December 2023

Business Signals – Client Alert

An alert about the legal implications of issues affecting businesses and business owners in the Central Gulf Coast region.

© 2023 Armbrecht Jackson LLP

THE CORPORATE TRANSPARENCY ACT:

NEW SMALL BUSINESS REPORTING RULES FOR 2024 AND BEYOND!

J. Robert Turnipseed, Armbrecht Jackson LLP

On January 1, 2021, Congress passed the Corporate Transparency Act ("CTA") as part of the Anti-Money Laundering Act of 2020. 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, and then released their final regulations on September 29, 2022.

As a general rule, the CTA requires new and existing 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.

The final regulations have now been released regarding the CTA. The major issues addressed in the 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 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 which is 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.

It should be noted that **sole proprietorships, general partnerships and trusts** usually will not fall under the definition of reporting company. In most states, no document has to be filed with the secretary of state or similar office for any of these types of entities in order to form the entity. However, there are notable exceptions for general partnerships and trusts, most notably in California and Delaware (both of which require filings for those types of entities), so lawyers should consult their own local law relating to filing requirements in order to determine whether the GP or trust would be required to comply with the CTA.

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. Regarding the first category, the regulations 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. See 31 CFR 1010(d)(2)(ii). Ownership can be direct or indirect, and the regulations provide extensive examples of what would be included, including joint ownership, ownership through another agent or intermediary, trustees and beneficiaries, grantors with a right to revoke a trust, and ownership through separate entities.

The regulations provide rules for calculating whether a person owns 25 percent of the ownership interests of a reporting company, specifically in 31 CFR § 1010(d)(2)(iii). This includes the following:

1. Ownership interests to be calculated at present, and any options or similar interests treated as exercised.
2. Capital or profits interests—ownership interests are total capital or profits interest in entity, calculated as % of total outstanding capital and profits interest in entity.
3. Corporations—total ownership calculated as (1) total combined voting power of all classes as % of total outstanding voting power of all classes of interests entitled to vote, or (2) total combined value of the ownership interests of individual as total outstanding value of all classes of ownership interests.
4. Fail safe rule—if none of the above apply, any individual who owns or controls 25% or more of ANY CLASS OR TYPE of ownership interest deemed to own or control 25% or more of reporting company.

Regarding the second category, the final regulations 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 of 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. See 31 CFR 1010.380(d)(1). Due to the broad "catch all" provisions in the regulations, this will be a "facts and circumstances" test, so it is an issue lawyers should address with their clients.

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. ***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?

Under the new regulations, the final rule will go into effect on January 1, 2024. The regulations provide the following rules for all Reporting Companies:

1. Reporting companies created or registered before January 1, 2024—between January 1, 2024 and December 31, 2024.

2. Reporting companies created after January 1, 2024—within 90 days of formation.[1]

3. Reporting companies have 30 days to correct or update changes to information in their previously filed reports.

Under the new regulations, reporting companies created prior to January 1, 2024, do not have to submit information relating to Company Applicants. This means that pre-2024 companies only have to submit information on the companies themselves and beneficial owners. This is a significant change from the proposed regulations and means that pre-2024 Reporting Companies do not have to disclose information about their Company Applicants (which in many cases was their CPA or lawyer!).

[1] This time frame was originally established as 30 days for companies created after January 1, 2024, but in a recent release FINCEN extended the deadline to 90 days during the 2024 year. In 2025, that time limit will revert to 30 days for newly created entities. See 88 FR 83499.

The regulations provide a specific rule relating to inherited ownership interests. Inherited interests are excluded from the definition of beneficial owner. However, under the regulations, when the interests are actually distributed to the beneficiaries by the Estate, a change with respect to required information will be deemed to occur, and the reporting company will be obligated to amend its report to reflect the change and identify the new owners. This will be an important new issue for lawyers with a probate practice, mainly to ensure that the entity files the proper reports when the ownership interests are assigned to the beneficiaries.

Congress is currently considering legislation to delay reporting obligations. On December 12, 2023, by a bipartisan vote of 420 to 1, the House passed the Protect Small Business and Prevent Illicit Financial Activity Act (HR 5119), which extends the reporting obligations for existing companies until January 1, 2026. It also codifies the new 90 day reporting requirement for companies formed after January 1, 2024. The Senate has not yet addressed the bill, but it is possible that it will do so prior to the end of the year, or even in 2024. As of the date of publication of this alert, however, the current deadlines in the FINCEN regulations still apply.

5. Who can access the information?

Importantly, the information disclosed under the Act will not be publicly available, which is very important to all of our clients. Per the proposed regulations, it will 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 regulations both address the requirement that safeguards be put into place by FinCEN to protect this information in a secure database. FINCEN released additional rules on December 16, 2022, which outlined the development of a Beneficial Ownership Secure System in accordance with the CTA requirements, and which also established a Proposed Access Rule to lay out protocols for access by law enforcement and eligible financial institutions. 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 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, 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.

FINCEN has released many different sets of regulations, both final and proposed, relating to the CTA. 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. According to news reports, FINCEN was bombarded with comments from companies, lobby groups, trade groups, attorneys, and individuals from all over the country. FINCEN has issued a helpful guide for small businesses, found at https://www.fincen.gov/boi/small-entity-compliance-guide, which they are updating as new regulations are released.

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

QUESTIONS OR CONCERNS? Please feel free to contact the author as follows:

J. Robert Turnipseed
jrt@ajlaw.com
Armbrecht Jackson, LLP
11 North Water Street, 27th Floor
Mobile, AL 36602
251.405.1311

The information contained in this handout is of a general nature only and is not intended to be relied upon as, nor a substitute for, specific professional advice. For additional information regarding the qualifications of the firm or the speaker, please visit the website at www.ajlaw.com.

"No representation is made that the quality of the legal services to be performed is greater than the quality of legal services performed by other lawyers."