Patterson Belknap Webb & Tyler LLP

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FinCEN Issues Notice of Proposed New Beneficial Ownership Information Reporting Requirements Under the Corporate Transparency Act

Introduction

The Financial Crimes Enforcement Network ("FinCEN"), a bureau of the United States Department of the Treasury, published a Notice of Proposed Rulemaking (the "Proposed Rules") on December 8, 2021 in the Federal Register.[1] The Proposed Rules would implement the requirements in the Corporate Transparency Act ("CTA") that certain domestic and foreign entities submit beneficial ownership information and company applicant information to FinCEN.

The Proposed Rules would impose filing obligations on start-up companies, smaller operating businesses, holding companies and other entities that do not fit into one of the exemptions described below. These entities would need to file certain information with respect to beneficial owners and applicants (individuals who do the filings to form or register the entity).

The information that FinCEN will collect will be held in a non-public database and will be disclosed to certain government agencies for those purposes specified in the CTA as well as to financial institutions to assist them in meeting their customer due diligence requirements. The Proposed Rules are intended to "protect U.S. national security, provide critical information to law enforcement, and promote financial transparency and compliance."[2]

FinCEN intends to issue three sets of rules to fully implement the requirements of the CTA. The first set of rules – and the subject of this alert – will implement the beneficial ownership information reporting requirements for the applicable reporting companies, the second set of rules will implement the CTA's protocols for access to, and disclosure of, the collected beneficial ownership information, and the third set of rules will revise the existing Customer Due Diligence rule to align it with the requirements of the CTA. FinCEN is only seeking comment on the first set of rules, which are due by February 7, 2022.

Reporting Company

The reporting requirements would apply to both domestic "reporting companies" and foreign companies that have registered to do business in the United States.

Domestic reporting company

The CTA defines a reporting company as "a corporation, limited liability company, or other similar entity" that is "created by the filing of a document with a secretary of state or a similar office under the law of a State or Indian Tribe."[3] As the CTA does not define "corporation" or "limited liability company", the Proposed Rules intend to interpret these terms by reference to the governing law of the jurisdiction in which a domestic reporting company that is a corporation or limited liability company is formed.[4] The Proposed Rules do not define "similar entity"; however, they state that such term refers to "any entity that is created by the filing of a document with a secretary of state or similar office."[5] FinCEN states in the Proposed Rules that the definition of domestic reporting company would, in addition to corporations and limited liability companies, likely include limited liability partnerships, limited liability limited partnerships, business trusts, and most limited partnerships.[6]

Foreign reporting company

The Proposed Rules define a foreign reporting company as "any entity that is a corporation, limited liability company, or other entity that is formed under the law of a foreign country and that is registered to do business in the United States by the filing of a document with a secretary of state or equivalent office under the law of a state or Indian Tribe."[7]

Exemptions

The CTA excludes the following twenty-three entities from the definition of "reporting company" which FinCEN proposes to adopt in the final rules, with clarifying language for certain entity types as noted below:

1. securities issuers with any class of securities registered under Section 12 or subject to Section 15(d) of the Securities Exchange Act of 1934, as amended (e.g., public reporting companies)[8];
2. domestic governmental authorities;
3. banks;
4. domestic credit unions;
5. depository institution holding companies;
6. money transmitting businesses;
7. brokers or dealers in securities;
8. securities exchange or clearing agencies;
9. other Securities Exchange Act of 1934 entities;
10. registered investment companies and advisers;
11. venture capital fund advisers;
12. insurance companies;
13. state licensed insurance producers;
14. Commodity Exchange Act registered entities;
15. accounting firms;
16. public utilities;
17. financial market utilities;
18. pooled investment vehicles;
19. tax exempt entities that are (a) described in section 501(c) of the Internal Revenue Code of 1986, as amended (the "Code"), and exempt from tax under Section 501(a) of the Code, (b) political organizations, as defined in

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section 527(e)(1) of the Code, that are exempt from tax under section 527(a) of the Code, or (c) a trust described in paragraphs (1) or (2) of section 4947(a) of the Code[9];

20. entities assisting tax exempt entities;

21. large operating companies that (a) employ more than 20 employees on a full-time basis in the U.S., (b) who have filed in the previous year U.S. federal income tax returns demonstrating more than $5,000,000 in gross receipts or sales in the aggregate, including the receipts or sales of other entities owned by the entity and through which the entity operates, and (c) who have an operating presence at a physical office within the U.S.;

22. subsidiaries of certain exempt entities (FinCEN proposes to clarify this exemption by requiring any subsidiary that claims this exemption to be owned entirely by one or more specified exempt entities); and

23. inactive businesses that (a) are in existence for over one year, (b) are not engaged in active business, (c) are not owned, directly or indirectly, by a foreign person, (d) have not, in the preceding 12-month period, experienced a change in ownership, (e) have not, in the preceding 12-month period, sent or received more than $1,000, and (f) do not otherwise hold assets of any type (including equity in another entity). FinCEN proposes to interpret the first prong of this exemption as applying to the one-year period before enactment of the CTA. FinCEN proposes to interpret the 12-month period in the fourth prong as applying to any 12-month period.[10]

While the CTA reserves for additional exemptions that the Secretary of Treasury, with the written concurrence of the Attorney General and the Secretary of Homeland Security may later adopt, FinCEN states in the Proposed Rules that it does not anticipate creating any additional exemptions in the final rules.

Information to be Reported

As mandated by the CTA, the Proposed Rules require a reporting company to submit to FinCEN a report identifying each beneficial owner of the reporting company and each company applicant by:

- full legal name;
- date of birth;
- current residential or business street address; and
- unique identifying number from an acceptable identification document; or, if this information has already been provided to FinCEN, by a FinCEN identifier.[11]

Beneficial Owners

The CTA defines a beneficial owner for a reporting company as "any individual who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise (i) exercises substantial control over the entity; or (ii) owns or controls not less than 25% of the ownership interests of the entity".[12] However, the CTA does not define the terms "substantial control" or "ownership interests". Therefore, FinCEN has defined these terms in the Proposed Rules. The Proposed Rules would require a reporting company to identify any beneficial owner who satisfies either of these two components.

Substantial Control

The Proposed Rules list three specific indicators of "substantial control": "(1) service as a senior officer of a reporting company; (2) authority over the appointment or removal of any senior officer or dominant majority of the board of directors (or similar body) of a reporting company; and (3) direction, determination, or decision of, or substantial influence over, important matters of a reporting company".[13] The Proposed Rules also include a catch-all provision to make clear that substantial control can take additional forms not specifically listed. FinCEN wants a reporting company to identify those individuals who stand behind the reporting company and directs its actions either directly or indirectly.

Ownership Interests

"Ownership interests" for the purposes of the Proposed Rules would "include both equity in the reporting company and other types of interests, such as capital or profit interests (including partnership interests) or convertible instruments, warrants or rights, or other options or privileges to acquire equity, capital, or other interests in a reporting company. Debt instruments are included if they enable the holder to exercise the same rights as one of the specified equity or other interests, including the ability to convert the instrument into one of the specified equity or other interests."[14] FinCEN's stated goal in adopting this definition is to ensure that the underlying reality of ownership, not the form it takes, drives the identification of beneficial ownership. FinCEN believes that this approach will thwart the use of complex ownership structures and ownership vehicles to obscure a reporting company's real owners and what is ultimately disclosed to FinCEN.

Exceptions to Proposed Definition of Beneficial Owner

The Proposed Rules provide the following five exceptions to its definition of beneficial owner:

1. Minor Children: information on minor children does not need to be reported provided that the reporting company reports the required information for a parent or legal guardian of such minor child.[15]

2. Nominee: With respect to the exception for an individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual, FinCEN notes that the CTA affirms that reporting companies must report real parties in interest who exercise control indirectly.[16]

3. Employees: The CTA exempts from the definition of a beneficial owner an employee of a reporting company, "acting solely as an employee" whose "control over or economic benefits from" a reporting company are derived solely from their employment status. The Proposed Rules clarify this exemption by using "substantial" to modify "control" so that this is not the same level of "control" as "substantial control" over a reporting company. The Proposed Rules further clarify this exemption by stating that a person acting as a senior officer of a reporting company cannot avail themselves of such exemption.[17]

4. Inheritance: The CTA's definition of beneficial owner excludes "an individual whose only interest…is through a right of inheritance."[18] The Proposed Rules clarify that this exception refers to a "future" interest associated with a right of inheritance, not a present interest that a person may acquire as a result of exercising such a right. However, once ownership interest is inherited and comes to be owned by an individual, such individual has the same relationship to an entity as any other individual who acquires an ownership interest through another means and, therefore, can no longer avail themselves of such exemption.[19]

5. Creditors: The CTA's definition of beneficial owner excludes a creditor of a reporting company unless the creditor exercises substantial control over the entity or owns or controls 25% of the entity's ownership interests.[20] However, the CTA does not define the term "creditor". The Proposed Rules remedy this by clarifying that an exempt creditor is an individual who meets the definition of beneficial owner solely through rights or interests in the reporting company for the payment of a pre-determined sum of money, such as a debt and the payment of interest on such debt. The Proposed Rules clarify that any capital interest in the reporting company, or any right or interest in the value of the reporting company or its profits, would not be considered rights or interests for payment of a pre-determined sum, regardless of whether they take the form of a debt instrument.

Accordingly, if an individual has a right or ability to convert the right to payment of a pre-determined sum to any form of ownership interest in such reporting company, that would prevent that individual from claiming the creditor exception.

Company Applicant

The Proposed Rules define a company applicant as "any individual who files a document that creates a domestic reporting company or who first registers a foreign reporting company with a secretary of state or similar office in the United States."[21] The proposed definition of company applicant would also include "any individual who directs or controls the filing of such a document by another person".[22] FinCEN's aim in requiring this information is to ensure that the reporting company provides information on individuals who are responsible for the decision to form a reporting company given that, in many cases, the company applicant may be an employee of a business formation service or law firm, or an associate, agent, or family member who is filing the document on behalf of another individual. FinCEN believes that disclosure of the information about the person exercising such direction or control about the formation or registration of the applicable reporting company would be useful to law enforcement and other governmental agencies as they may be able to draw connections between seemingly unrelated reporting companies, beneficial owners, and company applicants from this additional disclosure.

Timing of reports, updates, and corrections

Initial Report

The Proposed Rules outline the following timing requirements for a reporting company's initial report:

- Any domestic reporting company created before the effective date of the final rules and any entity that became a foreign reporting company before the effective date of the final rules would be required to file a report no later than one year after the effective date of the final rules.[23]

- Any domestic reporting company or foreign reporting company formed or registered, as the case may be, after the effective date of the final rules will need to file its report within 14 calendar days of the date it was formed or registered, as applicable.[24]

- An entity that can no longer claim one or more exemptions must file its initial report within 30 calendar days after the date on which it no longer meets its applicable exemption criteria.[25]

Updates & corrections

The Proposed Rules contain the following rules for a reporting company to file an updated report or to correct a previously filed report:

- An updated report will need to be filed within 30 days after the date on which there is any change to any information previously filed with FinCEN, including any change with respect to who is a beneficial owner of a reporting company, as well as any change with respect to information reported for any particular beneficial owner. An updated report will also need to be filed if a reporting company becomes exempt after the filing of its initial report.

- A report to correct inaccurately filed information within 14 days after the date on which the reporting company becomes aware or has reason to know that any information contained in a previously filed report was inaccurate when filed and remains inaccurate.

Reporting Violations

The CTA makes it unlawful for any person to "willfully provide, or attempt to provide, false or fraudulent beneficial ownership information…to FinCEN" or to "willfully fail to report complete or updated beneficial ownership information to FinCEN."[26] The CTA provides for a civil penalty of up to $500 for each day a violation continues or has not been remedied, and such violator may be fined up to $10,000 and imprisoned for up to two years, or both, for a criminal violation.[27]

Under the Proposed Rules, "person" includes any individual, reporting company, or other entity. The term "beneficial ownership information" under the Proposed Rules would include any information provided to FinCEN. The Proposed Rules also clarify that a person who willfully provides false or fraudulent information directly or indirectly to the reporting company will be liable for such action. Lastly, if a person willfully directs a reporting company not to report, or willfully fails to report while in substantial control of such reporting company, they will be subject to the aforementioned civil and/or criminal penalties.[28]

The CTA provides a safe harbor if a report that contains inaccurate information is voluntarily corrected within 90 days after the date on which the report was submitted to FinCEN, so long as the incorrect report was not submitted to evade the reporting requirements or with actual knowledge that it contained false or inaccurate information.[29]

Conclusion

FinCEN will likely issue final regulations in 2022, so reporting companies and their beneficial owners and applicants should begin to collect the necessary information to make their initial filings. We will continue to monitor developments in this arena and will report on the new rules when promulgated.

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[1] Proposed Rules, "Beneficial Ownership Information Reporting Requirements", 86 Fed. Reg. 69,920 (Dec. 8, 2021), available at https://www.govinfo.gov/content/pkg/FR-2021-12-08/pdf/2021-26548.pdf.

[2] *Id*. at 69,920.

[3] 31 U.S.C. 5336(a)(11)(A)(i)–(ii).

[4] Proposed Rules at 69,938.

[5] *Id*. at 69,938.

[6] *Id*. at 69,938, 69,939.

[7] *Id*. at 69,939.

[8] *Id*. at 69,971.

[9] *Id*. at 69,972.

[10] 31 U.S.C. 5336(a)(11)(B)(i)–(xxiii); Proposed Rules at 69,939-69,940.

[11] 31 U.S.C. 5336(b)(1)(A); 31 U.S.C. 5336(b)(2); *Id*. at 69,929, 69,930.

[12] 31 U.S.C. 5336(a)(3)(A); Proposed Rules at 69,933.

[13] Proposed Rules at 69,933, 69,343.

[14] *Id*. at 69,935.

[15] *Id*. at 69,936.

[16] *Id*. at 69,936.

[17] *Id*. at 69,936, 69,937.

[18] 31 U.S.C. 5336(a)(3)(B)(iv).

[19] Proposed Rules at 69,937.

[20] 31 U.S.C. 5336(a)(3)(B)(v).

[21] *Id*. at 69,937, 69,938.

[22] *Id*. at 69,938.

[23] *Id*. at 69,941.

[24] *Id*. at 69,9341.

[25] *Id*. at 69,942.

[26] 31 U.S.C. 5336(h)(1); Proposed Rules at 69,944.

[27] 31 U.S.C. 5336(h)(3)(A).

[28] Proposed Rules at 69,944.

[29] 31 U.S.C. 5336(h)(3)(C).

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