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## CHOICE OF ENTITY FOR A NEW SUBSIDIARY OF AN S CORPORATION


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When an S corporation wants to create a wholly-owned subsidiary, it has three choices: a C corporation, a qualified subchapter S subsidiary (a "QSub") or a limited liability company ("LLC"). This article explains why an LLC is usually the best choice.

**Alternative Structures**. An existing S corporation might operate a business and also own a valuable asset (examples: real estate, art or another business operated as a division). Management will want to insulate the valuable asset from catastrophic claims that might arise in the operation of the corporation's primary business.[2] There are various ways to accomplish this:

- The valuable asset could be distributed to the shareholders. This would insulate it, but the shareholders would pay tax on the appreciation in the asset.[3] If the built-in gain tax applied, the corporation would also pay a tax.[4] Also, it might not be convenient for the shareholders to hold the assets as tenants in common.

- The S corporation could form a subsidiary and transfer the valuable asset to the new subsidiary. However, a claim against the parent corporation could be satisfied with the stock of a corporate subsidiary holding the valuable asset. If the subsidiary holding the valuable asset is an LLC, the result might be different. Although a judgment creditor of an LLC member (in this case, the parent corporation) is generally limited to a charging order or becoming a holder of an economic interest – not a voting membership interest – in the LLC, many doubt that a judgment creditor of a single-member

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[2] This would be a judgment that exceeded the value of the corporation's assets less its *(footnote continued…)*

*(footnote continued)*
other liabilities and also its insurance coverage.

[3] I.R.C. § 311.

[4] I.R.C. § 1374.

LLC would be prevented from obtaining the LLC's assets.[5]

- The primary business could be transferred to a subsidiary and the valuable asset could be held in the parent corporation.[6] This would be satisfactory if the valuable asset was art or another asset that would not generate liabilities, because the subsidiary stock would be subject to claims against the parent corporation. To preserve the benefits of S corporation status[7] the parent must elect to be an S corporation and must elect to treat the old corporation/new subsidiary as a QSub.[8] A QSub is disregarded for tax purposes and its assets are treated as assets of its S corporation parent.[9] Because the QSub is "disregarded' for tax (but not liability) purposes, it could be merged into a limited liability company wholly-owned by the parent corporation. A single-member LLC is also disregarded for federal tax purposes.[10] Consequently, this merger would have no effect for federal tax purposes – the assets and liabilities of the parties to the merger would be the assets and liabilities of the parent (for tax purposes) before and after the merger.

- A new holding company could be organized with two sub-

[5] Cal. Corp. Code § 17302 (no charging order exception for single-member LLCs); *but see* In re A-Z Electronics, 2006 Bankr. LEXIS 2105 (Bankr. D. Idaho, February 23, 2006) (bankruptcy trustee of sole member and not member-manager entitled to file bankruptcy petition on behalf of the LLC); In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003) (allowing a bankruptcy trustee to reach the assets in the debtor's single-member LLC). *See also* J. Stein, Building Stumbling Blocks, BUSINESS ENTITIES (September/October 2006) 28, 34-36.

[6] This could be accomplished by creating a new corporation and issuing its shares to the existing shareholders in exchange for their shares of the existing corporation. The old corporation would become a subsidiary of the new corporation. The subsidiary would distribute its valuable asset to the parent corporation.

[7] The principal benefit of S corporation status is the ability to sell the business assets and to pay one level of tax, with the goodwill taxed as capital gain so that the favorable tax rates for long-term capital gain can apply. An S corporation that is not subject to the built-in gain tax can accommodate the buyer's wish to buy assets (not stock) without creating a double tax for the selling share-
*(footnote continued...)*

*(footnote continued)*
holders. For a mature business with substantial cash flow, S corporation status allows the business to distribute profits to shareholders with one level of tax.

[8] I.R.C. § 1361(b)(3)(B); Treas. Reg. § 1.1361-3.

[9] I.R.C. § 1361(b)(3)(A); Treas. Reg. § 1.1361-4(a). Because the separate existence of the QSub is disregarded, the transfer of assets between the parent and subsidiary has no effect for tax purposes. To avoid piercing the corporate veil, the transfers must be properly documented and properly reflected on the accounting records of both entities.

[10] Treas. Reg. § 301.7701-3(b)(1) (the "check-the-box" rules for entity classification for federal tax purposes).

sidiaries: the existing corporation and a new subsidiary. The existing corporation would transfer its valuable asset to the new subsidiary. The holding company would own only the stock or other ownership interests in the subsidiaries. A claim against one subsidiary could not be satisfied with the stock or assets of the other subsidiary or with the stock or assets of the holding company.[11]

**C Corporation.** In these examples the subsidiaries hold valuable assets and businesses. If the value of the asset or business exceeds its tax basis – or is likely to exceed its tax basis in the future – it generally should not be held in a C corporation. When the asset is sold by a C corporation, the corporation will pay tax on the gain and the shareholders will pay tax again when the after-tax sale proceeds are distributed to them. This rules out a C corporation as a subsidiary in many situations.[12] So the choice is between a QSub or a single-member LLC.

**QSub**. For a subsidiary to be a QSub, the parent must (1) be an S corporation, (2) own 100% of the outstanding shares of the QSub and (3) file an election.[13] If the election is not filed or shares are acquired by anyone other than the S corporation parent, the subsidiary ceases to be a QSub and becomes a C corporation – subject to a double tax when it sells its assets. When the subsidiary ceases to be QSub, a special tax fiction applies to the "transformation." The assets of the subsidiary are treated as if the parent contributed them to the subsidiary on the transformation date in exchange for stock of the subsidiary. The liabilities of the subsidiary are treated as if the subsidiary assumed them from the parent on the transformation date.[14] Generally, the deemed exchange of assets for subsidiary stock will be tax-free under Section 351 of the Internal Revenue Code (the "IRC"). However, to the extent that liabilities of the subsidiary exceed the tax basis of its assets, gain will be recognized by the parent on the "transforma-

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[11] In this article we assume that the entities would be organized and operated in way that would prevent a creditor from piercing the corporate veil of any entity.

[12] If the parent corporation is a C corporation – not what we assume in this article – it might make sense for its subsidiary to be a C corporation and to use the consolidated return rules and the dividends-received deduction to minimize taxes on transfers within the consolidated group. I.R.C. §§ 1501-1564. However, using a "disregarded" single-member LLC will often involve less complication than the consolidation rules. For example, there is no deferred inter-company gain and no excess loss account *(footnote continued...)*

*(footnote continued)*
for subsidiaries structured as "disregarded" single-member LLCs.

[13] I.R.C. § 1361(b)(3)(B); Treas. Reg. § 1.1361-2.

[14] I.R.C. § 1361(b)(3)(C); Treas. Reg. § 1.1361-5(b)(1)(i).

tion" of the subsidiary.[15] It is also possible that the transformation will not satisfy the requirements of a Section 351 tax-free exchange and therefore will be taxable.[16]

**Single-Member LLC**. In contrast, an LLC will never become a C corporation unless it files a C corporation tax return. If the number of members exceeds one, it will "transform" into a partnership for tax purposes. Consequently, the transformation of a single-member LLC into a multi-member LLC will not result in a double tax when the LLC sells its assets. Section 721 of the IRC provides for the tax-free exchange of assets for partnership interests and is less restrictive than Section 351. It is possible for a partner to recognize gain if the liabilities that the partnership assumes from the partner exceed the basis of the assets contributed by the partner, but it is less likely than with a QSub transformation.[17]

**Liability Protection**. The reason to use a subsidiary is to isolate liabilities, so it is necessary to go beyond tax issues and consider the liability protection that the entities provide. Courts have respected the limited liability of shareholders for many years in dozens of *alter ego* cases. The California LLC statute provides that a member of an LLC will have limited liability to the extent that shareholders of corporations have limited liability in similar circumstances.[18] To some extent, the statutory liability protection of members is stronger than for shareholders.[19] However, for very risky enterprises, a corporation might provide more certain liability protection until we have California appellate cases respecting the limited liability of members of LLCs.

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[15] I.R.C. § 357(c).

[16] For these three reasons, it is a good idea to issue only one share of a QSub and legend the stock certificate that "This corporation is a qualified subchapter S subsidiary. Special tax rules apply to it. Tax advice should be obtained before issuing or transferring any shares of this corporation." A better idea: use a single-member LLC instead.

[17] See McKee, Nelson & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶4.03[1][c]. The "disguised sale" rules can also apply. *Id.* At ¶ 13.02[3][b]. State taxes can also be a factor in choosing the LLC. *(footnote continued...)*

*(footnote continued)*
The minimum tax in California and the possible resurrection of the gross receipts tax are concerns, are the new margin tax in Texas and the Pennsylvania tax on LLCs.

[18] Cal. Corp. Code § 17101.

[19] I did not find in the General Corporation Law a provision corresponding to Section 17101(a) of the Limited Liability Company Act, explicitly limiting the liability of a member.