

Conversion from One Entity to Another

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Advanced Partnerships, LLCs and LLPs: Organization and Operation in Minnesota

I. Introduction

A. Why Does It Matter? Reasons for Conversion From One Entity to Another

Shareholders of corporations, partners in partnerships and members of limited liability companies (“LLCs”) often want to convert from one form of entity to another¹. Traditionally such conversions were accomplished through a series of contributions and distributions of property out of the old organization and into the new organization². With the advent of the LLC and revision to partnership laws, statutes have been amended to permit direct merger or conversion of one organization into another³. Several private letter rulings have considered the effect of a conversion of a partnership or other form of organization into an LLC.⁴

Perhaps the most significant development motivating conversions among entity types is the fairly recent and rapid development of the LLC entity form. Wyoming created the first LLC statute around 1977, but the LLC form did not become the “preferred” choice of entity until the IRS issued

¹ Robert R. Keatinge, “Choice of Entity”, *Minnesota State Bar Association Advanced Business Planning*, September 16, 2005, p. 6.

² *Id.*

³ *Id.*

⁴ *Id.*, citing Priv Ltr Ruls 9010027 (conversion of a limited partnership into an LLC), 9010067 (conversion of corporation into an LLC), 9129019 (merger of four partnerships into an LLC), 9210019 (merger of a Texas limited partnership into a Texas LLC), and 9226035 (conversion of a state A general partnership to a state B LLC).

rulings in the late 1980's clarifying the partnership tax treatment afforded to an LLC and, finally, in 1995, when all fifty states had enacted some form of LLC governing statute. The IRS' "check the box" regulations in 1997 made the LLC the predominant and most desirable entity form and, as a consequence, many existing entities sought to convert to this structure for its tax advantages and flexibility.

Another changing area of the law motivating entity conversions are the statutes governing partnerships, limited partnerships and limited liability partnerships. For example, Minnesota became one of the first states in January 2005 to adopt the Uniform Limited Partnership Act 2001.

B. Types of Conversions

In general, entity conversions are accomplished through one of the following methods:

1. Conversions upon formation (such as the conversion of a sole proprietorship or de facto partnership to an LLC);
2. Conversions between entity types;
3. Mergers of different entity types; or
4. A change of entity domicile.

II. Conversions and Mergers Involving LLCs

A. Advantages of an LLC. The LLC business form has become the preferred entity choice for a variety of businesses. An LLC has tax

advantages as a pass-through entity. Furthermore, and most importantly, the LLC provides flexibility and contractual advantages not found in other entity forms⁵. An LLC is the only formal entity structure that can be tailored and customized to specifically meet the unique needs of the participants, and also remains flexible enough to accommodate future changes in those needs⁶.

B. Tax Paradigms: “Assets Over”, “Assets Up” and “Interest Over” Forms. Most LLC statutes permit the merger of LLCs with other LLCs and many permit merger of LLCs with other business forms⁷. While the tax consequences of such mergers will differ depending on whether the parties to the merger are all partnerships or some are corporations, there are three (3) basic paradigms for the tax treatment of mergers: the “assets over”, “assets up” and “interest over” forms.

1. “Assets Over” Form.⁸

Under the assets over form, the assets of a disappearing entity are contributed by the disappearing entity to the surviving entity (the first step) in exchange for interests in the surviving entity (the

⁵ Joseph F. Schlueter, “An Analysis of the Changing Landscape Regarding the Tax Treatment of Options, Warrants, and Compensatory Interests for Partnerships and LLCs”, *The Effective Use of LLCs*, Minnesota State Bar Association, October 11, 2005, p. 5.

⁶ *Id.*, at p. 6. As an example, an LLC may have multiple classes of membership interests and retains its pass-through taxation. *Id.* On the other hand, a corporation with more than one class of stock will be taxed as a subchapter C corporation. *Id.*

⁷ Keatinge at p. 6.

⁸ Partnership mergers under state law or in any form other than assets up, will be treated by default as an assets over merger. Keatinge at p. 12.

second step) followed by a liquidating distribution by the disappearing entity to its members of interests in the surviving organization (the third step).⁹ Under this form of merger a terminating partnership will not recognize gain or loss upon contribution of its property to the resulting partnership in exchange for interests in the resulting partnership.¹⁰ “The basis of the partners in the terminating partnership in their interests in the surviving partnership will be equal to their basis in their interests in the terminating partnership. The distribution of the interests in the surviving partnership to the partners of the terminating partnership will not trigger gain under IRC §§ 704(c)(1)(B) or 737.”¹¹

2. “Assets Up” Form.

Under the assets up form of merger, the assets of the disappearing entity are distributed in liquidation to the members of the disappearing entity (step one), followed by a contribution by those members to the surviving entity (step two) in exchange for interests in the surviving entity (step three).¹² Under the assets-up form, partners could recognize gain when the terminating partnership distributes the assets to the partners. In contrast, under

⁹ *Id.* at p. 7.

¹⁰ *Id.* at p. 8, citing IRC § 721.

¹¹ *Id.* at p. 8-9, citing IRC § 722 and Treas. Reg. §§ 1,704-4(c)(4), 1.737-2(b).

¹² Keatinge at p. 10.

the assets-over form, gain under IRC §§ 704(c)(1)(B) and 737 is not triggered. Under the “assets-up” form, because the adjusted basis of the assets contributed to the surviving partnership or LLC is determined first by reference to IRC § 732, and then IRC § 723, in certain circumstances, the adjusted basis of the assets contributed may not be the same as the adjusted basis of the assets in the terminating partnership. These circumstances occur if the partners’ aggregate adjusted basis of their interests in the terminating partnership does not equal the terminating partnership’s adjusted basis in its assets. Under the assets-over form, because the resulting partnership’s adjusted basis in the assets it receives is determined solely under Section 723, the adjusted basis of the assets in the resulting partnership is the same as the adjusted basis of the assets in the terminating partnership.¹³

3. “Interest Over” Form.

Under the interest over form of merger a contribution of interests in the disappearing entity is made by the members of the disappearing entity (step one) in exchange for interests in the resulting entity (step two) followed by a liquidation of the disappearing entity (step three).¹⁴ By default, interest over form

¹³ *Id.* at p. 11.

¹⁴ *Id.*

partnership mergers are treated by the IRS as assets over mergers.¹⁵

C. Conversion of a Sole Proprietorship into an LLC.

1. The most basic entity conversion involving an LLC occurs when a previously existing unincorporated business (i.e., a sole proprietorship) converts to an LLC.

Two recent developments have made it possible to organize a sole proprietorship into an LLC (thereby obtaining the benefit of the LLC's liability shield) while preserving the sole proprietorship tax status: (i) the Internal Revenue's 1997 "check the box regulations" and (ii) the subsequent amendment of state LLC statutes permitting one member LLCs¹⁶.

The "check the box" regulations, adopted in January 1997, specify that unless an election is made, a one-member LLC is disregarded for federal tax purposes¹⁷. If the one member is a corporation, the LLC is treated as a division of the corporation¹⁸.

¹⁵ RIN 1545-AX32, 2000-1 C.B. 455, 65 FR 1572.

¹⁶ Mark J. Silverman, Lisa M. Zarlenga and Derek E. Cain, *Use of Limited Liability Companies in Corporate Transactions*, 449 PLI/Tax 239, 292-293 (October-November 1999).

¹⁷ Treas. Reg. § 301.7701-3(b)(ii).

¹⁸ *Id.* Prior to January 1, 1997, the entity classification regulations, referred to as the Kintner Regulations, applied a four (4) factor test for determining whether an entity was classified as a corporation or a partnership for federal tax purposes. A business entity was classified as a corporation if it had more than two (2) of the following "corporate characteristics": (1) limited liability; (2) centralization of management; (3) free transferability of interests; and (4) continuity of life. Old Treas. Reg. § 301.7701-2.

2. The conversion of a sole proprietorship into an LLC is a straightforward process. The owner transfers to the LLC all assets and liabilities of the sole proprietorship in exchange for 100% of the LLC membership interests. The sole proprietorship assets are transferred to the LLC pursuant to a bill of sale, and contracts, debts, and liabilities may be transferred to the LLC pursuant to an assignment and assumption agreement.¹⁹
3. A conversion to an LLC benefits the former sole proprietorship with limited liability in lieu of personal liability to the sole proprietor.

D. Conversion of a Partnership into a LLC

1. A partnership is converted into an LLC through one of the following methods:

- a. The partners can contribute their partnership interests to an LLC in exchange for LLC membership interests. This exchange is followed by a liquidation of the partnership and a distribution of partnership assets (the LLC membership interests) to the Partners. Finally, the

¹⁹ See Appendix, Exhibits A and B, respectively, for sample Bill of Sale and Assignment and Assumption Agreements.

partnership goes through the process of dissolution. This is the “interest over” form.

b. Alternatively, a partnership could transfer its assets and liabilities to an LLC in exchange for 100% of the LLC membership interests. This transfer is followed by a liquidating distribution of the partnership’s assets (the LLC membership interests) and liabilities to the partners resulting in dissolution of the partnership. This is the “assets over” form.

c. **Under either method outlined above, the partnership is essentially the organizer of the LLC.²⁰ The partnership will have to follow the ordinary LLC formation process, including filing articles of organization with the Secretary of State.²¹**

2. Contributions

a. In general, conversion is treated as a tax-free contribution of property from the existing partnership to the newly formed entity. Subject to any restrictions in the articles of organization or a member control agreement (and only

²⁰ Minn. Stat. § 322B.105.

²¹ Minn. Stat. § 322B.115.

when authorized by the board of governors or pursuant to a member control agreement), a limited liability company may accept contributions, make contribution agreements, and make contribution allowance agreements.²² Accordingly, a person or entity is permitted to make a contribution to a limited liability company in the following ways:

1. by paying money or transferring the ownership of an interest in property to the limited liability company, or rendering services to or for the benefit of the limited liability company; or
 2. through a written obligation signed by the person or entity to pay money or transfer ownership of an interest in property to the limited liability company or to perform services to or for the benefit of the limited liability company.
- b. However, no purported contribution is to be treated or considered a contribution, unless the board of governors accepts the contribution on behalf of the limited liability company and the contribution and its value are both

²² Minn. Stat. § 322B.105.

accurately reflected in the required records of the limited liability company.

- c. The determinations of the board of governors as to the amount or fair value of the contribution are presumed to be proper if they are made in good faith and on the basis of accounting methods, or a fair valuation or other method, reasonable in the circumstances.

- 1. Governors who are present and entitled to vote, and who, intentionally or without reasonable investigation, fail to vote against approving a consideration that is unfair to the limited liability company, or overvalue property or services received or to be received by the limited liability company as a contribution, are jointly and severally liable to the limited liability company for the benefit of the then members who did not consent to and are damaged by the action, to the extent of the damages of those members.

3. Terms of membership interests:

- a. All membership interests of an LLC must be of one class and without series unless the articles of organization or a

member control agreement establish, or authorize the board of governors to establish, more than one class or series within classes²³.

- b. All membership interests must also be ordinary membership interests entitled to vote as provided by Minnesota law and have equal rights and preferences in all matters not otherwise provided for by the board of governors unless the articles of organization or a member control agreement have fixed the relative rights and preferences of different classes and series.²⁴
- c. All membership interests must share profits and losses and be entitled to distributions.

4. Advantages of Conversion of a Partnership to a LLC

- a. The primary advantages of conversion to a LLC are flow through taxation and limited liability for LLC members. Conversion to a LLC does not produce taxable gain for a former partner, so long as his interests in the new LLC

²³ By contrast, a corporation with multiple classes of stock requires the corporation to be taxed as a C corporation, carrying the income tax penalty of double taxation, while remaining nowhere near as flexible as an LLC in the ability to adopt future changes. See Schlueter at p. 6.

²⁴ See Minn. Stat. § 322B.356,

remain equivalent to his interests in the terminating partnership.²⁵

5. Tax Treatment of the Conversion of a Partnership to a LLC

General and limited partnerships may convert without incurring termination as long as subsequent to the conversion, the former partnership's business continues and each partner's interests in the profits, losses and capital of the new partnership remain the same.²⁶ "The partners are deemed to exchange their old interests for the new interests; *their outside bases will not change if their shares in the new partnership's liabilities remain the same.* Consistent with treating LLCs as partnerships for tax purposes, the [IRS] has ruled privately, that partnerships converting to LLCs do not terminate solely be reason of the conversion."²⁷

In Revenue Ruling 95-37, the [IRS] ruled on a conversion of a general partnership into an LLC. The general partnership contributed all of its assets to the LLC in exchange for all the ownership interests in the LLC, with the LLCs assuming all of the obligations of the partnership. The partnership then dissolved, liquidated, and distributed membership interests to the

²⁵ See Rev. Rul. 95-37. 1995-17 I.R.B. 10.

²⁶ See Rev. Rul. 84-52, 1984-1 CB 157, 158.

²⁷ Keatinge at p. 5, emphasis added, citing Rev. Rul. 84-53, 1984-1 CB 159 and Priv. Ltr. Ruls 9029019, 9119029 and 901002789.

partners in the same proportion as their interests in the partnership. *The ruling stated that the conversion of a general partnership to an LLC is analogous to the conversion of a general partnership interest to a limited partnership interests under Revenue Ruling 84-52.* It went on to hold that no termination would result under IRC § 708, that, except as provided in IRC § 752, no gain or loss would be recognized by members on the contribution, and that the resulting LLC may use the same employee identification number as the partners.²⁸

E. Conversion of a Corporation into an LLC

- 1. A corporation may become a domestic limited liability company, and a domestic limited liability company may become a corporation, in each case pursuant to a plan of conversion.²⁹**

- 2. Pursuant to Minnesota law a plan of conversion must contain³⁰:**
 - a. The name of the converting organization;**
 - b. The name of the converted organization;**

²⁸ Keatinge at p. 14, emphasis added, citing Rev. Rul. 95-37, 1995-1 CB 130 and Rev. Rul. 84-52, 1984-1 CB 157.

²⁹ Minn. Stat. § 302A.681.

³⁰ Minn. Stat. § 302A.683.

- c. Whether the converted organization is a corporation or a limited liability company;
- d. The terms and conditions of the proposed conversion;
- e. The manner and basis of converting each ownership interest in the converting organization into ownership interests in the converted organization or, in whole or in part, into money or other property;
- f. A copy of the proposed articles of incorporation or articles of organization of the converted organization; and
- g. Any other provisions with respect to the proposed conversion that are deemed necessary or desirable.

3. Board Approval

- a. A resolution containing the plan of conversion must be approved by the affirmative vote of a majority of the directors or governors present at a meeting of the board of directors or the board of governors of the converting organization.³¹ The plan must then be submitted at a

³¹ Minn. Stat. § 302A.685, subd. 1.

regular or a special meeting to the owners of the converting organization.³²

i. Written notice must be given to every owner of the converting organization, whether or not entitled to vote at the meeting, not less than 14 days or more than 60 days before the meeting.

a. The written notice must state that a purpose of the meeting is to consider the proposed plan of conversion.

b. A copy or short description of the plan of conversion must be included in or enclosed with the notice.

4. Articles of Conversion³³

a. Upon receiving board approval for a plan of conversion, Minnesota law requires that articles of conversion be prepared.³⁴ The articles of conversion must contain:

ii. The plan of conversion;

³² *Id.*

³³ Refer to Exhibit C for Sample Articles of Conversion.

³⁴ Minn. Stat. § 302A.687.

- iii. The name of the converting organization immediately before the filing of the articles of conversion and its name following conversion³⁵;
- iv. The type of organization that the converted organization will be;
- v. A statement that the plan of conversion has been approved by the converting organization pursuant to Minnesota Statutes, Chapter 302A, Section 685; and
- vi. A copy of the articles of incorporation or the articles of organization of the converted organization.

b. The articles of conversion must be signed on behalf of the converting organization and filed with the secretary of state.

- i. Filing of the articles of conversion is also deemed to be a filing with the secretary of state

³⁵ The name must satisfy the laws applicable to the converted organization.

