DISREGARDED OR NOT?

AN UPDATE ON QSUBS AND SINGLE-MEMBER LLCS

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This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome

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1. HOW TO BE "DISREGARDED" FOR FEDERAL TAX PURPOSES

1.1 Single-Member LLCs

1.1(a) The **federal check-the-box regs** provide that a domestic entity with one member that is not a corporation for state law purposes is "disregarded as an entity separate from its owner."[1]

⇒ A single-member LLC can elect to be classified as a corporation for tax purposes.[2] If it does so, it is not disregarded for tax purposes.

1.2 QSubs

1.2(a) If an S corporation holds 100% (and no less) of the stock of another corporation, the subsidiary can be disregarded

[1] All Section references are to the Internal Revenue Code of 1986, as amended, and the Income Tax Regulations unless otherwise specified. Treas. Reg. § 301.7701-3(b)(1)(ii). See Section 3 (Special SMLLC Issues – Ignored Members) below.

[2] The regs permit single-member LLCs to elect to be treated as corporations. Partnership classification is not an option. Treas. Reg. § 301.7701-1(a)(4), -3(a). For late entity classification elections (as well as late S corporation elections), see Rev. proc. 2007-62, I.R.B. 2007-41, 767 (must be filed within six months after the due date for the first return, including extensions, for the first year of the new classification).

if the parent S corporation ("S Parent") makes an appropriate election.[3]

⇒ The 100%-owned subsidiary is a "qualified subchapter S subsidiary" (a "QSub") when the election is effective.[4]

⇒ *Note*: If one share is transferred to another shareholder -- *even a person otherwise qualified to hold S corporation stock* -- the QSub status is lost and the subsidiary becomes a *C corporation* (unless *all* of the shareholders are transferred to eligible shareholders and they and their spouses *all* make an S corporation election).

1.2(b) Acquiring a Target S corporation and making an immediate QSub election will not make Target a C corporation for any period of time for purposes of the Section 1374 built-in gains tax.[5]

1.2(c) QSubs are allowed and are disregarded for California tax purposes, except for the minimum tax.[6]

⇒ The California QSub election must be consistent with the federal election.[7]

⇒ No QSub election is filed for California tax purposes.[8]

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[3] Effective for taxable years beginning after December 31, 1996. Small Business Tax Act § 1308, amending I.R.C. § 1361 to add paragraph (b)(3); Joint Explanation of Conferees on H.R. 3448, Small Business Job Protection Tax Act of 1996 ("Conference Explanation") 51 (1996), DAILY TAX REPORT (BNA) August 5, 1996 Supp. at S-21; Treas. Reg. §§ 1.1361-2(a), -4(a)(1).

[4] I.R.C. § 1361(b)(3)(B). The QSub must be the type of entity that could make an S corporation election if it had all eligible shareholders.

[5] Treas. Reg. § 1.1361-4(b)(3)(ii).

[6] Cal. Rev. & Tax. Code § 23800.5(a)(1)(B), (a)(2)(B).

[7] Cal. Rev. & Tax. Code § 23800.5(a)(3).

1.2(d) If the QSub was formerly a member of an affiliated group of corporations filing consolidated returns, the QSub election could be a disposition that results in S parent taking into account any excess loss account in the subsidiaries' stock.[9]

2. WHAT DOES "DISREGARDED" MEAN?

2.1 "Disregarded" for all purposes of federal tax law

2.1(a) "Division" treatment for a QSub follows the REIT subsidiary model.[10] The single-member LLC owned by an entity has the same treatment.

2.1(b) The QSub is treated as a division and cannot be a member of or file a consolidated return with an affiliated group.[11] Inter-corporate sales, charges and dividends have no effect.[12]

2.1(c) The QSub's tax attributes, including built-in gain, undistributed C corporation earnings and profits, and unused net operating losses, become attributes of the S parent.[13]

(footnote continued from previous page)

[8] Cal. Rev. & Tax. Code § 23800.5(a)(3)(B).

[9] Treas. Reg. §1.1502-19(a)(1), (b)(1)(ii). *But see* Treas. Reg. §1.1502-19(c)(2) (a complete liquidation of a subsidiary, without more, does not trigger recognition, nor does the common parent becoming the only remaining member of the affiliated group).

[10] *See* I.R.C. § 856(i). The other two models considered were the consolidated return model (considered a complex nightmare) and the flow-through model, using the existing S corporation rules (considered -- not necessarily correctly -- to provide too many opportunities to shift S corporation income to entities with low tax rates, losses, credits or loss or credit carry forwards).

[11] I.R.C. §§ 1361(b)(3)(A), 1504(b)(8); Treas. Reg. § 1.1361-4(a).

[12] Treas. Reg. § 1.1361-4(a)(2)(i); see J. Eustice & J. Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 3.07[3][c] n. 865.

[13] Treas. Reg. §§ 1.1361-4(c); 1.1366-2(c)(1).

2.1(d) The Service has held that because the single-member LLC is disregarded for income tax purposes, a single-member LLC can hold shares of an S corporation if the LLC is owned by a person who would himself be an eligible shareholder.[14]

2.1(e) Taxpayers have successfully used SMLLCs to acquire their replacement property in Section 1031 exchanges.[15]

2.1(f) The Service can write regs specifying when a QSub – usually ignored as a separate entity for tax purposes and treated as a division of the parent S corporation – will be treated as a separate entity for tax purposes.[16]

2.1(g) But … the QSub or SMLLC is treated as a separate entity for taxes, credits and refunds for periods before it was disregarded. [17]

⇒ And "any special rules applicable to banks under the Internal Revenue Code" apply as if the QSub was not disregarded.[18]

2.1(h) Some have argued that a SMLLC should not be disregarded for estate and gift tax purposes.[19] *Editorial:* The "disregarded entity" concept is difficult enough without creating a lot of exceptions that practitioners will have to

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[14] Treas. Reg. § 1.1361-2(b)(1); PLRs 2008-16-004 and -002, January 14, 2008; PLR 97-45-017, June 26, 1997; PLR 97-39-014, 9-26-97.

[15] E.g., PLR 2008-07-005, November 9, 2007; PLR 2007-32-012, May 11, 2007.

[16] I.R.C. § 1361(b)(3)(A), as amended by 1997 TRA § 1601(c)(3).

[17] Treas. Reg. § 1.1361-4(a)(6). Similar rules apply to SMLLCs and were adopted at the same time. Treas. Reg. § 301.7701-2(c)(2)(iii); T.D. 9183, February 24, 2005.

[18] Treas. Reg. § 1.1361-4(a)(3).

[19] See R. Klomparens & S. Youmans, Single Member LLCs and Estate & Gift Tax Treatment, Cal. Tax Lawyer 20 (Spring 2006) (arguing that a SMLLC should not be disregarded for estate and gift tax purposes).

remember. I would adhere to "for all purposes of federal tax law" as closely as possible. I would encourage estate planners to become familiar with the "disregarded entity" concept and to plan around it.

2.2 Identity for reporting

2.2(a) A single-member LLC does not file a Form 1065 because it is not a partnership for federal tax purposes.

2.2(b) An SMLLC files a partial FTB Form 568 with a Limited Liability Company Income Worksheet and pays its California taxes. No K-1 is needed.[20]

⇒ The FTB takes the position that California credits attributable to the CMLLC's activity are limited to the income from the SMLLC.[21]

2.2(c) After the QSub election is effective, when the S-parent transfers assets into a QSub or the QSub assumes liabilities of the parent, there is non-recognition without invoking Section 351, and there is no Section 357(c) problem if liabilities exceed basis.[22]

2.2(d) QSubs of QSubs? S corp owns SMLLC which owns QSub? Why not? It's all one big pool of assets. The regs bless the concept and establish default rules for timing QSub elections for tiered entities.[23]

2.2(e) There is no special federal return to report QSub ownership. The QSub's tax items are combined with the S parent's and shown on Form 1120S.

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20 Instructions to 2007 FTB Form 568, page 8.

21 *Id.* A method for applying the limit is included in the Instructions.

22 Treas. Reg. § 1.1361-4(a)(2).

23 Treas. Reg. § 1.1361-2(d) *Examples 1, 2 and 3*; -4(b)(2) and -4(b)(2) (timing rules) and (3)(ii); *see also* Treas. Reg. § 1.1361-5(b)(3) *Example 6* (how tiered QSubs unwind at termination of their QSub status).

⇒ Note: The IRS is considering requiring C corporations to list on their Form 1120 and disregarded entity that it owns.[24] This would be effective after 2008.

2.2(f) For California the S parent attaches Schedule QS to its FTB Form 100S to identify its QSubs and to assure that the $800 minimum tax is paid for each.[25]

⇒ If the QSub is not unitary with the S parent, then business income and apportionment factors of the QSub(s) and the S parent are computed separately.[26]

2.3 EINs

2.3(a) A disregarded entity retains its EIN if it has one.[27]

2.3(b) A disregarded entity without an EIN must use its owner's EIN.[28]

2.3(c) The explanation of the January, 2000 regulations indicates that the January, 1999 guidance remains in effect, allowing disregarded entities to obtain their own EINs.[29]

2.3(d) Just get it.

2.3(e) EIN or SSN – which should the IRS use in collection efforts?[30]

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[24] DAILY TAX REPORT (BNA) August 3, 2007, No. 149 at G-1.

[25] Instructions to FTB Form 100S page 10.

[26] *Id.*

[27] Treas. Reg. § 301.6109-1(h)(1), (i)(1).

[28] Treas. Reg. § 301.6109-1(h)(2)(i), (i)(2).

[29] T.D. 8869, January 20, 2000, Explanation of Provisions. See also Instructions to Form SS-4, Application for Employer Identification Number (Rev. 2-06) at page 3.

[30] Chief Counsel Advice 2008-16-023, March 14, 2008, DAILY TAX REPORT (BNA) April 21, 2008 TaxCore, No. 76 at K-3.

2.4 **Employment taxes**

2.4(a) When the disregarded entity is used for liability protection, the owners want the employees of the disregarded entity to be treated as employees of that entity for all purposes, including employment tax purposes. The IRS was surprised that there is an area in which taxpayers do not want the single-member LLC or QSub to be disregarded. Because liability protection and not tax avoidance is at issue, the IRS has been cooperative.

2.4(b) In January, 1999 the IRS announced that disregarded entities could either pay their own employment taxes or the owner could pay them.[31]

Note: QSubs and SMLLCs with employees will want to have their own EINs, so that the QSub/SMLLC does not need to provide the owner's EIN on W-2s forms. Whether the QSub/SMLLC has its own EIN or files its own employment tax returns *should* not in theory make any difference for liability purposes. However, if the reason for the QSub/SMLLC is to isolate liabilities, it would be not be helpful in a hearing on piercing a subsidiary's corporate veil to have to explain to a skeptical judge why the parent paid the employment taxes of its subsidiary.

2.4(c) The check-the-box regs have been challenged and upheld in the context of the owner's liability for the employment taxes of an SMLLC.[32]

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[31] Notice 99-6, 1999-1 C.B. 321, allowing either the S Parent/member or the QSub/SMLLC to report and pay the employment taxes. The S parent/member remains primarily liable for the taxes. *See* Office of Chief Counsel Internal Revenue Service Memorandum 2003-38-012, September 19. 2003 (SMLLC is not an "other person" for purposes of collecting employment taxes under Section 3505(a)).

[32] Littriello v. United States, 2005-1 U.S.T.C. ¶50,385 (CCH) (W.D. Ky. May 18, 2005), Daily Tax Report (BNA) August 29, 2005 (motion for reconsideration denied by order August 3, 2005), *aff'd* 2007-1 U.S.T.C. ¶50,426 (CCH) (6th Cir. April 13,

(footnote continued)

2.4(d) Regs proposed in 2005 (after the *Littriello* decisions) and finalized in 2007 treat a QSub or an SMLLC as a separate (should we say "regarded"?) corporation for employment and excise tax purposes.[33]

3. SPECIAL SM LLC ISSUES – IGNORED MEMBERS

3.1 **Lender**

3.1(a) Lender was the second member, with no economic interest and limited veto rights. Second member was ignored and the LLC was treated as a single-member LLC. This allowed the taxpayer to use a single purpose entity to acquire property in a Section 1031 exchange.[34]

3.2 **Husbands and wives** as members

3.2(a) If **wife is the only owner** of an interest in the LLC and husband has a community property interest in the LLC interest, they can treat the LLC as a partnership or as a single-member limited liability company.[35]

3.2(b) If the **husband and wife are both members**, there are no other members, and the husband and wife own their

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(footnote continued from previous page)

2007), petition for rehearing *en banc* filed. The owner of an SMLLC was held liable for its employment taxes because the entity was disregarded. *See* W. Rowe, Right Without Reason? The Check-the-Box Corporate or Partnership Election Regulations Correctly Held Valid, 59 TAX LAWYER (ABA) 913 (Spring 2006).

[33] Treas. Regs. §§1.1361-4(a)(7) and 301.7701-2(a), (c)(2)(iv) and (e)(3), final T.D. 9356, I.R.B. 2007-39, 675, August 16, 2007 (proposed 70 Fed. Reg. 60475, October 18, 2005). The owner of the disregarded entity is *not* liable for the disregarded entity's employment or excise taxes. Many consolidated groups would prefer the old approach, with the owner paying the employment taxes of the disregarded entities – proving that you cannot make everyone happy. DAILY TAX REPORT (BNA) April 29, 2008, TaxCore (Letter of Tax Executives Institute to Treasury).

[34] PLR 1999-11-033, 1999-14-006.

[35] Rev. Proc. 2002-69, 2002-2 C.B. 31.

interests entirely as community property, then the LLC, the husband and the wife can treat the LLC *either* as a partnership *or* as a single-member limited liability company.[36]

3.2(c) If the husband or wife or both hold the interest in a **grantor trust** of which he, she or both is a grantor, there are no other members, and the husband and wife own their interests entirely as community property, can the LLC ever be a single-member limited liability company for tax purposes?

⇒ The LLC, the husband and the wife can treat the LLC a partnership or as a single-member limited liability company, because the grantor trust is disregarded for income tax purposes.

3.2(d) The LLC can flip back and forth from single-member limited liability company status to partnership classification, but the change is a conversion for check-the-box purposes.[37]

3.2(e) These rules do not apply if the husband or wife holds any interest in the LLC in **any form other than community property**.

3.2(f) Assume husband and wife are both members, but only wife is active in the business. How much of the LLC's income is subject to **self-employment tax**?

⇒ If the LLC is disregarded, all of the income is probably subject to self-employment tax.[38]

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[36] *Id.*

[37] *Id.*

[38] Even if one spouse is the nominal owner of the membership interest, the income belongs to the spouse who earned it for self-employment tax purposes. Edwards v. Comm'r, 95 T.C.M. 1104 (February 7, 2007) (insurance renewals taxed to husband who had the insurance license, not to wife who had no license but was the nominal owner).

⇒ If the LLC is treated as a partnership, probably only the wife's share is subject to self-employment tax.

Editorial: If husband and wife are both named as members in the operating agreement, I count two members and would treat the LLC as a partnership. If only the husband or wife is named as a member in the operating agreement, I count one member and would disregard the LLC. Rev. Proc. 2002-69 emphasizes the need (to have an operating agreement and) to state in the operating agreement whether the member(s) want to disregard the LLC or treat it as a partnership.

4. SPECIAL SM LLC ISSUES – STATE TAXES

4.1 **California conforms** to the federal check-the-box regs concerning disregarding single-member LLCs.[39] Inconsistent federal and California elections are not permitted.[40]

4.1(a) Like any other LLC, a single-member LLC operating in California must file a Form 568 and pay the $800 flat tax and the total receipts tax.[41]

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[39] Cal. Rev. & Tax. Code § 23038(b)(2)(B)(iii); Cal. Admin. Code title 18, § 23038(b)-1(a)(4).

[40] Cal. Rev. & Tax. Code § 23038(b)(2)(B)(ii), (iii).

[41] Cal. Rev. & Tax. Code §§ 17941 (flat tax), 17942 (tax rates on "total income"). The current "total income" tax rates are:

Total Income	Tax
$0-$249,999	$-0-
$250,000 -$499,999	$900
$500,000 - $999,999	$2,500
$1 million - less than $5 mill.	$6,000
$5 million or more	$11,790

California has aggressively applied these taxes. A Nevada LLC that used a California address was required to pay California taxes because it invested in California LLCs and partnerships and its only member and manager was a California resident. International Health Institute, LLC, SBE No. 305199, March 7, 2006, State Tax Reporter (California) (CCH) ¶ 403-979. A member-managed Montana LLC with two members, both California residents, did no business in California but filed a California return and used a California

(footnote continued)

4.1(b) The "disregarded" nature of a SMLLC must be respected for purposes of California municipal taxes.[42]

4.1(c) The **California LLC Act** has allowed single-member limited liability companies since 2000.[43]

(footnote continued from previous page)

address. Mockingbird Partners, LLC, SBE No. 306061, May 17, 2006. ("In regards to [the LLC]'s property being located in Montana, it is not where property is located that is most germane, but where the activity of the business which owns that property occurred.") Both LLCs used California accountants.

The constitutionality of the California total receipts tax has been challenged successfully. Northwest Energetic Services LLC v. FTB, 159 Cal. Application. 4th 841 (2008) (fee held unconstitutional for entity registered in California but doing no business in California); Ventas Finance I, LLC v. FTB (Super. Ct. S.F. County Case No.CGC-05-440001, Nov. 7. 2006) (Delaware LLC doing business within and outside of California; on appeal Cal. Ct. App., No. A116277). In Ventas the trial court stated that the law could not be reformed. Initially, legislation to fix the tax retroactively was vetoed as premature (the FTB had not yet appealed the Nothwest Energetic case and the Ventas case had not yet been decided). A.B. 1614 (Ruskin). Spidell's California TaxLetter 173 (November 2006). A suit has been filed (by the same law firm that handled the Nothwest Energetic and Ventas cases) in the same court challenging the constitutionality of the fee in the case of a California LLC doing business entirely within California. Bakersfield Mall, LLC v. FTB (Super. Ct. S.F. County Case No. CG07462728, filed on April 25, 2007); Spidell's California TaxLetter 96 (June 2007).

A bill was enacted to fix *prospectively* the LLC fee statute. AB 198 (2007), amending Cal. Rev. & Tax Code § 17942. The bill apportions the LLC fee in the same way that corporate taxes are apportioned. The bill was initially retroactive to 1997, then to 2001. As passed, it applies to tax years beginning on and after January 1, 2007. *See* Daily Tax Report (BNA) June 11, 2007 at H-1 and March 15, 2007 at H-7.

The FTB issued a "Public Service Bulletin" on March 21, 2006 with a special procedure for filing protective refund claims. State Tax Reporter (California) (CCH) ¶ 403-983, March 17, 2006, or go to www.ftb.ca.gov and search for "Ventas." In April 2008 the FTB issued Notice 2008-2, requesting info so that it can process refunds for LLCs similar to Northwest.

[42] City of Los Angeles v. Furman Selz Capital Management, LLC., 121 Cal.App.4th 505 (2004).

Note: Even an LLC with one member should have an **operating agreement**,[44] which allows outsiders (like banks and title companies) to know if the persons who say they are agents of the LLC really have that authority. It also explains how a new manager is selected if the member is not capable of doing so.

4.1(d) California law prohibits any LLC from engaging in a business in California that requires a **license** under the California Business and Professions Code.[45]

4.2 **Texas** imposes a "margin" tax on the gross profit margins of LLCs.

(footnote continued from previous page)

[43] Cal. Corp. Code §§ 17001(t), 17050(b).

[44] Cal. Corp. Code §§ 17001(ab), 17005. For Delaware limited liability companies, this document is called a "limited liability company agreement." Del. Corp. Code § 18-101(7).

[45] 1996 Cal. Stat. ch 57, § 30 ("Nothing in this act nor Chapter 1010 or Chapter 1200 of the Statutes of 1994 shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 of the Corporations Code, in this state."); 1994 Cal. Stat. ch. 1200, § 93 ("Nothing in this act shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 of the Corporations Code, in this state unless expressly authorized under applicable provisions of the Business and Professions Code or the Chiropractic Act."); Cal. Corp. Code § 13401(a) ("'Professional services' means any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code or the Chiropractic Act.").

"[W]e find that some services that require a license, certification, or registration pursuant to the Business and Professions Code are 'professional services' and others are 'nonprofessional services.' To determine whether a particular service is one or the other requires an examination of the educational, training, and testing prerequisites." "A business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code may conduct its activities as a limited liability company if the services rendered require only a nonprofessional, occupational license." 87 CA Op. Atty Gen. Cal. 109 (2004). The Attorney General has not provided a list of "nonprofessional, occupational license[s]" required under the B&P Code.

4.3 More states are looking to tax pass-through entities, so investigate each state in which your LLC plans to do business. State taxation might affect your choice-of-entity decision.

5. SPECIAL SMLLC ISSUES – OWNED BY A NONPROFIT

5.1 The SMLLC is an ideal way for a **nonprofit** entity to isolate liability-prone "**related**" activities without subjecting them to corporate tax or obtaining another tax exemption for a "subsidiary" organized as a supporting organization of the parent.

5.1(a) A nonprofit organization is offered a donation of a **property that might have environmental problems**. The organization asks the donor to transfer the property to a SMLLC and to transfer the membership interest -- not the deed to the property -- to the organization.

5.1(b) The SMLLC may qualify for a **property tax** exemption if the SMLLC has its own determination letter.[46]

5.1(c) Will a **donation to a SMLLC** owned by a Section 501(c)(3) organization be treated as a charitable deduction under Section 170? It should. But … until the IRS provides guidance that it will, donors should make their donations directly to the organization with the Section 501(c)(3) determination letter.

5.1(d) Profits subject to the tax on **unrelated business taxable income** or **debt-financed income** should be moved to taxable C corporation subsidiaries.[47] The nonprofit does not want that income (which could threaten its tax-exempt status), only the after-tax dividends.

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[46] Cal. Rev. & Tax. Code § 214.

[47] See PLR 2007-52-042, October 1, 2007 (profit from SMLLC's business activity was UBTI for exempt parent; parent's exemption not affected because SMLLC's revenue was 2% of total revenue). This exempt parent was more involved in the SMLLC's business than most advisors would recommend.

5.1(e) In October, 2007 the IRS issued an internal "Guide Sheet" for tax-exempt organizations using LLCs.[48]

6. EFFECT OF BEING DISREGARDED

6.1 SM LLC owned by:

6.1(a) Individual

⇒ Not community property

- An LLC owned by a domestic **individual** is a **sole proprietorship** and files a schedule C for federal tax purposes[49]

⇒ Community property

- An LLC owned by an **individual** as community property with a spouse can be either (1) a **sole proprietorship** and file a schedule C for federal tax purposes OR (2) a partnership filing Form 1065.

6.1(b) Husband and wife

⇒ Not community property

- An LLC of which both husband and wife are members and the membership interests are **not** held as community property defaults to a partnership filing Form 1065.

⇒ Community property

- An LLC of which both husband and wife are members and the membership interests **are** held as community property can be either (1) a **sole proprietorship** and file a

48 DAILY TAX REPORT (BNA) October 2, 2007, TaxCore.

49 Edwards v. Comm'r, 95 T.C.M. 1104 (February 7, 2007).

Schedule C for federal tax purposes OR (2) a partnership filing Form 1065. [50]

6.1(c) Nonresident alien

⇒ A domestic LLC owned by a individual who is a **nonresident alien** is a sole proprietorship. It will require the member to file federal and California tax returns.

6.1(d) Domestic corp

⇒ A single-member LLC owned by a **domestic corporation** is a **division** for tax purposes. No consolidation is necessary. Inter-company transactions are ignored for federal tax purposes. No deferred gain or excess loss accounts.

- An SMLLC owned by an **S corporation** avoids the concerns (discussed below) of an unplanned termination of "qualified S corporation subsidiary" status – especially when an interest in the subsidiary's business is acquired by someone other than the parent.

6.1(e) Foreign corp

⇒ A single-member LLC owned by a **foreign corporation** is a **branch** for U.S. tax purposes, and is subject to U.S. corporate tax, the branch profits tax and applicable treaties.[51]

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[50] Rev. Proc. 2002-69, 2002-2 C.B. 831; see Grothues v Comm'r, n.8 (treating a partnership between a husband and wife in Texas, a community property state, as a sole proprietorship based on this Revenue Procedure).

[51] I.R.C. §§ 882, 884.

6.2 Q-sub, always owned by an S corporation

6.2(a) Treated as a division for tax purposes, except for California $800 minimum tax.

7. CONTRIBUTIONS TO CAPITAL – SECTIONS 351 ISSUES

7.1 A shareholder contributes all of Target's outstanding stock to S parent, which is also owned by the shareholder of S parent and which makes a QSub election for Target. A Section 351 contribution to capital? No. A Type B reorg (stock swap)? No. It's a Type D reorg.[52]

7.2 If Target's liabilities exceed its basis in its assets, the shareholder would recognize gain.[53]

8. SALE OF ASSETS

8.1 SMLLC assets

8.1(a) Treated as sale of assets by the sole member

8.2 Q-sub assets

8.2(a) Treated as sale of assets by the S Parent

9. SALE OF ENTITY INTEREST

9.1 SMLLC interest

9.1(a) The membership interest in the QSub should be disregarded, so the transaction should be treated as a sale to the buyer of the assets of the SMLLC and the assumption by the buyer of the liabilities of the SMLLC.

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[52] Treas. Reg. § 1.1361-4(a)(2)(ii) *Example 3*. This type of D reorg is a transfer of assets from one corporation to a related corporation, followed by a liquidation of the transferor corporation. The QSub election effects the "liquidation". See fn. 80.

[53] I.R.C. § 357(c).

9.2 Q-sub stock

9.2(a) S parent sells all of the QSub/Target shares to unrelated buyer, which does *not* make a QSub election for Target. A stock sale? No, it's an asset sale followed by the contribution by buyer of the Target assets to a new corporation.[54]

9.2(b) If buyer is an S corp and makes a QSub election for Target, the transaction is treated by both the seller as an asset sale, but without the contribution by the buyer S corp to a new corp.[55]

9.2(c) The stock of a QSub is disregarded for all federal tax purposes.[56]

10. REORGS WITH QSUBS

10.1 Merger of QSub into Target

10.1(a) **S parent receives Target stock**:

⇒ Not a good Type A reorg?[57]

⇒ Probably a taxable exchange of S parent's assets for Target stock?[58]

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54 Treas. Reg. § 1.1361-5(b)(3) *Example 9*. Same result for a C corp seller to an S corp that makes an immediate QSub election for Target. Treas. Reg. § 1.1361-4(a)(2)(ii) *Example 1*.

Note that The buyer's *basis in the stock* will *disappear* and the assets will the same basis in the buyer's hands as in Target's. I.R.C. § 334(b)(1). This might be a problem if the buyer paid more for the stock that the Target's basis in its assets. In that case, the shareholders of the S corporation buyer might was to buy the Target stock themselves and to make an S corporation election for Target, to preserve the high basis in its stock.

55 Treas. Reg. § 1.1361-5(b)(3) *Example 9*.

56 Treas. Reg. § 1.1361-4(a)(4). The only exception admitted in this reg is determining whether 100% of the outstanding QSub stock is owned by S Parent.

57 Treas. Reg. § 1.368-2(b)(iii) *Example 6*.

10.2 Merger of Target into QSub

10.2(a) **Target shareholders get S Parent stock**:

⇒ A good Type A merger reorg.[59]

10.2(b) **Swap Target stock for QSub stock**:

⇒ Not a good Type A reorg.[60]

⇒ QSub election terminates, because 100% of QSub shares are no longer held by S Parent.

- Could be a good Section 351 transfer to the capital of QSub.

⇒ QSub becomes a C corporation. This might be a tax disaster.

10.3 Merger of S Parent into SMLLC owned by C Corp

10.3(a) Good Type A reorg because QSub ceases to be disregarded and becomes as asset of C Corp (because SMLCC continues to be disregarded).[61]

10.4 Merger of S Parent into QSub

10.4(a) A good Type A reorg (a merger of two corporations)?

10.4(b) No, because the subsidiary is disregarded. It's a Type F reorg (a mere change of form).[62]

(footnote continued from previous page)

[58] *I.e.*, a bad Section 351 transaction. If the requirements of Section 351were met, could it be a good tax-free Section 351 contribution to capital?

[59] Treas. Reg. § 1.368-2(b)(iii) *Example 7*.

[60] Treas. Reg. § 1.368-2(b)(iii) *Example 2*.

[61] Treas. Reg. § 1.368-2(b)(iii) *Example 3*.

[62] Treas. Reg. § 1.1361-4(a)(2)(ii) *Example 2*. See fns. 68, 79.

10.4(c) If QSub merges into S Parent, not a Section 332 liquidation because QSub was disregarded. QSub's assets already belonged to S Parent for federal tax purposes, so the merger (or dissolution) of QSub would not change anything.

10.5 **Merger of Target into SMLLC, Target shareholders receive SMLLC's grandparent stock** (SMLLC owned by a C corporation)

10.5(a) Good triangular merger. [63]

10.6 **Swap Target stock for S Parent stock**

10.6(a) S parent acquires Target [stock?] in exchange for S parent stock and makes a QSub election for Target. Taxable exchange of stock? No. Type B reorg (stock swap) followed by a Section 332 liquidation of Target? No. It can be a Type C reorg (assets for stock).[64] The Target shareholders who acquire S parent shares might eventually be able to use their suspended losses and other tax attributes from Target.[65] Debt of the QSub is treated as debt of the S parent, presumably for the purpose of absorbing losses of the S parent.[66]

10.7 **Transfer Target assets to QSub, give S Parent shares to Target, which dissolves**

10.7(a) A good Type C reorg?

10.8 **Transfer QSub assets to Target, give Target shares to QSub, which dissolves**

10.8(a) A good Type C reorg? Or must S Parent dissolve?

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63 Treas. Reg. § 1.368-2(b)(iii) *Example 4*.

64 Treas. Reg. § 1.1361-5(b)(3) *Example 8*.

65 Treas. Reg. § 1.1361-4(c).

66 I.R.C. § 1366(d); Treas. Reg. § 1.1361-4(a)(1)(ii).

10.9 S Parent distributes QSub stock to shareholder(s) of S Parent

10.9(a) Could be a tax-free Section 355 distribution. [67]

10.10 F Reorgs with QSubs

10.10(a) Shareholders of S Target create a new holding company and contribute all their S Target stock to the new holding company, making an S corporation election for the holding company and a QSub election for S Target. Result: F reorg, with the holding company continuing the tax attributes of S Target – but with a new EIN.[68]

⇒ Note – The means that creating the holding company will probably not allow a late S election of S Target was a C corp. Unless there is a third entity involved?

10.10(b) Same result if S Target forms Sub1 that forms Sub2 and Sub2 merges into S Target, with S Target surviving but shareholders get Sub1 stock for their S Target stock. Just another way to make S Target a QSub of the new holding company.[69]

11. SECTION 338 ELECTIONS

A Section 338 election is permitted even if S Parent elects QSub status for Target immediately after the stock purchase.[70]

11.1 Straight Section 338 Election (or "Section 338(g) election")

11.1(a) S Parent buys 100% of Target shares, makes (g) election followed by QSub election for Target

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[67] Treas. Reg. § 1.1361-5(b)(3) *Example 2*.

[68] Rev. Rul. 2008-18, I.R.B. 2008-13, 674, March 7, 2008.

[69] *Id.*

[70] Treas. Reg. § 1.1361-4(b)(4).

⇒ Even if Target was an S corporation before the stock purchase, Target must file a return as a C corporation to reflect the sale.[71]

11.1(b) Buyer buys over 80% of QSub shares, makes (g) election

⇒ Because the shares of a QSub are disregarded,[72] this is probably treated as Buyer purchasing the assets of QSub from S Parent, so no Section 338 election (a) is needed, since it is a "real" purchase, or (b) can be made, since there is no stock purchase.

11.2 Section 338(h)(10) election

11.2(a) Shareholders of Target S corp makes (h)(10) election for it and sell all of its stock to S Parent, which make a QSub election for it.

11.2(b) S Parent gets basis step-up in QSub assets

11.2(c) Selling shareholders absorb the inside gain, but it increases the basis in their shares, so there is no additional tax when they sell shares. Some ordinary income (such as depreciation recapture) might flow through to the selling shareholders.

12. TRANSFORMING TO AND FROM DISREGARDED STATUS

12.1 Single-Member LLC → S corporation

12.1(a) Why – charging order protection

⇒ Protects the *LLC's* assets and the *other members* from the creditor of another member

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[71] Treas. Reg. § 1.1361-4(b)(4).

[72] See footnote 54 above.

⇒ Applies to claims *not* arising from the LLC's business

⇒ Albright case[73]

12.1(b) How

⇒ Forms 8832 and 2553[74]

⇒ No special allocations or distributions based on capital accounts

12.1(c) Why not[75]

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73 Although a judgment creditor of an LLC member is generally limited to a charging order or becoming a holder of an economic interest – not a voting membership interest -- in the LLC, some doubt that a judgment creditor of a single-member LLC would be prevented from obtaining the LLC's assets. Cal. Corp. Code § 17302 (charging order rules, with no statutory exception for single-member LLCs); *but see* In re A-Z Electronics, 350 B.R. 886 (Bankr. D. Idaho, 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 Chapter 7 bankruptcy trustee to reach the assets in the debtor's single-member LLC). *But see* Evans v. Galardi, 16 C. 3d 300 (1976) (both partners liable to same creditor on same debt – charging order is only remedy, at least is there are sufficient assets outside the partnership to satisfy the claim); *see also* J. Stein, Building Stumbling Blocks, BUSINESS ENTITIES (September/October 2006) 28, 34-36, and J. Stein, Advanced Asset Protection and Tax Planning with LLCs, 29 Los Angeles Lawyer 17 at nn. 20-21 (June 2006) (arguments in favor of respecting charging order protection for the single-member LLC.)

74 Treas. Reg. § 301.7701-3(c)(1)(v)(C) ("An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made [a check-the-box-] election under this section [7701] to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b).").

75 Is a single-member LLC taxed as an S corporation the perfect entity because it provides pass-through tax treatment, reduces SSI and Medicare taxes for the member and the member's creditors are limited to charging orders, as opposed to getting the stock of a real S corporation? Probably not, because the S corporation can default to a C corporation, the full SSI should be paid anyway in most active businesses, and the structure will cause confusion forever.

⇒ One class of stock rule – risk of becoming a C corporation

⇒ Expectations of advisors (They expect a single-member LLC to be disregarded for tax purposes.)

⇒ Transaction costs – getting every advisor up to speed

12.2 Partnership → Single-Member LLC

12.2(a) Before terminating the tax partnership by becoming a single-member limited liability company, consider whether any tax benefit will be lost.

⇒ If so, consider (creating and) adding another member before the event which would otherwise cause there to be only one member.

12.2(b) An LLC (a partnership for tax purposes) has as members two corporations. The merger of one corporate partner into the LLC, creating a SMLLC, was a good Type A reorg, even though the two corporations did not merge into each other.[76]

12.3 Single-Member LLC → Partnership

12.3(a) The sale of a partial interest in the SMLLC to an unrelated buyer is treated for federal income tax purposes as a sale to buyer of an undivided interest in all of the LLC's assets, followed by a contribution by seller and buyer of all of those assets to a new partnership.[77]

⇒ The SMLLC cannot become a C corporation unless the members make an affirmative 'check-the-box" election. Compare this to the QSub that

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[76] Treas. Reg. § 1.368-2(b)(iii) *Example 11*.

[77] Treas. Reg. § 1.1361-5(b)(3) *Example 2*.

ceases to be 100% owned by S parent and becomes a C corporation.

⇒ It is possible that there could be Section 752 deferred gain recognition later, but it could be managed and would not create a double tax.

12.4 **Corporation → QSub**

12.4(a) QSub elections should be made on Form 8869, Qualified Subchapter S Subsidiary Election.[78]

12.4(b) The QSub election can be retroactive for up to two months and 15 days (like the S corporation election), but can be made at any time during the year (unlike the S corporation election, which must be made at the beginning of the year).[79]

12.4(c) Transfer of all of the stock of Target to a shareholder's other S corporation and immediate QSub election can trigger Section 357(c) gain if the liabilities of Target/QSub exceed its basis in its assets.[80]

12.4(d) When the QSub election is effective, the QSub is deemed to liquidate into the S parent.[81]

⇒ If the deemed liquidation would not qualify as tax-free under Section 332, the IRS takes the position

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[78] Notice 2000-58, 2000-2 C.B. 491. It is not necessary or possible to file a separate election for California. *See* Instructions to 2007 Form 100S page 10 and Instructions to Schedule QS to 2007 Form 100S.

[79] Treas. Reg. § 1.1361-3(a)(3), (4).

[80] Treas. Reg. § 1.1361-3(a)(2)(ii) *Example 3*. Because it is a D reorg. See fn. 52.

[81] Treas. Reg. § 1.1361-4(a)(2). Tax attributes of the QSub become tax attributes of the S parent. I.R.C. § 381(a)(1).

that gain can be recognized on the QSub election.[82] This position is controversial.

⇒ Is the outside basis higher than the subsidiary's inside basis? If so, making the QSub election will eliminate the opportunity to benefit from the higher outside basis.[83]

⇒ If the QSub used LIFO, the QSub election might trigger LIFO recapture.[84]

Note: OldCo is a C corp with a March 31 year end. In November, the OldCo shareholders organize S parent, elect S corporation status and a September 30 year end for S parent, contribute all their OldCo shares to S parent and elect QSub status for OldCo. The effect is to make a mid-year S corporation election for OldCo, but ... the Service asserts that the step transaction doctrine applies so that S parent is treated as a successor to OldCo in a Type F reorg.[85]

12.4(e) S parent owns 75% of Target shares and the sole shareholder of S parent owns the other 25%. Target redeems shareholder's 25% interest in Target and S parent makes a QSub election. Is the deemed liquidation of Target into S parent a bad Section 332 and therefore taxable because immediately before the transaction S parent did not own at least 80% of Target?[86]

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[82] Treas. Reg. § 1.1361-4(d) *Example 5*. But see I.R.C. § 337(b)(1) limiting the gain to the parent's gain. The subsidiary does not have gain in this situation.

[83] I.R.C. § 334(b)(1).

[84] J. Eustice & J. Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 3.07[3][c] n. 861.

[85] See fn. 68.

[86] I.R.C. §§ 332(b)(1), 1504(a)(2).

⇒ Making the QSub election is treated as the adoption of the plan of liquidation for Target.[87]

⇒ Presumably, when read together with Section 332(b)(1), this means that the redemption will not be stepped together with the liquidation and the liquidation will be a good (that is, tax-free) Section 332 liquidation.

12.4(f) Consider authorizing and issuing only **one share of stock** of a QSub.

⇒ This will make it harder to transfer shares or issue shares in a way that would trigger horrible tax consequences if the transfer is an inadvertent termination of the QSub status.

⇒ It will require an amendment of the articles of incorporation to issue another share, which will take some time and expense, which your client may or may not appreciate.

12.4(g) Consider attaching a warning **notice** to the stock certificate of a QSub and placing a legend on the certificate to "See attached Notice before transferring shares represented by this certificate."

12.4(h) Consider a **written communication** to the client confirming that that the client has selected a QSub over a SMLLC and noting the tax risk of an inadvertent termination of the QSub status.

12.4(i) After the QSub election, consider merging the QSub into a SMLLC, which does not have the risks of a QSub.

12.5 **QSub → C corporation**
***** THIS IS THE IMPORTANT STUFF *****

[87] Treas. Reg. § 1.1361-4(a)(2)(iii) and (iv).

12.5(a) When a QSub ceases to be wholly-owned by an S corporation, its QSub election terminates.[88]

12.5(b) When QSub status terminates, the S-parent is treated as contributing to the former QSub all of the QSubs assets, and the former QSub is treated as assuming from the S-parent all of the liabilities of the former QSub.[89]

⇒ *Note*: If S-parent retains at least 80% of the sub's stock, the non-recognition rule of Section 351 will probably apply, subject to Section 357(c).[90] Otherwise, *it's a taxable exchange* of stock and assumed liabilities for assets, and *any appreciation in the assets will be recognized* under Section 1001.[91]

⇒ If there is an opportunity to plan before the termination of QSub status, consider merging the QSub into a SMLLC. When another party acquires more than 20% of the LLC, gain will be recognized only with respect to the portion acquired by the other party. In the failed Section 351 transaction, all of the gain is recognized.

12.5(c) There is no carryover of tax attributes from S parent, since this is the creation of a new corporation for tax purposes.

12.5(d) If the former QSub stock is still partly owned by S parent, *the subsidiary becomes a C corporation!*

12.5(e) A QSub that loses its status must wait five years before re-electing either QSub or S corporation status.[92]

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88 Treas. Reg. § 1.1361-5(a)(1)(iii).

89 I.R.C. § 1361(b)(3)(C); *see* Treas. Reg. § 1.1361-5(b) (1998).

90 Treas. Reg. § 1.1361-5(b)(3) *Example 3*.

91 Treas. Reg. § 1.1361-5(b)(3) *Example 1*.

92 I.R.C. §§ 1361(b)(3)(D); Treas. Reg. § 1.1361-5(c).

12.6 QSub → S corporation

12.6(a) When QSub status terminates, an immediate S or QSub election by buyer is permitted.[93]

12.6(b) Presumably, the corporation is treated as if it never became a C corporation for purposes of the Section 1374 built-in gains rules.

13. ORGANIZING A SUBSIDIARY

13.1 S Corps with C Corporation Subsidiaries

13.1(a) The rule prohibiting an S corporation from owning more than 80% of a C corporation was repealed in 1996.[94]

13.1(b) C corporations owned by an S corporation can be members of an affiliated group filing consolidated returns, but the S corporation cannot join in that return.[95]

⇒ Application: An S corporation could own some or all of the stock of a C corporation parent of an affiliated group.

⇒ Application: An S corporation could own less than 20% of the stock of a C corporation member of an affiliated group.

13.1(c) If an S corporation owns 80% of the stock of a C corporation, then the dividends of that C corporation will not be treated as passive receipts of the S corporation for passive receipts tax purposes "to the extent such dividends are attributable to the earnings and

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[93] Treas. Reg. § 1.1361-5(c)(2).

[94] Effective for taxable years beginning after December 31, 1996. Small Business Tax Act § 1308(a), amending I.R.C. § 1361; Conference Explanation at 51 (1996).

[95] I.R.C. § 1504(b)(8).

profits of such C corporation derived from the active conduct of a trade or business."[96]

13.1(d) Why use a C corp subsidiary of an S corp? There might be unused loss or other carry forwards for regular tax or AMT purposes. The subsidiary might have a DISC that it does not want to terminate. These concerns need to be balanced against the disadvantage of delaying the beginning of the 10-year built-in gain period under Section 1374, and the risk that the built-in gain will be increase if the value of the business increases while the subsidiary remains a C corp.

13.2 Subsidiary of an S corporation – Q-sub or SMLLC?

13.2(a) When a QSub terminates,

⇒ It could be come a C corporation.

⇒ All gain on appreciated assets in the subsidiary could be recognized if the "transformation" is a failed Section 351 transfer.

⇒ Even if the transformation is a good Section 351 transfer, gain will be recognized to the extent the "assumed" liabilities exceed the basis of "contributed" assets.

13.2(b) When a SMLLC terminates,

⇒ It will not become a C corp

⇒ It will become a partnership for tax purposes.

⇒ It is possible that liabilities in excess of basis will result in recognizing gain or treating a future transaction a disguised sale.

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[96] I.R.C. § 1362(d)(3)(F); *see* Treas. Reg. § 1.1362-8.

13.2(c) Corporations have a long history of appellate courts respecting the limited liability of shareholders. LLCs do not have this history. Some shareholders with risky businesses (example: manufacturing explosives) might prefer the more certain liability protection offered by a corporation.[97]

13.2(d) Bottom line: A SMLLC has less tax risk than a QSub, but a QSub, because it is a corporation, might provide more certain liability protection.

13.3 Of a C corp – consolidated corp or disregarded SMLLC?

13.3(a) The QSub is not an option for a C corporation

13.3(b) The choice is between:

⇒ The more certain liability protection of the corporation, which carries the complexity of consolidated return tax accounting, or

⇒ The much more simple accounting for a SMLLC, which provides less certain liability protection.

[97] 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. Cal. Corp. Code § 17101. 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. It could be argued that this makes the statutory liability protection of members stronger than for shareholders.

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.

Those cases exist in other states. See E. Miller, *Cases Involving Limited Liability Companies and Registered Limited Liability Partnerships*, in PUBOGRAM, The Newsletter of the Committee on Partnerships and Unincorporated Business Organizations, ABA Business Law Section, (October, 2006) at pages 29-31.

14. OTHER EFFECTS ON CHOICE OF ENTITY DECISIONS

14.1 When the Congress or IRS issues new rules identifying the "general partner" of an LLC under **Section 1402**, the QSub might become attractive in situations in which using an LLC would generate substantial SSI and Medicare taxes (for example, when a non-employee owns an active business).[98]

14.2 Businesses **licensed** under the California Business and Professions Code will not be able to use an LLC, and so a QSub or a brother-sister S corporation might be the only alternatives.[99]

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[98] For the history of the Section 1402 issue and the alternatives considered, see David C. Culpepper, Sanford Holo, Robert R. Keatinge, Thomas C. Lenz, Bahar A. Schippel, Richard A. Shapack, and Thomas E. Yearout, Self-Employment Taxes and Pass-Through Entities: Where Are We Now?, 109 Tax Notes Today 211 (October 10, 2005).

[99] Cal. Corp. Code § 17375 ("Nothing in this title shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 and in Section 13401.3, in this state."); 1996 Cal. Stat. ch 57, § 30 ("Nothing in this act nor Chapter 1010 or Chapter 1200 of the Statutes of 1994 shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 of the Corporations Code, in this state."); 1994 Cal. Stat. ch. 1200, § 93 ("Nothing in this act shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 of the Corporations Code, in this state unless expressly authorized under applicable provisions of the Business and Professions Code or the Chiropractic Act."); Cal. Corp. Code § 13401(a) ("'Professional services' means any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code or the Chiropractic Act.").

In 2004 the California Attorney General wrote "[W]e find that some services that require a license, certification, or registration pursuant to the Business and Professions Code are 'professional services' and others are 'nonprofessional services.' To determine whether a particular service is one or the other requires an examination of the educational, training, and testing prerequisites." "A business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code may conduct its activities as a limited liability company if the services rendered require only a non-professional, occupational license." 87 Op. Atty Gen. Cal. 109 (2004). The Attorney General did not publish a list of "nonprofessional services" required to be licensed under the B&P Code.

14.3 If the new entity could be a **brother-sister corporation**, it would be possible to bring in other investors without blowing the S corporation status (whereas giving those investors stock of a QSub would transform the QSub into a C corporation.) However, Section 311, the sheer number of shareholders or an uncooperative shareholder might prevent the move from a QSub to a brother-sister S corporation.

14.4 A **sole proprietor** getting his affairs in order for estate planning might prefer a single-member LLC as a smaller step away from the status quo than incorporating the business.

14.5 Say the officers of a business held by a corporation develop a promising but somewhat **risky new business**. They want to protect the assets of the old business from possible tort liabilities arising from the new business.

14.5(a) The easiest way to achieve that is to drop the new business down into a subsidiary of the old corporation. It is often unclear whether there is any goodwill associated with the new business, and it will remain unclear until the business proves itself.

14.5(b) If the business is a winner, it might appear in hindsight that there was substantial goodwill at the time of the drop-down. But the gain on the goodwill transfer -- if there is any -- will be sheltered from recognition in the drop-down by Section 351.

⇒ The alternative of creating a brother-sister structure risks corporate-level gain[100] on the deemed gain when the owners of the old corporation become owners of the stock of the new sister corporation.

⇒ Until 1997 the drop-down technique was available to C corporations, but not to S corporations. The

[100] I.R.C. § 311. And corporate-level built-in gain tax if it applies.

SMLLC and QSub rules permits S corporations to use subsidiaries in these situations.

⇒ Dropping a new business into a subsidiary protects the old business assets from claims against the new business.

⇒ However, the parent's interest in the subsidiary is available to satisfy claims against the parent's old business. Creating a holding company with no assets except interests in entities that operate active businesses is a techniques to protect each active business from claims against other active businesses.

15. SOMETHING NEW – "CELLS"

15.1 A "protected cell company", "segregated account company" or "segregated portfolio company" is similar to a series LLC in that the cells have separate owners and separate contracts with insured, and claims against one cell cannot be satisfied with the assets of another cell of the same company.

15.1(a) The Service held that arrangement between a cell and its insured could be insurance for tax purposes.[101]

15.1(b) The Service also issued a notice to say that it proposed to rule that a cell could be a separate insurance company from its "protected cell company."[102]

15.1(c) This guidance was issued by the Financial Institutions and Products Group and not by the Pass-Through Group in the Associate Chief Counsel's office.[103]

[End of outline.]

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101 Rev. Rul. 2008-8, I.R.B. 2008-5, 340, January 15, 2008.

102 Notice 2008-19, 2008-5 I.R.B. 366, January 15, 2008.

103 *See also* TAM 2008-16-029, December 3, 2007 ("whether an entity classified as a partnership … should be considered the insured entity").