NEWS ANALYSIS

Beneficial Ownership Reporting and the Constitution

by Lee A. Sheppard

Middle-class people buy their own heirlooms.

Paul Fussell made that snooty comment in his acerbic book *Class: A Guide Through the American Status System.* The joke was ultimately on him. His trenchant observations about middle-class status anxiety revealed him to be chafing to escape it. Striving and status insecurity are middle-class markers, as he cogently observed. And while Fussell was poking fun, business and their captive politicians were plotting to dismantle the middle class.

What Fussell didn't understand at the time was that these pretentious purchases would eventually prove useful and durable as the quality and style of household goods deteriorated precipitously. Decades later, *The Wall Street Journal* publishes endless articles about how to gracefully refuse your mother's brown furniture (there is no graceful way to do it) and how to dispose of it when your parents are gone (sell it on www.chairish.com or give it to www.habitat.org).

So here's an alternative, practical suggestion: Keep your mother's brown furniture.

But I'm not becoming my parents! Yes, you are. Still rebelling at the age of 45 is unbecoming. Brown furniture is furniture for grown-ups. Minimalism is over. Your dwelling does not have to look like your iPhone.

But it's not my personal style! What you call your personal style looks suspiciously like a trendy lifestyle catalog. In those catalogs, overpriced, poorly made furniture offerings are shown in spectacular settings — a look that can be achieved only in a multimillion-dollar Brooklyn or San Francisco Victorian townhouse with 10-foot ceilings. You may never have that dream house, so why not hang on to some decent furniture that can make your unassuming flat more pleasant?

Your mother's brown furniture goes with everything. It's sculptural. It lives happily with less than spectacular interior architecture — a lot of colonial houses had 7-foot ceilings. It blends nicely with your colorless modern farmhouse look, as decorators are starting to appreciate. Gray decor is over, and it's depressing to live with. A brown chest with cabriole legs or a wing chair might liven up the room.

Your mother's brown furniture is sturdy and better built than the new stuff. The bookshelf you bought as a flat pack is groaning under the weight of the multivolume set of code and regulations you keep at home. And unlike that lacquered coffee table that the housekeeper chipped with the vacuum cleaner, traditional furniture looks better when it's beat up and lived in.

But Mother's furniture is white faux French with gold lines painted on it! No child was allowed to enter the parlor, where it resided under plastic covers. For centuries, rich people have used antique or reproduction French furniture, because those designs have never been surpassed. Genuine or reproduction 1750 French bergères sit in many wealthy abodes because they're so comfortable. Decorators in the 1970s understood that baroque and rococo pieces could liven up monotonous midcentury modern interiors. It was all about the contrast between the masculine straight sides and the feminine curlicues.

Three years ago, Congress decided to throw out all the furniture of state regulation of business formation and replace it with a flat-pack federal database of beneficial ownership of companies. A federal district court held that the Corporate Transparency Act (CTA) is unconstitutional and does not even satisfy the commerce clause, which has been historically interpreted to justify all kinds of intrusive federal regulations. The federal government is expected to ask for a stay of the court's permanent injunction and appeal the decision. Appeal would be to the Eleventh Circuit (*National Small Business United et al. v. Janet Yellen et al.*, No. 5:22-cv-01448 (N.D. Ala. Mar. 1, 2024)).

Sometimes old things are just better. (rilueda@123RF.com)

Background

The CTA became effective at the beginning of this year.

Readers will recall that for many years, tax fairness campaigners asked for a law requiring collection and disclosure of corporate ownership information. Some U.S. states are effectively secrecy jurisdictions because they collect no information on business formation. Those regimes are much loved by the nervous Central and South American rich, as well as domestic Medicare fraudsters. For that reason, tax fairness campaigners have put the United States on their miscreant lists.

The CTA was part of the 2021 National Defense Authorization Act. It requires all companies formed or registered to do business in the United States to disclose beneficial ownership information to Treasury's Financial Crimes Enforcement Network. Essentially the CTA codified the Financial Action Task Force recommendations for beneficial ownership reporting, complete with their gaps.

Limited liability companies and limited partnerships formed in U.S. states are covered. Foreign companies registered to do business in U.S. states are covered. The law has 23 exemptions, including publicly traded companies and nonprofit organizations. Among the exemptions are operating companies with more than 20 employees, annual gross receipts exceeding $5 million, and a U.S. operating office. So a small company could grow out of reporting. Thus, there would be a federal database of ownership (31 U.S.C. section 5336(a)(11)(A)).

A beneficial owner is defined as an individual who directly or indirectly exercises substantial control over a reporting entity or directly or indirectly owns or controls not less than 25 percent of the ownership interests of a reporting entity (31 U.S.C. section 5336(a)(3)). Substantial control is broadly defined in the regulations to include serving as an officer, appointing directors, having substantial influence over important decisions, and having any other form of substantial control (31 C.F.R. 1010.380(d)(1)(i)).

According to FinCEN, that'd affect nearly 40 million entities; about 5 million new entities are formed each year. FinCEN was fast off the blocks with implementing regulations in September 2022 and a handy brochure for advisers (31 C.F.R. section 1010.380, 87 Fed. Reg. 59498 (Sept. 30, 2022)). Still, it left some important CTA concepts unaddressed.

The Opinion

On cross-motions for summary judgment, the district court issued a permanent injunction.

The plaintiffs knew not to gripe about the legislative purpose. A law can have an admirable purpose and still be unconstitutional. "The wisdom of a policy is no guarantee of its constitutionality. Indeed, even in the pursuit of sensible and praiseworthy ends, Congress sometimes enacts smart laws that violate the Constitution," wrote District Court Judge Liles C. Burke.

Congress relied on the commerce clause, foreign policy power, and taxing powers of the Constitution. Burke held that there was no nexus to any enumerated power of Congress. "The CTA exceeds the Constitution's limits on the legislative branch and lacks a sufficient nexus to any enumerated power to be a necessary or proper means of achieving Congress' policy goals," he wrote.

The government argued that business formation touches the channels, instrumentalities, and activities that have a substantial effect on interstate commerce. Channels are roads and rivers. Instrumentalities are trucks and phones. Is forming or registering a company a commercial activity? The government cited the Supreme Court upholding the Bank Secrecy Act cash reporting requirements (*California Bankers*

Association v. Shultz, 416 U.S. 21 (1974)). But cash reports pertain to movement of money. Burke responded that "the act of incorporation is not enough to invoke the commerce power."

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The government countered that corporate formation may have a substantial effect on interstate commerce. Burke observed that a taxpayer's activity may not cross state lines, depriving Congress of power to regulate it. He noted that the CTA covers entities that do business only within one state or don't conduct any business, so the wording of the clause doesn't cover this activity. Burke inexplicably concluded that business formation is not necessarily a commercial activity, even if many businesses so formed engage in interstate commerce. And the possibility that a newly formed company might engage in interstate commerce is not enough to trigger the commerce power.

"The Commerce Clause is not a general license to regulate an individual from cradle to grave, simply because he will predictably engage in particular transactions," Burke wrote, quoting the Supreme Court rejection of the commerce power to justify Obamacare (*National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012)).

Congress has exclusive power in foreign affairs (*Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994)). The government argued that collecting beneficial ownership information is vital to protect national security by enabling tracing of funds for terrorism, money laundering, and illicit finance (a meaningless phrase used by campaigners). Burke countered that "those powers do not extend to purely internal affairs."

Burke held that the foreign affairs power was not invoked because incorporation is a power generally left to the states. He explained that federal incorporation was considered and rejected at the 1787 Constitutional Convention to prevent the federal government from picking winners and losers. And Congress rejected calls for federal incorporation during the Progressive Era of the early 20th century. Burke noted that federal securities law does not preempt state law regulating corporate takeovers (*CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987)).

The government argued that the CTA was part of a larger bank reporting scheme. Burke observed that FinCEN's regulation requiring banks to perform due diligence on their customers, including collection of beneficial owner information, has been approved by the Supreme Court. He didn't believe that the CTA closes a gap, holding that the CTA is not necessary and proper to effectuate the anti-money-laundering rubric. Banks appreciated the CTA for making their anti-money-laundering compliance easier, but Burke kicked responsibility right back to them. While small businesses challenged the CTA, banks supported it (*The Wall Street Journal*, Mar. 4, 2023).

The plaintiffs conceded that the "necessary and proper" clause might justify the CTA as an exercise of the taxing power if it were limited to information collection for tax enforcement. The government argued that the "necessary and proper" clause extends to all parts of article 1, not just the commerce clause. The congressional power to tax was invoked to sustain Obamacare (*King v. Burwell*, 576 U.S. 473 (2015), *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012)).

The government argued that reporting was necessary and proper to ensure that taxable income was appropriately reported. The CTA gives Treasury access to the data for tax enforcement. Burke held that data collection was insufficient to justify the exercise of the taxing power. Just because beneficial ownership information would be useful in tax collection doesn't mean that invocation of the taxing power is warranted.

"Read that way, the necessary and proper clause would sanction any law that provided for the collection of information useful for tax administration and provided tax officials with access. All Congress would have to do to craft a constitutional law is simply impose a disclosure requirement and give tax officials access to the information," Burke wrote. Um, like FATCA? A

constitutional challenge to FATCA intergovernmental agreements was dismissed for lack of standing (*Crawford v. U.S. Department of Treasury*, 868 F.3d 438 (6th Cir. 2017), *cert. denied*, 584 U.S. 916 (2018)).

"Compliance with international standards may be good policy, but it is not enough to make the CTA 'necessary' or 'proper.' As admirable as Congress' goals may be, this Court's only job is to consider whether the CTA follows the Constitution, not whether it is good policy," Burke wrote.

The court did not reach the plaintiff's allegations that the CTA violated the First, Fourth, Fifth, Ninth, and 10th amendments. CTA reports ask for the individual beneficial owner's birth date, residential address, and driver's license or passport number, plus a picture of each said document. This was a case about domestic privacy rights, but the CTA also affects foreign flight capital. If the United States were in possession of beneficial owner information, it would be obliged to furnish it to treaty partners. The United States has long avoided this obligation by not collecting information. This would cause the world's skittish rich to park their liquid assets in Switzerland or Singapore instead.

Ramifications

Practitioners advise clients to continue gathering their information and being prepared to comply with the CTA, given the government's request for a stay of the injunction and the likelihood of appeal.

"The Court's opinion is a very comprehensive analysis of an unusually narrow view of Congress' power under the various provisions of the Constitution. In particular, it is hard to see how the formation of companies and similar entities, which exist almost exclusively to engage in economic activity, do not fall within the ambit of the commerce clause," said Bryan Skarlatos of Kostelanetz LLP, predicting that the decision will be reversed on appeal. "Reporting companies would be well advised to continue to comply with the CTA in the foreseeable future."

Debevoise & Plimpton lawyers cautioned that the district court's permanent injunction is effective only as to the named plaintiffs in the case. The National Small Business Association said it represents more than 65,000 businesses and entrepreneurs located in all 50 states. "The judgment, thus, leaves the CTA intact against other parties and is highly likely to be appealed. However, the court's decision likely paves the way for further challenges to the CTA," the lawyers wrote in a public memo.

How's that again? "The Defendants, along with any other agency or employee acting on behalf of the United States, are PERMANENTLY ENJOINED from enforcing the Corporate Transparency Act against the Plaintiffs," Burke wrote in a separate final judgment.

In a March 4 notice, FinCEN takes the position that the decision applies only to the plaintiffs. "It is not clear from the face of the opinion whether the judgment's application to the NSBA extends to its member small businesses, but FinCEN has decided not to enforce the CTA against NSBA members so long as the court's order is in effect," Debevoise & Plimpton lawyers explained. The FinCEN CTA compliance website is still up and running.

"Unfortunately by its terms, the district court judgment provides injunctive relief only to the plaintiffs in the case. There is some authority suggesting the relief may apply more broadly," said Matthew Kadish of Frantz Ward and CEO of the Small Business Council of America (for example, *Mann Construction Inc. v. United States*, 651 F. Supp. 3d 871 (E.D. Mich. 2023), *rev'd as moot* 86 F.4th 1159 (6th Cir. 2023); and *GBX Associates LLC v. United States*, 130 A.F.T.R. 2d 2022-6440 (N.D. Ohio 2022) (universal vacatur not necessary to afford complete relief)).

"FinCEN should announce a complete suspension of CTA beneficial ownership information reporting until the question of the CTA's constitutionality is resolved," Kadish said. "Unless/until the court's opinion is reversed, everyone else is left with uncertainty on whether the government can (or will) continue to enforce the CTA. For example, are new entities formed after the date of the decision still required to file a beneficial owner information report, despite the CTA having been declared unconstitutional?"

"The decision created some uncertainty as to whether filing a beneficial ownership information report is still required while this case plays out. FinCEN has tried to clarify some of that

uncertainty by indicating that it will abide by the Court's ruling — presumably pending appeal — as it applies to these plaintiffs only," said Eddie A. Jauregui of Holland & Knight. "By implication, it will continue enforcing the CTA as against all others. Non-parties would be wise to continue adhering to the CTA's requirements in the meantime."

"If a stay is granted, the CTA's reporting requirements will remain in place. Even if a stay is not granted, if the District Court's decision is ultimately overturned on appeal, the CTA's current reporting deadlines may be restored," lawyers from Sullivan & Cromwell wrote in a public memo. Entities formed before the effective date of the CTA have a January 1, 2025, deadline to file beneficial ownership information with FinCEN. Entities formed in 2024 have 90 days from formation to report, while entities formed next year will have 30 days.

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"Clients should still be prepared to comply because I expect this injunction to be stayed or reversed," said Alicea Castellanos of Global Taxes LLC, who serves inbound private investors primarily from Central and South America.

"We're advising clients to get their information together, and we hope that FinCEN comes out with definitions that will assist us in preparing these forms," said Steve Bankler of Steven Bankler, CPA, Ltd., who represents closely held business clients.

Readers, FinCEN hasn't defined crucial terms of the CTA. "Who is an indirect owner? Define direct and indirect owner. The code has attribution rules; do those apply? CTA gives us no clue," Bankler said (section 318). "As a CPA firm, we are barred from practicing law. If there is a complex structure, we need a letter from the client's attorney describing direct and indirect ownership because the interpretation of the law is beyond our expertise."

"Although only one court's opinion, the Northern District of Alabama's decision could have an impact on states presently contemplating adopting 'mini' CTAs. California, Massachusetts, and Maryland have proposed bills, and other states may follow," Holland & Knight lawyers wrote in a public memo. New York recently enacted the New York LLC Transparency Act modeled on the CTA, to allow state agencies to collect ownership information for LLCs, which are often used to hold real estate. ■