PacificCPE

COURSE
81654A

Business Entities: Conversions, Dissolutions, and Multistate Operations

Covering some of the more complex situations business owners face, this course examines what happens when an LLC converts to another entity type and how to handle corporate conversions, dissolutions, and sales. It also addresses the often-overlooked challenges of doing business across state lines, including registration requirements and tax considerations. Practitioners advising clients on exit strategies, restructuring, or expansion into new states will find this course directly applicable to their work.

CREDIT HOURS **2** | FIELD OF STUDY **BUSINESS** | EXAM QUESTIONS **10**

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall conversion methods for an LLC-to-corporation conversion.
- Recall the definition of successor liability.
- Recognize the difference between a trademark and a service mark.

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Chapter 1: CONVERTING AN LLC TO ANOTHER ENTITY

Chapter Objective

After completing this chapter, you should be able to:

- Recall conversion methods for an LLC-to-corporation conversion.

Once you form an LLC, you are not locked into it forever. After several years of successful business operations, you may wish to incorporate. Changing from an LLC to a corporation enables a business to attract capital or obtain the special tax breaks and incentives associated with the corporate form.

It's also possible—though less common and typically not advisable—that you might wish to head in a less formal direction and convert your LLC to a sole proprietorship or partnership. This chapter explains how an LLC can convert to a different legal entity, and the paperwork, tax, and securities law implications of such conversions.

CONVERTING AN LLC TO A CORPORATION

Most LLC owners that convert their business to another type of entity choose to incorporate. They do so for at least four reasons:

- **Corporate income and tax splitting.** Accumulated business earnings and profits that are kept in the corporation are taxed at the federal corporate income tax rate of 21%, which might be lower than the income tax rates of the LLC owners. If the owners keep income in the business, it might make sense to incorporate so that the retained business earnings are taxed at this lower rate.
- **Corporate stock.** Incorporating allows the owners to issue standard (common) and special (preferred) shares of stock, which makes the business more appealing to investors. Investment firms and public markets generally prefer to invest in corporations rather than LLCs, so that they can receive corporate stock in return for management, voting, and special dividend and liquidation rights. In family businesses, switching to the corporate form allows owners to create special classes of stock, in anticipation of handing over the reins of control and ownership to the next generation.
- **Corporate equity-based employee plans.** The corporate structure allows owners to create incentives for key employees—such as tax-favored employee stock options, restricted stock bonus and purchase plans, and other equity-based employee incentives. These incentives are a unique, tax-favored benefit of the corporate form.

- **Built-in corporate structure.** Although the LLC has a formal structure, the corporate structure is often more suitable for larger businesses because it allows for separate management, supervisory, and investment roles. State corporation laws create separate director, officer, and shareholder positions, each with its own legal rights and responsibilities.

Legal Procedures

When converting from an LLC to a corporation, you'll need to take the following steps:

- **Review state law and termination provisions of your LLC operating agreement.** Most LLC operating agreements and many state laws require the unanimous consent of all members to dissolve the LLC. Even if your operating agreement or state law doesn't impose this requirement, it's a good idea to get each member's approval to terminate the LLC. Dissolution will affect each member's status as a business owner and might create tax consequences, so each member should carefully consider and approve the change.
- **File articles of dissolution.** Typically, you file legal papers called articles of dissolution (or something similar) with the state corporations section or division of the secretary of state's office in order to legally dissolve an LLC. Many states provide online fill-in-the-blank articles of dissolution forms, which you can complete and file online. Typically, you'll have to provide the name and address of the LLC, its date of dissolution, and a description of the membership vote obtained to approve the dissolution.
- **File articles of incorporation.** The owners file articles of incorporation with the state corporate filing office. Standard articles forms are available online at most state corporate filing office websites. (See the appendix for information on finding your state's website.) Along with the articles, you submit the required filing fee, usually a flat fee or a charge based on the number and type of shares authorized in the articles.
- **Transfer assets and liabilities; issue shares.** Typically, the former LLC owners transfer the assets and liabilities of the LLC, or their ownership interests in the LLC, to the new corporation in return for shares of stock. The owners usually receive a percentage of shares in the corporation that is equal to their share of the assets or ownership of the prior partnership—for example, if four people owned equal shares of an LLC, each would receive one-fourth of the shares issued to owners. New co-owners, such as passive investors, might be brought into the new corporation.
- **Revise licenses, permits, and registrations.** The owners should cancel any licenses and permits taken out in the name of the now-defunct LLC, then take out new permits and licenses in the name of the new corporation. If the corporation will do business under a name other than the one specified in its articles of incorporation, it should file a fictitious business name statement with the county clerk, or, in some states, with the state corporations division.

- **Review leases, loans, and contracts and revise them if necessary.** If you entered into a lease or loan agreement as an LLC, you need to notify your landlord or lender that you are now operating as a corporation. The lease or loan agreement should be revised to name the corporation as the tenant or borrower. You will likely need to reexecute any personal guarantee of the lease or loan, this time as corporate shareholders instead of LLC members.
- **Get an EIN.** All corporations are required to obtain an employer identification number (EIN), whether or not they have employees. An LLC converting to a corporation should get a new EIN for the corporation.

Additional Considerations When Filing a State Entity Conversion Form

Many states provide a simple entity conversion form to convert one type of entity to another (see the website of the agency that accepts corporate filings in Appendix A). You check the appropriate boxes on the conversion form, add some commonly used clauses, as explained in the form instructions, file the form, and you're done. The new business is formed, the assets of the old business are transferred to the new business, and the old business is dissolved. All of this happens automatically, according to each state's entity conversion statute. What could be simpler? Of course, nothing is quite so simple when law and taxes are involved, and both come into play when you use a state conversion form to convert an LLC to a corporation.

Basically, the IRS will treat your conversion as if you had transferred LLC's assets and liabilities "over" to the new corporation, the corporation issued its stock to the LLC, the LLC transferred the stock to its owners in proportion to their LLC capital interests, and then the LLC dissolved. The law allows for different paths of transfer, but when you use a state form and end up with this one by default, the tax implications for the corporation and the owners can be significant, particularly if owners want to claim deductions for worthless stock. Make sure to consult a tax professional if you use a state form for conversion, to be in the know about the tax consequences.

Consider a common conversion—converting a multi-member LLC to a corporation. Normally, an LLC-to-corporation conversion is tax-free if the prior business owners are in control of 80% or more of the stock of the new corporation (see IRS Publication 542).

But there's more to it. IRS Revenue Ruling 84-111 puts partnership-to-corporation conversions into one of the three categories shown below. This ruling should apply to LLC-to-corporation conversions because multi-member LLCs are treated for many tax purposes like partnerships.

"Assets-over" conversion. In this conversion, the LLC transfers its assets and liabilities "over" to the new corporation, the corporation issues its stock to the LLC, the LLC transfers the stock to its owners in proportion to their LLC capital interests, and then the LLC dissolves.

"Assets-up" conversion. In this conversion, the LLC transfers its assets and liabilities "up" to its members and then dissolves. The members then transfer these assets to the new corporation in return for stock.

"Interests-over" conversion. In this conversion, the LLC owners transfer their LLC capital interests "over" to the new corporation in return for a proportionate amount of corporate stock, and then the LLC dissolves.

Each of these conversion methods can have a different effect on the corporation's tax basis and holding period in the assets received. The shareholders' tax basis in their stock, and the

immediate tax results they experience, will differ depending on the conversion method they use. For instance, an owner might have to pay taxes at the time of the conversion.

Okay, this is already sufficiently complicated, but there's more to consider. Revenue Ruling 2004-59 explains how the IRS treats an automatic conversion of an LLC to corporation through the filing of a state conversion form. This ruling says that when an entity treated as a partnership, which for tax purposes generally includes a multi-member LLC, is converted to a corporation through the filing of a state conversion form without an actual transfer of assets or interests, the IRS assumes the following steps occur, in the following order:

1. The partnership contributes all its assets and liabilities to the corporation in exchange for stock in such corporation.
2. The partnership liquidates, distributing the stock of the corporation to its partners.

This assumed sequence of events matches the sequence of events described in the assets-over conversion listed above, which means it's likely that the IRS will consider the conversion of an LLC to a corporation through a state conversion form filing to be an assets-over conversion. This leads to further complications that can have significant tax effects.

For example, IRC Section 1244 allows business owners to treat worthless stock as an ordinary loss, which can be deducted against ordinary income on their tax returns. However, one of the requirements of using Section 1244 is that the shareholder claiming the loss must be the original owner of the stock. But if you reread the description of an assets-over conversion, you'll see that the LLC entity, not its owners, is considered to be the original owner of the shares under that conversion scenario, and the corporation's shareholders are considered to be the second set of shareholders (they receive their shares from the dissolving LLC).

The upshot is that the use of a simple state conversion form to convert an LLC to a corporation might eliminate the future ability of the corporation's shareholders to take a deduction on their individual tax returns. Instead, the shareholders might be limited to claiming only a capital loss if their corporation fails. Since a capital loss can only be used to offset capital gains, the owners might be unable to deduct the loss on their capital investment, or might have to wait several years to do so.

Income Tax Consequences of Conversion

Converting an LLC to a corporation is a tax-free transaction, as long as the conversion meets the requirements of Section 351 of the Internal Revenue Code. In fact, because the IRS treats a one-person LLC as a sole proprietorship, converting the one-person LLC to a corporation is, for tax purposes, the same as converting a sole proprietorship to a corporation.