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Disregarded Entity Eligibility for the CTA Large Operating Company Exemption

Summary: As discussed in detail below, the Corporate Transparency Act (CTA) provides an exemption to its reporting requirements for certain large operating companies (the Large Operating Company Exemption or "LOC Exemption"). In order to qualify for the LOC Exemption, a reporting company must, among other requirements, "have filed a Federal income tax or information return in the United States in the previous year demonstrating more than $5,000,000 in gross receipts or sales." Certain reporting companies are "disregarded entities" (DREs) for Federal tax purposes and, as such, do not themselves directly have a Federal tax filing obligation or ability. However, based upon guidance from FinCEN and the IRS, support exists for the proposition that the Federal tax filing of a DRE's sole individual owner or sole parent entity constitutes the filing referenced in the LOC Exemption, and that a DRE reporting company is not, per se, disqualified from utilizing the LOC Exemption.

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Certain business entities may elect (including through default attribution under the Internal Revenue Code, (IRC) to be treated as "disregarded" from their individual owner or parent entity for U.S. federal income tax purposes. Such entities include limited liability companies (LLCs) who have a single member (unless such an LLC has elected on Internal Revenue Service (IRS) Form 8832 to be taxed as a "corporation"), or certain wholly owned subsidiaries of "S-corporations" where the parent S-corporation has made an election (referred to as a "Q-Sub election") on IRS Form 8869 to treat the subsidiary as a qualified subchapter S subsidiary (QSub), whereby such Q-Sub is deemed to be liquidated (for federal tax purposes only) into the parent S-corporation.

These entities, often referred to simply as "disregarded entities" do not, as a distinct, juridical person, file a federal income tax return per se. Instead, DREs have their taxable income and loss reflected, on an aggregated basis, on the federal income tax return of their individual owner or (direct or indirect) parent entity. In fact, when reporting the taxpayer identification number (TIN) of a DRE on an IRS Form W-9 (Request for Taxpayer Identification Number and Certification), the DRE provides the federal employer identification number (FEIN) of a parent entity or a social security number (SSN) of an

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individual owner, rather than a TIN of the DRE itself. This is true even if the DRE has filed for, and has received from the IRS, its own FEIN.

Further to this point, some DREs do not, and are not required to, file for their own FEIN. As such, not all DREs possess their own FEIN or other entity distinct TIN.

The Financial Crimes Enforcement Network (FinCEN), in its Frequently Asked Question F.13 issued July 24, 2024, acknowledged this fact as follows:

"An entity that is disregarded for U.S. tax purposes—a "disregarded entity"—***is not treated as an entity separate from its owner for U.S. tax purposes***. Instead of a disregarded entity being taxed separately, ***the entity's owner reports the entity's income and deductions as part of the owner's federal tax return***. …

Consistent with rules of the Internal Revenue Service (IRS) regarding the use of TINs, different types of tax identification numbers may be reported for disregarded entities under different circumstances:

- ***If the disregarded entity has its own EIN, it may report that EIN as its TIN. If the disregarded entity does not have an EIN, it is not required to obtain one to meet its BOI reporting requirements so long as it can instead provide another type of TIN***….
- ***If the disregarded entity is a single-member limited liability company (LLC) or otherwise has only one owner that is an individual with a SSN or ITIN, the disregarded entity may report that individual's SSN or ITIN as its TIN.***
- ***If the disregarded entity is owned by a U.S. entity that has an EIN, the disregarded entity may report that other entity's EIN as its TIN***.
- ***If the disregarded entity is owned by another disregarded entity or a chain of disregarded entities, the disregarded entity may report the TIN of the first owner up the chain of disregarded entities that has a TIN as its TIN***.

As explained above, a disregarded entity that is a reporting company must report one of these tax identification numbers when reporting beneficial ownership information to FinCEN."[i]

While the above FAQ is not offered by FinCEN specifically in the context of the LOC Exemption, this FAQ does have important implications for the LOC Exemption. In stating that a DRE is not required to obtain an FEIN merely for purposes of having such a number for purposes of filing a beneficial ownership information report (BOIR) under the CTA, and acknowledging that a DRE may provide a SSN of an individual owner, or an FEIN of a parent entity, in satisfaction of the DRE's requirement to provide a tax identification number as required in FinCEN's form for filing BOIRs, FinCEN has recognized that the same TIN required by the IRS to be disclosed on a Form W-9 in respect of a DRE is recognized by FinCEN as an appropriate TIN in respect of the DRE for purposes of such entity's BOIR filing.

As such, the federal tax return filing associated with such a TIN is, therefore, the tax return associated with the DRE reporting such TIN on its BOIR filing. In other words, the fact that an individual owner or a parent entity has made a prior year's federal tax return filing, which filing includes the U.S. generated gross receipts or sales of the DRE, should be sufficient to satisfy the DRE's prior year's federal tax return filing status with respect to such revenue.

As stated in FAQ F.13 above, "a DRE—is not treated as an entity separate from its owner for U.S. tax purposes…, the entity's owner reports the entity's income and deductions as

part of the owner's federal tax return…"

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With this background, we next analyze the associated implications to a DRE that may qualify for the LOC Exemption.

For purposes of clarity, the requirements for an entity to qualify for the LOC Exemption is that the entity satisfy all three parts of the following three-part test:

"[A]***n entity*** must have more than 20 full-time employees in the United States, ***must have filed a Federal income tax or information return in the United States in the previous year demonstrating more than $5,000,000 in gross receipts or sales***, and must have an operating presence at a physical office in the United States."[ii]

The CTA itself provides more specificity in this regard. The CTA provides that the term "reporting company" does not include ***any entity that:***

"(I) employs more than 20 employees on a full-time basis in the United States; ***(II) filed in the previous year Federal income tax returns in the United States demonstrating more than $5,000,000 in gross receipts or sales in the aggregate, including the receipts or sales of (aa) other entities owned by the entity; and (bb) other entities through which the entity operates;*** and (III) has an operating presence at a physical office within the United States."[iii]

Although FinCEN has, to date, issued no formal acknowledgment or interpretation with regard to the applicability of the above "revenue prong" specifically in the DRE context, for the reasons outlined above, a reasoned and supported proposition in the DRE situation may be that the "filed Federal income tax or information return" referenced in the LOC Exemption is the federal tax return filing of the reporting company's individual owner or parent entity, as applicable.

Further to the revenue prong, it appears that if the DRE itself generates U.S. generated gross receipts or sales in excess of five million dollars as reported on the prior year's federal tax return filing, that the DRE meets the revenue prong of the LOC Exemption. However, based on the above analysis, it may also be a colorable position that the DRE MAY be able to assert that ALL of the U.S. generated gross revenue appearing on the individual owner's or parent entity's federal tax return filing may be attributable to the revenue test prong of the LOC Exemption, because all of such revenue is associated with that tax return. This situation is notionally similar to FinCEN's interpretation that all members of a consolidated corporate taxed group (including each subsidiary) may share in credit for the aggregated gross receipts or sales of the entire group in meeting each of their respective, individual revenue requirements under the LOC Exemption. Here, both the individual and DRE or the parent entity and disregarded subsidiary would be relying upon the same federal tax return, in the individual or partnership tax context.

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For purposes of clarity and completeness, we acknowledge a countervailing position espoused by some commentators in the marketplace. That position holds that a DRE is *ab initio* ineligible to qualify for the LOC Exemption merely because of such reporting company's status as a DRE (*i.e.*, that it, itself, as a business entity, does not directly cause the filing of its own, independent federal tax return). For the reasons outlined herein, we find this position less compelling than the proposition that disregarded entities have a filed

Federal income tax or information return when filed by their individual owner or parent entity.

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With respect to exemptions from the reporting obligations under the CTA, each such exemption is "self-executing." In other words, if an exemption applies to a reporting company, that reporting company has no filing obligation to FinCEN under the CTA. As such, there is no BOIR filing on record documenting that the DRE is relying on its individual owner's SSN or its parent entity's FEIN, and, derivatively, the associated federal tax return filing, in establishing compliance with the revenue prong of the LOC Exemption test. We recommend that each DRE making such a reliance-based exemption determination maintain a record of their CTA diligence, analysis and exercise of business judgment made upon a fully informed basis, that underpins the substantiation of the DRE's satisfaction of all parts of the LOC Exemption test.[iv] Such substantiation may be needed in the future if FinCEN or one of the DRE's financial institutions requests substantiation of the DRE's asserted position that such DRE is not required to file a BOIR under the CTA.

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Conclusion. The compliance requirements under the CTA went live on January 1, 2024, and you have only the remainder of this year to take any action to prepare for your compliance position. Now is the time to discuss the CTA with your Polsinelli legal team for guidance.

[i] *See* FinCEN CTA FAQs F.13 (issued July 24, 2024)(https://www.fincen.gov/boi-faqs)

[ii] *See* FinCEN CTA FAQs L.7 (issued April 18, 2024)(https://www.fincen.gov/boi-faqs)

[iii] U.S.C. § 5336 (a)(11)(B)(xxi).

[iv] Note that there are other factors of the LOC Exemption that must be met in order to rely on that exemption, and such other factors are required to be met ***directly*** by the DRE. This discussion is not intended to suggest that the DRE may rely, for example, on employee counts of affiliated entities or impermissible U.S. physical address locations in qualifying for the LOC Exemption.