

Business Signals – Client Alert

*An alert about the legal implications of issues affecting businesses
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The Corporate Transparency Act: New Disclosure Rules for Small Businesses

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On January 1, 2021, Congress passed the Corporate Transparency Act (“CTA”) as part of the Anti-Money Laundering Act of 2022. As stated in the summary of the proposed regulations, the CTA was intended to help prevent and combat money laundering, terrorist financing, tax fraud, and other illicit activity, by requiring entities to submit beneficial ownership in company applicant information. On December 7, 2021, the Department of Treasury Financial Crimes Enforcement Network (“FinCEN”) issued proposed regulations which addressed various issues under the CTA.

As a general rule, the CTA requires certain business entities to disclose their beneficial owners and applicants and other related information to FinCEN. Although there were already many statutes and regulations on the books requiring disclosures of such information for larger entities, the CTA significantly expands the types of entities that are required to report such information, specifically adding small business entities.

While the new proposed regulations are only five pages long, the explanation of those regulations in the Federal Register is forty-nine pages long, which is indicative of the complexity of the issues involved with the new Act. The major issues addressed in the proposed regulations include the following:

1. Who must file a report?
2. Who is a beneficial owner or company applicant?
3. What information must be reported?
4. When must the information be reported?
5. Who can access the information?

6. What are the penalties for non-compliance?

This article will summarize how FinCEN proposes to deal with these particular issues in its new proposed regulations.

1. Who must file a report?

The proposed regulations recognize two types of reporting companies covered by the CTA -- Domestic Reporting Companies and Foreign Reporting Companies. “Domestic Reporting Company” means any corporation, limited liability company, or other entity that is created by the filing of a document with the Secretary of State or similar officer under the laws of a state or Indian tribe. A “Foreign Reporting Company” is any entity that is a corporation, limited liability company, or other entity formed under the law of a foreign country, and registered to do business in the United States by the filing of a document with the Secretary of State or equivalent office under the law of the State or Indian tribe.

There are many exemptions listed in the statute and proposed regulations. First, there are twenty-three different types of specific businesses that are excluded from the definition of reporting company, including such things as banks, broker dealers, and other entities. There is also a major exemption for *large operating companies*, which is defined as companies that a) employ more than twenty employees on a full-time basis in the United States, b) have more than five million dollars in gross receipts or sales and c) have a physical office within the United States. There is an additional exemption for *inactive entities* where they meet certain requirements, most importantly that it was in existence on or before January 1, 2020, and is not engaged in an active business, and further has not received funds in an amount greater than one thousand dollars in the preceding year. Finally, there is an additional provision in the CTA which allows the Secretary of Treasury to exempt other potential filers, although FINCEN has stated it does not intend to expand the listed exemptions at this time.

Even with all these listed exemptions, the CTA encompasses the vast majority of small businesses in the United States. It applies to all corporations, LLCs, and other entities, both foreign and domestic, which are required to file with the Secretary of State or equivalent office under the laws of the State or Indian tribe.

2. Who is a Beneficial Owner of Company Applicant?

The regulations provide that a person is a beneficial owner of a reporting company who directly or indirectly a) owns or controls twenty-five percent or more of the ownership interest in the entity or b) exercises substantial control over the reporting company. The proposed regulations further attempt to define substantial control in a variety of ways, including the following:

- A person who serves as senior officer of the reporting company;

- A person who has authority over the appointment or removal of any senior officer or a majority or dominant minority of the Board of Directors;
- A person who has direction, determination or decision of or substantial influence over, important matters affecting the reporting company; or
- A person who has any other form of substantial control of the reporting company (catch all provision).

The regulations contain provisions addressing the direct or indirect exercise of substantial control which are extensive and which cover many different kinds of relationships within the company. The regulations also provide a comprehensive description of “ownership” to include both equity interests in the reporting company and many other kinds of interests, such as capital or profits interests or other types of interests.

The regulation also contains some exclusions from the definition of beneficial owner. These include the following:

- Minor children, if information of guardian is reported;
- Nominees, intermediators, custodians, or agents on behalf of another individual;
- Individuals acting solely as employee of entity, and whose control or economic benefits are derived solely from employment;
- Persons whose interests in the entity are derived through a right of inheritance;
- Creditors of the entity.

Importantly, the regulations provide that “Company Applicants” must be reported as well. The regulations define the term “Company Applicant” to mean any individual who actually files the document creating the domestic reporting company or which registers a foreign reporting company, including any individual who directs or controls the filing of such document. *It should be noted that this includes lawyers and CPAs who file or have filed formation documents for various entities.*

3. What information must be reported?

Each reporting company must disclose information on the entity and on each beneficial owner and applicant, including the following information:

1. full legal name;
2. date of birth;
3. current residential or business street address and
4. a unique identifying number from an acceptable identification document or FinCEN identifier.

Under the regulations, an acceptable identification document includes such things as passports, driver’s license numbers, or state ID numbers. Interestingly, this definition does not include a social security number, which is

surprising considering that most other types of regulations of this nature would include them.

For most owners, the regulations provide that the reporting company would use their residential address. The regulations provide that for company applicants, the reporting company may use a business address for formation agents, and then residential street addresses for other types of applicants.

Reporting companies must also provide information about themselves, to include the following: (1) Name and any alternative names (DBAs); (2) Business street address; (3) Jurisdiction of formation and registration; and (4) Unique identification number (usually EIN).

4. When must the information be reported?

The proposed regulations provide extensive commentary on the timing of disclosures that must be made by reporting companies. This includes the following:

1. New Organizations--must file report within fourteen calendar days of formation;
2. Existing Entities--not more than one year after the effective date of final regulations;
3. Corrected Reports—must file corrected reports within fourteen calendar days after the date on which it becomes aware or have reason to know required information was inaccurate,
4. Updated Reports--must file updated reports setting out changes to previously reported information (including changes of ownership) within thirty days after the change.

Interestingly, the regulations conflict with the actual provisions within the CTA regarding the timing of reporting. The provisions of the CTA are far more generous than the regulations, including a provision allowing for reporting from existing entities within two (2) years of the passage of the final regulations, and one (1) year for updated reports. You can expect that the timing provisions in the proposed regulations will be subject to further litigation and rulemaking.

Importantly for all practitioners, the CTA will not be considered effective until the final regulations are issued, meaning that there is currently no reporting requirements today. But all practitioners should be aware that the time periods noted above will take effect once the final regulations have been issued, which is expected to be some time this year.

5. Who can access the information?

Importantly, the information disclosed under the Act will not be publically available, which is very important to all of our clients. It will, however, be available to the following entities:

- U.S. Federal Law Enforcement Agencies (including the IRS);
- With court approval to certain state and local enforcement agencies;
- To non-U.S. law enforcement agencies, prosecutors or judges if based on a request of U.S. Federal Law Enforcement Agency;
- With the consent of the reporting company, to financial institutions and their regulators.

The CTA and the proposed regulations both address the requiring that safeguard be put into place by FinCEN to the protection of this information in a secure database. It is expected that future regulations will cover the procedures relating to the release of this information to these various entities. The CTA contains significant penalties for the unauthorized disclosure or use of the beneficial ownership information, including \$500 per day penalties for each day the violation continues and is not remedied; up to \$250,000 fines and imprisonment of up to 5 years; or up to \$500,000 fines with 10 years of imprisonment for violations in conjunction with violations of other laws.

6. What are the penalties for non-compliance?

There are significant penalties, both civil and criminal, relating to violations of the CTA. The statute itself defines a reporting violation as a willful provision of false information or the willful failure to report, complete or update beneficial ownership information to FINCEN. It contains a civil penalty of up to \$500 per day for as long as the willful failure continues. The CTA provides also a fine of up to \$10,000 and potential imprisonment for up to 2 years for willful failure to comply with the regulations. Under the statute, willfulness means a voluntary, intentional violation of a known legal duty.

The big question under the regulations is who exactly is going to be responsible for these civil fines or subject to the criminal liability. The summary to the regulations notes while the CTA requires the reporting company to file these reports, it does not appear to specify who may be liable if the required information is not reported. While it will be clear when an individual willfully directs a company not to report the information, the summary notes that it is much less clear what happens when a company simply fails to report as required by the regulations. FINCEN has requested comments on this particular issue to clarify it in the regulations.


Conclusion

Congress and the Department of Treasury have long wanted rules requiring the disclosure of ownership of small entities. This is an area which has been problematic for many years for U.S. government agencies in the

enforcement of various rules and regulations. The CTA now mandates for the first time that such ownership information be provided for use in both criminal enforcement actions as well as other regulatory matters, including tax matters.

At this time, only the proposed regulations have been issued. FinCEN's requests for comments in the proposed regulations were extraordinary, as they have invited comments on over 22 specific questions in their commentary on the proposed regulations, with more questions buried within the text of the commentary itself. We expect that FinCEN will issue additional sets of regulations, as well as provide the final regulations on the current proposed regulations, later this year.

Regardless, all practitioners should be aware of the Corporate Transparency Act and its requirements. This new Act will require, at the very least, certain changes in attorney practices, including revisions to due diligence forms in M&A transactions; changes to business formation practices and procedures; additional disclosures and documentation in loan transactions; and general notification procedures for our clients. But given the heavy fines and potential criminal liability, attorneys should at the very least know the basics of the new rules and pay attention to their upcoming implementation dates, in order to properly advise their clients.

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