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Insights

THE CTA'S IMPACT ON TRUSTS

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BENEFICIAL OWNERSHIP REPORTING REQUIREMENTS, 87 FR 59498 (SEPTEMBER 30, 2022)

- See FinCEN additional information >

The Corporate Transparency Act (CTA) and its reporting requirements has now gone live as of the first of this year and applies to nearly all existing and future entities (corporations, partnership and limited liability entities). The CTA and its implementing rules issued by FinCEN require beneficial ownership and company applicant reporting for these entities unless the entity qualifies for one of the 23 exemptions. Failure to comply with the CTA reporting requirements (or qualify for an exemption) may result in significant civil or criminal penalties. The entity that is a reporting company has the burden of filing the report with FinCEN in all events, but the determination of who must be reported by the reporting company as beneficial owners takes an analysis of the pertinent documents and the law and rules and is said to be the practice of law.

Information about the company applicant must be included in the reports filed by any reporting company formed after January 1, 2024. No information is required to be reported on company applicants of reporting companies formed prior to that date, which would have been an impossible task. For newly formed companies, there will generally be up to two company applicants, such as the vendor that files the formation documents with the Secretary of State and the lawyer who prepares or supervises the preparation of the formation documents. Once this information is reported on the initial report, it never needs to be updated.

Reporting information about the reporting company's beneficial owners is much more fluid and can change from time to time. A beneficial owner is generally an individual who either (1) has substantial control of the reporting company, either directly or indirectly, or (2) owns or controls at least 25% of the ownership of the reporting company by vote or by value. Substantial control can be by serving as a senior officer, as manager, or on the company's governing board, or by having the power to remove and replace those individuals or by having power over the significant decisions of the reporting company, or in any other way that amounts to substantial control.

A trust is generally formed by the creation of a trust agreement and not by the filing with a Secretary of State's office, so a trust would generally not be a reporting company, even if the trust was registered with a court to establish jurisdiction. While a trust would not be a reporting company, a trust can be a beneficial owner of a reporting company. Trusts can be impacted by the CTA if the trustee owns or controls at least 25% of the ownership interests of a reporting company in its fiduciary capacity as trustee of the trust, or if the trustee has substantial control over a reporting company. (FinCEN FAQ D. 14) Trust terms vary from trust to trust and must be reviewed to determine who is to be reported as a beneficial owner. As stated by FinCEN in FAQ D.15, particular facts and circumstances relating to a trust must be reviewed to

> "determine whether specific trustees, beneficiaries, grantors, settlors, and other individuals with roles in a particular trust are beneficial owners of a reporting company whose ownership interests are held through that trust."

The trustee will likely be a beneficial owner of a trust that owns the requisite interest in a reporting company because the trustee has the ownership authority over the reporting company that is an asset of the trust and has the authority to dispose of the assets of the trust. Depending on the extent of the trust's ownership interest in the reporting company, the trustee may also be a beneficial owner of the reporting company by virtue of the trustee's power to remove and replace the directors of the reporting company or the power to participate in significant company decisions. If a beneficiary has the power to remove and replace the trustee who has substantial control of the reporting company or who has authority to dispose of trust assets, that beneficiary would be a beneficial owner of the reporting company as well, through indirect control over the trustee having substantial control of the reporting company. If multiple trusts own interests in the reporting company, the interests would be aggregated so that if the same trustee is serving as such for each of the ownership trusts, these interests would be aggregated to determine the 25% ownership.

In addition, FinCEN has stated that a beneficiary who is the sole permissible distributee of the trust's income and principal, whether discretionary or mandatory, will be a beneficial owner, as will a beneficiary who has the right to demand distribution of "substantially all of the assets of the trust." It is not clear whether this last power of withdrawal only arises once it is a current power or whether a beneficiary who has the right to withdraw trust assets at certain ages or at specifically determined periodic dates will be captured within this description. On the other hand, it is clear that a beneficiary of a 2503(c) trust and the beneficiary of a marital trust would be beneficial owners if the trust owns at least 25% of a reporting company. A beneficiary with a lifetime power of appointment over the trust assets will also likely be a beneficial owner of the reporting company if the trust owns at least 25% of the reporting company, since any individual who has the power to dispose of trust assets would be a beneficial owner (FAQ D15). If multiple trusts own interests in the reporting company, and the beneficiary of each of those trusts is the same, those interests would be aggregated to determine the 25% ownership of a trust beneficiary.

Finally, the settlor of a revocable trust and the settlor of an irrevocable grantor trust where the grantor trust trigger is based on a swap power would be a beneficial owner of a reporting company if the trust owns at least 25% of the reporting company. Additionally a trust protector could be a beneficial owner of a reporting company if the trust owns at least a 25% interest in a reporting company depending on whether the trust protector has the power to remove and replace a trustee with substantial control over the reporting company; a trust director could be a beneficial owner of such a trust if the trust director has the power to direct distribution of trust assets; and a trust investment advisor could be a beneficial owner of such a trust if the trust investment advisor has the power to dispose of trust assets.

Since FinCEN is looking for individuals who are beneficial owners of the reporting company, you might ask how a reporting company reports beneficial owners when a corporate trustee is serving as trustee of the trust with the 25% or greater ownership interest in or control over a reporting company. FinCEN attempted to answer this question in FAQ D.16, by saying that the reporting company is to determine the ownership of the corporate trustee and the trust's ownership interest in the reporting company and apply a mathematical solution to determine whether that equals at least the 25% threshold. The example provided is that the trust owns a 50% interest in the reporting company and individual A owns a 60% interest in the corporate trustee, then individual A would be a beneficial owner of the reporting company (60% X 50% = 30%, which is greater than 25%). This is only helpful if the corporate trustee is a private trust company or is owned in large part by only a few individuals. In that event, as stated by FinCEN in FAQ D.16,

> [t]he reporting company may, but is not required to, report the name of the corporate trustee in lieu of information about an individual beneficial owner only if all of the following three conditions are met:

- the corporate trustee is an entity that is exempt from the reporting requirements;
- the individual beneficial owner owns or controls at least 25 percent of ownership interests in the reporting company ***only*** by virtue of ownership interests in the corporate trustee; **and**
- the individual beneficial owner does not exercise substantial control over the reporting company.

Most corporate trustees, however, are publicly traded and owned by a large number of individuals so that even if the trust owns 100% of the reporting company, the threshold percentage would never be obtained. In that case, it is possible to report only the name of the corporate trustee and information about it. However, if the corporate trustee has substantial control over the reporting company and its significant decisions or has power to remove and replace the governing board making those decisions, the individual(s) inside the corporate trustee responsible for those decision would be reported as the beneficial owners. Several large corporate trustees have already identified the individual(s) who would be identified as beneficial owners with substantial control, and that individual generally has obtained a FinCEN ID to provide to the reporting companies.

Needless to say, the CTA requirements will impact practitioners as they set up trusts and as they establish procedures for their clients to follow when the entities they create are reporting companies. Employment agreements will need to be prepared that include provisions for requiring senior officers to provide the information needed to file the initial reports, and to update that information on a timely basis to enable the reporting company to update its FinCEN report within 30 days of any such change in the information initially reported. Practitioners should consider including provisions in companies' LLC operating agreements, partnership agreements or shareholder agreements requiring entity owners to provide the required information and to update that information on a timely basis so that updated reports can be filed with FinCEN. Finally, consideration should be given to requiring senior officers and entity owners to obtain a FinCEN ID, as that shifts the burden of updating the information provided by the individual from the reporting company to the individual.

A final consideration is when to file the initial report for reporting companies formed prior to the beginning of this year. These reporting companies are required to file the initial report no later than January 1, 2025. If the initial report is filed now, and one of the individuals identified as a beneficial owner dies or changes his or her information after the initial report is filed, the report will need to be updated within 30 days of the change. But if the initial report has not yet been filed, the reporting company has until the later of January 1, 2025 or 30 days from the date of the change to file the initial report (FAQ G.6). And the beneficial owner that is to be reported on that report is the beneficial owner at the time of filing the report (FAQ G.4).

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