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WHAT ACCOUNTANTS AND LAWYERS SHOULD KNOW ABOUT ENTITY-OWNED SINGLE-MEMBER LLCs

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EXECUTIVE SUMMARY

For corporations and other entities, including LLCs, that can benefit from holding assets or conducting operations through wholly-owned subsidiaries, the best entity choice for these subsidiaries is often a single-member LLC. However, in forming a single-member LLC to serve as a subsidiary, a parent entity should give careful consideration to all relevant legal and tax issues, including, especially, issues concerning the subsidiary's management structure.

DISCUSSION

A. INTRODUCTION; LEGAL ADVANTAGES OF SINGLE-MEMBER LLCs AS SUBSIDIARIES

It is often wise for corporations and other entities to hold valuable business assets and to conduct business operations through one or more wholly-owned subsidiary entities.

> EXAMPLE. XYZ, Inc. manufactures widgets. Its manufacturing equipment is worth $1 million. To protect this equipment, XYZ should hold it directly but should conduct its manufacturing, sales and service operations in a wholly-owned subsidiary. This holding company/operating company structure is likely to provide powerful business asset protection to XYZ's equipment if the subsidiary's operations ever result in a lawsuit. Assuming proper structuring, any resulting judgment will very likely be against the subsidiary, not against XYZ itself.

In deciding what type of entity it should use as a subsidiary, a parent company has two main choices—a state-law business corporation of which it will be the sole shareholder or a single-member LLC of which it will be the sole member. Its choice should almost always be a single-member LLC. From a business organization law viewpoint, single-member LLCs are substantially better than corporations. Among other considerations:

1) The liability shield provided by single-member LLCs to their members is at least as strong as that provided by corporations to their shareholders.
2) Entities that own single-shareholder corporations must comply with numerous burdensome statutory formalities, and their failure to comply with them can create a risk of veil-piercing. LLCs are subject to only the most minor formalities.

B. FEDERAL AND STATE TAX CONSIDERATIONS

The federal and state taxation applicable to single-member LLCs is also generally better than that applicable to single-shareholder corporations. Briefly:

1) Single-member LLCs as "disregarded entities." Except as otherwise provided under Internal Revenue Code Subchapter S, corporate subsidiaries will be subject to taxation as C corporations, and, in general, their parents must determine their tax liabilities in accordance with U.S. Treasury consolidated return regulations. These regulations are complex and can sometimes yield unwanted results. By contrast, by reason of federal Entity Classification Regulations (the famous "Check-the-Box Regulations"), almost all single-member LLCs owned by entities are classified as "disregarded entities" for federal tax purposes. This means that their tax items are treated as those of their parents, and their parents need not be concerned about the consolidated return regulations.
2) State taxation. Under the tax laws of most states, single-member LLCs are treated as pass-through entities whose taxation is generally similar to that of disregarded entities under federal rules. Furthermore, while single-member LLCs are subject to entity-level taxes under the New Hampshire Business Profits Tax and Business Enterprise Tax, careful tax planning can generally assure that the aggregate New Hampshire tax liability of entities that use single-member LLCs as subsidiaries will be the same as if these entities operated without subsidiaries.

C. DO SINGLE-MEMBER LLCs OWNED BY ENTITIES NEED LLC AGREEMENTS?—MANAGEMENT STRUCTURE ISSUES

Entities that form single-member LLCs as subsidiaries should enter into LLC agreements with their subsidiaries that will alter the default rules of the governing LLC act to the extent that these rules are inappropriate for single-member LLCs and that will properly determine the tax and legal structure of these LLCs. The key issue that should be addressed in the LLC agreement of such an LLC should be its management structure. In general:

1) The manager of the single-member LLC owned by an entity should never be the parent entity itself, since this will increase the risk that the parent will be sued for activities of the subsidiary.
2) If the business activities of the single-member LLC subsidiary are relatively limited, the subsidiary should be managed by an individual appointed as manager by the board of directors, managers or other governing persons (the "Governing Body") of the parent.
3) If the business activities of the subsidiary are somewhat complex, the subsidiary should be managed by two or more managers appointed by the parent's Governing Body. The titles and functions of these single-member LLC managers will generally resemble those of corporate officers.
4) If the business activities of a subsidiary single-member LLC are extensive, the parent should consider appointing an internal board in the subsidiary to exercise general

supervision of the subsidiary's activities. However, board operations are inevitably complex and potentially expensive, and any failure of the internal board of a single-member LLC subsidiary to comply with traditional corporate statutory formalities applicable to boards may create a risk of veil-piercing for the subsidiary's parent. Thus, in general, appointing internal boards for single-member LLC subsidiaries is not a good idea.

D. INTERCOMPANY AGREEMENTS BETWEEN PARENTS AND SINGLE-MEMBER LLC SUBSIDIARIES

For both tax and legal reasons, parents should always establish carefully constructed intercompany agreements between themselves and their subsidiaries, whether these subsidiaries are single-member LLCs or single-shareholder corporations. These agreements may be, among other things, supply agreements, real property and personal property lease agreements, license agreements, loan and security agreements, and agreements under which the parent provides administrative services to the subsidiary. The terms in these agreements should always be arm's-length terms. For both tax and legal purposes, a good basis for drafting these terms is the set of intercompany rules set forth in the U.S. Treasury Regulations under Internal Revenue Code Section 482.