Out of Scope - Exemptions from the Corporate Transparency Act

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The second installment in a multi-part series looking at the new Corporate Transparency Act discusses what is likely to be the first question that many companies have whenever a new law is passed – are we exempt?

The new Corporate Transparency Act and its related regulations (the "CTA") applies to all entities that constitute a "reporting company" under the CTA, which is broadly defined. However, the CTA also exempts a long list of entities from the definition of a "reporting company" and from compliance with the CTA, though there are nuances that may limit the scope of certain exemptions.

Whenever any new law is passed, one of the first questions that many companies will ask is, am I exempt? This article is the second of a series on the CTA and discusses entities that are exempt from compliance with the CTA. Further articles will discuss what companies covered by the CTA must do to comply.

<u>Definition of a Reporting Company and Entities Not Created by Filing of a Document</u>

First, before we start looking at the list of statutory exemptions, the definition of a "reporting company" leaves out a few entities. Reporting companies are either a domestic or foreign reporting company. A domestic reporting company is a corporation, limited liability company ("LLC"), or other entity that is created by the filing of a document with a state or tribal government, and a foreign reporting company is any entity formed under the law of a foreign country that is registered to do business in any state or tribal jurisdiction by the filing of a document with a government.

To be a domestic reporting company, an entity must be created by the filing of a document with a government. Corporations and LLCs are easily covered by this definition, but the analysis of whether partnerships and trusts constitute a reporting company is more complex. Limited partnerships ("LPs"), limited liability limited partnerships ("LLLPs"), and statutory business trusts that are created by a filing with a secretary of state's office that are created by a filing with a government likely count as reporting companies. However, FinCEN guidance states that sole proprietorships, trusts, and general partnerships that are not created by the filing of a document with a government are not a reporting company and thus not subject to the CTA.

There may be debate around whether a limited liability partnership ("LLP") is a reporting company. Under Virginia law, for example, a general partnership can become an LLP by filing with Virginia a statement of registration as an LLP. A general partnership must file a document with Virginia to become an LLP; however, the general partnership already exists when it files this document and does not need to file any document with Virginia to be a legal entity. In early guidance, FinCEN stated its belief that the definition of a reporting company included LLPs "because such entities appear typically to be created by a filing with a secretary of state or similar office." In subsequent guidance, however, FinCEN acknowledged disagreement on this issue and appeared to avoid taking a position on LLPs, merely noting that state formation law and practices would dictate whether an entity was covered. In determining whether an LLP is covered by the CTA, the state law governing the formation of the LLP should be closely reviewed.

Exempted Entities and their Subsidiaries

The CTA specifically exempts several types of entities from the definition of a “reporting company”, regardless of whether they’re created by the filing of a document with a government. A full list of exempted entities is included at the end of this article. Many exemptions cover entities that are registered or licensed with a regulator or comply with heightened IRS reporting requirements to satisfy a specific qualification under the federal tax code.

In many cases, an entity that is wholly owned by an exempt entity is itself exempt from the CTA. However, that is not true for all exemption categories. Entities with ownership interests that are wholly owned by (i) exempt money transmitting or money servicing businesses, (ii) exempt pooled investment vehicles, (iii) entities that are exempt by virtue of operating exclusively to assist certain tax-exempt entities, or (iv) exempt inactive entities (although it appears to be impossible under the CTA for an entity to own equity in another entity and qualify as an inactive entity) are not exempt from the CTA by virtue of their parent’s exemption, and must either comply with the CTA or satisfy another exemption.

For privately-held entities that are not licensed or registered with a regulator, there are two exemption categories that may be of particular interest: (1) large operating companies and (2) inactive entities.

What counts as a large operating company?

Exempt “large operating companies” are entities that meet all of the following 3 conditions:

- The entity employs more than 20 full-time employees in the United States,
- The entity has an operating presence at a physical office in the United States, AND
- The entity filed a federal income tax or information return in the United States for the previous year that reported more than $5 million in gross receipts or sales (net of returns or allowances), excluding gross receipts or sales from sources outside of the US.

Entities that are wholly owned by large operating companies are also exempt. However, an entity that owns a large operating company is not exempt by virtue of owning a large operating company and must comply with the CTA unless it fits another exemption.

For an entity to be exempt as a large operating company, it must have filed a tax or information return for the prior year. Therefore, newly formed entities cannot be a large operating company in their formation year unless they are wholly owned by another large reporting company. Entities planning to become a large operating company will need to file the initial report with FinCEN and then determine if they meet the large operating company test in later years.

What counts as an inactive entity?

Exempt “inactive entities” are entities that meet all of the following 6 conditions:

- It must have existed on or before January 1, 2020;
- It must not be engaged in active business;
- It must not be owned by a foreign person (defined in the CTA), wholly or partially, directly or indirectly;
- It must not have experienced any change in ownership in the last 12 months;
- It must not have sent or received any funds in an amount greater than $1,000, directly or through any account in which the entity or its affiliate had an interest, in the last 12 months; and
- It must not otherwise hold any kind or type of assets, including any ownership interests in any corporation, LLC, or similar entity.

An entity formed after January 1, 2020, can never satisfy the “inactive entity” exemption.

If your entity didn’t make the cut

If your entity doesn’t qualify for any of the exemptions, then your entity will need to start preparing to comply with the CTA. Fortunately, CTA compliance shouldn’t be a terribly time-intensive process, although it will need to be included as a required action item on checklists. Future articles

in this multi-part series will turn to discuss the obligations imposed by the CTA on reporting companies.

List of Exemptions

1. Publicly traded companies and companies required to file reports under the Securities Exchange Act;
2. Governmental entities;
3. Banks, credit unions, and bank holding companies, as defined under certain federal statutes;
4. Money transmitting or money servicing businesses registered with FinCEN;
5. Securities brokers or dealers registered under the Securities Exchange Act;
6. Securities exchanges or clearing agencies registered under the Securities Exchange Act;
7. Other entities registered under the Securities Exchange Act that are not described above;
8. Investment companies or investment advisers registered with the SEC under the Investment Company Act or the Investment Advisers Act;
9. Investment advisers that constitute "venture capital fund advisers" under the Investment Advisers Act and have filed certain portions of the Form ADV with the SEC;
10. Insurance companies as defined in the Investment Company Act;
11. Insurance producers that are authorized by a state, subject to state supervision, and have an operating presence at a physical office in the US;
12. Certain entities registered with the CFTC or otherwise under the Commodity Exchange Act;
13. Public accounting firms registered under Sarbanes-Oxley;
14. Regulated public utilities as defined in the Internal Revenue Code (the "Code");
15. Entities designated as a "financial market utility" by the Financial Stability Oversight Council under Section 804 of the Payment, Clearing, and Settlement Supervision Act of 2010;
16. Pooled investment vehicles that are operated or advised by a bank, credit union, registered money transmitter, registered investment company, registered investment adviser, or venture capital fund adviser, each as described above;
17. Entities described in Code Section 501(c) and exempt from tax under Code Section 501(a), political organizations defined in and exempt from tax under Code Section 527, and charitable trusts and split-interest trusts described in Code Sections 4947(a)(1) and (2);
18. Entities that (i) operate exclusively to provide financial assistance to, or hold governance rights over, tax-exempt entities described in 17 above, (ii) are US persons (as defined in the CTA), (iii) are owned or controlled exclusively by US citizens or permanent residents, and (iv) derive a majority of their funding or revenue from US citizens or permanent residents;
19. "Large operating companies," described above;
20. "Inactive entities," described above; and
21. Entities with ownership interests that are controlled or wholly owned by any exempt entity described above other than (i) exempt money transmitting or money servicing businesses, (ii) exempt pooled investment vehicles, (iii) entities that are exempt by virtue of operating exclusively to assist certain tax-exempt entities, or (iv) exempt inactive entities.

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