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A New Era of Compliance Comes Closer: Regulations Proposed for Implementation of Corporate Transparency Act

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The Corporate Transparency Act (the ''CTA'') was enacted as part of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021.[1] At the core of the CTA are reporting requirements imposed on substantially every small business organized or registered to conduct business in the United States through any type of limited liability entity. Reporting companies will be required to submit, to the Financial Crimes Enforcement Network of the U.S. Treasury Department (FinCEN), identifying information regarding their owners and those who participate in the formation and domestic registration of those businesses. Implementation of the reporting requirements of the CTA is largely deferred. Its reporting requirements take effect on the effective date of final regulations prescribed by the Secretary of the Treasury.[2]

In most respects the proposed regulations largely parrot the statute. They would not expand on the companies required to report or the companies exempt from the reporting requirements of the CTA. They would expand only modestly on the information required for disclosure and would not make reference to the penalties provided by the statute for failures and inaccuracies in reporting other than to observe their existence.

Where the proposed regulations would provide considerable new guidance is with respect to beneficial ownership. That guidance is the subject of this article.

BENEFICIAL OWNERS

While the CTA requires disclosure of information regarding reporting companies, the purpose of the Act is to compel reporting companies to disclose information regarding beneficial owners. A beneficial owner would be defined by the proposed regulations as ''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 interest of such reporting company.''[3]

Substantial control would include:

- services as senior officer of the reporting company,
- authority over the appointment or removal of any senior officer or a majority or dominant minority of the members of the board of directors (or similar body)),
- control of or substantial influence over important matters affecting the reporting company as specified in the proposed regulations, and

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[1] Pub. L. No. 116-283 (Jan. 1, 2021), §6403, adding 31 U.S.C. §5336. For a discussion of the CTA as enacted, see Ward *We May Not Know Who You Are or Where You Live, But We Intend to Find Out: The Corporate Transparency Act of 2020*, 50 Tax Mgmt. Int'l J. No. 3 (Mar. 5, 2021).

[2] CTA §6403; 31 U.S.C. §5336(6)(5).

[3] Prop. 31 C.F.R. §1010.380(d). All citations to 31 C.F.R. §1010.380 are to the regulations as proposed and published in 86 Fed. Reg. 69,969–69,974 (Dec. 8, 2021) (hereinafter Prop. 31 C.F.R. §1010.380).

- "[a]ny other form of substantial control over the reporting company."[4]

The proposed regulations are most helpful in clarifying the circumstances in which an individual's authority will be viewed as sufficiently substantial as to require reporting information regarding that individual. This determination is to be made without regard to an individual's office or title; control or substantial influence over the nature, scope, or attributes of the business conducted by the reporting company, in actions such as:

- transfers of its principal assets;
- reorganization, dissolution, or merger of the reporting company;
- major expenditures or incurring significant debt;
- selection or termination of business lines or geographic areas in which the reporting company does business;
- compensation schemes;
- incentive programs for senior officers, and
- approval or termination of contracts.

This will subject the person executing such authority to disclosure.[5] The means through which such control is exercised is irrelevant and may be direct or indirect, formal or informal, including simple business relationships — even if such control is never exercised, if the *ability* to exercise exists.[6]

Disclosure of information regarding non-controlling owners is required if their ownership of the reporting company equals or exceeds 25%. Any type of equity interest — whether financial or simply voting — including "participation in a profit-sharing arrangement" is sufficient to be measured and considered to identify beneficial owners. In the case of non-corporate entities, any proprietary interest, any interest in capital or profits including limited and general partnership interests must be accounted for. Less direct equity interests are also considered, including convertible debt, warrants, rights to purchase or subscribe to equity interests, and any "put, call, straddle, or other option or privilege of buying or selling" any ownership interest.[7]

Measuring whether the 25% threshold is met requires accounting for "all ownership interests of any class or type, and the percentage of such ownership interests that an individual owns or controls shall be determined by aggregating all of the individual's ownership interests in comparison to the undiluted ownership interest of the company."[8] Consistent with the statute, the proposed regulations would make clear that certain equity owners will be ignored and not subject to reporting:

- minor children (provided the reporting company discloses the required information regarding the parent or legal guardian of the minor child);
- individuals acting as nominees, intermediaries, custodians, or agents;
- employees of reporting companies "acting solely as an employee and not as a senior officer, whose substantial control over or economic benefits from such entity are derived solely from the employment status of the employee;"
- individuals whose only interest is an expectancy through a right of inheritance; and
- creditors of the reporting company.[9]

With respect to creditors, the proposed regulations would distinguish between holders of "simple" debt obligations and holders of more sophisticated lending instruments. Creditors not requiring disclosure are persons whose beneficial ownership is derived "solely through rights or interests in the company for the payment of a predetermined sum of money . . . and the payment of interest on such debt."[10] If the right or interest in the value of the reporting company is a right or interest in its value or profits, such an obligation is not one "for payment of a predetermined sum" even if it takes the form of a debt instrument. Thus, participating debt must be accounted for as an ownership interest whose holders will require disclosure as beneficial owners if the value of the debt instrument equals or exceeds 25% of the outstanding ownership interests in the reporting company.

Not only are the equity and other interests described above sufficient to establish beneficial ownership whether owned directly or indirectly, but beneficial ownership may also exist even when the beneficial owner shares ownership or does not directly or indirectly own an equity interest described by the proposed regulations. Specific examples provided by the proposed regulations include:

- joint ownership;
- control of an ownership interest owned by another; and

[4] Prop. 31 C.F.R. §1010.380(d)(1)(i) – §1010.380(d)(1)(iv).

[5] Prop. 31 C.F.R. §1010.380(d)(1)(iii).

[6] Prop. 31 C.F.R. §1010.380(d)(2).

[7] Prop. 31 C.F.R. §1010.380(d)(3).

[8] Prop. 31 C.F.R. §1010.380(d)(3)(iii).

[9] Prop. 31 C.F.R. §1010.380(d)(4).

[10] Prop. 31 C.F.R. §1010.380(d)(4)(v).

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- a trust or similar arrangement that holds the ownership interest.[11]

In the case of an ownership interest owned by a trust, the identity of the trustee and other reporting information regarding the trustee will always require disclosure. In addition, if the trust has a single beneficiary, the identity and other reporting information regarding the beneficiary must be disclosed. In the case of a trust with more than one beneficiary, disclosure is only required of those beneficiaries who have a right to withdraw trust assets or demand distributions.[12] Finally, if the trust's settlor has the ability to revoke the trust or otherwise withdraw its assets, disclosure of the identity and other reporting information regarding such settlor is required. Thus, in the right set of circumstances, an ownership interest in a reporting company held through a trust may require disclosure of the trustee, one or more beneficiaries, and the settlor of that trust. It is probably not a coincidence that the rights to revoke or withdraw that make beneficiaries and settlors subject to disclosure also make those persons owners of trust income and corpus under the grantor trust rules of subpart E.[13]

COMPANY APPLICANTS

For professionals involved in entity formation, the most intrusive aspect of the CTA is the requirement for disclosure of information regarding company applicants. The proposed regulations would expand the scope of disclosure by expanding the persons who are regarded as applicants requiring disclosure.[14] The term ''company applicant'' would be defined to mean any individual who files the document that creates the domestic reporting company or registers a foreign reporting company ''including any individual who directs or controls the filing of such document by another person. . . .''[15] Thus, a company applicant is not only the lawyer or paralegal who files the articles of incorporation, certificate of limited partnership, articles of organization, or similar document for organization of a domestic company or the registration of a foreign entity with a state or tribal authority, but also a partner or senior lawyer directing such persons on these activities.

INFORMATION REPORTED

Consistent with the statute, the proposed regulations would require disclosure of the full legal name, date of birth, address, and an identifying number for each beneficial owner and company applicant.[16] In the case of a company applicant filing the document organizing and registering the reporting company as part of such individual's business, the business address of the company applicant should be provided; in the case of any other individual, the residential street address used by the company applicant or beneficial owner for tax residency purposes.[17] The number identifying the beneficial owner or company applicant may be taken from a current U.S. passport, driver's license, or non-expired identification number issued to the individual by a state, local, or tribal government for identification purposes. In the case of an individual who does not have one of the foregoing identification documents, a non-expired passport issued by a foreign government to such individual will suffice.[18] In addition to providing the foregoing information, the reporting company must also provide a picture ID for the beneficial owner or company applicant which includes the identification number.[19]

In lieu of any beneficial owner or company applicant providing the information described above, the individual who is a beneficial owner or company applicant may, instead, provide a FinCEN identifier.[20] The proposed regulations do not provide guidance regarding how an individual may obtain a FinCEN identifier. Presumably that guidance will be forthcoming and will involve submission of the information described above directly regarding beneficial owners and company applicants directly to FinCEN. The proposed regulations would require updating and correcting information submitted to FinCEN ''at the same time and in the same manner'' as updated or corrected reports are required of reporting companies.[21]

TIME WITHIN WHICH REPORTING INFORMATION MUST BE PROVIDED

As enacted, the CTA is vague regarding when the reporting information is to be provided to FinCEN. Initial reporting is due ''at the time of formation or

[11] Prop. 31 C.F.R. §1010.380(d)(3)(ii).

[12] Prop. 31 C.F.R. §1010.380(d)(3)(ii)(C)*(2)(ii)*.

[13] See §673 and §676 with respect to settlors and §678 with respect to beneficiaries. All section references not specifying Title 31 or the CTA are to the Internal Revenue Code, as amended (Title 26 of the U.S. Code).

[14] *Compare* 31 U.S.C. §5336(a)(2) *with* Prop. 31 C.F.R. §1010.380(e)(1).

[15] Prop. 31 C.F.R. §1010.380(e)(1), §1010.380(e)(2).

[16] *Compare* 31 U.S.C. 5336(b)(2)(A) *with* Prop. 31 C.F.R. §1010.380(b)(1)(ii).

[17] Prop. 31 C.F.R. §1010.380(b)(1)(ii)(C).

[18] Prop. 31 C.F.R. §1010.380(b)(1)(ii)(D)*(4)*.

[19] Prop. 31 C.F.R. §1010.380(b)(1)(ii)(E).

[20] Prop. 31 C.F.R. §1010.380(b)(5)(ii)(A).

[21] Prop, 31 C.F.R. §1010.380(b)(5)(ii)(D).

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registration.''[22] Reporting on changes in beneficial ownership will be required ''in a timely manner.''[23] The proposed regulations set deadlines.

The initial report for domestic or foreign reporting companies must be filed within 14 calendar days of the date of formation (in the case of a domestic reporting company) or within 14 days of registration (in the case of a foreign reporting company).[24] For entities existing prior to the effective date of final regulations, the initial report is due not later than one year after that date.[25] In the case of an entity no longer meeting the criteria for exemption, the initial report is due within 30 calendar days after the date on which such exempt status ended.[26] The initial report must be updated in a variety of circumstances:

- within 30 days of the date on which there is ''any change with respect to any information previously provided, including changes with respect to beneficial ownership, as well as any change with respect to the information reported for any particular beneficial owner or applicant;''[27]
- when the reporting company becomes an exempt entity; and
- when a beneficial owner dies (within 30 days of settlement of the estate of the deceased beneficial owner).

In addition to updating the initial report for the above-mentioned status changes, reporting companies are also obligated to correct any inaccurate submitted information within 14 calendar days after becoming aware or having reason to know of such inaccuracy.[28]

How reporting companies will know or compel disclosure of corrections to the reporting information of beneficial owners and company applicants remains a mystery. While the statute requires updating information regarding beneficial owners, it does not require updating such information for company applicants.[29] The proposed regulations would extend the obligation to update information to company applicants as well as beneficial owners.[30]

OBSERVATIONS

The proposed regulations fill in some, but not all, of the gaps left by the statute. For example, the proposed regulations fail to provide definitive guidance with respect to attribution of beneficial ownership, other than as described above. Thus, there are no specific rules corresponding to §318 or §958 by which constructive ownership would be attributed to a potential beneficial owner. A broad array of ownership interests can make someone a beneficial owner subject to disclosure. By way of example, the proposed regulations explicitly refer to convertible debt, straddles, jointly owned interests, and beneficial interests in trusts. However, no guidance has been provided as to how these interests will be measured for purposes of the 25% threshold for disclosure of noncontrolling beneficial owners.

There appear to be multiple ways to avoid the reporting requirements:

- Only entities deriving limited liability through state or tribal charter (in the case of domestic entities) or registration with state or tribal authorities (in the case of foreign entities) are subject to reporting. Sole proprietorships and general partnerships are not.
- Ownership of a reporting company through a nongrantor multibeneficiary trust with respect to which the beneficiaries have no withdrawal rights requires disclosure of information regarding the trust's trustee but not the settlors or beneficiaries. Trusts with Crummey powers will not avoid disclosure of beneficiaries holding powers of withdrawal, nor will §2503(c) trusts. However, many settlors may be willing to forego annual exclusions for gifts to such trusts if the identity and information regarding beneficiaries can be protected.
- Organization of the reporting company as one of the types of organizations exempted from reporting avoids disclosure of beneficial owners and company applicants, as well. Obviously, this opportunity is limited and may require a willingness to assume other reporting obligations and regulatory oversight. However, in certain cases, regulatory oversight may not exist or may not extend to disclosure of individuals exercising substantial control or satisfying the 25% beneficial ownership threshold of the CTA.

Although the Corporate Transparency Act requires disclosure of information about reporting companies, the information required is not significantly greater than that necessary to organize or register the company with state or tribal authorities. However, make no mistake. Information regarding the reporting companies, as well as their company applicants, should be understood as a means to gather and compel information regarding the beneficial owners of those compa-

[22] 31 U.S.C. §5336(b)(1)(C).
[23] 31 U.S.C. §5336(b)(1)(D).
[24] Prop. 31 C.F.R. §1010.380(a)(1)(i)–§1010.380(a)(1)(ii).
[25] Prop. 31 C.F.R. §1010.380(a)(1)(iii).
[26] Prop. 31 C.F.R. §1010.380(a)(1)(iv).
[27] Prop. 31 C.F.R. §1010.380(a)(2).
[28] Prop. 31 C.F.R. §1010.380(a)(3).
[29] *See* 31 U.S.C. §5336(b)(1)(D).
[30] Prop. 31 C.F.R. §1010.380(a)(2).

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nies. Practitioners should consider how this will influence their relationship with clients who engage them to organize corporations, limited liability companies, limited partnerships, and other business entities organized to protect the personal assets, but no longer the identities, of their owners.

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