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Navigating New Disclosures Under the Corporate Transparency Act

By Christopher R. Agostino on January 8, 2024

The Corporate Transparency Act (CTA) generated substantial commentary throughout 2023 as businesses and advisors worked to determine compliance and reporting burdens imposed by the Act in advance of its January 1, 2024 effective date.

Originally passed in 2021, the CTA is the first federal law that requires non-exempt business entities to disclose the identity of certain beneficial owners, as well as information about the individuals responsible for creating those entities (i.e. attorneys, corporate service companies, etc.).

The CTA's reporting obligations are mandatory unless a specific exemption applies. Several states, California for instance, already require that certain entities disclose underlying ownership. However, most states including Massachusetts do not require disclosure of ownership information for entities organized in their jurisdiction contrary to popular belief. State reporting is usually limited to the names of officers, who may or may not have any financial interest in the entity.

Unlike state reporting that is accessible to the public, CTA disclosures are confidential and are only accessible by government agencies for law enforcement purposes, particularly anti-terrorism and money laundering investigations.

The Financial Crimes Enforcement Network (FinCEN) is the division of the Treasury Department charged with implementing and enforcing the CTA. Following a 10-month review and comment period, **FinCEN issued 184 pages of final rules and commentary on the CTA in September of 2022**. FinCEN's online submission portal went live on January 1, 2024, which revealed FinCEN's disclosure forms to the public for the first time. All CTA reporting must be done electronically through FinCEN's website. If an entity qualifies as a reporting company and is not exempt it *must* file a CTA report with FinCEN through FinCEN's online submission portal. Exempt entities are *not* required to file any form with FinCEN or otherwise establish their right to an exemption through any process. All reporting companies formed between January 1, 2024 and December 31, 2024 must file within 90 days of their organization. Companies formed on or after January 1, 2025 must file within 30 days of organization. Reporting companies that existed prior to January 1, 2024 must file an initial report not later than January 1, 2025.

The basics of the CTA have been republished and summarized in countless articles since FinCEN adopted its final rules in 2022; however, the CTA warrants further discussion as the law now takes effect, entities begin to file with FinCEN, and questions will most likely arise.

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What Entities Are Required To Report?

The CTA requires disclosure by any "reporting company," which FinCEN defines as all *non-exempt* entities that are corporations, limited liabilities companies, or that are "[c]reated by the filing of a document with the secretary of a state or any similar office under the law of a State or Indian tribe." Reporting companies include entities organized outside of the US if such entities are registered with any U.S. secretary of state.

Absent some twist of state law that allows for registration of trusts with a secretary of state as de facto business entities, e.g. a registered Massachusetts Business Trust, trusts are not "entities" for purposes of the CTA. The definition of "reporting company" is intentionally broad to cover nearly any business entity created or registered under the laws of any state.

FinCEN's list of exemptions do not help most small- to mid-sized businesses escape the otherwise expansive definition of a "reporting company." Generally, the exemptions only apply to businesses that are already highly regulated at a federal level, e.g. publicly traded companies, banks, broker-dealers, securities exchanges, federally registered investment advisors (RIA's), registered venture capital advisors, regulated insurance businesses, public utilities and the like. The regulations also exempt "subsidiaries of certain exempt entities," which is narrowly defined as "[a]ny entity whose ownership interest are controlled or wholly owned, directly or indirectly, by one or more [exempt] entities." Non-profit entities that are duly qualified under IRC 501(c)(3) are also exempt. Notably public accounting firms are exempt while law firms are not.

One important exemption that is general in nature and not limited to highly regulated industries is for a "large operating company," which is defined as any entity that employs more than 20 full-time employees in the United States, operates at a physical office located in the United States, *and* has more than $5 million in aggregate U.S-source gross receipts based on its most recent federal tax return. The large operating company exemption generated significant commentary during FinCEN's review but did not result in any change to the proposed rule.

For instance, the rule does not include any guidance as to calculation of full-time employees and instead refers to IRS procedures that may not be applicable in all instances. It is clear however that entities cannot aggregate employees across related entities for purposes of the exemption and the specific entity claiming the exemption must satisfy the 20 full-time employee threshold standing alone.

Conversely, the $5 million gross receipts threshold does aggregate income across related entities (i.e. entities that file a consolidated tax return), however only income from U.S.-sources (i.e. non-foreign income) qualifies. The physical office requirement further limits this exemption by excluding businesses that operate in shared workspace or through remote work policies. The wholly owned subsidiary exemption described above applies to wholly owned subsidiaries of large operating companies. Given the importance of this exemption to non-regulated business entities, FinCEN has volunteered that it will issue additional guidance or FAQ's to assist with this exemption as the CTA is rolled out.

Information About Reporting Company

In keeping with the CTA's purpose, FinCEN collects only basic information regarding the reporting company itself, while more detailed disclosures are required for the individuals behind the entity. The CTA requires disclosure of the company's legal name and trade name (if different), physical street address (P.O. Box numbers are unacceptable), jurisdiction of organization and the company's IRS issued taxpayer identification number (D&B numbers or state registration numbers are unacceptable). Foreign reporting companies must also report their jurisdiction of origin outside the United States. If a US TIN is not available foreign reporting companies may use a foreign tax identification number.

Information About Individual Beneficial Owners

Once a reporting company identifies its "beneficial owners" for purposes of the Corporate Transparency Act through the analysis described below, the company must collect and report detailed information about these individuals. Specifically, the CTA requires disclosure of each beneficial owner's: 1) full legal name, 2) date of birth, 3) residential street address, 4) a valid passport number, state issued ID card number, driver's license number, or foreign passport number if no other number is available, and 5) a copy of the valid passport, state ID, driver's license or foreign passport showing the individual's personal identification number. FinCEN's commentary provides that only a beneficial owner's current residential street address will suffice and a business address, P. O. box, or "care of" address are unacceptable. The individual's street address need not be in the United States.

Updated Information

A reporting company is obligated to update FinCEN within 30 days if any information previously submitted about the company or its beneficial owners has changed. This does not include changes that affect a company applicant. The obligation to update FinCEN includes changes in beneficial owners, name changes, address changes, changes to personal identification numbers or any other information submitted with the initial report with respect to reporting companies and their beneficial owners. The only exception to this 30-day window is with respect to changes in beneficial ownership following death, which shall be reported within 30 days of the date that the deceased's estate is finally settled and not within 30 days of death. If a legal guardian or parent was previously named as the beneficial owner of a minor child's interest, the designation must be updated within 30 days of the child's 18th birthday.

Once FinCEN has an individual's personal information as outlined above the individual may apply to FinCEN for a unique FinCEN identification number. A FinCEN identifier can be used for future Corporate Transparency Act reporting in lieu of re-submitting an individual's personal information and documentation one piece at a time. FinCEN identifiers are intended to streamline the filing process for beneficial owners of multiple reporting companies. FinCEN's process for issuance and maintenance of FinCEN identifiers is still under development.

Who Are Beneficial Owners?

Individuals Who Exercise "Substantial Control"

The CTA requires that non-exempt reporting companies disclose detailed information about their beneficial owners, i.e. the individual person or persons who ultimately own and control the entity. The beneficial owner of a reporting company under the CTA is, "any individual who, directly or indirectly, either exercises *substantial control* over such reporting company or *owns or controls at least 25 percent of the ownership interests* of such reporting company." According to FinCEN's commentary, every reporting company must identify at least one beneficial owner based on the "substantial control" test, where substantial control encompasses a broad array of influence over an entity.

Service as a "senior officer" – defined as president, CEO, CFO, COO, or general counsel – carries with it substantial control for purposes of the Corporate Transparency Act. Any individual with the authority to appoint or remove senior officers or a majority of directors or that otherwise "has substantial influence over important decisions made by the reporting company" is deemed to have substantial control. The CTA provides a repetitive catch-all whereby an individual has substantial control under the CTA if he or she "has any other form of substantial control over the reporting company." Importantly, the definition of "substantial control" for purposes of the CTA is entirely irrelevant to traditional legal concepts of control by ownership, vote or agreement, and is instead a new legal construct intended to compel disclosure of those individuals who exercise "substantial influence" over entities.

Individuals Who Own Or Control Not Less Than 25% Ownership Interest

While the definition of substantial control is inherently flexible in its application, identification of individuals who own or control at least 25% of the ownership interest in a reporting company is more mechanical but no less intricate. Given the complexity of modern business transactions and capital structures the Corporate Transparency Act's definition of ownership intentionally takes a simplistic approach to cut through artificial constructs that may be designed to obfuscate ownership. Based on the commentary submitted to FinCEN, seasoned corporate lawyers are losing sleep over FinCEN's refusal to specifically address common transaction structures that do not fit squarely into the CTA's regulatory structure, e.g. SAFE notes, so-called "waterfall" distribution structures in LLC's, and various types of convertible securities. FinCEN's simplistic approach could result in instances where more than four individuals are deemed to own at least 25% of a reporting company, among other results offensive to those familiar with math.

Definition Of Ownership Interests

The Corporate Transparency Act defines "ownership interests" to include any equity, stock, security, capital or profit interests, convertible debt instruments, and any put or call rights applicable to any of the foregoing, whether or not such interests carry voting rights. The CTA again uses circular language as a catch-all to include, "[a]ny other instrument, contract, arrangement, understanding, relationship or mechanism used to establish ownership." Generally, any present or future claim to equity or profits in an entity will qualify as an ownership interest.

In response to considerable commentary on this topic, FinCEN did add that ownership interests are to be calculated "at the present time, and any options or similar interests of the individual shall be treated as exercised." FinCEN's existing commentary does not elaborate on what interests it considers similar to options, but interestingly this proviso added in response to commentary could artificially dilute present interest holders thereby masking would-be 25% owners. FinCEN again commits to provide additional commentary and guidance on implementation of these rules, which remains to be seen.

Calculation of Ownership Interest

For entities taxed as corporations or that otherwise issue capital stock, an individual's percentage ownership interest is the greater of: 1) the individual's voting rights as a percentage of the entire issued and outstanding voting rights of the entity, or 2) the value of the individual's ownership interest as a percentage of the value of all issued and outstanding ownership interests of the reporting company. For entities that issue capital, percentage or profits interests – most limited liability companies – an individual's percentage interest shall be that individual's total percentage interests across all classes of ownership as a percentage of all outstanding capital and profits interests of the reporting company. Most LLC operating agreements will make this calculation easy. If unique circumstances affect an entity such that neither method can determine an individual's percentage ownership interest with "reasonable certainty" FinCEN's default rule is that any individual owning more than 25 percent of any individual class or type of ownership interest "shall be deemed to own or control more than 25 percent" of the reporting company and such individual shall be disclosed under the Corporate Transparency Act.

Exceptions To Status As Beneficial Owner; Nominees and Trusts

FinCEN does provide limitations and a few clear exceptions to the definition of beneficial owner. In particular, bona fide creditors of a reporting company whose rights are merely "intended to secure the right to receive payment [of a predetermined sum] or enhance the likelihood of repayment" are not beneficial owners even if they might hold debt convertible to equity. The regulations provide that an employee cannot be deemed a beneficial owner merely as a result of substantial control associated with their limited role as an employee. This so-called "employee exception" is intended to safeguard against the broad description of “substantial control” under the Corporate Transparency Act that might otherwise capture rank and file employees as beneficial owners. Employees who are also named as senior officers do not qualify for the employee exception. Minor children cannot be deemed beneficial owners provided that their parent or legal guardian must be named in their place. An individual holding an interest as “nominee” or “agent” for another is not a beneficial owner and the underlying principal must be named instead.

Estate and family law attorneys continue to review the impact that the CTA will have on their practices. For this discussion it is enough to point out that where an ownership interest is held in trust, the individual beneficial owner is deemed to be: 1) any trustee with authority to dispose of trust assets, 2) a beneficiary solely entitled to withdraw principal and income, or solely entitled to demand distribution of substantially all of the trust’s assets, or 3) a trust’s grantor who has the right to revoke the trust. Generally the CTA’s commentary anticipates that trustees will be named as beneficial owners for most true trust arrangements.

Reporting for Company Applicants

The Corporate Transparency Act also requires detailed disclosure about the individuals who create business entities. FinCEN claims that such reporting will allow it to better investigate connections between seemingly unrelated entities. The CTA defines a “company applicant” as the individual who “directly files” documents that create a reporting company (or register a foreign reporting company), as well as the individual “primarily responsible for directing or controlling such filing if more than one individual is involved in the filing of the document.”

FinCEN anticipates that the regulations will cover “one or two” individuals, likely the attorney that prepares the organization documents and the paralegal, administrative assistant or processor who makes the submission to the state. If a beneficial owner of a reporting company also creates the entity, that individual must be named as the company applicant as well. Notably, FinCEN will not require company applicants to be named for entities that were created prior to January 1, 2024, which eliminates the need for existing entities to go back in time to track down the individual or individuals responsible for organizing existing entities, which may be an impossible task.

Reporting Violations

Any person who willfully reports incorrect information about a reporting company or its beneficial owners or willfully fails to report or update beneficial ownership information to FinCEN is subject to civil and criminal penalties prescribed under the Corporate Transparency Act. Penalties include civil damages of up to $500 per day that a violation continues, as well as a criminal fine of up to $10,000, and/or imprisonment for not more than two years. The definition of “person” for purposes of enforcement includes any senior officer of a reporting company; therefore, the president, general counsel and C-Suite of a reporting company can be personally liable for the reporting company’s failure to file or update beneficial owner information with FinCEN.

The law does provide for a safe-harbor whereby individuals can avoid liability by filing corrective reports within 30 days of the date the individual “becomes aware or has reason to know” of inaccurate information in a prior report. The CTA also provides a safe harbor for reporting companies that correct inaccurate information within 90 days of the date such incorrect information was submitted to FinCEN. Company applicants (i.e. attorneys, CPA’s, etc.) can qualify as a “person” subject to penalties under the CTA if they knowingly submit incorrect information to FinCEN on behalf of a reporting company or beneficial owner.

Conclusion

Over time it is likely that the Corporate Transparency Act will become just another element of entity formation and maintenance. However, at the outset businesses of all sizes will spend considerable time working to ensure compliance with the CTA. Even exempt organizations must review their corporate structure to ensure that they do not have any non-exempt entities in their organization chart that might require special attention.

Company applicants, including RIW, have developed processes and procedures to address the CTA's new filing requirements and potential liabilities.

If your organization needs guidance regarding the Corporate Transparency Act, please contact the author of this alert, **Chris Agostino**.

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