

Federal Beneficial Ownership Reporting Requirements Coming Soon for Many Corporations and LLCs

Article

Amundsen Davis Corporate Alert

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The U.S. Congress slipped the Corporate Transparency Act (CTA) into the National Defense Authorization Act enacted on January 1, 2021, after an override of former President Trump's veto. The CTA will increase the regulatory burden on the vast majority of new and existing corporations and limited liability companies (LLCs) and may change how new businesses are organized.

Following a one-year rulemaking period, the CTA will require reporting companies to submit personally-identifiable information (PII) about the individuals who own or control them to a national database administered by the Financial Crimes Enforcement Network (FinCEN). This database will be available to law enforcement and national security officials, Federal agencies, and financial institutions, and is intended to assist in the fight against money laundering and other criminal activities conducted through shell companies and to streamline customer due diligence requirements for financial institutions.

CTA applies to all corporations and LLCs and to other similar entities organized by filing with a secretary of state (as determined by the Secretary of the Treasury's rulemaking process). CTA also applies to non-U.S. organized companies that are qualified to transact business in the U.S. These entities are called "reporting companies."

Most notably CTA does not apply to any entity that (i) employs more than 20 employees on a full-time basis in the U.S., (ii) filed in the previous year Federal income tax returns in the U.S. demonstrating more than \$5,000,000 in gross receipts or sales in the aggregate (on a consolidated basis), and (iii) has an operating presence at a physical office within the U.S. There is no guidance available yet on how 20 employees on a full-time basis will be calculated. In passing the CTA, Congress concluded there is less risk of illicit activities, such as money laundering, the financing of terrorism, and human and drug trafficking, in larger business organizations. Certain publicly-traded companies, financial institutions, broker-dealers, investment companies, investment advisers, public accounting firms, 501(c) organizations, and dormant companies are also exempt

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from reporting. These companies are called "exempt entities."

Each newly-created or existing reporting company will be required to submit the PII of their beneficial owners to FinCEN and periodically update this information during the reporting company's operating life. "Beneficial owner" means, with respect to a reporting company, an individual who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise (a) exercises substantial control over the reporting company or (b) owns or controls not less than 25% of the ownership interests of the reporting company. There is no guidance available yet on what "substantial control" means or how to calculate the 25% ownership interest requirement in complex capital structures. Unfortunately, business owners are left to ponder these questions until the CTA regulations become effective. Certain persons were specifically exempted from the definition of beneficial owner including certain minor children, custodians or agents, an individual acting solely as an employee of a reporting company, certain heirs, and certain creditors of reporting companies.

The Secretary of the Treasury has until January 1, 2022, to adopt the CTA rules and regulations. Any reporting company in existence prior to the effective date of the CTA regulations must report the PII of its beneficial owners not later than two years after the regulations become effective. Any reporting company that is formed or registered after the effective date of the CTA regulations must report the PII of its beneficial owners at the time of formation or registration. Once in the system reporting companies must report changes in the PII of its beneficial owners no later than one year after any change.

The reported information shall identify each beneficial owner of the reporting company and each applicant of the reporting company, including their full legal name, date of birth, current residential or business address, and a unique identifying number from an acceptable identification document or a FinCEN identifier. Acceptable identification documents include an unexpired U.S. passport or an unexpired state identification card or driver's license. If an exempt entity is a beneficial owner, the exempt entity may be listed by its name only without including the PII of the individuals who are beneficial owners of the exempt entity.

CTA defines an applicant as any individual who (x) files an application to form a corporation, LLC or other similar entity under the laws of a state or (y) registers or files an application to register a corporation, LLC or other similar entity formed under the laws of a foreign country to do business in the U.S. CTA does not exempt lawyers or law firms from reporting, although the Secretary of Treasury has the discretion to do so in the final CTA regulations. Whereas, in the past, business lawyers and paralegals often acted as the incorporator or organizer of new corporations and LLCs, business clients may be required to act as incorporator or organizer of new entities if their counsel is unwilling to report as an applicant under the CTA and subject themselves to CTA beneficial ownership reporting. This may slow down the organization of new entities.

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CTA may have other consequences for business clients. Legal commentators have suggested that shareholder and LLC agreements may need to be revised to require beneficial owners to provide the necessary PII and allow the companies to disclose PII to FinCEN. This begs the question as to what remedies a company has if an owner fails to comply. Would a non-compliant owner's interest be redeemed, would they be expelled or would they be converted to an economic interest holder? The CTA provides plenty of food for thought.

The penalties for willful false reporting or willful failure to report or update changes in beneficial ownership may include a civil penalty of not more than \$500 for each day that the violation continues and a fine of not more than \$10,000 and/or not more than two years in prison. So, unlike the failure to file state annual reports (which may be rectified by simply filing late and paying any applicable fees or penalties), the risk of non-compliance with CTA is potentially draconian. Business owners will need to be vigilant about CTA compliance.

The CTA is a story of good news and bad news. The good news is implementation of CTA will be delayed up to one year while the Secretary of the Treasury finalizes the CTA regulations. The bad news is increased regulation by the Federal government of state-chartered businesses and mandatory disclosure of PII of beneficial owners of reporting companies. All business clients are encouraged to follow the CTA rulemaking process and be prepared well in advance for the new CTA reporting requirements.