrative agencies, they generally do not have the authority to question or verify the information provided on the forms and would need additional authority from state legislatures to do so.

State and private sector officials pointed out that ownership information collected at formation or on periodic reports might not be complete or up to date. Information collected at formation, for instance, might not be useful because ownership information can change frequently throughout the year. For example, an official from Delaware commented that many privately held LLCs and corporations in Delaware and other states may have thousands of shareholders and LLC members that buy and sell shares and memberships on a daily basis. Another state official commented that collecting this information at formation would not be useful without requiring that it be updated frequently. In addition, since LLCs can be owned by individuals or other businesses, even if states required LLCs to list a member name, the name provided may not be that of an individual but

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<sup>48</sup>See OECD, *Behind the Corporate Veil*. This report examined the misuse of different types of companies in both onshore and offshore jurisdictions, including corporations, trusts, foundations, and partnerships with limited liability features. The report excluded companies engaged in financial services activities and those whose shares are publicly traded or listed on a stock exchange.

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another company. Disclosing ownership information on periodic reports, however, could mean that a year or more would pass before it was collected—too long to be of use in many investigations. In addition, we found that some states do not require these reports.<sup>49</sup> Further, once it is formed, a shell company being used for illicit purposes in the United States or other countries may not file required periodic reports. Law enforcement officials told us that many companies under investigation for suspected criminal activities had been dissolved by the states in which they were formed for failing to submit periodic reports.

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### State Officials and Others Were Concerned about Privacy Issues

State officials, agents, and other industry experts said the need for access to information on companies must be weighed against privacy issues. Company owners may want to maintain their privacy in part because state statutes have traditionally provided this privacy and in part to avoid lawsuits against them in their personal capacity. Some business owners may also seek to protect personal assets through corporations and LLCs. One state law enforcement official also noted that if more information were easily available, criminals and con artists could take advantage of it. He noted that information available on official Web sites was sometimes used to target companies for scams. For example, the official described a case in which an individual sent letters that appeared to be from a secretary of state's office to companies listed on the state Web site, telling the recipients that they were to file their annual meeting minutes with the state, although no such requirement existed. The individual offered to provide filing services for a fee, and collected the fees from companies, but did not forward any minutes to the state. Providing more easily accessible information to the public could result in more such activities.

Business owners might be more willing to provide ownership information if it were not disclosed in the public record. Some state officials we interviewed said that since all information filed with their office is a matter of public record, keeping some information private would require new legislative authority. The officials added that storing new information would be a challenge because their data systems are not set up to maintain

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<sup>49</sup>Our review of state statutes indicated that 14 states did not require periodic reports for LLCs and that 3 did not require them for corporations. In at least 3 states (Alabama, New Jersey, and Oklahoma), the annual report is submitted to a different office, such as the department of revenue, than the office that handles formation filings. In addition, biennial reports were required to be filed by corporations in 7 states and by LLCs in 5 states.

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confidential information. However, one official from Maryland said that keeping some information private would not be a problem since the office that accepted company formation and periodic report filings also handled tax filings and already had procedures for keeping information such as taxpayer identification numbers confidential. An official in Oregon also told us that the Corporations Division office had recently enacted procedures to keep some information private in cases such as domestic abuse. Individuals can petition the state to have information removed from databases available online and redacted in the paper file, but it is still available to law enforcement. The Arizona Corporation Commission also tries to remove Social Security numbers from its Web site if applicants include them on their paper forms, but maintains the information on paper forms.<sup>50</sup>

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## Two Foreign Jurisdictions Have Had Mixed Experiences with Requiring the Collection of Company Ownership Information

Because states do not typically collect and verify ownership information and because state and private sector officials could not quantify the extent of the possible costs of taking these steps, we reviewed the experiences of Jersey and Isle of Man in implementing the regulation of firms that provide services such as company formation (company service providers).<sup>51</sup> Fewer companies are formed in both jurisdictions, especially by local residents, than in the United States, and the number of company service providers is much smaller.<sup>52</sup> However, some of the concerns states and agents expressed about increased regulation also have been born out in Jersey and the Isle of Man, although officials also pointed to certain benefits of collecting ownership information and the new regulatory regime. Company service providers in both jurisdictions must be licensed, and are subject to periodic monitoring and inspections by government agencies. In both of

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<sup>50</sup>Arizona requires companies to include a Certificate of Disclosure with their articles of incorporation and annual reports that includes information about certain types of felonies and bankruptcies. Persons who have been convicted of specific types of felonies must include their Social Security numbers and other personal information, and according to Arizona officials, this information may be publicly available.

<sup>51</sup>Jersey and Isle of Man use the term trust companies or company service providers to refer to firms that provide company formation and registered agent services. We refer to these types of firms in the United States as agents. We chose to speak with officials from Jersey and the Isle of Man because they are two of a small number of jurisdictions that require disclosure of beneficial ownership when a company is formed.

<sup>52</sup>Jersey has about 30,000 incorporated entities and 183 company service providers, and the Isle of Man has about 35,000 incorporated entities and 180 company service providers.

### Jersey and Isle of Man



Source: Art Explosion.

Jersey, which lies about 100 miles south of mainland Britain and 14 miles from the coast of France, has an area of 45 square miles. Isle of Man is located in the Irish Sea and has an area of 227 square miles. The two islands are self-governing crown dependencies that do not belong to the United Kingdom and are not members of the European Union. Each has its own parliament and laws. In response to international concern in the mid-1990s about the role of companies formed in offshore jurisdictions such as these two islands in tax evasion schemes and other illicit activities, Jersey and Isle of Man began regulating company service providers in 2001 and 2000, respectively. The Financial Services Commission in Jersey and the Financial Supervision Commission in Isle of Man oversee the regulation of the company service provider industry. Officials from both jurisdictions noted that the regulations were implemented to improve the legitimacy and reputations of companies formed there.

these jurisdictions, company service providers are required to conduct due diligence to verify the identity of their clients and obtain company ownership information to form a new company. The ownership information is not maintained in the public record, but is kept at the registry in Jersey and with company service providers in Isle of Man and is available only to law enforcement.

Despite strong initial resistance, the company service provider industry in these two jurisdictions is now perceived as successful because licensed companies have continued to remain profitable. In addition, one company service provider told us that the regulations have instilled a degree of professionalism in the company service provider industry. Further, law enforcement officials can obtain information about company ownership when they need it.

However, government and private sector officials told us that implementing these regulations was a significant challenge. Both jurisdictions experienced consolidation in the company service provider industry. Some companies merged, and others moved to locations with fewer requirements or went out of business because they either did not want to comply with the new regulations or could not charge fees high enough to cover due diligence costs. One company service provider said the time required to form a company increased, as the due diligence requirements company service providers must follow can take weeks to complete depending on the client, though once documents are submitted to the Jersey or Isle of Man registry offices, formations are finished in 48 hours or less. The workload of company service providers has also increased. One company service provider told us that the company had increased its staff by 25 percent to 30 percent because of the requirement that the company verify customer information. Fewer companies are formed in Isle of Man, according to an Isle of Man official. Before the regulations, Isle of Man had 40,000 incorporated entities, but it now has 35,000. Finally, because ownership is fluid, it is a challenge to keep the information up to date. In Isle of Man, the responsibility for keeping information up to date lies with the company service providers. In Jersey, ownership information is updated on annual reports.

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## Other Potential Sources of Company Information May Be Available, but Obtaining Information from These Sources May Also Be Challenging

State officials, agents, and others told us that some other sources of company ownership information that law enforcement officials could access existed, including internal company documents, financial institutions, and the IRS.

### Internal Company Documents

Our review of state statutes found that all states require corporations to prepare a list of shareholders, typically before the mandatory annual shareholder meeting, and that almost all states require that this list be maintained at the corporation's principal or registered office.<sup>53</sup> Industry experts told us that LLCs also usually prepare and maintain operating agreements that generally name the members and outline their financial interests.<sup>54</sup> These documents are generally not public record, but law enforcement officials can subpoena them to obtain ownership information, and ICE officials in one field office said they always looked at LLC operating agreements during an investigation. However, accessing these lists may be problematic, and the documents themselves might not be accurate or even exist. For example, law enforcement officials said that shell companies may not prepare these documents and that U.S. officials may not have access to them if the company is located in another country. In addition, law enforcement officials may not want to request these documents in order to avoid tipping off a company about an investigation.

Industry experts also cautioned that even these internal documents may not reveal the true beneficial owners of a company. For example, the list could include nominee shareholders, which would reduce the usefulness of the shareholder list because the shareholder on record may not be the

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<sup>53</sup>Delaware, Kansas, and Oklahoma statutes do not expressly state that a corporation is required to maintain a list of shareholders, but shareholders must be able to extract information on shareholders from corporate documents maintained by the corporation.

<sup>54</sup>Some states may not require written operating agreements. If there is no operating agreement, the LLC follows default provisions of the LLC act of the state where the company was formed.



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beneficial owner.<sup>55</sup> In addition, shareholders could sell their stock and not register the sale with the company; in such cases, the new owners would not be known. Shareholders could also sell their stock before the filing date and then buy it back after the filing date to avoid being listed. Further, in states that allow bearer shares, the owners' names are anonymous because bearer share certificates do not contain the names of the shareholders.<sup>56</sup> Therefore, while law enforcement authorities could obtain lists of shareholders from companies by subpoena, further investigation might still be needed to find the true beneficial owners.

## Financial Institutions

Financial institutions may also have ownership information on some companies. Customer Identification Program (CIP) requirements implemented by the USA PATRIOT ACT in 2001 establish minimum standards for financial institutions to follow when verifying the identity of their customers in connection with the opening of an account.<sup>57</sup> Under these standards, financial institutions must collect the name of the company, its physical address (for instance, its principal place of business), and an ID number, such as the tax identification number. The regulations also mandate that financial institutions develop risk-based procedures for verifying the identity of each customer to the extent that doing so is reasonable. For example, representatives from financial institutions told us that they typically requested a company's articles of incorporation when a new account was opened to verify that the entity existed. One representative said that his institution also checked names against the OFAC list and requested photo identification from all signers on the account. Industry representatives noted that institutions may also compare the customer information with information obtained from a consumer

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<sup>55</sup>With publicly traded shares, nominees (e.g., shares registered in the names of stockbrokers) are commonly and legitimately used to facilitate the clearance and settlement of trades. Nominee shareholders can also be used in privately held companies to shield beneficial ownership information.

<sup>56</sup>According to the U.S. Money Laundering Threat Assessment, Nevada and Wyoming allow the use of bearer shares, which accord ownership of a company to the person who possesses the share certificate.

<sup>57</sup>Section 326 of the USA PATRIOT ACT directs Treasury and the federal financial regulators to adopt CIP requirements for all "financial institutions," which is defined broadly to encompass a variety of entities, including, among others, (1) banks that are subject to regulation by one of the federal banking regulators, as well as credit unions that are not federally insured, private banks, and trust companies; (2) securities broker dealers; (3) futures commission merchants and introducing brokers; and (4) mutual funds. See 31 U.S.C. § 5312; 31 C.F.R. part 103.

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reporting agency, public database, or other sources. Finally, based on a risk assessment, the institution may obtain information about individuals with authority or control over the account in order to verify their identities.<sup>58</sup>

Representatives of financial institutions told us that although they are not required to obtain ownership information in all cases, they may investigate high-risk applicants to uncover the ultimate beneficial owners. These applicants may include casinos, companies that are not listed on world stock exchanges, companies with complex structures, or companies from certain high-risk countries.<sup>59</sup> For such applicants, financial institutions may ask about information such as beneficial owners and officers of the company. Financial industry representatives said that conducting the necessary due diligence on a company absorbs time and resources, because institutions must sometimes peel back layers of corporations or hire private investigators to find the actual beneficial owner or owners of a company.

One financial institution we interviewed collects the name, date of birth, and tax identification number of all individuals with ownership and control of a corporation or LLC. However, officials from some institutions told us that obtaining such information on all applicants would be an added burden to an industry that is already subject to numerous regulations. Some industry officials also said that financial institutions may not want to request ownership information in all cases for fear of losing a customer. In addition, industry representatives noted that collecting ownership information at financial institutions might not always be useful or available, because ownership might change after the account was opened and not all companies opened bank or brokerage accounts. Furthermore, Department of Justice officials noted that, in some instances, the financial activity of a shell company under investigation does not involve U.S. financial institutions. Finally, correspondent accounts create opportunities to hide the identities of the account holders from the banks themselves. A foreign bank can open a correspondent account with a U.S. bank to avoid bearing

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<sup>58</sup>See GAO, *USA PATRIOT ACT: Additional Guidance Could Improve Implementation of Regulations Related to Customer Identification and Information Sharing Procedures*, GAO-05-412 (Washington, D.C.: May 6, 2005).

<sup>59</sup>Industry representatives told us that high-risk countries include those that are listed on the OFAC list of countries that U.S. entities are prohibited from doing business with and countries that are identified by the Financial Action Task Force on Money Laundering (FATF) as “non-cooperative countries and territories.”

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the costs of licensing, staffing, and operating its own offices in the United States. Many of the largest international banks serve as correspondents for thousands of other banks. The USA PATRIOT ACT requires financial institutions that provide correspondent accounts to foreign banks to maintain records of the foreign bank's owners and of the name and address of an agent in the United States designated to accept service of process for the foreign bank for records regarding the correspondent account.<sup>60</sup> However, law enforcement and industry representatives told us that the foreign banks may commingle funds from many different customers into one correspondent account, making it difficult for U.S. banks to identify the individuals with access to the account.<sup>61</sup>

## IRS

IRS was mentioned as another potential source of company ownership information for law enforcement, but IRS officials pointed to several limitations with this data. First, IRS may not have information on all companies formed. The agency collects company ownership information on certain forms, such as the application for an employer identification number (EIN) (SS-4).<sup>62</sup> Form SS-4 requires the name and tax identification number (such as the Social Security number) of the principal officer if the business is a corporation, or general partner if it is a partnership, or owner if it is an entity that is disregarded as separate from its owner (disregarded

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<sup>60</sup>31 U.S.C. § 5318(k)(3)(B)(i).

<sup>61</sup>In January 2006, FinCEN issued a final rule to implement the requirements in section 312 of the USA PATRIOT ACT that requires U.S. financial institutions to establish policies, procedures, and controls to detect and report money laundering through correspondent accounts. See 71 Fed Reg. 496 (Jan. 4, 2006). According to the rule, financial institutions must assess the money-laundering risk of correspondent accounts based on the nature of the foreign financial institution's business, the type of account, the institution's relationship with the foreign financial institution, the anti-money-laundering regime of the jurisdiction that issued the charter or license of the foreign financial institution, and information about the foreign financial institution's anti-money-laundering record. In addition, U.S. financial institutions must apply risk-based procedures and controls to each correspondent account, including a periodic review of account activity to determine consistency with anticipated activity. 31 C.F.R. § 103.176.

<sup>62</sup>The Internal Revenue Code authorizes IRS to collect such information as may be necessary to assign an identifying number to any person. 26 U.S.C. § 6109(c).

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entity), such as a single member LLC.<sup>63</sup> Disregarded entities owned by a corporation enter the corporation's name and EIN. However, not all LLCs are required to have EINs.<sup>64</sup> In addition, the name of an owner may be on the form LLCs file to select how they will be taxed. IRS also currently collects some general ownership information, including an identifying number, name, and address, on certain LLCs on separate schedules that the company files with the IRS.<sup>65</sup> For LLCs that are taxed as partnerships, this form specifies whether members are member-managers or another type of member of an LLC and reports the member's share of the company profits, losses, and capital. But if an LLC has only one member, the individual reports income on an individual tax return.<sup>66</sup> In addition, IRS classifies certain LLCs as corporations for tax purposes, and others may choose to be

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<sup>63</sup>IRS regulation, 26 C.F.R. § 301.7701-2, classifies the following entities as corporations, among others, for tax purposes: an business entity organized under a federal or state statute when the statute indicates that the entity is incorporated or is a corporation; an association; a state joint-stock company or joint-stock association; an insurance company; a state-chartered depository company whose deposits are federally insured; and certain foreign entities. Nevertheless, certain LLCs may elect how they will be treated for tax purposes. See 26 C.F.R. §§ 301.7701-3 and 301.7701-2. Specifically, single owner LLCs may elect to be treated for tax purposes either as a sole proprietorship (referred to as an entity to be disregarded as separate from its owner) or as a corporation, and LLCs with two or more owners may elect to be treated for tax purposes either as a partnership or as a corporation. Moreover, there are certain defaults under the tax rules. Single owner LLCs are treated by default as an entity to be disregarded as separate from its owner, and LLCs with more than two owners are treated by default as partnerships unless an election is filed with IRS.

<sup>64</sup>For example, a single member LLC with no employees is not required to have a separate EIN.

<sup>65</sup>S corporations and LLCs that are taxed as a partnership do not pay taxes on their income but instead allocate the income to shareholders or members, who are required to report it annually to IRS with their individual tax returns. Allocated income is reported to IRS by the company with the company's tax return on a corresponding Schedule K-1. Copies of the Schedule K-1 are provided to shareholders and members for use when filing their respective annual returns (examples of the appropriate forms include Schedule K-1 (Form 1065) for LLCs filing as partnerships and Schedule K-1 (Form 1120S) for S corporations).

<sup>66</sup>The owner of a single member LLC reports the business activities of the LLC on the individual's tax return. See, for example, Schedule C (Form 1040), which requests the name of the business. However, this information is not required, and the field asking for the information states that it may be left blank. If left blank, there is no way for the IRS to determine that the individual is the owner of an LLC.

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classified as corporations.<sup>67</sup> Ownership information is available for LLCs that are classified as corporations and file as S corporations, but generally not for those that are taxed as C corporations.<sup>68</sup>

Second, IRS officials reported that the ownership information the agency collected may not be complete or up to date. As we have discussed, the agency does not have information on every company, because some companies do not request or need EINs. In addition, some EINs become inactive after a certain period, dropping off the IRS database. For example, Department of Justice officials told us that U.S. shell companies being used in foreign criminal activity are sometimes inactive in the United States. In addition, ownership information on LLCs owned by foreign individuals or entities would only be available if the LLC obtained an EIN for income that was subject to tax in the United States. Further, data gathered on IRS forms may not always be accurate. In a recent report, we found that data transcription errors made by IRS staff entering data into a database and invalid taxpayer identification numbers submitted by companies lowered the accuracy of these data.<sup>69</sup> IRS officials also noted that the information collected might not always be useful in finding the ultimate beneficial owner of a company, because another entity could be listed as the owner, requiring further investigation to identify the true owner. Finally, IRS officials said that the information in the agency's records might not be up to date because IRS was not always notified when ownership changed.

Third, law enforcement officials could have difficulty accessing IRS taxpayer information. As part of the administration of federal tax laws, IRS investigators can use IRS data in their investigations of tax and related

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<sup>67</sup>Federal tax laws automatically classify and tax the following LLCs as corporations: a business formed under a federal or state statute or a federally recognized Indian tribe if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; an association or joint stock association; a state-chartered business conducting banking activities if any of its deposits are insured by the Federal Deposit Insurance Corporation; a business wholly owned by a state or foreign government; certain foreign entities; and insurance companies.

<sup>68</sup>C corporations file Form 1120, which asks if a controlling shareholder (or group of related persons) owns 50 percent of a stock. Therefore, in some limited instances, IRS may be able to identify the owners of an LLC that files as a C corporation.

<sup>69</sup>The most frequent transcription errors dealt with names and addresses. IRS also found transcription errors in dollar amounts and taxpayer identification numbers. See GAO, *Tax Administration: IRS Should Take Steps to Improve the Accuracy of Schedule K-1 Data*, GAO-04-1040 (Washington, D.C.: Sept. 30, 2004).

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statutes, but access by other federal and state law enforcement is restricted by 26 U.S.C. § 6103.<sup>70</sup> IRS officials said that federal law enforcement officials can access IRS information provided by taxpayers (or their representatives) when a federal court issues an ex parte order.<sup>71</sup> Under 26 U.S.C. § 6103(i)(1), the federal law enforcement agency requesting the information through an ex parte order must show that it is engaged in preparation for a judicial, administrative or grand jury proceeding to enforce a federal criminal statute or that the investigation may result in such a proceeding.<sup>72</sup> Information IRS receives from a source other than taxpayers (or their representatives), such as taxpayers' employers or banks, can be obtained without a court order.<sup>73</sup> Moreover, in certain limited situations, there are additional provisions currently in the tax code providing for disclosure of such information relating to criminal or terrorist

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<sup>70</sup>Tax administration is defined at 26 U.S.C. § 6103(b)(4) to mean "(A)(i) the administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws or related statutes (or equivalent laws and statutes of a State) and tax conventions to which the United States is a party, and (ii) the development and formulation of Federal tax policy relating to existing or proposed internal revenue laws, related statutes, and tax conventions, and (B) includes assessment, collection, enforcement, litigation, publication, and statistical gathering functions under such laws, statutes, or conventions." Whether a particular statute is "related" to the internal revenue laws depends on the nature and purpose of the statute and the facts and circumstances in which the statute is being enforced or administered. Typically, according to IRS, where violation of another statute is committed in contravention of the internal revenue laws, then the former may be considered a "related statute" and IRS's investigation is considered tax administration. 26 U.S.C. § 6103(a) sets up the general rule that returns and return information for use in federal criminal investigations shall be confidential and may not be disclosed except as authorized under the Internal Revenue Code.

<sup>71</sup>26 U.S.C. § 6103(i)(1) permits the disclosure of returns and return information upon the grant of an ex parte court order by a federal district court judge or magistrate upon application by certain high level Department of Justice officials. Because the proceeding is ex parte, the taxpayer will not know that the government has applied for an ex parte court order or that its application has been granted.

<sup>72</sup>To grant an ex parte order, the court must determine that there is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed, there is reasonable cause to believe that the return or return information is or may be relevant to a matter relating to the commission of such act, and the return or return information is sought exclusively for use in a federal criminal investigation or proceeding concerning such act, and the information sought to be disclosed cannot reasonably be obtained, under the circumstances, from another source. 26 U.S.C. § 6103 (i)(1)(B).

<sup>73</sup>See e.g., 26 U.S.C. § 6103(i)(2).

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activities or emergency circumstances.<sup>74</sup> State law enforcement officials can access IRS information for enforcement of state tax laws when IRS has sharing agreements with state taxing authorities.<sup>75</sup> Law enforcement officials can also obtain IRS information with the taxpayer's consent.<sup>76</sup> Officials in one ICE field office told us that they have obtained IRS information; however, officials in another ICE field office said that obtaining this information was difficult. IRS officials commented that collecting additional ownership and control information on IRS documents would provide IRS investigators with more detail when conducting investigations but that the agency's ability to collect and verify such information would depend on the availability of resources.

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## Observations

States and agents collect a variety of information when individuals form companies, but most state statutes do not require that they collect or verify information on ownership. Therefore, minimal information is collected on the owners of these companies. During our review, we encountered a variety of legitimate concerns about the merits of collecting ownership information on companies formed in the United States. Many of these concerns reflected conflicting interests. On the one hand, federal law enforcement agencies were concerned about the lack of information, because criminals can easily use U.S. shell companies to mask the identities of those engaged in illegal activities. From a law enforcement perspective, having more information would make using U.S. shell companies for illicit activities harder and give investigators more information to use in pursuing the actual owners. In addition, since U.S. shell companies are used in criminal activity abroad because of their perceived legitimacy, collecting more information when a company is formed could improve the integrity of the company formation process in the United States. On the other hand, states and agents were concerned about increased costs, potential revenue losses, and privacy protection. Collecting more information would require more time and resources and could reduce the number of start-ups. Approving applications could take longer, potentially creating obstacles for those forming companies for

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<sup>74</sup>26 U.S.C. § 6103(i)(3) and (7). The authority for disclosures to combat terrorism expires on December 31, 2006.

<sup>75</sup>26 U.S.C. § 6103(d).

<sup>76</sup>26 U.S.C. § 6103(c).

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legitimate business purposes. And importantly, because information on companies is currently part of the public record, requiring certain information on ownership could be considered a threat to the current system, which values the protection of privacy and individuals' personal assets.

Any requirement that states, agents, or both collect more ownership information on certain types of companies would need to balance these conflicting concerns. Further, such a requirement would need to be uniformly applied in all U.S. jurisdictions. If it were not, those wanting to set up shell companies for illicit activities would simply move to the jurisdiction that presented the fewest obstacles, undermining the intent of the requirement.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Departments of Justice, Homeland Security, and the Treasury. Justice and Treasury provided technical comments that were incorporated into the report, where appropriate.

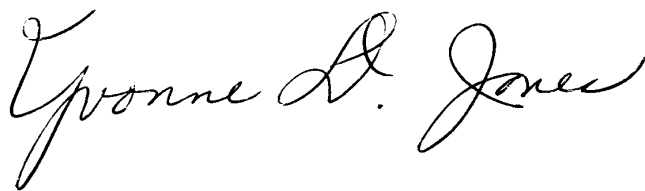
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As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the report date. At that time, we will send copies to the Departments of Justice, Homeland Security, and the Treasury; and interested congressional committees. We will also make copies available to others on request. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>. The survey and a more complete tabulation of state-by-state and aggregated results can be viewed at <http://www.gao.gov/cgi-bin/getrpt?GAO-06-377SP>.



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If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or [jonesy@gao.gov](mailto:jonesy@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix IV.

A handwritten signature in black ink that reads "Yvonne D. Jones". The signature is written in a cursive style with a large, stylized initial "Y".

Yvonne D. Jones  
Director, Financial Markets  
and Community Investment

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# Objectives, Scope, and Methodology

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This report describes states' company formation and reporting requirements and the information that is routinely obtained and made available to the public and law enforcement officials regarding ownership of nonpublicly traded corporations and limited liability companies (LLC) formed in each state given concerns about the potential for using companies for illicit purposes. Specifically, this report discusses

1. the kinds of information—including ownership information—that the 50 states and the District of Columbia collect during company formation and the states' efforts to review and verify it;
2. the roles of third-party agents, such as company formation agents, and the kinds of information they collect on company ownership;
3. the role of shell companies in facilitating criminal activity, the availability of company ownership information to law enforcement, and the usefulness of such information in investigating shell companies; and
4. the potential effects of requiring states, agents, or both to collect company ownership information.

To respond to the first objective and describe the ways company formation and periodic reporting documents can be filed, we conducted a Web-based survey of the 50 states and the District of Columbia on formation and reporting practices. We worked to develop the questionnaire with social science survey specialists. Because these were not sample surveys, there are no sampling errors. However, the practical difficulties of conducting any survey may introduce errors, commonly referred to as nonsampling errors. For example, differences in how a particular question is interpreted, in the sources of information that are available to respondents, or in how the data are entered into a database can introduce unwanted variability into the survey results. We took steps in the development of the questionnaires, the data collection, and data analysis to minimize these nonsampling errors. For example, prior to administering the survey, we pretested the content and format of the questionnaires with state officials in Florida, Maine, Maryland, Virginia, and Washington, D.C., to determine whether (1) the survey questions were clear, (2) the terms used were precise, (3) respondents were able to provide the information we were seeking, and (4) the questions were unbiased. An official from the International Association of Commercial Administrators (IACA) also reviewed a draft of the survey. We made changes to the content and format

of the final questionnaires based on pretest results. We sent the finalized survey to contacts responsible for company filings in secretary of state offices (or their equivalents) in all 50 states and the District of Columbia. See *Survey of State Officials Responsible for Company Formation*, [GAO-06-377SP](#), for the final version of the survey and state-by-state results. We received survey responses from each of the 50 states and the District of Columbia. In that these were Web-based surveys whereby respondents entered their responses directly into our database, the possibility of data entry error was minimized. We also performed computer analyses to identify inconsistencies in responses and other indications of error. We contacted survey respondents as needed to correct errors and verify responses. In addition, a second independent analyst verified that the computer programs used to analyze the data were written correctly.

To test the reliability of survey data, we compared state responses on our survey with data states provided to IACA in its 2005 annual report of jurisdictions for four key variables—the number of LLCs and corporations filed in 2004 and the total number on file. The data were markedly the same, with very high correlations and no significant differences in mean values. Based on this testing, we believe our reporting of the trends based on the number of corporations and LLCs to be reliable. We also corroborated the survey results with information we collected from a systematic review of state Web sites and state statutes. Where we found a discrepancy on key variables, we contacted the relevant state official for clarification of the state's requirement. Our review of the state corporation statutes included analysis of provisions regarding company formation, registered agents, shareholder identification, requirements for record keeping, and periodic reporting. In addition, we reviewed provisions in state LLC statutes relating to company formation, periodic reporting, and registered agents. We also reviewed the content of company formation forms and other information available on state Web sites. The data collected from our review of state statutes and Web sites is as of October 2005. We also visited Arizona, Delaware, Florida, Nevada, and Oregon to conduct in-depth interviews with state officials about practices in these states. We selected these states because of the number of companies formed there or unique practices we identified from the statutes, forms, or survey responses.

To respond to the second objective and describe the roles of third-party agents, we interviewed academics with expertise in corporate and LLC law, selected professional agents, and state officials. In selecting agents to interview, we interviewed only companies that act as agents for service of

process for more than one client. We chose a range of large national companies (three) as well as midsize or small companies (nine). We interviewed selected agents about the information they collect on companies and analyzed survey results on states' requirements regarding oversight of these agents. We also interviewed officials from the National Public Records Research Association, an association that represents companies providing corporate services and public records research, and the Nevada Resident Agent Association, which represents a number of resident agents in Nevada. In addition, we reviewed state statutes for requirements regarding becoming an agent for service of process.

To respond to the third objective and determine what information states and agents make available to law enforcement and the public, we reviewed company formation and periodic reporting forms on state Web sites and reviewed state Web sites for the type of information made available online and other methods individuals may use to obtain information. In addition, we interviewed selected state officials and agents about the methods they use to provide information. We also interviewed selected state and federal law enforcement officials about their experiences in obtaining company information from states to aid their investigations, including officials from the following state and federal agencies: the Arizona Attorney General, Drug Enforcement Agency, Federal Bureau of Investigation, the Florida Attorney General, Immigration and Customs Enforcement, Internal Revenue Service/Criminal Investigations, Financial Crimes Enforcement Network, U.S. Attorneys Office, and Office of Foreign Assets Control.

To respond to the fourth objective and determine the implications of requiring states or agents to collect company ownership information, we analyzed survey results and interviewed selected state officials and a range of professional agents. To determine how other jurisdictions have implemented regimes requiring collection of ownership information, we interviewed officials from Jersey and Isle of Man, which require the collection of this information, about the implications of implementing these requirements. Jersey and Isle of Man are two of a small number of jurisdictions that require disclosure of beneficial ownership information when a company is formed. We also reviewed an Organization for Economic Co-operation and Development report describing requirements in one of the jurisdictions. To determine other potential sources of company information, we asked academics, agents, state officials, law enforcement officials, and representatives of professional associations their perspectives on where this information could be obtained. We also reviewed state statutes on requirements for company record keeping. In

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addition, we interviewed representatives of selected financial institutions and the IRS about the company information they typically collect.

We conducted our work from May 2005 through March 2006 in Arizona, Delaware, Florida, Maryland, Nevada, New York, Oregon, Virginia, and Washington, D.C. We performed our work in accordance with generally accepted government auditing standards.

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# Company Formation and Reporting Documents Can Be Submitted in a Variety of Ways

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Company formation and reporting documents can be submitted in person or by mail, and many states also accept filings by fax. Review and approval times can depend on how documents are submitted. For example, a District of Columbia official told us that a formation document submitted in person could be approved in 15 minutes, but a document that was mailed might not be approved for 10 to 15 days. Most states reported that documents submitted in person or by mail were approved within 1 to 5 business days, although a few reported that the process took more than 10 days. Officials in Arizona, for example, told us that it typically took the office 60 days to approve formation documents because of the volume of filings the office received.

In 36 states, company formation documents, reporting documents, or both can be submitted through electronic filing (fig. 7 shows the states that provide a Web site for filing formation documents or periodic reports).<sup>1</sup> In addition, some officials indicated that they would like or were planning to offer electronic filing in the future. Of the 36 states that allow electronic filing, 23 or more reported a moderate or greater benefit in the following areas as a result of electronic filing:

- less paperwork;
- reduced staff time for recording and processing filings;
- less need to store paper records;
- electronic transfer of filing fees; and
- built-in edit and data reliability checks.

State officials also commented that they had seen their error or rejection rates fall, and had been able to improve their customer service with electronic filing. States said that there were some or moderate costs associated with electronic filing, such as increased expenses for technology (hardware and software) and staff training. Overall, according

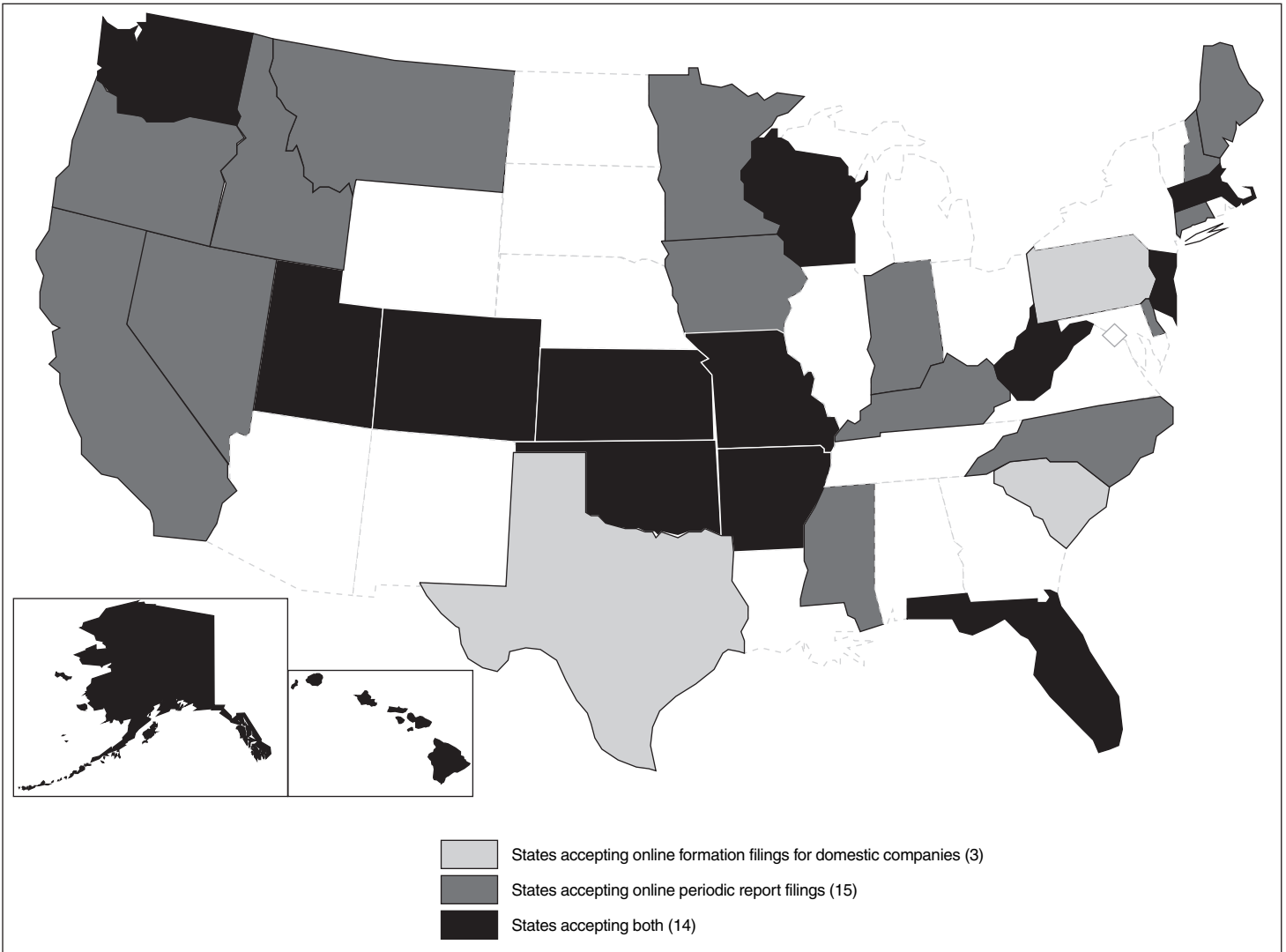
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<sup>1</sup>Electronic filing includes the ability to file a document through a Web site, e-mail, or fax. Five states reported that they offer e-mail filing for company formation documents, and four states reported that they offer e-mail filing for periodic reports. In addition, 27 states reported that they accept formation or periodic report filings by fax.

**Appendix II**  
**Company Formation and Reporting**  
**Documents Can Be Submitted in a Variety of**  
**Ways**

to our survey, 28 of the 36 states that offer electronic filing reported that the benefits exceeded the costs.

**Figure 7: States That Provide a Web Site for Filing Formation or Periodic Report Filings**



Sources: GAO survey of state officials responsible for company formation (data); Art Explosion (map).

**Appendix II**  
**Company Formation and Reporting**  
**Documents Can Be Submitted in a Variety of**  
**Ways**

**Company Formation Fees**

As shown in table 3, in many cases states charge the same or nearly the same fee for forming a corporation or an LLC. In others, such as Illinois, the fee is substantially different for the two business forms. We found that in two states, Nebraska and New Mexico, the fee for forming a corporation may fall into a range. In these cases, the actual fee charged depends on the number of shares the new corporation will have. As stated earlier, the median company formation fee is \$95, and fees for filing periodic reports range from \$5 to \$500.

**Table 3: State Company Formation Fees as of November 2005**

<b>State</b>	<b>LLCs</b>	<b>Corporations</b>
Alabama	\$75	\$40
Alaska	250	250
Arizona	50	60
Arkansas	50	50
California	70	100
Colorado	125	125
Connecticut	60	150
Delaware	90	50
District of Columbia	150	89
Florida	125	79
Georgia	100	100
Hawaii	50	50
Idaho	100	100
Illinois	500	150
Indiana	90	90
Iowa	50	50
Kansas	165	90
Kentucky	40	40
Louisiana	75	60
Maine	175	145
Maryland	100	100
Massachusetts	500	275
Michigan	50	60
Minnesota	135	135
Mississippi	50	50
Missouri	105	58



**Appendix II**  
**Company Formation and Reporting**  
**Documents Can Be Submitted in a Variety of**  
**Ways**

*(Continued From Previous Page)*

<b>State</b>	<b>LLCs</b>	<b>Corporations</b>
Montana	70	70
Nebraska	100	60-300
Nevada	75	75
New Hampshire	100	50
New Jersey	125	125
New Mexico	50	100-1,000
New York	200	125
North Carolina	125	125
North Dakota	125	80
Ohio	125	125
Oklahoma	100	50
Oregon	50	50
Pennsylvania	125	125
Rhode Island	150	230
South Carolina	110	135
South Dakota	125	125
Tennessee	300	100
Texas	200	300
Utah	52	52
Vermont	75	75
Virginia	100	25
Washington	175	175
West Virginia	100	50
Wisconsin	170	100
Wyoming	100	100

Source: GAO analysis of state Web sites.

Thirty states reported offering expedited service for an additional fee. Of those, most responded that with expedited service, filings were approved either the same day or the day after an application was filed. Two states reported having several expedited service options. Nevada offers 24-hour expedited service for an additional \$125 above the normal filing fees, 2-hour service for an extra \$500, and 1-hour, or “while you wait,” service for an extra \$1,000. Delaware offers same day service for \$100, next day service for \$50, 2-hour service for \$500, and 1-hour service for \$1,000.

# Information on Company Formation Documents

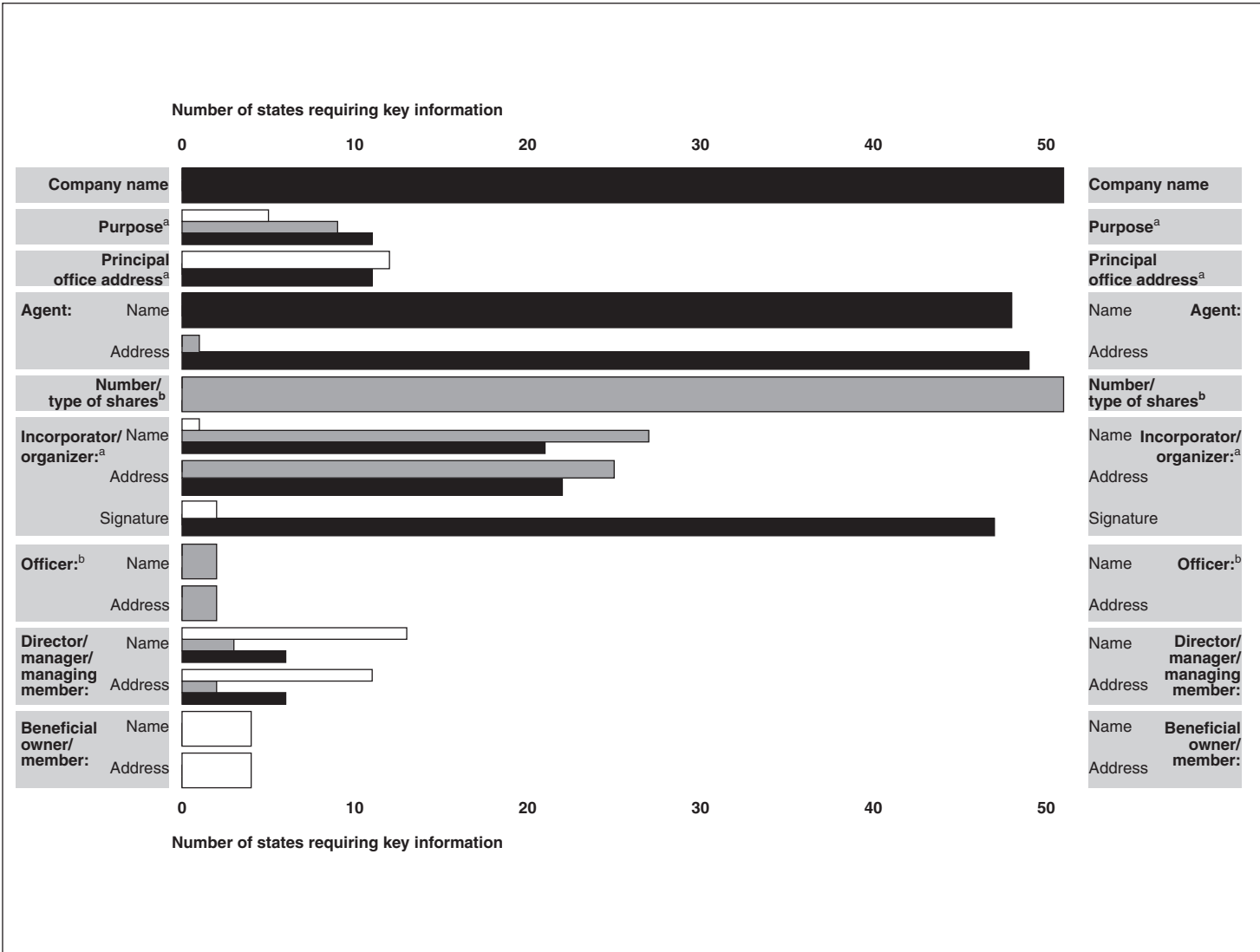
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This appendix includes a table of the information states require in their company formation documents for corporations and LLCs. As shown in figure 8, states collect different information on their company formation documents. Most states require the company name, agent name and address, and the name and signature of the incorporator or organizer, and for corporations, information about the number and types of shares the corporation will issue. The requirements for the company's purpose, principal address, and names and addresses of owners and management are not as consistent across the states.

Figures 9 and 10 are examples of company formation documents from two states that have different information requirements.



**Appendix III  
Information on Company Formation  
Documents**



<sup>a</sup>Although state statutes may not require this information, some states request or require this information be included on the company formation documents.

<sup>b</sup>Information on number and type of shares and officer names and addresses applies only to corporations.

<sup>c</sup>New Mexico and Arkansas did not respond to some of our survey questions. However, we found from our legal review that Arkansas does not require the address of a beneficial owner on articles or periodic reports. Our legal review also found that New Mexico does require corporations to list the names and addresses of directors, but not officers or beneficial owners on articles of incorporation. For LLCs, we found that New Mexico does not require the names and addresses of members or managers on formation documents.

Figure 9: Sample Articles of Incorporation Form for a Corporation

**STATE of DELAWARE**  
**CERTIFICATE of INCORPORATION**  
**A CLOSE CORPORATION**  
**Of**

\_\_\_\_\_  
(name of corporation)

- **First:** The name of this Corporation is \_\_\_\_\_.
- **Second:** Its Registered Office in the State of Delaware is to be located at \_\_\_\_\_  
\_\_\_\_\_ (street), in the City of \_\_\_\_\_  
\_\_\_\_\_ County of \_\_\_\_\_ Zip Code \_\_\_\_\_. The name of the  
registered agent is \_\_\_\_\_.
- **Third:** The nature of business and the objects and purposes proposed to be  
transacted, promoted and carried on, are to engage in any lawful act of activity for  
which corporations may be organized under the General corporation Law of  
Delaware.
- **Fourth:** The amount of the total stock of this corporation is authorized to issue is  
\_\_\_\_\_ shares (number of authorized shares) with a par value  
of \_\_\_\_\_ per share.
- **Fifth:** The name and mailing address of the incorporator are as follows:  
Name \_\_\_\_\_  
Mailing Address \_\_\_\_\_  
\_\_\_\_\_ Zip Code \_\_\_\_\_
- **Sixth:** All of the corporation's issued stock, exclusive of treasury shares, shall be held  
of record by not more than thirty (30) persons.
- **Seventh:** All of the issued stock of all classes shall be subject to one or more of the  
restrictions on transfer permitted by Section 202 of the General Corporation Law.
- **Eighth:** The corporation shall make no offering of any of its stock of any class which  
would constitute a "public offering" within the meaning of the United States  
Securities Act of 1933, as it may be amended from time to time.
- **I, The Undersigned,** for the purpose of forming a corporation under the laws of the  
State of Delaware, do make, file and record this Certificate, and do certify that the  
facts herein stated are true, and I have accordingly hereunto set my hand this  
\_\_\_\_\_ day of \_\_\_\_\_, A.D. 20\_\_\_\_\_.

BY: \_\_\_\_\_  
(Incorporator)  
NAME: \_\_\_\_\_  
(type or print)

Source: Delaware Division of Corporations.

**Appendix III  
Information on Company Formation  
Documents**

**Figure 10: Sample Articles of Organization Form for an LLC**

<p><b>DO NOT PUBLISH THIS SECTION</b></p> <p><b>ARTICLE 1</b> The company name must contain an ending which may be "limited liability company," "limited company," or the abbreviations "L.L.C.," "L.C.," "LLC" or "LC". If you are the holder or assignee of a tradename or trademark, attach Declaration of Tradename Holder form.</p> <p><b>ARTICLE 2</b> May be in care of the statutory agent.</p> <p><b>ARTICLE 3</b> The statutory agent must provide a street address. If statutory agent has P.O. Box, then they must also provide a street address/location. The agent must sign the Articles or provide a consent to acceptance of appointment.</p> <p>The agent must consent to the appointment by executing the consent.</p> <p><b>ARTICLES 4</b> Complete this section only if you desire to select a date or occurrence when the company will dissolve. If perpetual duration is desired, leave this section blank.</p>	<p align="center"><b>ARTICLES OF ORGANIZATION</b></p> <p align="center">A.R.S. §29-632</p> <p>1. <u>Name</u>. The name of the limited liability company is: _____</p> <p>2. <u>Known Place of Business</u>. The address of the company's known place of business in Arizona is: _____ _____</p> <p>3. <u>Statutory Agent</u>. (In Arizona) The name and street address of the statutory agent of the company is: _____ _____</p> <p><b>Acceptance of Appointment By Statutory Agent</b></p> <p>I _____, having been designated to act as <small>(Printed Name)</small> Statutory Agent, hereby consent to act in that capacity until removed or resignation is submitted in accordance with the Arizona Revised Statutes.</p> <p>_____ Signature of Statutory Agent</p> <p>[If signing on behalf of a company serving as statutory agent, print company name here]</p> <p>_____</p> <p>4. <u>Dissolution</u>. The latest date, if any, on which the limited liability company must dissolve is: _____</p>	<p><b>DO NOT PUBLISH THIS SECTION</b></p> <p><b>ARTICLE 5</b> Check which management structure will be applicable to your company. Provide name, title and address for each person.</p> <p>5. <u>Management</u>.</p> <p><input type="checkbox"/> Management of the limited liability company is <b>vested in a manager or managers</b>. The names and addresses of each person who is a manager <b>AND</b> each member who owns a twenty percent or greater interest in the capital or profits of the limited liability company are:</p> <p>Name: _____ [ ] member [ ] manager [ ] member [ ] manager</p> <p>Address: _____ City, State, Zip: _____</p> <p>Name: _____ [ ] member [ ] manager [ ] member [ ] manager</p> <p>Address: _____ City, State, Zip: _____</p> <p><input type="checkbox"/> Management of the limited liability company is <b>reserved to the members</b>. The names and addresses of each person who is a member are:</p> <p>Name: _____ [ ] member [ ] member</p> <p>Address: _____ City, State, Zip: _____</p> <p>Name: _____ [ ] member [ ] member</p> <p>Address: _____ City, State, Zip: _____</p> <p>The person(s) executing this document need not be manager or member(s) of the company.</p> <p>EXECUTED this _____ day of _____, _____.</p> <p>_____ [Signature] [Signature]</p> <p>_____ [Print Name Here] [Print Name Here]</p> <p>PHONE _____ FAX _____</p> <p>LL-0004 Rev. 09/05</p> <p><small>Your fax and phone number is optional.</small></p> <p><small>See A.R.S. §29-601 et seq. for more info.</small></p>
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Source: Arizona Corporation Commission.

# GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Staff Acknowledgments

In addition to the contact named above, Kay Kuhlman (Assistant Director), LaKeshia Allen, Todd M. Anderson, Carolyn Boyce, Emily Chalmers, William R. Chatlos, Jennifer DuBord, Marc Molino, Jill M. Naamane, and Linda Rego made key contributions to this report.

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# Glossary

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<b>Agent for service of process</b>	A person or entity authorized to accept service of process or other important tax and legal documents on behalf of a business. Agents for service of process may be known as registered agents, resident agents, statutory agents, or clerks in different states.
<b>Articles of incorporation</b>	A corporate formation document setting forth basic terms governing the corporation's existence. The articles are filed in most states with the secretary of state during the formation process. This document is called a "certificate of incorporation" for corporations formed in Connecticut, Delaware, New Jersey, New York and Oklahoma; "articles of organization" for corporations formed in Massachusetts; and a "charter" for corporations formed in Tennessee.
<b>Articles of association or articles of organization</b>	A governing document legally creating a nonstock organization, similar to "articles of incorporation" described above for incorporated entities. This document is called a "certificate of formation" for limited liability companies formed in Mississippi, New Hampshire, New Jersey, and Washington, and a "certificate of organization" for limited liability companies formed in Pennsylvania.
<b>Bearer security</b>	An unregistered security payable to the holder. For instance, a bearer stock certificate is owned by the person legally holding (in possession of) the certificate even when no one else knows who holds the certificate. Bearer shares may be bought, sold, or exchanged in complete privacy.
<b>Beneficial owner</b>	Shareholders with the power to buy or sell their shares in the company, but who are not registered or reflected in the company's records as the owners. A beneficial owner is the natural person who ultimately owns or exercises effective control over a legal entity, transaction, or arrangement.
<b>Certificate of existence</b>	A certificate issued by a state official as conclusive evidence that a corporation is in existence or authorized to transact business in that state. The certificate generally sets forth the corporation's name, and that it is duly incorporated under the law of that state or authorized to transact business in that state; that all fees, taxes and penalties owed to that state

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have been paid; and that the corporation's most recent annual report has been filed, and articles of dissolution have not been filed. Also may be known as a certificate of good standing or certificate of authorization.

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Company formation agent

A person or business that acts as an agent for others by filing documents with officials of the selected jurisdiction for the formation of legal business entities. Such agents may also act, or arrange for another person to act, as a director or secretary of a company, a partner of a partnership, or a nominee shareholder for another person. Other business services may also be provided, such as providing a registered office, or a business, correspondence, or administrative address for a company.

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Corporate veil

The legal doctrine of separating the acts of a corporation from the acts of its shareholders, which prevents the shareholders from being held personally liable for the acts of the corporation.

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Piercing the corporate veil

An equitable doctrine where the separate existence of a corporation is disregarded by the law and the shareholders are held responsible for the acts and obligations of the corporation. This doctrine has also been used in certain circumstances to impose liability on corporate officers and directors. Piercing the corporate veil is justified only in extraordinary circumstances where a court finds that a unity of interest and ownership between an individual and a corporation exists to such an extent that recognizing a separate existence between the two would result in an injustice. In such cases, a court may disregard the corporate entity and impose personal liability on the individual.

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Corporation

An artificial being (usually a business entity) created by law that provides authority for the entity to act as a separate and distinct legal person apart from its owners and provides other legal rights, such as the right to exist indefinitely and to issue stock.

Federal law classifies corporations created by state law into S corporations and C corporations for purposes of federal income taxes as follows:

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S corporation	A small business corporation that elects to be taxed as an S corporation under the federal tax code. <sup>1</sup> The taxable income of an S corporation is passed through to the shareholders and taxed at the shareholder level.
C corporation	A corporation that is not an S corporation.
Director	A person elected or appointed to serve as a member of the board of directors for a corporation, which generally manages the corporation and its officers.
Dummy (or nominee) director	A member of a corporation's board of directors who is a mere figurehead and who has no true control over the corporation. Typically, a nominee director may have no knowledge of the business affairs or accounts, may not exercise independent control of or influence over the business, and may not act unless instructed to act by the beneficial owner.
Limited liability	Liability restricted by law or contract, such as the liability of the owners of a business entity for only the capital invested in the business.
Limited liability company (LLC)	A company whose owners (members) have limited liability (see "limited liability") and that is managed either by managers or its members. An LLC consists of one or more members (see "member").
Manager-managed company	A limited liability company that designates in its articles of organization that it is a manager-managed company. In this type of LLC, each member is not generally an agent of the LLC solely because of being a member of the LLC. Rather, each manager is such an agent.
Member (LLC)	An owner of an LLC interest; similar to a shareholder in a corporation.

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<sup>1</sup>A small business corporation may have no more than one class of stock and may not have more than 100 shareholders, all of whom must be individuals, estates, certain trusts, or certain exempt organizations and may not be nonresident aliens.

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**Member-managed company** A limited liability company that does not designate in its articles of organization that it is a manager-managed company. In this type of LLC, each member is an agent of the LLC and may generally act on behalf of the LLC for the purpose of the LLC’s business.

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**Nominee** An individual or entity designated to act on behalf of another, such as a nominee director acting on behalf of a beneficial owner (see “beneficial owner”). Most often in offshore tax avoidance schemes, the nominee may pretend to be the owner of an entity, asset, or transaction to provide a veil of secrecy as to the beneficial owner’s involvement.

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**Officer** A person elected or appointed by a corporation’s board of directors to manage and oversee the day-to-day operations of the organization, such as a chief executive officer, chief financial officer, chief administrative officer, and secretary.

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**Partnership** An association of two or more persons jointly owning and conducting a business together where the individuals agree to share the profits and losses of the business.

**Limited partnership** A partnership consisting of one or more limited partners who contribute capital to and share in the profits of the partnership, but whose liability for partnership debts is limited to the amount of their contribution and one or more general partners who control the business and are personally liable for the debts of the partnership.

**Limited liability partnership (LLP)** A partnership where a partner is not liable for the negligent acts committed by other partners or by employees not under the partner’s supervision. Certain businesses (typically law firms or accounting firms) are allowed to register under state statutes as this type of partnership.

**Limited liability limited partnership (LLLP)** A partnership where general and limited partners are not liable for the partnership’s debts and obligations because of their status as a partner.

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**Service of process** The delivery of legal process or other legal notice, such as a writ, citation, summons, or a complaint or other pleading filed in a civil court matter.

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**Sole proprietorship**

A business where one person owns all of the business assets, operates the business, and is responsible for all of the liabilities of the business in a personal capacity.

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