

Income Tax Consequences of Changing Business Entity

Abstract:

Current businesses may consider changing their type of entity for a number of reasons. It is very important that they consider the tax consequences of making the change. This material discusses the various types of change and what tax liability can be expected.

ISSUE 2: INCOME TAX CONSEQUENCES OF CHANGING BUSINESS ENTITY

For an existing entity, the decision to change the business form and operate as a different business entity must be analyzed to determine the feasibility and tax consequences.

Feasibility. First, is it even possible to get from the current entity to the new entity? Whether it is possible to convert an existing business to a new form of entity refers to the need for an enabling statute, an allowable number of owners (two in most states), and the cooperation of creditors. A second statute may be required whenever the particular form of business being conducted is restricted to specific forms of entity, such as the conduct of professions such as law, medicine, or public accounting. Also, if the business has secured creditors who may object to the transfer of assets, they must be appeased.

Tax Consequences. Assuming the feasibility requirements are met, does it make sense? Do the tax and nontax strengths outweigh the tax and nontax costs of the conversion? Tax costs are dramatically different for each of the different tax entities. With few exceptions, proprietorship and partnership conversions can be accomplished tax-free. Conversions from a corporation to a different entity can involve a corporate liquidation. That means two possible levels of tax for a C corporation and for an S corporation. However, if the assets and stock have depreciated rather than appreciated, it may be clearly advantageous to liquidate.

A: CONVERSION OF A SOLE PROPRIETORSHIP TO AN LLC

A sole proprietor has unlimited liability for his or her business debts and action. An LLC can protect the business owner's personal assets

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| <p>Practitioner Note. Most states have amended their statutes to allow one-member LLCs, but some states still require two or more members.</p> |
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Formation. When a sole proprietorship is converted to a one-member LLC, the LLC is disregarded for tax purposes unless the member elects to have it taxed as a corporation. The sole proprietor can contribute all of the assets of the business, subject to the associated liabilities, to the newly formed entity. Although the legal owner of the asset changes, the transfer has no tax effects if the LLC is a disregarded entity, since the sole proprietor remains the owner of the assets for tax purposes. When a sole proprietor forms an LLC with another member or a one-member LLC converts to a two-member LLC (whether by selling an LLC interest to the new member or by having the new member contribute cash or property to the LLC), the transaction is treated as a

partnership formation. (Rev. Rul. 99-5, 1999-5 I.R.B., I.R.C. §§721; 722; 723; 1001; 1223).

Practitioner Note. There may be issues other than federal tax issues to consider, depending on state law. Other issues may include homestead exemption, franchise tax, filing new articles of organization, and filing new mortgages or other documents to secure debt.

Taxation. In general, contributions to an LLC taxed as a partnership are tax-free under Code §721. There are exceptions and special rules for contributions of debt and contributions of services. If an interest in an LLC is issued in exchange for services, the exchange is taxable if the interest is an interest in capital and may be taxable if it is an interest in profits only.

How a sole proprietorship converted to an LLC will be treated for federal tax purposes depends on the number of members and the check -a-box election. A one-member LLC is a disregarded entity reported on the member's Schedule C or F. A two-or-more-member LLC is treated as a partnership. An LLC (whether it has one member or more than one member) can elect to be taxed as a corporation by filing Form 8832, Entity Classification Election.

Sole proprietorships that convert to an LLC may also need to consider at-risk recapture under I.R.C. §465(e), application of self-employment tax, application of state unemployment, and workers compensation.

Example 2. Joe Smith operates a vegetable growing enterprise. He grows and delivers vegetables to the local grocery. He has operated in the past as a sole proprietor reporting taxable income and expenses on Schedule F. He is considering starting a pick-your-own enterprise and wants the added liability protection of an LLC. Joe's state statute provides for a one-member LLC. He has the following assets and liabilities:

| Description | FMV | | Tax Basis | Potential Gain |
|---------------------|------------------|-----------------|------------------|-----------------|
| | Assets | Liabilities | | |
| Land & improvements | \$200,000 | \$75,000 | \$125,000 | \$75,000 |
| Machinery | <u>\$ 45,000</u> | <u>\$12,500</u> | <u>\$ 32,500</u> | <u>\$12,500</u> |
| Total | \$245,000 | \$87,500 | \$157,500 | \$87,500 |

With the approval of Joe's creditors, Joe will contribute the above assets and liabilities to Joe's U-Pick, LLC.

Question 2A. Will Joe recognize any of the \$87,500 taxable gain by forming Joe's U-Pick?

Answer 2A. No, his basis from the debt is the same as the deemed distribution resulting from the LLC's assumption of his debt.

Question 2B. How will Joe report income and expenses for tax purposes?

Answer 2B. Joe will continue to report on Schedule F, unless he elects to be taxed as a corporation on Form 8832.

B: CONVERSION OF A PARTNERSHIP OR LLC TO A CORPORATION

A partnership or LLC can be incorporated three different ways: (1) a transfer of assets and liabilities from the partnership or LLC to the corporation in exchange for corporate stock and any other consideration, followed by the liquidation of the partnership; (2) a distribution of partnership or LLC assets and liabilities to its partners or members, who then transfer the assets and liabilities to the corporation in exchange for stock and other consideration; or (3) the contribution by the partners or members of their partnership or LLC interests to the corporation in exchange for corporate stock and other consideration.

The IRS has ruled that the tax consequences with regard to partnership incorporation are determined by the method that is used. (Rev. Rul. 84-111, 1984-2 C.B. 88). Incorporation of an LLC that is taxed as a partnership will be subject to the same rules. As a general rule, any of the methods will result in tax-free incorporation, but the method may affect the tax consequences. Thus, practitioners must determine the tax implications at each step of the transaction.

Example 3. Jim Jones and his dad have operated as a farm partnership for many years. They are equal partners. They bring you their records for 1999. They tell you that they incorporated their farming business in February 1999 because their insurance agent told them they needed to limit their liability from the farming operation. The balance sheet for the new corporation for 2/28/99 reflects the following:

| <u>ASSETS</u> | <u>FMV</u> | <u>Basis</u> |
|--|------------------|------------------|
| Cash | \$ 745 | \$ 745 |
| Accounts Receivable | 467 | 0 |
| Inventories | 615 | 0 |
| Chemicals | 8,207 | 0 |
| Depreciable Assets | \$263,472 | |
| Less: Accumulated Depreciation (160,045) | 103,427 | 103,427 |
| Co-op Book Credits | 1,178 | 1,178 |
| Total Assets | \$130,231 | \$105,350 |

LIABILITIES AND CAPITAL

Short-term Notes:

| | | |
|--------------------------------|-----------|-----------|
| Operating Note #123 | \$161,844 | |
| Chemical Note - Vendor # 1 | 38,207 | |
| Operating Note - #234 | 10,750 | |
| Operating Note - #345 | 10,000 | |
| Total Liabilities | | \$220,801 |
| Shareholders' Capital Accounts | | (90,570) |
| Liabilities and Capital | | \$130,231 |

Question 3A. Is the initial contribution to a corporation in exchange for corporate stock a tax-free exchange?

Answer 3A. No, as explained below. I.R.C. §351 states:

Sec. 351. Transfer to corporation controlled by transferor.

- a. General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined by §368(c)) of the corporation.

Thus, it **appears** that the above transaction would be tax free, if the individuals making the transfers control the new corporation. However, I.R.C. §357(c) must be considered:

Sec. 357. Assumption of liability

- c. (c) Liabilities in excess of basis.
 - 1. In general. In the case of an exchange—
 - A. To which §351 applies, or
 - B. To which §361 applies by reason of a plan of reorganization within the meaning of §368(a)(1)(D), if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

Certain Liabilities Excluded. Since the amount of total liabilities transferred to the new corporation exceeds the basis of the assets transferred, Jim and his father must report taxable gains on their 1999 individual tax returns.

| Computation of the Taxable Gain on Transfer | |
|--|------------------|
| Total liabilities transferred to corporation | \$220,801 |
| Less: Chemical Note which, if paid, is deductible | <u>(38,207)</u> |
| Balance | \$182,594 |
| Less: Basis of assets transferred to corporation | <u>(105,350)</u> |
| Amount of taxable gain on the conversion | \$ 77,244 |

Jim and his father would each report half of the **gain**, or **\$38,622**, in Part II on their 1999 Forms 4797, Ordinary Gains and Losses.

C: CONVERSION OF A C CORPORATION TO ANOTHER ENTITY SUCH AS AN LC

Conversion of a C corporation to an LLC can create significant negative tax consequences. Liquidation can be taxable to both the corporation and its shareholders. If the corporation's assets and/or stock have appreciated, the tax cost of liquidation can be prohibitive. If the corporation has losses, there may be little or no tax cost. Each situation must be analyzed to determine feasibility. Assuming that state statutes allow the conversion and creditors are agreeable, the tax cost of liquidation must be weighed against the benefits from conversion to an LLC.

Liquidation of a corporation is generally a taxable event for both the corporation and its shareholders. I.R.C. §336(a) states that a liquidating corporation recognizes gain on the

distribution of appreciated property, recognizes depreciation recapture as if the corporation had sold each of its assets at its fair market value, and generally recognizes loss on the distribution of depreciated property. I.R.C. §331(a) provides that the corporation's shareholder(s) also recognize gain or loss on the distribution equal to the fair market value of the distribution received minus the basis in the shareholder's stock.

If the tax cost associated with a complete corporate liquidation is too great, alternatives include:

- Parallel operations
- Installment sale followed by liquidation
- Parallel operations coupled with sale of assets
- Parallel operations coupled with leasing and/or licensing of assets
- Joint venture

No matter what conversion technique is used to convert a business from pure corporate ownership to substantial or complete LLC ownership, valuation of the business is a key issue and potential point of attack by the IRS. Any corporate conversion technique that does not involve liquidation of the corporation is an invitation to the IRS to see whether it can come up with some variation of a substance-over-form argument that would result in more tax being due. The most dramatic argument for the IRS is that there has been a constructive liquidation of the corporation.

The IRS has ample weapons—the accumulated earnings tax, the personal holding company tax, and the S corporation passive income limitation—to keep taxpayer advantages from the operation of passive corporations within reasonable bounds. All alternatives to complete liquidation carry significant risks.

Careful consideration should be given before converting a C corporation to an LLC.

Practitioner Note. Conversion of an S corporation to another entity such as an LLC has similar tax consequences at the corporate level—gain or loss is recognized on sale or distribution of assets at fair market value. However, gain recognized by the corporation passes through to the shareholders and increases the shareholders' basis in their shares of stock, which reduces their gain upon liquidation of the corporation.