

Corporate Transparency Act Poses Challenges for Homeowner Associations: Most HOAs Will Need to File in the Coming Year

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The Corporate Transparency Act ("CTA") will require most homeowner associations ("HOAs") to file a beneficial ownership report in the coming year. Although the CTA exempts certain non-profit entities from having to file, most HOAs will not satisfy the requirements to be exempt from the CTA. Raising awareness of this new legal requirement, and collecting the information required for the report, will pose a challenge for many HOAs in the coming year. This Client Alert identifies the issues facing HOAs when addressing the CTA and the preparation of a first beneficial ownership report.

HOMEOWNER ASSOCIATIONS IN THE U.S.

Homeowner associations, or HOAs, play a unique role in residential real estate. There are more than 355,000 HOAs in the United States with an average of 22 more formed every day.¹ Those HOAs manage more than 40 million housing units, housing more than 74 million Americans.

HOAs are often formed to administer real estate covenants that apply to a community and often collect dues from many with which to pay for common area upkeep and maintenance. Some HOAs manage golf courses, tennis courts, swimming pools and other amenities available to residents of the community. In some instances, HOAs also provide benefits for the public at large, in addition to their home-owning residents. The average HOA charges a resident \$250 per month in dues.

Most HOAs are formed as not-for-profit ("NFP") corporations under state law. Most states have a separate legal system for the formation of NFP corporations from the corporation code that govern for-profit entities. In most states, an NFP is formed by the filing of articles of incorporation with the state's Secretary of State or similar office. Because the NFP does not have investors and does not hope to produce a profit, most NFP's have no shareholders. After the NFP is formed by the filing of articles of incorporation, the initial incorporator appoints an initial slate of directors. Under the auspices of state law, those directors manage and supervise the business activities of the NFP, appointing officers, opening bank accounts, collecting dues from members, and hiring and paying vendors.

Most NFP HOAs are exempt from federal income tax by virtue of Section 528 of the Internal Revenue Code ("IRC"). Section 528 provides that qualifying HOAs are considered exempt from federal income tax purposes. Section 528 imposes a tax on an HOA's net income but excludes from the calculation of net income any amounts received as dues from homeowners within the HOA. As a result, HOAs that have no income apart from dues will pay no income tax. An HOA qualifies as tax exempt under Section 528 if it (a) is organized and operated to provide for the acquisition, construction, management, maintenance and care of association property, (b) 60 percent or more of its gross income consists solely of dues or assessments from homeowners, (c) 90 percent or more of its expenditures are on the acquisition, construction, management, maintenance and care of association property, (d) no part of the

¹ HOA Facts & Statistics, <http://www.ipropertymanagement.com/research/hoa-statistics> (last visited February 4, 2023).

net earns of the HOA inures to the benefit of any private shareholder or individual (other than through activities involving association property), and (e) the organization elects to be treated under Section 528 as a tax-exempt HOA. An HOA 'elects' to be treated as tax-exempt under Section 528 when it files an annual income tax return on Form 1120-H.

THE CORPORATE TRANSPARENCY ACT

On December 11, 2020, as part of the National Defense Authorization Act for 2021, the U.S. Senate passed the Corporate Transparency Act (CTA). The bill was vetoed by President Trump but bipartisan supermajorities in both houses of Congress overrode that veto and the bill became law.

In December 2021, the Financial Crimes Enforcement Network (or "FinCEN") of the U.S. Treasury Department issued a preliminary draft of regulations (the "Preliminary Rule") that would implement the beneficial ownership reporting requirements of the CTA.² On September 30, 2022, FinCEN issued its final rule (the "Final Rule"), indicating that the new reporting requirements would take effect on January 1, 2024.³

The CTA requires most companies doing business in the U.S. to file a beneficial ownership report with FinCEN that discloses specific items of personally identifiable information ("PII") with respect to each beneficial owner of the company.

The CTA provides that the information FinCEN collects will not be available to the public. Instead, FinCEN will maintain a database of beneficial ownership data that it will make available to law enforcement. FinCEN's provision of that data to law enforcement will be outlined in a future FinCEN rulemaking.

MOST HOMEOWNER ASSOCIATIONS ARE CTA REPORTING COMPANIES

The CTA applies to each "reporting company," which may be either a "domestic reporting company" or a "foreign reporting company." A "domestic reporting company" is any entity that is either (a) a corporation, (b) a limited liability company, or (c) created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe.⁴ An HOA that is formed by the filing of articles of incorporation with a secretary of state will be a "reporting company" for purposes of the CTA.

MOST HOMEOWNER ASSOCIATIONS WILL NOT BE EXEMPT

The Final Rule exempts from the definition of "reporting company" twenty-three separate categories of entities that are highly regulated and whose beneficial ownership is already a matter of public record.⁵

² <https://www.federalregister.gov/documents/2021/12/08/2021-26548/beneficial-ownership-information-reporting-requirements>

³ The Final Rule will be codified as 31 CFR § 1010.380.
<https://www.federalregister.gov/documents/2022/09/30/2022-21020/beneficial-ownership-information-reporting-requirements>

⁴ 31 CFR § 1010.380(c)(1)(i).

⁵ 31 CFR § 1010.380(c)(2).

Subsection 1010.380(c)(2)(xix) of the Final Rule exempts from filing obligations three types of tax-exempt entity, including:

- (A) An organization that is described in section 501(c) of the Internal Revenue Code of 1986 (Code) (determined without regard to section 508(a) of the Code) and exempt from tax under section 501(a) of the Code, except that in the case of any such organization that ceases to be described in section 501(c) and exempt from tax under section 501(a), such organization shall be considered to continue to be described in this paragraph (c)(1)(xix)(A) for the 180-day period beginning on the date of the loss of such tax-exempt status;
- (B) A political organization, as defined in section 527(e)(1) of the Code, that is exempt from tax under section 527(a) of the Code; or
- (C) A trust described in paragraph (1) or (2) of section 4947(a) of the Code.

Importantly, this exemption does not apply to an HOA that is exempt from taxation under IRC Section 528.

Most HOAs elect to be exempt from taxation under IRC Section 528 because the requirements of Section 528 are easy to satisfy. It is possible, however, for an HOA to apply for exemption from federal income tax under either Section 501(c)(4) or 501(c)(7). To pursue either of these exemptions, however, would require the HOA to forgo the automatic exemption under Section 528 and would require the HOA to apply specially for 501(c) recognition with the IRS. If the HOA failed to qualify under 501(c), the HOA would be at risk of having to pay federal income tax for each tax year in which it was not qualified⁶. For most HOAs, the application process, and the risk of potentially being subject to federal income tax, would not be worth the effort.

WHAT MUST HOMEOWNER ASSOCIATIONS REPORT TO FINCEN

If a reporting company is not exempt, it must file a beneficial ownership report with FinCEN, the Financial Crimes Enforcement Network of the U.S. Treasury. Entities that are in existence on or before January 1, 2024 will need to file their first report no later than December 31, 2024.⁷ Entities formed after January 1, 2024 will need to file their first report within 30 calendar days after their formation.

⁶ Section 528 requires an annual election by an HOA – failure to elect in any given year would cause the HOA to be a taxpayer that would be required to file a Form 1120 for that year. For that year, the HOA would be taxed as a “regular” for-profit corporation. The risk in seeking exemption under Section 501, is that even if the HOA qualifies for 501(c)(4) or (7) treatment in a given year, an audit may reveal that it failed to qualify in one or more subsequent years – at a time when it might be too late for the HOA to go back and make the annual election to be taxed under 528 for those non-qualifying years. See e.g. LTR 201349018 (July 10, 2012) (finding an HOA that had qualified under 501 to have failed to qualify in subsequent years). If the HOA fails to qualify under Section 501(c) in any year, the HOA will need to file the unfiled Forms 1120 for all non-qualifying years and pay any taxes on its income without the benefit of Section 528. For most HOAs in such a circumstance, the tax burden would be substantial as all of the dues received by the HOA from its members would be taxable income.

⁷ 31 CFR § 1010.380(b)(2)(iv).

The initial report filed by a reporting company must include:⁸

(i) For the reporting company:

- (A) The full legal name of the reporting company;
- (B) Any trade name or “doing business as” name of the reporting company;
- (C) A complete current address consisting of:
 - (1) In the case of a reporting company with a principal place of business in the United States, the street address of such principal place of business; and
 - (2) In all other cases, the street address of the primary location in the United States where the reporting company conducts business;
- (D) The State, Tribal, or foreign jurisdiction of formation of the reporting company;
- (E) For a foreign reporting company, the State or Tribal jurisdiction where such company first registers; and
- (F) The Internal Revenue Service (IRS) Taxpayer Identification Number (TIN) (including an Employer Identification Number (EIN)) of the reporting company, or where a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of such jurisdiction;

The initial report must also include:⁹

(ii) For every individual who is a **beneficial owner** of such reporting company, and every individual who is a company applicant with respect to such reporting company:

- (A) The full legal name of the individual;
- (B) The date of birth of the individual;
- (C) A complete current address consisting of:
 - (1) In the case of a company applicant who forms or registers an entity in the course of such company applicant's business, the street address of such business; or
 - (2) In any other case, the individual's residential street address;
- (D) A unique identifying number and the issuing jurisdiction from one of the following documents:
 - (1) A non-expired passport issued to the individual by the United States government;
 - (2) A non-expired identification document issued to the individual by a State, local government, or Indian tribe for the purpose of identifying the individual;

⁸ 31 CFR § 1010.380(b)(1)(i).

⁹ 31 CFR § 1010.380(b)(1)(ii).

- (3) A non-expired driver's license issued to the individual by a State; or
- (4) A non-expired passport issued by a foreign government to the individual, if the individual does not possess any of the documents described in paragraph (b)(1)(ii)(D)(1), (b)(1)(ii)(D)(2), or (b)(1)(ii)(D)(3) of this section; and
- (E) An image of the document from which the unique identifying number in paragraph (b)(1)(ii)(D) of this section was obtained.

As a result, HOAs that are non-exempt reporting companies will need to report to FinCEN these five pieces of personally identifiable information ("PII") from each of their "beneficial owners." Since HOAs do not have stockholders or investors, HOA directors will need to understand how the CTA defines "beneficial owner" as part of their reporting efforts.

WHO IS A BENEFICIAL OWNER?

The PII required in a beneficial ownership report relates to a reporting company's beneficial owners and (with respect to reporting companies formed after the effective date of the Final Rule) company applicants.

Under the Final Rule, a "beneficial owner" means, "any individual who, directly or indirectly, either exercises substantial control over such reporting company or owns or controls at least 25 percent of the ownership interests of such reporting company."¹⁰ The Final Rule looks only to the "individual" and requires reporting companies to look through non-natural persons to derive the individuals who own or control them.

Also, the definition of "beneficial owner" includes any person who "exercises substantial control." The Final Rule provides¹¹ 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;

¹⁰ 31 CFR § 1010.380(d).

¹¹ 31 CFR § 1010.380(d)(1)(i).

- (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.”

The Final Rule’s definition is non-exclusive and requires the reporting company to include any individual who “has any other form of substantial control.” As a result, many reporting companies will need to engage counsel to consider whether particular corporate governance arrangement bring individuals within the ambit of “substantial control” and thereby render them into beneficial owners.

The Final Rule also clarifies¹² that an individual may exercise “substantial control” over a reporting company, directly or indirectly, including as a trustee of a trust or similar arrangement, 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.

This guidance is non-exclusive and requires a reporting company to consider “any other contract, arrangement, understanding, relationship or otherwise” that might cause an individual to exercise “substantial control” in an indirect manner. The Final Rule establishes a facts and circumstances test that cannot be circumvented through a formalistic arrangement if there is an unwritten or covert “understanding, relationship or otherwise” that gives an individual indirect “substantial control.”

For Homeowner Associations that are governed by a board of directors, each director would be expected to exercise “substantial influence over important decisions” by virtue of their vote. Any senior officer of the HOA would also be a beneficial owner under the language in the Final Rule.

¹² 31 CFR § 1010.380(d)(1)(ii).

HOAs that are managed by an external management company should consider whether that management company exercise any “other form of substantial control” by virtue of their management contracts. A management company that exercised substantial control could be deemed to have substantial control, thereby requiring the management company to go through a similar analysis to determine those individuals that are beneficial owners of the management company. To avoid being deemed to have substantial control, management companies should review their management companies to ensure that they do not have the discretion required to exercise independent decision-making. A management company whose actions were entirely subject to the board of directors would likely take the position that it lacked substantial control.

WHEN ARE AMENDMENTS REQUIRED?

After an HOA files its first beneficial ownership report with FinCEN, the HOA must make certain to file an amendment to “reflect any change with respect to required information previously submitted to FinCEN concerning a reporting company or its beneficial owners.”¹³

The Final Rule requires an amendment whenever there are changes in a reporting company’s exemption status.¹⁴ If a reporting company was formerly exempt, but loses its exemption, it must file an “updated report” that announces the change and that includes all the information required in a reporting company’s initial report.

WHAT SHOULD HOMEOWNER ASSOCIATIONS DO NOW?

To file a beneficial ownership report, the HOA will need to familiarize itself with the CTA filing rules. In many circumstances, this may require the HOA to obtain legal or other professional advice.

Once the HOA has determined who its beneficial owners are, it will need to collect the five pieces of PII from each of those beneficial owners in order to file its first report. The HOA will also need to implement a compliance policy or procedure to ensure that it learns immediately about any change in the PII of its beneficial owners. The HOA will need that procedure to make certain it files an amendment to its beneficial ownership report within 30 calendar days after any piece of previously report information changes.

TAKEAWAYS

FinCEN’s publication of the Final Rule has started a countdown to its effective date on January 1, 2024. Reporting companies in existence before that date will have until January 1, 2024 to file an initial report of beneficial ownership. Reporting companies created or registered after that date will have 30 calendar days after the date of formation or registration to file an initial report.

Most HOA boards are probably unaware of these upcoming deadlines. HOAs, and the management companies that advise them, should engage counsel to evaluate their board arrangements to determine who are their beneficial owners. In some instances, reporting companies and individuals may want to change their corporate governance arrangements to clarify or exclude certain individuals from becoming beneficial owners. Nearly all HOAs will

¹³ 31 CFR § 1010.380(b)(3)(i).

¹⁴ 31 CFR § 1010.380(b)(3)(ii).

need to adopt procedures to collect the PII required for filing a beneficial ownership report and will need to obtain tools and systems for collecting and storing that confidential PII.

Compliance will be important because the CTA provides that the knowing failure to provide complete and/or updated information, or willfully providing false or fraudulent information, is punishable by civil penalties of up to \$10,000 (\$500/day) and criminal penalties of up to two years in prison.