

# PUBLICATION

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## The Importance of Knowing Whether You Own the Company: The Corporate Transparency Act and Beneficial Ownership

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**In less than two weeks, "reporting companies" as defined in the Corporate Transparency Act (CTA) will be obligated to provide beneficial ownership information to the Financial Crimes Enforcement Network (FinCEN). Who those beneficial owners are should be relatively straightforward for companies with simple structures but will be less obvious for companies with more complex structures. As we will see when delving deeper into these new rules, while the CTA is meant to bring transparency to the identity of beneficial owners, the process of determining who those beneficial owners are might not always be particularly clear.**

While the [first alert](#) provided a general overview of the CTA and the [second alert](#) provided guidance on how one might go about determining whether a company is, or is not, a reporting company for CTA purposes, this alert will look into the process of determining who is deemed a beneficial owner under the CTA. In order to do that it might be worthwhile first to consider who is expressly not a beneficial owner under the CTA.

The term "beneficial owner" does not include: (i) a minor child, as defined in the state in which the entity is formed, if the information of the parent or guardian of the minor child is reported in accordance with the CTA; (ii) an individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual; (iii) an individual acting solely as an employee of a corporation, limited liability company, or other similar entity and whose control over or economic benefits from such entity is derived solely from the employment status of the person; (iv) an individual whose only interest in a corporation, limited liability company, or other similar entity is through a right of inheritance; or (v) a creditor of a corporation, limited liability company, or other similar entity, unless the creditor "meets the requirements of subparagraph (A)" i.e., creditor's relationship with the reporting company provides the creditor with the requisite equity ownership interest or substantial control that would otherwise establish the creditor as a beneficial owner.

A "beneficial owner" is, however, with respect to an entity, an 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 percent of the ownership interests of the entity. Note that FinCEN expects every reporting company to have at least one beneficial owner. Let's look at each prong in turn.

### Substantial Control

The final rules tell us that an individual exercises substantial control over a reporting company if the individual: (A) serves as a senior officer of the reporting company; (B) has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body); (C) directs, determines, or has substantial influence over important decisions made by the reporting company, including decisions regarding: (1) 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; (2) the reorganization, dissolution, or merger of the reporting company; (3) major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company; (4) the selection or termination of business lines or ventures, or geographic focus, of the reporting company; (5)

compensation schemes and incentive programs for senior officers; (6) the entry into or termination, or the fulfillment or non-fulfillment, of significant contracts; (7) 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 (D) has any other form of substantial control over the reporting company.

It is important to also recognize that any such "substantial control" might be exercised directly or indirectly. More precisely pursuant to the regulations, an individual may directly or indirectly, including as a trustee of a trust or similar arrangement, exercise substantial control over a reporting company through: (A) board representation; (B) ownership or control of a majority of the voting power or voting rights of the reporting company; (C) rights associated with any financing arrangement or interest in a company; (D) control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company; (E) arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or (F) any other contract, arrangement, understanding, relationship, or otherwise. When reviewing these rules, it is a good idea to keep in mind one of the points raised by the CTA's principal authors in Congress in a letter to Treasury in relation to the CTA's implementation stating, "[To do this] means writing the rule *broadly* to include in the reporting as many corporate entities as possible while *narrowly* limiting the exemptions to the smallest possible set permitted by the law." Simply put, the language casts a wide net, is meant to do so, and should be interpreted accordingly.

"Senior Officer" under the regulations is defined as any individual holding the position or exercising the authority of 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. Note in particular, the "or exercising authority of" modifier as it reflects the importance of the activities regardless of title. Also, note the breadth in (F) above with regard to the direct or indirect "substantial control" rules, "any other contract, arrangement, understanding, relationship, or otherwise." FinCEN states in its comments that "this provision recognizes that control exercised in novel and less conventional ways can still be substantial."

## Ownership Interests

Pursuant to the final rules, an "ownership interest" reads as follows: (A) any equity, stock, or similar instrument; preorganization certificate or subscription; or transferable share of, or voting trust certificate or certificate of deposit for, an equity security, interest in a joint venture, or certificate of interest in a business trust; in each such case, without regard to whether any such instrument is transferable, is classified as stock or anything similar, or confers voting power or voting rights; (B) any capital or profit interest in an entity; (C) any instrument convertible, with or without consideration, into any share or instrument described in paragraph (d)(2)(i)(A), or (B) of this section, any future on any such instrument, or any warrant or right to purchase, sell, or subscribe to a share or interest described in paragraph (d)(2)(i)(A), or (B) of this section, regardless of whether characterized as debt; (D) any put, call, straddle, or other option or privilege of buying or selling any of the items described in paragraph (d)(2)(i)(A), (B), or (C) of this section without being bound to do so, except to the extent that such option or privilege is created and held by a third party or third parties without the knowledge or involvement of the reporting company; or (E) any other instrument, contract, arrangement, understanding, relationship, or mechanism used to establish ownership.

As with substantial control, an ownership interest can be held directly or indirectly. The regulations specify that an individual may directly or indirectly own or control an ownership interest of a reporting company through any contract, arrangement, understanding, relationship, or otherwise, including: (A) joint ownership with one or more other persons of an undivided interest in such ownership interest; (B) through another individual acting as a nominee, intermediary, custodian, or agent on behalf of such individual; (C) with regard to a trust or similar arrangement that holds such ownership interest: (1) as a trustee of the trust or other individual (if any) with the authority to dispose of trust assets; (2) as a beneficiary who: (i) is the sole permissible recipient of income and principal from the trust; or (ii) has the right to demand a distribution of or withdraw substantially all of the assets

from the trust; or (3) as a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust; or (D) through 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.

As with the analysis to determine whether a company may be exempt based on the detailed definitions of the 23 exemptions under the CTA, it is helpful to review the comments offered by FinCEN to gain clarity on the best approach – certainly, at this early stage of implementation. For example, an option or similar interest may be worth nothing prior to exercise, yet for purposes of determining an ownership interest it is the potential value of the option that needs to be considered. FinCEN comments, "Options and similar interests are treated as though exercised and added to the calculation of an individual's total ownership interests, and if this calculation cannot be conducted with reasonable certainty, the options and similar interests are treated as exercised for purposes of the catch-all rule. It should be noted that the present value of a contingent interest is irrelevant to the calculation of percentage of ownership interests. For example, if the exercise of an option or similar interest at the present time would result in an individual holding 26 percent of the profit interests in an entity, the individual would be deemed to own or control 25 percent or more of the ownership interests in the reporting company even if the value of those profit interests is indeterminate or negligible at the present time." One might consider how a buy-sell provision for a pre-determined price in an LLC operating agreement might be treated with, say, the trigger event being the death of a majority member. If the majority member owns an 80 percent interest and the minority member owns a 20 percent interest (both with respect to management and economic rights, although management rights are not as important with respect to the "ownership interest" analysis), the minority member does not appear to have the requisite 25 percent ownership interest at the present time. The buy-sell provision, however, provides the minority member with the right to purchase the remaining membership units from the majority owner's estate thereby giving the minority member a potential 100 percent, or perhaps some other lesser interest meeting the requisite 25 percent interest in the LLC. Based on the above, does the minority member currently possess the requisite ownership interest in the LLC since there is a possibility via the operating agreement that today's 20 percent owner could be tomorrow's 25 percent owner? Consider this in light of FinCEN's comment that "convertible instruments are widely used and, particularly when the holder may convert the interest at will, they are tantamount to equity ownership. Even if the instrument is not immediately convertible, the potential conversion of the instrument at a later time provides significant opportunities for exerting influence and maintaining an economic interest tantamount to ownership" or in relation to Simple Agreements for Future Equity (SAFEs) in which investors provide funding that changes to equity upon some event that might or might not occur. In relation to this FinCEN comments, "It may be difficult to calculate how much equity will be received when the relevant condition occurs, and if the condition does not occur, the investor may receive no equity at all. Although FinCEN recognizes that such structures may complicate the calculation of the percentage of ownership interests, investors and companies who establish such structures do so in the expectation that they will receive a certain level of capital and profit interests."

For more information on the Corporate Transparency Act, please contact [Perry F. Sofferman](#) or another member of Baker Donelson's [Corporate Group](#).