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# The Corporate Transparency Act: Implications for ESOPs

The Corporate Transparency Act (CTA) took effect on January 1, 2024. With the aim of deterring money laundering and other illegal activity through shell companies, the CTA requires reporting companies to disclose the name, residential address, and a copy of a current driver's license, passport, or other government-issued identification of its beneficial owners to the Financial Crimes Enforcement Network (FinCEN). Beneficial owners generally include managers, c-level executives, directors, and owners of 25% or more of the reporting company's equity. Due to the CTA's wide net and potential penalties, each ESOP-owned company should determine whether it is a reporting company that is subject to the CTA's reporting requirements.

## Background

The CTA's reporting obligations apply to "reporting companies," which are broadly defined to include any corporation, LLC, or other entity created by filing a document with a secretary of state or similar office. Unless an exemption applies, this includes a corporation owned by an ESOP as well as subsidiary entities.

There are 23 categories of exemptions from the CTA. Likely, among those most often applicable to ESOP companies will be the "large operating company" exemption. A large operating company is an entity with (i) more than 20 full-time employees in the U.S.; (ii) more than \$5 million in gross receipts reported on its prior year tax return; and (iii) an operating presence and physical location in the U.S. Exemptions also are available for various regulated entities, such as banks, credit unions, or insurance companies.

Entities exempt from taxation under Section 501(c)(3) of the Internal Revenue Code are also exempt from reporting under the CTA. However, an ESOP is exempt from tax under Section 501(a), not Section 501(c)(3), which means

that an ESOP does not fall within the tax-exempt entity CTA exemption. Also relevant to ESOPs, a nonbank trustee is not an exempt category.

### **Impact on ESOP companies**

ESOP-owned businesses should review their entity structure and determine whether an exemption applies. In many instances, the ESOP owns the operating company directly. In this structure, if the ESOP-owned operating company is a large operating company or fits under one of the other exemptions, then neither the ESOP-owned operating company nor the subsidiaries it controls is subject to the CTA's reporting requirements.

### **ESOP holding companies**

ESOP structures commonly have a holding company that owns the principal operating company and perhaps other entities as subsidiaries. In this structure, the company owned by the ESOP is the holding company. Unless the holding company directly employs more than 20 employees and meets the gross receipts requirement, it would not be a large operating company.

If the large operating company exemption does not apply, the ESOP holding company should consider whether the subsidiary exemption applies. Under CTA and FinCEN guidance, a business that is wholly owned or wholly controlled by an exempt entity is generally exempt as a subsidiary. The trustee of an ESOP holds legal title to the shares of the company owned by the ESOP. An ESOP company that is owned 100% by an ESOP is wholly owned or wholly controlled by the ESOP trustee. Although this may not be the intuitive prototype of a parent-subsidiary corporate relationship, it is a reasonable interpretation and application of the CTA and FinCEN guidance. ESOPs should consult legal counsel to examine its particular circumstances.

### **What kind of trustee does your ESOP have?**

If the ESOP trustee is an individual, then the subsidiary exemption will not apply. An individual trustee cannot be a large operating company.

On the other hand, if the trustee is an institutional trustee that itself is a large operating company or regulated entity, such as a bank, then the subsidiary exemption should apply, assuming the holding company is wholly owned by the ESOP. We have asked FinCEN to confirm this conclusion, but FinCEN has declined to do so.

The CTA provides for attention-getting penalties, including a civil penalty of up to \$500 per day and also possible criminal penalties of up to a \$10,000 fine and up to two years in prison for a willful failure to report. The requirement that noncompliance must be **willful** establishes an extremely low

risk that an ESOP holding company that relies on the subsidiary exemption with an institutional trustee would be assessed a penalty for the failure to report beneficial ownership.

## **What this means to you**

ESOP-owned companies might be—but are not necessarily—exempt from the CTA’s reporting requirements. Decisionmakers at ESOP companies should work with ESOP counsel to determine whether they should be considered reporting companies subject to the CTA’s reporting requirements.

## **Contact us**

Husch Blackwell is ready to help with all of your CTA and ESOP needs. Contact Jordan Bergkamp, Alan Kandel, Yuefan Wang, Aly Winters, or your Husch Blackwell attorney for more information.

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