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Use of Limited Liability Entities in Tax Strategies and Techniques for Business Acquisitions and Dispositions

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USE OF LIMITED LIABILITY ENTITIES IN TAX STRATEGIES AND TECHNIQUES FOR BUSINESS ACQUISITIONS AND DISPOSITIONS

William and Mary Tax Conference
Thursday, November 20, 2003

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Taxable Mergers and Acquisitions of Target

1. Tax consequences to Target and Shareholders 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. stock purchase
   d. reverse subsidiary merger into Target
   e. stock purchase with §338 election or §338(h)(10) election

3. Tax Status of Target:
   a. C Corp
   b. S Corp
Advantages and Disadvantages of an Asset Sale

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.\[1] \[2]
Advantages and Disadvantages of a Stock Sale

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

Disadvantages
1. Purchaser bears economic burden of Target liabilities.
2. Purchaser inherits a carryover basis in Target’s assets.
Taxable Sale of Assets

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

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

$20M cash/P note

Step 2

T stock
Cash/P note

P:
- $20M stepped up basis in T assets
- recognizes no gain
- T's tax attributes remain with T

Target:
- recognizes $15 M gain
- if Target had NOLs, OK to use
Shareholders:
- recognize CG if Target liquidates entitled to recognize their CG on installment method for P notes if Target properly adopts plan of liquidation and liquidates within proper 12 mos. period and if Target stock and P notes are not publicly traded
- double tax on sale

Structuring for Asset Purchase not desirable unless:
- large Target NOL to absorb taxable gain on sale of assets (P NOL does not help)
- delay liquidation of Target until Shareholders’ death
- Target shareholder (and tax advisors) are clueless
Taxable Forward Merger

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

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

$20M cash/P note

merger

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

AFTER

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

$20M cash/P note

merger

P Corp

Sub Corp

AFTER

P Corp

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

- 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 C Corporation into LLC

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

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

P LLC

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 (generally effective 7-1-02) 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 OR C CORPORATION

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

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

Merger

$20m cash/
P note

AFTER

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

- although no published authority, 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 Corp - Assets:
- TB = $5M, FMV = $20M

$20M Cash/P notes → T stock → P Corp

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
  • Inputed interest
• 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
Taxable Stock Sale (P makes §338 Election)

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

- **P Corp**
  - T stock
  - $20M Cash/P note

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

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

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

- **Points**
  - 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 NOLs, the §338 election makes sense
Taxable Sale of Assets by S Corporation

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

P Corp:
- $20M stepped up basis in T assets
- recognizes no gain
- T's attributes remain with T

T:
- pays no federal income tax

$20M cash/P note

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.
- same result if structured as a taxable forward merger.
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 Sale of S Corporation Stock with Section 338(h)(10) Election

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.
- all shareholders of T and Purchaser must make a joint election.
- the joint election must be filed by the 15th day of the ninth month following the acquisition.
Non-Consenting Shareholders of Target S Corporation - Squeeze to Achieve Section 338(h)(10) Election

- P Corp desires to acquire all of the stock of T, and the “consenting shareholders” and P Corp desire to make a section 338(h)(10) election. Such an election, however, requires consent of all T shareholders.
- consenting shareholders form Merger Corporation, and Merger Corporation merges with and into T (S Corp) with T (S Corp) surviving. In the merger the “non-consenting shareholders” are squeezed out for cash. Treated as a redemption by T (S Corp) of T stock held by non-consenting shareholders, and tax treatment governed by §1368.
• P Corp acquires remaining outstanding T (S Corp) stock from consenting shareholders.
• P Corp and consenting shareholders make §338(h)(10) election.
Taxable Sale of Interests in Partnership or LLC

- **Members/Partners**
  - Interests:
    - **TB = $5M**
    - **FMV = $20M**
  - $20M cash/Buyer Note
  - 100% Interests

- **T - LLC/P'ship**
  - Assets:
    - **TB = $5M**
    - **FMV = $20M**

- **AFTER**
  - **Buyer**
    - **Assets**:
      - **TB = $20M**
      - **FMV = $20M**

- **Buyer gets $20M stepped-up basis in assets. Buyer need not file any elections to obtain step-up. Same result whether Buyer purchases 100% of ownership interests in T or purchases the assets directly from T.**

- **if Buyer purchased less than 100% of the ownership interests in T, a §754 election would be necessary to achieve stepped-up basis in**
Taxable Acquisition by Qualified Subchapter S Subsidiary (Q Sub)

P subsidiary is a qualified subchapter S subsidiary (Q Sub). A Q Sub is a domestic corporation that is wholly-owned by an S corporation and for which the S corporation has made a Q Sub election.

A Q Sub is not treated as a separate corporation and all of its assets, liabilities, income, deductions and credit are treated as assets, liabilities, income, deductions, and credit of the parent S corporation.

- the purchase of T stock by P subsidiary is treated as a purchase of T stock by P.
- same analysis as taxable purchase of T stock by P.
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.
Disposition 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)

- 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).
- T recognizes $3.15M gain. 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 and $4.2M, respectively, under §722.
- future allocations of gain by T Sub-LLC subject to §704(c).
- T Sub-LLC becomes a partnership for tax purposes.
Use of Single Member LLC to Eliminate Excess Loss Accounts ("ELA")

- Parent Corp is parent of an affiliated group filing a consolidated return with Sub. Sub has an excess loss account (ELA). Parent Corp is considering a sale of Sub that would trigger the ELA into income.
- Sub transfers all of its assets and liabilities to a single member LLC (a disregarded entity). The transfer is treated as a liquidation of Sub under §332 and eliminates the ELA. Treas. Reg. 1.1502-19(b)(2).
Use of Single Member LLC to Achieve Equivalent of a Section 338 Election

Step 1

- Parent Corp and T are members of an affiliated group.
- Buyer is a non-corporate purchaser that (i) wants to acquire T, (ii) wants a stepped-up basis in T’s assets, (iii) does not want to form an acquisition corporation.
- because Buyer is not a corporation, §338 is not available.
- T merges into a single member LLC (disregarded entity) which is treated as a §332 liquidation of T.

Step 2

- Buyer then purchases 100% of interests in disregarded entity which is treated as a purchase of T’s assets by Buyer.
Use of Single Member LLC for SRLY Losses

Step 1:
- P and T file consolidated return
- P acquired T years ago. T has NOLs generated before becoming a member of the P group (SRLY Losses)
- P wants to use the losses, but does not want T's assets and liabilities

Step 2:
- Merge T into LLC

- LLC disregarded as a separate entity
- merger treated as 332 liquidation of T into P
- P inherits T's losses (under 381); SRLY taint gone
- T's assets and liabilities still separate and apart from P

SRLY Loss $10M
Use of Single Member LLC to Avoid Section 311 Gain on Property Distribution

- Parent Corp, Sub, and Sub-1 are members of an affiliated group. Sub desires to transfer its stock of Sub-1 to Parent Corp and not incur a taxable gain under §311 (albeit deferred intercompany gain under Treas. Reg. §1.1502-13(b)(1)).
- Sub merger into single member LLC (disregarded entity) is treated as §332 liquidation of Sub.
- the LLC then distributes the Sub-1 stock to Parent Corp with no §311 gain.
Sale of a Single Member LLC

- 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.
- 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)
- LLC is owned by a single buyer, P, and therefore it will remain a disregarded entity in P’s hands.
- 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.
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. §1.197-29(k), example 18.
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)
Disregarded Entities - Mergers and Acquisitions

Isolate a risky target corporation.

S/H

Acquiring stock

merger

Target

Acquiring

S/H

Acquiring stock

Restructure

Target

Acquiring

merger

Acquiring stock

membership interests

LLC

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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.

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McGuireWoods 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

- 2003 Proposed and Temporary Regulations under Temp. Reg. § 1.368-2T(b)
- Terms under temporary regulations:
- 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). Temp. Reg. § 1.368-2T(b)(1)(i)(A).
- Combining entity - A business entity that is a corporation that is not a disregarded entity. Temp. Reg. § 1.368-2T(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. Temp. Reg. § 1.368-2T(b)(1)(i)(c).
Disregarded Entities - Mergers and Acquisitions

- Operative rule under temporary regulations (Temp. Reg. § 1.368-2T(b)(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 or 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


- 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


- 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 transferee 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.
Use of SMLLC to Avoid Gain on Unwanted Assets

Current Structure

Step 1

- S merges into SMLLC, SMLLC survives

Step 2 & 3

- P corporation has a wholly-owned subsidiary-S; S owns two businesses - Bus. A and Bus. B.
- P desires to sell Bus. B, but keep Bus. A. P desires to avoid the Section 311 gain that would result if S distributed Bus. A to P.
- Implement Steps 1 - 3.
Use of SMLLC for Bankruptcy Remote Financing

- Lender desires to have financed property held in a separate, special purpose entity to protect assets from a bankruptcy of the owner of the assets ("bankruptcy remote entity"). Traditional vehicles have been corporate subsidiaries (for corporations) and grantor trust arrangements. For non corporate taxpayers, the use of a corporation or grantor trust arrangement was cumbersome at best and tax disadvantageous at worst.
- Non corporate taxpayer can use SMLLC as the separate, special purpose entity to satisfy lender while avoiding cumbersome and tax adverse results of a trust or corporate arrangement.

PLR 199911033 (12/18/99)
Use of SMLLC to Avoid Real Estate Recordation Tax

- Will incur real estate recordation tax

\[ \text{Seller} \rightarrow \text{Black Acre} \rightarrow \text{Buyer} \]

- Will not incur real estate recordation tax?

\[ 100\% \text{ SMLLC Interests} \]

\[ \text{Seller} \rightarrow \$ \rightarrow \text{Buyer} \]

- Instead of Seller transferring real estate to Buyer and causing Seller and Buyer to pay Virginia recordation tax, Seller forms SMLLC, transfers real estate to SMLLC in exchange for 100% membership interests in SMLLC, and Seller then sells to Buyer 100% membership interests in SMLLC.
Use of SMLLC in Like-Kind Exchange

IRC section 1031(a) provides that no gain or loss in recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind, which is to be held either for the productive use in a trade or business or for investment. IRC section 1031(a)(2)(D) provides that an exchange of an interest in a “partnership” is not eligible for nonrecognition treatment under section 1031.

Because a SMLLC is not a “partnership”, the use of a SMLLC may be permitted to effect a 1031 exchange.

Because SMLLC is disregarded as an entity separate from LLC-1, LLC-1 is deemed to own the assets of SMLLC directly (i.e., LLC-1 is deemed to own the real estate directly). Therefore, the exchange of 100% of the membership interests in SMLLC for Buyer's real estate should qualify for section 1031 nonrecognition treatment (PLR 200118023).
State Sales and Use Tax Issues

- For Virginia sales and use tax purposes the SMLLC (or QSSS) remains a separate legal entity (i.e., the SMLLC (or QSSS) is not a disregarded entity.
- Virginia sales and use tax law, unlike Virginia income tax law, is NOT tied to federal income tax law by the concept of conformity and has a specific definition of "dealer" for the purposes of retail sales and use tax.
- As a separate legal entity the SMLLC (or QSSS) is governed by the applicable sales and use tax laws.
- X Corp must collect sales tax from SMLLC on the periodic rent payments. Alternatively, X Corp. can take from SMLLC a certificate of exemption indicating that the equipment will be used in an exempt activity. Virginia P.D. 98-157. (October 20, 1998).