Complex Ownership Structures: Addressing the Risks for Beneficial Ownership Transparency (DRAFT)

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1. Introduction

On 6 October 2020, the Tax Justice Network, together with City University London, the Independent Commission for the Reform of International Corporate Taxation (ICRICT), Transparency International, and the Financial Transparency Coalition, hosted a closed virtual roundtable to discuss complex ownership chains, their risks for transparency and tax abuse, and the potential for regulation.

The roundtable was attended by 52 experts and researchers from academia, international organisations, civil society, country authorities and the private sector. The roundtable applied Chatham House rules, and everyone was asked to speak on a personal level as experts, not on behalf of their organisations.

This brief is focused on beneficial ownership transparency, and it is based on the ideas presented and discussed at (and following) the roundtable.

Part 1 explains the risks that complex structures pose to beneficial ownership transparency. **Part 2** presents evidence of abuses of current beneficial ownership frameworks through complex structures, it offers examples on the number of entities employing complex structures. **Part 3** describes legitimate cases of complex ownership chains. **Part 4** offers specific and general measures to fix the problem, as well as short-term recommendations.

Key Concepts

Individuals may set up a wide variety of types of legal vehicles: companies, partnerships, trusts, foundations, Anstalts, cooperatives, and more. They may use them to provide goods or services, hold assets, protect vulnerable people, invest money, fund charitable causes, and so on.

Based on these positive uses, societies (countries' laws) confer a range of general and specific benefits on legal vehicles, including:

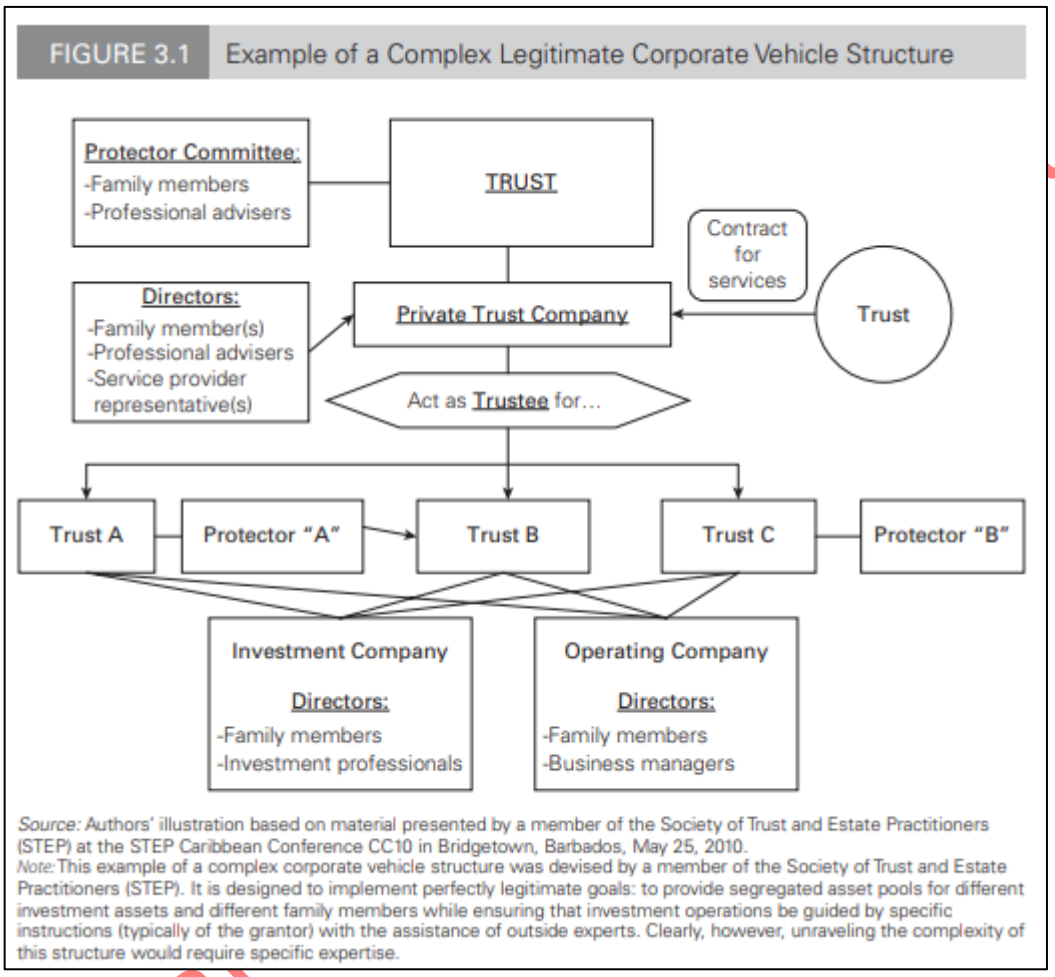
- **Limited liability**: Limited liability is the right to cap a legal or natural person's losses up to their investment in a legal vehicle, shielding the rest of their personal wealth from the entity's debts. Limited liability is two-sided: i) the personal creditors of a shareholder in limited liability Company A have no direct right over the company's assets (they can seize the shareholder's shares, but they can't reach into Company A to seize its equipment etc.), while ii) the creditors of Company A cannot access the shareholder's personal assets. Limited liability is usually obtained simply by creating or incorporating a legal vehicle as a separate entity. It may also be achieved where the law recognises a distinct pool of assets without separate legal personality, for example in a trust, where the law distinguishes between the trustee's personal assets from the assets held by the trustee in relation to a trust.

- **Recognition of foreign legal vehicles**: Called the doctrine of "hospitality" and related to the theory of incorporation, this principle considers that a foreign legal person will be valid locally, as long as it complies with the law of its place of incorporation (foreign laws). This holds true even if that type of legal vehicle is not available under local laws. For example, while local Company A may be prevented by its country's laws from issuing bearer shares, its country may still recognise as valid that local Company A is fully owned by foreign Company B, even though Company B has issued bearer shares.

- **Everything that is not forbidden is allowed ("Party autonomy" and the constitutional right of "legal reserve"**): Under these principles and rights, parties may create any type of legal structure, as long as it does not violate any law.

  Based on these key concepts, and especially the last one, any person may legally create a legal vehicle with an ownership structure that is as complex as they wish, and they may include foreign entities in the ownership chain. For example, the World Bank/UNODC StAR's famous 2011 paper "The Puppet Masters" described the structure illustrated in Figure 1, which was proposed by a member of the Society of Trusts and Estate Practitioners (STEP) in Barbados, as "an example of a complex structure that is nonetheless perfectly legitimate".

Figure 1: Example of what StAR considers a "complex (but) legitimate corporate vehicle structure"



Source: Authors' illustration based on material presented by a member of the Society of Trust and Estate Practitioners (STEP) at the STEP Caribbean Conference CC10 in Bridgetown, Barbados, May 25, 2010.
Note: This example of a complex corporate vehicle structure was devised by a member of the Society of Trust and Estate Practitioners (STEP). It is designed to implement perfectly legitimate goals: to provide segregated asset pools for different investment assets and different family members while ensuring that investment operations be guided by specific instructions (typically of the grantor) with the assistance of outside experts. Clearly, however, unraveling the complexity of this structure would require specific expertise.

Abusive arrangements.

Despite their many legal and legitimate uses, legal vehicles can be abused (legally and illegally) for many purposes, such as to facilitate illicit financial flows related to corruption, money laundering, private equity dividend recapitalisations, tax abuse, the financing of terrorism, and so on.

Complexity in the ownership and control structure of a legal vehicle may become an important factor indicating potential abuse. Individuals may hide behind complex legal vehicles to engage in corruption, money laundering or tax evasion. Complexity may also result in disguising the true operations and functions of entities within a multinational group in order to engage in tax abuse or other abuses.

The Egmont Group/Financial Action Task Force paper "Concealment of Beneficial Ownership" describes that "despite the legitimacy of many complex ownership and control structures, these structures can also be used to obscure beneficial ownership, avoid taxation obligations, conceal wealth, and launder the proceeds of crime. Complex structures are also used in fraudulent investment schemes, phoenix activity[1], false invoicing, and other types of fraud. The majority of case studies that involved tax evasion, fraudulent investment schemes and fraud as predicate offences also utilised complex structures to conceal beneficial ownership" (page 27).

It would be wonderful if there was a simple, readily observable factor with which to easily distinguish between legitimate and illegitimate legal vehicles. Unfortunately, it is impossible to determine this just by looking at an entity's structure. A legal vehicle *per se*, such as a company, is not illegal. Nor is it illegal *per se* to incorporate the company in a tax haven (also referred to as a secrecy jurisdiction).

So how do we separate the wheat from the chaff?

Some instruments, such as bearer shares (physical papers that bestow ownership of shares in a company to whoever simply holds the papers in their hands, like ultra-high value banknotes), are inherently problematic, which is why many jurisdictions have outlawed them. However, it is important to move beyond the analysis of "potential" risks and seek evidence that this complexity or secrecy is in fact exploited for abuse.

There may be legitimate needs for creating complex structures or at the very least, there may be legitimate constraints against simplifying complex structures that already exist (eg high economic costs).

An additional factor to consider is the number of affected entities and their importance: if only a very few entities use complex ownership chains, measures that affect them will have no major economic or social consequences unless these few entities are very important (eg big companies employing thousands of people). By balancing the risks created by complexity against the legitimate reasons for having a complex ownership structure, different measures could be proposed and assessed, informed by a consideration of their proportionality and consequences for societies.

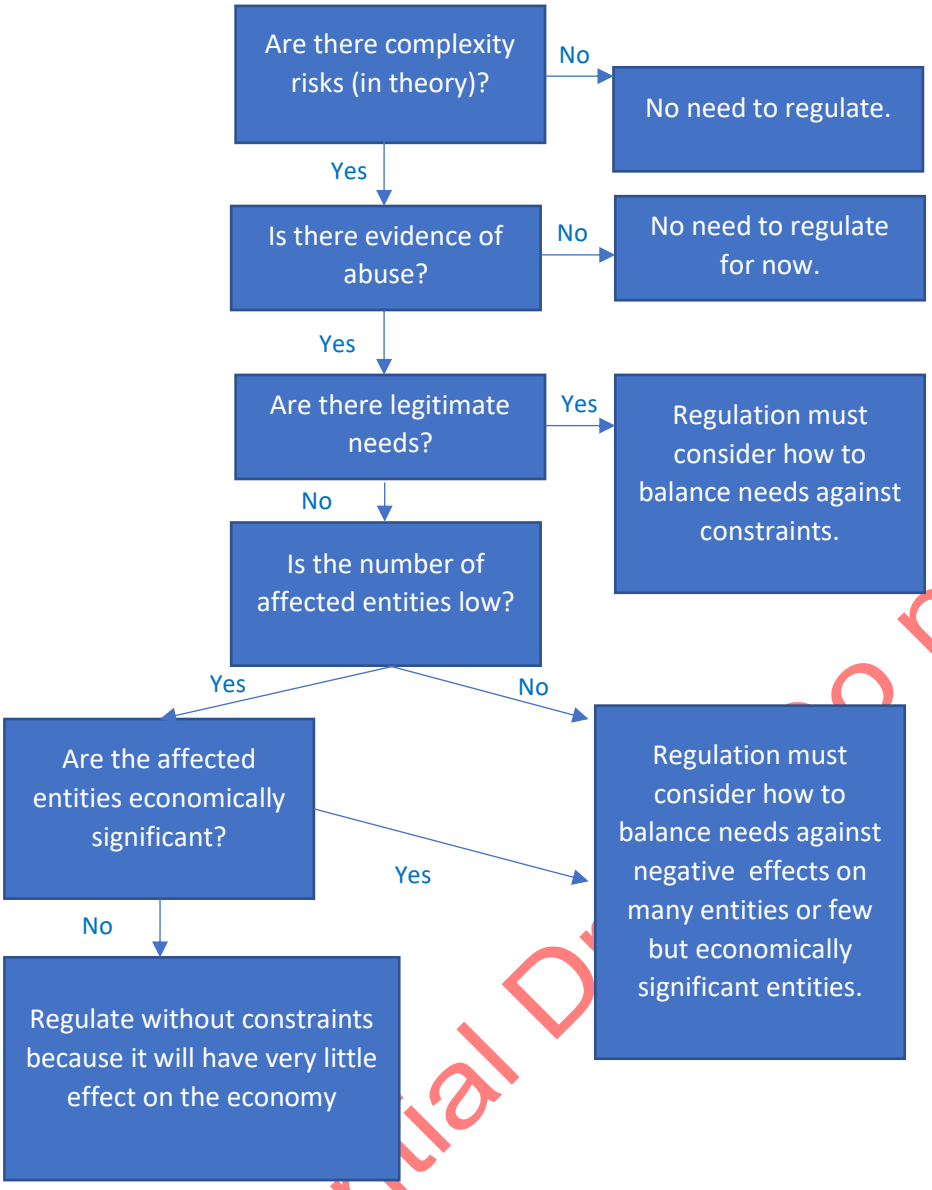
This brief asks whether laws should change to start regulating complex ownership structures, and it explores what any new measures might look like, taking into account the following:

1. Risks created by complexity
2. Evidence that complexity is exploited for abuses
3. Legitimate needs for complexity, or high costs of reducing complexity
4. The number of affected entities and their relevance

Any proposed policy measures should depend on the interaction of all these issues, as the next conceptual decision tree shows for illustration purposes.

[1] Where a new company is created to continue the business of an existing company that has been deliberately liquidated to avoid paying outstanding debts, including taxes, creditors and employee entitlements.

Figure 2: Conceptual decision tree to determine policy measures



According to the first part of the decision tree, if there are no risks, or if despite the apparent risks there is no evidence that these complex structures are used for abusive purposes, there would be no need for policy measures.

By contrast, if there are big complexity risks and evidence that complex structures are abused, policy measures should address this. However, before measures are determined, it is important to consider if there are other factors, such as legitimate needs or constraints, that could justify the need for complexity.

If there are risks resulting from complexity, but no legitimate needs to keep these structures, policy measures can neutralise the big risks with harsh provisions, such as prohibition. On the other hand, if legitimate needs are present, the analysis will have to consider how to balance them. In this case, measures may have to be more specific and moderate.

The last factor in the decision tree is to consider is the number of affected entities. If no or very few entities exploit complexity in a given country, prohibiting or imposing restrictions on them would have no major consequence (very few would be affected). However, if these few entities are the most relevant

companies in the country, then consequences will have to be considered. This will also have an impact on the level and type of measures that may be implemented.

Part 1: Understanding complexity

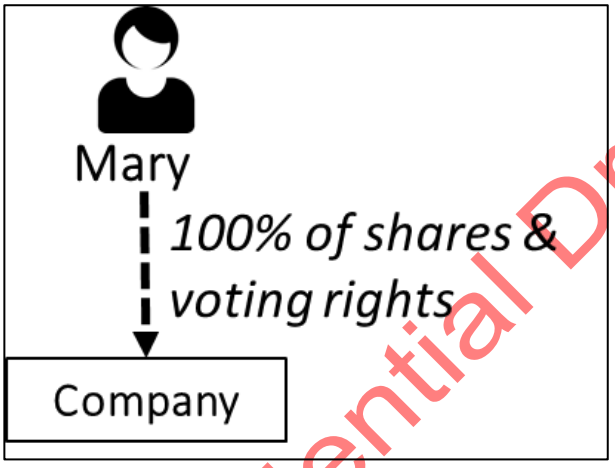
1.1 Understanding the beneficial ownership transparency risks created by complex structures

This section focuses on the beneficial ownership transparency risks created by complexity, primarily the way in which complex ownership chains often create difficulty in the identification (and verification) of the beneficial owners of a legal vehicle.

1.1.1 Concept

Beneficial ownership refers to the natural persons who ultimately own, control, or benefit from legal vehicles. As such, transparency of beneficial ownership is considered one of the main tools available to tackle illicit financial flows. Verifying beneficial ownership information to ensure it is accurate is, however, very difficult. To illustrate this, consider the simplest scenario wherein the beneficial owner directly owns and controls a vehicle as the sole shareholder with 100 per cent of ownership and voting rights (see Figure 3).

Figure 3: Basic beneficial ownership scenario



Verification of beneficial ownership information would involve determining if there is documentary evidence (eg a copy of a passport) to confirm the identity of the registered beneficial owner (in this case, Mary in Figure 3). Verification would also at the least require ensuring that: Mary is aware she is being registered as a beneficial owner (in case someone registered the data on her behalf); her registered data is valid (eg her address exists, she is still alive according to the national register of natural persons, her declared tax identification number matches the tax authorities' records, etc.); there are no red flags against her (eg being mentioned in a sanctions list, etc).

But this scenario is just a simple structure for which we already know who the beneficial owner is. Complex ownership chains, on the other hand, typically involve several layers of secretive entities and can make it difficult if not impossible to determine who the beneficial owner is to begin with. Obviously, none of the abovementioned verification can take place before the beneficial owner is identified.

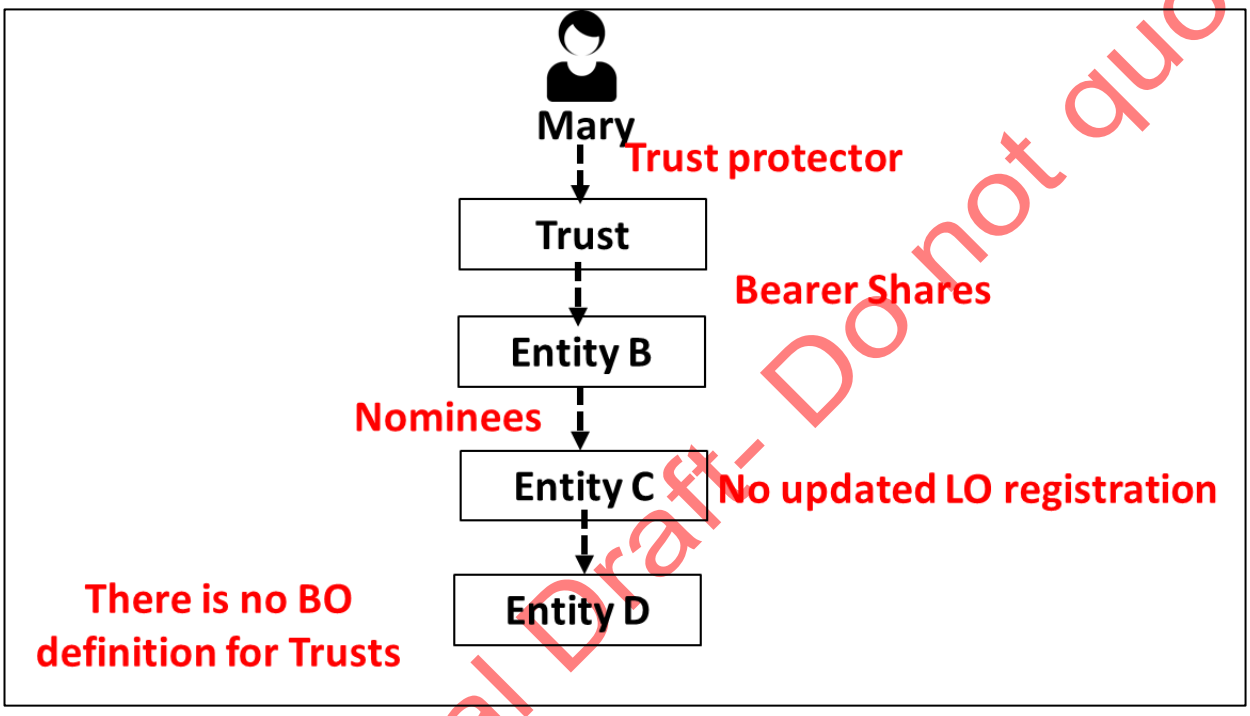
Figure 4 below illustrates some of the potential structures that may result in difficulty identifying the true beneficial owner in a complex ownership chain. If any of the layers in the ownership chain in Figure 4 prevents the identification of the legal owner above it, it may be impossible to determine the (ultimate) beneficial owner (eg Mary) at the very top.

For example, Entity C may be incorporated in a country where registration of legal ownership information is not required, or where legal ownership information is required but does not need to be updated, or where registration of information is required and needs to be updated but is not publicly disclosed. In any of these case, Entity C can make it impossible to trace ownership further up the chain. Entity C may also be incorporated in a country where nominee ownership is allowed. This would allow a nominee, such as a lawyer, to appear on the register instead of the real owner, which is Entity B.

Or another layer in the chain, Entity B, could have issued bearer shares which are physical papers bestowing ownership of Entity B to whoever physically holds the papers in their hands. These bearer shares may be freely circulating or held by a private custodian (likely, a lawyer) in a foreign country. Unless an authority can know who holds the bearer shares at any time, it would be impossible to know for sure who owns Entity B.

Lastly, the ownership structure may use a trust as a layer in the chain, or in the case of Figure 4 as the final layer. In this case, even if the country where Entity D was incorporated has a public beneficial ownership register, it may fail to identify the relevant beneficial owner (Mary, the trust's "protector") if the country's laws do not have a proper (or any) beneficial ownership definition for trusts[2].

Figure 4: Secrecy risk factors within the ownership chain



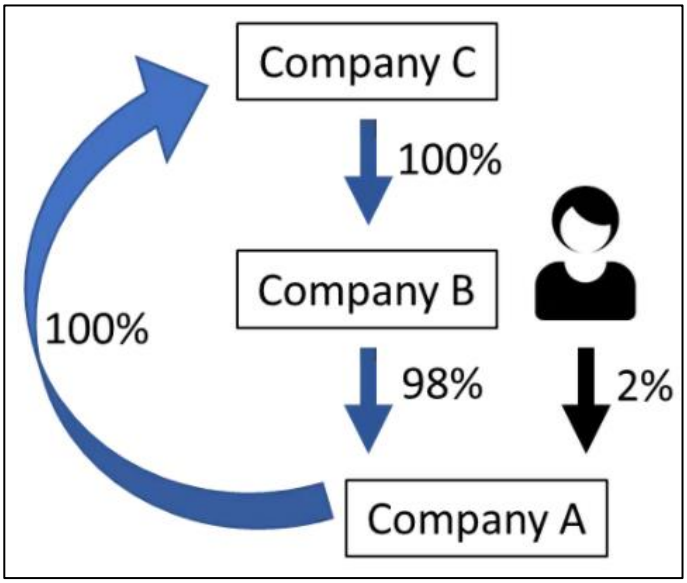
1.1.2 Specific complexity schemes

In addition to the specific risks to transparency posed by the strategies mentioned above, the ownership structure itself may be manipulated to hide the beneficial owner. This section describes potential ways in which this may occur.

[2] For instance, some countries require the identification of only the settlor, trustee and beneficiary. By contrast, the Financial Action Task Force also requires the identification of all the parties to the trust, including the protector as well as any other person with effective control over the trust.

a) Circular ownership

Figure 5: Circular ownership



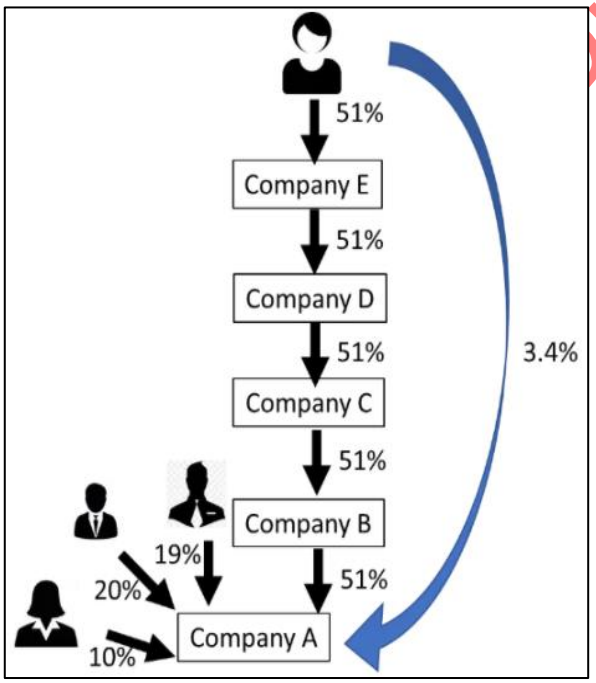
Source: "More beneficial ownership loopholes to plug"

Circular ownership structures in principle should be prohibited. A fully circular structure may be a deliberate attempt to avoid liability or transparency, where no single individual ever owns any entity. It also may be an attempt, as in Figure 5, to allow an individual with very little ownership (eg a 2 per cent ownership stake) to control the entity.

While this simplified version makes the circular ownership structure obvious, the legal ownership chain may involve 10 different layers, each incorporated in a different country, rendering the circular ownership structure far less obvious. For instance, a Global Witness analysis of the UK's Companies House revealed 487 UK companies that were part of circular ownership structures.

b) Fragmented ownership

Figure 6: Fragmented ownership



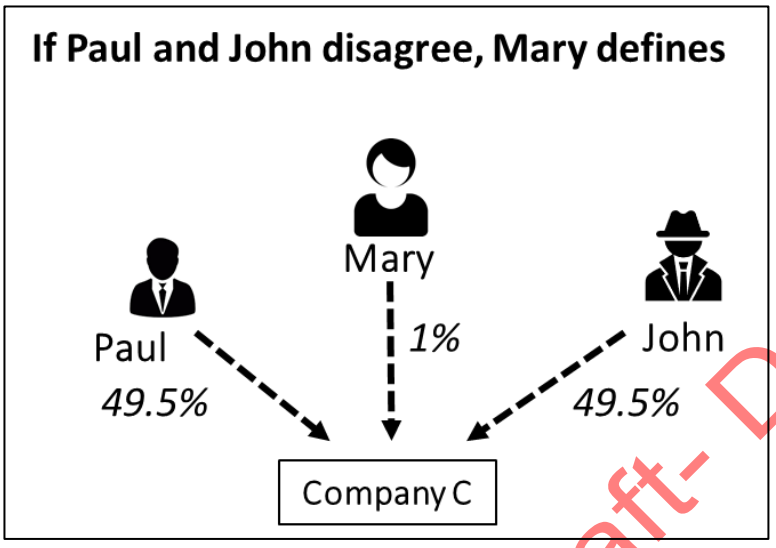
Source: "More beneficial ownership loopholes to plug"

Fragmented ownership structures may give the impression that no individual, either directly or indirectly, passes a threshold (such as more than a 25 per cent stake) for anyone to be considered a beneficial owner. However, as Figure 6 shows, it is possible for an individual to control a company, despite having what looks like a small stake, through the use of shell companies. In the case illustrated in Figure 6, the woman at the top of the chain is a beneficial owner of Company A because she has control over the company despite effectively owning only 3.4 per cent of its shares. In short, Company E controls Company D, which controls Company C, and so on down to Company A.

c) Coalition: tiny equity but decisive voting rights

Coalition ownership structures may give decisive control to shareholders with very little equity. This is not to say that coalitions are abusive per se, but that they may end up giving a lot of power to a beneficial owner who would not be required to be identified if the beneficial ownership definition is for example 25 percent. As described by Anders Rodenberg from Bureau van Dijk, even a tiny equity holding of 1 per cent may give controlling power to a shareholder. This may occur if each of the other two shareholders cannot obtain a majority by themselves, eg if each has 49.5 per cent. The two shareholders could get together and vote with 90 per cent, but if they disagree, they will depend on the tiny shareholder to achieve a majority.

Figure 7: Minority control via coalition



d) Control decoupled from ownership

As explained in our blog post "Determining 'control' unrelated to ownership", control of a legal vehicle may be achieved without having majority ownership by using contracts, power of attorney, and financial instruments.

For example, as described by Brandon Whitehill in "Buyer Beware: Chinese Companies and the VIE structure", it is possible for foreigners to hold interests in strategic Chinese industries (which are meant to be owned only by nationals) through the following arrangements (it works if all are present):

- A **loan agreement** and **call option agreement**, where an entity held by foreigners transfers money to the strategic industry company as an interest-free loan and has the right to purchase the strategic industry company at a pre-determined price, usually the amount of the loan agreement.A **power of attorney** in favour of the foreigners' entity, granting the entity shareholder rights such as voting, attending shareholder meetings and submitting shareholder proposals.
- A **technical services agreement and an asset licensing agreement** designating the foreigners' entity as the exclusive provider of services. These "services" justify why the foreigners' entity may get all the strategic industry company's pre-tax income (as payment for those services).

Another way to enjoy control without ownership (or vice versa), involves more sophisticated financial instruments called "morphable ownership and voting rights". Henry T. C. Hu and Bernard Black published "The new vote buying: empty voting and hidden (morphable) ownership" saying:

"hedge funds have been especially creative in decoupling voting rights from economic ownership. Sometimes they hold more votes than economic ownership – a pattern we call empty voting. In an extreme situation, a vote holder can have a negative economic interest and, thus, an incentive to vote in ways that reduce the company's share price. Sometimes investors hold more economic ownership than votes, though often with morphable voting rights – the de facto ability to acquire the votes if needed. We call this situation hidden (morphable) ownership because the economic ownership and (de facto) voting ownership are often not disclosed."

The authors give an example of hedge fund P: "[P] held 'morphable' voting rights – which could disappear when [P] wanted to hide its stake, only to reappear when [P] wanted to vote." (page 837)

The task of identifying and verifying beneficial ownership in cases where control is decoupled from ownership does not just require obtaining information on all the contracts and financial instruments used, but also having the ability to understand the complex contracts and instruments. In some cases, that would require a high-level knowledge of finance, or, in other cases, the capacity to undertake thorough analysis of large data sets of commercial transactions.

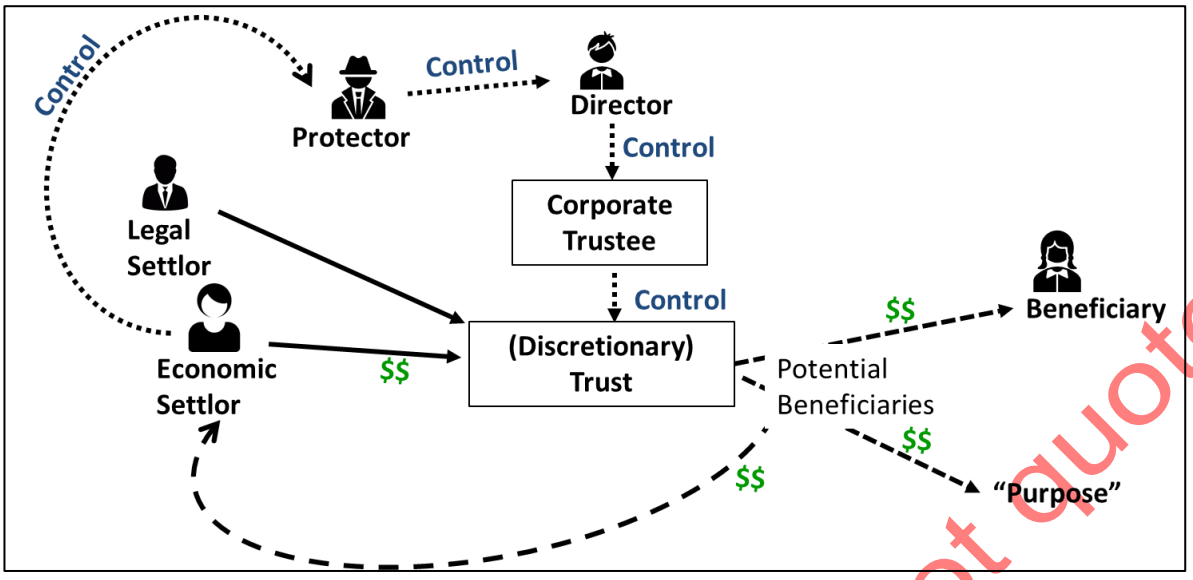
e) Sophisticated structures

Some jurisdictions offer sophisticated structures, like trusts, Anstalts or private foundations, which can increase complexity—and therefore the risk of secrecy—within an ownership chain. This is especially true if local regulations do not cover all parties to the legal vehicle.

In relation to trusts, the FATF/Egmont Group paper on "Concealment of Beneficial Ownership" said that:

"[D]espite the benefits associated with trusts and other legal arrangements, which offer significant opportunities to enhance anonymity by providing a partition between the legal and beneficial ownership of the property, the complexity and expenses associated with establishing and managing a legal arrangement may make them less attractive to criminals. It is also possible that the use of legal arrangements may increase the difficulty of investigating and identifying the beneficial owner, thereby explaining their relatively low prevalence in the case study sample." (page 34).

Figure 8: Parties to the trust



Sophisticated structures can be very complex, given the multiple possibilities of parties that may be present. For instance, a trust must have a settlor (who settles or creates the trust). However, some jurisdictions may distinguish between a legal or nominee settlor (who appears in the trust deed) and the economic settlor who is the person (or entity) who actually gave the assets to be settled in the trust.

The other party that must exist in any trust is the trustee, who in most cases, will hold the trust assets under their name, but the assets do not belong to them, nor can they benefit from them beyond agreed fees for providing trustee services. In Common Law countries, trusts are usually not considered legal persons with legal personality, so the trust itself cannot own assets. The trustee holds them "in trust" – so the assets do not belong to the trustee's personal wealth, but they also cannot be accessed by the trustee's personal creditors.

In some jurisdictions the settlor may also be the trustee, or the trustee can be an entity (a "corporate trustee"). In these cases, whoever owns and/or controls that company may control the trustee. In principle, any trust should have beneficiaries or at least classes of beneficiaries (such as "the future grandchildren of X"). Depending on the jurisdiction, the settlor may also be a beneficiary, or the only beneficiary (eg a self-settled trust). However, in some jurisdictions, eg the Isle of Man, trusts may have "purposes" in addition to, or even instead of, beneficiaries.

If the trust is a discretionary trust, then beneficiaries' rights may be dependent on the trustee's discretion to give them a distribution. The OECD's Common Reporting Standard for automatic exchange of bank account information allows discretionary beneficiaries not to be identified until they obtain a distribution from the trust. In addition, distributions can be concealed by pretending that the trust is engaging in phony transactions, such as a donation, a sale of trust assets at a very low value, etc., rather than a proper "distribution".

Discretionary trusts, which presuppose that the trustee has independence and discretion, usually involve a "protector" or "enforcer" for the settlor to control the trustee who has discretion to make distributions. What's worse, even if there is no "protector", the settlor can still control the trustee (and thus the management and distribution of assets) either by owning or controlling the corporate trustee, by having the trust as "revocable", by retaining the right to veto, the right to remove or appoint more trustees, and so on.

The Financial Action Task Force and some regulations, eg the EU Anti Money Laundering Directive (AMLD), require the settlor, trustee, protector (if applicable), beneficiaries or classes of beneficiaries, and any other

individual with effective control over the trust to be identified. However, some jurisdictions have no beneficial ownership definition for trusts, or cover only the trustee, settlor and beneficiary.

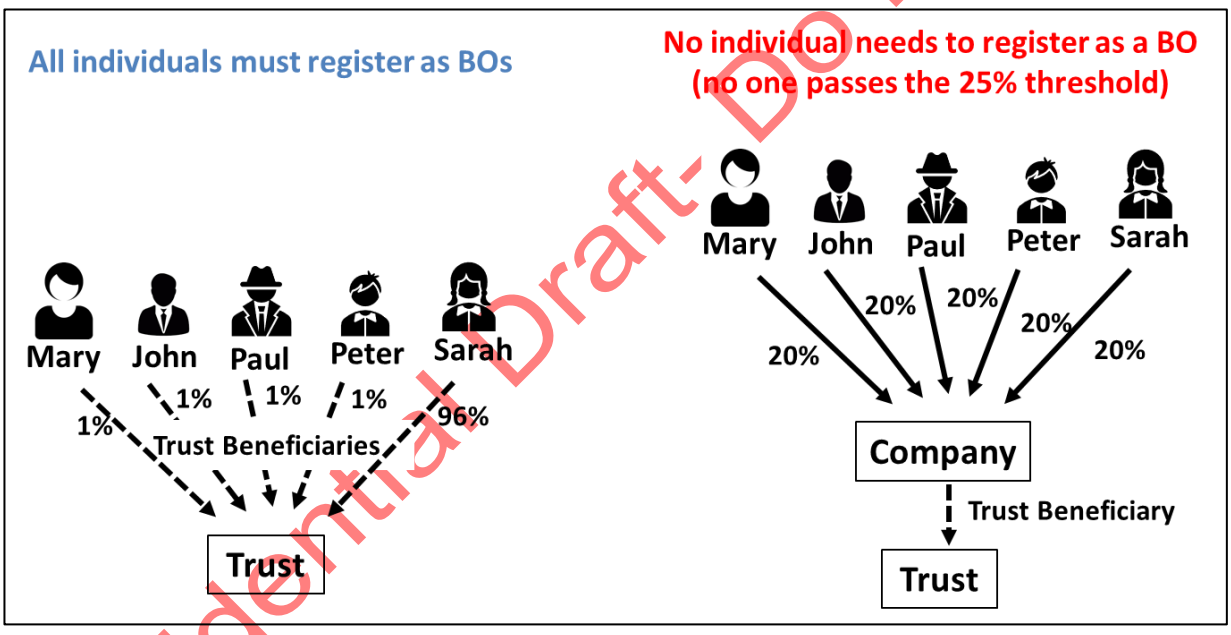
f) Combination of types of legal vehicles

A trust is usually accompanied by an underlying company to avoid having the trustee hold the assets under their own name. The trustee will usually hold shares in an underlying company which in turn holds the trust assets under the company's name.

Another combination is possible where the parties to the trust are also legal vehicles instead of natural persons. Figure 8 above shows the trustee as a corporate entity, which allows not only its permanence (a natural person trustee will eventually die), but also more control over the corporate trustee by the settlor, beneficiaries or whoever controls the corporate entity. As explained in different sections of this brief, determining who controls an entity may be a challenge.

Another obstacle created by having legal persons as parties to the trust is that they allow company threshold rules to be abused to escape disclosure, as Figure 9 illustrates.

Figure 9: Interposition of a legal vehicle to circumvent registration of the parties to a trust



Source: Knobel, A., "Transparency of Asset and Beneficial Ownership Information", UN FACTI Panel, July 2020, page 33.

The left-side of Figure 9 illustrates the beneficial ownership definition used by the Financial Action Task Force (FATF) and by the OECD's Global Forum on Exchange of Information. There are no thresholds: all parties, including all beneficiaries must be identified, regardless of their interests in the trust's income and capital.

However, as described by the Tax Justice Network's State of Play of Beneficial Ownership Registration 2020, more than 60 jurisdictions establish thresholds in their beneficial ownership definitions for companies. In most cases, individuals do not have to identify themselves as beneficial owners unless they reach the infamous "more than 25 per cent" threshold. Many jurisdictions in which trusts must register their beneficial owners rightly require all parties to a trust to be disclosed without any threshold. But, by allowing a company to be interposed as the trust beneficiary (and the natural-person trust beneficiaries as shareholders of the beneficiary-company), it may be that thresholds are added that can enable parties to a trust to avoid disclosing their beneficial ownership. This is illustrated on the right-side of Figure 9.

The FATF/Egmont Group paper "Concealment of Beneficial Ownership" explains:

"whereas the situation of criminals setting up a complex structure involving multiple trusts seems relatively rare…, the combination of a trust interacting with at least one company appears more frequently in the case studies. Almost all of the cases that involved the use of a legal arrangement also involved a company or other legal person. This demonstrates that trusts and similar legal arrangement are rarely used in isolation to hold assets and obscure beneficial ownership, but generally form part of a wider scheme; it might also show that schemes that only involve a trust may be more difficult for authorities to identify. The interaction of the trust with other legal persons adds an additional layer of complexity and helps frustrate efforts to discover beneficial ownership. As further demonstrated by the outcomes of the Horizontal Study, information on legal arrangements is rarely available, or is subject to significant challenges with regard to its relevance and accuracy." (page 34)

1.1.3 The risks of outdated information

Even if the full ownership chain is initially known because it was disclosed to a bank or beneficial ownership registry, the secrecy risk may still be present if information is not updated regularly. Any change in any of the intermediary entities involved in the ownership chain, if not updated on the beneficial ownership register, may result in the beneficial ownership data no longer being valid.

The longer the ownership chain, the more likely that a change in any link will render the beneficial ownership data outdated. This was also described by the Egmont Group/ Financial Action Task Force "Concealment of Beneficial Ownership" report:

"there are considerable challenges in ensuring accurate and up-to-date information on legal persons in many jurisdictions. As a result, the greater the number of companies and countries involved in a corporate structure, the greater the challenges associated with discovering the ultimate beneficial owner in a timely manner." (page 27).

Box 1: Regulations already address complexity, so what's the fuss?

One could argue that regulations already address complexity, at least indirectly, because they already require entities to identify their beneficial owners: each complex entity would have to find a way to look through its own structure to determine its beneficial owners. Some countries, eg Belgium, Ecuador, Uruguay already require the full ownership chain to be disclosed.

What's more, regulated entities such as banks and notaries are already required to identify the beneficial owners of the entities to which they provide services regardless of the complexity of their structure, and some may even consider applying enhanced due diligence if the structure presents secrecy risks.

The problem with this argument is that it assumes that all jurisdictions require this by law and that laws are enforced. According to the Tax Justice Network's "State of Play of Beneficial Ownership Registration in 2020", only 37 out of 133 jurisdictions have loophole-free frameworks for legal ownership registration of companies, and 44 have loophole-free frameworks for beneficial ownership registration. (Only 25 have loophole-free frameworks for both legal and beneficial ownership registration.) When considering all types of legal vehicles, no jurisdiction achieves a loophole-free framework of registration. So even if a corporate registry or a bank were to employ every possible resource to ensure accurate verification of an entity's ownership chain, this cannot guarantee success because an ownership structure can always pass through at least one jurisdiction without ownership registration. What's worse, most of the recent money laundering and tax evasion scandals suggest that countries and banks are very far from "employing every possible resource": on the contrary, they often understaff the relevant compliance and verification officers or even directly assist or turn a blind eye to illegal schemes.

So, a lack of ownership information cannot be remedied simply by requiring private actors to obtain this information.

1.1.4 The perception of risk when complex schemes are combined

To identify potential secrecy risks, we must consider the fact that some factors may not necessarily pose risks on their own, but they may be exacerbated when accompanied by other risk factors. For instance, a structure with an abnormally high number of layers (eg more than 20) may suggest a transparency risk, but if the structure involves only local entities and the local commercial registry provides easy access to the updated legal owners of each layer, there would be no secrecy risk. If the structure involves additional secrecy risk factors, however, such as incorporation in a secrecy jurisdiction, use of fragmented ownership, etc, then there may be cause for concern.

On the other hand, a legal vehicle with a very simple structure may be impossibly secretive. A legal vehicle could have just one layer up to the beneficial owner, but if the entity-legal owner is a company from a secrecy jurisdiction or a local company that issued bearer shares, it may be impossible to determine the beneficial owner.

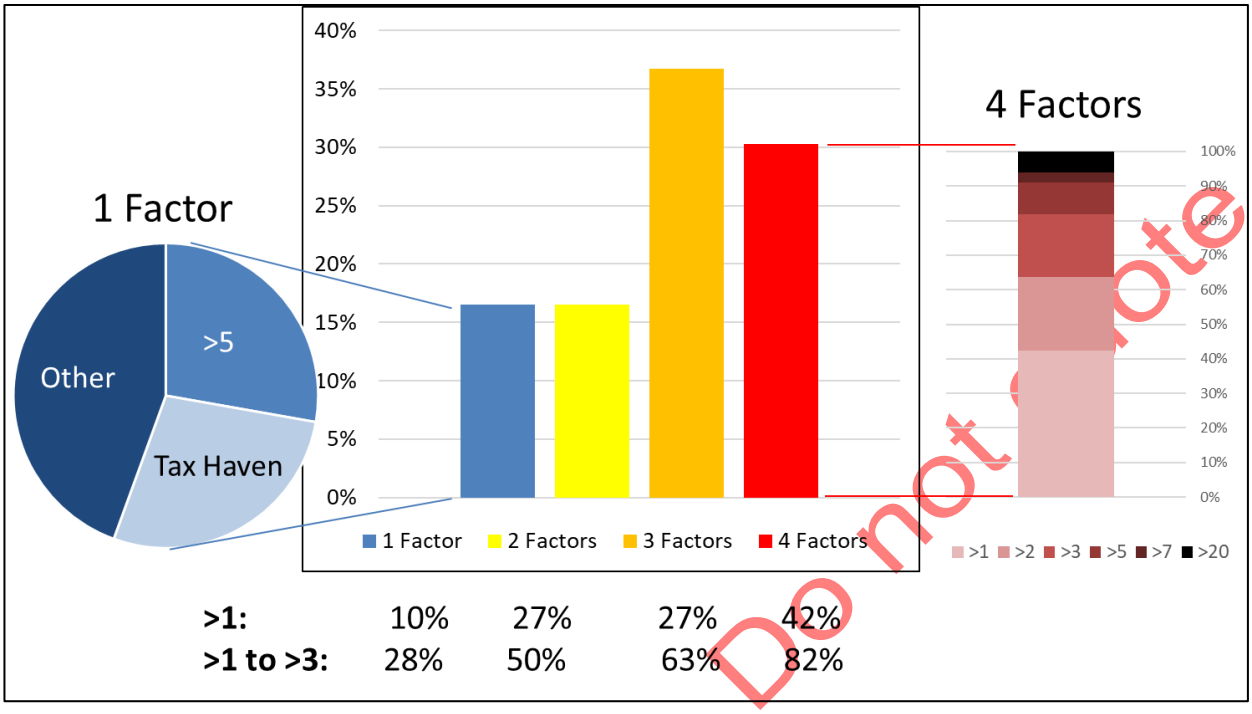
A UK impact assessment on beneficial ownership from 2014 agreed with the risks created by complexity, suggesting that trusts and foreign entities add complexity. The study's classification was as follows: "'simple' with 0-1 layers in the ownership chain; 'reasonably complex' with 2-3 layers of ownership (UK-owned, no trusts in the ownership chain); and 'complex' with over 4 layers and/or foreign ownership."

The next figure shows an online poll of more than 100 compliance officers from banks and other financial institutions from Latin America who were surveyed about factors they considered would add risk to a structure. The factors included the presence in the ownership chain of:

- a legal vehicle from a secrecy jurisdiction,
- a foreign trust,

- an “exotic” entity (eg Anstalt), and
- a high number of layers (>1, >2, >3, >5, >7, >20)

Figure 10: Responses by 100+ compliance officers on 4 potential risk factors



Almost 70 per cent said risk is created by the presence of three or four of the factors. For those that said risk is created by the presence of only one factor, most considered at least five layers as a risk factor. Yet when combined with other factors, even a low number of layers can create risks.

Part 2: Harms of complexity

2.1 Evidence that complexity is exploited for abuses

One of the issues discussed at the roundtable was whether it makes sense to focus on complexity in ownership chains given that illegal activities may not always depend on complex structures. This section does not refer to evidence that complexity is the most relevant factor for illicit financial flows. For instance, tax evasion, at least in some developing countries, may still be committed mostly by individuals or very simple (unincorporated) businesses. Bribes may still be paid directly to individuals using cash. Money laundering schemes may largely depend on thousands of money mules.

Instead, the question we are looking at is whether complexity is in fact abused to engage in illicit financial flows, specifically as a way to hide beneficial owners. On this matter, the Egmont Group/Financial Action Task Force paper "Concealment of Beneficial Ownership" assessed more than 100 case studies and explained that:

"a key method used to disguise beneficial ownership involves the use of legal persons and arrangements to distance the beneficial owner from an asset through complex chains of ownership. Adding numerous layers of ownership between an asset and the beneficial owner in different jurisdictions, and using different types of legal structures, can prevent detection and frustrate investigations. More than half of the case studies submitted in support of this report made use of complicated ownership structures, whereby control was affected through a combination of direct and indirect control. These complex structures were achieved through the establishment of chains of ownership, which often involved a number of legal persons and arrangements across multiple countries, distancing the beneficial owner from the assets of the primary corporate vehicle… The majority of case studies that involved tax evasion, fraudulent investment schemes and fraud as predicate offences also utilised complex structures to conceal beneficial ownership." (pages 26-27).

During the virtual roundtable, Antonio Bosisio and Michele Riccardi from Transcrime presented some preliminary results from their research activity of the *EU-funded Project DATACROS*. Their findings suggest that anomalous complexity of ownership (length of the ownership chain compared to companies in similar activity and dimension) is one of the calculated factors that have predictive power in identifying companies linked to negative evidence.[3]

An assessment in the UK confirms that complex structures are involved in criminal investigations and that they demand a considerable amount of time to identify the beneficial owners. According to the 2014 Impact Assessment in the UK on Enhanced Transparency of Company Beneficial Ownership, *"law enforcement agencies say the opacity of current beneficial ownership arrangements is a significant barrier to tackling money laundering and successfully recovering stolen assets… The Met [Metropolitan Police]*

[3] One of the objectives of the project is to measure ownership anomalies at micro level (company level) and macro level (by regions, sectors), and assess whether they can help identifying companies involved in illicit activities. Risk indicators are drawn from relevant AML principles and guidelines at international level and calculated on a sample of 13,4 million companies in Europe. Two risk factors are considered: i. Anomalous complexity of ownership: length of ownership chain of a company, compared to the values observed for peer companies in terms of activity and dimension., and ii. Links with risky jurisdictions: ownership links to countries included in official blacklists (i.e. EU black and grey list of non-cooperative jurisdictions for tax purposes, FATF AML blacklist and grey list). Risk indicators are then validated against evidence of sanctions or criminal conducts by companies and companies' owners. Results show that all calculated risk indicators have a predictive power in identifying companies linked to negative evidence. Also, results highlight that possible vulnerabilities may arise in specific geographic areas and economic sectors where risky companies are concentrated. See more details here: Jofre M., Bosisio A., Riccardi M. and Guastamacchia S., 2021, "Money laundering and the detection of bad entities: a machine learning approach for the risk assessment of anomalous ownership structures", 2021 Empirical AML Research Conference, https://bahamasamlconference.com

estimate that in cases where hidden beneficial ownership is an issue, 30-50% of an investigation can be spent in identifying the beneficial owners through a chain of ownership 'layers'."

During a presentation on beneficial ownership transparency in South Africa organised by Vienna University, a representative from South Africa's financial intelligence unit explained that determining and verifying beneficial owners is complicated by complex schemes, especially those involving foreign trusts and more than three layers up to the beneficial owner.

Moreover, complex ownership chains have been identified as a key factor in one of the increasing concerns around illegal, unreported and unregulated fishing (IUU fishing). A paper by RUSI described how *"these networks are often hidden behind corrupt practices and complex company structures that obscure the beneficial owners – those who actually gain from the IUU fishing activities."*[4]

Lastly, the following examples provide anecdotal cases described by Egmont Group/FATF and media outlets. They show that there is indeed evidence that complexity is abused, especially by sophisticated individuals and criminals. While these cases may be limited (compared to the thousands of individuals and unincorporated businesses engaging in illegal activities), given that many times they involve high-ranking politicians or high net worth individuals, they may very well be relevant for policy purposes.

2.1.1 Cases described by the Egmont Group/FATF paper 'Concealment of Beneficial Ownership'

The paper "Concealment of Beneficial Ownership" describes that *"more than half of the case studies submitted in support of this report made use of complicated ownership structures".* Below are some examples.

Case Study 1 – Argentina

"**A complex corporate structure, with Company G 95% owned by Mr. A and 5% by Mr. B. Company G purchased a power generator from Company K, owned by Company R in the Cayman Islands**. Company R was linked to Panamanian Foundation P, which had Mr. A and his spouse as beneficiaries. Company G leased the generator to Company E, receiving amounts cleared by Company L. The funds were drawn against Company K's bank account, and Company G made payments to K to settle a debt. The funds were credited to the accounts of Companies S, T and R. **The simulation of commercial operations introduced funds of dubious origin to the financial system, hiding the true beneficiary**" (emphasis added)

Case Study 42 – Italy

"The Nucleo Polizia of Milan conducted a preventive seizure of funds traceable to a single family, which were held in the Channel Islands, for a total value of EUR 1.3 billion. **The assets were concealed through a complex network of trusts. Multiple trust accounts hid the beneficiaries of assets consisting of public debt securities and cash**. The investigation established that between 1996 and 2006 **the subjects placed their assets in Dutch and Luxembourg companies through complex corporate operations and by transferring them to different trusts in the Channel Islands**. Subsequently, the funds were legally repatriated through a tax amnesty in December 2009." (emphasis added)

[4] Charlie de Rivaz, Cathy Haenlein, Alexandria Reid and Veerle Nouwens, "Turning the Tide? Learning from Responses to Large-Scale Illegal, Unreported and Unregulated Fishing in Five Countries", *Whitehall Reports*, 29 November 2019. International Security Studies, Organised Crime and Policing, Organised Crime. Available in: https://rusi.org/publication/whitehall-reports/turning-tide-learning-responses-large-scale-illegal-unreported-and

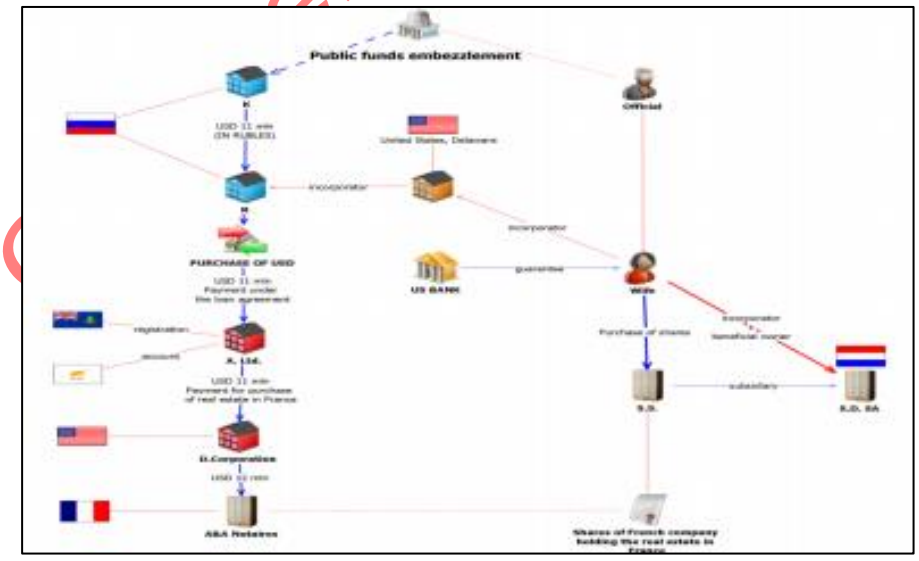
Case Study 78 – New Zealand

"A New Zealand law firm was linked to clients who had been implicated, arrested or convicted of a myriad of offences including embezzlement, bribery, corruption, tax evasion, and money laundering. … The companies and partnerships were set up by this New Zealand law firm, who routinely used its employees as nominee directors and shareholders, with the beneficial owners (who were sometimes offenders and their associates) not publicly named. **Furthermore, often a chain of companies was established, with one company the shareholder of another, which was the shareholder of another, which added complexity to the structure, and further removed the beneficial owner from the assets**. Sometimes a New Zealand (shell) company was used as a trustee of the trust. The companies involved were usually all shell companies with nominee directors, shareholders, and addresses. **The companies, partnerships and trusts comprised the complex structures established by this New Zealand law firm, which can be used to hide and protect wealth. Furthermore, sometimes entities were set up internationally by this New Zealand law firm's business associates in other countries, which were added to the structures, further increasing the complexity and decreasing the ability and efficiency of detecting crime and hidden wealth. If suspicions did arise and a person with such a structure was investigated, there was a convoluted audit trail that would have been arduous to trace**. There were strong indications that criminals have had structures set up by this New Zealand law firm with evidence that some of these structures have been used by criminals to hide assets." (emphasis added)

Case Study 88- Russia

"Embezzled public funds worth RUB 300 million (11 million USD) were transferred from the account of Company K to the account of Company R. Company R, a Delaware corporation, was owned and managed by the Russian wife of the suspect, a state official. The same day, Company R transferred USD 11 million as a loan to an account of Company A (BVI) held by a Cypriot bank. Company A then transferred more than USD 11 million to the Company D (US) to purchase real estate in France. Company D transferred more than USD 12 million to a French Notaries Bureau. Information from the FIU of Luxembourg showed that one of the US banks acted as a guarantor for the suspect's wife in a transaction to purchase shares of a French company – and the holder of the real estate. The transaction was conducted via an S.S. company – a French subsidiary of a Luxembourg S.D. SA., incorporated and owned by the same individual. Analysis showed that these two chains were interrelated and the real estate was purchased with the proceeds of public funds embezzled for the benefit of the state official's wife."

Figure 11: Case study 88- Russia



Case Study 93 – Switzerland

"An operational coal mining company paid out EUR 800 million to their owner, a Dutch NV over a period of four years. The financial intermediary came across information that there was an ongoing prosecution of the Dutch NV and its owner in a third country and filed a STR for misappropriation of funds. The documentation held by the Swiss financial intermediary showed that this Dutch NV was owned by Mr. A, a citizen of another European country. Over a time period of 10 years **CHF 3.5 billion was transferred through a large and complicated structure of 32 companies in different countries including the British Virgin Islands and the Netherlands.** The Swiss financial intermediary's documentation identified the beneficial owner of almost all of the companies as Mr. A" (emphasis added)

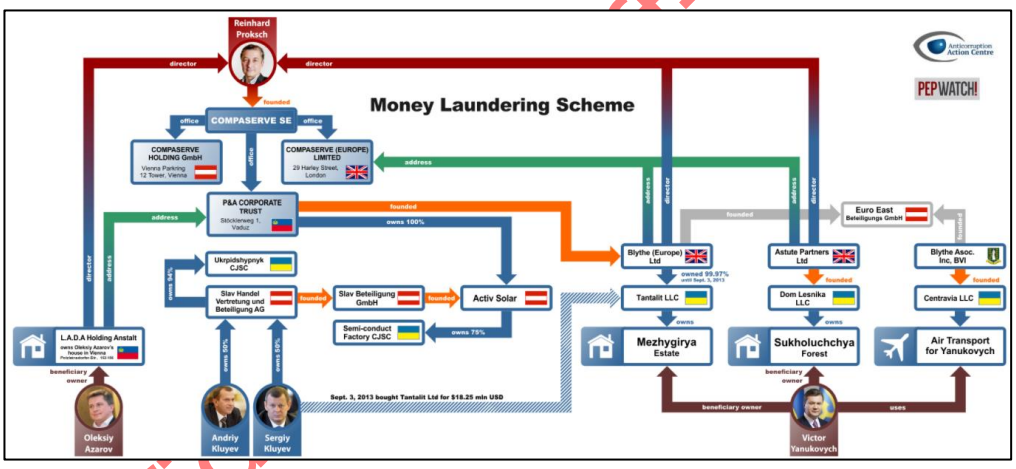
2.1.2 Other anecdotal cases

This section includes examples of complex ownership structures that according to the media or sources could be potentially involved in corruption, money laundering, tax abuse, etc. The sole purpose of their inclusion is to illustrate the use of complex structures in practice, without suggesting that any wrongdoing actually took place.

Former Ukrainian President, Yanukovych

Figure 12 describes how former Ukrainian President, Viktor Yanukovych (who fled the country accused of corruption) held interests in the state mansion, a forest and an airport through a very complex structure.

Figure 122: Complex structure used by Viktor Yanukovych to hold interests

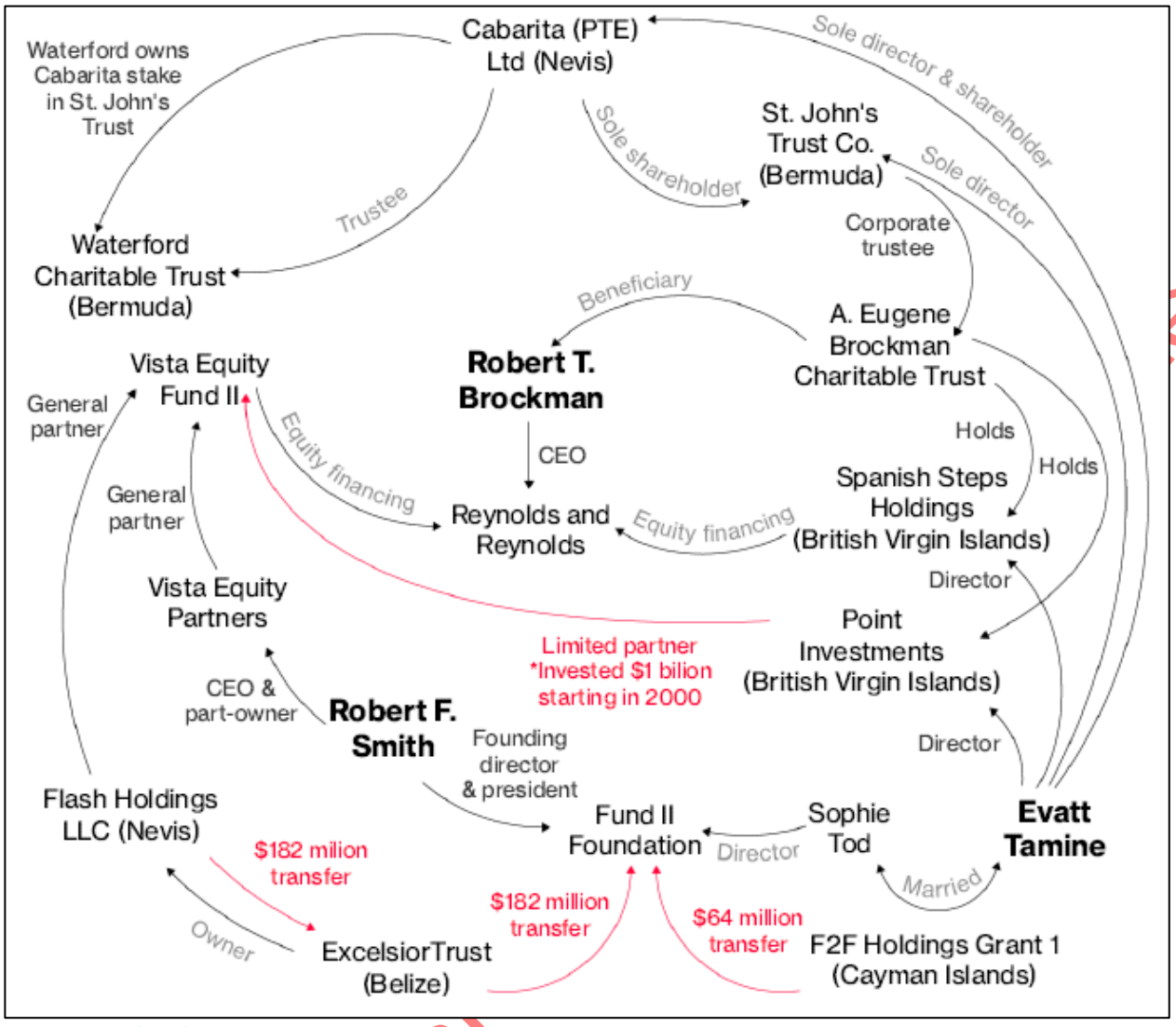


Source: https://new.antac.org.ua/en/investigations/prokladky-zlochynnoji-vlady-rejnhard-proksh/

Largest tax evasion case in the US

The Washington Post reported on allegations of a US$ 2 billion tax fraud, the biggest in the US history, in a case brought against billionaire Robert Brockman. According to the news outlet, "the case against Brockman was bolstered by witness and alleged co-conspirator Robert Smith… Smith is the founder of Vista Equity Partners, a San Francisco-based private-equity fund that had a single investor: Brockman. According to prosecutors, Smith helped Brockman hide his profits earned through Vista in offshore accounts so he could avoid paying taxes." Figure 13 is an illustration by Bloomberg of the very complex scheme that related Brockman to Smith.

Figure 133: Complex structure connecting the tax evader to the alleged co-conspirator

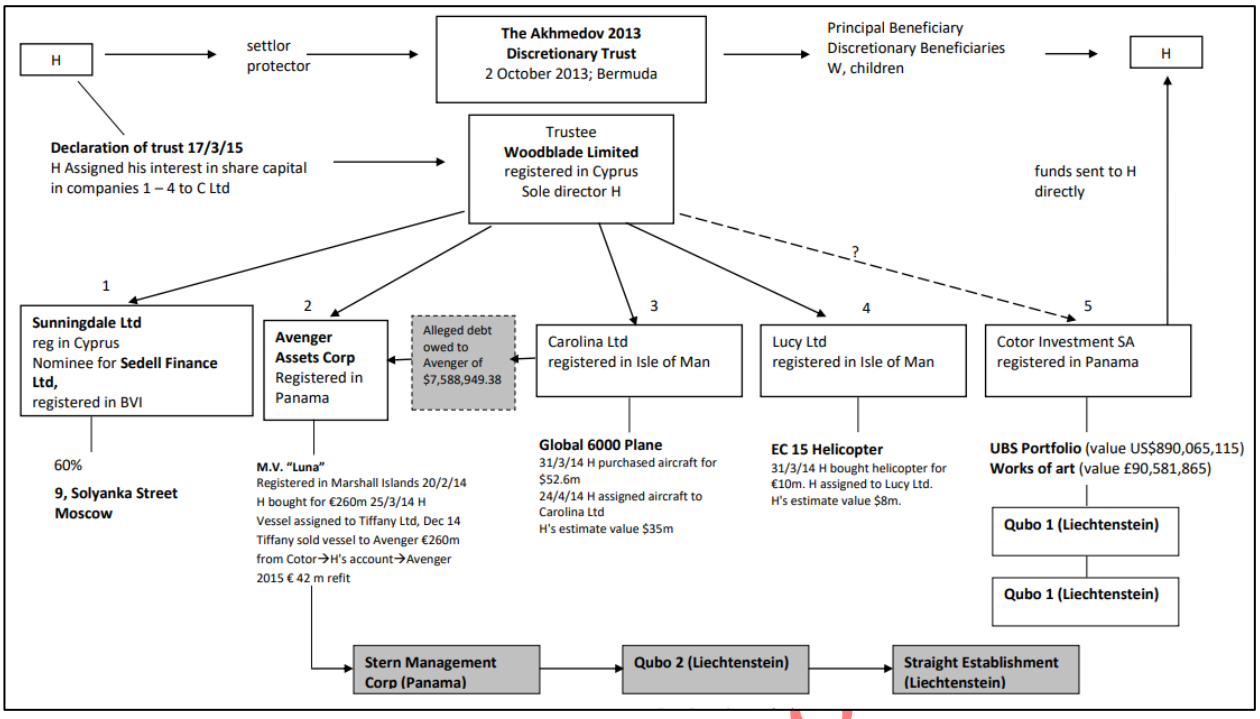


Source: Bloomberg

Most expensive divorce in the UK, but wife unable to collect after the ruling

In the highest-stake divorce case in the UK, the former wife of Russian oligarch Farkhad Akhmedov (one of Putin's allies) unsuccessfully tried to collect her awarded £453 million. In addition to the complications of trying to enforce the judgement on several jurisdictions, the court document described in the following Figure 14 show how her former husband's a Panama company on the second day of the trial and then to an Anstalt from Liechtenstein..

Figure 144: Complex structure used to hold and transfer assets by Farkhad Akhmedov

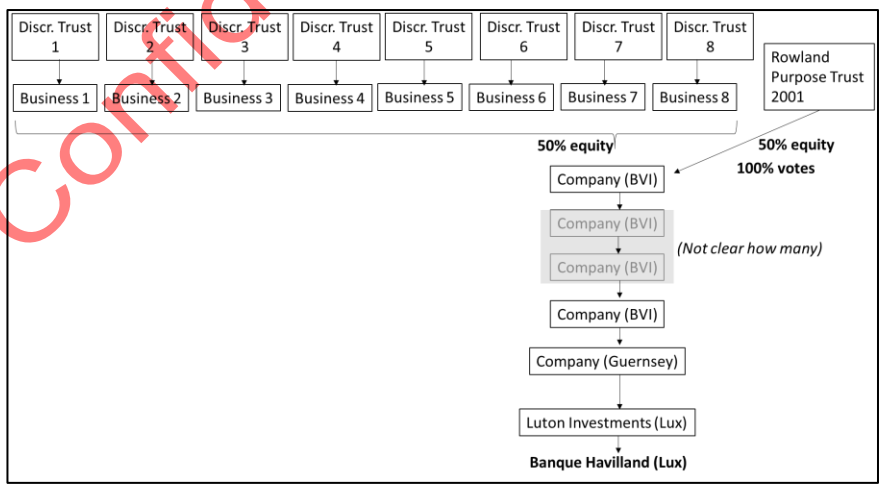


Source: Neutral Citation Number: [2018] EWFC 23 (Fam), Royal Courts of Justice Strand, London, WC2A 2LL, page 21.

Luxembourg bank "pitching services to potential clients including dictators and kleptocrats"

Bloomberg reported on an ownership structure regarding a Luxembourg bank which "pitch their services to potential clients from the ranks of the world's dictators and kleptocrats". According to the news outlet, David Rowland *"bought the bank through a Luxembourg-based company, Luton Investments, which at the time was owned by a company based in Guernsey. That entity was in turn controlled by a series of nesting British Virgin Islands companies, the last of which was half-owned by eight businesses controlled by eight discretionary trusts whose beneficiaries are his children. The other half, and all of its voting rights, are controlled by an entity called Rowland Purpose Trust 2001."* The following figure depicts the structure described above.

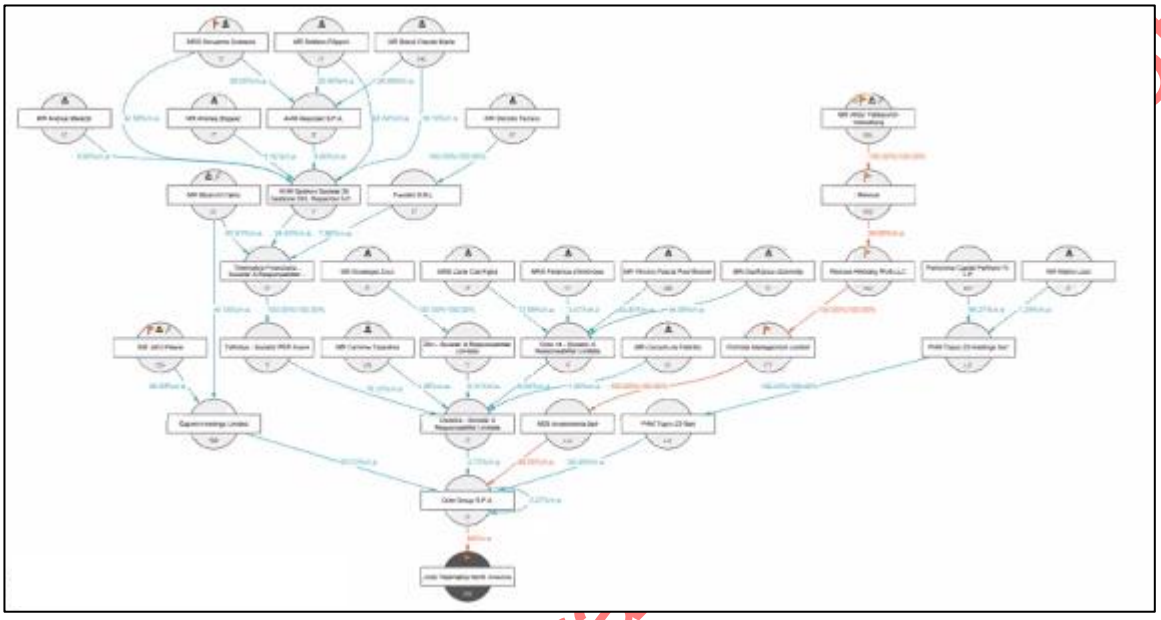
Figure 155: Complex structure used to hold interests in the Luxembourg Bank



Russian Politically Exposed Person (PEP) under US sanctions

Anders Rodenberg from Bureau van Dijk described during a presentation at the AML Shop that when a Russian oligarch was put on the US Office of Foreign Assets Control's sanction lists, he changed his equity over to different entities in order to be below the sanction's trigger points, yet still retaining control through power through potential voting coalitions in the complex structure illustrated in Figure 16. The structure involved a US entity that is owned by entities from Italy, the UK, Luxembourg, Cyprus, Bahamas (four entities), the British Virgin Islands and Cayman Islands:

Figure 166: Complex structure used by the Russian oligarch to hold interests

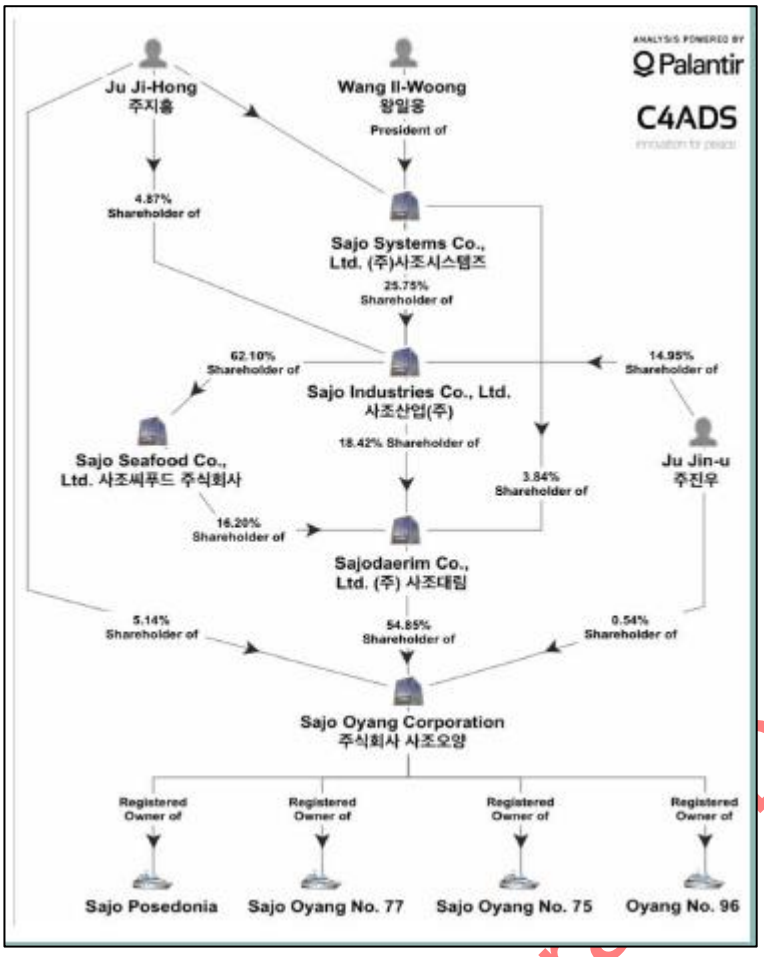


South Korean vessels engaging in Illegal unreported and unregulated (IUU) fishing

C4ADS' paper "Strings exploring the onshore networks behind illegal, unreported, & unregulated fishing" described a South Korean fishing company operating two vessels in the Atlantic involved in the following cases related to illegal, unreported and unregulated fishing (IUU fishing):

"The Oyang No. 77 was illegally fishing without a license in Argentina's EEZ [Exclusive Economic Zone]. A subsequent inspection of the Oyang No. 77 found the vessel violating fishing net regulations and with more than 142,000 kilograms of catch onboard… In New Zealand, both the Oyang No. 77 and the Oyang No. 75 were implicated in the exploitation of migrant laborers from Indonesia, who reportedly were deceptively recruited to work in abusive and unsafe working conditions onboard the Oyang vessels. They were reportedly forced to work long hours under threat of physical and financial penalty and upon completion of their contracts were severely underpaid or denied pay altogether… Additionally, between 2012 and 2014, the Oyang No. 75 and Oyang No. 77 were fined for illegally dumping catch and filing false catch returns while operating in New Zealand. The vessel owners were repeatedly found to contravene legal statutes to maximize profits during this period of time."

Figure 177: Complex structure to hold the vessels



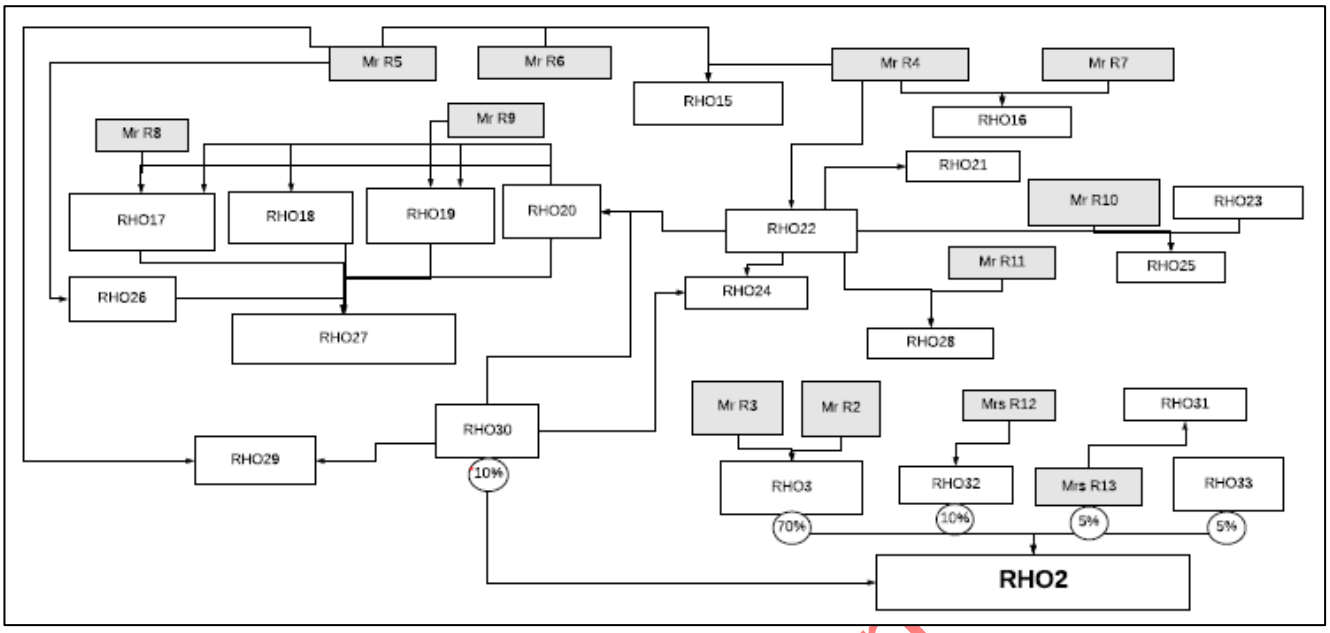
Source: C4ADS

Chinese box scheme used by Italian Mafia

In the 2018 report 'Mapping the risk of organised crime infiltration in Europe'[5], Transcrime describes a complex ownership structure employed in a case of mafia infiltration in the Italian legitimate companies. The structure allowed representatives of a Cosa Nostra family to control the company RHO2 (alias company name) in order to obtain a monopoly in providing logistic and security services to a leading food retailer and to the local tribunal.

[5] https://www.transcrime.it/wp-content/uploads/2018/12/MORE_FinalReport.pdf

Figure 18: Complex structure used by Italian Mafia



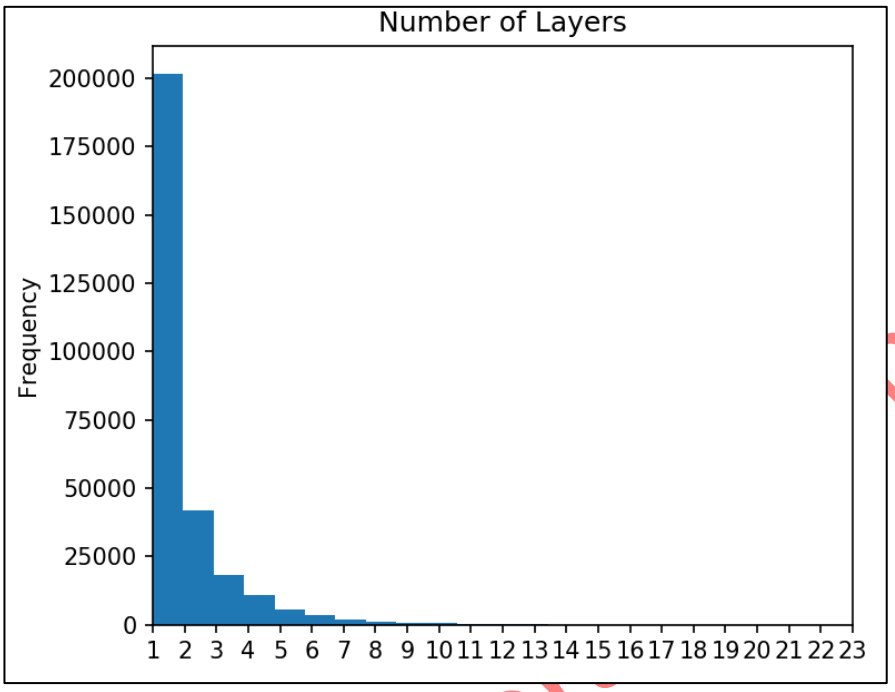
Source: Transcrime 2018

In conclusion, complex ownership structures have been involved in more than half of the cases assessed by the Egmont Group/Financial Action Task Force paper "Concealment of Beneficial Ownership", confirming that the scope for abuse provided by complexity is key for those involved in illicit financial flows. The use of complex ownership chains is evidenced in various types of crimes such as illegal, unreported and unregulated fishing, and there is anecdotal evidence that it is exploited mainly by sophisticated individuals who should therefore be the targets of policy measures.

2.2 The number of affected entities

The risks to transparency in practice and the need for measures to address complexity may be determined by the number of entities that have a complex structure. At the roundtable, Oliver Seabarron presented the Tax Justice Network's research on the legal ownership chains of UK companies. He showed that, while there were companies with more than 20 layers, the vast majority of them had very few layers, between 0 and 1.

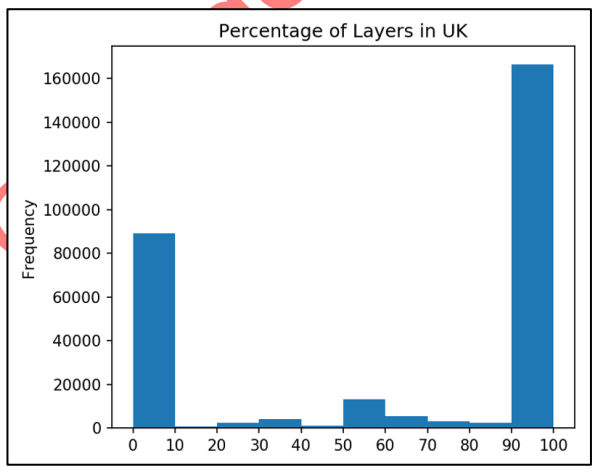
Figure 19: Distribution of number of layers of UK companies



As the Figure 19 shows, 75 per cent of companies have no more than 1 layer up to the beneficial owner; 4.5 per cent have 5 or more layers; 0.5 per cent have 10 or more layers. The maximum number was 23 layers.

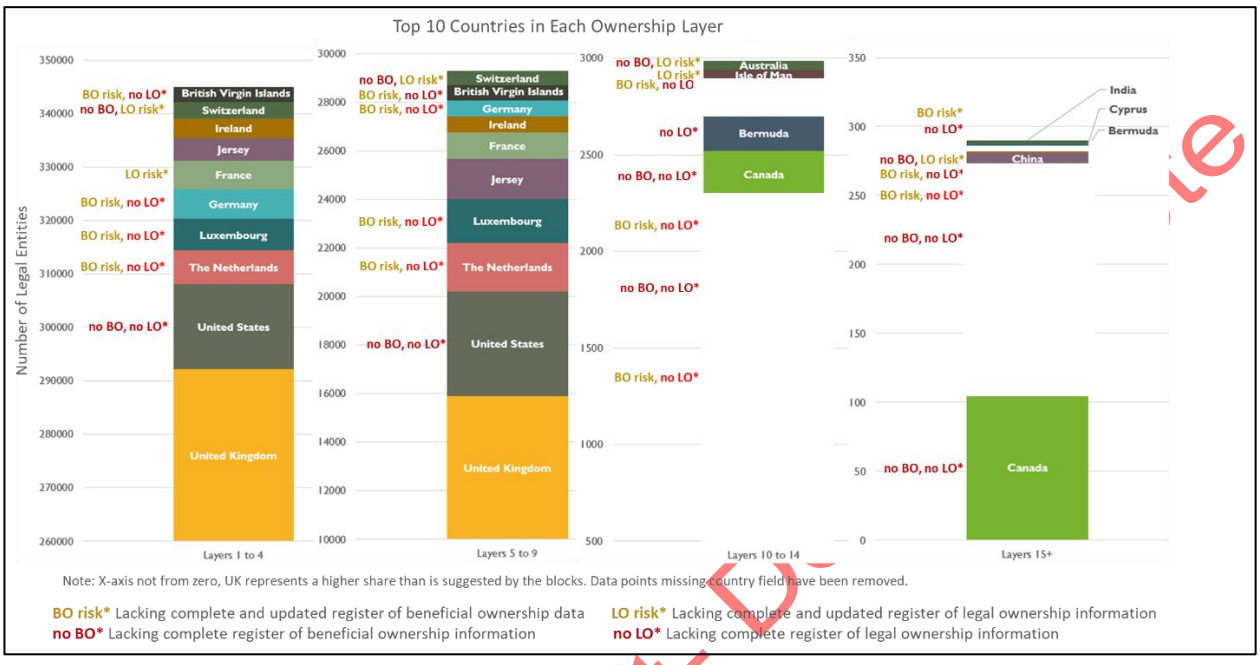
As regards the geographic spread of these companies, the next figure shows that roughly 66 per cent have layers based in the UK (all UK entities), although close to 33 per cent have no layers in the UK.

Figure 20: Percentage of UK-layers of UK companies



Zeroing in further on the specific countries in which the non-UK layers were incorporated, the next figure illustrates that many non-UK layers were incorporated in secrecy jurisdictions where there is no comprehensive registration of legal or beneficial ownership, let alone requirements for public disclosure of information.

Figure 21: **Geographic spread of layers of UK companies**



A first conclusion that could be drawn from the above charts is that any proposed measure (eg prohibition of chains with more than two layers) would only affect a minority of UK entities. In addition, a geographic limitation (eg prohibiting layers of entities from countries without legal and beneficial ownership registration) would not affect most UK companies either.

However, some experts at the roundtable warned that, while the universe of complex structures may refer to just a few UK companies, they may be the biggest UK companies. In other words, given the power and economic concentration of just a few very large UK companies with complex structures, measures targeting complexity could have a big impact on the UK economy.

In support of this, the UK 2014 Impact Assessment report suggested a similar conclusion. A sample of more than 3 million entities was classified between “micro and small” (fulfilling at least two of the three following criteria: (i) Turnover < £6.5m; (ii) Balance sheet < £3.26m; (iii) Employees < 50); or the opposite, “medium and large” (fulfilling at least two of the tree following criteria: (i) Turnover > £6.5m; (ii) Balance sheet > £3.26m; (iii) Employees > 50).

As the next table shows, out of the 3.1 million “micro and small” companies, 95 per cent had a “simple” structure (0-1 layers in the ownership chain) while almost 3 per cent had a “reasonably complex” structure (2-3 layers of ownership, all UK-owned, no trusts in the ownership chain) and almost 2 per cent had a “complex” structure (with over 4 layers and/or foreign ownership). On the contrary, out of the 54,180 “medium and large” companies, 52.8 per cent had a “simple” structure, 16 per cent had a “reasonably complex” structure and 31 per cent had a “complex” structure.

Table 122: Interaction of risk factors when risk-neutralising conditions are unmet

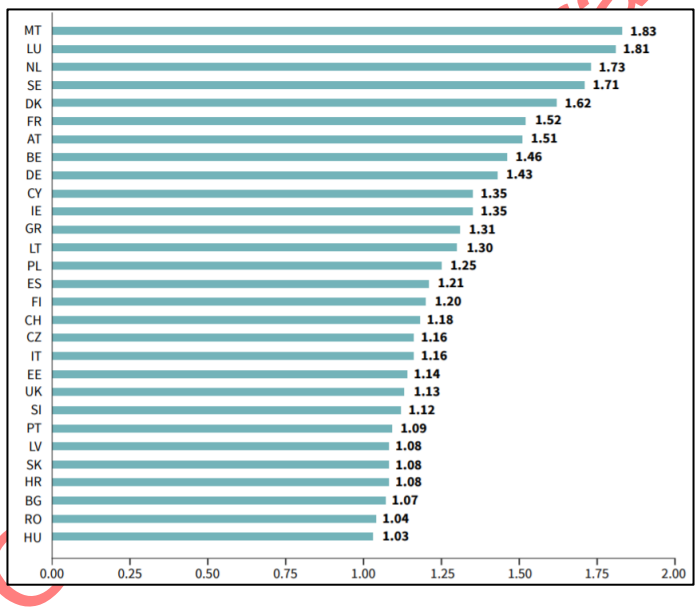
Weighing Grid	Simple	Reasonably Complex	Complex	Total
Small / Micro	95%	3%	2%	100%
Medium / Large	53%	16%	32%	100%

Source: Table with percentages considering all small/micro companies vs all medium/large companies, adapted from the Impact Assessment's original table (page 61), which considered all percentages based on the total number of companies.

Based on Table 1, measures addressing complexity would affect close to half of all medium and large companies (ie, those that have a complex or reasonably complex structure). While the economic impact may discourage such measures, authorities could at the very least, investigate the total of 5 per cent of complex (2 per cent) and reasonably complex structures (3 per cent) of the 3.1 million small and micro companies, which are outliers compared to the 95 per cent of small and medium companies with simple structures.

It would be important to have similar studies from other countries. For instance, the final report of the DATACROS project[6] included a calculation of the average beneficial ownership distance across European countries (when the beneficial owner distance equals 1, it means that the entity is directly owned or controlled by its beneficial owner). As the next figure shows, it appears that across Europe, complexity is not the norm, but the exception, so it should be possible to design measures that affected just those entities, as will be discussed in Part 4.

Figure 232: Average beneficial owner distance across European countries



Source: Bosisio A., Carbone C., Jofre M., Riccardi M., Guastamacchia S., 2021, Developing a Tool to Assess Corruption Risk factors in firms' Ownership Structures – Final report of the DATACROS Project. Milano: Transcrime – Università Cattolica del Sacro Cuore

[6] Source: Bosisio A., Carbone C., Jofre M., Riccardi M., Guastamacchia S., 2021, Developing a Tool to Assess Corruption Risk factors in firms' Ownership Structures – Final report of the DATACROS Project. Milano: Transcrime – Università Cattolica del Sacro Cuore

Part 3- Evaluating justifications for complexity

3.1 Legitimate cases of complexity and their risks

Many legitimate businesses involve complex structures. For instance, the Egmont Group/Financial Action Task Force paper "Concealment of Beneficial Ownership" describes a series of cases where complex structures are involved in **legal** activities:

"Complex ownership and control structures are not, in and of themselves, unlawful. Often, these corporate structures serve legitimate purposes and facilitate a wide range of commercial activities, entrepreneurial ventures, and the management of personal finances. Advances in communications technology, ease of travel, and other effects of globalisation are increasing the accessibility of global finance and business centres to all population segments, beyond large corporations and high net worth individuals. Complex ownership structures can simplify business transactions for companies that regularly trade transnationally, provide services to international clients, or conduct parts of a company's operations (such as manufacturing or research and development) in another country. Often complex control structures are used by family businesses, by government-owned or operated public or commercial business ventures, and by publicly traded companies to structure their affairs." (page 27).

During the roundtable, a practitioner described different legal reasons (considered by some also as "legitimate") that may justify complexity.

a) Family issues

- Succession planning: a corporate owner may want to divide different business lines for them to be inherited by different heirs, preventing future family conflicts and re-organisation.

b) Business issues

- Organic growth: businesses may acquire other firms as part of merger and acquisitions processes. In such cases, even if the firm wanted to simplify its structure, it may be prevented from doing so because of the costs of simplification (eg hiring an accountancy or legal firm to merge or dissolve entities). In addition, even if beneficial owners and functions remain the same, the mere act of simplification could trigger capital gains tax or stamp tax duties, increasing costs further.

- Different conditions (eg preferential right to income) for different types of investors/shareholders: it may be easier to establish different entities with different conditions for different types of investors or shareholders. However, in some countries this could be solved by issuing different types of shares or classes of shares.

- Different lines of business (eg pharma, technology): Different business types may require different types of decisions. Although the presence in several countries for supply-chain purposes may explain some level of complexity, it is not clear why this requires a different structure between business sectors which all have presence in multiple jurisdictions.

c) Business issues of questionable legitimacy

While the following issues were mentioned during the roundtable as a justifications for complexity, their legitimacy could be questionable. These cases include tax avoidance, contravention of legal restrictions or exploitation of limited liability.

- Circumventing the "unique shareholder" prohibition: some regulations prevent a single-member entity based on the fact that partnerships or "societies" (Sociedad anónima, société à responsabilité limitée, etc)

involve, by definition, more than one person. However, having one person indirectly owning an entity through two different entities (formally complying with the requirement of two shareholders) should be considered against the law. The law may make no sense, but the solution in this case would be to reform the law.

- Ensuring limited liability for the business: valuable assets (eg IP) may be held by one holding entity, while the business (eg services, sale of goods) is performed by an operating entity to avoid liability risks of the operating entity to affect the do-nothing-but-hold-assets risk-free holding entity. However, this is unfair. The group may enjoy the benefits of operations and having valuable assets, without needing to respond with their valuable assets if things go wrong. In addition, in the history of limited liability, it was never meant to benefit the relationship between a subsidiary and its parent entity, but between an entity and its (individual) shareholder.

- Engaging in tax avoidance (also referred to as "tax planning" or "tax minimisation"). For example, a multinational could engage in abuse of transfer pricing to shift profits among its subsidiaries and thus avoid paying taxes. In addition, the multinational could engage in treaty shopping and incorporate shell companies in different jurisdictions to exploit double tax agreements or other regulations (eg hybrid mismatches) that allow a multinational to abuse taxes. At the individual level, someone could set up a discretionary trust to abuse this discretion to only give distributions to beneficiaries depending on the tax consequences. For instances, distributions could be made when a beneficiary has reported losses (so that both are offset preventing the payment of taxes), while distributions would be withheld, if that would make beneficiaries pay taxes at a higher marginal tax rate.

  While there may be many versions (and controversy) on the definition of tax avoidance, in this brief we consider the following: For a "tax minimisation" strategy to be considered legitimate, first it should be within the spirit of the law. The law should be trying to reduce taxes for that specific activity or taxpayer in a rather literal way, not subject to much interpretation. For example, those producing solar-energy panels get a tax benefit (to incentivise green energy). Second, the tax benefit should be achievable by anyone, and in a rather simple and straightforward way. For example, any person who acquires a government bond is exempted from tax on the bond income. On the other hand, if the only way to achieve the tax benefit relies on hiring lawyers and accountants and setting up different types of entities in different countries, then it should not be considered a legitimate tax minimisation strategy.

In addition to the arguments presented during the roundtable, a paper by Damien Murphy "Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications" suggests more reasons why groups create subsidiaries (thus becoming more complex):

- separate companies may enhance decentralisation of decision-making in large corporate groups;

- flexibility, to apply special regulatory controls and regimes to an isolated entity within the group, rather than across the entire group (if the company had no subsidiaries, then all the business lines would be affected by the special regulatory controls and regimes); …

- particular foreign jurisdictions may insist upon a locally incorporated subsidiary;

- groups may want the ability to sell the entire company or business through the sale of shares, whether for tax or operational reasons; and

- maintaining the 'goodwill', loyalty of employees, or 'brand' name after a takeover which would otherwise be threatened through a complete integration.

Although the paragraphs above describe several instances in which complex structures with many layers of entities are used and why they may be convenient, most of them do not mean that complex structures are necessary (let alone indispensable). The exceptions may be the benefit of limited liability, the requirement by foreign countries to incorporate a subsidiary, or the prohibitive costs of simplification after a merger (eg the need to transfer assets, employees, services and contracts to different entities).

Given the risks of complex ownership chains, at the very least in terms of transparency, it is not clear why the efficiency arguments should outweigh the transparency needs. As was expressed above, until all countries become fully transparent or until they adopt the four comprehensive risk-neutralising conditions, transparency cannot be ensured.

On the other hand, many of the benefits obtained by complex structures could be achieved, albeit possibly less efficiently, in much less risky ways. For instance, a will could determine how the family business is to be divided (into different heirs and hence independent owners). Decentralisation of decisions could be achieved by different categories of managers, rather than establishing separate entities. Facilitating the sale of business units through the sale of shares could take place only upon the need to sell the business, but not preventively. In this case, a subsidiary would be created for a very limited time. In addition, different investors could obtain different rights based on different types of shares, rather than by creating different entities.

As for situations that depend on creating or keeping different entities (that cause complexity), the following observation can be made. Leaving limited liability aside, both the costs of simplifying a business after a merger or the need to incorporate a subsidiary in a foreign country refer to very specific cases. At the very least, they should depend on the existence of a merger. As for a requirement to incorporate an entity in a foreign country to operate abroad, the need would justify only one subsidiary in each country of operations, not more layers.

This takes us to another issue that was discussed during the roundtable. Even if all of the arguments in favour of complexity were accepted as valid, what was not addressed is the genuine need for each specific factor. For instance, even if the succession planning was considered a legitimate reason, it is not clear how many layers or entities from how many countries would be necessary to achieve that goal. In other words, except for the organic growth case, the general explanation does not justify the specific complex structure that each situation or goal (eg family succession) requires.

An alternative approach to determining the specific structure required, proposed by Alex Cobham of the Tax Justice Network, is to shift the burden of proof and to require the justification of the benefits resulting from each extra layer or factor. For instance, the first entity is required in order to enjoy limited liability. The first layer of ownership is needed to operate in a foreign country. But in this case, what would be the benefit of adding a second layer of entities? What about the third and fourth layers? Or what is the benefit of spreading the structure in different countries (where there are no operations)?

Part 4: Fixing the problem

4.1 Specific measures for each risk

One could argue that no factor is risky per se, especially if mitigation measures neutralise the risk (eg if the structure involves only local entities and the local commercial register gives access to each entity's updated legal owners). The following table describes the different factors affecting transparency, how they create risk in isolation, what measures would neutralise that risk, and the likelihood of those mitigating measures being available.

Table 224: Individual assessment of risk factors

Factor	Risk (in isolation)	Mitigation / neutralisation of risk	Likelihood of mitigation/ neutralisation
Number of layers	The longer the chain, the higher the chance that one link won't disclose its legal owners.	All entities integrating the ownership chain are local entities, or are from countries with updated and verified legal ownership information, where information is easily accessible (eg interconnected or public and free registries).	Very low: No country prohibits foreign entities from owning local entities. In addition, legal ownership registries with updated information are not available in many countries. Even fewer countries have interconnected or public registries.
Geographic spread	The wider the geographic spread of an ownership chain, the more likely that at least one jurisdiction won't register legal ownership information or won't disclose it or won't even exchange information to respond to a request.	All entities integrating into the ownership chain are registered in countries with updated and verified legal ownership information, where information is easily accessible (eg interconnected or public and free registries).	
Bearer shares	To identify the owner, it's necessary to know who holds the physical bearer share at any given time	Bearer shares are immobilised/registered in countries that give access to information, or they are immobilised by custodians that give access to information to any foreign authority, regulated entity or user	Mid: Bearer shares are available in at least 46 countries where they aren't registered by a public authority.[7] Regardless of who immobilises the bearer shares, access may be difficult or impossible
Sophisticated structures, eg discretionary trust, Anstalt, investment funds	Not all relevant parties will be identified (eg the protector or economic settlor). The combination of trusts and companies creates obstacles (eg adds thresholds for requiring the identification of beneficial owners if a shell company is made party to the trust instead of individuals)	The regulation and definition requires all parties to be identified	Low: Many countries fail to have a beneficial ownership definition for trusts, or one that covers all relevant parties to the trust. Some fail to require the registration of trusts at all.
Use of nominees	Professional or de facto nominees may hide the (real) legal and beneficial owner	Nominees are properly identified and the real (legal or beneficial owner) are always registered too	Low: Many countries allow professional nominees, and while many countries prohibit de facto nominees, the lack of verification may render this prohibition unenforceable
Unequal shareholdings in or disproportionate voting rights in relation to equity	Small equity rights may disguise the high voting power, eg if 99% owned by circular structure and 1% owned by the (real) beneficial owner	The beneficial ownership definition covers all factors: ownership, voting rights, rights to dividends or other benefits, and any means of control, without any threshold.	Medium: most definitions cover only ownership and votes, and don't give guidance on "control via other means"

Source: elaborated by author

[7] See the Tax Justice Network's State of Play of Beneficial Ownership Registration in 2020, page 26.

4.1.1 Comprehensive conditions to neutralise risk

Based on the table above, no single factor (eg length of chain) would create risk if the following four conditions are met:

i. Establish quality limits on the ownership chain of a local legal vehicle so that it may only contain (local or foreign) entities that must register and update every relevant legal owner;

ii. Ensure immediate access to the information regarding the point above, for example by interconnecting ownership registries or allowing foreign entities as long as they are from countries with public online legal and beneficial ownership registries;

iii. Establish entity-type limits on the ownership chain so that it may contain only local or foreign entities whose ownership and control structure is properly addressed in the definitions of local regulations. For instance, if a local entity is owned by a foreign trust, the regulations for local entities must contain proper beneficial ownership definition for trusts that require the identification of all the parties to the trust. If there is no definition for a type of legal vehicle, eg an Anstalt, no Anstalt should be allowed to be in the ownership chain of a local entity; and

iv. Establish no thresholds in the beneficial ownership definition and cover all possible ownership, control, or benefit manifestations (eg ownership, voting rights, rights to dividends or economic benefit, right to appoint/remove a director or trustee, power of attorney, party to a financial instrument involving equity or votes, etc).

4.1.2 Interaction of risk factors when comprehensive risk-neutralising conditions are absent

The failure to meet *all four* conditions mentioned in the point above will create risks that may be exacerbated by different factors of the ownership chain. This is described in the following table.

Table 325: Interaction of risk factors when risk-neutralising conditions are unmet

Risk-neutralising condition	If the risk-neutralising conditions are absent, risks may be further exacerbated by
Quality limit (only entities that registered their update legal ownership) **&** **Immediate access to updated legal ownership**	• the number of layers up to the beneficial owner • the geographic spread of the entities integrating the ownership chain • the availability of bearer shares and nominees in any country
Entity-type limit (only entities properly addressed by local regulations)	• the presence of "exotic" (not properly covered) foreign legal vehicles, eg trust, Anstalt, etc.
No thresholds & coverage of all manifestations of ownership, control or benefit	• the presence of "exotic" (not properly covered) foreign legal vehicles, eg trust, Anstalt, etc. • the presence of structures with unequal shareholdings or disproportionate voting rights in relation to equity

Absence of conditions I and II

The lack of the first two conditions (quality limit and access to information), means that local authorities cannot guarantee that updated legal ownership information on each layer will be obtained in a timely manner. In this case, the secrecy risks of the ownership chain are exacerbated by:

- the number of layers leading up to the beneficial owner
- the geographic spread of the entities integrating the ownership chain
- the availability of bearer shares and nominees in any country

In other words, if local legal vehicles may be owned by entities from any country (even those incorporated in secrecy jurisdictions), the longer the chain and the wider its geographic spread, the more likely that authorities or regulated entities will be unable to obtain or verify the ownership information.

Absence of condition III

The lack of the third condition (entity-type limits), where local legal vehicles may be owned by any type of legal vehicle, results in the secrecy risks of the ownership chain being exacerbated by:

- the presence of "exotic" (not properly covered) foreign legal vehicles, eg trust, Anstalt, etc.

Absence of condition IV

The lack of the fourth condition ("no thresholds"), where beneficial ownership definitions cover only a few individuals (eg those with more than 25 per cent), results in the secrecy risks of the ownership chain being exacerbated by:

- the presence of "exotic" (not properly covered) foreign legal vehicles, eg trust, Anstalt, etc.
- Structures with unequal shareholdings or disproportionate voting rights in relation to equity

In this case, the beneficial owner may avoid registration by exercising control through tiny thresholds, contracts, or a power of attorney. They may also use a sophisticated vehicle (eg trust) or a combination of trusts and companies (eg if a company is used as a party to the trust to incorporate thresholds).

Unfortunately, it appears that there is no country in which all four of these conditions are met. For instance, in terms of registration of updated legal ownership information, both the Egmont Group/Financial Action Task Force paper "Concealment of Beneficial Ownership" and the Tax Justice Network's "State of Play of Beneficial Ownership in 2020" confirm that most countries lack updated ownership information, especially in relation to trusts, therefore failing to meet condition I. Only a few countries (eg Argentina, Ecuador) come close to meeting risk-neutralising condition IV by establishing no thresholds in their beneficial ownership definition for legal persons. Consequently, most – or very likely all – countries may be affected by the different risk factors because not all four risk-neutralising conditions are met.

4.2 General measures

At the roundtable, participants were presented with a survey asking for their preference among the following measures, from harshest to softest:

- Outright prohibition of complex structures
- Requirement of authorisation before an entity is allowed to be incorporated
- Requirement of a justification or explanation upon request from authorities
- Enhanced due diligence, most likely from corporate registries or regulated entities (eg banks, notaries)
- Do nothing

In addition to the options listed above, the roundtable discussion drew support for an alternative view: the enforcement of existing laws and regulations, rather than the enactment of new ones.

The next table summarises the pros and cons of each measure, plus the reasons justifying it and the pragmatic reason why it should be adopted.

Table 426: Interaction of risk factors when risk-neutralising conditions are unmet

Measure	Pros	Cons	Reasoning	Pragmatic / Realistic reasoning
Do nothing	No cost, no conflict	Doesn't address the problem	There's not enough evidence that complexity is bad or creates risks. There are other ways to tackle IFF	The remedy may be worse than the disease
Enforce existing laws	No cost, no conflict	Difficult to achieve (laws are already obligatory)	Current laws are good enough to address complexity risks	There's no guarantee that new rules will be enforced, so why bother creating new ones before at least enforcing the ones that exist already?
Enhanced due diligence	Already required for high risk situations	Difficult to enforce	The world is too complex for a one-size-fits-all solution. Better leave it to regulated entities dealing directly with the entities	Easy to implement. Most regulations already contemplate enhanced due diligence. Just extend it to complex chains
Require explanation upon request	Required only when needed (no lost costs)	Too costly, may not get answers on time & "unknown unknowns"	Instead of adding a new measure affecting everyone, require it only when needed	There's already too much information that authorities cannot process, so why ask for more?
Require prior justification	Only entities that need complexity are allowed to have them. No illegitimate use	Costly to implement, risk of corruption, high bureaucratic costs	If there's a real need, it should be easy to explain it	It still allows complexity for those that need it, so it separates the wheat from the chaff
Prohibition	No cost, easy to implement	Difficult to approve legal change, may be considered extreme, affects entities that legitimately need complexity	There's a need to rethink the system, capitalism, etc. Why allow structures that create risks for all society, and benefits for just a few?	Prior justification is difficult to implement. Prohibition is easy and cheap. Nothing complex is allowed, no exceptions or loopholes

In essence, there are three different approaches: to do nothing, to enforce existing regulations, or to adopt new ones.

The mains reasons to "do nothing" may be related to the fact that there is no evidence that complexity is problematic or at least any more so than other risks to transparency. It could also be argued that regulating complexity may lead to unintended consequences that would leave societies worse off, such as

divestment, loss of jobs, etc. In response to this, one could answer that these measures are not intended to solve absolutely all illicit financial flows related to money laundering, corruption, tax abuse, etc. It may be the case that countries have more urgent related measures (eg increasing staff and budget for the financial intelligence unit) or even other measures (eg measures related to the Covid 19 pandemic). However, policy is not necessarily a zero-sum game. Staffing the financial intelligence unit can be done as well as regulating complexity. In fact, this brief described sufficient evidence that complexity is a risk factor used in more than half of the cases studied by the "Concealment of Beneficial Ownership" report, and that it is used mostly by sophisticated individuals and criminals engaged in illegitimate or illegal activities.

The second approach, to enforce existing regulations, is somewhere in between. It is not a radical proposal, and it has two very good points. First, current regulations (eg beneficial ownership transparency disclosures, customer due diligence obligations, etc) already address complexity, they should simply be enforced by authorities. Second, if enforcement of current laws is absent, there is no guarantee that any new proposed measure will actually be enforced either.

The Tax Justice Network's response to these points questions the suitability of existing measures. To put this in perspective, consider beneficial ownership definitions. These may require general obligations, such as identifying any individual with effective control over an entity. This a very comprehensive rule. Any regulated entity that invested sufficient resources in complying with this rule, eg taking the time and requesting information to understand the ownership structure and relationships within an entity, would likely identify the right person. However, there is no guarantee that all regulated entities will spend the time to do this, let alone that they will get it right even if they spend sufficient resources.

An alternative approach, preferred by the Tax Justice Network, is to give very clear (and mechanical) instructions such as "identify every individual who holds at least one share, any individual with a power of attorney or any individual who manages the entity's bank account". This latter approach may end up identifying many individuals who have no control at all. However, it should likely include the relevant individual among the many registered, and it should be easy to implement and to supervise by regulated entities, corporate registries and authorities. In this case, authorities would have to verify that 100 per cent of all shareholdings were identified. A mere cross check with the registries of banks and notaries would show whether anyone with a power of attorney or right to manage the bank account was identified. This mechanical supervision would be very different from auditing a regulated entity and checking that in all cases, they rightly identified the individual with effective control.

The mechanical approach would lead to registering information on many individuals (every holder of shares, every holder of a power of attorney, etc). This should not be a problem as long as authorities have enough information on the nature of each beneficial owner (eg John holds 95 per cent of the shares, Mary has power of attorney). By already having information on all potentially relevant people, it is much more likely that authorities will find (and prosecute) the right individual, than if they have to trust that the regulated entity managed to find the right individual after performing customer due diligence. In other words, both approaches need enforcement, but the mechanical one is much easier to enforce and supervise.

To give another example, one could consider airport security. Security personnel are required to identify suspects and prevent illegal materials from boarding planes. However, upon suspicions of the use of liquid substances for terrorism purposes, most airports prohibit taking more than 100 ml of liquid within personal luggage. This measure is certainly extreme and affects millions of people who were simply carrying drinking water, perfume, etc. However, the mechanical check that no one is carrying liquids, weapons, sharp objects, etc is much easier to implement and enforce than the general requirement to "prevent terrorists from boarding planes with bombs".

This leads to another pragmatic issue. While there is no guarantee that any new measure will be enforced, some outcomes are easier to achieve than others. Faced with resource constraints, it is rather difficult for civil society organisations to argue that governments should properly staff and equip authorities. On the other hand, advocating for a new regulation (the mechanical approach, eg prohibit any structure with more than three layers), may be an indirect but easier way to achieve the desired result of more transparency.

Based on the fact that tax abuse, corruption and money laundering scandals keep popping up, this brief considers that doing nothing or waiting for current laws to be enforced is unacceptable. Instead, it supports the adoption of new measures. The question is, which ones. The next section offers ideas on what could be undertaken, while considering that more research may be needed.

4.3 Recommendations

This section offers recommendations on partial measures that authorities and researchers could undertake before final and more encompassing measures are agreed upon.

4.3.1 Empirical research: taking stock of a country's ownership complexity

a) Ownership structures of local entities

Similar to the Tax Justice Network's research on UK companies' ownership chains, every country should undertake an inventory of the features of the ownership chains of both local and foreign entities operating in their territories. This inventory should consider in particular:

- Length of chains
- Geographic spread of entities integrating into the ownership chain
- Type of legal vehicles within the chain
- Equity and voting rights allocation among legal owners and beneficial owners within the chain

Findings should be disaggregated depending on:

- The type of legal vehicle (eg company, partnership, trust) whose ownership chain is being explored,
- Size (balance sheet, income and number of employees)
- Industry (eg mining, pharma, IT, etc)
- Listed on the stock exchange or not
- Status, either active (engaging in business activities) or passive (holding of assets)
- Presence of politically exposed persons (PEPs)
- Year of incorporation

b) Involvement in illegal or illegitimate activities

Determine the proportion and relevance of complex structures involved in illegal activities by conducting anecdotal research (eg based on news stories, leaks), or an analysis of case law, indictments, or audits/investigations by the tax administration or financial intelligence unit related to corruption, money laundering, tax abuse, etc.

4.3.2 Investigate outliers

Based on the research above, authorities or researchers should start investigating outliers. For instance, based on the 2014 Impact Assessment, UK authorities should investigate the reasons why 5 per cent of micro and small companies have complex structures, compared to the 95 per cent that is organised in simple structures with fewer than two layers.

4.3.3 Determine the minimum complexity needs

Countries should start public consultations, especially with the private sector, to understand not only the legitimate needs for complexity in general (as those described in Part 3), but more importantly the concrete requirements for meeting those needs: Countries should seek to understand the need or benefit of every extra layer, country of incorporation or unreasonable shareholding allocation (eg 99.9 vs 0.1 per cent), etc. A hypothetical example of a minimum complexity need might look like this: "three layers is the only way to ensure different conditions for different types of investors, which benefits society because of increase investment opportunities". Once these minimum requirements have been established, anything beyond those requirements could be either prohibited or require specific authorisation. In other words, countries would establish a safe harbour (eg three layers), and any structure becoming more complex than that would be subject to regulation.

While prohibition may be easier to implement, it may lead to unintended consequences. Specific authorisation may offer more flexibility. To minimise corruption consequences (where authorities are bribed to rubber-stamp an illegitimate complex structure), the justification should be publicly available.

Following Slovakia's example of the Register of Partners of the State for those entities involved in procurement or receiving subsidies, there should be a shift in the burden of proof. Anyone should be able to challenge the justification for each complex structure (eg "why do you need 5 layers if a company in the same industry and with more employees has just 3 layers?"). It would be up to the entity to prove the need for that specific structure.

4.3.4 Test measures within a sample

Authorities could choose a sample of the riskiest cases (or those with the least justified need for complexity), as long as these entities have a low impact on the economy, and test any of the new and harshest measures (eg prohibition or previous justification).

For instance, testing new measures on big companies engaging in active business and employing many people may have unintended consequences on the economy. This is especially true for those companies listed on the stock exchange. Therefore, authorities could start by testing new measures on legal vehicles which meet all of the following conditions:

- Passive entities (those which are not engaging in any business such as the provision of goods or services, but rather merely holding assets and obtaining passive income through dividends, interests, or royalties)
- With few or no employees
- Not listed on the stock exchange
- Have a complex structure that makes them outliers compared to other similar entities (passive-unlisted) with simpler structures.

Although testing companies listed on the stock exchange could have disruptive effects, authorities could still at least test the ownership structure through which a beneficial owner owns, controls, or benefits from the holding structure, regardless of the complex business structure underneath the holding. For example, if Mark is the beneficial owner of a listed company engaged in social media, authorities could assess the structure used by Mark to control the listed company.

4.3.5 Adopt risk-neutralising conditions

a) Length and geographic spread

Countries could establish quality limits on the ownership chain of local entities eg within a deadline of 2 years, prohibiting foreign entities from integrating into the ownership chain unless they are from countries that:

i. Require legal ownership to be registered and updated with an authority that either makes information publicly available or that has the framework to exchange information with local authorities,
ii. Prohibit bearer shares, and
iii. Prohibit nominee ownership

An alternative option would be to allow entities to either meet the above conditions and then have any structure they wish (eg 20 layers of foreign entities that disclose their legal owners), or allow foreign entities from any country to integrate into ownership chains as long as the chains have no more than, say, two layers, both of which were incorporated in the same country.

b) Type of entity and thresholds

Regarding types of entities and thresholds, countries should require the identification of every individual who directly or indirectly owns, controls, or benefits from each legal vehicle (without any threshold), considering especially those with a power of attorney, power to manage the entity's bank accounts, or any beneficiary of a contract that could obtain control or benefit over an entity (eg creditors with convertible shares, beneficiaries of financial instruments like call options, equity swaps, short-selling, etc.)

Until thresholds are removed from all definitions of beneficial ownership, they should at least be removed in cases where a structure combines different types of legal vehicles (eg if a company is the trustee of a trust). Instead of applying the corresponding beneficial ownership definitions to each type of vehicle integrated into the ownership chain, the most inclusive definition should be applied. If a company is a party to a trust (eg a trust beneficiary), the beneficial owners of the trust should include all the natural persons who hold at least one share or vote in the corporate-beneficiary, regardless of any thresholds. Otherwise, the trust beneficiaries may avoid registration if they hold ownership interests in the corporate beneficiary below the threshold (eg less than 25 per cent of the shares or votes) because the beneficial ownership definition for a company is often less inclusive (eg employs thresholds) than that of a trust (which shouldn't employ thresholds).

An alternative solution to the paragraphs above would be for countries not to allow any "unconceived/not-covered" type of entity to integrate into the ownership chain of a local entity. For instance, if the only definition of beneficial owners available in one country refers to "the individuals with more than X percentage of shares", those legal vehicles without shares (eg trusts or private foundations) should not be allowed to own local entities either directly or indirectly. Similarly, the StAR "Puppet Masters" report referred to a case of a compliance officer in one Indian bank who refuses to do business with a Liechtenstein Anstalt, regardless of the circumstances, because they do not understand "what it is, why someone would use it, or what business it has in India." (page 100)

In conclusion, these limitations on the party autonomy to define how each business wants to arrange their ownership structure would involve a non-recognition of foreign entities that fail to meet the local requirements (eg because they issued bearer shares, they do not disclose their updated legal owners in public registries, etc). These "rogue" foreign entities should be prevented not only from becoming part of the ownership chains of local entities, but also from holding interests in any local asset, eg real estate, mining license, etc.

4.3.6 Naming and shaming companies with complex structures

An alternative partial measure proposed at the roundtable would be to create an index of companies and list or rank those with the most complex structures. This may create peer pressure towards simplification, and a warning for authorities. This measure could run in parallel with those suggested above.

4.3.7 Simplification plan for big companies "too complex to fail"

After the 2007/2008 financial crisis, in which some banks were considered too big to fail (and their CEOs too necessary to jail), financial regulations were considered that would require systemic financial institutions to prepare dissolution plans describing how their financial institution and its many complex financial contracts could be be dissolved in an organised and orderly manner, should it become insolvent or bankrupt. Based on this idea, complex structures, especially those that are the result of organic growth (after mergers and acquisitions), should be required to prepare and describe a simplification plan, even if they are not required to undertake such simplification.

Countries should then consider imposing simplification requirements, not "despite" but rather "because of" risks to the survival of big concentrated groups. It could be an anti-trust / anti-monopoly indirect measure. The increase of administrative costs may render many mergers and acquisitions, as well as private equity investments, too expensive and thus prevent the existing market concentration which has negative consequences itself (companies that are more powerful than elected democratic governments, have too much lobbying power, or prevent newcomers from entering the market).