Not So Sweet Home Alabama

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In a recent opinion out of the U.S. District Court for the Northern District of Alabama, the newly-effective Corporate Transparency Act[1] ("CTA") has been found unconstitutional. In *National Small Business United v. Janet Yellen*,[2] Plaintiffs Isaac Winkles and the National Small Business Association challenged Congress' authority to compel the disclosure of beneficial ownership information from entities incorporated at the state level. Judge Liles C. Burke agreed with the plaintiffs, finding that the CTA exceeds congressional authority under the Constitution because it lacks a sufficient nexus to Congress' enumerated powers.

The CTA was passed as part of the 2021 National Defense Authorization Act, and pursuant to a final rule issued by FinCEN in 2022, the CTA took effect on January 1, 2024. The CTA is designed to elicit certain identifying information from state-registered entities for the purpose of combating illicit activities such as money laundering and tax evasion. Specifically, the CTA requires "reporting companies" to disclose the identity and address of their beneficial owners to FinCEN. Remedies for the failure to disclose include civil penalties and criminal liability.

The plaintiffs challenged the CTA on a number of grounds, arguing that Congress lacked the authority to mandate such disclosures under its enumerated powers, and contending that said disclosure requirements violate the plaintiffs First, Fourth, and Fifth Amendment rights. The government offered four sources for congressional authority to implement the CTA, and Judge Burke addressed each in turn.

First, the government argued that the CTA was a valid exercise of Congress' foreign affairs powers and the Necessary and Proper Clause, because the collection of beneficial ownership information is necessary to protect national security interests and bring the United States into compliance with international financial standards. While acknowledging Congress' extensive foreign affairs powers and the deference typically given to Congress on policy matters, the court rejected the government's arguments because it found state-level incorporation to be an internal affair, not one of foreign affairs, because incorporation is a creature of state law and has historically remained within the purview of the states. Consequently, the CTA cannot be justified as an extension of Congress' foreign affairs powers, and instead must be justified under Congress' enumerated powers.

Second, the government argued that the CTA is a valid exercise of the Commerce Clause and Necessary and Proper Clause, because many CTA reporting companies are frequent users of the channels and instrumentalities of interstate and foreign commerce. The court, however, found no constitutional justification for regulation of the entire class of state-incorporated entities just because some members of that class may utilize the channels and instrumentalities of commerce at some point after formation. Judge Burke even remarked that the CTA could have been validly written to regulate the channels and instrumentalities of commerce, had it prohibited their use "for harmful purposes, even if the targeted harm itself occurs outside the flow of commerce."[3] Because the CTA imposes disclosure obligations upon state registration, and not when the entities actually engage in commerce, it cannot be sustained as a regulation of those channels and instrumentalities of commerce.

Third, the government argued that the CTA was justified under the Commerce Clause in that reporting companies have a substantial effect on commerce in the aggregate when they collectively withhold their beneficial ownership information from regulatory bodies. Judge Burke found the government's purported connection between entity formation and the illicit activity the CTA seeks to combat as far too attenuated to permit Congress to exercise its Commerce Clause authority. Likewise, Judge Burke rejected the government's argument that the CTA was a necessary and proper means of exercising Congress' power to curb illicit commercial activity, because the recipient of the disclosed ownership information, FinCEN, already receives such information under its Customer Due Diligence rules.

Lastly, the government argued that CTA's collection of beneficial ownership information can be justified as a necessary and proper method of effectuating efficient tax administration, thereby validating the CTA under Congress' taxing powers. Again, the court rejected this argument for its attenuation, finding that the mere provision of access to a new database of information for tax administration does not establish a close enough relationship between CTA's disclosure provisions and Congress' taxing power, so as to justify it under that taxing power. To find differently, opined Judge Burke, would constitute a "substantial expansion of federal authority."**[4]**

Given the court's determination that the CTA is unconstitutional for its lack of justification under Congress' enumerated powers, the court did not need to address whether it violated Plaintiffs' First, Fourth, or Fifth Amendment rights. While this decision raises questions about the viability of the CTA, it must be noted that the decision only applies to the plaintiffs in this case. The CTA remains fully enforceable against all other reporting companies, and it does not affect similar state-level legislation such as the New York LLC Corporate Transparency Act. As expected, this decision has been appealed and we will monitor and report on any future developments.

[1] 31 U.S.C. § 5336

[2] No. 5:22-cv-01448-LCB, 2024 WL 899372 (N.D. Ala. Mar. 1, 2024).

[3] Memorandum Opinion, *Nat'l Small Bus. United v. Yellen*, No. 5:22-cv-01448-LCB, at 32.

[4] *Id.* at 52.