

# **Conversion from One Entity to Another**

Prepared and Presented by:

**Jeffrey C. O'Brien**  
Mansfield, Tanick & Cohen, PA



# 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 another<sup>1</sup>. Traditionally such conversions were accomplished through a series of contributions and distributions of property out of the old organization and into the new organization<sup>2</sup>. 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 another<sup>3</sup>. Several private letter rulings have considered the effect of a conversion of a partnership or other form of organization into an LLC.<sup>4</sup>

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

---

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

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *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 forms<sup>5</sup>. 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 needs<sup>6</sup>.

**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 forms<sup>7</sup>. 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.<sup>8</sup>**

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

---

<sup>5</sup> 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.

<sup>6</sup> *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.*

<sup>7</sup> Keatinge at p. 6.

<sup>8</sup> 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).<sup>9</sup> 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.<sup>10</sup> “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.”<sup>11</sup>

## 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).<sup>12</sup> Under the assets-up form, partners could recognize gain when the terminating partnership distributes the assets to the partners. In contrast, under

---

<sup>9</sup> *Id.* at p. 7.

<sup>10</sup> *Id.* at p. 8, citing IRC § 721.

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

<sup>12</sup> 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.<sup>13</sup>

### 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).<sup>14</sup> By default, interest over form

---

<sup>13</sup> *Id.* at p. 11.

<sup>14</sup> *Id.*

partnership mergers are treated by the IRS as assets over mergers.<sup>15</sup>

### 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 LLCs<sup>16</sup>.

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 purposes<sup>17</sup>. If the one member is a corporation, the LLC is treated as a division of the corporation<sup>18</sup>.

---

<sup>15</sup> RIN 1545-AX32, 2000-1 C.B. 455, 65 FR 1572.

<sup>16</sup> 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).

<sup>17</sup> Treas. Reg. § 301.7701-3(b)(ii).

<sup>18</sup> *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.<sup>19</sup>
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

---

<sup>19</sup> 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.<sup>20</sup> The partnership will have to follow the ordinary LLC formation process, including filing articles of organization with the Secretary of State.<sup>21</sup>**

## 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

---

<sup>20</sup> Minn. Stat. § 322B.105.

<sup>21</sup> 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.<sup>22</sup> 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

---

<sup>22</sup> 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 classes<sup>23</sup>.

- 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.<sup>24</sup>
- 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

---

<sup>23</sup> 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.

<sup>24</sup> See Minn. Stat. § 322B.356,

remain equivalent to his interests in the terminating partnership.<sup>25</sup>

#### **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.<sup>26</sup> “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.”<sup>27</sup>

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

---

<sup>25</sup> See Rev. Rul. 95-37. 1995-17 I.R.B. 10.

<sup>26</sup> See Rev. Rul. 84-52, 1984-1 CB 157, 158.

<sup>27</sup> 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.<sup>28</sup>

**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.<sup>29</sup>**
  
- 2. Pursuant to Minnesota law a plan of conversion must contain<sup>30</sup>:**
  - a. The name of the converting organization;**
  - b. The name of the converted organization;**

---

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

<sup>29</sup> Minn. Stat. § 302A.681.

<sup>30</sup> 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.<sup>31</sup> The plan must then be submitted at a

---

<sup>31</sup> Minn. Stat. § 302A.685, subd. 1.



regular or a special meeting to the owners of the converting organization.<sup>32</sup>

**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 Conversion<sup>33</sup>**

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

**ii. The plan of conversion;**

---

<sup>32</sup> *Id.*

<sup>33</sup> Refer to Exhibit C for Sample Articles of Conversion.

<sup>34</sup> Minn. Stat. § 302A.687.

- iii. The name of the converting organization immediately before the filing of the articles of conversion and its name following conversion<sup>35</sup>;
- 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

---

<sup>35</sup> The name must satisfy the laws applicable to the converted organization.

of the articles of incorporation or the articles of organization of the converted organization.

- ii. The secretary of state then issues a certificate of conversion and a certificate of incorporation or a certificate of organization to the converted organization or its legal representative.

#### **5. Effective Date of Conversion**

- a. Conversion is effective when the articles of conversion are filed with the secretary of state or on a later date or at a later time specified in the articles of conversion.

#### **6. Abandonment of Conversion Pursuant to Minnesota law<sup>36</sup>:**

- a. After a plan of conversion has been approved and before the effective date of the plan, it may be abandoned:
  - i. If the owners of the converting organization entitled to vote on the approval of the plan approve the abandonment by majority vote;
  - ii. If the plan itself provides for abandonment and all conditions for abandonment set forth in the plan are met;

---

<sup>36</sup> Minn. Stat. § 302A.689

**iii.** By a resolution of the board of directors or governors of the converting organization which is approved by a majority of the board members present; or

**iv.** By Articles of Abandonment

**a.** If articles of conversion have been filed with the secretary of state, but have not yet become effective, the converting organization can file with the secretary of state articles of abandonment that contain:

**i.** The name of the converting organization;

**ii.** The provision of this section under which the plan is abandoned; and

**iii.** If the plan is abandoned by board resolution, the text of the resolution abandoning the plan.

## **7. Effect of Conversion**

**a. A converted organization is for all purposes the same organization as the converting organization when it was originally incorporated or organized.**

**b. A conversion becomes effective when:**

**i.** If the converted organization is a corporation, the converted organization has all the rights, privileges, immunities, and powers, and is subject to all the duties and liabilities, of a corporation;

**ii.** If the converted organization is a limited liability company, the converted organization has all the rights, privileges, immunities, and powers, and is subject to all the duties and liabilities, of a limited liability company.

**iii.** All property owned by the converting organization remains vested in the converted organization.

- iv. All debts, liabilities, and other obligations of the converting organization continue as obligations of the converted organization.
- v. Any action or proceeding pending by or against the converting organization may be continued as if the conversion had not occurred.
- vi. All rights, privileges, immunities, and powers of the converting organization remain vested in the converted organization.

**8. Effect on Shareholders<sup>37</sup>**

a. When a conversion becomes effective, each share or membership interest in the converting organization is deemed to be converted into shares or membership interests in the converted organization or, in whole or in part, into money or other property to be received under the plan by the shareholders or the members. This is subject to any dissenters' rights.

**b. In general, the basic methods for converting a corporation into an LLC are:**

---

<sup>37</sup> Minn. Stat. § 302A.691

- i. The shareholders can contribute their shares of stock in the corporation in exchange for LLC membership interests, followed by a liquidating distribution of the corporation's assets into the LLC<sup>38</sup>;
- ii. A corporation can contribute all of its assets and liabilities to an LLC in exchange for LLC membership interests, followed by a liquidating distribution of the LLC membership interests to the shareholders; or
- iii. The corporation can dissolve and liquidate by distributing all of its assets, liabilities and business to the shareholders, followed by a contribution of the assets, liabilities and business to an LLC in exchange for LLC membership interests.<sup>39</sup>

## **9. Tax Treatment of the Conversion of a Corporation to a LLC**

---

<sup>38</sup> See Priv. Ltr. Rul's 9404021 (Jan. 28, 1994) and 9409016 (March 4, 1994).

<sup>39</sup> Any corporate conversion should be carefully analyzed because there could be taxable gain to the corporation and/or the shareholders.

- a. Since the Internal Revenue Code and corresponding Treasury Regulations generally do not provide for a tax-free reorganization of a corporation into an LLC, the conversion of an existing corporation to an LLC requires the liquidation of the corporation.**
- b. Due to the dual taxation of C corporations, conversion transactions can lead to a tax loss.
- c. However, a conversion transaction might not generate a tax loss in the stock of an S corporation. Losses pass-through to S corporation shareholders and reduce the tax basis of their stock, leaving less opportunity to recognize a loss on liquidation. Moreover, S corporations already pass through losses to their investors, so the LLC form would not add a benefit in that respect.
- d. For federal tax purposes, neither the former corporation nor the resulting LLC recognize any gain from the contribution of corporation property to the LLC for purposes of conversion. As a result of the conversion the former corporation takes a substituted basis in the interests of the new LLC, equivalent to its basis in its



former assets, now contributed to the LLC. Shareholders of the former corporation recognize gain upon distribution of the LLC interests in complete liquidation, and have a basis of the fair market value of the new LLC's interests.<sup>40</sup>

- e. “[Private Letter Ruling] 9701029 describes in detail the tax consequences of the conversion of a corporation into an LLC. Under the private letter ruling, the merger of a corporation into an LLC is treated as a transfer by the corporation of its assets to [the] LLC in exchange for [the] LLC’s assumption of the corporations liabilities and the corporations receipt of interests in the LLC, followed by a distribution of the LLC interests to the shareholders in a taxable liquidation of the corporation under IRC § 331. Neither the corporation nor the LLC recognizes gain as a result of the contribution of the property to the LLC, and the corporation takes a substituted basis in the interest in the LLC equal to its basis in the assets contributed to the LLC. The corporation and the shareholders will recognize gain on the distribution of the LLC interests to the shareholders in complete liquidation.

---

<sup>40</sup> See Priv. Ltr. Rul. 97011029 (Jan. 3, 1997).

The shareholders will take a fair market value basis in the LLC interest. The distribution in liquidation will constitute a termination of the LLC under IRC § 708(b)(1)(B) and will constitute a transfer within the meaning of IRC § 743, and because the LLC had made an election under IRC § 754, the LLC will adjust the basis of its assets under IRC §§ 743 and 755 as a result of X's liquidation. The private letter ruling also discusses the consequences of the termination of the LLC for tax purposes under the former regulations under IRC § 708.<sup>41</sup>

 **Practice Tip**

Another option is to maintain the existing corporation for established operations while transferring new business into an LLC. Although this method does not convert an existing corporation to an LLC, it avoids liquidation of the corporation.

Under either method of conversion, however, both the corporation and its shareholders could recognize gain with respect to appreciated assets distributed by

---

<sup>41</sup> Keatinge at p. 23, citing Rev. Rul. 68-289, 1968-1 CB 314, Rev. Rul. 69-6, 1969-1 CB 104, Rev. Rul. 86-73, 1986-1 CB 282, and IRC §§ 721 and 722.

the liquidated corporation.<sup>42</sup> Although an existing corporation's shareholders' capital losses can be used to offset total recognized gain resulting from the liquidation of the corporation, the resulting tax consequences may still outweigh the advantages sought by conversion.

**F. Conversion of an LLC to a Corporation**

1. In very limited circumstances, certain advantages may support the conversion of an LLC to a corporation.

The tax rates on taxpayers with 'qualified production activities income' were further reduced in 2004. There is a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's 'qualified production activities income.' For taxable years beginning after 2009, the deduction is equal to 9% of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this provision) for the taxable year. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is 6% of

---

<sup>42</sup> I.R.C. §§ 331 and 336.

income. The deduction is limited to 50% of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. Thus, in taking advantage of the reduced rates, the amount of W-2 wages paid by a taxpayer is important.<sup>43</sup>

2. Minnesota Statutes § 322B.78 refers to the conversion provisions of Minnesota Statutes §§ 302A.681 – 302A.691 for the procedure of converting an LLC to a corporation; the procedure is the same as discussed above for conversion of a corporation to an LLC with the difference being that a corporation is the surviving entity.

3. The tax consequences of such a conversion must be carefully analyzed.

On an LLC's becoming a corporation, the treatment of change will turn on the method used to incorporate the LLC. Revenue Ruling 84-111, explains the concepts attributable to the incorporation of a partnership. Under Revenue Ruling 84-111, the form of the incorporation determines the tax consequences. There are three methods in which an LLC may be incorporated, in addition to incorporation by operation of law such as through statutory merger or conversion, an LLC may be incorporated by:

---

<sup>43</sup> Keatinge at p. 2, citing IRC § 199.

(1) the contribution of assets by the LLC to the corporation followed by a distribution of the stock of the corporation in liquidation (although the term “assets over method” is not used in Revenue Ruling 84-111, the transaction in which the disappearing organization makes a contribution to the surviving entity followed by a distribution of the interests in the surviving entity in liquidation of the disappearing entity is described in the partnership merger regulations . . . as the ‘assets over method’), (2) a distribution of the assets of the LLC in liquidation followed by a contribution of the assets to the corporation (the ‘assets up method’ described in Revenue Ruling 84-111 . . . ); or (3) the contribution of the interests in the LLC to the corporation in exchange for interests in the surviving organization, followed by the liquidation of the LLC (either in fact or constructively as a result of it having only one member)(the interests over method described in Revenue Ruling 84-111).<sup>44</sup>

When an LLC treated as a partnership for tax purposes merges with or converts into a corporation, there is a risk of recognition of gain if the LLC is subject to liabilities or if the members do not own 80% or more of the stock of the corporation after the merger or conversion. If the members do now own at

---

<sup>44</sup> Keatinge at p. 24-25, citing Rev. Rul. 84-111, 1984-2 CB 88.

least 80% of the stock, the gain deferral provisions of IRC § 351 will not apply and the members will recognize gain or loss measured by the difference between their basis in the assets contributed and the fair market value of the stock received.<sup>45</sup>

#### **G. Merger of Corporation into a Limited Liability Company**

1. A Minnesota LLC can merge with another LLC or a corporation under Minnesota law.<sup>46</sup> A merger practically results in a conversion of the LLC to a corporation where the corporation is the surviving entity. Partnerships, on the other hand, cannot merge with LLCs or corporations under Minnesota law, although some states (Delaware, for example) permit LLC and partnership mergers.
2. A merger involving a Minnesota LLC requires a plan of merger that is approved by the governors and members, and filing of Articles of Merger with the Secretary of State. A plan of merger must be approved by each constituent organization. In Minnesota, a plan of merger must be approved by the board of governors and by the members of an LLC.<sup>47</sup>

---

<sup>45</sup> *Id.* at p. 25.

<sup>46</sup> Minn. Stat. § 322B.70, subd. 1.

<sup>47</sup> Minn. Stat. § 322B.72, subd. 1.

**a. A plan of merger must contain the following four required provisions:**

- i.** The name of the LLC and the name of each constituent organization involved, and the name of the surviving organization;
- ii.** The terms and conditions of the merger;
- iii.** The manner and basis for converting the ownership interests of the constituent organizations into ownership interests of the surviving organization (or ownership interests of any other entity), and/or into cash or other property; and
- iv.** Any amendments to the Articles of Organization or Articles of Incorporation of the surviving organization.

**b.** The board of governors must approve resolutions containing the plan of merger. Unless otherwise required under the organizational documents, the plan must be approved by a majority of the governors present at a board meeting.

- c. Unless otherwise required under the organizational documents, the plan of merger must also be approved at a regular or special LLC member meeting by the members holding a majority of the membership interests entitled to vote.<sup>48</sup>
  
- d. Written notice of the member meeting must be given to all LLC members, regardless of their voting rights. The notice must be sent 14 to 60 days prior to the meeting date, and it must include a copy or short description of the plan and indicate that the purpose of the meeting is to consider the proposed plan of merger.<sup>49</sup>
  
- e. After the plan of merger has been approved on behalf of each constituent organization in the merger, articles of merger must be signed on behalf of each constituent organization and filed

---

<sup>48</sup> Minn. Stat. § 322B.72, subd 2.

<sup>49</sup> Minn. Stat. § 322B.72, subd. 1.



with the Secretary of State, together with a \$60 filing fee.<sup>50</sup>

- f. The articles of merger must contain a copy of the plan of merger, and must state that the plan has been approved on behalf of each constituent organization.

### **3. Tax Treatment**

“[Private Letter Ruling] 9404021 considered a merger between an LLC and a corporation. In the ruling, a Louisiana corporation (P) had a wholly owned subsidiary (S). P formed another subsidiary (H) and P and H formed a Louisiana LLC which was equally owned by P and H. S was then merged with the LLC. The ruling held that the merger of S with and into the LLC would be treated as: (1) a transfer by S of its assets to the LLC in exchange for the LLC’s assumption of S’s liabilities and S’s receipt of an increased interest in the items of income, gain, deduction, or loss of the LLC; followed by, (2) a distribution of S’s interest in the LLC to P in complete liquidation of S within the meaning of IRC § 332. The initial transfer of S’s assets to the LLC would be tax free under § 721

---

<sup>50</sup> Minn. Stat. § 322B.73, subd. 1-2.

and the subsequent liquidation would be tax free under IRC § 332. Thus, as a result of the fact that the assets and liabilities stayed within an affiliated group of corporations, the taxpayer was able to move assets from a corporation to a passthrough entity without the current recognition of gain. Transactions of this sort could be useful where licensing, nontax tax law, or state taxation would be more favorable if applied to an LLC than to a corporation.”<sup>51</sup>

#### **H. Merger of an LLC into a Corporation**

1. Due to the fact that Minnesota law permits mergers of LLCs with other LLCs and corporations, a merger practically results in a conversion of the LLC to a corporation where the corporation is the surviving entity.<sup>52</sup> Minnesota law permits the merger of a corporation with an LLC.<sup>53</sup> Therefore, a merger with an LLC may practically result in a conversion of the corporation to an LLC where the LLC is the surviving entity. Remember, a conversion of this sort will require careful tax analysis.

---

<sup>51</sup> Keatinge at p. 23-24, citing Rev. Rul. 69-6, 1969-1 CB 104, and Priv. Ltr. Ruls. 9404021 and 9409016.

<sup>52</sup> Minn. Stat. § 322B.70.

<sup>53</sup> Minn. Stat. § 302A.601, subd. 4.

2. The tax treatment of the merger of an LLC into a corporation will vary depending on the form of merger; the form of incorporation of the LLC will determine the tax consequences of the merger.<sup>54</sup>

### **I. Dealing with Dissenters Rights.**

An adverse tax consequence may occur when a partner in the terminating partnership does not want to become a partner in the resulting partnership and would like to receive money or property instead of an interest in the resulting partnership.”<sup>55</sup> Minnesota law provides that a plan of merger or plan of conversion for a LLC creates dissenters rights.<sup>56</sup> Specifically, when faced with a plan of merger or of conversion an LLC member has the right to dissent from the conversion or merger and collect payment on the fair market value of that member’s interests in the LLC.<sup>57</sup> “[T]he receipt of cash or property by that partner [or member] should be treated as a sale of that partner interest in the terminating partnership to the resulting partnership, not a disguised sale of the terminating partnership’s assets. Accordingly, [if the agreement of merger] specifies that the resulting partnership is purchasing the existing partner’s interest in the terminating partnership and the amount paid for the interest, the

---

<sup>54</sup> Rev. Rul. 84-111, 1984-2 CB 88; for a more detailed analysis refer to II. Section F of this article.

<sup>55</sup> *Id.* at p. 15.

<sup>56</sup> Minn. Stat. § 322B.383, subd. 3 and 5 (1993).

<sup>57</sup> *Id.*

transaction will be treated as a sale of the existing partner's interest to the resulting partnership.<sup>58</sup>

**J. Conversion of a LLP into a LLC.** The conversion of a limited liability partnership (“LLP”) to an LLC proceeds in the same manner as the conversion of a general partnership to an LLC<sup>59</sup>. One difference, however, is that the statement of qualification must be canceled in conjunction with the conversion<sup>60</sup>.

### **III. Conversions Involving Partnerships**

#### **A. Conversions of General Partnerships to Limited Partnerships**

1. A general partnership may be converted to a limited partnership pursuant to Minnesota law.<sup>61</sup> After all partners approve the conversion, the partnership has to file a certificate of limited partnership.<sup>62</sup>

**a. Pursuant to Minnesota law the certificate must include<sup>63</sup>:**

---

<sup>58</sup> Keatinge at p. 15.

<sup>59</sup> NOTE that Uniform Partnership Act of 1994 (codified at Minn. Stat. Chapter 323A) includes a limited liability partnership within the definition of “partnership”. Minn. Stat. § 323A.0101(8).

<sup>60</sup> Minn. Stat. §§ 323A.1001(e), 323A.0105(d).

<sup>61</sup> Minn. Stat. § 323A.0902.

<sup>62</sup> Minn. Stat. § 321.1105.

<sup>63</sup> Minn. Stat. § 321.1105.

- i. A statement that the partnership was converted to a limited partnership from a partnership;
- ii. its former name; and
- iii. a statement of the number of votes cast by the partners for and against the conversion and, if the vote is less than unanimous, the number or percentage required to approve the conversion under the partnership agreement.

**b. The conversion takes effect when the certificate of limited partnership is filed or at any later date specified in the certificate.**

## **B. Conversions of General Partnerships to Limited Liability Partnerships**

1. A general partnership may become a limited liability partnership.<sup>64</sup> The terms and conditions on which a general partnership becomes a limited liability partnership must be

---

<sup>64</sup> Minn. Stat. § 323A.0903.

