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The New Corporate Transparency Act: Tax and Wealth Management Considerations for Owners of Closely Held Corporations, LLCs, Partnerships and Other Entities and Creators, Trustees and Beneficiaries of Trusts

By Erica Howard-Potter

The Corporate Transparency Act (the "Act") was enacted by Congress on January 1, 2021 as part of the National Defense Authorization Act, overriding then-President Trump's earlier veto. (A prior version of the Act had originally been passed by the House of Representatives in 2019.) The purpose of the Act, as its name suggests, is to collect information and lift the curtain on owners of corporations, limited liability companies ("LLCs") and other entities (collectively referred to herein as "Entities") in an effort to curb illegal activities such as money laundering, tax fraud, human and drug trafficking, financing terrorism and other serious crimes. **The Act's broad reach will affect many companies and individuals, far beyond those engaged in illegal activity.**

BACKGROUND

The Act was adopted about 15 years after the Financial Action Task Force on Money Laundering (generally known as "FATF"), of which the United States is a member, publicly criticized the United States for its failure to comply with international anti-money laundering standards. The European Union and other countries throughout the world have enacted similar laws long ago.[1]

The Act will have a far-reaching impact. It is aimed primarily at reducing the United States' vulnerability to "malign actors" who, for illegal purposes, may conceal their ownership or control of companies. However, in order to protect against illegal activity, a broad range of companies and individuals will be required by the Act to disclose and report identifying information. For example, the comprehensive scope of the Act raises questions about whether disclosure will be mandated for trusts owning interests in family limited partnerships, among other possible effects of the new law.

This article will provide an overview of the Act and focus on the potential effects on tax and wealth management clients and advisors.

WHO IS COVERED BY THE ACT?

Under the Act, all "reporting companies" must submit a report to the Financial Crimes Enforcement Network of the U.S. Department of the Treasury ("FinCEN") containing certain identifying information for each of the company's "applicants" and "beneficial owners." (An applicant is not necessarily a beneficial owner, and vice versa.)

An applicant is the individual who:

a) for Entities formed in the United States (under the laws of a state or Indian Tribe), files an application to form the Entity; or

b) for foreign Entities, registers or files an application to register an Entity to do business in the United States.

A beneficial owner is any individual who, directly or indirectly, exercises substantial control over the Entity

[1] Similar measures are already in effect in all 28 European Union member countries, Australia, South Africa, much of Asia and parts of South America.

or owns or controls at least 25 percent of the ownership interests of the Entity. An individual will not be considered a beneficial owner of an Entity if the individual is:

a) a minor child (and the relevant information of his or her parent or guardian is reported);

b) a nominee, custodian or similar agent acting on behalf of another;

c) an employee whose control/economic benefits derive solely from his or her employment status;

d) one whose only interest is through a right of inheritance; or

e) a creditor of the Entity (that does not otherwise meet the control or ownership requirements).

Reporting companies generally include any Entity formed in the United States (under the law of a state or Indian Tribe) or formed outside of the United States and registered to do business in the United States. Excluded from the definition of reporting companies are:

- publicly traded companies;
- tax-exempt entities (and entities owned or controlled by tax-exempt entities);
- certain Entities already heavily regulated (for example, by the Securities and Exchange Commission), such as banks, insurance companies, utility companies, credit unions, broker-dealers and investment advisors, as well as others;
- dormant companies, which include those Entities that (a) have been in existence at least one year, (b) are not engaged in active business, (c) are not owned, either directly or indirectly, by a foreign person, (d) have had no change in ownership over the past year, (e) have not sent or received funds in excess of $1,000, and (f) do not own assets of any kind; and
- Entities (a) with more than 20 full-time employees in the United States, (b) that reported more than $5 million in gross receipts or sales on the previous year's federal income tax return, and (c) that have an operating presence at a physical location in the United States.

It is anticipated that once the necessary regulations are promulgated (more on that below), additional Entities will be excluded from the definition of "reporting company."

For tax and wealth management purposes, companies and individuals may need to report under the Act in situations such as the following. Note that these examples are speculative and that final regulations are needed to determine exactly who will or will not be covered by the Act. Examples of those who need to report may include:

- Closely held family businesses with fewer than 20 employees, regardless of when the business was started.
- LLCs created as estate planning vehicles, both before and after gifts of the LLC interests are made.
- Attorneys who form single-member LLCs on behalf of their clients.

WHAT WILL HAPPEN UNDER THE ACT?

Required Reports. Once it is determined that an Entity is a reporting company, the Entity is required to file a report with FinCEN identifying each beneficial owner and applicant of the Entity. The report must include, for each applicant and beneficial owner, his or her:

a) full legal name;

b) date of birth;

c) current residential or business address; and

d) identification number from (i) a non-expired United States or foreign passport, (ii) a non-expired state driver's license (no foreign driver's licenses), (iii) a non-expired identification document (issued by a state, local government, or Indian Tribe – no foreign identification documents), or (iv) a FinCEN identifier (issued by FinCEN upon request).

Any Entity that is not a reporting company is exempt from the reporting requirement under the Act unless it has an ownership interest in a reporting company. In that case, the reporting company or applicant is required to disclose the name of the exempt Entity but no other information with respect to such Entity (such as its applicant or beneficial owners).

Penalties. There are both civil and criminal penalties for willfully failing to comply with the Act and/or providing false or fraudulent information to FinCEN. This includes civil fines of up to $500 per day for non-compliance and criminal fines of up to $10,000 and/or possible imprisonment of up to two years.

Government Storage and Confidentiality. FinCEN will store all information collected for each Entity until at least the fifth anniversary of the date on which the Entity terminates. Information reported as required by the Act is to remain confidential, unlike several other jurisdictions around the world where the information collected is publicly available. There are serious civil and criminal penalties imposed on anyone who knowingly discloses or uses the information.[2]

IMPLEMENTATION AND DEADLINES

The Act requires the Secretary of the Treasury to promulgate regulations further delineating the scope of the Act on or before the first anniversary of the enactment of the Act (*i.e.*, on or before January 1, 2022). The effective date of those regulations triggers the reporting requirements of the Act (the "Effective Date"). In other words, there is nothing to do just yet!

All new Entities formed after the Effective Date that are reporting companies must submit the required report to FinCEN at the time of formation or registration.

Existing Entities that are reporting companies must, within two years of the Effective Date, submit the required report to FinCEN.

In addition, an Entity that has filed a report with FinCEN must submit an updated report to FinCEN if any information on the report changes. The updated report must be filed within one year after the date which causes the change in information as originally reported.

HOW WILL THIS AFFECT YOU?

So, how will the Act affect you? That depends, and until the regulations are issued, there are more questions than answers.

In the first instance, do you own a substantial interest in or have control over any Entity that is within the definition of a reporting company? Or were you responsible for creating such an entity (by, for example, filing a certificate of formation while acting as an authorized person for a client)? These answers may not be as simple as you would expect.

The Act applies to corporations, LLCs and similar entities, but it is not entirely clear what is considered a "similar entity." So, if you have the requisite ownership interest in or control over a corporation or LLC, then it *will* be necessary to comply with the reporting requirements of the Act. That much is clear.

But what if your ownership interest is in a partnership? The Act is not specific, though presumably partnerships would fall within the purview of the Act since they are sufficiently similar to corporations and LLCs.

What about interests in trusts (other than charitable and split-interest trusts, which are specifically excluded from the Act)? In all likelihood, a trust would not be considered a reporting company because it is typically not a "similar entity" to a corporation or LLC (though there are exceptions to this general rule for certain business trust arrangements). However, it is possible that a trust may own a significant enough interest in a reporting company, requiring information regarding the trust to be included in the report filed with FinCEN. In that case, what must be reported? The name of the trust creator (typically referred to as the "grantor" or the "settlor" of the trust)? The name of the trustee(s)? The trust beneficiaries (and, if so, is it just current beneficiaries or also future beneficiaries)?

[2] The Act permits disclosure in furtherance of the purposes of the Act, such as disclosure to a federal law enforcement agency upon request for use in furtherance of its law enforcement activity or a request by a financial institution to ensure compliance with customer due diligence requirements.

Does it matter whether or not the trust is treated as a grantor trust for income tax purposes? (This final issue should not be a determining factor, in my opinion.)

Moreover, what does exercising "substantial control" over an Entity mean? The Act specifically provides that each individual who owns or controls at least 25 percent of an Entity is by definition a beneficial owner. But there is no delineated threshold for "substantial control," which means that individuals with no ownership interest could be treated as beneficial owners. For instance, does being a manager, but not an owner, of an LLC constitute substantial control?

In addition, many attorneys, advisors and other authorized persons who are not shareholders, members or owners regularly act as entity organizers for the sake of convenience. These organizers come within the definition of "applicant" under the Act and, therefore, it appears, must be identified in the report filed with FinCEN. If you acted as an organizer for someone else (such as a client), are you now responsible for making sure that the entity is compliant with the Act? Is there a consequence to you if the entity files the report with FinCEN and does not include your information? The limits, if any, on this requirement are unclear.

For example, for very old reporting entities that will now be required to file a report, is it necessary to identify an organizer who filed the initial paperwork? What if that person can no longer be found (so the required information is unavailable)? Or what if the organizer refuses to cooperate? To require those with significant economic interests in an entity to comply seems reasonable, but it seems onerous and unfair to require compliance by an individual who created an entity for a client 20 years ago. What is the consequence for failing or refusing to comply in these situations?

Moreover, does an attorney who advised a client to create an entity that is now subject to the Act have an obligation to track down each such client and advise the client of his, her or its obligations under the Act?

POSSIBLE NEXT STEPS FOR COMPANIES AND INDIVIDUALS

Presumably, the various open questions will be answered when the regulations are issued. In the meantime, for persons involved in the creation or oversight of entities likely subject to the Act, it would be prudent to at least create a list of such entities so as to be ready when the regulations come out.

It is possible that certain entities will be "grandfathered" out of having to comply. The regulations could end up allowing, for example, any entity formed before a given date to only report relevant changes to the ownership/control structure. But until these clarifications are provided, we should assume that any entity meeting the definition of a reporting company will be required to file the FinCEN report.

For those who own interests in Entities that definitely are or likely will be subject to the reporting requirements of the Act, consider acting now to collect the relevant information required to be reported for each applicant and beneficial owner. This preparation may prove especially useful for those individuals who are difficult to find or are deceased. Being prepared with the relevant information now will avoid a scramble later.

And for situations where current beneficial owners are preparing to make gifts or sales of significant interests in existing Entities, it may help to do so now, before the requirements of the Act are in force. Engaging in these preparations now will avoid multiple filings with FinCEN (namely, an initial filing to comply and then a subsequent filing to report the change in beneficial ownership). While it is unlikely that multiple filings will pose a real hardship, effectuating anticipated transactions now might prevent confusion potentially caused by additional paperwork and filings, over and above all of the necessary "red tape" currently required by other laws.

In general, a wide range of companies and individuals should consult with legal counsel to understand the Act and how it may affect them. ◆

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