Strafford

Presenting a live 110-minute teleconference with interactive Q&A

Taxation of Cross-Entity Mergers and Conversions

Navigating Complex IRS Rules to Merge or Convert LLCs, S Corps and C Corps.

WEDNESDAY, FEBRURAY 29, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Jed A. Roher, Atty, **Godfrey & Kahn**, Madison, Wis.

Douglas J. Patch, Shareholder, **Godfrey & Kahn**, Milwaukee

Alexander W. Hansch, Atty, **Godfrey & Kahn**, Milwaukee

Attendees seeking CPE credit must listen to the audio over the telephone.

Please refer to the instructions emailed to registrants for dial-in information. Attendees can still view the presentation slides online. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Conference Materials

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the + sign next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

Continuing Education Credits

FOR LIVE EVENT ONLY

For **CLE** credits, please let us know how many people are listening online by completing each of the following steps:

- Close the notification box
- In the chat box, type (1) your **company name** and (2) the **number of attendees at your location**
- Click the SEND button beside the box

For **CPE** credits, attendees **must** listen to the audio over the telephone. Attendees can still view the presentation slides online.

Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Tips for Optimal Quality

Sound Quality
For this program, you must listen via the telephone by dialing **1-866-873-1442** and entering your PIN when prompted. There will be no sound over the web connection.

If you dialed in and have any difficulties during the call, press *0 for assistance. You may also **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

Viewing Quality
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

GODFREY KAHN S.C.

Taxation of Cross-Entity Mergers and Conversions

February 29, 2012

Who We Are

Alexander W. Hansch is a member of G+K's Corporate practice group in the Milwaukee office. He focuses his practice on mergers, acquisitions and general corporate matters.

ahansch@gklaw.com

414.287.9464

Douglas J. Patch focuses his practice on the tax and corporate law aspects of complex business transactions, including private equity financings, acquisitions, tax-free reorganizations, like-kind exchanges and acquisitive partnership transactions.

dpatch@gklaw.com

414.287.9324

Jed A. Roher is a member of G+K's Tax and Employee Benefits practice group in the Madison office. He concentrates his practice on federal corporate and partnership tax law.

jroher@gklaw.com

608.284.2269

Our Agenda

I. Corporate law mechanisms for cross-entity conversions

II. Partnership* mergers and combinations

III. Partnership merger or conversion into corporation

IV. Corporation merger or conversion into Partnership

* We will use "Partnership" and "LLC" interchangeably to refer to entities taxed as partnerships for federal tax purposes.

Corporate Law Mechanisms

- Mechanics
- Internal Concerns
- External Concerns

Corporate Law Mechanisms

- Mechanics
  - Conversion
    - Formation Documents
      - Certificate/Articles/Statement of Conversion
      - Certificate/Articles of Incorporation
    - Termination Document
      - Articles of Dissolution; Certificate of Cancellation
      - State-specific (e.g., Alabama)

Corporate Law Mechanisms

- Mechanics, cont'd
  - Merger
    - "Assets Over"
      - Sale of old entity's assets/liabilities to new entity in exchange for equity
      - Dissolution of old entity
      - Issuance of equity in the new entity as a liquidating distribution
    - "Assets Up"
      - Liquidation of the old entity
      - Contribution of assets to new entity in exchange for equity
    - "Interests Over"
      - Equity in the old entity is contributed to the new entity
      - Liquidation of old entity
      - Distribution of equity in the new entity to the owners

Corporate Law Mechanisms

- Internal Concerns: Conversion/Merger Process
  - Voting Rights
    - Conversion: requires majority consent of voting and non-voting stock
    - Merger: requires majority consent of voting stock
  - Dissenters'/Appraisal Rights
    - Conversion: do not apply
    - Merger: do apply (except for limited partnerships)

Corporate Law Mechanisms

- Internal Concerns: Post-Merger/Conversion
  - Transition Statutes
    - New entity is treated as having existed since the formation of the old entity
    - Some states have statutes that apply higher voting thresholds to entities that have been in existence prior to a certain date
  - Management Rights
    - Member-managed LLC: minority participation
    - Corporation/Manager-managed LLC: no minority participation
  - Withdrawal/Redemption Rights
    - Corporation: redemption upon triggering appraisal/dissenters' rights
    - LLC: withdrawal and payment of fair value possible at any time
    - Partnership: no power to withdraw

Corporate Law Mechanisms

- External Concerns
  - Anti-assignment clauses: generally not triggered
  - Covenants in credit facilities: more likely to be triggered
    - Example of affirmative covenant triggered:

      Borrower will "maintain its [corporate/limited liability company existence] in good standing under the laws of its jurisdiction of [incorporation/organization] and its qualification to transact business in each jurisdiction in which the character of the properties owned, leased or operated by it or the business conducted by it makes such qualification necessary."
    - Example of negative covenant triggered :

      Borrower shall not "merge or consolidate or enter into any analogous reorganization or transaction with any person."
  - Owner liability: limited vs. unlimited
  - Creditor protection

Our Agenda

I. Corporate law mechanisms for cross-entity conversions

II. Partnership* mergers and combinations

III. Partnership merger or conversion into corporation

IV. Corporation merger or conversion into Partnership

* We will use "Partnership" and "LLC" interchangeably to refer to entities taxed as partnerships for federal tax purposes.

What is a Partnership Merger?

- Section 708(b)(2)(A) is the sole Code provision regarding partnership mergers
- Section 708(b)(2)(A) defines the survivor of the merger, but nothing more
- Regulations provide the balance of the guidance

What is a Partnership Merger?

- No relationship between the tax rules relating to corporate mergers and the rules relating to partnership mergers

- There is also a disconnect between what happens under state law and what is deemed to occur pursuant to the tax rules

Example: State Law Merger Without Tax Merger

- In transactions like this, the IRS says that there is no partnership merger and no partnership termination

- State law form of transaction is irrelevant to the IRS. See Rev. Rul. 95-37, 1995-1 C.B. 130

Significance of Continuing Partnership

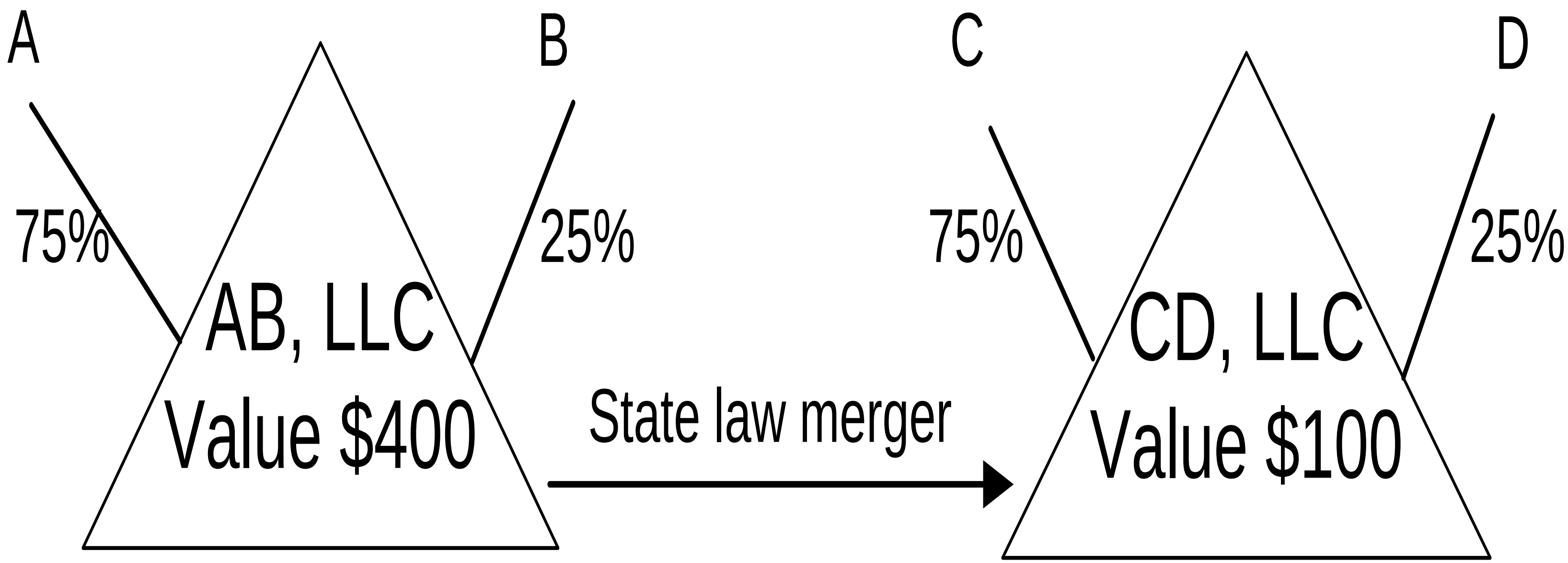
- Continuing Partnership files full year tax return and retains EIN

- Other Merged Partnerships are treated as terminating and file short year return

Determination of Continuing Partnership

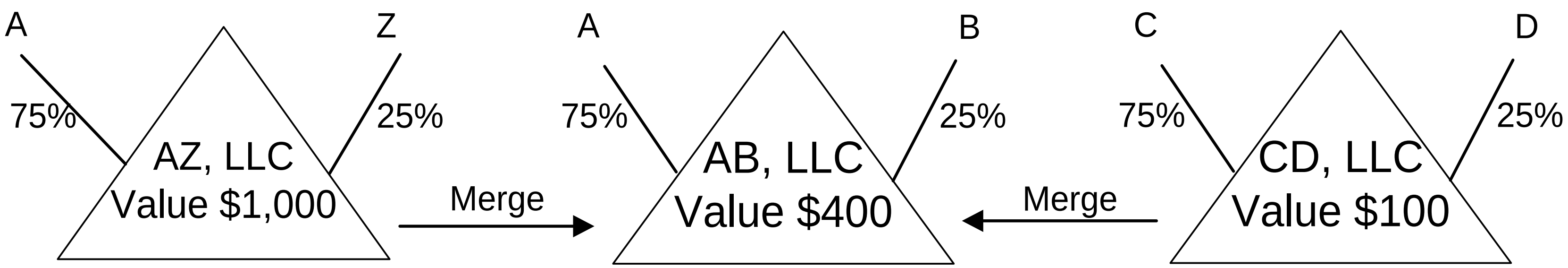
- When two or more partnerships combine, the transaction is technically a termination of both partnerships unless the partners of one of the partnerships ends up with more than 50% of the capital and profits interests of the resulting partnership. Section 708(b)(2)(A)
- If more than one partnership can meet the 50% test, the continuing partnership is the one with the largest net value of assets. Reg. § 1.708-1(c)(1)

Illustration of Continuing Partnership



- AB is continuing partnership for tax purposes

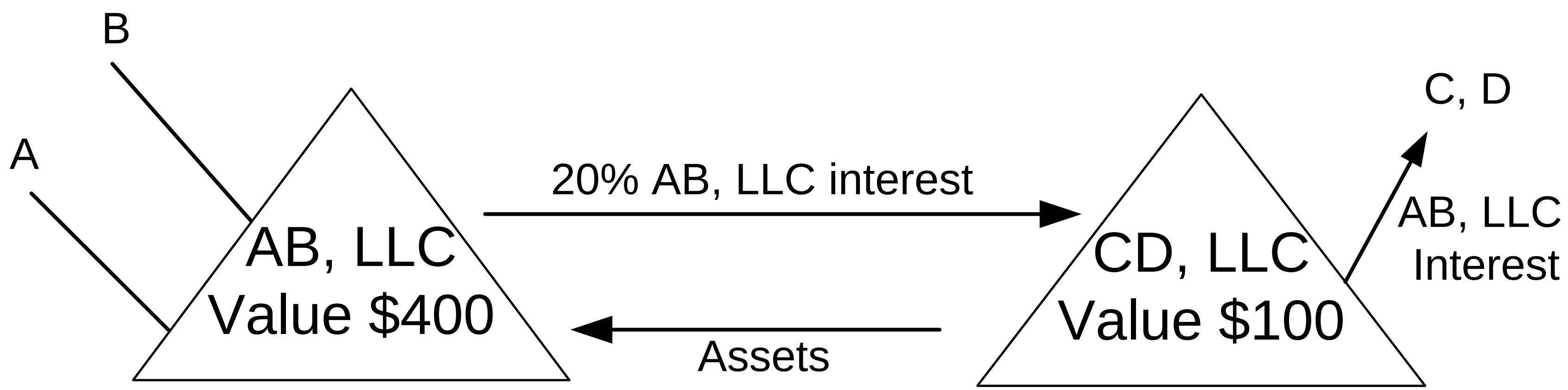
Second Illustration of Continuing Partnership



Assets Over (Default Form)

- Under the "assets over" form, the partnership that is considered terminated is deemed to do the following:
  - Contribute all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership.
  - Immediately afterwards distribute interests in the resulting partnership to its partners in liquidation.

Illustration of Assets Over



Consequences of Merger

- Contribution analyzed under § 721
- Distribution analyzed under §731
- Capital Accounts should be revalued per Regs. § 1-704-1(b)(2)(iv)(f)
- Holding period tacks for capital gain property under § 1223(1)
- Book/tax differences will likely be created
- Outside basis in resulting partnership should be the same as outside basis in the merged partnership under § 732

Exceptions which may cause Gain Recognition

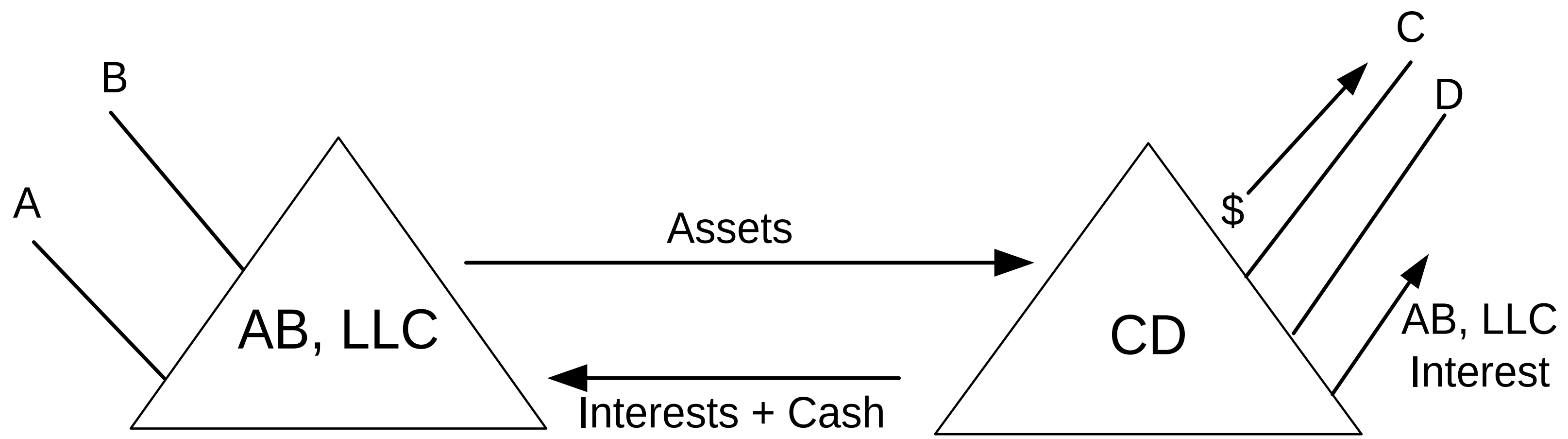
- Distribution of cash/marketable securities in excess of basis (including "deemed distribution" on liability shift). Code §§ 731(a)(1), 752(b).

- Change in shares of ordinary income ("hot") assets. Code § 751(b).

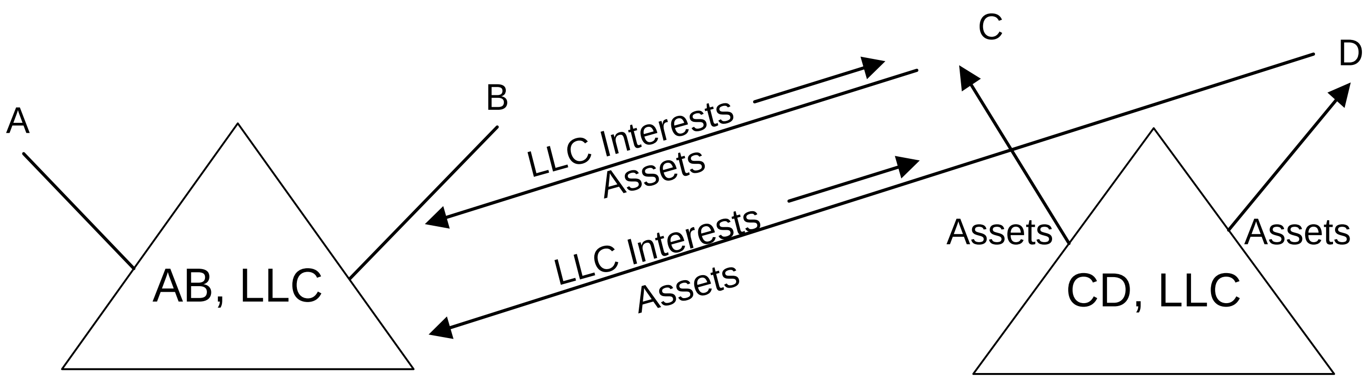
- "Disguised sale." Code § 707(a)(2)(B).

- "Mixing bowl." Code §§ 704(c)(1)(B) and 737.

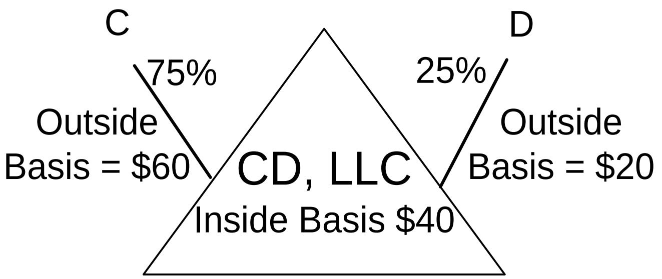
Reg. 1-708-1(c)(4) – Sale of Partnership Interests



Assets Up Form



Why use assets up form?



Our Agenda

I. Corporate law mechanisms for cross-entity conversions

II. Partnership* mergers and combinations

III. Partnership merger or conversion into corporation

IV. Corporation merger or conversion into partnership

* We will use "Partnership" and "LLC" interchangeably to refer to entities taxed as partnerships for federal tax purposes.

LLC to Corporation

- Tax consequences of an LLC-to-corporation transaction depend on general partnership tax principles.
- Taking a step back:
  - Capital Accounts
  - Partnership Liabilities
  - Outside Basis
  - Limitations on Losses

Background: Capital Accts

- Capital Accounts: keeping track of partners' stake in the partnership.
- Capital Accounts are *increased* by
  - partner's capital contributions and
  - partner's share of book profits
- Capital Accounts are *decreased* by
  - distributions to the partner and
  - partner's share of book losses

Background: Liabilities

- Partnership Liabilities: “recourse” or “non-recourse”
- Liability is “recourse” if any partner bears the economic risk of loss related to the liability. Treas. Reg. § 1.752-1(a)(1).
- Liability is “non-recourse” if no partner bears the economic risk of loss related to the liability. Treas. Reg. § 1.752-1(a)(2).

Background: Liabilities

- If a partnership liability is “recourse,” the liability is allocated among the partner(s) that bear(s) the economic risk of loss for the liability. Treas. Reg. § 1.752-2(a).
- If a partnership liability is “non-recourse,” the liability is allocated among the partners in accordance with their respective shares of partnership profits. Treas. Reg. § 1.752-3(a)(3).

Background: Liabilities

- A decrease in a partner’s share of partnership liabilities is **treated as a distribution of money by the partnership to the partner**. Treas. Reg. § 1.752-1(c).
- On the sale or exchange of a partnership interest, the reduction in the transferor partner’s share of partnership liabilities is **treated as an amount realized** under § 1001. Treas. Reg. § 1.752-1(h).

Background: Outside Basis

- Outside basis in partnership interest
  - Initially, the value of the partner's contribution(s) to the partnership for an interest. § 722.
  - *Increased* by share of partnership taxable and tax-exempt income. § 705(a)(1).
  - *Decreased* (but not below zero) by share of losses and non-deductible expenses. § 705(a)(2)
- Partner's share of partnership liabilities is *included* in outside basis. Treas. Reg. § 1.705-1(a)(6).

Background: Use of Losses

- Limitations on use of partnership losses
  - Basis
  - Amount at risk
  - Passive activity loss rules

Tax Form of Conversion

- Three recognized forms for LLC to Corp conversions:
  - “Assets-Over”: LLC contributes all assets to corporation, then distributes stock of corporation to members in complete liquidation.
  - “Assets-Up”: LLC distributes all assets to members, members then contribute assets to corporation in exchange for stock
  - “Interests-Up”: members transfer LLC interests to corporation

Tax Form of Conversion

- “Check the box” election, conversion under state law formless conversion statute both treated as “assets-over.” Treas. Reg. § 301.7701-3(g)(1)(i); Rev. Rul. 2004-59.
- If parties go through mechanical “assets-up” form, form will be respected.

Tax Treatment, Assets-Over

- Tax consequences of "assets-over" form (Rev. Rul. 84-111, *Situation 1*):
  - No gain or loss to LLC
  - Corporation's basis in assets equal to **LLC's basis in assets**
  - Corporation's holding period in assets includes LLC's holding period in assets
  - LLC's basis in stock equal to LLC's basis in assets, *minus* liabilities assumed by corporation

Tax Treatment, Assets-Over

- Tax consequences of “assets-over” form (cont’d):
  - LLC’s holding period in stock generally includes LLC’s holding period in assets
  - Corporation’s assumption of liabilities reduces each member’s share of liabilities
  - Member’s basis in stock equals member’s basis in LLC interest, *after* relief from liabilities
  - Member’s holding period in stock includes LLC’s holding period.

Tax Treatment, Assets-Up

- Tax consequences of “assets-up” form (Rev. Rul. 84-111, *Situation 2*):
  - Member’s **basis in assets distributed equals basis in LLC interest**
  - Distribution of assets doesn’t affect member’s share of liabilities, but assumption of liabilities by corporation treated as a distribution of money to members.
  - Member’s basis in stock equal to basis in assets received from LLC, less liabilities assumed by corporation

Tax Treatment, Assets-Up

- Tax consequences of "assets-up" form (cont'd):
  - Corporation's basis in assets equals **members' basis in assets.**
  - Member's holding period in stock includes LLC's holding period in assets
  - Corporation's holding period in assets includes members' holding period.

Tax Treatment, Interests-Up

- Tax consequences of “interests-up” form (Rev. Rul. 84-111, *Situation 3*):
  - No gain or loss recognized by members on transfer of interests for stock
  - Transfer of interests to stock terminates LLC
  - Assumption of liabilities by corporation treated as a distribution of money to members.
  - Member’s basis in stock equal to basis in membership interest, less liabilities assumed by corporation

Tax Treatment, Interests-Up

- Tax consequences of “interests-up” form (cont’d):
  - Member’s holding period in stock includes holding period in partnership interest
  - Corporation’s **basis in assets equals members’ basis in their LLC interests**.
  - Corporation’s holding period in assets includes LLC’s holding period in assets.

Other Considerations

- Treatment of stock under § 1244
- Inside / Outside basis differentials
- Investment tax credit recapture

Our Agenda

I. Corporate law mechanisms for cross-entity conversions

II. Partnership* mergers and combinations

III. Partnership merger or conversion into corporation

IV. Corporation merger or conversion into Partnership

* We will use “Partnership” and “LLC” interchangeably to refer to entities taxed as partnerships for federal tax purposes.

Corporation to LLC

- Tax consequences of a corporate-to-LLC transaction depend on general corporate tax principles.
- Taking a step back: corporate liquidations
  - Treatment of liquidating corporation
  - Treatment of shareholders

Background: Liquidating Corp

- Liquidating corporation is treated as selling assets for fair market value. § 336(a)
- If liquidating distribution is to an 80% parent, no gain or loss to distributing corporation on portion of assets distributed to parent. § 337(a)
- If liquidating distribution *not* to an 80% parent, liquidating corporation recognizes gain. § 336(a)

Background: Shareholders

- Distributions in complete liquidation of a corporation are generally treated as exchanges of the corporation's stock for the distribution proceeds. § 331
- Exchange will be taxable unless shareholder is a corporation that owns at least 80% of the vote and value of the liquidating corporation. § 332

Tax Form of Conversion

- Two possible forms of corporate-to-LLC transaction:
  - Liquidating distribution by corporation to shareholders followed by contribution by shareholders to LLC (check-the-box election - Treas. Reg. § 301.7701-3(g)(ii))
  - Transfer of assets by corporation to LLC followed by distribution of LLC interests to shareholders in complete liquidation (merger into partnership – PLR 200606009)

Tax Treatment: Assets Up

- On deemed liquidation, corporation and shareholders will recognize gain or loss (assuming no 80% parent).
- Deemed contribution to new partnership will be tax-free under § 721.
- Partnership will take FMV basis in assets.

Tax Treatment: Assets Over

- Contribution of assets by corporation to partnership is tax-free under § 721.
- Partnership will take carryover basis in assets.
- Corporation and shareholders will recognize gain or loss on distribution of partnership interests in liquidation (assuming no 80% parent)

Thank You.

GODFREY & KAHN S.C.

WWW.GKLAW.COM

OFFICES IN MILWAUKEE, MADISON, WAUKESHA, GREEN BAY AND APPLETON, WISCONSIN AND WASHINGTON, D.C.