Business Combinations: Mergers and Sales and Purchases of Ownership Interests and Entity Assets

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Advantages and Disadvantages of an Asset Sale by Entity

Advantages
1. Purchaser (and Seller) has flexibility to pick and choose assets to be purchased (and sold).
2. Purchaser has flexibility to pick and choose those liabilities of seller that purchaser will assume.
3. If the purchase price paid for the assets exceeds the seller’s tax basis for those assets, purchaser may obtain a stepped-up basis in the assets and may in turn benefit from increased future tax deductions.

Disadvantages
1. Asset sales are often more cumbersome to accomplish than stock sales (e.g., must convey ownership of assets, record real estate conveyances, usually must deal with licenses, permits, etc.).
2. Sale of assets may generate ordinary income or short-term capital gain (rather than long-term capital gain) which may result in higher income taxes.
Advantages and Disadvantages of a Sale of Ownership Interests in Entity

Advantages
1. Gain recognized by seller of ownership interests is often characterized as capital gain.
2. Can limit exposure of seller of ownership interests to future liabilities of Target.
3. Ownership interest sales can be easier to accomplish than asset sales.
4. Ownership interest sales often do not require consents or approvals with respect to licenses, permits, intellectual property.
5. Avoids entity-level income tax and transfer taxes, recording fees, etc.

Disadvantages
1. Purchaser bears economic burden of Target liabilities.
2. Purchaser may inherit a carryover basis in Target’s assets.
Tax Stakes in Business Combinations, Acquisitions and Dispositions

1. tax basis - stepped up or carry over
2. taxable gain - recognized or not recognized
3. taxable loss - recognized or not recognized
4. tax attributes - what happens to tax attributes such as NOLs, tax credits, earnings and profits, etc.
5. holding period - tacked or new
Taxability of Business Combinations, Acquisitions and Dispositions

1. Taxability of business combinations, acquisitions and dispositions come in two flavors:
a. Taxable (to Target and/or its owners)
b. Tax-free (to Target and its owners)

2. Operating rule is that if a transaction fails to satisfy all of the particular requirements of a tax-free transaction, the transaction is taxable.
Types of Tax Free Mergers and Acquisitions for S Corps.

A. Tax free reorganizations

1. Forward Merger (T merges into P, P survives) (A reorg.)
2. Forward Triangular Merger (T merges into subsidiary of P; subsidiary survives)
3. Reverse Triangular Merger (subsidiary of P merges into T; T survives)
4. Stock for Stock Exchange (P, or subsidiary of P, acquires stock of T (B reorg.)
5. Stock for Asset Exchange (P, or subsidiary of P, acquires assets of T) (C reorg.)
6. Other Requirements for Tax Free Reorganization
   a. plan of reorganization
   b. business purpose
   c. continuity of business enterprise
   d. continuity of interest requirement:
      old T shareholders need not retain P stock received in the transaction. Old T shareholders may sell their P stock to any person other than P or a corporation related to P.
7. Tax Stakes in Tax Free Reorganization

Shareholders of T:
- no recognized gain on receipt of P stock
- substituted basis in P stock
- tacked holding period in P stock
- recognize gain to the extent “boot” received
  (boot includes nonqualified preferred stock of P)

T:
- no recognized gain

P:
- no recognized gain
- carryover basis in T’s assets or stock of T
- tacked holding period in T’s assets or stock of T
- tax attributes of T carryover to P (with limitations in some cases)
Forward Merger (A reorg.)

Shareholders
- T stock:
  TB = $1M
  FMV = $20M

T Corp
- Assets:
  TB = $5M
  FMV = $20M

P Corp

P Corp
- Assets:
  TB = $5M
  FMV = $20M

Former T
Shareholders
- P Stock

P stock (cash)

merger

- T must be a corporation (C or S); P must be a corporation (C or S)
- mix of consideration to T’s shareholders must be at least 40% P stock
  (voting or non-voting, common or preferred)
Forward Triangular Merger

- Shareholders
  - T stock: TB = $1M, FMV = $20M

- T Corp
  - Assets: TB = $5M, FMV = $20M

- P stock (cash)

- Sub

- P Corp

AFTER

- Former T Shareholders
  - P Stock

- Sub
  - Assets: TB = $5M, FMV = $20M

- P Corp

- same requirements as forward merger (A reorg.)
- in addition, T must transfer “substantially all” of its assets to subsidiary of P.
Reverse Triangular Merger

- **Shareholders**
  - **T stock:**
    - **TB = $1M**
    - **FMV = $20M**

- **P voting stock**
  (up to 20% cash)

- **T Corp**
  - **Assets:**
    - **TB = $5M**
    - **FMV = $20M**

- **Sub**

- **P Corp**

- **AFTER**
  - Former **T Shareholders**
  - **P Corp**

- **T Corp**
  - **Assets:**
    - **TB = $5M**
    - **FMV = $20M**

- **Requirements**:
  - T, S and P must be corporations
  - Mix of consideration to T’s shareholders must be at least 80% P stock (voting only)
  - P must “control” T after the merger (at least 80% per §368(c))
  - T must “hold” “substantially all” of its assets
Stock for Stock Exchange (B reorg.)

- T and P (and subsidiary of P if one is used) must be corporations
- consideration to T’s shareholders must be solely P voting stock
Stock for Assets Exchange (C reorg.)

- T and P (and subsidiary of P if one is used) must be corporations
- consideration to T for its assets must be solely P voting stock (with one limited exception - boot relaxation rule under §368(a)(2)(B))
- T must liquidate
B. Section 351 Transfer of T Stock

- T’s shareholders and P contribute assets to Newco Corp in exchange for Newco stock and after the transfer the shareholders and P “control” Newco Corp.
- receipt of Newco stock by Shareholders of T is tax free under §351; recognize gain to the extent “boot” received
C. Section 721 Transfer of T Stock (or T Corp Assets)

- T's shareholders and P contribute assets to Newco Partnership or LLC in exchange for ownership interests in Newco.
- receipt of ownership interests is tax free under §721; recognize gain with respect to boot.
Disregarded Entities - Mergers and Acquisitions

Isolate a risky target corporation.

Diagram:

- S/H
- Acquiring stock
- Target
- Merger
- Acquiring
- Restructure
- Acquiring stock
- Target
- Merger
- Acquiring stock
- LLC
- Membership interests
Disregarded Entities - Mergers and Acquisitions

Avoid shareholder vote on direct merger with owner corporation.

Shareholders of Acquiring may have to approve merger under state law.

Restructure.

LLC member must approve merger, but not shareholders of Acquiring.
Disregarded Entities - Mergers and Acquisitions

- Other potential uses for disregarded entities.
  - Comply with regulatory restrictions on directly engaging in the target or owner corporation business.
  - Minimize third party consents and state transfer taxes that would result from a transaction structured as an asset transfer rather than a merger.
  - Qualify for more flexible treatment available under Section 368(a)(1)(A) for statutory mergers (no “solely for voting stock” requirement and no “substantially all” requirement).
Disregarded Entities - Mergers and Acquisitions

- Disregarded entity - A business entity that is disregarded as an entity separate from its owner for Federal tax purposes (e.g., single-member LLC, qualified REIT subsidiary, qualified subchapter S subsidiary). § 1.368-2(b)(1)(i)(A).
- Combining entity - A business entity that is a corporation that is not a disregarded entity. § 1.368-2(b)(1)(i)(B).
- Combining unit - A combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for Federal tax purposes. § 1.368-2(b)(1)(i)(c).
Disregarded Entities - Mergers and Acquisitions

• Operative rule (§ 1.368-2(b)(1)(ii)): A statutory merger or consolidation is a transaction effected pursuant to the laws of the United States or a State or the District of Columbia, in which, as a result of the operation of such laws, the following events occur simultaneously at the effective time of the transaction -
  
  – (A) All the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharge in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transfer unit); and
  
  – (B) The combining entity of each transferor unit ceases its separate legal existence for all purposes.

• Foreign mergers involving disregarded entities are not permitted.
Disregarded Entities - Mergers and Acquisitions


- Target merges into Acquiring’s LLC under state law.
- Pursuant to state law, the following events occur simultaneously at the effective time of the transactions --
  - All assets and liabilities of Target become assets and liabilities of the LLC; and
  - Target’s separate legal existence ceases for all purposes.
- In the merger the Target shareholders receive Acquiring stock.
Disregarded Entities - Mergers and Acquisitions

Triangular A Reorganization (Section 368(a)(2)(D)) - Target merges into disregarded entity of Acquiring. Reg. §1.368-2(b)(1)(iii), Example 4.

- Acquiring is treated as owning all assets of LLC.
- Acquiring is treated as acquiring substantially all properties of Target in merger.
- Target shareholders receive Parent stock, a corporation in control of Acquiring.
Disregarded Entities - Mergers and Acquisitions

Failed A Reorganization - Merger of Target into disregarded entity owned by partnership. Reg. § 1.368-2(b)(1)(iii), Example 5.

- Acquiring is a partnership for Federal tax purposes.
- Merger fails as an A Reorganization because neither Acquiring nor LLC qualifies as a combining unit.
Disregarded Entities - Mergers and Acquisitions


- Merger fails as an A Reorganization because all assets and liabilities of a transferor unit (Parent and LLC) do not become assets and liabilities of one or members of the transforee unit. (Acquiring)
- LLC by itself does not qualify as a combining unit.
Disregarded Entities - Mergers and Acquisitions


- Immediately following merger, LLC fails to qualify as disregarded entity because it has more than one member. It becomes a partnership.
- Because LLC ceases to be a disregarded entity, all assets and liabilities of Target, the combining entity of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit.
Taxable Mergers and Acquisitions of Target

1. Tax consequences to Target and Owners of Target will be affected by the structure of the acquisition or merger and by the tax status of Target.

2. Traditional structures:
   a. asset purchase
   b. forward merger of Target into Purchaser (or subsidiary of Purchaser)
   c. ownership interest purchase
   d. reverse subsidiary merger into Target
   e. ownership interest purchase with §338(h)(10) election (for S corporations) or §754 election (for partnerships, LLCs)

3. Tax Status of Target:
   a. S Corp
   b. LLC or partnership
Taxable Sale of Assets by S Corporation

Shareholders:
- T Stock:
  - TB = $1M
  - FMV = $20M

T (S Corp):
- Assets:
  - TB = $5M
  - FMV = $20M

$20M cash/P note

P Corp:
- $20M stepped up basis in T assets
- Recognizes no gain
- T's attributes remain with T
- Pays no federal income tax

Shareholders:
- $15M gain passes through to shareholders who will pay income tax on the gain.
- $15M gain passed through increases shareholders' tax basis to $16M
- Installment method available for P notes.
Section 1374 Built-in Gains
Tax on Certain S Corporations

1. If T was a C corporation and converted to S corporation status generally after 1986, it is subject to a 10-year corporation level penalty tax on its net recognized built-in gain as of the date it converted to S corporation status. The section 1374 built-in gain tax is imposed on asset sales (or deemed asset sales under section 338(h)(10)) during the first 10 years as an S corporation, to the extent of the built-in gain when T converted from C to S status.

2. If T was never a C corporation but acquired assets from another C corporation in a carry-over basis transaction, the assets so acquired will be subject to the section 1374 built-in gain tax on asset sales (or deemed asset sales under section 338(h)(10)) during the first 10 years after the carry-over basis transaction from the other C corporation to the extent of the built-in gain when T acquired the carry-over basis assets.
Taxable Forward Merger

- transaction treated as if T first sold its assets for $20M cash/P note and then liquidated and distributed net assets to shareholders. Rev. Rul. 69-6. No tax free reorganization because consideration does not include P stock. T is merged out of existence.
- caveat: because of merger P inherits T’s corporate tax liability (if any) on T’s deemed sale of assets for $20M.
- same tax results as taxable sale of assets
Taxable Forward Subsidiary Merger

- Shareholders
  - T stock:
    - TB = $1M
    - FMV = $20M

- T (S Corp)
  - Assets:
    - TB = $5M
    - FMV = $20M

- $20M cash/P note

- P Corp

- Sub Corp

- AFTER

  - P Corp
    - Sub Corp stock:
      - TB = $20M
      - FMV = $20M

- Sub Corp
  - Assets:
    - TB = $20M
    - FMV = $20M

- merger

- no tax-free reorganization because consideration does not include P stock
- isolates P Corp’s assets from T’s liabilities
- same tax results as taxable sale of assets
Merger of S Corporation into LLC

- Shareholders
  - T stock:
    - TB = $1M
    - FMV = $20M

- T (S Corp)
  - Assets:
    - TB = $5M
    - FMV = $20M

- $20M Cash/P note

- merger

AFTER

- P LLC
  - Assets:
    - TB = $20M
    - FMV = $20M

- no tax free reorganization because P is not a “corporation” for tax purposes
- same tax results to T Corp and shareholders as a taxable sale of assets
Virginia law permits a Virginia corporation to convert into a Virginia limited liability company (Virginia Code Section 13.1-722.14). No need to do a merger.

- treated as a taxable liquidation of T Corp. Same tax results to T Corp and shareholders as a taxable sale of assets
Merger of LLC Into S Corporation

Members
- T membership interests
  
  TB = $1M
  
  FMV = $20M

T LLC
- Assets:
  
  TB = $5M
  
  FMV = $20M

$20m cash/ P note

Merger

P Corp

AFTER

P Corp
- Assets:
  
  TB = $20M
  
  FMB = $20M

- the merger of T LLC into P corp would likely be characterized as a transfer of assets by T LLC to P corp (asset sale by T LLC) followed by a liquidation of T LLC.
alternatively, if the consideration consisted of P corp stock (in lieu of cash/P note) the exchange of T LLC assets for P corp stock could qualify under IRC §351 (if the requirements under IRC §351 were otherwise satisfied). The deemed distribution by T LLC of the P corp stock to the members would not disqualify an otherwise good §351 transaction (Rev. Rul. 84-111).
Taxable Sale of Target Stock (no §338 Election by P)

- Shareholders:
  - T Stock: $TB = $1M, $FMV = $20M
  - T (S Corp): Assets: $TB = $5M, $FMV = $20M
  - $20M Cash/P notes
  - T stock

  **AFTER**
  - P Corp
  - $20M TB in T stock
  - T Corp
  - Assets: $TB = $5M, $FMV = $20M

- Shareholders:
  - recognize LTCG of $19 M
  - entitled to recognize gain on installment method if T stock not publicly traded and P notes are not publicly traded
  - must pay annual interest charge to IRS on tax deferred if shareholder has more than $5M of installment notes
  - can secure P notes with standby LOC and still get installment method
• Target recognizes no gain

• P Corp:
  – $20M stepped up basis in T stock
  – recognizes no gain
  – carry over basis of $5M in T assets
  – any T NOLs, credits limited under Section 382
Taxable Reverse Subsidiary Merger (no §338 Election by P)

- IRS treats (Rev. Rul 73-427) structure as taxable stock sale by shareholders; taxable purchase of T stock by P. Not a tax free reorganization because consideration does not include any P stock.
- Structure useful if T’s shareholders are numerous or some of T’s shareholders are troublesome
- Disregard merger subsidiary
- Source of consideration: if consideration (cash/note) comes from P, P is treated as acquiring the stock of T; if consideration comes from T, T is treated as redeeming its stock from the shareholders
- Same tax result as stock purchase; consider effect on T’s E&P (if any)
Taxable Stock Sale (P makes §338 Election)

- Shareholders
  - T Stock:
    - TB = $1M
    - FMV = $20M
- $20M Cash/P note
- P Corp
- T stock
- T (S Corp)
  - Assets:
    - TB = $5M
    - FMV = $20M

AFTER

- P Corp
  - T stock:
    - TB = $20M
    - FMV = $20M
- T Corp
  - Assets:
    - TB = $20M
    - FMV = $20M

- stock sale/purchase for non-tax purposes
- shareholders treated as selling T stock and would recognize capital gain of $19M
- §338 Election by P permits it to write up tax basis of T's assets to $20M. However, T must recognize $15M of taxable gain as if the assets were sold in a taxable transaction for $20M. Economic burden of the tax incurred by T falls on P.
- if T has C corporation NOLs, the §338 election makes sense
Taxable Sale of S Corporation Stock with Section 338(h)(10) Election

Shareholders
- T Stock:
  TB = $1M
  FMV = $20M

P Corp

T (S Corp)
- Assets:
  TB = $5M
  FMV = $20M

$20M cash/P note

T Stock

P Corp
- T Stock:
  TB = $20M
  FMV = $20M

T
- Assets:
  TB = $20M
  FMV = $20M

Effect of Section 338(h)(10) election (stock sale treated as an asset sale).
- P Corp, T, and shareholders treat transaction as an asset deal. After the transaction, T is a subsidiary of P, but T has a $20M stepped-up basis in its assets.
• T-S Corp is treated as having sold its assets for $20M. The $15M recognized gain passes through to shareholders. T is then treated as if it liquidated and distributed the $20M to shareholders in liquidation.
• shareholders recognize $15M gain passed through from T on the deemed sale of assets, and recognize $4M gain on the deemed liquidation of T.
• Installment method at shareholder level is available for P note.
• do not confuse section 338 election with section 338(h)(10) election.
• some states do not recognize section 338(h)(10) election (be careful).

Requirements for Section 338(h)(10) election:
• purchaser must be a corporation
• purchaser must purchase at least 80% of the stock of the S corporation from an unrelated seller within a period of 12 months.
• Purchaser and all shareholders of T must make a joint election.
• the joint election must be filed by the 15th day of the ninth month following the acquisition.
Taxable Sale of Interests in Partnership or LLC

Members
- Interests:
  TB = $5M
  FMV = $20M

$20M cash/Buyer Note
100% Interests

P Corp

AFTER

P Corp

T-LLC
- disregarded entity
- Assets:
  TB = $20M
  FMV = $20M

- P Corp gets $20M stepped-up basis in assets (although assets still legally owned by T-LLC which is disregarded for tax purposes). P Corp need not file any elections to obtain step-up. Same result whether P Corp purchases 100% of ownership interests in T or purchases the assets directly from T.
- If P Corp purchased less than 100% of the ownership interests in T, a §754 election would be necessary to achieve stepped-up basis in assets.
Disposition of Entire Interest in Qualified Subchapter S Subsidiary (Q Sub)

T (S Corp) → $20M cash → Buyer

100% of stock in T Subsidiary

T Subsidiary (Q Sub)
- Assets:
  TB = $5M
  FMV = $20M

AFTER

Buyer
- T stock:
  TB = $20M
  FMV = $20M

T Subsidiary
- Assets:
  TB = $20M
  FMV = $20M

- as a Q Sub, T Subsidiary is treated as a division of T (S Corp) and not as a separate entity. The sale by T (S Corp) to Buyer of T Subsidiary stock terminates the Q Sub status of T Subsidiary.
Disposition of Entire Interest in Qualified Subchapter S Subsidiary (Q Sub)

- apparently, if Buyer purchases 100% of the Q Sub’s stock IRS will treat the transaction as a purchase by Buyer of the Q Sub’s assets, rather than a purchase of the Q Sub’s stock followed by a contribution by Buyer of the purchased assets to a newly formed subsidiary. Treas. Reg. §1.1361-5(b)(3), example 9.
- shareholders of T (S Corp) recognize $15M gain on deemed sale of assets to Buyer.
- Buyer treated as having purchased the assets and contributed the assets to T Subsidiary (a new C corporation) in exchange for stock of T Subsidiary.
- Buyer takes $20M tax basis in stock of T Subsidiary.
- T Subsidiary takes $20M tax basis in its assets.
- no need for Buyer to make §338 election or §338(h)(10) election to achieve $20M stepped-up basis in assets of T Subsidiary.
Disposal of Qualified Subchapter S Subsidiary (Q Sub)

- as a Q Sub, T subsidiary is treated as a division of T (S Corp) and not as a separate entity. The sale by T (S Corp) to Buyer of T Subsidiary stock terminates the Q Sub status of T Subsidiary.
- upon termination of Q-Sub status, T Subsidiary is treated as a “new” corporation acquiring all of its assets and assuming all of its liabilities from its S Corp parent. This transfer is deemed to occur immediately before the stock transfer of 21% to Buyer. Step transaction doctrine creates a “busted” 351 transaction as to T (S Corp) because T (S Corp) is not in “control” (80% per §368(c)) immediately after the deemed exchange and sale to Buyer. Treas. Reg. §1.1361-5(b)(3), example 1.
- shareholders of T (S Corp) recognize $15M gain. Trap for unwary.
- same result to T (S Corp) and its shareholders whenever Buyer purchases more than 20%, but less than 100%, of stock of Q Sub
Alternative 1 Structure for Disposition of Qualified Subchapter S Subsidiary (Q Sub)

T (S Corp)  

Buyer

cash

21% of stock of T Subsidiary

T Subsidiary
- Assets:
TB = $5M
FMV = $20M

• instead of transferring cash to T (S Corp), Buyer transfers cash (or property) to T Subsidiary in exchange for a 21% interest in T Subsidiary. T Subsidiary’s Q Sub status terminates because of Buyer’s stock ownership, but the deemed transfer by T (S Corp) to T Subsidiary is now tax-free under §351 because Buyer is also a transferor to T Subsidiary and Buyer’s stock ownership may be aggregated with T (S Corp) stock ownership in meeting the “control” (80% under §368(c)) requirement. T recognizes no gain.
the purchase consideration, however, is in T Subsidiary (rather than with T (S Corp)). T Subsidiary becomes a C corporation, and distributions by T Subsidiary to T (S Corp) would have to navigate the §301 distribution rules.
Alternative 2 Structure for Disposition of Qualified Subchapter S Subsidiary (Q Sub)

**Step 1**
- merge the Q Sub (T Subsidiary) into a single member LLC (T Sub-LLC) owned by T (S Corp). This merger is ignored for federal income tax purposes because both Q Sub and the single member LLC are disregarded entities.
- T’s sale to Buyer of 21% interest in T Sub-LLC is treated as though T sold (and Buyer purchased) a 21% undivided share of each of the assets held by T Sub-LLC. T and Buyer are then treated as if they contributed their share of the assets to a newly formed partnership (T Sub-LLC) under §721 (Rev. Rul. 99-5).

**Step 2**
- T (S Corp) transfers cash to Buyer in exchange for 21% member interest in LLC.
- T Sub-LLC transfers assets to T (S Corp) or converts.

T Subsidiary
- Assets:
  - TB = $5M
  - FMV = $20M

T Sub - LLC
- Assets:
  - TB = $5M
  - FMV = $20M
- T recognizes $3.15M gain (21% x $15M). T Sub-LLC holds assets with a tax basis of $8.15M under §723. T and Buyer have tax basis in their membership interests of $3.95M (79% x $5M) and $4.2M (21% x $20M), respectively, under §722.
- future allocations of gain by T Sub-LLC subject to §704(c).
- T Sub-LLC becomes a partnership for tax purposes.
Sale of a Single Member LLC

1. LLC is disregarded as an entity separate from T. Therefore, T is not treated as owning membership interests in LLC for federal tax purposes. Instead, T is deemed to own LLC’s assets.
2. T’s sale of all of its membership interests to a single buyer is treated as a sale by T of LLC’s assets. T recognizes $15M gain and the character of the gain (capital or ordinary) will depend on the nature of the assets sold. (Rev. Rul. 99-5)
3. LLC is owned by a single buyer, P, and therefore it will remain a disregarded entity in P’s hands.
4. P will likewise be treated as purchasing the assets of LLC directly from T and will take a $20M basis in the assets under §1012.

LLC
- disregarded entity
- Assets:
  TB = $5M
  FMV = $20M

T
  100% interests
  $20M Cash

P
  100% interests
  100% LLC
Sale of Less Than All of the Membership Interests of A Single Member LLC

- T owns 100% of the membership interests of LLC which is a disregarded entity for federal tax purposes. T sells a 50% membership interest in LLC to P for $10M cash.

- Because LLC is disregarded, T is treated as owning LLC assets directly. Therefore, the sale of the 50% interest in the LLC is treated as a sale by T of 50% of LLC assets to P. T recognizes $7.5M gain ($10M less $2.5M) and the character of the gain (capital or ordinary) will depend on the nature of assets sold. (Rev. Rul. 99-5)

- after the sale LLC has two owners and therefore it will be treated as a “partnership” for tax purposes.
• P is treated as having purchased 50% of the LLC’s assets from T and then having contributed the assets (with a $10M basis) to a newly formed “partnership” under §721.

• T is treated as having contributed the other 50% of LLC assets to a newly formed “partnership.” These assets would not receive a stepped-up basis (basis would remain at $2.5M)

• §704(c) will allocate the built-in gain in these assets to the deemed contributor (T).

• Section 197 (amortization of goodwill) issue if some of the LLC’s assets included goodwill which was not amortizable before enactment of section 197
  - Anti-Churning Rule: generally, section 197 amortization deduction may not be taken for an asset (which asset was not amortizable under the law before section 197) if the asset is acquired after August 10, 1993 and either (i) the taxpayer or a related person held or used the asset on or after July 25, 1991; (ii) the normal ownership of the intangible changes, but the use of the intangible does not; or (iii) the taxpayer grants the former owners the right to use the asset. §197(f)(1)(A).
- T is treated as owning LLC’s goodwill before the sale of 50% to P. T’s deemed contribution of 50% of the goodwill to the deemed newly formed “partnership” is a §721 transfer and the “partnership” (the LLC) takes a carry-over basis in the goodwill deemed contributed by T (which is presumably zero).

- Although P has a stepped-up basis in the portion of its 50% of the assets that includes goodwill, and although, because of the deemed contribution of this goodwill by P to LLC, LLC will also have a stepped-up basis in the goodwill under §723, the anti-churning rule of section 197 will prohibit LLC from amortizing this goodwill. P’s half of the goodwill was held by T and T is related to the LLC under §197(f)(9)(C) during the prohibited time period. Treas. Reg. §1.197-2(k), example 18.
Possible Solution to Churning Issue

- **X**, an affiliate of **T** (e.g., shareholder) contributes capital to LLC and becomes a member of LLC such that LLC converts from a disregarded entity to a “partnership” for tax purposes.

- **T** then sells the 50% interest in LLC to **P**. **P** has acquired a 50% interest in a “partnership” for tax purposes, not a 50% interest in the assets of LLC. **X** remains a member of LLC.

- 754 election by LLC would permit **P** to “step up” its share of LLC’s assets (including the goodwill).

- **P**’s stepped up share of goodwill (§743(b) adjustment) not subject to anti-churning rule. Treas. Reg. §§1.197-2(h)(12)(v); 1.197-2(k), example 19.
Conversion to Single Member LLC

- T and P each own 50% of membership interests in LLC (a “partnership” for tax purposes). P purchases from T its 50% membership interest for $10M cash. After the purchase, P owns 100% of the membership interests in LLC.
- After sale, LLC becomes a disregarded entity (it has one owner and it has not elected to be taxed as an association). Rev. Rul. 99-6 treats transaction differently as to T and P.
- LLC is deemed to terminate under §708(b)(1)(A) when P purchases T’s 50% membership interest. T must treat the transaction as a sale of a partnership interest. (Rev. Rul. 99-6)
• tax consequences to P: first, LLC is deemed to make a liquidating
distribution of its assets to T and P; second, P is treated as acquiring
from T those assets deemed distributed to T in the liquidating
distribution. Accordingly, P must recognize gain or loss, if any, on
any deemed distribution of cash to P in excess of P’s basis in its
“old” 50% membership interest under §731. P’s basis in the LLC
assets deemed distributed to P is determined under §732(b)
(generally, substituted basis), and the holding period for these assets
is determined under §735(b). P is treated as having purchased from
T those assets that are deemed to have been distributed to T by LLC.
Therefore, P will have a $10M basis in these assets under §1012,
and its holding period will begin on the day following the T’s sale of
its 50% interest to P. (Rev. Rul. 99-6)