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COUNSELLORS AT LAW

TAX LAW ALERT

January 2015

The Connecticut Entity Transactions Act

On January 1, 2014, Connecticut's version of the Model Entity Transactions Act – the Connecticut Entity Transactions Act (the "Act") – went into effect.[1] Aside from the new vocabulary that the Act brought into Connecticut (for example, a "domestic filing entity's public organic document" might ordinarily be known in Connecticut as articles of organization for an LLC), the Act also brought into the state a new flexibility in business planning.

The Uniform Law Commission (the organization behind the model act) notes that the last decade has seen three newer business forms come into wide use, namely the LLC, the LLP, and the LLLP.[2] As businesses organized as one of these entities (or more traditional business forms such as partnerships and corporations) grow, they might desire to (a) change the type of business entity, (b) change the location of the business entity, or (c) restructure or merge with other types of business entities.

The ability to accomplish these objectives is now possible in Connecticut under the Act. But these streamlined and "cross-species" transactions may have unintended adverse tax consequences. In short, before you avail yourself of the new conveniences provided by the Act, make sure you know the price.

Transactions now permitted under the Act include domestications, conversions, interest exchanges, and cross-entity mergers. Prior law in Connecticut did not permit a Delaware corporation to "domesticate" into Connecticut (that is, become incorporated under the laws of Connecticut). Similarly, prior law for the most part did not authorize LLCs, general partnerships, LPs, LLPs, LLLPs, and corporations to convert or merge from one of these forms to another. For example, merging an LLC into a corporation involved a multi-step process which included the creation of additional entities (possibly in other jurisdictions). Now, under the Act, these conversions and cross-species mergers can occur in one step. While these different entities might now have a legal process to convert or merge cross-species, not all transactions are treated equally for tax purposes. Consider three conversions permissible under the Act, and then consider the tax consequences of each transaction:

1. Conversion of a LP (the "converting entity") to a LLC (the "converted entity");
2. Conversion of a LLC (the "converting entity") to a corporation (the "converted entity"); and
3. Conversion of a corporation (the "converting entity") to a LP or LLC (the "converted entity").

For each of these three conversions, the Act operates the same way. Instead of dissolving, liquidating, and terminating the respective "converting entity" in order to then form the "converted entity," a certificate of conversion pursuant to the Act bypasses this process. The converting entity first adopts a plan of

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[1] *See* Connecticut General Statutes Sections 34-600 et. seq.

[2] The considerations that might influence a decision to become a LLP or a LLLP are outside the scope of this Tax Alert.

conversion according to the Act and its public organic document (*e.g.*, for transaction #3, the public organic document would be the corporation's certificate of incorporation). After the plan of conversion is adopted, the converting entity files a certificate of conversion with the Connecticut Secretary of the State and attaches to it the public organic document of the converted entity (which, for transaction #3, if the converted entity is an LLC, would be the converted entity's articles of organization). Once the certificate of conversion is filed, the converted entity is the new entity organized under Connecticut law.

Tax Implications of the Three Conversion Transactions

The Act's single, streamlined process can effect certain conversions without any adverse income tax consequences because of the non-recognition provisions of the Internal Revenue Code.[3] But the same process can cause taxation for other conversions, most likely at the entity level and again for the equity holders. Unless the non-recognition rules are completely satisfied, a taxable sale or exchange occurs upon any conversion.

> 1. The conversion of an LP into an LLC has its origins in the determination made by the Internal Revenue Service in Revenue Ruling 84-52[4] that considered the income tax consequences of the conversion of a general partnership into a limited partnership. Under the ruling, each partner's total percentage interest in the partnership's profits, losses, and capital remained the same after the conversion and the business continued to be carried on after the conversion.
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> The revenue ruling treated the conversion as an exchange under Section 721 of the Code. Therefore there is no sale or exchange for purposes of gaining recognition (unless there are changes in the sharing of liabilities resulting in a deemed distribution under Section 752 of the Code) under either Section 741 or Section 1001 of the Code, and no partnership termination under Section 708 of the Code. The partners' respective basis in their partnership interests carries over under Section 722 of the Code, and therefore any gain is deferred until some subsequent taxable event (*e.g.*, termination and liquidation). The same analysis was applied in Revenue Ruling 95-37[5] where a partnership converted into an LLC classified as a partnership for federal income tax purposes. The revenue ruling went on to explain that these federal income tax consequences are the same whether the resulting LLC is formed in the same or a different state. The same principles have been extended to the conversion of other partnership entities (*e.g.*, conversion of a general partnership into a registered limited liability partnership[6]).

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[3] All references to the Internal Revenue Code (or "Code") mean the Internal Revenue Code of 1986, as amended.

[4] 1984-1 C.B. 157.

[5] 1995-1 C.B. 130.

[6] Revenue Ruling 95-55, 1995-2 C.B. 313.

2. The conversion of an LLC into a corporation can be handled simply by having the members "check-the-box" to be treated as an association taxable as a corporation. More likely the members desire to avail themselves of state law (*e.g.*, the Connecticut Business Corporation Act[7]), and that is where the Act can assist you. Revenue Ruling 84-111[8] provided for three means to that end (assets-over, assets-up, or interest-up) that should qualify for nonrecognition by application of Section 351 of the Code, consistent with the treatment found in Section 721 with some subtle differences that may hinge on which one of the three means is selected. Revenue Rule 2004-59[9] provides that conversion of an LLC to a corporation under state law such as the Act will be treated as an "assets-over" form (although the same tax principles are applicable to the two other forms).

In an assets-over form, the LLC transfers its assets to a newly created corporation (NEWCO). Upon the contribution, Section 351 of the Code provides that no gain or loss is recognized to either the corporation or the LLC members as long as (a) the exchange is solely for stock and (b) immediately after the LLC members are in "control" of NEWCO [the new shareholders must own at least 80% of the total combined voting power and 80% of the total number of shares (Section 368(c) of the Code)]. NEWCO's basis in the assets is carried over from the LLC pursuant to Section 362 of the Code, and the basis in the stock is exchanged for the basis in the LLC assets pursuant to Section 358 of the Code (reduced by any liabilities assumed that are taxed as boot under Section 357 of the Code). Once again, it is the transfer of the basis that establishes the deferral of recognition under Section 351.

On distribution of the stock from the LLC to its members, the LLC is terminated pursuant to Section 708 of the Code and a final partnership tax return is prepared. Pursuant to Section 732 of the Code, the basis of the stock distributed to the members in liquidation of their partnership interest is equal to the adjusted basis each held in their respective membership interests (adjusted for any taxable boot deemed distributed).

3. The conversion of a corporation (OLDCO) into an LLC should set off the sirens. In order for the shareholders of OLDCO to become the sole members of the newly formed LLC, OLDCO is deemed to distribute its property in a complete liquidation that is a taxable event to the corporation and its shareholders pursuant to Section 336 and Section 331 of the Code, respectively. At the corporate level, OLDCO recognizes gain or loss on the deemed sale in an amount equal to the

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[7] Connecticut General Statutes Sections 33-600, et. seq.

[8] 1984-2 C.B. 88.

[9] 2004-24 I.R.B. 1050.

> difference between the fair market value and the adjusted basis of the assets. At the shareholder level, the difference between the amount realized and their respective adjusted basis in their stock is also subject to tax. In most instances, this double taxation makes the conversion of a corporation into an LLC cost-prohibitive.[10]

In conclusion, any conversion or other transfer intended to be effectuated through the Act may have adverse tax consequences. A single, streamlined process may turn out to be an expensive trip. Before venturing down one of the new paths blazed by the Act, be sure to stop and smell for taxes.

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[10] Although in most instances a subchapter S corporation does not pay tax at the entity level, the conversion is still treated as a complete liquidation under Section 336 of the Code. There is an entity level gain on the deemed sale of assets equal to the difference between the fair market value and adjusted basis of the assets that is then passed through to the S corporation shareholders. The gain should increase the shareholder's basis in their respective S corporation stock so that only one level of tax is paid. Nonetheless, the expense of this single level of tax may also make the conversion of an S corporation into an LLC a non-starter.

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