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USING SINGLE-MEMBER LLCs AS OPERATING SUBSIDIARIES—TAX AND LEGAL CONSIDERATIONS

EXECUTIVE SUMMARY

No company with valuable assets should operate as a single entity; instead, in order to obtain maximum protection of these assets, its management should restructure the company into two separate legal entities—namely, a holding company and an operating company. The simplest and often the best way to achieve this holding company/operating company structure is through the use of one or more single-member LLCs.

DISCUSSION

A few New Hampshire businesses have valuable assets even when their owners first form them, and many New Hampshire businesses that begin with few or no valuable assets accumulate them over the years.

> Example. John Doe formed Doe Construction Company, Inc. ("Doe Construction") in 1990. When he launched Doe Construction's business, Doe Construction rented most of the vehicles and other equipment that it needed, and it financed the rest. However, renting and financing can be expensive; so today, Doe Construction owns outright almost all of its business assets. Taken together, these assets have a current fair market value of many hundreds of thousands of dollars and a replacement cost that is even higher.

However, if John continues to hold the above assets in the same entity as his operating company (i.e., Doe Construction) and if, because of employee negligence or otherwise, Doe Construction incurs a judgment that exceeds its liability insurance coverage, a court will almost certainly order the sale of Doe Construction's assets to cover the unsatisfied amount of the plaintiff's claim.

John can prevent the loss of Doe Construction's assets in such a situation through various arrangements. However, the arrangement that is likely to be the least expensive for John and the best arrangement for him from a tax and legal viewpoint will be for Doe Construction, Inc. to form a single-member LLC of which it will be the sole member and which will conduct all of Doe Construction's operations. This new structure will leave Doe Construction itself with only two functions—namely,

1) To lease its assets to its single-member LLC; and

2) To exercise general supervision of its single-member LLC's operations.

If, once Doe Construction has implemented its new holding company/operating company structure, its operations result in a lawsuit, only its single-member LLC will be a party to the suit; as long as Doe Construction has not participated in the wrongdoing that resulted in the suit, Doe Construction cannot be a party. The result? All of Doe Construction's assets will be protected from the suit.

Why should Doe Construction use a single-member LLC as its operating subsidiary instead of following long-standing tradition and using a wholly owned corporation for this purpose? There are two main reasons:

- First, the default federal income tax classification of entity-owned single-member LLCs under the Check-the-Box Regulations is that of "disregarded entities"—i.e., entities whose income and other tax items are deemed for federal tax purposes to be those of their parents. Thus, a corporation that is the parent of a single-member LLC need file only a single federal tax return—namely, its own return; and it need not comply with federal consolidated return regulations. By contrast, all business corporations that are C corporations but that have one or more corporate subsidiaries are required to comply with these regulations, and many such corporations find this compliance both complex and expensive.
- Second, neither multi-member LLCs nor single-member LLCs are required to comply with statutory management formalities in order to prevent third parties from "piercing their veils"—i.e., from holding their members liable for LLC negligence and other misconduct. By contrast, corporations that want to avoid veil piercing must comply with extensive management formalities.

To minimize the risk of veil piercing, what should be the management structure of single-member LLCs that are wholly owned by entity parents? Among corporate lawyers, this is a hotly debated topic. Some of these lawyers argue that since judges are likely to bring corporate concepts to veil piercing cases involving single-member LLC operating subsidiaries, not only the parents of these subsidiaries but also the subsidiaries themselves should have boards of directors and should comply religiously with all traditional board procedures.

In my view, however, this "internal subsidiary board" structure makes no sense, since, among other considerations, if the subsidiary fails in even a minor respect to comply with board formalities, this could provide plaintiffs with a strong argument in favor of piercing the subsidiary's veil and holding its parent liable for its actions.

Thus, I always recommend to clients that are setting up single-member LLC operating subsidiaries that they appoint one or more subsidiary employees as managers of these subsidiaries, although I also recommend that, to facilitate dealings with third parties, the parents give these employees traditional corporate titles such as president or chief financial officer. The resulting subsidiary management will be far more intuitive and user-friendly for the managers and employees of both the parent and subsidiary; and, in my view, it will create significantly less veil-piercing risk than a subsidiary board management structure.