

Corporate Transparency Act - What is Substantial Control

Take-Away: Anyone with *substantial control* of a reporting entity must be reported to FinCEN as a beneficial owner of the reporting entity. FinCEN's definition of *substantial control* is so broad that it ultimately results in guesswork who should be reported as a beneficial owner.

Background: Under the Corporate Transparency Act (CTA) beneficial owners of a reporting entity are not just individuals who directly or indirectly own 25% or more of the entity, but also those individuals who have *substantial control* as identified under FinCEN's most recent rules. What does *substantial control* mean?

Substantial Control: An individual can exercise *substantial control* over a reporting company in four different ways:

Office or Position: The individual is a senior officer, e.g., President; CEO; General Counsel; CFO; COO, or any other officer who performs a similar function. The FinCEN rules state that the title of Secretary or Treasurer, standing alone, does not rise to the level of exercising *substantial control* over the reporting entity.

Appoint or Remove Power: The individual possesses the authority to appoint or to remove certain officers or a majority of the board of directors (or a similar body like a managing committee of an LLC) of the reporting company.

Important Decision Maker: The individual is an important decision maker, who is defined by FinCEN as an individual who can direct, determine, or who has *substantial influence* over important decisions of the reporting company. This includes actions such as determining the scope of business, the ability to enter or terminate important contracts, approving major financial decisions, or influence over the reporting company's structure. Would the largest customer of a reporting company possess *substantial influence* over the reporting company's financial decisions, if it could withhold continuing to purchase from the reporting company?

The *Black Hole:* The individual has *any other* form of *substantial control* over the reporting company. [So much for *helpful* guidance from FinCEN!] FinCEN threw in this last category in anticipation of

new or unique ways that could still be considered *substantial control* in a flexible corporate or LLC structure that is not covered by the prior categories.

Ownership: Ownership in a reporting company comes in many different forms, more than just owning stock in a corporation or a membership interest in an LLC. Also covered as a form of *ownership* are : (i) a profit interests; (ii) any convertible instruments; (iii) options; (iv) privileges. All these rights or privileges must be reported as a form of ownership. Under the current FinCEN rules, the reporting company is directed to assume that these ‘rights or privileges’ are in fact converted when it calculates the 25% ownership ‘test.’

Compliance and Penalties: It is the responsibility of the reporting company, and the individual beneficial owners to report to FinCEN. Each can be held liable for their failure to report, with both civil and criminal penalties. FinCEN has recommended that reporting companies advise their beneficial owners of this reporting requirement, the need to obtain from those beneficial owners their information, and the need for those beneficial owners to timely keep the reporting company apprised of changes in their reported information. As has been mentioned in the past, it would be wise, too, for reporting companies to amend Shareholder Agreements, LLC Operating Agreements, and employment agreements with those individuals who hold *substantial control* over the reporting company to ensure they include provisions that require timely compliance with their beneficial ownership information reporting obligations, along with the insertion of penalty provisions for those individuals who refuse to cooperate or furnish their information to the reporting company.

Conclusion: The civil penalty for failing to file beneficial owner information with FinCEN is *\$591 per day*. If there is a willful violation of the beneficial ownership information reporting obligation, that individual may also be subject to criminal penalties of up to *two years imprisonment and a fine of up to \$10,000*. With these threats hanging over the heads of a reporting company and a beneficial owner, one would think that FinCEN would be much more helpful in clarifying its definition of a beneficial owner.

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