

NEWS

The Corporate Transparency Act is about to matter. Here's what it means for you.

Publications

Carolyn Meade

01.2022

Starting this year (2022), most private, domestic U.S. entities formed from and after January 1, 2021 will be required to self-report to the U.S. Treasury's Financial Crimes Enforcement Network ("FinCEN") certain basic information about themselves, their beneficial owners and those individuals authorized to act on their behalf. These new requirements were enacted on January 1, 2021 as part of the Corporate Transparency Act (the "CTA").^[1] They represent a major departure from the United States' historic approach to business entity operation, as most private companies have not previously been subject to any beneficial ownership reporting requirements outside the context of a business relationship with a regulated financial institution. The stated purpose of the CTA is to "discourage the use of shell corporations as a tool to disguise and move illicit funds," part of a broader federal initiative to prevent and combat money laundering, terrorist financing and tax fraud.

The CTA requirements apply without regard to the intended purpose of the newly-formed entity. Starting a new business as an LLC or non-publicly traded corporation? Creating a vehicle through which investors can participate in a private placement raising capital? Forming an entity to acquire the assets of an existing company? Creating a holding company for real property? In each case, begin with the assumption that reporting will be required. The CTA is intended to ensure that U.S. law enforcement can identify who is behind every entity, particularly those entities not already subject to substantial federal or state regulation.

The CTA statute has been in place for over a year at this point, but no reporting has been done to date as FinCEN has yet to promulgate the final implementing regulations and build the online infrastructure that will be necessary to receive information of the type and volume anticipated. On April 1, 2021, FinCEN released an initial Advance Notice of Proposed Rulemaking and, on December 8, 2021, the agency published its proposed rules (the "Proposed Rules") in the Federal Register.^[2] The Proposed Rules clarify which entities are subject to, and which exempt from, the CTA's reporting requirements. The rules also address some of the privacy concerns that had previously been raised by broadening the types of identification accepted from beneficial owners. The comment period expires February 7, 2022, with final regulations to follow. Entities formed prior to the date FinCEN issues the final CTA regulations (the "Regulation Effective Date") will have a period of one (1) year following the Regulation Effective Date to submit their initial reports.^[3] Entities formed from and after the Regulation Effective Date will have to report within fourteen (14) calendar days of formation or incorporation.^[4]

Who Must File?

THE CORPORATE TRANSPARENCY ACT IS ABOUT TO MATTER. HERE'S WHAT IT MEANS FOR YOU.

A “reporting company” for purposes of the CTA is a corporation, limited liability company “or other similar entity” created or registering to do business in the United States by filing a document with the secretary of state (or similar) office under the laws of a U.S. state or Indian Tribe.^[5] FinCEN’s commentary to the Proposed Rules indicates that FinCEN anticipates “other similar entities” will include LPs, LLPs, LLLPs, and business trusts (also known as statutory trusts or Massachusetts trusts). Most estate planning trusts will not qualify as reporting companies, as they can be created without filing or registering with a secretary of state’s office. While the CTA and the Proposed Rules address both domestic and foreign entities registered to do business in the U.S., this article focuses on domestic entities.

The Proposed Rules specifically exclude 23 types of entities from the definition of “reporting company”. In general, these exempt entities fall into three major categories: (a) those already reporting beneficial ownership based on prior state or federal regulation, (b) service providers, and (c) tax-exempt entities. Specifically, the 23 exempt entity types are:

- securities issuers^[6]
- domestic governmental authorities
- banks
- domestic credit unions
- depository institution holding companies
- money transmitting businesses
- securities broker-dealers
- securities exchange or clearing agencies other Securities Exchange Act of 1934 entities
- registered investment companies and advisers
- venture capital fund advisers
- insurance companies
- state licensed insurance producers
- Commodity Exchange Act registered entities
- accounting firms
- public utilities
- financial market utilities
- pooled investment vehicles
- tax exempt entities
- entities assisting tax exempt entities, subsidiaries of certain exempt entities,
- inactive businesses^[7]
- large operating companies^[8]

THE CORPORATE TRANSPARENCY ACT IS ABOUT TO MATTER. HERE'S WHAT IT MEANS FOR YOU.

Newly-formed, privately-held entities will generally be considered reporting companies. Note that this remains true even for entities formed specifically for the purpose of acquiring the assets of a large operating company, as the newly-formed entity will not itself have the necessary federal tax filing history to meet the large operating company exemption. This will also be true for a newly-formed, private entity intended solely as a holding company or as a capital-raising vehicle to fund a downstream operating company or a holder of real property. For the most part, these rules will apply only to future cases. Existing entities have been grandfathered as exempt so may undertake similar activities without reporting.

Who Must Be Identified and What Information Must be Reported About Them?

Each reporting company will submit to FinCEN information about (a) its beneficial owners, (b) (i) the individual who files the document that creates or registers the reporting company in or with a U.S. state or Indian Tribe and (ii) the individual at whose direction such filing was submitted (each person in subpart (b), a "Company applicant") and (c) itself

Beneficial Owners

Under the CTA, a "beneficial owner" is anyone who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise (i) exercises "substantial control" over an entity or (ii) owns or controls not less than 25% of the "ownership interests" of the entity.[9]

The CTA requires each reporting company to submit to FinCEN a report identifying each beneficial owner's full legal name, date of birth, current residential address and "unique identifying number from an acceptable identification document".[10] If the foregoing has previously been submitted to FinCEN, the report can include a "FinCEN identifier" instead.[11] The Proposed Rules make clear that the unique identifying number of an individual does not have to be his or her social security number, but may instead be his or her passport number or drivers' license number, in each case, with the underlying document scanned to FinCEN as part of the report.[12] These requirements will feel familiar to those who have previously completed "know your customer" questionnaires for a banking or escrow relationship, but, as discussed below, CTA reporting will likely capture information on more individuals and will identify more beneficial owners than would be the case for purposes of opening a bank or escrow account.

The Proposed Rules provide guidance on the two-pronged beneficial owner definition.

Substantial Control Prong

Exercising "substantial control" includes (a) serving as a senior officer (e.g., CEO, President, CFO, Treasurer, COO, Secretary, General Counsel, etc.) of a reporting company; (b) exercising authority over the appointment or removal of any senior officer or a dominant majority of the board of directors or managers (or similar body) of a reporting company; or (c) directing, determining, or substantially influencing important matters of a reporting company.[13] The Proposed Rules also include a catch-all provision which notes that control can take other forms beyond those specifically listed. While the CTA exempts from the definition of a beneficial owner an employee of a reporting company "acting solely as an employee" whose "control over or economic benefits from" a reporting company are derived solely from his or her employment status, the Proposed Rules make it clear that a person who is a senior officer of a reporting company cannot use the exemption.[14]

THE CORPORATE TRANSPARENCY ACT IS ABOUT TO MATTER. HERE'S WHAT IT MEANS FOR YOU.

The regulations are silent as to whether a member of the board of directors or a manager of a reporting company exercises “substantial control” by virtue of performance of his or her duties, but the commentary suggests that the number of members of the board and the voting rights of the members would determine whether or not substantial control exists. For example, an individual serving as the sole manager of a limited liability company would exercise substantial control, and would thus be considered a beneficial owner; an individual serving as one of seven board members of a reporting company, without any other ownership or control, likely would not be considered a beneficial owner. FinCEN also indicates in their comments that a property manager or other individual running day-to-day operations for an entity holding real estate would not be considered a beneficial owner on these facts alone where such individual or entity has been hired by and reports to the owners of the property or real property holding company.[15]

Ownership Prong

An individual who, directly or indirectly, owns or controls not less than 25% of the ownership interests of an entity is a beneficial owner of the entity for purposes of the CTA.[16] The Proposed Rules clarify that “ownership interests” should be read to include both traditional forms of equity (stock, units, capital interests) as well as profits interests, convertible instruments such as warrants or options and, if such interests enable the holder to exercise the same rights as one of the foregoing ownership interests, debt instruments also.[17] Using this fully-dilutive approach may impact owners whose direct or indirect interests are near the reporting threshold, either including them (where they might not have been were incentives ignored, for example) or excluding them (where the impact of an incentive program or debt instruments is dilutive to capital interests held). In situations where both an intended operating company or property holding company and one or more intermediate holding entities are all formed for one transaction, each of the new entities will be a reporting company. In that case, an individual who is not a beneficial owner of the operating company or property holding company may still be reported as a beneficial owner of the intermediate holding entity.

Exceptions

There are five categories of persons excepted from the beneficial ownership definition in the Proposed Rules:

- minor children (a parent or legal guardian may report their information instead, indicating that they are the parent or legal guardian of the owner);
- custodians or agents acting on behalf of another individual (report the actual beneficial owner vs. the apparent beneficial owner);
- employees (see discussion above);
- inheritors (persons named in a will as intended to receive ownership are not owners until such time as they become the owner); and
- creditors (unless exercising substantial control or owning or controlling $\geq 25\%$ of the ownership interests of the entity, directly or indirectly).[18]

THE CORPORATE TRANSPARENCY ACT IS ABOUT TO MATTER. HERE'S WHAT IT MEANS FOR YOU.

Company Applicants

As previously noted, “Company applicants” include both those who submit to a state secretary of state’s office or the applicable office of an Indian tribe the documents forming or registering a reporting company as well as, if different, those who directed them to do so.[19] For example, if an attorney or paralegal forms an entity on behalf of a client, both the legal professional and the client requesting the services are Company applicants.

As with beneficial owners, reporting companies must submit to FinCEN each Company applicant’s full legal name, date of birth and “unique identifying number from an acceptable identification document”. [20] For Company applicants providing a business service as a corporate or formation agent (e.g. registered agent services, law firms) the address to be submitted is the business address associated with the Company applicant instead of the personal, residential address of the Company applicant.[21] From a policy perspective, to the extent Company applicants make a business of filing documents on behalf of many companies, reporting the associated business address is more useful information for national security, intelligence and law enforcement agencies than reporting a residential address, particularly as the business address allows identification of patterns of entities created or registered by Company applicants working at the same business address.[22]

For Company applicants seeking greater data security, the option for use of a “FinCEN identifier” is available to Company applicants who have previously submitted their information to FinCEN, just as it is for beneficial owners.[23] Once again, the proposed regulations make clear that the unique identifying number of an individual does not have to be his or her social security number, but may instead be his or her passport number or drivers’ license number, in each case, with the underlying document scanned to FinCEN as part of the report.[24]

Reporting Company Information

Finally, to ensure that FinCEN can identify each reporting company, the Proposed Rule requires each reporting company to provide to FinCEN its legal name, any d/b/a under which it conducts business, its business street address, the jurisdiction of formation (or, for a foreign reporting entity, the jurisdiction of registration), and its employer identification number (“EIN”) or other unique identification number if no EIN exists for the entity.[25]

Where to Start

While publication of the final CTA regulations is not anticipated before March 2022, private equity companies, sponsors and other recurring investors may wish to begin cataloging those entities formed over the last 12+ months and collecting the information required to complete their reporting requirements now.

[1] Title XIV of the William M. (Mac) Thornberry National Defense Authorization Act for 2021, Public Law 116-283, (2021). The CTA adds a new section, 31 U.S.C. 5336 to the Bank Secrecy Act (Subchapter II of Chapter 53 of Title 31, United States Code).

THE CORPORATE TRANSPARENCY ACT IS ABOUT TO MATTER. HERE'S WHAT IT MEANS FOR YOU.

[2] Federal Register Vol. 86, No. 233 (Wednesday, December 8, 2021), p. 69920-69973.

[3] Proposed 31 CFR 1010.380(a)(1)(iii).

[4] Proposed 31 CFR 1010.380(a)(1)(i).

[5] 31 U.S.C. 5336(a)(11)(A)(i)-(ii).

[6] Publicly listed companies or other entities registered with and regulatory reporting to the SEC. Proposed 31 CFR 1010.380(c)(2)(i).

[7] Entities in existence for more than 1 year, not engaged in an active business, with no foreign ownership, which have neither sent nor received more than \$1,000 in the last year, have experienced no change in ownership in the last year and which hold no assets. Proposed 31 CFT 1010.380(c)(xxiii).

[8] Entities which employ more than 20 full-time employees in the United States, filed in the prior year a U.S. federal income tax return reporting more than \$5,000,000 in gross receipts or sales (including with any consolidated subsidiaries) and has an operating presence in a physical office owned or leased by the entity in the United States. Proposed 31 CFR 1010.380(c)(xxi).

[9] 31 U.S.C. 5336(a)(3)(A).

[10] 31 U.S.C. 5336(b)(10)(A) [reporting requirement]; 31 U.S.C. 5336(b)(2) [required information].

[11] Proposed 31 CFR 1010.380(b)(5). For entities, the FinCEN identifier replaces only the EIN, DUNS number or LEI. Proposed 31 CFR 1010.380(b)(5)(ii).

[12] 31 U.S.C. 5336(h)(1)(A).

[13] Proposed 31 CFR 1010.380(d)(1); for the specified "senior officers", proposed 31 CFR 1010.380(f)(8).

[14] Proposed 31 CFR 1010.380(d)(4)(iii).

[15] Fed. Reg. Vol. 86, No. 233 (12/8/2021), p. 69934 ("The ordinary execution of day-to-day managerial decisions with respect to one part of a reporting company's assets or employees typically should not, in isolation, cause the decision-maker to be considered in substantial control of a reporting company unless that person satisfies another element of the 'substantial control' criteria.")

[16] 31 U.S.C. 5336(a)(3)(A)(iii).

[17] Proposed 31 CFR 1010.380(d)(1).

[18] Proposed 31 CFR 1010.380(d).

THE CORPORATE TRANSPARENCY ACT IS ABOUT TO MATTER. HERE'S WHAT IT MEANS FOR YOU.

[19] Proposed 31 CFR 1010.380(e).

[20] 31 U.S.C. 5336(b)(2)

[21] Fed. Register Vol. 86, No. 233 (12/8/2021), p. 69930.

[22] Id.

[23] 31 U.S.C. 336(b)(3)(A)(o). Proposed 31 CFR 1010.380(b)(5). For entities, the FinCEN identifier replaces only the EIN, DUNS number or LEI. Proposed 31 CFR 1010.380(b)(5)(ii).

[24] Proposed CFR 1010.380(f)(2)

[25] Proposed 31 CFR 1010.380(b)(i). Reporting companies which have not yet been issued an EIN may use a Dun & Bradstreet Data Universal Numbering System (DUNS) number or a Legal Entity Identifier (LEI).