Client Alert: The Corporate Transparency Act

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There are new federal reporting and compliance requirements that will impact many U.S. companies under the Corporate Transparency Act.

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The Corporate Transparency Act (the "Act") establishes reporting requirements for certain types of corporations, limited liability companies, and other similar entities created, or registered to do business in the United States. The Act became law in January 2021, and the U.S. Treasury's Financial Crimes Enforcement Network ("FINCEN") issued a proposed rule in December 2021 and a **final rule implementing the beneficial ownership information reporting requirements of the Act in September 2022. The regulations go into effect on January 1, 2024.**

Purpose of the Act:

To collect data and create a database of who owns the economic interest and, more importantly, who is in control of these vast number of entities that are created in the U.S. (35-40 million entities currently registered in the U.S.).

Focus of the Act:

The focus is on smaller businesses **that are created by filing a document**, typically with the Secretary of State, or other comparable agency. A substantial part is to gain information about the people in control.

The Act also applies to foreign entities that are required to register in the US to do business, but that is beyond the scope of this alert which is focused on domestic entities.

What is considered a smaller business?

Essentially, those that are not already heavily regulated by agencies already collecting the same kinds of information.

What is the nature of the information one must disclose?

The nature of the required information is the very information we are all told to keep private to prevent identity theft. If an individual is deemed a '**beneficial owner**' of a '**reporting company**' (a company that's subject to the law as detailed below), the individual must provide the following information and keep it current:

- Full legal name;
- Date of birth;
- A picture of an official ID card, which must be a driver's license issued by a state or a state ID (or Passport) that has the same name and date of birth on that document; and
- Residential address (not a PO Box or mailing address, must be your residential address).

If you are a reporting company that is subject to the Act, the beneficial owner information must be provided to the company, and the company must then provide it on a FINCEN beneficial ownership report and keep that information current. The reporting companies are generally responsible for that information and for keeping it up to date.

What are the deadlines?

An entity is a reporting company:

- If the entity **already exists** or **exists before January 1, 2024**, the entity has until **December 31, 2024** to file the initial report.
- If the entity is created **after January 1, 2024**, the entity has **30 days from formation** to file the initial report.

What about changes/amendments/modifications?

If there is a **change in the beneficial ownership** information, an entity has **30 days from the change** to update the report. This is an event driven law, not an annual (or other time-based) report.

Are there penalties for failure to comply?

Yes, and they can be severe. Not complying, providing false or fraudulent reports, or willfully failing to comply may result in fines of $500 a day for as long as the report is inaccurate, and that is just the civil penalty. Failure to comply may also be subject to criminal penalties up to a $10,000 fine or two years in jail.

Generally speaking, FINCEN is not after so-called "mom and pop" clients (unless they are money laundering), but the above stated consequences are the penalties for non-compliance.

If a mistake is made inadvertently or a false report is submitted, there is a safe harbor if a corrected

report is promptly and proactively consistent with FINCEN regulations no more than 90 days after the date of the submission of the inaccurate report. However, the safe harbor is only available to reporting companies that file corrected reports within that time frame, even if a correction is filed after becoming aware (or having reason to know) that it needs to be corrected. The regulations do not include any standard of good faith regarding the requirements to correct or update the reports.

Who is responsible for reporting?

The Act places the reporting responsibility squarely on **reporting companies**, including the obligation to accurately report and keep the reports up to date. For the most part, the requirements cover **beneficial owners** of these **reporting companies**. Most companies might have a couple of people that will fall under the beneficial owner definition. More on that below.

Practice Tip:

FINCEN provides an opportunity to take the responsibility from our reporting companies and move it to the individual (beneficial owner) to keep that personal information updated.

How do we shift that responsibility?

FINCEN has provided the ability for every individual to get a **FINCEN identification number** by providing FINCEN with:

- Full legal name
- Identification (US passport, driver's license, state ID card, or a foreign passport if available).

FINCEN will then issue a number so that the reporting company then needs only a **FINCEN number**, which means the individual will not have to disclose its residential address to the company, if an individual wishes to maintain privacy. If individual moves or changes its name, the individual has **30 days** to disclose such information to FINCEN.

Practice Tip:

It is a good idea for companies to require that anyone the company would otherwise need to report on to have a FINCEN number in order to protect the privacy of beneficial owners, and minimize inadvertent disclosure/data breach. We will need to rely on FINCEN to keep that information protected, but the company may not have the same level of protection to keep such information private.

Who is subject to the Act?

Reporting companies, beneficial owners and company applicants, unless one falls within an exemption.

Reporting Company:

The reporting company will include those registered entities noted above: LLC's LP's, certain corporations, Delaware business trusts, family offices, small businesses, or any other entity that has

to be registered with a state agency or equivalent (usually Secretary of State) unless you fall within an exception from the reporting requirements, such as "**large operating companies,**" publicly traded companies or entities in industries that are regulated by other agencies, for example. Charitable organizations, many other nonprofits such as private foundations, and trusts are generally not reporting companies and/or will fall within **the large operating company exception**.

What is a large operating company?

A large operating company includes a company that has:

- a physical presence in the US/the principal's office is in the US,
- $5 million of gross revenue with certain accounting adjustments (i.e., $5 million of gross revenue per your prior year's tax return, which can come from subsidiaries that flow up to the to the parent company)
- 20 full-time employees
  - Full-time is defined under the Affordable Care Act for this purpose, but generally, it includes people that work 30 hours a week/130 hours a month, and includes personal/paid time off; and
  - Note that the employees of your subsidiary companies **don't** count. You need to have those employees at the **company level** so if you only have 15 employees at the higher entity level, and 6 employees down in a subsidiary, you **have not** met this exception and **all** of the related entities are likely to be reporting companies.

However, if an entity has 20 employees at the company (as opposed to the subsidiary) level and the entity has $5 million of gross revenue, **all** of its wholly owned subsidiaries are automatically exempt.

Practice Tip:

If an entity can meet the large operating company exemption, **all** of the wholly owned subsidiaries are included. If someone outside of the specific company owns even 1%, that subsidiary is **not** exempt.

A Note about Holding Companies:

A potential concern for certain large operating companies is that a holding company might meet the revenue test by virtue of the flow up from subsidiaries, but they may not have any employees. So it will be important to first, determine how to restructure these companies to meet the large operating company exemption based on the employee criteria, and second, for those companies that are close to the $5 million revenue test, to evaluate its income and expenses, perhaps during the 4th quarter of the tax year, to determine whether any deferrals would be warranted.

A Note about Real Estate Investors:

Real estate investors, in particular, may be vulnerable to the reporting requirements under the Act, particularly in light of how real estate ownership is regularly structured.

Many real estate ownership entities will not be able to take advantage of the Act's exemptions and will be deemed reporting companies and therefore subject to the Act. Real estate is commonly owned

by single purpose private taxable entities (SPEs) without employees, as is typically required by third party mortgage lenders, and are without a physical office. Further, many real estate investments will not reach the $5 million revenue threshold since they do not include other assets that are unrelated to the real estate. Even if an SPE owns income producing property that reaches the $5 million revenue threshold, it is unlikely to have 20 full time employees. Those SPEs that do not fall within the exemptions will be deemed reporting companies, and beneficial owner information will likely need to be reported.

It is not uncommon for real estate SPEs to have only a few owners or even one sole owner. Therefore, most or all of the beneficial owners (i.e., those with an ownership interest of at least 25% and/or other control rights) will have to provide their beneficial owner information.

For those real estate entities that have only a few owners or control parties, putting aside privacy concerns, the information may not be terribly burdensome to gather and report, but for real estate investments that are put together by sponsors, the individual owners may be passive investors who are not commonly involved in the day-to-day, and often will not know each other. Sponsors may know the name, address, and tax identification number of each individual investor, but if the investor is an entity, particularly trusts, they may not have that information for its beneficiaries, and are unlikely to have copies of the required identification documentation.

There is also the issue of changes in ownership and update requirements for reporting. As a real estate fund is marketed, the beneficial ownership of early investors will likely (and frequently) change. Early investors may initially be 25% owners of the entity until they bring on additional investors, and new sales of units may require updates to the FINCEN report within 30 days of the change.

Practice tip:

For new real estate investors, gather the beneficial owner information during the initial questionnaire and investment process, or, better yet, require each investor to obtain their own FINCEN identifier number and provide it to the company, which may help to reduce privacy concerns and minimize data breach risk, by shifting the reporting burden to the individual. As new investments are offered, include these requirements in subscription agreements, offering materials, and entity documents and require the investors to keep the information updated. Be sure to include authorizations to provide the required information to FINCEN, in accordance with the Act, and update privacy protocols.

A Note about small businesses:

Although not the intended focus of the Act, many small operating businesses will also be subject to the act because they will not fit within the above exemptions, even if they have significant operations. A small retailer or service provider is unlikely to have $5 million in revenue or more than 20 full-time employees.

Practice Tip:

It is prudent to conduct an annual review to determine whether to take in income that year if an entity is a cash basis taxpayer, or to defer it to next year if the subsequent year may not be as

lucrative, to maximize the likelihood that the revenue threshold will be met. For expenses, an entity should also evaluate whether to take in expenses now or later. There may be some fine-tuning required to meet those requirements to fit within the exemption to bring a company outside of the reporting requirements.

Beneficial Owners and Company Applicants:

Company Applicants:

Another category of people that must provide the same type of information as a beneficial owner is **company applicants**. A company applicant is **the person who actually files the document** with the Secretary of State, and **the person who directs the filer**, if those are different people. Note that this is information only required for companies formed after January 1, 2024, so thankfully, this will not include previously formed entities.

Practice Tip:

Most law firms have multiple people involved in the formation process. In those cases, each of those people (paralegals, associates, partners, whomever is involved) can get their own FINCEN identifier number and provide that as part of the formation process, and to the companies, so the companies can also include them in their reports.

Beneficial Owners:

On its face, it may seem relatively easy and straightforward to figure out who the beneficial owners are, however, if one truly understands the scope of the Act, it is clearly not so simple in practice. Although a beneficial owner includes anyone who owns more than 25% of a company (easy to determine) it also includes two other categories which are harder to determine.

There are actually three categories of individuals (and this applies to individuals, even if the individual is working in a Trust Company) that are included as beneficial owners:

- An individual that **directly or indirectly owns more than 25% of the interests** in the company.
- The individual(s) that **actually control the more than 25% interest** in the company.
- Those individuals that **actually control the company** itself.

One individual might meet all three categories, or they might be completely different people. There may be one **legal owner** of the company but many people that could be deemed **beneficial owners.**

Direct or Indirect Ownership of More than 25% of the Interests in the Company:

Many businesses are comprised of pro-rata entities. In those cases, it may be fairly simple to determine who directly or indirectly owns more than 25% of the interest, particularly if those owners are individuals. If the owners are entities, or own different classes of interests, it becomes a little more complicated.

The test is individual by individual, and most indirect interests are likely to arise out of other entities

in which an individual has an interest, and from trusts as beneficiaries. Fortunately, there is no family attribution, so, by way of example, an individual's descendant's interest is not attributed to them.

Indirect Ownership:

An individual may indirectly own or control an interest in a reporting company in a many ways, including through another entity, joint ownership, certain trust arrangements, or as an intermediary, custodian, or agent on behalf of someone else in certain cases. Convertible instruments, warrants, and other purchase, sale or subscription rights may also be included, as are puts, calls, and other options to buy or sell interests, unless they are created and held by a third party without the reporting company's knowledge.

For indirect ownership through another entity, it will depend on the proportionate interest in such entity that owns the interest, and one would need to trace that through proportionately on a case by case basis to make the determination. Remember, it traces up to individuals for reporting purposes.

The rules provide that an individual who directly or indirectly exercises substantial control of a reporting company, including as a trustee of a trust or similar arrangement, would be a beneficial owner. Beneficial ownership interest in a trust is fairly narrowly described in the regulations.

- If an individual is the sole beneficiary, current beneficiary, the only one entitled to income or principal distributions, or have the right to demand a distribution or withdraw trust assets, it will be considered beneficiary owned or controlled;
- if an individual is a grantor, the right to revoke interest held in the trust, it would be deemed as owned or controlled by the grantor;
- **BUT** the regulations provide that these are only examples, and other beneficial interests involving trusts could be included later.

Practice Tip:

Ownership may also include less formal arrangements. An individual may provide funds to another to invest on their behalf, as an agent, intermediary, custodian, or otherwise. If for some reason the beneficial holder cannot be on the formal paperwork, but on a handshake, it is agreed with that the individual owns half the interests because they contributed half of the funds, that would also count, so informal arrangements that are similar to ownership have to be taken into consideration.

Control of the Interest:

To determine control of an interest, one must review who actually has the primary ability to dispose of that interest. Voting is certainly a consideration and can come up in less obvious ways. If a trustee of a trust has the power to dispose of an asset, the trustee is a beneficial owner, and even if a trust protector, an investment director, or the individual owns someone who has veto power over a disposition, even if under an informal arrangement where a friendly party agrees they will follow instructions of another, such individual will be deemed to be in control of that interest.

Control of the Company:

The Regulations provide that the following are included as controlling the company:

- Senior officers, including the President, CEO, CFO, COO, general counsel, or anyone else holding a similar position, or those powers or authority, even under a different name or title.
- If one has the ability to vote on, to set the compensation of, or to remove and replace a senior officer, or a majority of the board of directors, manager, or equivalent.
- If one directs, determines, or has a substantial effect on important matters or substantial control over the company.

Practice Tip:

The control threshold could, as a practical matter, bring in all members of an LLC, even if an entity has five members that each have a 20% vote, with none of them owning more than 25%. The regulations provide that if multiple individuals can exercise the power(s) together, each has an equal vote, or all participate in that vote, they will attribute that power to all individuals.

Further, regarding those who have possible influence or direction over **major decisions** within the entity, the regulations suggest that under certain covenants in a lending agreement, the lender might now have some control over the company, and there are other contractual arrangements that could bring someone else in. Mere lenders of money with a security interest would probably not be included, nor would mere professional advisors, unless they fall into some other category. Regardless of how an individual describes themself and their role, they might fall into that range if they have in place substantial **control agreements**. Obviously, care needs to be given to evaluating who can make those kinds of decisions in the entity, even if they do not have an obvious title.

Who has access/Is this public information?

No, this is not public information. Although there is sufficient intrusiveness introduced by these regulations to cause panic, there is some good news. The Act only allows **access** to the beneficial ownership information in the FINCEN database **by law enforcement and taxing agencies** (it is not a public database and not just for curious spectators for commercial purposes).

The Act authorizes FINCEN to collect the information and disclose it to “authorized government authorities and financial institutions, subject to effective safeguards and controls” in order to “provide essential information to law enforcement, national security agencies, and others to help prevent criminals, terrorists, proliferators, and corrupt oligarchs from hiding illicit money or other property in the United States” as FINCEN has stated.

This information is not public and is to be kept by the government for law enforcement type purposes. There is certainly a concern about data breach, particularly because even the IRS has not always managed to keep taxpayer information secret, so it will certainly be a challenge, and will require significant funding of FINCEN to implement, but comfort can be found in the fact that it is not a database that is accessible by the general public.

Practice Tip:

- Determine whether an entity is a reporting company, and whether it can be structured to fall within

an exception.
- Take care to determine and structure who the beneficial owners are, whether through direct or indirect pro rata economic ownership or through control.
- Identify one's clients and verify that identity (i.e., get a copy of their identification with proof of residence).

Note that this type of reporting system already exists in areas outside of the U.S. with KYC (Know Your Client/Customer), Anti-Money Laundering and Anti-Terrorism regulations. Sometimes the process goes even further. In some areas, if one suspects that one's client has engaged in money laundering or criminal conduct, one must tell the government and practitioners are prohibited from warning their client ("suspicious activity reporting"). There are systems in place with extensive rules on how identity must be identified and certified, and how to determine the beneficial owners, sometimes requiring substantial due diligence.

If practitioners or their clients have been involved in commercial transactions in Europe, they are probably already familiar with these processes. In some cases, an advisor (or other 'qualified' person) must certify the identification documents and residences and provide a reference letter confirming that the individual has not been engaged in any money laundering or criminal conduct. Indeed, I have personally been required to provide this information on behalf of some of our firm's U.S. clients as part of the KYC reporting and onboarding process in connection with their European commercial and investment transactions.

Thankfully, all these requirements have not yet made their way to the United States, but that may change very quickly. It is always prudent practice to know your one's clients, their entities and investment vehicles and their general business purposes. Now there is no choice as the Act requires a deeper dive into the entities practitioners create and who owns and controls them.

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Please feel free to contact me at (212) 994-9963, x204 or at eschajer@federmansteifman.com if you would like to discuss further.

If you would like to further explore the final Rule, you can view it here: Beneficial Ownership Information Reporting | FinCEN.gov.

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