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Complying with new US FinCEN beneficial owner register: substantial control and 25% ownership interest tests

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This article is part two in a series on using 2023 to get ready to comply with the new US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) beneficial owner register. This instalment expands the discussion of the final regulations retention of the two-prong definition of "beneficial owner" (for part one of the series please see "Using 2023 to get ready to comply with new US FinCEN beneficial owner register").

Background

The Corporate Transparency Act (CTA) was enacted on 1 January 2021, announcing the creation of a federal beneficial owner register for entities established under the law of a US state. On 29 September 2022, FinCEN released final regulations and set a 1 January 2024 start date.

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The final regulations retain the two-prong definition of "beneficial owner". A reporting company's "beneficial owner" is any individual who directly or indirectly, either:

- exercises "substantial control" over the reporting company; or
- owns or controls at least 25% of its "ownership interests".

Substantial control and 25% ownership interest are not defined in the CTA. The final regulations provide guidance to determine whether substantial control or a 25% ownership interest exists.

Substantial control test

In determining who must be reported under the substantial control test, the underlying question is whether the individual is exercising the authority or performing the functions of a senior officer, or otherwise has authority indicative of substantial control.

Four indicators

The final regulations provide that an individual has substantial control if they:

- serve as a senior officer of the reporting company;
- have authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body);
- direct, determine or have substantial influence over important decisions made by the reporting company, including decisions regarding:
 - the nature, scope and attributes of the business of the reporting company, including the sale, lease, mortgage or other transfer of any principal assets of the reporting company;
 - the reorganisation, dissolution or merger of the reporting company;
 - major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company;
 - the selection or termination of business lines or ventures, or geographic focus, of the reporting company;

- compensation schemes and incentive programmes for senior officers;
 - the entry into or termination, or the fulfillment or non-fulfillment, of significant contracts;
 - amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures; or
- have any other form of substantial control over the reporting company.

"Senior officer" includes a president, chief financial officer, general counsel, chief executive officer, chief operating officer or any other officer, regardless of official title, who performs a similar function. The final regulations omit the roles of corporate secretary and treasurer, which tend to entail ministerial functions with little control of the company.

Any other form of substantial control could include an individual who may not have power to direct or determine important decisions but may play a significant role in the decision-making process.

Substantial control can be direct or indirect

When reviewing who will be reportable as a beneficial owner under the control test, family advisers must consider individuals, including a trustee of a trust or similar arrangement, who exercise direct or indirect control through:

- board representation;
- ownership or control of a majority of the voting power or voting rights of the reporting company;
- rights associated with any financing arrangement or interest in a company;
- control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;
- arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or

- any other contract, arrangement, understanding, relationship or otherwise.

Substantial control takeaways

The concept of substantial control does not require ownership in an entity, but relates to authority and decision making, as reflected in the four indicators discussed above. Advisers to family structures should remember that:

- FinCEN expects that a reporting company will always be in a position to identify at least one beneficial owner under the substantial control test;
- FinCEN's final regulations require the reporting company to report all persons with substantial control. However, the presumption that there must be someone with the right or ability to exercise substantial control has been removed, so that only persons actually exercising direct or indirect control are required to be reported; and
- FinCEN believes that the approach taken in the final regulations:
 - supports the basic goal of requiring a reporting company to identify who stands behind the company and directs its actions; and
 - closes loopholes that enable corporate structuring to obscure owners or decision-makers and is crucial to unmasking shell companies.

The four indicators provide relatively straightforward identifiers that advisers should communicate to families. The family must be informed that details for individuals who serve as senior officials or who have the authority to appoint or remove senior officials or a majority of the board of directors will be provided in the company's initial beneficial ownership information report.

FinCEN's third indicator is broad and vague, requiring advisers and families to thoughtfully support decisions on who to include and not to include. The fourth catch-all indicator scoops in individuals who exercise control through various arrangements and governance structures not covered by other indicators.

25% or more ownership test

The final regulations add a catch-all provision to the already expansive definition of "ownership" included in the proposed regulations. A reportable ownership interest is evidenced by any instrument, contract, arrangement or mechanism used to establish ownership of a legal entity, including capital or profit interests, convertible instruments, puts, calls, straddles or other similar options. It is immaterial whether:

- the ownership interest is transferable, classified as stock or anything similar; or
- it confers voting powers or rights.

Ownership or control of ownership interest can be direct or indirect

An individual may directly or indirectly own or control an ownership interest in a reporting company through a variety of means, including:

- joint ownership with one or more other persons of an undivided ownership interest;
- another individual acting as a nominee, intermediary, custodian or agent;
- a trust or similar arrangement that holds the ownership interest as:
 - a trustee of the trust or other individual (if any) with the authority to dispose of trust assets;
 - a beneficiary who is the sole permissible recipient of income and principal from the trust or has the right to demand a distribution of or withdraw substantially all of the assets from the trust; or
 - a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust;
- ownership or control of one or more intermediary entities (or ownership or control of the ownership interests of any such entities) that separately or collectively own or control ownership interests of the reporting company; or
- any other contract, arrangement, understanding or relationship.

It is important to note that a reportable ownership interest does not include ownership through constructive ownership or attribution. Further, ownership does not include options or privileges created and held by third

parties or third parties without the knowledge or involvement of the reporting company. However, known options and similar interests are treated as though exercised and added to the calculation of an individual's total ownership interests. If this calculation (set out below) cannot be conducted with reasonable certainty, the options and similar interests are treated as exercised for purposes of the catch-all rule.

Calculation guidelines for determining ownership

Family advisers will need to ascertain which individuals own or control at least 25% of the company's ownership interests using the following guidelines provided by the final regulations:

- The individual's total ownership interests must be:
 - determined at the present time, treating options and similar interests as exercised; and
 - calculated as a percentage of the total outstanding ownership interests in the reporting company.
- For reporting companies that issue capital and profits interests (including entities taxed as a partnership), an individual's percentage is calculated as a percentage of the total outstanding capital and profits interests in the entity.
- For reporting companies that issue shares of stock under a "vote or value" approach, an individual's percentage is the greater of:
 - the individual's total combined voting power of all classes of ownership interests as a percentage of total outstanding voting power of all such interests entitled to vote; or
 - the individual's total combined value of the ownership interests as a percentage of the total outstanding value of all such interests.
- The catch-all rule states that if above calculations cannot be performed with certainty, an individual is deemed to hold 25% or more of total ownership interests if the individual owns or controls 25% or more of any class of ownership interests.

Comment

Advisors to families whose succession planning structures include US reporting companies should begin to review which individuals will be reported in 2024 as owning and controlling those companies under the CTA final regulations. Personal details must be gathered, and family members should be educated on disclosure, maintenance of information by FinCEN and confidentiality of beneficial owner reports. Where anonymity and confidentiality are paramount, changes should be considered and implemented in 2023.

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