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Reporting beneficial owners of certain US companies: observations relevant to private client structures

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Introduction

The first part of this series summarised details of the new Corporate Transparency Act (CTA) requirement to report beneficial owners of certain US companies, which became law on 1 January 2021 (for further details please see "Reporting beneficial owners of certain US companies – details of new Corporate Transparency Act"). This article considers aspects of the CTA, such as the broad definition of 'beneficial owner' when applied to trusts, privacy concerns and further compliance responsibilities that may be of interest in the context of family succession planning structures that include entities established under the laws of a US state.

Questions and uncertainty around the CTA's broad definition of beneficial owner

It is a 'reporting company' as defined by the CTA that must provide details regarding its beneficial owner. The CTA defines a 'beneficial owner' of a reporting company as an individual who, directly or indirectly – through any contract, arrangement, understanding, relationship or otherwise – exercises substantial control over the entity or owns or controls no less than 25% of the ownership interests of the entity. The CTA does not define or provide further illustration for what is meant by 'exercises substantial control'. Given the two-prong definition, exercising 'substantial control' is different from controlling 'not less than 25 percent of the ownership interests'. In addition, since both ownership and control may be held 'indirectly', some sort of attribution or look-through mechanism must be applicable. The CTA itself does not provide any details on indirect or constructive ownership.

Trusts owning a reporting company

Trusts themselves should generally not be considered a reporting company because most trust formations do not require the filing of a state document. However, it is unclear how the CTA will treat trust ownership of a reporting company. For example, if a trust owns shares of a reporting company, the statute is silent as to which individuals (eg, beneficiaries, settlor, trustee, investment director) the CTA will treat as indirectly owning or controlling the reporting company. Given the stated purpose of the CTA to combat abuse of anonymous companies, it is likely that someone is going to have to be reported.

At a high level, the CTA is looking for individuals who are significantly connected with a reportable company. The connection could be through "any contract, arrangement, understanding, relationship, or otherwise", directly or indirectly. At a minimum, the CTA's definition of 'beneficial owner' seems broad enough to require consideration of domestic and foreign trusts, estates and other forms of control or ownership agreement, such as stockholder agreements, voter agreements, articles, bylaws, LLC operating agreements, side letters or control restrictions in parent entities, not to mention control provisions found within trust deeds, wills and divorce or separation agreements.

Trustee

Under the Financial Crimes Enforcement Network's (FinCEN's) current Customer Due Diligence (CDD) Rule (issued in 2016), which imposes obligations on US financial institutions to identify and verify beneficial ownership information for their legal entity customers at the time of opening a new account, if a trust owns directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, 25% or more of the equity interests of a legal entity customer, the beneficial owner is the trustee. Perhaps the CTA will take the same approach.

Investment director

Trusts, especially those established under the law of a US state with a US-directed trust company trustee, will often have a fiduciary known as an 'investment director' who has sole responsibility for directing the acquisition and sale of the reporting company stock and how such stock is to be voted. Such an investment director certainly seems to be exercising substantial control over the entity or controlling the ownership interests. Perhaps a reporting company will have to report an individual investment director's name, birth date, address and passport number to FinCEN.

Beneficiary

The definition of 'beneficial owner' in an earlier version of the CTA (HR 2513), not finally adopted, had a third prong for individuals who "receive substantial economic benefits from the assets of a corporation or limited liability company". Here, 'substantial economic benefit' meant that "the person has an entitlement to more than a specified percentage of the funds or assets of the corporation or limited liability company, which the Secretary of the Treasury shall, by rule, establish".

The fact that the final CTA did not include this economic benefit prong could speak to the continuing struggle to apply the rules to beneficiaries of trusts that hold reporting companies. For example, in the case of passive foreign investment companies (PFICs) owned by trusts, it is possible for discretionary beneficiaries of foreign non-grantor trusts to be deemed owners of the underlying PFICs, triggering tax consequences and reporting obligations (for further details please see "Need for regulations on taxation of US beneficiaries of foreign trusts owning PFICs"). Perhaps the exclusion of an economic benefit prong means that the CTA will not cast such a wide net.

The CTA as enacted specifically excludes from the definition of 'beneficial owner' an "individual whose only interest in a corporation, limited liability company, or other similar entity is through a right of inheritance". Clarification is needed as to what is meant by a 'right of inheritance' and whether this includes the interest of trust beneficiaries. It is worth noting that under the existing CDD Rule, FinCEN does not require financial institutions to look through non-statutory trusts to identify beneficiaries. Perhaps this will also be the case under the CTA.

Settlor

The reference in the CTA definition of 'beneficial owner' to "indirectly" signals that the government intends to look through the chain of ownership entities and intermediaries to identify the natural individuals significantly connected to the reporting company. This may be similar in application to the US grantor trust tax rules where certain settlors are taxed for US income tax purposes as if the settlor still owned the trust property (for further details please see "Overview (January 2021)"). Perhaps the individual treated as the owner of trust income for US tax purposes will also be considered the beneficial owner of a reporting company owned by the trust for purposes of the CTA.

Privacy concerns and potential misuse

Many advisers to international families are conscientious about maintaining the family's privacy, both their personal and financial details. The CTA is careful to describe the required security, checks and balances and intention for beneficial ownership information to remain non-public and secure. The CTA specifically defines the different government, legal and financial organisations that may request access to the beneficial owner database (for further details please see "Reporting beneficial owners of certain US companies – details of new Corporate Transparency Act"). There are penalties for unlawful disclosure by any government employee or third party with access, although the unlawful disclosure penalties are not that much more than the reporting penalties ($500 for each day that the violation continues, capped at $250,000 with five years in prison). However, the fact remains that confidential and private information could make its way into the public sphere.

FinCEN may disclose beneficial ownership information to US federal agencies requesting information on behalf of a non-US law enforcement agency. In deciding whether to continue to use US holding companies, some international families may give extra weight to this avenue of disclosure given experiences in their home countries.

FinCEN may also disclose beneficial ownership information to US financial institutions subject to FinCEN's CDD Rule, with the consent of the reporting company, to meet those CDD requirements. This will help US financial institutions to identify and verify beneficial owners of legal entity customers under the obligations already imposed on the financial institutions by the CDD Rule, but it also means transferring data that could be subject to breach.

Given the sheer number of those employed by governments and financial institutions with potential access to this information, the risk of someone unlawfully disclosing information is real. Exposing the identity of certain beneficial owners could create serious safety and economic risks to them and their families, in addition to their businesses. Many families were negatively affected by past leaks known as the 'Panama Papers' and 'Paradise Papers'. Most recently, FinCEN itself had documents leaked and globally publicised in September 2020. And unfortunately, despite the potential risks and costs associated with the disclosure required under the CTA, bad actors may not report their true identity anyway, making this new reporting regime less effective.

Yet another compliance reporting obligation with penalties for failure to file

The CTA effectively shifts the existing burden of collecting and reporting beneficial ownership information from financial institutions under the current CDD Rule and other anti-money laundering guidelines to the reporting companies. While the CTA does not completely eliminate the CDD imposed on the financial institutions, it requires FinCEN to revise the rule to "reduce any burdens on financial institutions that are, in light of the enactment of the [CTA], unnecessary or duplicative".

The CTA requires the reporting entity itself to identify both the applicant (attorney, banker, lawyer, trustee or anyone else who files to create the US company) and its beneficial owners, with potential civil and criminal penalties for failure to file or filing false information (for further details please see "Reporting beneficial owners of certain US companies – details of new Corporate Transparency Act"). While the statute appears to levy these penalties on the reporting entity, it seems to do so only if information relating to the beneficial owner is not reported, or reported falsely, not information relating to the applicant – it seems like this may have been a drafting error since a reporting company must report the identity of both the beneficial owner and the applicant. Moreover, such penalties could also apply to other persons beyond the reporting entity if such person provides false information to FinCEN (ie, the applicant or even an employee or beneficial owner).

Like the foreign bank account report (FBAR), the CTA reporting obligations are found in Title 31 of the Bank Secrecy Act, not Title 26 of the Internal Revenue Code, meaning that everything from enforcement to collections may be different from traditional tax penalties. It remains to be seen just how rigorously the statutory penalties will be imposed. Penalties associated with FBARs and other international information returns, especially regarding non-US trusts, can be high (for further details please see "US reporting checklist for foreign trusts"). The CTA provides that negligent violations will not be penalised and provides a waiver process for violations that are due to reasonable cause and not due to wilful neglect.

Nevertheless, assessments of penalties in general have been increasing, and procedures for contesting and abating penalties are generally time consuming and require professional assistance. With the CTA adding yet another compliance obligation, family advisers should stress the importance of timely filing.

Reporting entities that are not supported by family offices, law firms or financial and other advisers must be sure not to miss the new CTA reporting requirements. The same is true for holding companies that often sit in structures with little attention paid to them year in and year out, although this has been changing with the enactment of economic substance rules, the Foreign Account Tax Compliance Act and the Common Reporting Standard (for further details please see "Practical FATCA and CRS compliance for family trust structures"). The CTA reporting requirements will apply to a large number of companies established in the United States or registered to do business in the United States. And even after filing the initial report, each reporting company will be responsible for updating its report every time that a beneficial owner, or a beneficial owner's information, changes. To get a rough sense of the extent of the anticipated compliance burden falling on US reporting entities, the Congressional Budget Office estimates that the CTA will require around 30 million filings each year.

Comment

Hopefully, the required FinCEN regulations implementing the CTA's reporting requirement will provide answers to issues relevant in the context of family succession planning structures that include entities established under the laws of a US state. During the Senate Finance Committee hearing for deputy Treasury Secretary Wally Adeyemo, he said that he would commit to making sure that the CTA reporting requirements will not burden small businesses and to writing implementing regulations sooner rather than later. In the meantime, families and their advisers should begin to identify all reporting companies within their succession planning structures and consider who will be reported as applicant and beneficial owner.

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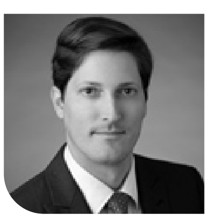

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