A C.T.A. OF THE C.T.A. – A CLOSER TARGETED ANALYSIS OF THE CORPORATE TRANSPARENCY ACT

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On January 1, 2021, Congress passed the Corporate Transparency Act (C.T.A.) as part of the National Defense Authorization Act. The C.T.A. is designed to shed light on the beneficial owners of certain entities, defined as reporting companies, by requiring those entities to report information on their beneficial owners and other individuals known as company applicants. The information is to be compiled in a database, accessible to employees of the U.S. Treasury Department and law enforcement.

Insights previously discussed 11 important questions regarding the C.T.A., but the legislation left many others unanswered. Much discussion centered around definitions and obligations of reporting companies, beneficial owners, and company applicants. On December 7, 2021, FinCEN provided greater clarity on how the new reporting regime will work. This article identifies the business entities that must comply, the entities that are excepted, and provisions that should be addressed in subsequent regulations.

Until final regulations are issued, the reporting obligation is not yet operative, but because the final regulations could be issued as soon as mid-2022, it is advisable for both owners of businesses, and advisers who routinely interact with business owners, to commence preparing for compliance in the coming weeks or months.

REPORTING COMPANIES

Reporting companies are the entities that must report information about their beneficial owners. A reporting company is a corporation, L.L.C., or other similar entity that meets one of the following tests:

- **Domestic Entity**: It is a domestic entity that is created by filing a document with a secretary of state or a similar office under the law of a State of the Union or an Indian Tribe.
- **Foreign Entity**: It is an entity that is formed under the law of a foreign country and registered to do business in the U.S. by filing a document with a secretary of state or a similar office under the law of a State of the Union or Indian Tribe.

Prior to the proposed regulations, there was a great deal of discussion over what a "similar entity" meant. The statutory language mirrors the language for a legal entity customer under FinCEN's customer due diligence (C.D.D.) rules that spell out required background checks that banks and other financial institutions must carry out as part of their account opening procedures. Accordingly, many commentators predicted that the C.T.A. regulations would follow C.D.D. footsteps. Crucially, the C.D.D. definitions exclude sole proprietorships or unincorporated associations,

despite the fact that they sometimes do have a filing requirement, but include general partnerships.

FinCEN's approach taken in the proposed rules reflects a literal interpretation: any entity that must file with any state office upon formation.[1] The agency anticipates that the following types of entities will also be included among reporting companies:

- Limited liability partnerships
- Limited liability limited partnerships
- Business or statutory trusts
- Most limited partnerships

The treatment of other entities – general partnerships, other trusts, and sole proprietorships – will depend on whether the specific state or Tribal law requires filing. FinCEN's interpretation is fairly literal.

The proposals include 23 specific exemptions from reporting. A significant exemption is for "large operating companies". A company is a large operating company if it

- has more than 20 full-time U.S. employees,
- filed Federal income tax returns in the previous year demonstrating over $5 million in gross receipts or sales, and
- has an operating presence at a physical office in the U.S.

Other specific exemptions are proposed for

- tax-exempt entities (churches, charities, nonprofits);
- entities that already have certain Federal reporting obligations, such as banks, insurance companies, and public companies; and
- a grandfathering provision for dormant entities (entities which, among other requirements, have been in existence for over a year before the C.T.A.'s enactment and are not engaged in an active business when the rules come into effect).

FinCEN is weighing whether companies will be required to apply for the exemption. Other suggestions under consideration include voluntary filing for exempt companies, or whether an exemption report would have to be obtained only if requested by a government body.

Legal practitioners will note that there is no exemption for small law firms and C.P.A. firms that fall within the definition of a reporting company. There are thousands of small law firms and accounting practices that operate in New York State, alone, where the vast majority of legal practitioners are solo practitioners or work in small firms with less than ten attorneys. Larger firms will be covered by the large operating company exemption.

The omission of law firms from the specific exemptions list is odd and most likely

[1] See also Fact Sheet: Beneficial Ownership Information Reporting Notice of Proposed Rulemaking (NPRM), Dec. 7, 2021, summarizing the approach.

unintended. In trying to stop "wrongdoers from exploiting United States corporations for criminal gain," the C.T.A. surely was not targeting small law firms. The owners of small law firms are rarely the subject of controversy and generally have sufficiently compelling, independent reasons for not participating criminal conduct and money laundering. Nor are small law firms a particularly popular vehicle for money laundering. Lawyers are already regulated by state bar associations, and information on law firm ownership is readily available. As the C.T.A. already exempts certain other entities for whom reporting would be redundant, an exemption for small law firms would not be out of place.

There is certainly room for change. If appropriate, FinCEN could broaden the categories of excepted businesses to exclude a larger swathe of licensed or registered professions, such as medicine and health, actuarial science, architecture, training schools, inspectors, surveyors, technicians and lab workers, and insurance agents, in addition to lawyers and C.P.A.'s. As for active, non-licensed entities that fail the large operating company exception but merit relief nevertheless, engagement in an exception could be fashioned for entities hat have an active business carried on at a fixed location could be coupled with a gross assets or gross receipts threshold as demonstrated in Federal tax filings, if appropriate. The prime example would be mom-and-pop grocery stores or small dining establishments. The rationale for crafting these additional exceptions is intuitive. Requiring such businesses to report "neither serve[s] the public interest nor [would] be highly useful in national security, intelligence, law enforcement, or other similar efforts."

BENEFICIAL OWNERS

The opacity surrounding many beneficial owners is the motivation behind the C.T.A. The C.T.A. defines a "beneficial owner" as a natural person who

- exercises substantial control over a company,
- owns at least 25% of a company's ownership interests, or
- receives substantial economic benefits from a company's assets.

This is subject to some exclusions. Minors and people acting on behalf of others, like intermediaries or employees, cannot be beneficial owners for the purposes of the C.T.A. Creditors and prospective heirs are also excluded.

Prior to the issuance of the proposed rules, many commenters pointed out that "substantial control" was not defined. The new rules give three indicators of substantial control:

- Service as a senior officer
- Authority over the appointment or removal of a senior officer or dominant majority of the board of directors (or similar body)
- Direction, determination, or decision of, or substantial influence over, important matters of the company

These indicators seek to unveil people who "stand behind the reporting company and direct its actions." Substantial control is not limited to this list, thanks to a catch-all provision that covers additional forms of control. This makes the definition

broad and undoubtedly will spark worries of ambiguity and overreach. But FinCEN rejected being boxed in by more easily administrable *per se* rules because it was persuaded that formal titles do not always reflect control.

The regulations also laid out the contours for other undefined "ownership interests" for which reporting is required. They include the following:

- Equity interests (of any class or type)
- Capital interests
- Profits interests (including partnership interests)
- Convertible instruments, warrants, rights
- Other options to acquire equity, capital, or other interests
- Debt instruments if they allow holder to exercise the same rights as other specified interests (*e.g.*, an instrument that can be converted to equity)

The proposed rules do not take into account the likelihood that the rights will be exercised. Grafting a more-likely-than-not standard could reduce overbreadth.

FinCEN acknowledges that the highest burden will be on small entities with complex structures or multiple owners. The agency's justification for the present approach is threefold:

- Most companies do not have such complex structures.
- Those companies that have complex structures already have higher compliance costs and presumably are better able to accept more compliance requirements.
- Small entities are precisely those perceived to have the highest risk of criminal activity that the C.T.A. was designed to fight.

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Without additional exceptions, the unintended consequence may be that many "innocent" smaller businesses will be ensnared even though their information is of no use to FinCEN. Small law firms are just one example of potential collateral damage.

For a foreign-owned U.S. business, if the foreign owner is a partnership or other type of business that is not required to register on formation, or that is not treated as having its own separate legal personality under that jurisdiction's law, it is not clear how many tiers of reporting are required, and whether it must be submitted on behalf of the individuals who are the ultimate beneficial owners (*i.e.*, the "warm body" at the top of the structure). As an example of the Proposed Regulations' approach, 31 C.F.R. §1010.380(b)(3)(iii) provides that if substantial ownership of certain foreign reporting companies is not clear because multiple individuals are involved, the information may be provided for the individual who has greatest authority. It is not clear what the equivalent rule would be for a foreign-owned domestic business owned through multiple tiers of foreign partnership. Based on the reported information and by analogy to C.D.D. rules, it is assumed that at least one 25% indirect owner who is a "warm body" must be reported even if multiple tiers up and multiple jurisdictions away.

REPORTS

Reporting companies must report the following information about both their beneficial owners and company applicants:

- Name
- Date of birth
- Address
- Unique identifying number from an acceptable identification document such as a driver's license registration number or a passport number accompanied by a copy of the identification document

Prior to the issuance of the proposed regulations, it was not clear whether a reporting company would have to report any information about the company itself. Nothing is explicitly required in the legislation, but it would have been odd if reporting companies could stay in the shadows. The proposed rules fill this gap; a reporting company must report its

- name;
- alternative names, if any, such as a d/b/a name;
- business address;
- jurisdiction of formation or registration; and
- unique identification number, which in most cases is likely to be a Tax Identification Number, or T.I.N. Alternatives are the Dun & Bradstreet DUNS Number and Legal Entity Identifier Code, or a 20-digit alphanumeric I.S.O. code available for companies which may be obtained here.

COMPANY APPLICANTS

In addition to information on beneficial owners, the C.T.A. requires reporting of "company applicants." Applicants are the individuals who file the document to form the entity in the case of domestic entities or register the entity in the U.S. in the case of foreign entities. It also includes those who direct or control the filing of the document.

The American Bar Association (A.B.A.) has expressed concern that applicants, which clearly includes attorneys, would acquire reporting obligations, which could conflict with the duty of confidentiality. The A.B.A. also highlighted privacy issues.

Regarding the nature of information provided, the regulations divide applicants into two categories. The first comprises those who provide a business service as a corporate or formation agent, such as lawyers. For this group, a reporting company should include the applicant's business address instead of a residential address. Although this might appear a response to privacy concerns, FinCEN believed that business addresses would provide greater value to law enforcement. All other applicants fall into the second category and must provide residential addresses.

The proposed rules confirm that applicants themselves do not have to file reports. This appears to address the A.B.A.'s confidentiality concerns.

TIMING

The date by which a reporting company must file reports depends on the date of formation relative to the C.T.A. Domestic companies formed after the C.T.A.'s effective date have 14 days from formation to file reports. Similarly, foreign reporting companies that have registered to engage in business in a particular State after the effective date have 14 days to file. By contrast, reporting companies formed before the effective date have a year to submit reports after the final regulations are effective. It is not yet clear precisely when the final regulations will be issued, but is anticipated that final regulations will not be issued before the middle of 2022.

The rationale for the discrepancy is that newly formed or registered companies are likely to have all necessary information on hand. However, FinCEN has already received comments that 14 days may not be enough. For example, a company that qualifies for exemption may need more time to obtain approvals that would establish its exempt status. Accordingly, FinCEN has invited further comment on whether the 14-day period will be too burdensome.

Additionally, reporting companies will not only have to file initial reports but provide updates and corrections as needed. Updates include a change in ownership and loss of exempt status. A company must provide updates to FinCEN within 30 days after the change and make corrections 14 days after the company becomes aware of any inaccuracies.

For the most part, these changes are more restrictive than the C.T.A. itself. Already existing companies would have had two years to file a report instead of one. Updates would have had to be disclosed within a year, rather than a month. But FinCEN does seem receptive to worries concerning newer companies – the 14-day deadline is more lenient than the C.T.A.'s would-be requirement that such reports be filed on formation.

PENALTIES

The C.T.A. makes it unlawful for any person to willfully provide, or attempt to provide, false or fraudulent beneficial ownership information or to willfully fail to report complete or updated beneficial ownership information to FinCEN. In general, a civil penalty of up to $500 may be imposed for each day a violation continues and a fine of up to $10,000 and imprisonment for up to two years may be imposed for a criminal violation.

CONCLUSION

These proposed regulations are not the end of the road – FinCEN is still accepting comments on the proposed regulations through February 7, 2022. Additionally, FinCEN intends to issue two more sets of proposed regulations. The first will deal with who gets access to the database that FinCEN will build using C.T.A. reports. As previously mentioned, access generally will be limited to the employees of certain government agencies. The second will revise C.D.D. rules as required by the C.T.A.

It is hoped that FinCEN will use the opportunity to also address some of the ambiguities identified in this article.

Those who believe that "what's past is prologue,"[2] will not be fooled if FinCEN takes several years to ramp up enforcement. As with enforcement of the Bank Secrecy Act, sooner or later FinCEN will initiate a campaign to seek out and penalize non-compliant reporting entities and their controlling persons. Those who ignore both history and the C.T.A. reporting obligation do so at their peril.

[2] See Act 2, Scene 1 of *The Tempest*, by W. Shakespeare.

