KRIEG DEVAULT

Insights

Corporate Transparency Act Held Unconstitutional: What This Means for Your Business

March 6, 2024

By: Robert A. Greising, Travis D. Lovett, and Jacob W. O'Donnell

The Corporate Transparency Act ("CTA") has been ruled unconstitutional by the U.S. District Court for the Northern District of Alabama ("Court") in an opinion issued on March 1, 2024. This ruling raises uncertainty for the approximate 32.6 million businesses that are subject to the CTA.

Background on CTA

The CTA was enacted on January 1, 2021, but its reporting obligations became effective on January 1, 2024. The CTA requires most small businesses to report to the Treasury Department personal information regarding its owners, management personnel, and those substantially involved in the formation of the company. Congress enacted the CTA for the purpose of preventing abuse of our business systems in support of terrorism, human trafficking and other nefarious activities and moving the US government's oversight of money laundering more in line with the efforts of other developed countries. It has been widely criticized, but it also provided a model for several states which have adopted their own versions of the CTA. For more information about the CTA, please **see our prior Alert here**.

The Case and Rulings

In *National Small Business United, et al., v. Yellen, et al.*, the National Small Business Association and one of its members who owns two small businesses sued the Treasury Department six weeks after the CTA became effective. The plaintiffs argued that the CTA's mandatory disclosure requirements exceed Congress' authority under Article I of the Constitution and violate the First, Fourth, Fifth, Ninth, and Tenth Amendments. The federal government, on the other hand, argued that the CTA falls within the ambit of the Commerce, Taxing, and Necessary and Proper Clauses, along with Congress' foreign affairs and national security powers. In its decision, the Court found that the CTA is unconstitutional under the United States Constitution and ruled in favor of the plaintiffs.

National Security. Asserting the Necessary and Proper Clause, the government argued that Congress, in enacting the CTA, concluded that the collection of information about a business' owners and management personnel is vital to protect the United States' national security interests and better enable critical national security, intelligence, and law enforcement efforts to counter money laundering, the financing of terrorism, and other illicit activity. The Court acknowledged that Congress holds extensive powers over foreign affairs and national security and that courts should generally defer to the political branches on matters of policy. But in the same breath, the Court noted that respect for Congress' policy judgments can never extend so far as to disavow restraints on federal power that the Constitution carefully constructed. The Court noted that the incorporation of a company is an internal affair of state law and, accordingly, explained that the CTA cannot be justified as necessary and proper to carry out Congress' foreign affairs powers because those powers do not

extend to purely internal affairs, especially in an arena traditionally left to the States.

Commerce Clause. The government further argued that the broad authority granted Congress under the Commerce Clause supported enactment of the CTA . Because many State entities engage in activities that qualify as or affect "commerce," the government argued that the act of corporate formation is itself enough to invoke Congress' commerce powers. The government posited that the CTA's regulations fit squarely within the three broad categories of activity that Congress may regulate under its commerce power, namely (1) the channels of interstate and foreign commerce, (2) the instrumentalities of, and things and persons in, interstate and foreign commerce, and (3) activities that have a substantial effect on interstate and foreign commerce.

The Court disagreed, noting that the plain text of the CTA does not regulate the channels and instrumentalities of commerce, let alone commercial or economic activity. The Court highlighted that the word "commerce" or references to any channel or instrumentality of commerce are nowhere to be found in the CTA. Because the CTA does not regulate the channels or instrumentalities of commerce or prevent their use for a specific purpose, it cannot be justified as a valid regulation of those channels and instrumentalities.

Regarding activities that have a substantial effect on interstate and foreign commerce, the Court analyzed whether Congress has authority under the Commerce Clause to regulate non-commercial, intrastate activity when entities use the channels of commerce, and their operations substantially affect interstate and foreign commerce. The Court answered a resounding "no," highlighting that the connection between incorporation and criminal activity is far too attenuated to justify the CTA. Indeed, the Court noted that if this connection was enough, Congress' commerce powers would essentially be limitless. The Court also opined that the CTA contains no jurisdictional hook for the regulation of interstate commerce, nor does it serve as an essential part of a comprehensive regulatory scheme. For these reasons, the Court held that the CTA falls outside of Congress' power to regulate non-commercial, intrastate activity.

Taxing Power. The government's final argument concerned the justification of the CTA through Congress' taxing power and the Necessary and Proper Clause. Specifically, the government argued that the collection of beneficial ownership information is necessary and proper to ensure taxable income is appropriately reported. Put more simply, the CTA's regulations are constitutional because they are sufficiently "incidental" to Congress' taxing power, according to the government.

In response, the Court highlighted that it would be a "substantial expansion of federal authority" to permit Congress to utilize its taxing power just by collecting "useful" data and allowing tax-enforcement officials to access that data. If Congress were to have that authority, the Necessary and Proper Clause would sanction any law that provided for the collection of information considered useful for tax administration and provided tax officials access to such. The Court noted that this sort of unfettered power on behalf of the legislature is not narrow in scope nor incidental to the exercise of commerce power. Furthermore, even if the CTA's regulations were necessary, such an expansion of federal power would not be a proper means for making the CTA's goals effective. Thus, this argument failed as well.

The Court held that the CTA is unconstitutional because it cannot be justified as an exercise of Congress' enumerated powers and therefore, it did not decide whether the CTA violates the First, Fourth, and Fifth Amendments.

Now that the CTA has been ruled unconstitutional, the federal government is likely to appeal to the Eleventh Circuit and seek a favorable ruling. In doing so, it could seek a stay of this decision.

Impact on Businesses

Importantly, the Court's ruling is limited. The Court did not issue a national injunction. Rather, it only enjoined the government from applying the CTA to the plaintiffs.

Therefore, currently, the CTA remains in effect for all other businesses that are not members of the National Small Business Association (as of March 1, 2024). Other businesses that are reporting companies under the CTA must still comply with the CTA. Those in place before January 1, 2024 have until January 1, 2025 to make their filing. Companies formed in 2024 that do not satisfy any of the 23 exemptions from the CTA obligations have 90 days from formation to make their filings.

However, other challengers will likely file similar lawsuits against the federal government and argue that the CTA is unconstitutional and therefore, the federal government should be enjoined from enforcing the CTA. They could seek broader injunctive relief that would benefit a wider group of companies. We will continue to monitor this development and will issue other Alerts as circumstances warrant.

If you have any questions regarding the CTA or obligations to comply with the reporting requirements, please contact **Robert A. Greising**, **Travis D. Lovett**, **Jacob W. O'Donnell**, or any member of our **Business, Acquisitions and Securities Practice**.

Disclaimer. The contents of this article should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult with counsel concerning your situation and specific legal questions you may have.