Exploring the Benefits of the Corporate Freeze Transaction

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Synopsis

The distribution of a C corporation's assets to its shareholders often triggers a heavy double tax burden. A corporate freeze transaction provides a way to distribute the future growth of a trade or business out of the corporate form without triggering double taxation. The first step in structuring a corporate freeze transaction involves the corporation contributing a business activity's assets to a limited liability company in exchange for a preferred LLC interest. The second step involves the issuance of common LLC equity to investors and service providers.

The key tax issue associated with the corporate freeze revolves around whether the preferred LLC interest issued to the corporation equates to the fair market value of the business activity assets contributed by the corporation. Note that this article focuses on corporate "business" freezes that are not part of a family's estate, gift and or income tax planning. Freeze transactions that involve families bring into consideration Section 2701 and other estate and gift tax planning provisions of the Internal Revenue Code.

Corporations are popular entities of choice for business activities.

Selecting the C corporation as the entity of choice has gained in popularity over the past several years. For some business owners, the extreme reduction of the corporate tax rate from 35% to 21% tipped the scales towards the C corporation. If that wasn't enough reason to select the C corporation, being positioned to potentially claim Section 1202's generous gain exclusion provided further icing on the cake.[1]

But sometimes business owners want to distribute assets out of a corporation.

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Situations do arise where business owners no longer want to operate one or more business activities through a C corporation. In some cases, owners realize that they have two or more incompatible business activities operating through one C corporation, making it awkward to attract debt and equity investors or potentially making it tax-inefficient to sell only part of the business. In other cases, owners conclude that operating the business activity through an LLC (taxed as a partnership) is simply the better choice from a tax standpoint. Business owners in these situations often first explore either making an S corporation election or undertaking a Section 355 split-up of the corporation, but these options are often not available for technical tax reasons. Also, some owners want to create a path for contributing the frozen business assets to a newly formed C corporation for purposes of positioning themselves for obtaining the benefits of selling qualified small business stock (QSBS) under Section 1202.

Unfortunately, distributing assets out of a C corporation often triggers an unacceptable (double) tax burden.

Although there may be compelling business and tax reasons for undertaking the restructuring outlined in the preceding paragraph, the difficulty lies in finding a way to effectively distribute an interest in assets held by a C corporation without subjecting the corporation and stockholders to an unacceptable tax burden. A liquidation of the corporation would be treated for tax purposes as a deemed sale of the corporation's assets at their fair market value, with any gain taxed at the 21% corporate tax rate.[2] At the stockholder level, the distribution of the assets would be treated as a taxable distribution or deemed stock sale. Not surprisingly, exposure to double taxation makes this type of restructuring prohibitively expensive.

Sometimes a corporation's assets can be divided into two brother-sister corporations using Section 355, but this approach requires a corporation with two business activities that each have a five-year operating history, along with satisfaction of several other eligibility requirements. In many cases, Section 355 won't present a viable planning option, not to mention that the goal of the restructuring is

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often to take assets out of corporate form, rather than doubling down on C corporations. Making an S election can be another planning option. But the S corporation often fails to satisfy all of the goals of the parties, and there are many instances where the corporation will have owners who are ineligible to hold S corporation stock. This is the point where the corporate freeze enters the picture as a viable planning option.

How does a corporate freeze avoid triggering double taxation in connection with "removing" assets from corporate ownership?

The "corporate freeze" provides a partial solution to the double taxation problem. In a corporate freeze, some or all of the corporation's business assets end up in an LLC taxed as a partnership. Unlike a complete liquidation of the corporation or distribution of assets by the corporation, each of which triggers a deemed asset sale and double taxation, the corporate freeze does not remove the assets entirely from corporate ownership (the corporation remains an indirect owner of the assets through the holding of a preferred LLC interest), but it does shift a significant share of the future appreciation of the assets to non-corporate owners. This shift is accomplished by bringing investors and service providers in as holders of some of the LLC's common equity (either through the purchase of common units to investors or the issuance of profits interests to service providers governed by Revenue Procedure 93-27). The "freeze" aspect of the restructuring means that the original stockholders equity interest is "frozen" through the holding of a preferred interest, with a substantial share of the upside of the business held by a new group of non-corporate owners.

The reason why a corporate freeze transaction generally avoids triggering double taxation is because the transaction is structured to be governed by Section 721, which generally allows for tax-free exchanges of property for LLC equity and/or Section 83 and Revenue Procedure 93-27, which govern the issuance of profits interests to service providers. The corporation is issued a preferred LLC interest in exchange for its assets that is designed to have a value at least equal to that of the contributed assets. Of course, the price for avoiding the triggering of double tax is the fact that the

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corporation retains a significant economic interest in the business, which in our opinion should include both the current value of the frozen assets, plus a meaningful share of the future upside associated with such assets. Properly structured and valued, the "frozen" asset value is not actually removed from corporate ownership. As mentioned above, the newco LLC's other owners contribute cash, other property or services for their "common" (and sometimes preferred) interests.

A possible variation of the corporate freeze transaction involves the issuance of preferred units to the corporation and the distribution of common units to the corporation's stockholders. The distribution of common units would be subject to double taxation, but the value of the distributed units might be quite low where the economic and governance features associated with the preferred equity are substantial relative to the value of the frozen assets.

Structuring corporate freeze transactions.

Many corporate freeze transactions will start with an "F" reorganization involving the creation of a new holding company and the conversion of the prior C corporation into a disregarded LLC for federal income tax purposes. This preliminary step is often used where it would cause regulatory or third-party consent or other logistical problems associated with transferring assets to a newco LLC. In an "F" reorganization, the historical C corporation converts into a disregarded LLC through a statutory conversion or merger transaction, so in either case, assets, liabilities and contracts of the historical C corporation are inherited by the LLC subsidiary by operation of law, which often creates less of a burden than physically transferring assets, liabilities and contracts to a new LLC subsidiary. If there are assets that are to be excluded from the LLC, they can be assigned out of the LLC after completion of the "F" reorganization.

A critical aspect of the corporate freeze is to make sure that the value of the corporation's LLC interest received in exchange for the deemed contribution of assets to the LLC equals or exceeds the value of the contributed assets.[3] The safest approach would be to obtain an independent valuation of the assets contributed to the

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LLC and set the liquidation preference payable to the corporation equal to or greater than this appraised value.[4] The IRS always has the power to challenge the corporation's valuation, and if successful, the IRS could take the position depending on the identity of the LLC's other members that the spread between the corporation's value and IRS's value represents a distribution subject to double tax or taxable compensation to the LLC's service providers who are issued common units. Where a corporate freeze is challenged by the IRS, we believe it should help the taxpayer's case if the corporation's preferred units not only have a liquidation and distribution preference, but also carry a reasonable return and participate at some meaningful level with the common unit holders in the upside of the business. Other features that might further enhance the value of the preferred units are voting and other governance rights commonly associated with preferred units issued in venture capital financing rounds.

In the corporate freeze, the unitholders other than the corporation might consist of the LLC's service providers who are issued profits interests,[5] investors who are issued common or preferred units in exchange for cash or property contributions, and/or some or all of the corporation's stockholders who are issued the economic equivalent of profits (common) units. A further possible transaction structure involves the formation by the corporation of the LLC subsidiary (whether or not the "F" reorganization is utilized), followed by a distribution of common units to the corporation shareholders. The units distributed to the shareholders would be taxable at their fair market value at the corporation level and again as a dividend at the shareholder level.

There often is a natural desire to keep the value of the distributed units as low as possible, given the tax consequences, but unless the units are issued directly by the LLC to its service providers (thereby bringing the units within the scope of a profits interest under Revenue Procedure 93-27), the approaches usually employed for valuing transferred carried interests (which are essentially profits interests with economic features comparable to the distributed units) are the option pricing and discounted cash flow methods, neither of which typically results in a *de minimis* valuation for the common equity.[6] On the other hand, common units issued in a

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corporate freeze are not unlike founders' stock, which are typically the beneficiary of low valuations that are not routinely challenged by the IRS[7], notwithstanding the fact that they have been described as being economically equivalent to an at-the-money call option on the common stock of a company.

Another possible transaction associated with the corporate freeze is one where the corporation's owners desire to spin out some assets with the goal of ultimately incorporating the partnership's business and thereby positioning the owners to potentially take advantage of Section 1202's gain exclusion. The corporation will not be able to claim Section 1202's gain exclusion with respect to its preferred stock, but other LLC members could potentially claim the gain exclusion if all of Section 1202's eligibility requirements are satisfied.[8]

Tax issues potentially implicated by a corporate freeze transaction.

There are few tax authorities addressing freeze transactions that don't involve family generational wealth transfer planning (which is outside the scope of this article focusing on "business" freezes).[9] The principal tax issue associated with a corporate "business" freeze appears to be one of valuation – i.e., is the preferred interest issued to the corporation in exchange for its business assets substantially equal in value to the assets held by the LLC at the time of issuance? A companion tax issue is whether the common units are properly valued in connection with their purchase, issuance for services or distribution by the corporation.

There are several tax doctrines that the IRS could call upon if attacking a corporate freeze that lacks a valid business purposes beyond tax savings, including the economic substance doctrine codified as Section 7701(o) and the partnership anti-abuse regulations (Treasury Regulation Section 1.701-2).[10] Section 482 is yet another provision that could potentially be asserted by the IRS as an argument for the reallocation of income between the corporation and the LLC, but the potential application of this provision may be subordinate to the IRS's argument that the value of the corporation's preferred interest falls well short of the value of the contributed business assets. But in connection with a corporate

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"business" freeze, the parties will often be able to cite several compelling non-tax business purposes for seeking the benefits of the LLC resulting from the corporate freeze, including better opportunities to grow and finance the business, the ability to take advantage of the LLC's governance structure, the benefits of separating business activities into separate entity buckets, and the LLC's favorable equity compensation arrangements (e.g., profits interest). In the course of one discussion of corporate freezes, practitioners "confidently" expressed doubt that the economic substance doctrine could be successfully invoked in the context of a corporate freeze where the principal tax issue would appear to be one of valuation rather than a transaction which lacks independent economic substance.[11]

Attorneys at Frost Brown Todd have developed substantial expertise assisting business clients with respect to tax planning and equity and bonus compensation arrangements. If you need assistance or would like additional information, contact Scott Dolson of Frost Brown Todd's **QSBS & Tax Planning Services** team.

This article is one of a series of posts related to planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Code.

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[1] For those holders of qualified small business stock (QSBS) meeting a number of eligibility requirements, including owning originally issued C corporation stock for at least five years, Section 1202 provides a generous per taxpayer, per issuer gain exclusion of at least $10 million. See our Section 1202 Qualification Checklist and Planning Pointers.

[2] The planning process should include consideration of whether the corporation has any net operating losses that could be used to offset gain on the deemed sale of its assets.

[3] Both the admission of a second member to a disregarded LLC that was the resulting entity post- "F" reorganization, or the admission of a second member after a corporation organizes an LLC and contributes assets in exchange for its preferred equity, should be treated as the formation of a partnership for federal income tax purposes governed by Section 721.

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[4] Depending on the economics associated with the business (i.e., does it throw off cash that is expected to be distributed), it may make sense to structure the liquidation preference to include an operating distribution preference versus common units.

[5] Profits interests under Revenue Procedure 93-27. Units issued to service providers where the corporation is issued a preferred interest with the features discussed in this article should qualify as "profits interests" because the liquidation preference payable to the preferred units should substitute for a "distribution threshold" typically found in LLC arrangements where the goal is to issue profits interests to service providers.

[6] See, for example, Marcus Ewald and Brendan Smith of Stout, *Carried Away: Valuation of Carried Interests for Transfer Purposes* and Andersen Tax LLC, *For the Record: Avoiding Hazards in Transferring Carried Interests*. For a good look at the difficulty that the courts had in valuing profits interests prior to the IRS conceding the field with Revenue Procedure 93-27, look at the Tax Court's discussion of the valuation issues in *Campbell v. Commissioner*, T.C. Memo 1990-162.

[7] See Fleischer, *Taxing Founders' Stock*, 59 UCLA L. Rev. 60 (2011). Fleischer footnotes Gilson & Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 Harv. L. Rev 874 (2003) as basically referring to founders' stock as a subsidiary: "Specifically, the government's tolerance of aggressively low valuations might be understood as a form of tax subsidy for high-tech startups, targeted at a critical feature of the venture capital contracting process: the high-intensity performance incentives provided to managers of early-stage companies. The IRS allows a substantial portion of a high-tech startup manager's compensation—in effect, wages for services—to be taxed as capital gain, instead of as ordinary income."

[8] One eligibility requirement that would need to be carefully examined is the $50 million aggregate gross assets limitation. Because the original corporation holds a substantial equity interest in the newco corporation, Section 1202's parent-subsidiary rules are likely to require its assets to be aggregated with those of the subsidiary for purposes of the $50 million test.

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[9] This article focuses on corporate "business" freezes that are not part of a family's estate, gift and or income tax planning. Freeze transactions that involve generations of families bring into consideration provisions such as Section 2701 and other family partnership provisions. For a thorough discussion of partnership freezes, see Rubin and Cavanagh, "*Guidelines for Using a Partnership Freeze to Reduce Corporate Taxes: Part I*" (7 J. Partnership Tax'n 299) and "*Guidelines for Using a Partnership Freeze to Reduce Corporate Taxes: Part II*" (8 J. Partnership Tax'n 3) (1991).

[10]Where the corporate freeze involves taking the future appreciation of certain business activities outside of corporate ownership into an LLC, but then is followed by the contribution of those same assets into a new corporation using Section 351, resulting in the issuance of QSBS that might be eligible for the Section 1202 gain exclusion, the IRS could theoretically make additional arguments based on the step transaction doctrine or the liquidation reincorporation doctrine (see Treasury Regulation Section 1.331-1(c), which provides that under certain circumstances a complete liquidation followed by a reincorporation might be recharacterized as a dividend – but obviously a corporate freeze transaction is not a liquidation, hence the focus on valuation (undervaluation of the frozen assets) issues as the most significant IRS threat associated with the corporate freeze transaction). See Revenue Ruling 76-429 for an example of a liquidation reincorporation of a subsidiary. That ruling indicates that the Section 332, which applied to the liquidation of a subsidiary by a corporate parent, was intended to be applicable to a complete liquidation where "the assets will no longer remain in their present form of corporate solution and that the activities will cease to be carried on in corporate form with the same shareholder." The liquidation reincorporation doctrine is intended to address situations where the liquidating corporation takes advantage of the tax benefits of liquidation (e.g., the use of NOLs) and then reincorporates. The liquidation reincorporation doctrine doesn't appear to be applicable to corporate freeze transactions because there is no liquidation. With respect to the possible application of the step transaction doctrine, the IRS would need to argue that the

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transaction should be reconfigured to eliminate the step where the assets are contributed into a partnership, prior to their contribution into a newco corporation. Here it would be necessary to take the proposed transaction and restructure it to involve (for purposes of the application of the step transaction doctrine) as the formation of a subsidiary of the original corporation, followed by the distribution, if applicable, of the common stock of that subsidiary to the original corporation shareholders (rendering those shares not QSBS because they would then fail the original issuance requirement). A relevant question here would be whether the step transaction doctrine can be invoked to require the taxpayer to restructure the ordering of a transaction to achieve the most unfavorable tax consequences (i.e., failure of the stock to qualify for QSBS treatment).

[11] See Elliott, Tax Notes, "*IRS Officials Indicate Economic Substance Not at Issue in Corporate Freezes*" (posted on June 11, 2013).

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