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Corporate Transparency Act ruled unconstitutional

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U.S. District Court Judge Liles Burke recently ruled that the Corporate Transparency Act (CTA) is unconstitutional because the Constitution does not give Congress the power to regulate the millions of business entities incorporated under state law and their shareholders the moment they obtain formal corporate status from the state.

According to Judge Burke, the CTA lacks a sufficient nexus to any of Congress's enumerated powers to be a necessary or proper means of achieving Congress's policy goals.[1] However, companies should continue to comply with the CTA pending the government's appeal of the decision and further administrative action.

The CTA, which went into effect January 1, 2024, requires an estimated 33 million existing entities and 5 million new entities formed each year, to disclose information to the Treasury Department's criminal enforcement division, the Financial Crimes Enforcement Network, which is often referred to as FinCEN. By requiring these entities, referred to as "reporting companies," to provide this information, Congress sought to prevent financial crimes like money laundering and tax evasion, which are often committed through shell corporations.

Reporting companies include corporations, LLCs, and similar entities that are created by filing a document with a Secretary of State. Businesses formed under the law of a foreign country that register to do business in any state by filing a document with a Secretary of State also qualify as reporting companies.

The CTA exempts 23 categories of entities from the definition of reporting companies. The most common exemption is for large operating companies, which have 20 or more full-time U.S. employees, more than $5 million in U.S.-sourced revenue, and a physical operating presence in the U.S. The CTA also provides a reporting exemption for subsidiaries that are controlled or wholly owned, directly or indirectly, by one or more exempt entities.

Each reporting company is required to report information to FinCEN about itself and each beneficial owner who directly or indirectly exercises either substantial control over the entity or owns or controls 25% of the equity. Reporting entities must give FinCEN a beneficial owner's full legal name, address, birthday, and identification number from a driver's license, ID card, or passport. Reporting entities must also provide an image of the identifying document. If any of that information changes, the reporting company must update FinCEN.

For new entities incorporated from January 1, 2024 onward, the CTA requires them to also disclose the identity and information regarding "applicants," defined as any individual, such as an attorney, who files the documents to form the entity with the Secretary of State or registers a foreign entity to do business in the United States. The CTA also imposes personal liability on the individual who is primarily responsible for directing or controlling the filing with FinCEN.

Companies should continue to comply with the CTA pending the government's appeal of the decision and further administrative action.

The CTA imposes substantial penalties for failure to comply. A willful provision of false or fraudulent beneficial ownership information or failure to report complete and updated beneficial ownership information to FinCEN by any person, including an applicant, is punishable by a $500 per day civil penalty, up to a maximum of $10,000, and two years in federal prison. These severe penalties apply to individuals, not reporting entities.

The National Small Business Association and one of its members who owned a reporting company filed the lawsuit in the U.S. District Court in Alabama seeking to challenge the constitutionality of the CTA.

U.S. District Court Judge Burke ruled that the individual business owner plaintiff's mandatory disclosure of sensitive personal information to FinCEN for law enforcement purposes satisfies the injury requirement for the individual plaintiff's First, Fourth, and Fifth Amendment claims.

District Judge Burke noted that the powers of the federal government are expressly enumerated in the Constitution. The Constitution's express conferral of some powers makes clear that it does not grant others and the federal government can exercise only the powers granted to it.

Judge Burke recognized that corporate formation has always been governed by state law. Although the CTA does not directly interfere with or commandeer state incorporation practices, the CTA still converts an astonishing amount of traditionally local conduct into a

matter of federal enforcement and involves a substantial extension of federal police resources.

The government offered three sources of constitutional authority for Congress's enactment of the CTA. The government argued that Congress has the power to enact the CTA under its foreign affairs powers.

The CTA imposes substantial penalties for failure to comply.

In addition, Congress has the power to enact the CTA via its Commerce Clause authority because many state entities engage in activities that qualify as or affect commerce. Finally, the CTA is a necessary and proper exercise of Congress's taxing power because one purpose of the FinCEN database created by the CTA is to assist in efficient tax administration.

The government argued the foreign affairs power justified enacting the CTA because Congress concluded that collecting beneficial ownership information was needed to protect the vital United States national security interests, including efforts to counter money laundering, the financing of terrorism, and other illicit activity. Moreover, the CTA was necessary to bring the United States into compliance with international anti-money-laundering and countering the financing of terrorism standards.

Judge Burke ruled that the CTA is not authorized by Congress's Foreign Affairs powers because those powers do not extend to purely internal affairs, especially in an arena traditionally left to the states. The Court's deference to matters of foreign policy cannot go so far as to disavow restraints on federal power that the Constitution carefully constructed.

Congress remains bound by the Constitution's enumerated powers limitation in this case because incorporation is a fundamental internal affair. Corporations are creatures of state law. States have authority to regulate domestic corporations.

Judge Burke also ruled that the Commerce Clause does not justify enactment of the CTA. Congress can regulate and protect the instrumentalities of interstate commerce, persons and things in interstate commerce and activities that have a substantial effect on interstate commerce.

However, the plain text of the CTA does not regulate the channels and instrumentalities of commerce, let alone commercial or economic activity. The CTA applies to all reporting companies the moment they are created, whether or not they touch interstate commerce. The CTA then mandates that those entities report information about their beneficial owners and applicants to FinCEN.

Judge Burke points out that the word "commerce" or reference to any channel or instrumentality of commerce is nowhere to be found in the CTA.

Judge Burke held that the government misses the mark when it argues that the Commerce Clause allows Congress to regulate an entire class of activity just because some members of the class use the channels and instrumentality of interstate commerce.

Judge Burke held that the Commerce Clause would allow Congress to regulate commerce to the extent of forbidding and punishing the use of such commerce but no further. According to Judge Burke, Congress could have written the CTA to pass constitutional muster by imposing the CTA's disclosure requirement on state entities as soon as they engage in commerce, or from prohibiting the use of interstate commerce to launder money or evade taxes.

However, the CTA does not regulate the channels and instrumentalities of commerce or prevent their use for a specific purpose. Therefore, it cannot be justified as a valid regulation of those channels and instrumentalities.

Judge Burke pointed out that submitting documents to a Secretary of State does not implicate the Commerce Clause. The proximity and degree of connection between the formation of an entity and its activities is too attenuated and therefore such a law cannot be sustained under a clause authorizing Congress to regulate commerce.

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The CTA is missing a crucial component of valid Commerce Clause legislation: it has no express jurisdictional element which might limit its reach to a discrete set of activities that additionally have an explicit connection with or effect on interstate commerce.

According to Judge Burke, the inclusion of a so-called jurisdictional hook is standard operating procedure for legislation enacted under the Commerce Clause because it guarantees legitimate nexus with interstate commerce and thereby precludes any serious challenge to the constitutionality of a statute as beyond the commerce power.

Finally, the government argued that Congress has the power to levy taxes and the collection of beneficial ownership information is necessary and proper to ensure that taxable income is properly reported. Congress recognized this relationship by drafting the CTA to allow the Department of Treasury to obtain access to beneficial ownership information for tax administration purposes.

Judge Burke rejected the argument finding that access to the CTA's database for tax administration purposes is not enough to establish a sufficiently close relationship with the government's taxing power to sustain the constitutionality of the CTA.

The ruling in *Yellen* is currently limited to the plaintiffs in the specific case that was in front of the District Court. *Yellen* does not apply to any other reporting companies. The government has filed an appeal of the District Court's decision. FinCEN has announced that it intends to enforce the CTA against all other entities.

The CTA remains the law of the land. Unless entities meet an exemption, they should plan to make the required CTA filings. However, the long-term future of the CTA is unclear pending the government's appeal and further administrative action.

Notes

[1] *National Small Business United v. Yellen*, 2024 WL 899372 (N.D. Al. March 1, 2024).

About the authors

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