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Use of Limited Liability Companies in Corporate Transactions

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USE OF LIMITED LIABILITY COMPANIES IN CORPORATE TRANSACTIONS

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I. INTRODUCTION

The new check-the-box regulations provide a host of planning opportunities for taxpayers, particularly with respect to the use of disregarded entities, such as single-member limited liability companies ("LLCs"). However, the fact that an entity may be disregarded for Federal income tax purposes generally does not affect the rights and obligations of the owners under state law. Treas. Reg. § 301-7701-1(a). Thus, if a state does not sanction the use of single-member LLCs or follow the check-the-box regulations, an entity that is disregarded for Federal tax purposes, may be classified differently for state tax purposes.

The consequences of classification as a disregarded entity are not fully addressed either in the regulations or the proposed amendments thereto. The regulations simply provide that "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner," and that the entity classification rules apply for all Federal income tax purposes. See Treas. Reg. §§ 301-7701-1; -2(a). As a result, there is currently no guidance regarding how a disregarded entity is treated when it is involved in corporate transactions. This outline will focus primarily on the Federal tax consequences of converting, disposing, reorganizing, and otherwise using single-member LLCs in corporate transactions. The outline will also address the use of multi-member LLCs and the state tax issues relating to the use of LLCs in corporate transactions.

A. Check-the-Box Regulations

On December 17, 1996, the Internal Revenue Service (the "Service") issued final regulations under section 7701, which greatly simplified the classification of business entities for Federal tax purposes. These so-called check-the-box regulations became effective on January 1, 1997.

The check-the-box regulations provide, in general, that an "eligible entity" (i.e., an entity that is neither a trust nor a "corporation" as defined in Treas. Reg. § 301.7701-2(b)) with two or more members can elect to be classified as either an association taxed as a corporation or as a partnership. Treas. Reg. § 301.7701-3(a). An eligible entity with only one owner can elect to be classified as a

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1 In the preparation of this outline several secondary sources were consulted, including the following: Samuel P. Starr, et al., Limited Liability Companies, 725 Tax Mgmt. (BNA) (1998); Lawrence M. Axelrod, Consolidated Return Planning Opportunities Using LLCs, reprinted in Practising Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings (1997); Christopher Barton, Much Ado About A Nothing: The Taxation of Disregarded Entities, 97 Tax Notes Today 125-98 (1997); David S. Miller, The Tax Nothing, 97 Tax Notes Today 22-69 (1997); Robert R. Casey, Planning for Entity Choice After the "Check-the-Box" Regulations, SB26 ALI-ABA 1069 (1996); Michael L. Schler, Initial Thoughts on the Proposed ‘Check-The-Box’ Regulations, 96 Tax Notes Today 118-79 (1996).
corporation or to be disregarded as an entity separate from its owner (a "disregarded entity"). Id. Certain default rules are provided in the regulations. Under these default rules, a multi-member entity will be classified as a partnership, unless it makes an affirmative election to be classified as a corporation; and a single-member entity will be disregarded, unless it makes an affirmative election to be treated as a corporation. Id. § 301.7701-3(b)(1).

Under the check-the-box regulations, a corporation as defined in Treas. Reg. § 301.7701-2(b) is always classified as a corporation for Federal tax purposes. A "corporation" includes a business entity organized under a state statute that describes the entity as incorporated, a corporation, body corporate, body politic, joint-stock company, or joint-stock association. Id. § 301.7701-2(b)(1), (3).

B. Proposed Amendments to the Check-the-Box Regulations – Effect of Change of Classification

1. In General
   
a. There are essentially three ways in which to accomplish a classification change: (i) An elective classification change, wherein the entity simply checks the box to change its classification; (ii) an automatic classification change, wherein an entity’s default classification changes as a result of a change in the number of owners; and (iii) an actual conversion, wherein an entity merges into or liquidates and forms a new entity that has the desired classification.

b. On October 28, 1997, the IRS issued proposed amendments to the check-the-box regulations. These proposed amendments address the tax consequences of an elective change in the classification of an eligible entity. In general, these consequences are intended to mirror the tax consequences of an actual conversion. See Preamble to Prop. Treas. Reg. § 301.7701.

c. In addition, the proposed regulations address the consequences of certain "automatic classification changes." An automatic classification change occurs when there is a change in the number of owners of an entity that precludes its current classification. For example, an entity can no longer be treated as disregarded if the number of owners increases above one. Similarly, a partnership can no longer be classified as such if the number of partners decreases to one.

d. These amendments are effective upon publication of the final regulations in the Federal Register.
Timing - A change of classification election is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur as the result of the change in classification are treated as occurring as of the close of the day before the election becomes effective. Prop. Treas. Reg. § 301.7701-3(g)(3). Because the tax impact of the deemed transactions may have different tax consequences depending upon the circumstances, care must be taken in choosing the effective date of the change in classification.

Tax Consequences - The proposed regulations treat an elective change in classification as triggering a series of deemed transactions, which differ depending upon the reclassification that takes place. The tax treatment of a change in classification is determined under all relevant provisions of the Code and general principles of tax law, including the step-transaction doctrine. Prop. Treas. Reg. § 301.7701-3(g)(2). "This provision in the proposed regulations is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations." See Preamble to Prop. Treas. Reg. § 301.7701.

Waiting Period - Under the check-the-box regulations an eligible entity that has exercised its right to elect its tax classification may not elect a different tax classification for a period of 60 months (the "60-month waiting period"). An election by a newly formed eligible entity that is effective on the date of formation is not considered an elective change; thus, the sixty-month waiting period is not triggered. See Prop. Treas. Reg. § 301.7701-3(c)(1)(iv).

In addition, an automatic classification change is not treated as an elective change, so the 60-month waiting period is unaffected by an automatic classification change. Prop. Treas. Reg. § 301.7701-3(f)(3). Thus, if an entity is formed on April 1, 1998, and an automatic classification change occurs on April 30, 1998, the entity may elect a different classification at any time, because the entity has not made a prior election for purposes of the 60-month waiting period.

For example, assume the deemed transactions triggered by the change in classification resolve a related group of corporations to recognize gain. If the group has an expiring NOL, the benefit of the group to have the election, which triggers the recognition of effective no later than the first day of the taxable year after the NOL expires. Thus, deemed transactions are treated as occurring immediately before the close of the day election is effective, the gain triggered by the deemed transactions could be offset by NOL.
5. Treatment of Elective Classification Changes Under the Proposed Regulations

a. An Association Elects to be Classified as a Partnership

(i) Deemed Transactions - If an eligible entity classified as an association elects to be classified as a partnership, the following transactions will be deemed to occur.

(a) First, the association is deemed to distribute all of its assets to its shareholders in liquidation.

(b) Second, the shareholders are deemed to contribute the assets to a newly formed partnership.

(ii) Tax Consequences:

(a) The distributing corporation is required to recognize gain on the distribution of its assets to its shareholders. The corporation’s gain is equal to the difference between the fair market value of the distributed assets and the corporation’s adjusted basis in those assets. Section 336(a). The shareholders are required to recognize gain on the distribution equal to the difference between the fair market value of the assets (less the amount of liabilities assumed) and the basis in their stock. Section 331. Under section 334(a), the shareholders take a fair market value basis in the assets distributed.

(b) Under section 331, the shareholders are treated as purchasing the assets received in the liquidating distribution; thus, the shareholders’ holding periods for the assets deemed distributed in the liquidation begin on the date of distribution.

(c) If the corporation is treated as liquidating into an “80-percent distributee” within the meaning of section 332(c), neither the liquidating corporation nor its parent corporation will recognize gain as a result of the liquidating distribution. Sections 332 and 337. If section 332 applies to the liquidation,

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3 For purposes of this discussion, unless otherwise specified, assume all corporations involved are solvent for all purposes.
the parent corporation will take a carryover basis and a tacked holding period in the assets acquired in the liquidating distribution. Section 334(b)(1). Under section 331, minority shareholders of the liquidating corporation are required to recognize gain on the distribution.

(d) Neither the shareholders nor the newly formed partnership recognizes gain on the transfer of the assets to the partnership in exchange for interests in the partnership. Section 721. Under section 722, the transferring partners take a substituted basis in their partnership interests equal to their basis in the assets, less the amount of liabilities assumed by the partnership, increased by the partners' shares of overall partnership liabilities. The partnership takes a carryover basis in the contributed assets, increased by the amount of gain recognized by the contributing partner under section 721(b). Section 723.

(e) Under section 1231, the partners’ holding periods for their partnership interests include their holding period for the property contributed. Under section 1223(2), the partnership’s holding period for the contributed assets includes the partners’ holding periods for those assets.

b. **A Partnership Elects to be Taxed as an Association**

(i) **Deemed Transactions** - If an eligible entity classified as a partnership elects to be classified as an association, the following transactions are deemed to occur.

(a) First, the partnership is deemed to contribute its assets to a newly formed corporation in exchange for all of the outstanding stock of a newly formed corporation ("Newco").

(b) Second, the partnership is deemed to distribute the stock of the newly formed corporation to its partners in complete liquidation.

(c) The preamble to Prop. Treas. Reg. §301.7701 states that although, the deemed transactions are deemed to occur pursuant to an election to change the classification of an entity under the check-the-box
rules, taxpayers may still employ other transactions to convert a partnership to a corporation, and the form of the transaction chosen will be respected. Specifically, the preamble provides that the proposed regulations do not affect the holdings in Rev. Rul. 84-111, 1984-2 C.B. 88, which dealt with three differing methods of converting a partnership to a corporation. In Rev. Rul. 84-111, the Service stated that the form chosen to convert a partnership to a corporation would be respected for tax purposes.

(ii) **Tax Consequences:**

(a) The partnership generally will not recognize gain or loss on the contribution of its assets to Newco in exchange for Newco stock. Section 351. Under section 362(a), Newco's basis in the assets received from the partnership equals the partnership's basis in those assets immediately before their contribution.

(b) The partnership takes a substituted basis in the Newco stock equal the partnership's basis in the contributed assets, reduced by the liabilities assumed by Newco. Section 358. Newco's assumption of partnership liabilities is treated as a payment of money to the partnership under section 358(d). If the amount of liabilities exceed the partnership's basis for the assets contributed, the partnership must recognize gain equal to the amount by which the liabilities exceed the partnership's basis in its assets. See section 357(c). An assumption of partnership liabilities by Newco will decrease each partner's basis in the partnership interest in accordance with the partnership agreement. Section 752.

(c) On the distribution of the Newco stock to the partners, the partnership terminates under section 708(b)(1)(A). Under section 732(b), the basis of the Newco stock distributed to the partners in liquidation of their partnership interest is, with respect to each partner, equal to the adjusted basis of the partner's basis in the partnership interest.
c. An Association Elects to be a Disregarded Entity

(i) Deemed Transactions - Generally, an eligible entity classified as an association, which has a single owner, may elect to be classified a disregarded entity. If such an election is made, the association is deemed to distribute all of its assets to its shareholder in a liquidating distribution. Thereafter, the owner is deemed to own the distributed assets directly.

(ii) Tax Consequences:

(a) The association is required to recognize gain on the distribution of any appreciated assets. Section 336(a). The shareholder receiving the liquidating distribution must recognize gain equal to the difference between the shareholder’s basis in its stock and the sum of any money and the fair market value of any property received in the distribution. Section 331.

(b) If section 331 is applicable, the shareholder is treated as purchasing the assets of the liquidating corporation, and thus, under section 334(a), the shareholder will take a fair market basis in the assets. Because the shareholder is deemed to purchase the assets, the shareholder’s holding period for the assets begins on the date of distribution.

(c) If the shareholder is an 80-percent distributee, neither the liquidating corporation nor its corporate shareholder will recognize gain as a result of the liquidating distribution. Sections 332 and 337. If section 332 applies to the liquidation, the shareholder takes a carryover basis and a tacked holding period in the assets acquired in the liquidating distribution. Section 334(b)(1). Under section 381, the parent corporation will succeed to the liquidating subsidiary’s enumerated tax attributes.

d. A Disregarded Entity Elects to be Classified as an Association

(i) Deemed Transactions - If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity
is deemed to contribute all of the assets and liabilities of the entity to a newly formed association ("Newco") in exchange for the stock of the association.

(ii) **Tax Consequences:**

(a) Generally, under section 351, neither the owner of the disregarded entity nor the transferee association will recognize gain or loss on the deemed contribution. However, under section 357(c), if the liabilities assumed by the transferee corporation exceed the transferor’s basis in the assets, then the transferor must recognize gain equal to the excess of the liabilities over the transferor’s basis.

(b) Under section 362(a), the new association’s basis in the assets received equals the transferor’s basis in those assets immediately before their contribution. Under section 358, the transferor takes a substituted basis in the association stock it is deemed to receive, reduced by any liabilities assumed by the association.

(c) Under section 1223(1), the transferor’s holding period for the association stock includes its holding period for the assets transferred. Under section 1223(2), the association’s holding period for the contributed assets includes the transferor’s holding period for those assets.

6. **Treatment of Automatic Classification Changes Under the Proposed Regulations**

a. **Partnership to a Disregarded Entity** - An eligible entity classified as a partnership will automatically become a disregarded entity as of the date the entity has a single owner (assuming it is still treated as an entity under local law). This automatic classification change will not be treated as a change in classification election and does not trigger a new 60-month waiting period.

b. **Disregarded Entity to a Partnership** - An eligible entity that is disregarded as an entity separate from its owner will automatically be classified as a partnership as of the date the entity has more than one owner. This automatic classification change will not be treated as a change in classification election and does not trigger a new 60-month waiting period.
II. WHAT IS A DISREGARDED ENTITY?

A. In General - The activities of a disregarded entity are treated as if they were actually performed by its owner. If the owner is a corporation, the activities of the disregarded entity are treated as if they were conducted by a division or a branch of the corporation. Treas. Reg. § 301.7701-2(a).

1. Transactions between disregarded entities and their owners, and transactions between commonly owned disregarded entities should be treated as interdivisional transactions and, thus, ignored for tax purposes.

2. Transactions between disregarded entities and third parties, however, should generally be treated as having occurred between the owner of the disregarded entity and the third party.

3. Until guidance is issued regarding the use of disregarded entities in corporate transactions, it may be helpful to look to the treatment of similar situations in which corporations have been disregarded.

a. Qualified REIT Subsidiaries – Under section 856(i)(1), a wholly owned subsidiary of a real estate investment trust (i.e., a qualified REIT subsidiary) is disregarded as an entity separate from its owner, and all of its assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and items of its owner.

b. Qualified S Corporation Subsidiaries (“QSSS”) – Similarly, under section 1361(b)(3)(A), a wholly owned subsidiary of an S corporation is not treated as a separate corporation, and all of its assets, liabilities, and items of income, deduction, and credit are treated as those of its owner.

c. Finally, the existence of corporate entities may be ignored through the application of the step-transaction doctrine, such as the case where a transitory subsidiary is ignored.
B. Examples

1. Transactions Between Disregarded Entities and Their Owners
   a. Example 1 – Contribution to Disregarded Entity

(i) **Facts:** Corporation P contributes property to a newly formed, wholly owned LLC. LLC does not elect to be taxed as an association.

(ii) **Tax Consequences:** Because LLC is disregarded as an entity separate from P, LLC is treated as a division of P. As a result, P’s contribution will be treated as an interdivisional transaction, which is ignored for Federal tax purposes. Thus, the contribution is tax free, because no sale or exchange of property has occurred for purposes of section 1001.
b. Example 2 – Distribution From Disregarded Entity

(i) **Facts:** P owns all of the membership interests in LLC, which does not elect to be taxed as an association. LLC makes a distribution of appreciated property to P.

(ii) **Tax Consequences:** Because LLC is treated as a division of P, the distribution will be treated as an interdivisional transaction, which is ignored for Federal tax purposes. Thus, similar to the contribution in the example above, the distribution will not result in the recognition of gain or loss to either LLC or P.
2. **Corporate Structures Involving Disregarded Entities**
   
a. **Example 3 – Multiple Disregarded Entities**

(i) **Facts:** Corporation P is the sole member of LLC-1 and LLC-2, both of which do not elect to be taxed as associations. LLC-1 and LLC-2 form LLC-3, with each taking a 50-percent membership interest.

(ii) **Tax Consequences:** LLC-1 and LLC-2 are disregarded as entities separate from P. Thus, P is treated as owning the assets of LLC-1 and LLC-2, including the interests in LLC-3, directly. As a result, LLC-3 should not be treated as a partnership, because it has only one member (P). Instead, the assets of LLC-3 should likewise be treated as owned directly by P.

(iii) Assume instead that P is an S corporation, and LLC-1 and LLC-2 are corporations that are treated as QSSSs, each of which owns a 50-percent interest in an LLC. In P.L.R. 9732030 (May 14, 1997), the Service ruled that, on these facts, the LLC was treated as owned directly by P and, thus, disregarded as an entity separate from P. Thus, the Federal tax results are the same whether LLC-1 and LLC-2 are organized as LLCs or QSSSs. Cf. Prop. Treas. Reg. § 1.1361-2(c), Ex. 2.
b. Example 4 – Preservation of S Corporation Status

(i) **Facts:** Individual A and Trust are qualified shareholders of S Corp. Trust forms LLC, and transfers its S Corp. stock to LLC in exchange for LLC interests. LLC does not elect to be taxed as an association.

(ii) **Tax Consequences:** These are the facts of P.L.R. 9745017 (Aug. 8, 1997), in which the Service ruled that because LLC is disregarded for Federal tax purposes, the transfer of S Corp. shares to LLC does not terminate S Corp.'s election.

III. RECHARACTERIZATION OF DEBT AS EQUITY

A. **Automatic Classification Change** - If a single-member LLC, which is treated as a disregarded entity, has outstanding third-party debt that is recharacterized by the Service as equity, the LLC is automatically reclassified as a partnership, because it no longer has a single member. Prop. Treas. Reg. § 301.7701-3(f)(2).
B. Example 5 – Convertible Debt

1. **Facts:** P owns 100 percent of LLC, which is a disregarded entity. LLC issues indebtedness to A Corporation, which is secured by LLC’s assets. The debt is convertible at A’s option into a membership interest in LLC.

2. **Tax Consequences:** Because LLC is disregarded as an entity separate from P, the debt should be considered as nonrecourse debt issued by P. Prior to the conversion of the debt (and assuming the debt is not considered equity), LLC should not be considered to have more than one member.
   
a. How should the conversion feature be treated? The debt is considered to be issued by P, but it is not convertible into stock of P. Rather, it is convertible into an interest in an entity that does not yet have a separate existence. Should the conversion feature be considered an option to acquire P assets? Does it matter whether P has guaranteed the debt?

b. If A exercises its conversion option and receives membership interests in LLC, LLC will no longer have a single member and, thus, will automatically be reclassified as a partnership. Prop. Treas. Reg. § 301.7701-3(f)(2). Presumably A will be treated as having purchased assets from P and contributed them to a newly formed partnership. **See** Example 16 below.
IV. CONVERTING AN EXISTING ENTITY INTO AN LLC

There are a number of different ways to convert an existing entity into an LLC. Despite the similarity in end result, the manner in which an entity is converted may result in different Federal and state tax consequences. In addition to the tax consequences, the method of conversion may impact other considerations that are important to the owners of the entity. For example, one method of converting a corporation to an LLC will expose the shareholders to the liabilities of the corporation, while another method will not. Thus, careful consideration should be exercised in choosing the method of converting an entity to an LLC. In addition to converting the legal form of an entity into an LLC, it is possible to elect a different tax classification for an entity under the check-the-box regulations.

A. Converting Existing Corporations Into LLCs

1. Example 6 - Liquidation of Corporation Followed by Contribution of Assets to LLC Classified as Either a Partnership or a Disregarded Entity

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\[4\] State tax issues are discussed below in section XI of this outline.

\[5\] Unless otherwise specified, assume that the corporations involved are solvent for all purposes.
a. **Facts:** Individuals A and B each own 50 percent of the stock of Corporation P. P has assets with a fair market value of $100 and an adjusted basis of $50. P distributes all of its assets and liabilities to A and B in complete liquidation. A and B, immediately, contribute the assets to a newly formed LLC.

b. **Tax Consequences:**

(i) P is required to recognize gain equal to $50 on the distribution of its assets to its shareholders. Section 336(a). Under section 331, A and B recognize gain on the distribution equal to the difference between the fair market value of the assets (less the amount of liabilities assumed) and the basis in their stock. Under section 334(a), A and B take a fair market value basis in the assets distributed. Under section 331, A and B are treated as purchasing the assets received in the liquidating distribution; thus, their holding periods for the assets distributed begins on the date of distribution.

(ii) Neither A, nor B, nor LLC recognizes gain on the transfer of the assets to LLC in exchange for membership interests in LLC. Section 721. Under section 722, each transferring member takes a substituted basis in his or her membership interest equal to his or her basis in the transferred assets, reduced by the amount of liabilities assumed by LLC, increased by the member’s share of LLC’s liabilities. LLC takes a carryover basis in the contributed assets, increased by the amount of gain recognized by the contributing partner under section 721(b). Section 723. Note that LLC’s basis in the contributed assets has been stepped-up to fair market value, because A and B are deemed to purchase the assets from P pursuant to P’s liquidation.

(iii) Under section 1231, the members’ holding periods for their membership interests include their holding periods for the property contributed. Under section 1223(2), the LLC’s holding period for the contributed assets includes the members’ holding period for those assets. Thus, because A and B’s holding periods begin at the time of the liquidating distribution, LLC’s holding period begins at the same moment.

c. **Nontax Considerations** - In addition to the Federal tax consequences, there are several additional issues, which must be considered. First, this approach requires two separate transfers of the assets. If state transfer taxes are imposed on the asset transfers,
this method of conversion results in the imposition of the transfer tax twice, initially on the distribution to the shareholders and again on the transfer of assets to the LLC. In addition, this approach exposes the shareholders to the liabilities of the corporation. The successive imposition of state transfer taxes and the shareholder exposure to the corporation's liabilities may be eliminated through the use of a "cause to be directed" transaction or through the use of one of the methods set forth below. See Rev. Rul. 70-140, 1970-1 CB 73.

2. Example 7 - Corporate Contribution of Assets to an LLC Classified as Either a Partnership or a Disregarded Entity Followed by Corporate Liquidation

**STEP 1:**

- A 50% Assets LLC Interests
- B 50%

**STEP 2:**

- A
- B
- LLC Interests

---

a. **Facts:** Individuals A and B each own 50 percent of the outstanding stock of P. P contributes all of its assets and liabilities to a newly formed LLC in exchange for membership interests in LLC. Following the contribution, P distributes the LLC membership interests to A and B in complete liquidation.

b. **Tax Consequences:** Because LLC is a disregarded entity, P is treated as owning LLC's assets directly. Thus, when P distributes its membership interest in LLC to A and B, P should be viewed as distributing its interest in LLC's assets to A and B. A and B are then deemed to contribute these assets to a newly formed
partnership. Accordingly, the results are the same as in Example 6, above.

(i) P is required to recognize gain on the distribution of its interest in LLC's assets to A and B in complete liquidation. Section 336(a). The character of P's gain depends on the character of LLC's assets. Under section 331, A and B recognize gain on the distribution equal to the difference between the fair market value of the assets (less the amount of liabilities assumed) and the basis in their stock. Under section 334(a), A and B take a fair market value basis in the assets distributed. Under section 331, A and B are treated as purchasing the assets received in the liquidating distribution; thus, their holding periods for the assets distributed begins on the date of distribution.

(ii) Neither A, nor B, nor LLC recognizes gain on the transfer of the assets to LLC in exchange for membership interests in LLC. Section 721. Under section 722, each transferring member takes a substituted basis in his or her membership interest equal to his or her basis in the transferred assets, reduced by the amount of liabilities assumed by LLC, increased by the member’s share of LLC’s liabilities. LLC takes a carryover basis in the contributed assets, increased by the amount of gain recognized by the contributing partner under section 721(b). Section 723. Note that LLC’s basis in the contributed assets has been stepped-up to fair market value, because A and B are deemed to purchase the assets from P pursuant to P’s liquidation.

(iii) Under section 1231, the members’ holding periods for their membership interests include their holding periods for the property contributed. Under section 1223(2), the LLC’s holding period for the contributed assets includes the members’ holding period for those assets. Thus, because A and B’s holding periods begin at the time of the liquidating distribution, LLC’s holding period begins at the same moment.

c. **Nontax Considerations** - Unlike the method of conversion set forth in Example 6 above, this approach results in a single imposition of any applicable transfer taxes. In addition, this method should shield the shareholders of the corporation from the corporation’s liabilities.
3. **Example 8 - Merger of Corporation Into Single-Member LLC**

![Diagram of Merger]

**Facts:** Individual A owns all of the stock of P Corporation and all of the membership interests in LLC. LLC does not elect to be taxed as an association. P is merged into LLC pursuant to Delaware General Corporation Law § 264 (which permits the merger or consolidation of a Delaware corporation with an LLC). Pursuant to the merger, all of P's assets and liabilities are transferred to LLC, and P's separate corporate existence ceases.

**Tax Consequences:**

(i) As set forth above, the default rule provides that a single-member LLC will be disregarded as an entity separate from its owner. As such, the merger of a corporation, with a single owner, into a single-member LLC, owned by the same person, should be viewed as a liquidation of the corporation. See P.L.R. 9822037 (Feb. 27, 1998).

(ii) Because the shareholder of P is not a corporation or an entity classified as an association, the liquidation is a taxable event to both the liquidating corporation and its shareholder. Sections 336(a) and 331.

(iii) Under section 331, A is treated as purchasing the assets received in the liquidating distribution. Thus, A's holding period for the distributed LLC membership interests begins on the date of distribution. Under section 1012, A has a
basis in the distributed LLC membership interests equal to the fair market value of such interests.

4. Example 9 – Merger of Wholly Owned Subsidiary Into Single Member LLC

a. **Facts:** Corporation X owns all of the stock of P Corporation and all of the membership interests of LLC. LLC does not elect to be taxed as an association. P is merged into LLC in a statutory merger.

b. **Tax Consequences:**

(i) As set forth above, the default rule provides that a single-member LLC will be disregarded as an entity separate from its owner. As such, the merger of a corporation into a single member LLC owned by the same person should be viewed as a liquidation of the corporation. See P.L.R. 9822037 (Feb. 27, 1998).

(ii) Under section 332, X does not recognize any gain or loss when P liquidates. Under section 337(a), P will not recognize gain or loss as a result of the liquidating distribution to X. Under section 334(b)(1), X takes a transferred basis and a tacked holding period in the assets received in the section 332 liquidation.
5. Example 10 - Formation of LLC by the Corporation and its Shareholders Followed by Liquidation of Corporation

**STEP 1:**

![Diagram of steps 1 and 2]

**STEP 2:**

a. **Facts:** P and its shareholders, A and B, form a new LLC. P contributes all of its assets to LLC, and LLC assumes all of P’s liabilities. A and B each contribute one dollar to LLC in exchange for an interest in LLC. Immediately thereafter, P distributes all of its LLC interests to A and B in complete liquidation.

b. **Tax Consequences:** - In this example (and Example 11, below), the tax consequences to the corporation and its shareholders are similar to those in Examples 6 through 9, above. However, as discussed below, the basis and holding period results for LLC may differ as a result of LLC’s recognition as a separate entity prior to P’s liquidation.

(i) Neither the transferors nor the newly formed LLC recognize gain on the contribution of assets to LLC in exchange for membership interests. Section 721. Under section 722, each transferor takes a substituted basis in the membership interests equal to the transferor’s basis in the contributed assets, less the amount of liabilities assumed by LLC, increased by the transferor’s share of LLC’s liabilities. LLC takes a carryover basis in the contributed assets, increased by the amount of gain recognized by the contributing partner under section 721(b). Section 723.
Under section 1223(2), LLC’s holding period for the contributed assets includes the transferors’ holding period for those assets.

(ii) Under section 336(a), P must recognize gain on the distribution of the membership interests in LLC in liquidation. P’s gain is equal to the difference between its basis and the fair market value of the LLC interests at the time of the distribution. Generally, the character of P’s gain is capital as opposed to ordinary. However, to the extent the partnership interest represents section 751 assets, the sale of the partnership interest will be considered as an amount realized from the sale or exchange of property other than a capital asset. See section 751(a). Under section 331, A and B must recognize gain on the distribution of the membership interests in LLC. The gain is equal to the difference between the basis in their P stock and the fair market value of the LLC membership interests received from P.

(iii) Under section 331, A and B are treated as purchasing the assets received in the liquidating distribution, thus, their holding period for the distributed LLC membership interests begins on the date of distribution. Under section 334(a), A and B take a fair market value basis in the LLC membership interests distributed.

(iv) P is treated as selling its interest in LLC to A and B in exchange for A and B’s P stock. Assuming P held membership interests representing more than 50 percent of the profits and capital interest in LLC, the distribution in liquidation will trigger a termination of LLC under section 708(b)(1)(B). See section 761(e). Under Treas. Reg. § 1.708-1(b)(1)(iv), a partnership that is deemed to terminate under section 708(b)(1)(B) is deemed to transfer all its assets to a new partnership in exchange for interests in the new partnership. Immediately after the deemed contribution, the partnership is deemed to distribute the interests in the new partnership to its partners in liquidation.

(v) Under section 721, neither the old partnership nor the new partnership will recognize gain on the deemed transfer of assets. Under section 723, the new partnership takes a basis in the contributed property equal to the terminating partnership’s basis in the assets immediately before their contribution. If the partnership has a section 754 election
in effect for the terminating year, the basis increase resulting from the operation of section 743(b) will be reflected in the new partnership's basis for the contributed assets. Under Treas. Reg. § 1.704-3(a)(3)(i), the contributed property will be treated as section 704(c) property only to the extent it was characterized as section 704(c) property in the hands of the terminating partnership.

(vi) Under section 732(b), the basis of the new partnership interests distributed to the partners of the terminating partnership is, with respect to each partner, equal to the adjusted basis of the partner’s interest in the partnership, which in this case is equal to fair market value.

c. **Nontax Considerations** - Unlike the method of conversion set forth in Example 6 above, this approach results in a single imposition of any applicable transfer taxes. In addition, this approach shields the shareholders of the corporation from the corporation's liabilities.

6. **Example 11 - Merger of Corporation Into Multi-Member LLC**

![Diagram of Merger of Corporation Into Multi-Member LLC]

a. **Facts:** P owns all of the stock of S-1 and S-2. P and S-2 form an LLC, with each initially taking a 50-percent membership interest. S-1 is merged into LLC in a state statutory merger. Pursuant to the merger, all of S-1’s assets and liabilities are transferred to LLC, and S-1’s separate corporate existence ceases. Following the merger, P owns 90 percent of the membership interests in LLC, and S-2 owns the remaining 10 percent.
b. **Tax Consequences:**

(i) In P.L.R. 9404021 (Nov. 1, 1993), the Service treated the statutory merger of a wholly owned subsidiary into a two-member LLC as a contribution of assets by the subsidiary in exchange for membership interests in the LLC, followed by the liquidation of the subsidiary. Pursuant to the deemed liquidation, the parent corporation was deemed to receive membership interests in the LLC.

(ii) Neither S-I nor the newly formed LLC recognizes gain on the deemed transfer of assets to LLC in exchange for membership interests. Section 721. Under section 722, S-I takes a substituted basis in the membership interests it is deemed to receive equal to its basis in the transferred assets (less the amount of liabilities assumed by LLC), increased by S-I’s share of LLC’s liabilities. LLC takes a carryover basis in the contributed assets, increased by the amount of gain recognized by the contributing partner under section 721(b). Section 723. Under section 1223(2), LLC’s holding period for the contributed assets includes S-I’s holding period for those assets.

(iii) Under section 332, P does not recognize any gain or loss as a result of the liquidating distribution. Under section 337, S-I does not recognize any gain or loss as a result of the liquidating distribution. Under section 334(b)(1), P takes a carryover basis and a tacked holding period in the LLC interests received in the section 332 liquidation.

(iv) When S-I liquidates, it transfers all of its membership interest in LLC to P. Because S-I held 50 percent or more of the profits and capital interests in LLC at the time of the liquidation, the distribution will result in the termination of LLC under section 708(b)(1)(B). See section 761(e).

(a) Under Treas. Reg. § 1.708-1(b)(1)(iv), a partnership that is deemed to terminate under section 708(b)(1)(B) is deemed to transfer all of its assets to a new partnership in exchange for interests in the new partnership. Immediately after the deemed contribution, the partnership is deemed to distribute the interests in the new partnership to its partners in liquidation.

(b) Under section 721, neither the old partnership nor the new partnership will recognize gain on the
deemed transfer of assets. Under section 723, the new partnership takes a basis in the contributed property equal to the terminating partnership’s basis in the assets immediately before their contribution. If the partnership has a section 754 election in effect for the terminating year, any basis increase resulting from the operation of section 743(b) will be reflected in the new partnership’s basis for the contributed assets. However, in this situation, because P takes a carryover basis in the LLC membership interest it receives when S-I liquidates, section 743(b) will not produce any increase in LLC’s basis in its assets. Under Treas. Reg. § 1.704-3(a)(3)(i), the contributed property will be treated as section 704(c) property only to the extent it was characterized as section 704(c) property in the hands of the terminating partnership.

(c) Under section 732(b), the basis of the new partnership interests distributed to P and S-2 equal their adjusted bases in the terminating partnership.

Summary Of Tax Consequence Differences – As set forth above, the method utilized for converting an existing corporation into an LLC may produce different tax consequences to LLC. In Examples 6 through 9, the corporation is deemed to liquidate prior to the recognition of LLC as an entity separate from its owner. Thus, the corporation’s shareholders are treated as receiving the corporation’s assets in exchange for their stock. Under section 334(a), the shareholders take a fair market value in the distributed assets. Under section 723, LLC takes a carryover basis in the assets equal to contributing partner’s basis in the assets. Thus, LLC takes a fair market value in the contributed assets.

Under section 331, the shareholders are deemed to purchase the assets received in a liquidating distribution. Thus, the shareholders’ holding periods for the distributed assets begins on the date of the distribution. Under section 1223(2), LLC’s holding period includes the contributing partner’s holding period. Therefore, LLC’s holding period for the contributed assets begins on the date the corporation makes its liquidating distribution.

In Examples 10 and 11, LLC is recognized as an entity separate from its owners prior to the liquidation of the corporation. Pursuant to these methods, the corporation is deemed to contribute its assets to LLC in exchange for membership interests in LLC. When the corporation liquidates, it is deemed to distribute the membership interests in LLC to its shareholders. If LLC does not have a section 754 election in effect for the
year in which the transaction takes place, the partnership will not be able
to increase its basis in its assets under section 743(b).
Under section 1223(2), LLC’s holding period includes the contributing
partner’s holding period. Thus, in Examples 10 and 11, LLC’s holding
period will include the corporation’s holding period, while in Examples 6
through 9, LLC’s holding begins on the date the corporation makes its
liquidating distribution. Thus, LLC’s holding period for its property will
include the corporation’s holding period.

8. Solvency Of Liquidating Corporation - In the conversion scenarios set
forth above, the corporation that is converting is actually liquidating or is
deemed to liquidate. In addressing the tax consequences of the various
scenarios presented, we have assumed that the corporations were solvent.
However, if the liquidating corporation is insolvent, some of the tax
consequences detailed above will not apply.

a. Where the actual or deemed liquidation involves the liquidation of
a subsidiary into an 80% distributee, any liquidating distribution is
normally tax free to both the liquidating corporation and the parent
corporation. However, if the controlled subsidiary is insolvent at
the time of liquidation, section 332 will not apply, and the
subsidiary will recognize gain or loss under section 1001. See
Treas. Reg. § 1.332-2(b). However, the parent corporation may be
entitled to a worthless stock deduction under section 165(g),
subject to any limitations that may be imposed by the consolidated
return regulations. See, e.g., Treas. Reg. § 1.1502-20. In addition,
because section 332 does not apply, the parent corporation will not
succeed to the liquidating corporation’s tax attributes under section
381, and the liquidating subsidiary may not use section 337(a) to
avoid the recognition of gain on the distribution of appreciated
assets.

b. Even if the liquidation does not involve a controlled subsidiary, but
rather involves individual shareholders, it has been held that
section 331 does not apply to the liquidation of an insolvent
corporation. Braddock Land Co. v. Commissioner, 75 T.C. 324
(1980); Jordan v. Commissioner, 11 T.C. 914 (1948).
B. Converting Existing Partnerships Into LLCs Classified as Partnerships

1. As with the conversion of corporations, there may be a number of ways to accomplish, under state law, a conversion of an existing partnership into an LLC that is classified as a partnership. Regardless of the method of conversion, however, the transaction is simply treated as a partnership-to-partnership conversion, which generally has no impact for Federal tax purposes. See Rev. Rul. 95-37, 1995-1 C.B. 130.

2. Example 12 – Partnership-to-LLC Conversion

- **Facts:** A and B each own a 50-percent interest in GP. A and B wish to convert GP into an LLC that is still classified as a partnership for Federal tax purposes, so A and B form LLC, with each taking a 50-percent membership interest in the LLC. A and B then cause GP to merge into LLC.

- **Tax Consequences:**
  
  (i) In Rev. Rul. 95-37, the Service held that the conversion of an existing domestic partnership into a domestic LLC classified as a partnership will not result in the recognition of gain to the LLC, the existing partnership, or its partners. Rev. Rul. 95-37, incorporated the holdings of Rev. Rul. 84-52, 1984-1 C.B. 157, in which the Service held that the conversion of a general partnership to a limited partnership was not a taxable event.

  (ii) Under the Service’s approach, the LLC is deemed to be a continuation of the old partnership. As long as the business
activity of the partnership is continued, the partnership will not be treated as terminating under section 708(b). Moreover, the LLC will maintain the partnership’s taxable year, the partnership’s basis in its assets, and the partnership’s taxpayer identification number. See Rev. Rul. 95-37 and Rev. Rul. 84-52.

(iii) Each partner’s basis in the partnership interest will remain the same as long as the partner’s share of the entity’s liabilities remains the same. See Rev. Rul. 95-37 and Rev. Rul. 84-52. Under section 1223(1), there will be no change in the holding period of any partner’s total interest in the partnership. Thus, if a partner held both general and limited partnership interests, the holding period for the LLC interests received in the exchange will not be bifurcated to reflect timing differences as to when the differing partnership interests were acquired.

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6 If a partner’s share of partnership liabilities does not change, there will be no change in the adjusted basis of the partner’s interest in the partnership. If a partner’s share of partnership liabilities changes and causes a deemed contribution of money to the partnership by the partner under section 752(a), then the adjusted basis of such partner’s interest will be increased under section 722 by the amount of the deemed contribution. If the partner’s share of partnership liabilities changes and causes a deemed distribution of money by the partnership to the partner under section 752(b), then the basis of such partner’s interest will be reduced under section 733 (but not below zero) by the amount of the deemed distribution, and gain will be recognized by the partner under section 731 to the extent the deemed distribution exceeds the adjusted basis of the partner’s interest in the partnership.
V. SALE OF A SINGLE-MEMBER LLC

A. Sale of All of the Membership Interests

1. Example 13 – Sale of All of the Membership Interests to a Single Buyer

   a. Facts: Corporation P owns all of the outstanding interests in LLC. LLC does not elect to be classified as a association (i.e., it is treated as a disregarded entity). The fair market value of LLC's assets is $100, and their adjusted basis is $50. P sells all of the outstanding membership interests in LLC to X, an unrelated party, for $100.

   b. Tax Consequences:

      (i) LLC is disregarded as an entity separate from P. As a result, P is not treated as owning “interests” in LLC for Federal tax purposes, but rather is treated as owning LLC’s assets directly. Thus, the sale of all of the interests in LLC, a disregarded entity, to a single buyer should be treated as a sale of assets by P. Under section 1001, P should recognize gain or loss on the sale, the character of which will depend on the nature of the assets sold. See Rev. Rul. 99-5, 1999-5 I.R.B. 1 (Jan. 14, 1999).

      (ii) It is not likely that P would be able to change this result by converting LLC into an association taxed as a corporation immediately prior to the sale of the LLC interests to X. Informal discussions with the Service have indicated that it
would likely apply step-transaction principles to treat P’s sale of the LLC interests as the sale of the LLC’s assets. See Rev. Rul. 70-140, 1970-1 C.B. 73.

c. **Treatment of Buyer**

(i) Because LLC will be owned by a single buyer, X, it will remain a disregarded entity in X’s hands. See Treas. Reg. § 301.7701-3(b)(ii). Accordingly, X should be treated as purchasing the assets of LLC directly from P.

(ii) What if LLC elects to be taxed as an association immediately after the purchase? Under the proposed amendments to the check-the-box regulations, if a disregarded entity elects to be treated as an association, the owner is treated as contributing all of the assets and liabilities of the disregarded entity to a newly formed association in exchange for stock of the association. Prop. Treas. Reg. § 301.7701-3(g)(1)(iv). Thus, X should be treated as contributing the assets of LLC to a newly formed association in a tax-free section 351 exchange.

2. **Example 14 - Section 338(h)(10)-Type Transaction**

![Diagram showing P, X, S, LLC, and relationships with arrows and labels: P to X labeled 'Installment Note', P to LLC labeled 'Merger', X to 100% LLC Interests, S to 100% of LLC, and 100% of LLC to P.]

a. **Facts:** Corporation P owns all of the stock of S. P forms a wholly owned LLC and merges S into the LLC. P then sells 100 percent
of the LLC interests to X, an unrelated party, in exchange for an installment note of X.

b. **Tax Consequences:**

(i) As discussed above, the conversion of S into an LLC will be treated as a section 332 liquidation, and the sale of the disregarded entity will be treated as an asset sale. Because the buyer uses its own note to acquire the target assets, the seller can report the sale under the installment method.

(ii) P might be able to obtain similar results without converting S into an LLC, but the analysis is more complicated.

(a) The purchase of S stock by X would constitute a qualified stock purchase as defined in section 338(d)(3), thus enabling P and X to make a section 338(h)(10) election. The election under section 338(h)(10) allows the purchaser to obtain a stepped-up basis in the assets of the purchased entity to reflect the purchase price of the entity. The cost of such an election is that the selling group must recognize gain on the difference between the purchase price and the target’s basis in its assets. This recognition is achieved through a series of deemed transactions. First, the target corporation ("old target") is treated as selling its assets to a new corporation owned by the acquiring corporation ("new target") in a taxable sale. Next, old target is treated as liquidating into its parent corporation.

(b) However, it is not clear whether X’s note would qualify for installment treatment under section 453(f)(3), because it may be considered a third-party note. Under section 453(f)(3) and Treas. Reg. § 15A.453-1(b)(3), the term “payment” includes the receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer. Under the fiction of a section 338(h)(10) election, old target is deemed to sell all of its assets to new target for the consideration received by the parent corporation for the target stock. Thus, if P had received a note from X in exchange for its S stock, old target would be deemed to sell its assets to new target in exchange for X’s note. Because the note is that of X rather
than new target, it technically may not qualify for installment treatment.

3. Example 15 – Sale of All of the Membership Interests Through a Cash Merger

![Diagram](image)

a. **Facts:** P owns all of the membership interests of LLC, which is treated as a disregarded entity for tax purposes. X wants to acquire LLC. X forms a transitory subsidiary, S. S merges into LLC in a reverse subsidiary cash merger, with LLC surviving (pursuant to a state statute permitting such mergers). P exchanges LLC interests for cash from X.

b. **Tax Consequences:** The transitory existence of S will be disregarded. See Rev. Rul. 73-427, 1973-2 C.B. 301. Thus, the result should be the same as in Example 13, above. Because LLC is disregarded as an entity separate from P, P is treated as owning LLC’s assets directly. Because the sole consideration for the merger is cash, the merger should be treated as the sale of LLC’s assets by P, and P should recognize gain or loss under section 1001. Moreover, because LLC, the surviving entity, will be owned by a single buyer, X, it will remain a disregarded entity in X’s hands (unless LLC elects to be taxed as an association). Treas. Reg. § 301.7701-3(b)(ii). Accordingly, X should be treated as purchasing the assets of LLC.
B. Sale of Less than All of the Membership Interests

1. Example 16 – Sale of Less than All of the Membership Interests

- Diagram:

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   P (50% of LLC) 
  /   \  
 /     \ 
 LLC   X (Cash) 
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a. **Facts:** P owns all of the outstanding interests in LLC, which is treated as a disregarded entity for tax purposes. The fair market value of LLC’s assets is $100, and their adjusted basis is $50. P sells 50 percent of the outstanding membership interests in LLC to X, an unrelated party, for $50.

b. **Tax Consequences:** LLC is disregarded as an entity separate from P. As a result, P is not treated as owning “interests” in LLC for Federal tax purposes, but rather is treated as owning LLC’s assets directly. Thus, the sale of 50 percent of the interests in LLC, a disregarded entity, to a single buyer is treated as a sale of 50 percent of the LLC assets by P. P recognizes gain or loss under section 1001, with the character of such gain or loss depending on the character of the assets sold. See Rev. Rul. 99-5, 1999-5 I.R.B. 1 (Jan. 14, 1999).

c. **Deemed Change In Classification:** Immediately after the sale, LLC has two owners and, thus, it will be treated as a partnership under the default rules of the check-the-box regulations. Treas. Reg. § 301.7701-3(b)(ii). Under Rev. Rul. 99-5, X is treated as having purchased assets from P and contributed the assets (with their stepped-up basis) to a newly formed partnership under section
721. The other 50 percent of the assets, which are deemed contributed by P would not receive a stepped-up basis; instead, LLC would take a carryover basis in those assets. Note that under section 704(c), the built-in gain with respect to the assets contributed by P will be allocated to P.

d. **Section 197 Anti-Churning Rules** – Assume that a portion of the assets held by LLC consisted of goodwill, which was not amortizable under pre-section 197 law. Would LLC be permitted to amortize its goodwill after the sale?

(i) In general, section 197 amortization deductions may not be taken for an asset, which was not amortizable under pre-section 197 law, if it 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) nominal ownership of the intangible changes, but the user of the intangible does not; or (iii) the taxpayer grants the former owner the right to use the asset. See Section 197(f)(1)(A). In addition, under section 197(f)(2), in certain nonrecognition transactions (including section 721 transfers), the transferee is treated as the transferor for purposes of applying section 197.

(ii) In the example above, P was treated as owning LLC’s goodwill directly, prior to the sale of 50 percent of LLC. Because P’s deemed contribution of 50 percent of the goodwill was pursuant to section 721, LLC takes a carryover basis in the goodwill (presumably 0), which will not be amortizable by LLC. Because X’s half of the goodwill was held by P, who is related to LLC under section 197(f)(9)(C), during the prohibited time period, the anti-churning rules will apply to X’s transfer of its 50-percent interest. Therefore, LLC’s entire basis in its goodwill is nonamortizable. See Prop. Treas. Reg. § 1.197-2(k), Ex. 16.

(iii) What if P sold more than 80 percent of the LLC membership interests to X? In that case, P is not related to the newly formed partnership within the meaning of section 197(f)(9)(C). Thus, the anti-churning rules should not apply. However, under Prop. Treas. Reg. § 1.197-2(h)(6)(ii), the time for testing relationships in the case of a series of related transactions is any time during the period beginning immediately before the “earliest acquisition” and ending immediately after the “last acquisition” of the intangible. Query whether P is considered related to the
newly formed partnership under this rule, because it was an entity not separate from LLC immediately before the initial acquisition by X.

(iv) There is a special partnership rule for purposes of determining whether the anti-churning rules apply with respect to any increase in basis of partnership property under section 732(d), 734(b), or 743(b). In such cases, the determinations are to be made at the partner level, and each partner is to be treated as having owned or used such partner’s proportionate share of the partnership property. Section 197(f)(9)(F); Prop. Treas. Reg. § 1.197-2(g)(3). Thus, if a purchaser acquires an interest in an existing partnership from an unrelated seller, the purchaser will be entitled to amortize its share of any step up in basis of the partnership intangibles.

(v) Assume that, in the example above, LLC was already classified as a partnership for tax purposes (e.g., P contributed the assets of LLC to a newly formed partnership in exchange for partnership interests, and, at the same time, another party contributed property to the newly formed partnership in exchange for nominal partnership interests), and LLC had a section 754 election in effect. If P then sold 50 percent of its partnership interest to X, X’s proportionate share of any basis step-up under section 743 should be amortizable.

2. Example 17 – Initial Public Offering of LLC Interests

![Diagram showing P selling 50% LLC Interests for Public and receiving Cash, LLC giving 100% to P]
a. **Facts:** P owns all of the outstanding interests in LLC, which is treated as a disregarded entity for tax purposes. The fair market value of LLC’s assets is $100, and their adjusted basis is $50. P sells 50 percent of its LLC membership interests to the public in an initial public offering (“IPO”).

b. **Tax Consequences:** Because LLC is disregarded as an entity separate from P, P is treated as owning LLC’s assets directly. Thus, the sale of 50 percent of the interests in LLC to the public in an IPO should be treated as a sale of 50 percent of the LLC assets by P. See Rev. Rul. 99-5, 1999-5 I.R.B. 1 (Jan. 14, 1999).

c. **Deemed Change in Classification**

(i) Immediately after the IPO, LLC has more than one owner. Thus, under the default rules of the check-the-box regulations, LLC will be treated as a partnership. Treas. Reg. § 301.7701-3(b)(ii). Upon the deemed reclassification as a partnership, the public should be treated as having purchased assets from P and contributed the assets (with their stepped-up basis) to a newly formed partnership under section 721. The other 50 percent of the assets, which would be deemed contributed by P would not receive a stepped-up basis; LLC would take a carryover basis in those assets. See Rev. Rul. 99-5, 1999-5 I.R.B. 1 (Jan. 14, 1999).

(ii) However, because the partnership interests are publicly traded, the partnership should immediately be reclassified as a corporation under section 7704 (unless the partnership is engaged in passive activities, e.g., real estate). Under section 7704(f), the partnership is treated as having transferred all of its assets to a newly formed corporation in exchange for stock of the corporation pursuant to section 351, and (ii) distributed such stock to its partners in liquidation of their interests. These deemed transfers are treated as occurring as of the first day that the partnership is treated as a corporation.

(iii) Because the deemed incorporation occurs at the same time that the entity is treated as a partnership, these transactions may be stepped together. See Prop. Treas. Reg. § 301.7701-3(g)(2) (providing that the step-transaction doctrine applies to elective changes in an entity’s classification).
application of the step-transaction doctrine could yield one of two results:

(a) P is viewed as selling half of the LLC’s assets to the public, followed by the transfer by P and the public of all of the assets to a newly formed corporation in a section 351 exchange.

(b) Alternatively, the transaction may be viewed as if P transferred all of the LLC’s assets to a newly formed corporation in exchange for stock, and then sold half of the stock to the public. In this case, the sale of half of the stock immediately after the transfer of the assets to the corporation would presumably disqualify the transaction under section 351. Informal discussions with the Service have indicated that it would not likely view this transaction as a sale of assets to the public under the principles of Rev. Rul. 70-140, 1970-1 C.B. 73. See also Prop. Treas. Reg. § 1.1361-5(b)(3), Ex. 1.

VI. REORGANIZATIONS INVOLVING SINGLE-MEMBER LLCs

A. Example 18 - B Reorganization

1. Facts: P forms a wholly owned LLC. LLC does not elect to be taxed as an association and is, thus, treated as a disregarded entity. LLC acquires T stock from the T shareholders in exchange for P voting stock.
2. **Tax Consequences:** Because LLC’s separate existence is disregarded, P should be treated as exchanging its voting stock for the T stock in a reorganization that qualifies under section 368(a)(1)(B).

   a. This result is consistent with the Service’s position on the use of transitory subsidiaries in similar situations. See Rev. Rul. 67-448, 1967-2 C.B. 144 (where a transitory subsidiary was merged into a target corporation, the Service disregarded the transitory subsidiary and recast the transaction as a direct exchange of the acquiring corporation’s stock for the target stock).

   b. What if T were immediately liquidated into LLC as part of the overall transaction?


      (ii) What if the subsequent liquidation were done by means of a statutory merger of T into LLC (assuming that state law permits mergers of corporations and LLCs)? Such a transaction would also be treated as if T merged into P. See King Enterprises, Inc. v. Commissioner, 418 F.2d 511 (Ct. Cl. 1969); P.L.R. 9539018 (June 30, 1995); see also section VI.C. below.

B. **Example 19 - C Reorganization**
1. **Facts**: P forms a wholly owned LLC, which is treated as a disregarded entity. P wants LLC to acquire the T assets in a tax-free reorganization. T has assets worth $100 and has recourse liabilities of $30. T transfers its assets and liabilities to LLC in exchange for P voting stock. T distributes all of the P voting stock to its shareholders in complete liquidation.

2. **Tax Consequences**: Because LLC's separate existence is disregarded, P should be treated as exchanging its voting stock for T's assets and liabilities in a reorganization that qualifies under section 368(a)(1)(C).

3. **Assumption of Liabilities**

   a. Under section 368(a)(1)(C), the acquisition of assets must be solely for voting stock of the acquiring corporation. However, in determining whether the exchange is solely for voting stock, liabilities assumed by the acquiring corporation are not taken into account. The Service has ruled that the assumption of liabilities by a corporation other than the acquiring corporation can destroy a tax-free C reorganization. See Rev. Rul. 70-107, 1970-1 C.B. 78; but see G.C.M. 39,102 (recommending revocation of Rev. Rul. 70-107 and suggesting that any party to a triangular reorganization should be able to assume part or all of the liabilities).

   b. In the above example, does the assumption by LLC of T's recourse liabilities constitute an assumption by the acquiring corporation?

      (i) P is treated as the acquiring corporation, because LLC is disregarded. But for state law purposes, LLC is treated as becoming the obligor on the liabilities. Thus, as a technical matter, LLC’s assumption of T’s liabilities may be treated as boot in the C reorganization.

      (ii) For purposes of the reorganization provision, however, P should be treated as assuming T’s liabilities.

         (a) The check-the-box regulations apply for all Federal tax purposes and provide that whether an entity is treated as separate from its owners is a matter of Federal, not state, law. Treas. Reg. § 301.7701-1(a).

         (b) Moreover, the Service has looked to the owner as the debtor in situations where a division has incurred debt. For example, in Rev. Rul. 80-228, 1980-2 C.B. 115, the Service disregarded intercompany debt between divisions of the same corporation, noting that such intercompany debt cannot give rise to a debtor-creditor relationship,
because a corporation cannot be liable for a debt to itself. See also P.L.R. 9109037 (Nov. 30, 1990) (involving the transfer of division assets and liabilities in a section 351 transaction).

c. Assuming that P is considered to have assumed T’s liabilities for Federal tax purposes, are the liabilities considered recourse or nonrecourse with respect to P? Because LLC is still considered the obligor for state law purposes, recourse liability could not attach to P. P would only be liable for the liabilities to the extent of the value of the assets in LLC. Thus, the liabilities should be considered nonrecourse liabilities of P for Federal tax purposes.

d. Has a significant modification of T’s debt occurred for purposes of section 1001?

(i) Although there has been a change in the obligor on the debt, such change resulted from a section 381(a) transaction and, thus, is not considered a significant modification. Treas. Reg. § 1.1001-3(e)(4)(i).

(ii) Although the nature of the debt changed from recourse to nonrecourse, such change is not considered significant if the instrument continues to be secured by its original collateral, which would appear to be the case here. Treas. Reg. § 1.1001-3(e)(5)(ii)(A), (B)(2).

C. Example 20 - A Reorganization
1. **Facts:** P forms a wholly owned LLC. LLC is treated as a disregarded entity. T merges into LLC pursuant to a state statutory merger, with the T shareholders receiving P voting stock.

2. **Tax Consequences:** It is not clear whether the merger of a target into a single-member LLC can qualify as a reorganization under section 368(a)(1)(A).

   a. Is this transaction a statutory merger? The regulations define an A reorganization as a "merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia." Treas. Reg. § 1.368-2(b)(1).

      (i) On the one hand, the LLC is disregarded for all Federal tax purposes, and P ends up with T's assets pursuant to a merger under the Delaware corporation laws. The substance of the transaction is a merger of T into P. Thus, the merger of T into LLC should be treated as a statutory merger into P.

         (a) This treatment is consistent with rulings involving qualified REIT subsidiaries. In P.L.R. 9411035 (Dec. 20, 1993), Parent owned all of the common stock and some of the preferred stock of Sub. Parent and Sub qualified as REITs. Parent formed Newco as a qualified REIT subsidiary. Parent caused Sub to merge into Newco under a plan of liquidation. The Service ruled that the merger of a corporation into a qualified REIT subsidiary, which is disregarded, is treated as a merger directly into the parent of the qualified REIT subsidiary. See also P.L.R. 9512020 (Dec. 29, 1994); P.L.R. 8903074 (Oct. 26, 1988).

         (b) In *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969), Minute Maid acquired all of Tenco's stock in exchange for cash, notes, and Minute Maid stock. Approximately 3 months later, Minute Maid approved a plan to merge Tenco and three other subsidiaries into Minute Maid. The court held that the transfer of the Tenco stock to Minute Maid, followed by the merger of Tenco into Minute Maid, were steps in a unified transaction to merge Tenco into Minute Maid, which qualified as an A reorganization.
(c) Similarly, in P.L.R. 9539018 (June 30, 1995), Acquiring formed Acquiring Sub, which was merged into Target in a triangular merger that qualified as a reorganization under section 368(a)(2)(E). Target then merged into Acquiring. The Service ruled that the two mergers would be treated as if Acquiring had directly acquired the Target assets in exchange for Acquiring stock through a statutory merger under section 368(a)(1)(A).

(ii) On the other hand, as a technical matter, section 368(a)(1)(A) may require that the state statutory merger actually involve the two corporations that qualify as parties to the reorganization. Because the merger was actually into LLC, and LLC is not a party to the reorganization, arguably there is no reorganization.

b. Who are the parties to the reorganization as defined in section 368(b)?

(i) Under section 368(b), a party to a reorganization includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another. Certainly the target corporation qualifies as a party to the reorganization.

(ii) Who is the acquiring party for purposes of this definition? LLC, because it is not a corporation, does not qualify as a party to the reorganization under this definition.

(a) Since LLC is disregarded, P is treated as having acquired the assets of T directly. Thus, P should qualify as the other party to the reorganization.

(b) However, because T is merging into LLC under state law, LLC may be considered the acquiring party. LLC cannot be a party to the reorganization under section 368(b), because it is not a corporation, and section 368(b) does not include a corporation that is in control of the acquiring corporation in a reorganization qualifying under section 368(a)(1)(A). Thus, arguably the transaction does

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7 Section 368(b) does include the corporation controlling the acquiring corporation as a party to the reorganization in triangular A reorganizations under section 368(a)(2)(D) and

(Continued …)
not qualify as an A reorganization, because the acquiring party is not a party to the reorganization. See Rev. Rul. 67-326, 1967-2 C.B. 143.

c. If the merger does not qualify as an A reorganization, it may qualify as a C reorganization. See Rev. Rul. 72-405, 1972-2 C.B. 217; Rev. Rul. 67-326, 1967-2 C.B. 143. However, section 368(a)(1)(C) provides much less flexibility in the consideration provided by P than is available in an A reorganization. In addition, a C reorganization has a substantially all requirement, which is not required for an A reorganization.

d. This analysis should not change if P has multiple tiers of disregarded entities. Thus, for example, if P owns all of the interests in an LLC, which, in turn, owns all of the interests in a second tier LLC, both of which are disregarded entities, the merger of T into the second tier LLC should be treated as an acquisition by P.

D. Example 21 - Triangular Reorganization

(a)(2)(E). However, because LLC is disregarded, the merger of T into LLC cannot constitute a triangular reorganization.
1. **Facts:** P's wholly owned subsidiary, S, forms a single-member LLC, which is disregarded for Federal tax purposes. T merges directly into LLC, and the former shareholders of T receive solely P voting stock.

2. **Tax Consequences:** LLC is disregarded as an entity separate from S; thus, this transaction should be characterized as a merger of T directly into S. Because S is using P stock as consideration, the transaction should qualify as a triangular merger under section 368(a)(1)(A) and (a)(2)(D).

   Alternatively, if, for the reasons discussed above, the merger does not qualify as an A reorganization, it could qualify as a parenthetical C reorganization.

3. If S had formed a wholly owned C corporation, instead of an LLC, the transaction would not qualify as a tax-free reorganization, because neither section 368(a)(2)(D) nor section 368(a)(1)(C) permits the use of grandparent stock as consideration in the reorganization. Thus, disregarded entities can be used to avoid this limitation.

**E. Example 22 – Intragroup A Reorganization**

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1. **Facts:** Individual A owns all of the stock of Holdco. Holdco is a holding company whose only asset consists of the stock of Opco, an operating
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company. Opco is insolvent. Holdco wants to merge downstream into Opco, but cannot do so because it violates certain loan covenants. Instead, Opco forms a single-member LLC, which is treated as a disregarded entity, and Holdco merges into the LLC pursuant to state law.

2. **Tax Consequences:** As discussed in Example 20, it is not clear whether the merger of a corporation into a single-member LLC can qualify as a reorganization under section 368(a)(1)(A). If the transaction is treated as an A reorganization, then Holdco will be treated as having merged into Opco for tax purposes, because the LLC is disregarded.

   a. If the merger does not qualify as an A reorganization, it may qualify as a D reorganization. Note that although the transaction may also qualify as a C reorganization, the D reorganization provisions trump the C reorganization provisions in cases where they both apply. Section 368(a)(2)(A).

   b. In order to qualify as a D reorganization, however, Holdco must transfer substantially all of its assets to the LLC.

      (i) Because Holdco owns only the stock of Opco, which is insolvent, there is an issue as to whether Holdco would be transferring substantially all of its assets.

      (ii) The rulings are inconsistent with respect to whether the assets of the holding company include the stock of the subsidiary for purposes of applying the substantially all test. *Compare* Rev. Rul. 57-465, 1957-2 C.B. 250 (holding that a downstream merger qualified as a D reorganization even though substantially all of the holding company’s assets consisted of stock of its subsidiary); P.L.R. 9122080 (Mar. 7, 1991) (holding that a downstream merger qualified as a D reorganization where holding company transferred only its investment assets other than the subsidiary stock); P.L.R. 8607104 (Nov. 20, 1985) (holding that a downstream merger qualified as a C reorganization even though more than half of the holding company’s assets consisted of stock of its subsidiary), with P.L.R. 8612082 (Dec. 30, 1985) (stating that the subsidiary stock owned by the holding company will not be taken into account for purposes of determining whether the substantially all test was met); P.L.R. 8221025 (Feb. 23, 1982) (expressly not ruling on whether merger of a holding company into Newco constituted a forward triangular merger, noting that there was a particular issue regarding the substantially all requirement); P.L.R. 8247087 (Aug. 25, 1982) (ruling that a downstream merger qualified as an A reorganization, but
conditioning the ruling on the fact that the holding company had more than de minimis assets other than the stock of its subsidiary).

(iii) Many of these conflicting rulings cite Rev. Rul. 78-47, 1978-1 C.B. 113. In Rev. Rul. 78-47, Y owned five percent of the stock of X (worth $90x). Y also owned $6x in cash and $36x in land. Y transferred all of its assets and liabilities to X in exchange for X stock. To eliminate state transfer taxes, Y kept the old X stock and received additional X stock. The Service, citing George v. Commissioner, 26 T.C. 396 (1956), acq., 1956-2 C.B. 5, ruled that the transaction qualified as a C reorganization even though Y did not transfer its principal asset, the X stock. The Service noted that Y transferred all of its business assets.

c. Query whether the downstream merger would be treated as a section 331 liquidation of Holdco. See, e.g., Rev. Rul. 68-602, 1968-2 C.B. 135 (ruling that the liquidation of an insolvent subsidiary is not a valid section 332 liquidation, because the parent received nothing in return for its stock); see also Administration’s Fiscal Year 2000 Budget Proposal (containing a provision that would treat the downstream merger into a less-than-80-percent subsidiary as a taxable distribution of the subsidiary’s stock).

F. Example 23 - Spin-Off

![Diagram of Example 23 - Spin-Off](image-url)
1. **Facts:** D is a holding company. It has four wholly owned subsidiaries, S-1, S-2, S-3, and S-4. The subsidiaries are each actively engaged in a trade or business for purposes of section 355. S-3 and S-4, however, were acquired in taxable transactions during the past five years. As a result, S-3 and S-4 are not engaged in qualifying active businesses under section 355(b). D wants to spin-off S-1 to its shareholders.

2. **Tax Consequences:** Assuming that the value of S-3 and S-4 exceeds 10 percent of D’s net value, D will not be considered to be engaged in an active trade or business, because “substantially all” of its assets are not stock or securities in subsidiaries that are so engaged. Section 355(b)(2).

3. **Alternatives**
   a. In order to satisfy the active trade or business requirement, D could contribute the stock of S-3 and S-4 to S-2. After the contribution, D would only hold stock of subsidiaries engaged in qualifying active businesses, and should be able to spin-off S-1 in a tax-free section 355 transaction.
   b. D could also liquidate S-2. D will then be considered to be directly conducting an active trade or business and will not be subject to the substantially all requirement. See Rev. Rul. 74-79, 1974-1 C.B. 8.
   c. D could convert S-2 into a wholly owned LLC by merging it into a newly formed LLC.
(i) The merger of S-2 into LLC should be treated as a section 332 liquidation. Thus, as in alternative b, above, D will then be considered to be directly conducting an active trade or business. See Rev. Rul. 74-79.

(ii) This alternative provides an additional benefit of shielding D’s assets from the liabilities of S-2. No such protection exists where S-2 actually liquidates. Similarly, D may not want to provide additional value to S-2’s creditors by contributing the stock of S-3 and S-4.

(iii) Rev. Proc. 96-30 provides that the protection of one or more businesses from the risks of another business may constitute a valid business purpose for spin-off. However, the ability to isolate contingent liabilities in single-member LLCs may reduce the use of the risk reduction business purpose set forth in Rev. Proc. 96-30.

G. Example 24 – Distribution of LLC Interests as a Spin-Off

1. **Facts:** Individuals A and B own all of the stock of D. D owns all of the interests in LLC, which is disregarded as a separate entity. LLC owns all of the stock of C. D distributes all of the LLC interests to A and B.
2. **Tax Consequences:** Because LLC is disregarded, the transaction should be treated as if D distributed all of the assets of LLC, and A and B thereafter contributed such assets to a partnership in exchange for partnership interests. See Rev. Rul. 99-5, 1995-5 I.R.B. 8 (Jan. 14, 1999). Thus, D is treated as distributing all of the stock of C. Does the distribution qualify as a section 355 spin-off?

a. Because D is treated as owning 100 percent of the C stock and is treated as distributing 100 percent of the C stock, and assuming the active trade or business requirements are satisfied, the distribution appears to qualify as a section 355 spin-off.

b. However, the deemed transfer of the C stock to the partnership immediately after the distribution raises certain issues under section 355.

   (i) The transfer should not violate the device requirement, because the transfer should be tax free pursuant to section 721.

   (ii) In addition, the transfer should not violate section 355(e), because A and B continue to own all of the stock of C by reason of the attribution rules of section 318(a)(2). Section 355(e)(4)(C)(ii).

   (iii) The regulations under section 355 also impose a continuity of interest requirement. Treas. Reg. § 1.355-2(c). Recent regulations under section 368 addressing the continuity of interest requirement for reorganizations, provide considerable flexibility with respect to post-reorganization dispositions. Treas. Reg. § 1.368-1(e). However, these regulations do not apply to section 355 transactions. Preamble to Treas. Reg. § 1.368-1(e), 63 Fed. Reg. 4174, 4176 (Jan. 28, 1998).

   (a) It is unclear what test is applied in determining whether continuity of interest is satisfied with respect to a spin-off.

   (b) A tax-free reorganization following a spin-off has been held not to violate the continuity of interest requirement. See Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966); Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Rul. 75-406, 1975-2 CB 125. Presumably a tax-free drop of stock to a partnership under section 721 should not violate the continuity of interest requirement.
H. **Example 25 – Avoiding the Requirements of Section 355**

![Diagram](image)

1. **Facts:** P owns all of the stock of D. D owns all of the stock of C. D wants to distribute C to P, but a section 355 spin-off is not available. Thus, P forms a single-member LLC, which is disregarded as a separate entity, and merges D into the LLC. LLC then distributes all of the C stock to P.

2. **Tax Consequences:**
   a. Because LLC is disregarded as an entity separate from P, D is treated as liquidating into P when it merges into the LLC. See P.L.R. 9822037 (Feb. 27, 1998).
   b. LLC is thereafter treated as a division of P, so the distribution of the C stock to P is treated as an interdivisional transaction, which is ignored for Federal tax purposes.
   c. Thus, P and D have achieved a tax-free distribution of the C stock without the necessity of meeting all of the requirements of section 355.
I. Example 26 – Section 355(e) Transaction

1. **Facts:** D distributes all of the stock of its wholly owned subsidiary, C, in a tax-free spin-off pursuant to section 355. Six months later, P offers to acquire the stock of C in a tax-free reorganization. C agrees instead to a transaction wherein it drops its assets into a newly formed LLC in exchange for 33 1/3 percent of the LLC membership interests, and P drops some of its assets into the LLC in exchange for 67 2/3 percent of the membership interests.

2. **Tax Consequences:**
   
   a. Does this transaction qualify as a tax-free spin-off under section 355?

   (i) Section 355(b)(1)(A) requires that D and C be engaged immediately after the distribution in the active conduct of a trade or business. Because C has transferred all of its assets (and employees) to LLC in exchange for a 33 1/3-percent interest, it will not be directly engaged in the conduct of an active trade or business. However, C's ownership of LLC may qualify as the conduct of an active trade or business if C can establish that, through its officers, it performs active and substantial management functions for LLC. Rev. Rul. 92-17, 1992-1 C.B. 142.
(ii) The regulations under section 355 also contain a continuity of business enterprise ("COBE") requirement. Treas. Reg. § 1.355-1(b). The preamble to the final COBE regulations (Treas. Reg. § 1.368-1(d)) acknowledge that the proposed regulations did not extend to transactions qualifying under section 355 and note that "[t]he COBE provisions in the final regulations apply to all reorganizations for which COBE is relevant." If the COBE regulations apply to section 355 transactions, then C will be treated as conducting the business of LLC, and thus, the COBE requirement will be met, because C owns a "significant interest" in LLC. See Treas. Reg. § 1.368-1(d)(4)(iii)(B), -1(d)(5), Ex. 9.

b. Does the transfer of C's assets to LLC avoid the application of section 355(e)?

(i) Section 355(e) provides in general that a distributing corporation must recognize gain on the distribution of the stock of a controlled corporation if the distribution is part of a plan or series of related transactions pursuant to which one or more persons acquire, directly or indirectly, stock representing a 50-percent or greater interest in either the distributing or controlled corporation.

(ii) If P had acquired the stock of C in a tax-free reorganization, then D would be required to recognize corporate-level gain under section 355(e).

(iii) In Example 26, however, P is not acquiring a 50-percent or greater interest in C. Rather, P acquires a 67-2/3 percent interest in an LLC that owns the assets previously held by C. It is not clear how the Service will treat these transactions.

VII. USE OF LLCs IN CONSOLIDATED RETURN CONTEXT

A. Selective Consolidation

1. By filing a consolidated return, an affiliated group of corporations may combine their items of income, deduction, gain and loss in the computation of the groups tax liability for the year. Under section 1501, an affiliated group of corporations may file a consolidated tax return if each member of the group consents to the election. Once the election is made, each "includible corporation," as defined in section 1504(b), that becomes a member of the affiliated group must join in filing a consolidated return with the existing consolidated group. Section 1501.
While an election to file a consolidated return may not be beneficial to the group as a whole, it may be advantageous to combine the tax items of some members of the group. However, the election to file a consolidated return is an all-or-nothing proposition. Thus, to obtain the benefits of combining the taxation of selected members of the group, the conversion of an existing subsidiary into an LLC should be considered.

2. Example 27 – Selective Consolidation

a. **Facts:** Corporation P owns all the stock of two corporations, S-1 and S-2. P does not want to file a consolidated return with S-2, but would like to include S-1's items of income, deduction, gain, and loss with its own. To accomplish the integration of P and S-1 for tax purposes, without the inclusion of S-2, S-1 merges into a newly formed LLC.

    a. **Tax Consequences:** For Federal income tax purposes, this conversion should be treated as a tax-free section 332 liquidation. See Example 9 above. Under the default rule, S-1 will be disregarded as an entity separate from P. Thus, S-1 will be treated as a division of P and all of S-1's items of income, deduction, gain, and loss will be included in the calculation of P's tax liability.

B. Avoiding SRLY Limitations

1. When a corporation joins an affiliated group of corporations filing a consolidated return, the new member's tax attributes and items of income, deduction, gain, and loss are generally taken into account in determining
the group's overall tax liability for the year. However, the consolidated return regulations restrict the use of certain tax attributes in determining the group's tax liability. Generally, this restriction is accomplished by classifying items as arising in a separate return year, thereby subjecting those items to the separate return limitation year ("SRLY") rules.

For example, if the new member has a net operating loss ("NOL") when it joins the consolidated group, the NOL is treated as a SRLY item, and its use in offsetting the group's consolidated taxable income ("CTI") is restricted. In order to avoid a target corporation's tax attributes from being characterized as SRLY, the target corporation could be merged into a newly formed LLC owned entirely by the common parent.

2. **Example 28 – SRLY Limitations**

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2. Example 28 - SRLY Limitations

a. **Facts:** P is the common parent of an affiliated group of corporations filing a consolidated return. P would like to acquire T. T has a large NOL. In order to avoid the treatment of the NOL as a SRLY item, P could acquire target by having T merge into a wholly owned LLC in a statutory merger.

b. **Tax Consequences:** Because P would be the sole owner of the LLC, LLC would be disregarded as an entity separate from P, and the merger of T into LLC should be treated as being directly into P. (It may qualify as a C reorganization. See Example 19 above.) Therefore, P should succeed to all of T's tax attributes under section 381, and SRLY should not apply. However, it should be
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kept in mind that P will not have unfettered use of T's tax attributes, because of the restrictions of sections 382, 383, and 384.

C. Avoiding Intercompany Transaction Rules

1. The fundamental policy goal of the intercompany transaction rules is to treat the separate members of the consolidated group as divisions of a single entity whenever possible. The primary means of effectuating this policy is through the operation of the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i) (the "matching rule"). Under the intercompany transaction rules, when one member of the group sells property to another member of the group, any gain or loss on the transaction is deferred until it is no longer possible to treat the members as divisions of a single entity. Thus, as long as an acceleration event has not taken place, gain or loss on the sale between members will be deferred. Common examples of acceleration events are the deconsolidation of the buyer or seller and the sale of the property outside the group. In a variety of circumstances, these rules may work to the disadvantage of the group. In such cases, the use of an LLC is more beneficial to a consolidated group of corporations than the use of a corporation.

2. Example 29 – Intercompany Sale

```
\begin{tikzpicture}
  \node (P) at (0,0) {P};
  \node (S-2) at (-1,-2) {S-2};
  \node (S-3) at (1,-2) {S-3};
  \node (S-1) at (0,-2) {S-1};
  \node (LLC) at (0,-3) {LLC};
  \draw (P) -- (S-2) node[midway, below] {Cash};
  \draw (P) -- (S-1) node[midway, above] {Land};
  \draw (S-1) -- (LLC) node[midway, right] {50\%};
  \draw (S-3) -- (LLC) node[midway, left] {50\%};
\end{tikzpicture}
```

a. Facts: Corporation P is the parent of an affiliated group of corporations filing a consolidated return. P’s group has a large NOL, which will expire at the close of the tax year. P owns appreciated investment real estate on which it would like to build a waste reclamation plant. Management of P would like to insulate P from any liability associated with the new reclamation plant and
find a way to utilize the group’s expiring NOL. P sells the land to LLC, which is owned by two of the P group members.

b. **Tax Consequences:** Because both a corporation and an LLC afford owners limited liability, shielding P from liability can be accomplished by using either entity. P would like to sell the property to the entity in order to generate gain to utilize all or a portion of the expiring NOL. Unfortunately, a sale of the land to a subsidiary would be deferred under the matching rule. On the other hand, a sale of the property to multi-owner LLC should produce a different answer.

(i) Under the default rule, a multi-member LLC is treated as a partnership. Thus, the entity is not an includible corporation within the meaning of section 1504(b). A sale of the land to an LLC owned by S-1 and S-3 should result in the current recognition of gain, because the matching rule will not apply. See P.L.R. 96-45015 (Aug. 9, 1996). By triggering this gain, P should be able to utilize all or a portion of its expiring NOL. It should be noted that when the intercompany transaction regulations were in proposed form, they contained an example that would have deferred the recognition of gain or loss on the transfer of property to a partnership controlled by the members of the consolidated group. See Prop. Treas. Reg. § 1.1502-13(h)(2), Ex. 2. However, this example was not included in the final regulations.

(a) In effect P would get a stepped-up basis in the land, paid for, in whole or in part, by the expiring NOL.

(b) The Service could argue that the anti-abuse rules of Treas. Reg. § 1.701-2 apply to this transaction and disallow the gain.

(ii) It should be noted that this strategy will not work with a single-member LLC. A single-member LLC may be classified as either a disregarded entity (the default rule) or as an association. In either case, a sale to a single-member LLC will not avoid the intercompany transaction rules. In the case of an LLC that is disregarded, such a sale would be ignored for Federal income tax purposes as a sale to a division. See Examples 1 and 2 above. In the case of an LLC taxed as an association, the LLC would be treated as an includible corporation and would be required to join the consolidated group in filing a consolidated return. In such
a case, the matching rule would cause the gain on the sale to be deferred.

3. Example 30 – Intercompany Debt

![Diagram]

a. **Facts:** Corporation P is the common parent of an affiliated group of corporations filing a consolidated return. P contributed its Business A and a P note to a newly formed subsidiary (“Newco”).

b. **Tax Consequences:** P has unwittingly exposed itself to the highly complex intercompany debt rules of Treas. Reg. § 1.1502-13(g)(3). Under these regulations, many common transactions involving P, Newco, or the intercompany obligation could trigger the deemed satisfaction and reissuance rules of Treas. Reg. § 1.1502-13(g)(3). These rules can often lead to harsh and seemingly unfair results. Taxpayers should consider avoiding these rules through the use of a single-member LLC as opposed to a corporate subsidiary.

D. **Deconsolidation of Two-Member Consolidated Group**

1. For a variety of reasons a two-member consolidated group may wish to deconsolidate. Generally, if the consolidated group wishes to maintain both entities, the group is required to continue filing consolidated returns until the Secretary of the Treasury grants permission to deconsolidate. A consolidated group will automatically terminate if the common parent is no longer a member of the group, or the common parent no longer has any subsidiaries. See Treas. Reg. § 1.1502-75(d).
2. **Example 31 – Deconsolidation Using a Single-Member LLC**

![Diagram of P, S, and LLC with 100% ownership and merger]

a. **Facts:** Corporation P owns all of the stock of S. P and S file a consolidated return. P forms a wholly owned LLC, which is disregarded for Federal tax purposes, and S merges into it.

b. **Tax Consequences:** By merging the subsidiary into a single-member LLC, the P effectively terminates the consolidated election, because LLC is disregarded for tax purposes. This approach has the dual benefit of allowing the two entities to combine their tax items for determination of tax liability for the year, while avoiding the complexity of the consolidated return regulations.

E. **Avoid Triggering Restoration Of ELAs**

1. Another common situation involves a consolidated group of corporations where the parent corporation has an ELA with respect to the stock of one of its subsidiaries. The group wishes to deconsolidate, but doing so will result in gain to the parent corporation as a result of the restoration of the ELA with respect to the subsidiary's stock. One means of avoiding the gain on the restoration of the ELA would be to liquidate the subsidiary into the parent corporation. However, management of the parent corporation does not wish to expose the assets of the parent corporation to the subsidiary's liabilities.
2. Example 32 – Avoiding Trigger of ELAs

a. **Facts:** Corporation P owns all of the stock of S. P and S file a consolidated return. P has an ELA in its S stock. P forms a wholly owned LLC, which is disregarded for Federal tax purposes, and S merges into it.

b. **Tax Consequences:** As a result of the merger S will be treated as liquidating into P. See P.L.R. 9822037 (Feb. 27, 1998). Under sections 332 and 337, the liquidation will be tax free to both P and S, and under Treas. Reg. § 1.1502-19(e), the ELA is eliminated. Under the default rule, the single-member LLC will be disregarded for tax purposes. Treas. Reg. § 301.7701-3(b)(1)(ii). Thus, P will be treated as owning LLC’s assets directly. The merger should insulate P from the liabilities of S.

VIII. **USE OF MULTI-MEMBER LLCs IN CORPORATE TRANSACTIONS**

A. **Mergers Involving Multi-Member LLCs** - The default classification for a multi-member LLC is a partnership. Treas. Reg. § 301.7701-3(b)(i). A partnership, however, cannot be a party to a reorganization. See Section 368(b).
1. Example 33 – Merger of Target Corporation Into LLC

**Facts:** P and its wholly owned subsidiary, S, formed LLC, with P receiving a 99-percent interest and S receiving a 1-percent interest. LLC does not elect to be treated as an association. LLC acquires the assets of T in exchange for LLC interests pursuant to a state statute providing for corporation-to-partnership mergers.

**Tax Consequences:** The merger should be treated as the transfer by T of its assets and liabilities to LLC in exchange for LLC interests, followed by a distribution of the LLC interests to the T shareholders in complete liquidation. T will not recognize gain or loss upon the transfer of its assets to LLC, section 721, but T and its shareholders will recognize gain or loss upon the liquidation under sections 331 and 336.

(i) In Rev. Rul. 69-6, 1969-1 C.B. 104, a stock savings and loan merged into a nonstock savings and loan. The Service ruled that the transaction did not qualify as a tax-free reorganization under section 368(a)(1)(A) or (a)(1)(C), because the continuity of interest requirement was not met. Instead, the transaction was treated as a taxable sale of assets, followed by a liquidation of the target corporation.

(ii) The Service has relied on this ruling to characterize the merger of a corporation into a partnership as a section 721 transfer, followed by a complete liquidation of the corporation. P.L.R. 9701029 (Oct. 2, 1996) (statutory
merger under Delaware law of a corporation into an LLC classified as a partnership); P.L.R. 9701008 (Sept. 26, 1996) (statutory merger of corporation into partnership); P.L.R. 9543017 (July 26, 1995) (merger of S corporation into an LLC classified as a partnership); P.L.R. 9404021 (Nov. 1, 1993) (statutory merger under Louisiana law of a corporation into an LLC classified as a partnership).

(iii) S should be recognized as a member for purposes of the entity classification rules, even though it holds only a one-percent interest in LLC. See P.L.R. 9716007 (Jan. 8, 1997).

(a) What if S only owned a .5-percent interest in LLC? The Service’s ruling position under the prior entity classification rules was that members had to meet a one-percent ownership threshold in order to be considered as lacking certain corporate characteristics. Rev. Proc. 95-10, §§ 4.02-4.05, 1995-1 C.B. 501. No such threshold appears in the check-the-box regulations. Thus, presumably if S owns any equity interest as a matter of form, it will be considered a member for purposes of the entity classification rules.

(b) The Service has indicated, however, that it will apply general principles regarding the determination of whether individuals have joined together as partners in a partnership. See P.L.R. 199911033 (Dec. 18, 1998). Thus, form may not always control.

i) In P.L.R. 199911033, a trust and a corporation wholly owned by the trust held interests in an LLC. The LLC agreement provided that all LLC decisions would be made by the trust, except that the corporation had certain limited veto powers (e.g., the LLC could not file for bankruptcy without the corporation’s approval). In addition, all profits and losses were to be allocated to the trust, and all distributions were to be made only to the trust.

ii) The Service ruled that the trust and the corporation did not enter an agreement to operate a business and share profits and
losses under general partnership principles. Accordingly, the LLC was treated as a disregarded entity wholly owned by the trust.

c. What if LLC used P voting stock, instead of LLC interests, as consideration for the merger? There appear to be two alternative ways to characterize such a transaction.

(i) First, the transaction could be treated as (i) the transfer of T assets to P in exchange for P stock, followed by (ii) the contribution by P of the assets to LLC under section 721. The transfer of T assets in exchange for P stock should qualify as a reorganization under section 368(a)(1)(C). The drop down of the assets to LLC will not violate the continuity of business enterprise requirement, because P and members of P's group own a significant interest in LLC. Treas. Reg. § 1.368-1(d)(4)(iii); see also P.L.R. 9727031 (Apr. 8, 1997). The drop down of assets to S should be tax free under section 351.

(ii) Alternatively, the transaction could be treated as (i) a contribution of P stock to LLC, followed by (ii) a purchase of the T assets by LLC using the P stock as consideration. Although the contribution of P stock to LLC in step 1 should be tax free under section 721, step 2 would constitute a taxable sale. Thus, T would recognize gain or loss on the sale of its assets, and LLC would recognize gain on the use of P stock in the taxable exchange, because LLC would have a zero basis in the P stock under section 723. But see T.A.M. 9822002 (Oct. 23, 1997) (ruling that a partnership is properly treated as an aggregate of its partners for purposes of applying section 1032 and implying that a zero basis would not carry over to the partnership where section 1032 applies).
2. Example 34 – Merger of LLC Into Acquiring Corporation

a. **Facts:** P owns a 99-percent interest in an LLC, and P’s subsidiary, S, owns the remaining 1-percent interest in the LLC. LLC has not elected to be treated as an association. LLC merges into A Corporation pursuant to a state merger statute.

b. **Tax Consequences:** The merger of LLC into A should be treated as (i) the transfer of LLC’s assets to A in exchange for A stock, followed by (ii) the distribution of A stock to P and S in termination and liquidation of LLC.

   (i) LLC’s transfer of assets in exchange for A stock should constitute a taxable exchange of assets. The transfer does not qualify as a tax-free reorganization under section 368, because LLC is not a corporation and, thus, cannot be a party to the reorganization under section 368(b). Moreover, the transfer would not qualify as a tax-free section 351 exchange, unless LLC receives 80 percent or more of A’s outstanding stock in the transfer.

   (ii) Upon the distribution of A stock to the members, no additional gain or loss should be recognized by P, S, or LLC.
B. Example 35 – Multi-Member LLCs in the Consolidated Return Context

1. Facts: P is the common parent of a consolidated group. P owns all of the stock of A, and A owns all of the stock of S. In Year 1, A distributes all of the stock of S to P, realizing gain under section 311(b), but deferring such gain under Treas. Reg. § 1.1502-13. In Year 2, P decides that S’s business should be conducted in partnership form. P forms two new corporations, B and C, to be the members of a newly formed LLC. LLC does not elect to be taxed as an association and is, thus, classified as a partnership by default. S then merges into LLC pursuant to a state statute providing for corporation-to-partnership mergers.

2. Tax Consequences: These are the facts of T.A.M. 9644003 (July 23, 1996). The Service ruled that the merger of S into LLC was treated as the transfer of assets by S to LLC in exchange for membership interests, followed by the distribution of the LLC interests to P in complete liquidation.

3. Deferred Intercompany Gain - The Service further ruled in T.A.M. 9644003 that, as a result of the deemed transfers, S was treated as redeeming its stock held by P. Thus, applying pre-July 12, 1995 law, A was required to restore its deferred section 311 gain under Prior Treas. Reg. § 1.1502-13(f)(1)(vi).

Under the current regulations, the section 311 gain is accelerated under Treas. Reg. § 1.1502-13(f)(5)(i) as a result of the deemed liquidation of S.
C. Change in Number of Members

1. Example 36 – Conversion of Multi-Member LLCs Into Single-Member LLCs

a. Facts: A and B each own a 50-percent interest in LLC. A sells its entire interest to B for $10,000. After the sale, the business is continued by LLC, which is owned solely by B. LLC does not elect to be taxed as an association.

b. Tax Consequences: Upon the sale of A’s 50-percent interest to B, LLC no longer has two owners, but rather has only a single owner. Thus, under the default rules, LLC becomes a disregarded entity. Treas. Reg. § 301.7701-3(b)(ii). The Service addressed the consequences of this conversion in Rev. Rul. 99-6, 1999-5 I.R.B. 1 (Jan. 14, 1999).

(i) Consequences to A. The partnership terminates under section 708(b)(1)(A) when B purchases A’s entire interest in the LLC. Thus, A must treat the transaction as a sale of a partnership interest. See Treas. Reg. § 1.741-1(b).

(ii) Consequences to B. For purposes of determining the tax consequences to B, the LLC is deemed to make a liquidating distribution of all of its assets to A and B, and B is then treated as acquiring the assets deemed to have been distributed to A in liquidation of A’s partnership interest. See McCauslen v. Commissioner, 45 T.C. 588 (1966).
(a) B must recognize gain or loss, if any, on any deemed distribution of cash in excess of B’s basis in his partnership interest to the extent required under section 731. B’s basis in these assets is determined under section 732(b), and B’s holding period for these assets includes the partnership’s holding period for these assets under section 735(b).

(b) With respect to the assets attributable to A’s 50-percent interest, B takes a cost basis of $10,000 under section 1012, and its holding period for these assets begins on the day immediately following the sale.

2. Example 37 – Conversion of Multi-Member LLCs Into Single-Member LLCs in the Consolidated Return Context

<table>
<thead>
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<td>X</td>
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<tr>
<td>Y</td>
<td>50%</td>
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<tr>
<td>LLC</td>
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a. **Facts:** P owns all the stock of X and Y. P, X, and Y join in filing a consolidated return. X and Y each own a 50-percent interest in LLC. X sells its entire interest in LLC to Y for $10,000. After the sale, the business is continued by LLC, which is owned solely by Y. LLC does not elect to be taxed as an association.

b. **Tax Consequences:** As set forth above in Example 36, Rev. Rul. 99-6 treats this transaction differently as to X and Y. Generally, under the matching rule of Treas. Reg. § 1.1502-13(c), gain or loss resulting from a sale of property between members of a consolidated group is deferred until such time as it is no longer
possible to treat the members as divisions of a single entity (i.e., the occurrence of an acceleration event). However, because the asset X is treated as selling (a partnership interest) is not the same asset purchased by Y (an interest in assets), Rev. Rul. 99-6 appears to preclude the operation of the matching rule, thus causing acceleration of X’s gain or loss. The tax consequences of this transaction turn on whether the analysis of Rev. Rul. 99-6 is appropriate in the consolidated return context.

(i) Under Treas. Reg. § 1.1502-13(c)(1), the separate entity attributes of X and Y are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if X and Y were divisions of a single entity. If the partnership interest sold by X is an attribute for purposes of Treas. Reg. § 1.1502-13(c)(1), then the transaction could be redetermined to treat X as selling assets to Y. By treating X as selling assets to Y, the matching rule should operate to defer any gain or loss on the sale. However, if the partnership interest sold by X is not an attribute for purposes of Treas. Reg. § 1.1502-13(c)(1), then it does not appear that X’s gain or loss is deferred under the matching rule.

(ii) **Treatment if Rev. Rul. 99-6 is respected:** If the treatment under the ruling is appropriate in the consolidated return context, and thus, the matching rule does not apply, X’s gain or loss on the sale of the partnership interest should be taken into account immediately.

(iii) **Treatment if Rev. Rul. 99-6 is not respected:** If the treatment under the ruling is not appropriate in the consolidated return context, then it would appear that X’s gain or loss would be deferred until an acceleration event occurs.

**IX. DISADVANTAGES OF USING LLCs**

As set forth above, there appear to be a number of circumstances in which it may prove more beneficial to operate a business in the form of an LLC as opposed to a corporation. However, there are also situations in which use of an LLC may prove less beneficial. Besides the disadvantages listed below, additional disadvantages may arise under state law. For a discussion of issues arising under state law, please see section XI below.
A. Certain LLCs Cannot Be Parties to Reorganizations

1. LLCs that are classified as either partnerships or as disregarded entities may not be parties to a reorganization. See section 368(b). Thus, the owners of such LLCs may not dispose of their interests in the LLC via a tax-free reorganization. In addition, it appears that an attempt to convert such an LLC into a corporation immediately before a reorganization will be disregarded. See Rev. Rul. 70-140, 1970-1 C.B. 73.

2. Example 38 – Achieving Results Similar to a Tax-Free Reorganization

**Facts:** Corporation P owns all of the membership interests in LLC. LLC has not elected to be taxed as an association. X would like to acquire LLC in a tax-free transaction. LLC transfers all of its assets to a newly formed corporation (“Newco”), in exchange for Newco preferred stock. At the same time X Corporation contributes property to Newco in exchange for common stock. In order to convert P’s interest in LLC into stock of X, the Newco preferred stock is convertible into the X stock after a period of years. The conversion feature requires P to present its Newco stock to X for conversion into X stock.

**Tax Consequences:** The transaction should qualify as a tax-free exchange under section 351.

(i) The preferred stock received by LLC in the section 351 exchange should not constitute nonqualified preferred stock
within the meaning of section 351(g), provided it does not contain any of the terms set forth below.

Nonqualified preferred stock is defined as preferred stock that contains one or more of the following terms (section 351(g)(2)):

(a) The holder has a put option;
(b) The issuer or a related person is required to redeem or purchase the stock;
(c) The issuer or related person has a call option, and, as of the issue date, it is more likely than not that the call option will be exercised; or
(d) The dividend rate varies, directly or indirectly, with reference to interest rates, commodity prices, or other similar indices.

(ii) Even if the preferred Newco stock is not characterized as nonqualified preferred stock, the right to convert the Newco stock into X stock may be treated as boot to P. Rev. Rul. 69-265, 1969-1 C.B. 109, provides that the right to convert the Newco stock into X stock (obtained directly from X) constitutes boot on the initial transfer of property to Newco. Thus, the fair market value of the right to convert the Newco stock into X stock is taxable to P at the time LLC transfers all its assets to Newco.

(iii) Alternatively, if the conversion option requires P to obtain the X stock directly from Newco, the conversion right will not be treated as boot to P when LLC transfers its assets to Newco. However, the subsequent exercise of this right would result in a taxable transaction to P. Thus, P’s goal of obtaining the X stock in a tax-free transaction would be frustrated. In addition, Newco may be forced to recognize gain on the conversion (under the zero basis rules) equal to the difference between its basis in the X stock and the stock’s fair market value.

B. Spinning Off a Lower Tier LLC

1. For valid business reasons a corporation may want to distribute the assets associated with a trade or business carried on by the corporation. If the trade or business is carried on through a corporate subsidiary, the distribution may be accomplished by distributing the stock of the subsidiary to the parent corporation’s shareholders. Assuming all the
requirements of section 355 are satisfied, the distribution of stock of the subsidiary will be tax free to both the parent corporation and its shareholders.

2. **Example 39 – Spin-off of an LLC**

   ![Diagram of spin-off process]

   a. **Facts:** Corporation P owns all of the membership interests in LLC. LLC has not elected to be taxed as an association. P would like to distribute the interests of LLC to its shareholders in a tax-free spin-off. LLC transfers all of its assets to a newly formed corporation ("Newco"), in exchange for Newco stock. P then distributes the Newco stock to its shareholders in a section 355 spin-off.

   b. **Tax Consequences:** Because LLC is disregarded as an entity separate from P, P is treated as owning LLC’s assets directly. If P were to spin-off LLC directly, P would be treated as having distributed assets to its shareholders and would be required to recognize gain under section 311. Accordingly, in order to effect a tax-free spin-off of LLC to P’s shareholders, P must first effect a reorganization within the meaning of section 368(a)(1)(D) by transferring LLC’s assets to a newly formed subsidiary. Following
this D reorganization, P may distribute the Newco stock to its shareholders in a tax-free spin-off.⁸

**C. Loss of Basis in the Stock of a Corporate Subsidiary**

1. In the conversion of a corporate subsidiary into an LLC, the subsidiary is usually deemed to liquidate. While this liquidation is generally tax free to both the subsidiary and its parent corporation, it also presents a potential downside to the parent corporation. When a subsidiary liquidates into its parent, the parent's basis in the subsidiary's stock is permanently lost. Thus, in situations where the parent paid a premium for the stock of the subsidiary and did not make an election under section 338(g) or (h)(10), the loss of basis may be too high a cost for the benefit offered by converting to an LLC.

2. **Example 40 – Disappearing Basis**

   ![Diagram]

   a. **Facts:** Corporation P owns all of the stock of S. P and S file a consolidated return. P acquired the stock of S five years ago and has a basis of $300 in the stock. S’s assets have an aggregate basis equal to $50. P forms a wholly owned LLC, which is disregarded for Federal tax purposes, and S merges into it.

   ⁸ Alternatively, LLC could elect to be classified as an association. Because, LLC would then be treated as a corporation for all Federal income tax purposes, P could distribute its membership interests in LLC to its shareholders in a section 355 spin-off.
b. **Tax Consequences:** Pursuant to the merger, S will be treated as contributing its assets to the newly formed LLC in exchange for membership interests in the LLC. S will then be treated as distributing these interests to P in complete liquidation. Under sections 332 and 337, the liquidation will be tax free to both P and S, and P will take a $50 carryover basis in those assets. Because S has liquidated, P’s $300 basis in S disappears.

**X. OTHER ISSUES**

**A. Cancellation of Debt ("COD") Income**

1. The debt of a single-member LLC is treated as debt of its owner. However, for state law purposes, the LLC is the obligor. Thus, a creditor can cancel debt of an LLC. How does section 108 apply to this cancellation?

2. In general, section 108(a) provides that gross income does not include income from the discharge of indebtedness, if the discharge occurs in a title 11 case, or if the discharge occurs when the taxpayer is insolvent.

   a. What if the debt of a single-member LLC, which is a disregarded entity, is discharged in a title 11 bankruptcy proceeding? Is its owner permitted to exclude the COD income? Presumably, the answer is yes. Because the exception for title 11 cases does not depend on the solvency of the taxpayer, the COD income should be excluded regardless of the owner’s solvency.

   b. Now assume that a debt of a single-member LLC is discharged, but the discharge does not occur in a title 11 case (and the other exceptions for farm indebtedness or real property business indebtedness do not apply). In order to exclude the COD income, the taxpayer must be insolvent. At what level is insolvency tested? Because the LLC is a disregarded entity, insolvency would be tested at the owner level. Thus, if the owner is solvent, but the LLC is insolvent, and a debt of the LLC is discharged, presumably the owner has COD income.

**B. Start-Up v. Expansion Costs**

1. Section 195 provides, in pertinent part, that start-up expenditures may, at the election of the taxpayer, be deducted ratably over a period of not less than 5 years beginning with the month the business began. In general, start-up expenditures are amounts paid or incurred in connection with the creation or acquisition of an active trade or business. Amounts paid or incurred after the beginning of an active trade or business may be currently deducted under section 162. Thus, costs to expand an existing trade or business are currently deductible under section 162.
2. For purposes of claiming a deduction for expansion costs under section 162, the existing business of a parent corporation cannot be attributed to its subsidiaries. See Specialty Restaurants Corp. v. Commissioner, T.C. Memo. 1992-221. In Specialty Restaurants, a parent corporation formed nine subsidiaries for the purpose of establishing and operating theme restaurants. Pre-opening expenses were incurred, which were paid by the parent corporation. The Tax Court held that because the subsidiaries were separate entities apart from the parent, the expenses did not constitute expansion costs deductible by the parent, but rather could only be amortized as start-up costs by the subsidiaries. Accordingly, the parent's payment of such expenses constituted a capital contribution to the subsidiaries.

3. The parent corporation in Specialty Restaurants could now use single-member LLCs to convert the amortizable start-up costs into deductible expansion costs. Because the single-member LLCs are disregarded as entities separate from the parent, the activities of the LLCs will be treated as an expansion of the parent's existing trade or business, thus allowing a current deduction.

C. Like-Kind Exchanges

1. In general, section 1031(a) provides that no gain or loss is 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. Section 1031(a)(3) permits deferred exchanges if the replacement property is identified and received within the specified time limitations.

2. Qualifying property – Section 1031(a)(2)(D) provides that an exchange of an interest in a partnership is not eligible for nonrecognition treatment under section 1031. Presumably, a similar limitation exists with respect to interests in an LLC that is classified as a partnership.

   a. Using a single-member LLC, however, may permit section 1031 exchanges of property held by the LLC.
b. Example 41 – 1031 Exchange

(i) **Facts:** LLC-1, a two-member LLC, owns all of the membership interests in LLC-2, which has not elected to be taxed as an association. LLC-2 owns an apartment complex. An individual, C, also owns an apartment complex. LLC-1 transfers its interest in LLC-2 to C in exchange for the apartment complex owned by C.

(ii) **Tax Consequences:** Because LLC-2 is disregarded as an entity separate from LLC-1, LLC-1 is deemed to own the assets of LLC-2, including the apartment complex, directly. Thus, arguably, the transaction qualifies for section 1031 nonrecognition treatment.

3. **Acquiring Replacement Property** – As noted above, section 1031 permits deferred exchanges if the taxpayer acquires replacement property within the specified time limitations.

a. The use of single-member LLCs may provide added flexibility in the acquisition of replacement property. For example, in P.L.R. 9751012 (Sept. 15, 1997), the taxpayer corporation held all of the stock of two subsidiaries. The subsidiaries transferred their hotel properties and identified replacement property. Before acquiring the replacement property, however, the subsidiaries liquidated, and the taxpayer corporation formed separate, wholly owned LLCs for each replacement property. The Service ruled that the transaction
qualified under section 1031. The taxpayer succeeded to the subsidiaries’ tax attributes in the liquidation, including their status with respect to the section 1031 exchanges, so the taxpayer was treated as the transferor. The taxpayer was also treated as the transferee of the replacement property, because the assets of the LLCs are treated as owned directly by their owner.

b. Similar flexibility should be permitted in acquiring replacement property for purposes of the involuntary conversion provisions of section 1033.

D. Employment Issues

1. Employer Identification Number (“EIN”)

a. The final check-the-box regulations do not address the issue of whether a disregarded entity is required or permitted to obtain its own EIN. The proposed amendments to the regulations, however, add special rules under Treas. Reg. § 301.6109-1 for disregarded entities. The proposed rules provide that a disregarded entity “must use its owner’s taxpayer identification number (TIN) for federal tax purposes.” Moreover, the proposed rules provide that when a disregarded entity becomes recognized as a separate entity, the entity “must acquire an EIN and not use the TIN of the single owner.” This language could be interpreted to mean that a disregarded entity is not permitted to obtain an EIN that is separate from its owner’s.

b. However, based upon informal conversations with personnel at the National Office of the Internal Revenue Service, we understand that there is no restriction on a disregarded entity obtaining its own EIN if a separate EIN is needed (for example, some states require that the disregarded entity have its own EIN). In Notice 99-6, 1999-3 I.R.B. 1 (Jan. 5, 1999), the Service provided that until final guidance is issued, the Service will generally accept reporting and payment of employment taxes with respect to employees of a QSSS or an entity disregarded as an entity separate from its owner under Treas. Reg. § 301.7701-2 if made in one of two ways. First, calculation, reporting, and payment of all employment tax obligations with respect to employees of a disregarded entity by its owner (as though the employees of the disregarded entity are

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10 Id. § 301.6109-1(h)(ii) (emphasis added).
employed directly by the owner) and under the owner’s name and the owner’s EIN. Second, separate calculation, reporting, and payment of all employment tax obligations by each state law entity with respect to its employees under its own name and EIN. If the second method is chosen, the owner retains ultimate responsibility for employment tax obligations of the owner incurred with respect to employees of the disregarded entity.

2. **Employment and Withholding Taxes** – Is a disregarded entity considered an employer for Federal employment tax purposes?

a. Although there is no specific guidance on this issue, the owner of the disregarded entity is likely to be considered the employer for employment tax purposes. If the proposed regulations regarding EINs for disregarded entity become final, a disregarded entity will not be permitted to file employment tax returns, and the owner will have to do so. See Treas. Reg. § 40.6109(a)-1(a).

b. This is consistent with the general rule in Treas. Reg. § 301.7701-1(a) that the check-the-box regulations apply for “federal tax purposes,” which implies applicability for all Federal tax purposes, including the Code’s employment tax provisions.

c. Moreover, this is consistent with cases and rulings dealing with employees of divisions or branches. See *In re Rutherford*, 95-1 U.S.T.C. ¶ 50,281 (S.D. Ohio 1995) (shareholder/president of corporation that had two separate divisions was the responsible party for withholding tax purposes); T.A.M. 8422012 (Feb. 8, 1984) (employees of both divisions of a corporation were held to be employees of the corporation); T.A.M. 7939011 (June 13, 1979) (parent corporation was the employer for withholding and FICA tax purposes, even though regular wages were paid by the corporation’s separate divisions or subsidiaries).

d. On the other hand, if Notice 99-6 is adopted by the Service, disregarded entities will have the flexibility to treat the owner or the disregarded entity as the employer. Given the practical difficulties faced by owners with multiple disregarded entities (which may be located in different states and subject to different employment laws), the flexible approach of Notice 99-6 makes sense.

3. **Employee Retirement Plans**

a. Section 401(a) provides that a trust “forming part of a stock bonus, pension, or profit sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries” constitutes a
qualified trust if it meets the other requirements of section 401. (Emphasis added.) Thus, if a disregarded entity cannot be an employer for Federal tax purposes, it cannot separately maintain a qualified plan, and any plan established by the disregarded entity would be treated as a plan of its owner.

b. Even if the disregarded entity could separately maintain a retirement plan, the disregarded entity and its owner would likely be treated as a single employer for purposes of applying the qualification rules of the Code. See section 414(b), (c).


E. Filing Requirements

1. A disregarded entity should not be required to file a separate income tax return. Indeed, if the proposed regulations regarding EINs becomes final, a disregarded entity will not be permitted to file a separate return. See Treas. Reg. § 40.6109(a)-1(a).

2. This is consistent with rulings involving arrangements under which all of the economic interests of a foreign entity are held by a single U.S. person. In such instances, the Service has held that because the entity is neither a corporation nor a partnership, it is not required to file a Form 1120 or Form 1065. See, e.g., P.L.R. 7802012 (Oct. 11, 1977); P.L.R. 7748038 (Aug. 31, 1977); P.L.R. 7743060 (July 28, 1977).

XI. STATE TAX CONSIDERATIONS

A. State Treatment of LLCs

Currently, all 50 states and the District of Columbia have adopted legislation that permits the formation of an LLC. A majority of these states have either issued public rulings, regulations or adopted legislation stating that they will conform to the Federal check-the-box regulations. See Bruce P. Ely and Christopher R. Grissom, State Tax Treatment of Limited Liability Companies and Registered Limited Liability Partnerships (as of September 25, 1998), State Tax Notes (Nov. 9, 1998). Listed below are the jurisdictions that have specifically stated that the Federal check-the-box regulations will be followed in the classification of an LLC for purposes of state taxation. Id.
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<thead>
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<td>Mississippi*</td>
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<tr>
<td>District of Columbia*</td>
<td>Missouri</td>
<td>Tennessee*</td>
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<tr>
<td>Florida</td>
<td>Montana*</td>
<td>Utah</td>
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<td>Georgia</td>
<td>Nebraska</td>
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<td>Hawaii</td>
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<tr>
<td>Idaho*</td>
<td>New Mexico</td>
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<td>Illinois</td>
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<td>Indiana</td>
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<tr>
<td>Iowa</td>
<td>North Dakota</td>
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It should be noted, that although these states follow the Federal entity classification rules, an entity may still have to file a state tax return even if a federal return is not necessary. For example, Alabama will treat a single-member LLC as a disregarded entity, but the single-member LLC must still file a partnership return. *Id.*

The remaining states classify LLCs as follows (id.):

1. While Arkansas taxes domestic LLCs as partnerships, it follows the Federal classification for foreign LLCs.

2. Michigan subjects LLCs to a single business tax, and its members are subject to tax on the LLC income.

3. Currently, New Hampshire follows the Federal classification of multi-member LLCs, however, the treatment of single-member LLCs is unclear.

4. Texas subjects LLCs to the corporate franchise tax.

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11 It should be noted that attorneys are not able to limit their liability for malpractice by operating their legal practice as an LLC. Attorneys remain jointly and severally liable for the malpractice of co-owners of the practice.

12 SMLLCs are disregarded for income tax purposes but are subject to state franchise taxes.

*Despite the general adoption of the Federal check-the-box regulations, these states either specifically do not allow domestic single-member LLCs or are ambiguous as to whether they are permitted.
5. Nevada does not have an income tax; therefore, the classification of an entity is irrelevant for state purposes.

6. Washington taxes LLCs as partnerships, however, it should be noted that Washington does not have a personal income tax.

7. Wyoming does not have an income tax; therefore, the classification of an entity is irrelevant for state purposes.

B. Achieving Consolidated Results in States That Prohibit Consolidation - Some states do not permit the filing of consolidated returns. Thus, consolidated groups are not able to combine their tax items in determining the group’s state tax liability. It may be possible to obtain results similar to consolidation through the use of single-member LLCs as opposed to corporate subsidiaries. There are a number of states that follow the Federal classification of entities and treat a single-member LLC as disregarded entity. In these jurisdictions, single-member LLC would be treated as divisions of a corporate owner, and the tax items of the LLC would flow directly to the corporate owner. Thus, corporations that choose to operate their “subsidiary” activities through a single-member LLC will be able to achieve state tax consolidation, while a consolidated group of corporations will have to file separate state tax returns.

C. Achieving Section 338(h)(10) Results in States That Do Not Recognize the Election

1. As discussed above in Example 14, the election under section 338(h)(10) allows a purchaser to step up the basis of the assets of a purchased entity to reflect the purchase price paid for the entity. The cost of such an election is that the selling group must recognize gain on the difference between the purchase price and the target’s basis in its assets. The gain triggered is included in the seller’s consolidated taxable income and may be offset by losses sustained by other group members. Because many states do not recognize this election, a purchaser will have different a basis for the acquired entity’s assets for Federal and state tax purposes.
2. Example 42 – Achieving Section 338(h)(10) Treatment for State Tax Purposes

a. **Facts:** Corporation P owns all of the stock of S. P and S were organized in a state that does not permit section 338(h)(10) elections, but that does follow the check-the-box regulations. P forms a wholly owned LLC and merges S into the LLC. P then sells 100 percent of the LLC interests to X, an unrelated party, in exchange for cash.

b. **Tax Consequences:** As discussed above, the conversion of S into an LLC will be treated as a section 332 liquidation. Because the state follows the check-the-box regulations, the LLC will be disregarded as an entity separate from P. Thus, upon the sale of its interests in LLC, P should be treated as selling the assets of LLC directly to X, and X should be treated as purchasing LLC's assets directly from P. Therefore, despite the state's nonrecognition of the section 338(h)(10) election, a purchaser of an interest in a single-member LLC should be able achieve the same tax treatment as if the state recognized the section 338(h)(10) election.