Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1

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Many owners who operate their business through a limited liability company or limited partnership consider at some point whether to convert their business into a C corporation.[1] C corporations are taxed at a flat 21% tax rate and stockholders of C corporations may be eligible to claim Section 1202's gain exclusion if they hold qualified small business stock (QSBS).[2] Previous articles have discussed the generous tax benefits associated with Section 1202's gain exclusion.[3] This gain exclusion is available only in connection with the sale or exchange of stock issued by a domestic (US) C corporation.

This two-part article provides guidance for business owners converting their Partnership into a C corporation. Part 1 addresses general business and tax considerations. Part 2, available here, addresses Section 1202 issues associated with Partnership conversions.[4]

I. Why do business owners elect to convert their tax partnership (LLC/LP) into a C corporation?

There are several reasons why a business owner might elect to convert a Partnership into a C corporation. [5] Business owners raising capital often run into investors who require the conversion so that they can purchase corporate stock or a corporate SAFE instrument rather than invest in a pass-through entity. Business owners might be attracted by the tax benefits of operating in a C corporation. The 21% federal income tax rate is particularly attractive if business owners intend to reinvest profits into growth and avoid the C corporation's double taxation problem. The benefits of Section 1202 are available only to holders of domestic (US) C corporation stock. Finally, if a sale to an ESOP is being considered, the owners might want to take advantage of Section 1042's deferral of gain, which is available only in connection with the

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sale to an ESOP of stock issued by a domestic (US) C corporation.

II. Why do business owners elect to operate their business outside of a C corporation and then later convert to C corporation status?

Prior to 2018, a side-by-side comparison of the benefits of operating through a C corporation versus a Partnership weighed heavily towards the Partnership.[6] Many closely held businesses were organized as LLCs after all 50 states passed LLC acts during the 1980s and 1990s. But the C corporation began to garner more attention when Section 1202's current 100% gain exclusion was coupled with a dramatic reduction in the federal corporate tax rate from 35% to 21%.

In spite of the C corporation's attractive tax benefits, there are several reasons why business owners might choose to operate initially as a Partnership, delaying incorporation and the issuance of QSBS. Some business owners want to take advantage of the pass-through of early-stage operating losses. C corporations are separate taxpayers and losses do not pass through to stockholders. Section 1202's "10X" gain exclusion cap provides a reason to grow a Partnership's value prior to conversion.[7] Gain on the sale of QSBS is generally subject to a $10 million per-taxpayer, per issuer exclusion cap. But Section 1202 also has a companion 10X gain exclusion cap, which permits a taxpayer to exclude 10 times the aggregate tax basis of QSBS sold in a given tax year. If a Partnership converts when its assets are valued at $45 million, a 10% owner has a potential $45 million Section 1202 gain exclusion. The cap works in this fashion because Section 1202 provides that for purposes of the 10X cap, property contributed upon conversion of a Partnership is treated as having a fair market value tax basis. The desire to build up value outside of the corporate form must be weighed against the requirement that Section 1202's gain exclusion is not available until a stockholder's holding period for his QSBS exceeds five years.

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III. Tax issues associated with Partnership conversions.

III.A. Tax consequences associated with the various methods available to convert Partnerships into corporations for tax purposes.

There are several methods available for converting a Partnership to a corporation. Revenue Ruling 84-111 should be reviewed for a more detailed look at how the method chosen affects the stockholders' and corporation's tax basis, holding period and other collateral tax aspects. The normal tax rules associated with the conversion of a Partnership to a corporation must be considered and understood, regardless of whether a goal of the conversion is taking advantage of Section 1202's gain exclusion down the road.

Revenue Ruling 84-111 describes the tax treatment for three methods to incorporate a Partnership:

> ***Situation 1 – the "assets over" method***. The Partnership's assets are contributed to the corporation in exchange for the corporation's "stock," (which might be an LLC/LP interest depending on how the conversion is accomplished) followed by the Partnership's termination and distribution of the stock in liquidation.
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> ***Situation 2 – the "assets up" method***. The Partnership's assets are distributed by the Partnership to its partners in termination of the Partnership, followed by the contribution of assets by the partners to the corporation in exchange for the corporation's stock.
>
> ***Situation 3 – the "interests up" method***. The partners transfer their Partnership interests to the corporation in exchange for the corporation's stock.

Revenue Ruling 84-111 describes how the IRS views the consequences of each method of conversion. The tax consequences differ depending on which method is chosen. In addition to the tax consequences associated with each of the three conversion categories identified by the IRS, there are a number of different ways to physically accomplish a conversion of a

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Partnership into a domestic (US) C corporation:

III.A.1. *Conversion through the filing of a "check-the-box" election*. A Partnership can file a "check-the-box" election on Form 8832 to be taxed as an association taxable as a corporation. Under Treasury Regulation Section 301.7701-3(g)(1)(i), a Partnership that elects to be classified as an association is treated a contributing all of its assets and liabilities to the association in exchange for stock in a Section 351 nonrecognition exchange, and immediately thereafter the Partnership is deemed to have liquidated and distributed the association's stock to the partners. See, "To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)."

The check-the-box conversion method certainly wins from a simplicity standpoint. Going forward, the owners of the corporation have the option of retaining intact the economic provisions of the LLC or LP agreement. But a complicated Partnership distribution waterfall will necessarily result in multiple economic classes of corporate equity. There is also a risk that venture investors will not react well to being asked to invest in a corporation that has multiple classes of partnership-like equity, including preferred classes of equity and profits interests subject to "distribution thresholds."

If the Partnership's owners do desire to simplify the economic structure and bring it in line with a standard corporate-style capitalization structure, then the various economic rights and priorities associated with the Partnership's distribution waterfall can be converted with some effort into a single class of common equity, or multiples classes of common and preferred equity. In some cases, this conversion might be difficult to accomplish satisfactorily because relative distribution rights sometimes shift as a Partnership's enterprise value increases. For example, if a fixed point in time is chosen to convert a carried interest into common stock (most likely using a liquidation method for allocating ownership in the Partnership), the holders of those profits interests might be entitled to fewer shares of common stock than they would receive if conversion took place at a later date (after further appreciation in the company's enterprise value). If profit interests are issued and the Partnership is converted before any increase in

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the Partnership's enterprise value occurs, the holders of profits interests would not be entitled to any share of the corporation's stock in a conversion, assuming the allocation is based on the Partnership's liquidation waterfall. On the other hand, if the liquidation method isn't used for determining the relative economic value of each Partnership's equity interest being converted into corporate stock, what method should be used? An "option value" can be placed on the potential economic value of the profits interest, but who determines what that value should be? Also, if the capital interest of a profit interest holder increases in connection with the conversion, there is an argument that the increase should be treated as taxable compensation. One approach might be to issue one class of common equity and one class of preferred equity and then tweak the arrangement to fit the Partnership's distribution waterfall. The preferred stock would be divided among the partners to reflect their relative economic interests in the Partnership on the date of conversion, while the common stock would be allocated between the investors and holders of carried interests respectively, based on the 80%/20% sharing of appreciation above the preferred stock's liquidation preference.

One way to avoid the thorny issues discussed in the preceding paragraph would be to structure the conversion as a contribution of assets by the Partnership to a corporation in exchange for the corporation's stock. If an actual contribution of assets, liabilities and contracts is impractical, a pre-conversion restructuring can be undertaken to place a Partnership holding company over the operating Partnership entity and then causing the new Partnership holding company to contribute its 100% membership interest to the corporation in exchange for the corporation's stock. The contribution of the membership interest would be treated as a contribution of assets and liabilities of the entity for tax purposes. The Partnership would then hold the stock until it is sold and the sales proceeds would then be distributed among the Partnership's owners in accordance with the distribution waterfall. This approach has the benefit of retaining intact the Partnership's economic waterfall arrangement while at the same time allowing for a customary capitalization structure at the corporate level. The Partnership's LP or LLC agreement should be amended to reflect

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the change in tax status from a partnership for tax purposes to a C corporation.

The "assets over" method should work for Section 1202 purposes because Section 1202(h)(2)(C) allows for the distribution of QSBS by a partnership to its partners. The shares of QSBS continue their partnership-level holding period and QSBS status in the hands of the distributee partners. But note that the "assets over" method won't work for purposes of Section 1244's ordinary loss treatment on the sale of certain stock, because there is no corresponding provision allowing for the distribution of Section 1244 stock from a Partnership to its partners. See Part 2 of this article for a more in-depth consideration of the intersection of Section 1202 and Partnership conversions.

III.A.2. ***State law conversion of a Partnership to a corporation***. Most state entity laws allow for conversion of an LLC or LP to a corporation by filing a conversion document (e.g., articles or certificate of conversion) with the Secretary of State (sometimes referred to as a "formless" conversion). Revenue Ruling 2004-59 provides that when a Partnership converts under a state law formless conversion statute, the entity will be deemed to have undertaken a Situation 1 "assets over" conversion with the same results as where the entity files a check-the-box election.[8] The Situation 1 "assets over" conversion should work for Section 1202 purposes. But the stock issued in an "assets over" conversion won't qualify as Section 1244 stock.

Under state entity statutes, a formless conversion is treated as an "operation of law" transaction, where the resulting business entity inherits by operation of law all of the assets and obligations of the converted entity. A statutory conversion should reduce the number of third party and regulatory consents and notifications that are required, but some Partnerships will have agreements with change-of-control provisions (not tied to beneficial ownership) or regulatory provisions that are triggered by the entity conversion.

Unlike making a check-the-box election, where no change is made to the entity for state law purposes, a statutory conversion will cause the entity to become a corporation for state law purposes and be governed by the state's business corporation statutes. The

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Partnership's LP or LLC agreement should be amended or replaced by a stockholders agreement and bylaws to reflect the change in state statutes governing the business and change in tax status. As discussed above, drafters of the corporate governance documents might elect to keep intact the Partnership's distribution waterfall economic provision or could translate the Partnership's distribution waterfall into preferred and common stock, or perhaps less frequently, just common stock.

III.A.3. ***Merger of the Partnership into a corporation or the corporation's acquisition subsidiary (corporation or LLC) in exchange for corporate stock***. This approach is often selected where a state doesn't have an applicable conversion statute, or where the parties desire to both convert and re-domicile the Partnership (e.g., the merger of a Kentucky LLC into a Delaware corporation to accomplish in one transaction both redomiciling the business and conversion from partnership to corporation for tax purposes).

If the Partnership does not survive the merger, the transaction should be a good Section 351 exchange and be treated as a Situation 1 "assets over" conversion under Revenue Ruling 84-111.[9] As discussed above, the Situation 1 "assets over" conversion should work for Section 1202 purposes. But as also noted above, the stock issued in an "assets over" conversion won't qualify as Section 1244 stock.

If the merger results in a corporation holding all of the Partnership's LP or LLC interests, the transaction should be a good Section 351 nonrecognition exchange, and be treated as a Situation 3 "interests up" contribution of partnership interests under Revenue Ruling 84-111.[10]

III.A.4. ***Actual contribution of assets by the Partnership***. An actual contribution of assets, liabilities and contracts by a Partnership to a corporation, followed by a liquidating distribution by the Partnership of the corporate stock in exchange for Partnership equity interests is a Situation 1 "assets over" transaction under Revenue Ruling 84-111.

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An alternative to the Situation 1 "assets over" scenario as described in the ruling would be one where the Partnership doesn't liquidate and continues to hold the stock of the corporation, which should qualify as a good Section 351 nonrecognition exchange of property for stock, and will also work for Section 1202 purposes, since a Partnership as a "pass-thru" entity can take advantage of Section 1202. As noted above, the "assets over" method should work for Section 1202 purposes because Section 1202(h)(2)(C) allows for the distribution of QSBS by a Partnership to its partners. The shares of QSBS continue their partnership-level holding period and QSBS status in the hands of the distributee partners. But note that the "assets over" method won't work for purposes of Section 1244's ordinary loss treatment on the sale of certain stock, because there is no corresponding provision allowing for the distribution of Section 1244 stock from a Partnership to its partners.

III.A.5. ***Actual distribution of assets to partners, followed by the partners contribution of the assets to the corporation***. This transaction structure is described in Revenue Ruling as a Situation 2 "assets up" transaction. It seems unlikely that this alternative would be chosen given the owners' potential exposure to the liabilities of the business and the availability of other less complicating conversion options. Perhaps there might be a different liability answer if the Partnership's assets consist of ownership interests in LLC subsidiaries, but absent special circumstances, there doesn't appear to be a good reason to adopt this method of conversion.

III.A.6. ***Actual contribution of interests in the Partnership to the corporation***. This transaction structure is described in Revenue Ruling 84-111 as a Situation 3 "interests up" (partnership interests transfer) transaction. This approach will work for Section 1202 purposes. If the Partnership interests were acquired prior to September 27, 2010, consideration should be given to possible impact of the percentage gain exclusion rules discussed in Section VI.F. (Part 2 of this article).[11]

III.A.7. ***Factors to consider when structuring a Partnership conversion.*** Each conversion method discussed in this article qualifies as a Section 351 nonrecognition exchange and should work for purposes of resulting in the issuance of QSBS. One

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consideration will be whether there is a desire to own QSBS through a Partnership, or whether the conversion should be structured so that the Partnership's equity owners end up with direct ownership of QSBS. Ownership of QSBS through the Partnership has the advantage of keeping intact the governance, buy-sell and economic provisions in the Partnership's governing agreement (i.e., LLC or LP agreement). Disadvantages of owning QSBS through the Partnership are the limitations on the sharing of Section 1202's gain exclusion through a "pass-thru" entity such as a Partnership, and Section 1045's right to roll over QSBS gain when ownership is through a "pass-thru" entity.[12]

As discussed above, there are a number of methods to undertake a Partnership conversion. Several of the methods don't involve an actual assignment of assets and contracts, or in some instances, won't trigger regulatory issues associated with assignment of assets (e.g., consents and notification triggered with respect to licenses and permits), which can be a significant factor depending on the nature of the business. In other instances, any conversion method selected will trigger applicable change-of-control provisions in contracts, or licenses and permits. Another factor to consider is whether retention of the Partnership's existing federal employer identification number (EIN) is important for regulatory or other reasons. If so, conversions that allow retention of the existing EIN, such as contribution of the membership interests to a newco-corporation, may be preferable to an actual contribution of assets into a newco-corporation[13].

In selecting a conversion method, consideration should be given to whether the Partnership's basis in its assets is different from the partners' aggregate basis in their Partnership interests. For example, if a partner purchased an interest or inherited an interest following the death of a partner and if the Partnership had not made a Section 754 election that would otherwise have stepped up the partner's share of the inside basis of the Partnership's assets, then the outside basis in the Partnership interest could be greater than the partner's share of inside basis of Partnership assets, resulting in a higher basis in the stock distributed on the termination of the Partnership but a lower basis in the assets held by the corporation.

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Another factor that should be considered when selecting the conversion method is a comparison of the forms of equity compensation available through a Partnership versus a corporation. Partnerships can take advantage of issuing "profits interests" (including carried interests and promotes) governed by Revenue Procedures 93-27 and 2001-43. The beneficial features of a profits interest, including the ability to issue profits interests without triggering taxable compensation, along with the right to immediately share in long-term capital gain distributions (subject to the Section 1061 three-year holding period requirement for some carried interests), are not available if the corporation directly issues equity compensation (versus profits interests issued by a Partnership acting as the corporation's stockholder). Both Partnerships and corporations can grant equity and equity rights (such as options), subject to Section 83's rules regarding taxation, along with phantom equity and other bonus arrangements.

III.B. Timing of the conversion; employer identification numbers (EINs).

Once the decision to convert a Partnership to a C corporation has been made, there is a case to be made that immediately conversion is best, given that the five-year+ clock won't start running for Section 1202 gain exclusion until the conversion is completed. On a practical note, however, conversion at month, quarter or year-end makes sense. In particular, if the conversion occurs at year-end, the calendar-year partnership return can serve as the final return without the need for a stub-period returns for the corporation and the Partnership. Other tax filings, including payroll and employment tax filings are simplified if the conversion occurs at year-end.

If retaining the Partnership's EIN is a priority, a conversion method should be selected that results in the operating company retaining the existing EIN. For example, a Partnership's EIN is retained by the operating company if a newco-corporation is organized and the Partnership's membership interests are contributed to the new corporation, resulting in a corporate parent, disregarded subsidiary (for tax purposes) structure.

III.C. Section 351 nonrecognition exchanges.

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Most Partnerships hold appreciated property, including goodwill contributing to the enterprise value of the business, and not surprisingly, a key goal of business owners is to accomplish the conversion to corporate form on a tax-free basis (rather than triggering deemed sale treatment). As outlined in Section I.A. above, each method of converting a partnership to a corporation under Revenue Ruling 84-111 should qualify as a nonrecognition exchange under Section 351 if the conversion is properly structured. In the absence of Section 351, transfers of appreciated property to corporations would be treated as taxable sales. Section 351 can be useful when structuring acquisitions where target stockholders want at least some of their consideration in the form of buyer stock.

A summary of the basic rules of Section 351 nonrecognition exchanges are discussed below. As you might expect, there are numerous additional rules that are beyond the scope of this introduction to Section 351 and related provisions.

III.C.1. ***Basic Section 351 rules and requirements***. A transfer of property to a corporation generally qualifies for nonrecognition treatment under Section 351 if the following statutory requirements are satisfied: (i) there is a transfer of "property" to the corporation; (ii) the transferors receive solely stock, which can be common stock, preferred stock that is not nonqualified preferred stock, or a combination of both; and (ii) immediately after the transfer, the transferors must be in control of the transferee corporation within the meaning of Section 368(c). See Section III.C.4. for a further discussion of "control." The exchange of property for securities or stock rights falls outside of Section 351.[14]

The transferor may receive different classes of voting and nonvoting common and preferred stock. But "nonqualified preferred stock" is treated as taxable "boot."[15]

If an exchange falls within the scope of Section 351: (i) the exchange of property for stock will be a nonrecognition event with no gain or loss recognized; (ii) the transferee corporation recognizes no gain or loss on its receipt of property in exchange for stock;[16] (iii) the basis of the stock issued in exchange for the property will equal the basis of the contributed property, increased by any gain recognized

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to the transferor on such transfer;[17] (iv) the holding period in the property transferred will carry over to the stock issued in exchange; and (v) the tax basis of the contributed property in the hands of the corporation will generally be the same as the tax basis in the hands of the contributors.[18] If the transferor receives not only stock but also money or other property (either referred to as "boot") in the exchange, Section 351(b) provides that gain but not loss must be recognized to the extent of the fair market value of boot, but not in excess of the amount of the transferor's realized gain under Section 1001 from the overall exchange. In Revenue Ruling 68-55, the IRS took the position that an asset-by-asset approach rather than an aggregate approach is taken in determining gain or loss. Thus, the total consideration deemed to be received is allocated among the transferred assets in proportion to their fair market values. The resulting amount of gain or loss realized with respect to each asset is equal to the difference between the portion of the consideration allocable to such asset and the asset's tax basis. Any gain realized with respect to an asset must be recognized. In contrast, any loss realized with respect to an asset is not recognized. If boot must be recognized, the character of the assets transferred usually determines whether the gain is ordinary income or capital gain, and in the latter case, whether it is long-term or short-term gain.[19] The assumption of liabilities in the exchange is discussed below in Section I.C.5. Section 1032(a) provides that a corporation does not recognize gain or loss when it exchanges its stock for money or other property.

Section 358(a)(1) provides that basis of stock received by a transferor is equal to the basis of the property transferred to the controlled corporation, decreased by the amount of money and the fair market value of other property received by the transferor and increased by the amount of gain recognized by the transferor.

III.C.2. *Both tangible and intangible property can generally be contributed to a corporation tax-free in a Section 351 nonrecognition exchange*. For purposes of Section 351, "property" that can be contributed in exchange for stock (QSBS) includes both tangible and intangible property, including stock, money, partnership interests, accounts receivable, inventory, trademarks, trade names, domain names, trade secrets, patents, and know-how.

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A software copyright can be transferred under Section 351, but if the transferor transfers a nonexclusive license to use the software, the IRS might take the position that the transferor is merely contributing use of software. The IRS has taken the position that all substantial rights to intangible property must be contributed in order to qualify as "property" for Section 351 purposes. Know-how and trade secrets are property for Section 351 purposes, but when transferring know-how, it is important that the transfer be complete (i.e., a transfer of all substantial rights in the know-how). Stock issued in exchange for a limited license to use intellectual property will be treated as a taxable payment. While services are not considered "property" (See Section I.C.3. below), the exchange of intellectual property created by the contributor for stock generally falls within the scope of Section 351.[20]

III.C.3. ***Services are not "property" that can be exchanged under Section 351.*** Section 351(d)(1) provides that stock issue for services is not considered issued in exchange for "property." Under Section 351, a profits interest (carried interest) issued in exchange for a partner's services can be exchanged for stock in a nonrecognition exchange, but stock issued for services to the transferee corporation will be taxable compensation.

If more than 20% of the corporation's stock is issued for services performed for the transferee corporation, the 80% control requirement (discussed below) won't be satisfied and the exchange will be treated as a taxable sale of the contributed property, which would generally be a tax trainwreck but nevertheless would permit the stock issued to be QSBS.[21] The shares received by a shareholder who receives stock for both property and services are generally counted towards satisfying the 80% test, but Treasury Regulation Section 1.351-1(a)(1)(ii) provides that stock issued for property which is of relatively small value in comparison to the value of the stock received for services is not treated as having been issued in return for property if the primary purpose of the transfer is to qualify under Section 351 the exchanges of property. It appears that shares issued to a service provider for services would be treated as being issued for "property" for purposes of the 80% control test if at least 10% of the shares issued to the service provider are for property rather than services.[22]

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III.C.4. *Satisfying Section 351's 80% control requirement*. One of Section 351's key requirements is that the transferors of property (which could include cash) must be in control of the corporation immediately after the transfer. "Control" is defined as ownership of at least 80% of (a) the voting power of all classes of stock entitled to vote, and (b) the total number of shares of all other classes of stock.[23] In a pure partnership incorporation transaction, the control requirement won't be an issue because the partnership's assets or interests will generally be exchanged for 100% of the corporation's stock. But there are situations where the control requirement will be an issue. If stock is being issued for services to the issuing corporation, and the service providers are not also contributing property, the stock issued will not only be taxable compensation (unless it is subject to risk of forfeiture and is not transferable) but will also count against the 80% control requirement. But see the discussion in Section III.C.3. regarding how the control requirement applies to a stockholder's contribution of both property and services.

If stock is going to be issued post-incorporation for property contributions (including an equity offering) or services, or some of the partners participating in the Partnership incorporation have an arrangement to transfer some of their stock, these actions should be carefully reviewed as they could endanger satisfaction of the control requirement.

Although a detailed discussion of what constitutes control "immediately after the exchange" is beyond the scope of this article, parties structuring Section 351 transactions should be aware that a purported Section 351 tax-free exchange could fail if there is a binding commitment at the time of exchange to issue additional equity or transfer to third parties shares issued in the exchange.

The issuance of options at the time of the exchange should not trigger a loss of control, but a conservative approach would be to let some time pass after the conversion before entering into a plan to issue, or issuing, compensatory options or stock grants, or making equity offerings.[24]

Section 351's 80% control requirement can be satisfied when a "global" or "overall" Section 351 exchange occurs, which involves

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multiple transferors being treated as a part of the same control group. A good example of a "global" Section 351 exchange would be where two partnerships contribute their assets to a newco-corporation in exchange for stock, or where the stockholders of an existing corporation form a holding company by contributing their stock to the holding company, while as part of the same global exchange, the members of an LLC also contribute their equity to the holding company in exchange for its stock.[25]

The ability to structure a global Section 351 transaction is critical because a common situation involves the conversion to a C corporation in connection with raising capital, where the investors expect to be issued preferred stock. When investors are brought in as part of the partnership conversion, the global Section 351 encompasses the contribution of assets or equity interests by the Partnership and money by the investors. If the investors are issued a SAFE, the tax treatment is less clear. If the SAFE is treated as equity, the investors would be treated as participating in the global Section 351 nonrecognition exchange. If the SAFE is treated as hybrid instrument (derivative), then the payment of money by the investors would not be treated as part of the Section 351 exchange but instead the payment would be accorded open transaction treatment (i.e., not taxable to the corporation), with the tax consequences delayed until the transaction is closed (i.e., typically upon the occurrence of the first price round when the SAFE converts and the preferred stock is delivered).

Arrangements and in particular binding commitments made by the issuing corporation or its stockholders to transfer stock received in the Section 351 exchange or issue additional shares should be carefully vetted for their effect on satisfying Section 351's "control immediately after the exchange" requirement. A gift of stock received in a Section 351 exchange generally should not cause a loss of control unless there was a binding obligation to transfer/gift the stock.[26]

III.C.5. ***Assumption of liabilities (Section 357 issues)***. The general rule under Section 357(a) is that in a Section 351 exchange, the assumption of liabilities, or the acquisition of property subject to liabilities, is not treated as boot. If there is boot, however, the

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liabilities assumed or to which the property is subject are taken into account in computing the amount of gain realized. Section 358(d) provides that liabilities assumed by the corporation and liabilities encumbering transferred property reduce the transferor's tax basis in the corporation's stock.

Section 357(c) provides that gain is recognized in the exchange to the extent that the sum of the liabilities assumed exceeds the transferor's basis in the property transferred. In connection with the incorporation of a Partnership, this result will generally occur if the partners have negative capital accounts. Under Section 357(c)(3), liabilities exclude cash basis trade account payables, interest and taxes to the extent the transferor would be entitled to a deduction if the transferor had paid the liability.[27] In some cases, potential Section 357(c) issues can be managed by reducing the amount of liabilities assumed by the corporation or by contributing a promissory note.[28] Gain recognized because of Section 357(c) must be reported as ordinary income or long-term or short-term capital gain according to the nature and the holding period of the transferred property.

If a Partnership is incorporated and its liabilities exceed the basis of its assets, the Partnership recognizes gain under Section 357(c) in a Situation 1 (assets over) transaction, even though its owners simultaneously transfer to the corporation other assets with a basis greater than the excess of partnership liabilities over the Partnership's basis in its assets. In contrast, if a Situation 2 (assets up) transaction is undertaken, then the Partnership itself is not a transferor and each transferor-partner may aggregate the basis of his Partnership interest with the basis of other assets he contributes to the corporation for purposes of applying Section 357(c).

Section 357(b) provides that all of the liabilities contributed to a corporation in a Section 351 exchange are treated as taxable boot if the principal purpose of the assumption of any liabilities is to avoid federal income tax on the exchange or if a bona fide business purpose does not exist for the assumption. A tax avoidance motive is most likely to be present where property contributed is borrowed against by the contributors in anticipation of the Section 351

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exchange.

III.C.6. ***The tax treatment of investment companies under Section 351(e)***. Section 351(e) limits the ability of taxpayers to use Section 351 to diversify their investment in readily marketable stock or securities or of interests in regulated investment companies or real estate investment trusts. Section 351(e) requires the transfer of nonidentical assets and can be circumvented if at least 20% of the assets do not fall into the categories of assets referred to in the preceding sentence.

III.C.7. ***Application of the business purpose doctrine to Section 351 exchanges***. The IRS can cite authority supporting the position that a Section 351 exchange may be disregarded or recast by the government if it lacks a "business purpose."[29] However, there is little support for the argument that there must be an independent non-tax business purpose for electing to convert from operating as a partnership to a corporation for the purpose of enjoying the tax benefits associated with operating in corporate form. In fact, the "check-the-box" regulations dictate Section 351 treatment in connection with the conversion of a partnership to corporation.[30]

III.C.8. ***Disproportionate issuances of stock in a Section 351 exchange***. Treasury Regulation Section 1.351-1(b) provides that when stock issued by a corporation in a Section 351 exchange is disproportionate to a transferor's contributed property, "*the entire transaction will be given tax effect in accordance with its true nature, and the transaction may be treated as if such had first been received in proportion and then some of such stock had been used to make gifts (section 2501 and following), to pay compensation (sections 61(a)(1) and 83(a)), or to satisfy obligations of any kind.*"

III.C.9. ***Potential application of Section 1239 and Section 707(b)(2) to gain recognized in conversion transactions***. A Partnership that contributes depreciable property in a conversion transaction where there is taxable boot (e.g., a cash distribution associated with the incorporation transaction) may be subject to the treatment of some or all of the boot as ordinary income under Section 1239. Section 1239(a) provides that "in the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as

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ordinary income if such property is, in the hands of the transferee, of a character that is subject to the allowance for depreciation provided in section 167." Under Section 197(f)(7), any amortizable Section 197 intangible (e.g., goodwill) is subject to the allowance for depreciation under Section 167.

Section 1239(b)(1) defines a related party as a person and all entities controlled by that person.[31] For partnerships, Section 707(b)(2) treats gains recognized on the sale of property that would otherwise be considered capital under Section 1221 as ordinary if the sale occurs between a partnership and a related person. The related-party conversion of capital gains to ordinary income can occur in a Section 351 transaction involving a partnership conversion under both Section 1239(b)(1) and Section 707(b)(2).[32]

Any excess cash in the Partnership should certainly be distributed to partners prior to undertaking the Section 351 exchange transaction. If the Section 351 transaction involves the contribution of cash by investors or non-Partnership parties, which is then distributed to the Partnership's partners, a pre-contribution distribution to partners may not be possible. In that case, the parties will need to explore alternative multiple-step transactions to avoid the triggering application of ordinary income treatment under Sections 1239(b)(1) or Section 707(b)(2).

III.C.10. *Effect of conversion of partnership on suspended passive losses*. If a partner has suspended passive losses when the partnership converts to a C corporation, those suspended losses first be used to offset "boot" received in the Section 351 exchange and then other gains under the authority of Section 469(g)(1)(A), which treats the transfer as a disposition of the taxpayer's entire interest in the passive activity if "*all gain or loss realized on such disposition is recognized*."[33]

III.C.11. *Section 304 – transfer of stock to a controlled corporation*. If stock in one controlled corporation is included among the property transferred to another corporation in a Section 351 exchange, and the transferor also controls at least 50% of the transferee corporation post exchange, any cash or other property may be treated as a dividend under Section 302 to the extent of

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earnings and profits rather than as an exchange of boot taxable under Section 351(b). This provision should not come into play too often in connection with the incorporation of a partnership but might apply if the conversion involves additional parties contributing stock.

III.D. Traps associated with the nature of the equity and equity rights exchanged or issued in a Partnership conversion.

Under Section 351, both voting and nonvoting common and preferred stock (other than nonqualified preferred stock) can be issued in a Partnership conversion. But Partnerships may have certain equity rights that can't be exchanged tax-free. And there are certain types of equity and equity rights that can't be issued tax-free. Take additional care in the situation where a Partnership is converted in a transaction where pre-conversion economic rights, including the distribution waterfall and outstanding equity and equity rights, are maintained intact as equity and equity rights in the corporation – it is possible that some of these equities and equity rights may be treated as taxable boot when "exchanged" in a Section 351 transaction for their corporate counterpart.

III.D.1. *Nonqualified preferred stock is treated as taxable "boot."*

If a goal of the exchange is nonrecognition treatment, it is important to structure the rights of preferred stock being issued in a Section 351 exchange to avoid "nonqualified preferred stock" treatment. For purposes of Section 351, "nonqualified preferred stock" is defined as stock that "*is limited and preferred as to dividends and does not participate in corporate growth to any significant extent*."[34] Participating preferred stock generally avoids "nonqualified preferred stock" characterization, but if the preferred stock has only a conversion feature, there must be a reasonable possibility that the conversion will occur.

In order for preferred stock to be characterized as "nonqualified preferred stock," it must have at least one of the following four characteristics, all of which should be avoided: (1) the holder has the right to put the stock to the issuer or a related party within 20 years of the issue date; (2) the stock is subject to a mandatory redemption by the issuer or a related party within 20 years of the

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issue date; (3) the issuer or a related party has the right to call the stock and, as of the issue date, it is more likely than not, that the right will be exercised within 20 years of the issue date; or (4) the dividend rate varies in whole or in part (directly or indirectly) by reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (e.g., adjustable rate stock) or as a practical result of other aspects of the stock (e.g., auction rate stock).

Transferors receiving only nonqualified preferred stock are treated as a transferor for purposes of determining "control," even though the nonqualified preferred stock is treated as taxable boot.

III.D.2. ***Securities (debt instruments) are treated as taxable boot when received in a Section 351 exchange***. Debt instruments (securities) are treated as taxable boot if received in exchange for property in a Section 351 transaction.

III.D.3. ***Stock rights are treated as taxable boot when received in a Section 351 exchange.*** Warrants and rights to acquire the corporation's stock are treated as taxable boot if received in exchange for property in a Section 351 transaction.[35]

III.D.4. ***Restricted Partnership interests exchanged for unrestricted stock***. Under Section 83, a restricted Partnership capital interest is not treated as being owned by the holder for tax purposes until the restrictions lapse, unless a timely Section 83(b) election was filed following the issuance of the restricted Partnership capital interest. The exchange of a restricted Partnership capital interest for unrestricted stock in Section 351 nonrecognition exchange will trigger compensation for the exchanging party equal to the fair market value of the corporate stock received in the exchange. If the goal is to position a Partnership owners to take advantage of Section 1202's gain exclusion, consideration should be given to either exchanging the restricted Partnership interest for unrestricted stock or making a Section 83(b) election with respect to restricted stock.[36] Like a restricted Partnership capital interest, restricted stock is not treated as owned, including for purposes of Section 1202 (and the commencement of the holding period), until the restrictions lapse,

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unless a timely Section 83(b) election was filed following the issuance of the restricted stock.

III.D.5. ***Restricted Partnership capital interests exchanged for restricted stock.*** The exchange of a restricted Partnership capital interest for restricted corporate stock should not trigger compensation income at the time of the exchange. But as previously mentioned, unless a Section 83(b) election was made, a restricted Partnership capital interest is not treated as being owned by the holder for tax purposes until the restrictions lapse. If a Section 83(b) election is made, the stockholder will have compensation income equal to the fair market value of the corporate stock received in the exchange in excess of any price paid for the stock.

If a Section 83(b) election was previously made for a restricted Partnership capital interest, then another Section 83(b) election should be filed at the time of the exchange. Based on the authority of Revenue Ruling 2007-49, 2007-2 CB 237, the filing of the Section 83(b) election under these circumstances should not trigger a compensation event. If the Section 83(b) election is not filed under these circumstances, the stock will be treated as unvested, even though an election was filed with respect to the Partnership capital interest. As discussed above, consideration should certainly be given to making a Section 83(b) election with respect to restricted stock if a goal is to position the Partnership's owners to take advantage of Section 1202's gain exclusion.[37]

III.D.6. ***Partnership compensatory nonqualified options exchanged for corporate nonqualified stock options (NQOs).*** The exchange of a Partnership nonqualified option for a corporate NQO in a Section 351 nonrecognition exchange should be nontaxable, if all of the requirements of Section 409A outlined below are successfully navigated. But as discussed below, this conclusion is not 100% clear under applicable tax authorities.

The principal tax issue associated with this exchange is whether it triggers any Section 409A issues. An exchange of options as part of a corporate transaction does not trigger Section 409A. Whether the Section 351 nonrecognition exchange is a "corporate transaction" is governed by Treasury Regulation Section 1.424-

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1(a)(3) which defines "corporate transaction" as follows: "*For purposes of this paragraph (a), the term corporate transaction includes – (i) A corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation; (ii) A distribution (excluding an ordinary dividend or a stock split or stock dividend described in § 1.424-1(e)(4)(v)) or change in the terms or number of outstanding shares of such corporation; and (iii) Such other corporate events prescribed by the Commissioner in published guidance*." Although the issue doesn't appear to be expressly addressed in tax authorities, an exchange of property for stock should fall into the category of an "*acquisition of property or stock*," since in the Section 351 nonrecognition exchange, property is acquired by the C corporation in consideration of the issuance of its stock. Assuming a Section 351 nonrecognition exchange does qualify as a "corporate transaction," Section 409A has the following additional requirements before the exchange can be considered a nonrecognition event:

- The excess of the aggregate fair market value of the shares subject to the new option immediately after the substitution over the aggregate option price of such shares (i.e., the intrinsic value of the shares) must not exceed the excess of the aggregate fair market value of the shares subject to the old option immediately before the substitution over the aggregate option price of such shares.
- On a share-by-share comparison, the ratio of the option price to the fair market value of the shares subject to the option immediately after the issuance of a new option must not be more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option immediately before the issuance of a new option. Basically, the aggregate spread needs to be maintained.
- The new option must contain all the terms of the old option, except to the extent those terms are rendered inoperative by reason of the corporate transaction.
- The new option must not give the optionee additional benefits that the optionee did not have under the old option.

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The parties should consider whether exercising options in connection with the conversion makes long-term sense as the holding of an option doesn't commence the running of Section 1202's holding period.

III.D.7. *Convertible debt exchanged for corporate stock*. The parties should consider converting debt into equity in connection with the Partnership conversion, as convertible debt is generally not treated as "stock" for Section 1202 purposes, with the result being that the five-year+ holding period requirement does not commence until the debt converts into QSBS.

IV. Non-tax considerations associated with Partnership conversions.

The approach selected for converting a Partnership into a corporation is often influenced by whether the parties want to convert the Partnership into a state law corporation, which is often the case if the conversion involves redomiciling the Partnership as a Delaware corporation. The method selected for undertaking the conversion also often takes into consideration the Partnership's governance structure (e.g., does the conversion require majority or super-majority approval or merely approval by a manager, general partner or board of managers?).

Drafters of Partnership governance agreements should consider the various means by which a conversion can be accomplished and make sure that the agreement adequately addresses the owners' wishes. For example, if a supermajority vote requirement is desired in connection with conversion of the Partnership into a corporation, it doesn't work to require a two-thirds vote to approve a merger but only majority approval, or mere manager or general partner approval, if the Partnership's assets are contributed to a corporation.

IV.A. Triangular merger structure.

If the conversion requires equity holder approval and ownership is spread among a number of equity holders, the conversion will often be structured as a merger of the target Partnership into an

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acquisition subsidiary of a newco-corporation. Approval of the merger often requires only majority approval of the Partnership's equity holders (a review of the appliable governance agreement and/or state law is necessary). The merger approach works well when the parties elect to convert into a Delaware corporation, in many cases with a 100% owned LLC subsidiary (the former operating Partnership).

The use of a triangular merger helps to minimize the required consents and approvals because the transaction involves a statutory transaction where the surviving business entity succeeds to the assets, liabilities and obligations of the target Partnership by "operation of law." Private Letter Ruling 199915030, concluded that the merger of a partnership into a corporation should be treated as a transfer of the partnership's assets to the new corporation in exchange for the new corporation's stock, followed by a distribution of the stock in liquidation of the partnership. Although Section 1202 is silent with respect to the issue of a corporation holding a 100% owned LLC, undertaking business operations through a disregarded entity for federal income tax purposes should not affect satisfaction by the corporation of Section 1202's active conduct requirement.[38]

While the merger structure can facilitate approval of the conversion without unanimous consent, the unwillingness of one or more owners to sign a new stockholders agreement could prove to be an issue. A simple check-the-box election would keep intact the covenants (e.g., restrictive covenants; buy-sell terms) in the Partnership's governing agreement, but those provision may or may not work on a going forward basis. The governance and related non-tax issues that arise in connection with the conversion of a Partnership differ greatly from transaction to transaction but can be critical, particularly if the conversion includes transitioning from a state-law partnership or LLC to state-law corporation.

IV.B. Contribution of equity interests to the corporation.

Where all of the Partnership's owners are in agreement with the terms of the conversion, the conversion can easily be accomplished through the contribution of each partner's equity interest to the

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new corporation in exchange for corporate stock. Structured in this fashion, a contribution agreement would include the terms of the contribution, applicable representations and warranties and the relative economic rights and preferences of the contributing parties. The owners would also typically enter into updated restrictive covenant agreements and buy-sell provisions as part of the conversion transaction. If the Partnership is an LLC, this arrangement would result in a parent (newco-corporation) subsidiary (LLC) structure, which may be useful if the conversion avoids an "assignment" of contract, permits and assets for state law purposes.

IV.C. Conversion by making an entity classification election.

Another conversion approach that should be considered is filing an entity classification election (i.e., a "check-the-box" election) for the Partnership to be taxed as an association taxable as a corporation. This approach has the benefit of retaining the company's existing entity status (e.g., LLC) for state law purposes, which may facilitate retaining both the entity's governance structure and its economic distribution waterfall. Often, third-party consents and regulatory approvals are not required since the entity form doesn't change under state law, but there might be contracts (e.g., loan agreements and franchise agreement) or some regulatory approval or consents that are triggered by the change in the entity's tax status.

If an eligible entity classified as a partnership elects under Treasury Regulation Section 301.7701-3(c)(1)(i) to be classified as a corporation, Situation 1 (asset transfer plus partnership liquidation) treatment is mandated by Treasury Regulation Section 301.7701-3(g)(1). As noted above, the "assets over" method should work for Section 1202 purposes because Section 1202(h)(2)(C) allows for the distribution of QSBS by a partnership to its partners. The shares of QSBS continue their QSBS status in the hands of the distributee partners. But note that the "assets over" method won't work for purposes of Section 1244's ordinary loss treatment on the sale of certain stock, because there is no corresponding provision allowing for the distribution of Section 1244 stock from a Partnership to its

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partners.

IV.D. Undertaking a "formless" conversion under state entity statutes.

Consideration should be given to accomplishing the conversion through state entity statutes that permit a "formless" conversion (i.e., articles or a certificate of conversion are filed and the entity converts without further action from an LLC or LP to a corporation governed by the state's applicable corporation statutes). The parties will undoubtedly want to rewrite their governance agreement, and perhaps restructure the owners' economic rights to fit the corporate form of doing business. This approach has the benefit of being an assignment by operation of law under the applicable entity statutes, which generally has the effect of reducing but not always eliminating the requirement of regulatory approvals and third-party consents, since contracts are not assigned (but change-of-control provisions in contracts may be triggered).

If a Partnership converts to a state law corporation under a state statute (a "formless conversion"), the transaction is treated in the same manner as a check-the-box election, Situation 1 (asset transfer plus partnership liquidation) treatment applies.[39] As noted above, the "assets over" method should work for Section 1202 purposes because Section 1202(h)(2)(C) allows for the distribution of QSBS by a partnership to its partners. The shares of QSBS continue their QSBS status in the hands of the distributee partners. But note that the "assets over" method won't work for purposes of Section 1244's ordinary loss treatment on the sale of certain stock, because there is no corresponding provision allowing for the distribution of Section 1244 stock from a Partnership to its partners.

IV.E. Contribution of assets and liabilities to a newco-corporation.

A simple conversion can be accomplished through the actual contribution of assets, liabilities and contracts by a Partnership to a C corporation in exchange for stock. This approach may be preferable where consents to assignment and regulatory issues are not a meaningful issue. The parties can pick and choose which

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assets and liabilities of the Partnership are contributed to the corporation. This incorporation method can be structured under Situation 1 of Revenue Ruling 84-111 – a transfer by the Partnership of its assets and liabilities to the corporation, in exchange for the corporation's stock, followed by the liquidation of the partnership and distribution of the stock to the partners. This incorporation method can also be structured under Situation 2 – the Partnership's assets and liabilities are distributed to its partners, followed by the partners' transfer of the assets to the corporation and the assumption of liabilities in exchange for the corporation's stock. With both Situation 1 and 2, the corporation can limit the assumption of liabilities to known, identified and expressly assumed liabilities. One undesirable aspect of Situation 2 is the distribution to partners of the Partnership's liabilities which results in the loss of the partners' statutory liability shield which would otherwise protect the partners against the Partnership's liabilities and obligations. Another issue that should be considered is whether the Partnership is holding any short-term capital assets and whether the partners have a short-term holding period in their partnership interests. If there is any boot involved in the incorporation, differences in inside (Partnership assets) and outside (Partnership interests) holding periods might result in differing tax liabilities because of the rate differences between long-term and short-term capital gains.

If the stock issued by the corporation is QSBS, Section 1202 would permit the Partnership to serve as a stockholder holding QSBS (a "pass-thru" entity under Section 1202) or the Partnership could distribute the QSBS to its partners. Under Section 1202, when QSBS is distributed by the Partnership to the Partners, the stock retains its QSBS status in the hands of the partners. This approach may be particularly useful if the Partnership has a problem with Section 1202's $50 million test (see Part 2 of this article) or the Partnership engages in activities that are on Section 1202's excluded activities list.

IV.F. Participation of an existing corporation in a Partnership conversion.

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Generally, the corporation involved in the Partnership conversion will be newly-organized, whether that means the corporation is newly incorporated or the result of a statutory conversion or check-the-box election. However, a Partnership's assets or equity interests could be contributed to an existing corporation. Particular attention would need to be paid to satisfying Section 351's 80% control requirement (discussed above) if an existing corporation is a party to the conversion, along with meeting Section 1202's $50 million test (discussed in Part 2 of this article).

In most cases, decisions regarding which method to use when converting a Partnership, and the tax and business consequences of selecting one method versus another method, will depend on the specific facts associated with the Partnership undergoing the conversion.

V. What happens to profits interests (carried interests) in a conversion transaction?

The favorable tax treatment of profits interests is governed by Revenue Procedures 93-27 and 2001-43.[40] But Revenue Procedure 93-27 states that the tax benefits of a profits interest do not apply if the holder disposes of the profits interest within two years of receipt. So what happens if a profits interest was issued within two years of the conversion of the issuing Partnership to a corporation? If the profits interest was fully vested when issued, the holder would likely take the following position: (i) that he or she holds an interest in the Partnership at the time of the conversion; (ii) that the interest had no ascertainable value when issued; (iii) that the value of the interest at the time of issue should be determined on a liquidation basis and for that reason would be zero; and (iv) that the two year rule in Revenue Procedure 93-27 should be interpreted to apply only if there was a binding commitment (or perhaps plan) to undertake the transfer (here conversion) at the time of the issuance of the profits interest. Putting aside the issue of whether there is any tax deficiency associated with the issuance of the profits interest, the exchange of a failed profits interest for corporate stock within two years after the issuance of the profits interest should nevertheless satisfy Section 1202's requirements.

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The potential application of the two-year rule takes on a more ominous tone if the profits interest is restricted and the holder did not file a protective Section 83(b) election. The IRS might take the position that where Revenue Procedures 93-27 and 2001-43 don't apply because of a failure to satisfy the two-year rule, the restricted interest should be governed by Section 83's rules and treated as not owned for tax purposes. If this position prevailed, the exchange of the profits interest for unrestricted corporate stock would be treated as payment of compensation based on the fair market value of the corporate stock, unless a protective Section 83(b) election was made at the time of the profits interest was issued. A taxpayer would likely dispute this treatment by arguing that the two-year rule shouldn't apply if the triggering event was not anticipated when the profits interest was issued, or that the purported "substantial risk of forfeiture" is one that would not be enforced.[41] The making of a protective Section 83(b) election when the restricted profits interest was issued might help the holder avoid the uncertainties associated with a premature "transfer" of the profits interest.

Typically, the transfer of nonvested equity by a service provider triggers a compensation event under Section 83. But Treasury Regulation Section 1.83-1(b)(3) provides that the general rule that a disposition of nonvested equity triggers a compensation event does not apply and no gain is recognized "*to the extent that any property received in exchange therefor is substantially non-vested. Instead, section 83 shall apply with respect to such property received (as if it were substituted for the property disposed of).*" Obviously, where a principal goal of the conversion is to facilitate the issuance of QSBS, careful consideration should be given to the pros and cons of making a Section 83(b) election at the time of the conversion (i.e., making the election would commence the running of the Section 1202 holding period).

Another significant issue that arises in connection with a conversion is the determination of the profits interest holder's share of QSBS being issued in the Partnership conversion. The Situation 1 "assets over" method of conversion is treated as a contribution of assets by the Partnership to the corporation in exchange for stock that is then distributed in liquidation to the Partnership's owners. From a

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Section 1202 standpoint, we believe that holders of profits interests should share in the Partnership's QSBS being distributed based on the holder's economic rights as set forth in the applicable Partnership agreement.[42] The argument is that for purposes of Section 1202, the economic rights provided for in the applicable Partnership agreement constitute the "interest" of the profits interest holder in the Partnership. The typical Partnership agreement would provide for a distribution threshold and would then set forth the rights of the profits interest holder to participate in appreciation in value of the Partnership's business.

In the conversion, the concept of the distribution threshold for the profits interests or other economic equivalent must somehow be carried over into the corporation's equity structure or the sharing of QSBS among the Partnership's equity owners. Treasury Regulation Section 1.351-1(b) provides that when stock issued by a corporation in a Section 351 exchange is disproportionate to a transferor's contributed property, "*the entire transaction will be given tax effect in accordance with its true nature, and the transaction may be treated as if such had first been received in proportion and then some of such stock had been used to make gifts (section 2501 and following), to pay compensation (sections 61(a)(1) and 83(a)), or to satisfy obligations of any kind.*" The risk of not maintaining economic equivalence (i.e., if there was a capital shift favoring the profits interest holder) could result in the profits interest holder being treated as receiving taxable compensation in the Partnership conversion.

The challenge when converting a Partnership with outstanding profits interests to a corporation is to avoid triggering gain by shifting capital to the profits interest holder. At the same time, converting all Partnership equity interests into a single class of corporate stock could result in profits interests holders not being treated fairly in the conversion. The extreme example would be where the profits interest was issued immediately before the conversion. If all Partnership equity was converted on the basis of capital at the time of conversion, the profits interest holder would lose out in that trade. One approach for maintaining the economic equivalence of varying equity interests would be for the corporation

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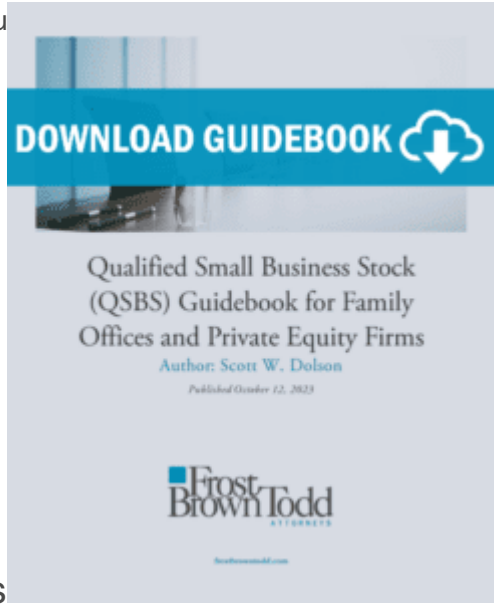
to mimic the Partnership's equity structure through classes of common and preferred stock. Another approach would be to maintain the Partnership as the stockholder of the new corporation, leaving the equity structure of the Partnership intact. The Partnership would then merely be a stockholder and gain on the sale of the corporate stock would flow up through the Partnership to be distributed based on the Partnership's economic waterfall structure. There isn't a "one size fits all" solution to structuring the conversion and the best method and approach will depend heavily on the facts associated with the Partnership's governance and economic arrangement and the goals of the parties going forward in terms of post-conversion issu
newco-corporation.



More QSBS Resources

- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2
- Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations

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- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] This article assumes that limited liability companies (LLCs) and limited partnerships (LPs) are taxed as a partnership for federal income tax purposes.

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[2] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. LLCs owned a single member default to disregarded entity status unless a "check-the-box" election is made on Form 8832 for the entity to be taxed as a corporation for federal income tax purposes.

[3] *See* Frost Brown Todd's **QSBS & Tax Planning Services page**.

[4] Although this article focuses on converting LLCs/LPs (taxed as partnerships) into corporations, a number of the tax issues addressed are equally applicable when converting a sole proprietorship to a C corporation.

[5] See the Scott Dolson article on the Frost Brown Todd website: "*Revisiting the Choice of Entity Decision for the Closely Held Business*."

[6] Except perhaps for start-ups raising capital from investors locked into purchasing corporate stock.

[7] See the Scott Dolson article on the Frost Brown Todd website: "*Maximizing the Section 1202 Gain Exclusion Amount*."

[8] Revenue Ruling 2004-59, 2004-1 C.B. 1050. The ruling provides that Revenue Ruling 84-111 does not apply in the case of a formless entity conversion but instead the conversion is treated the same as one where a check-the-box election has been made. For all practical purposes, it does appear that the tax consequences are identical to those occurring when the conversion is accomplished through the "assets over" method described in Revenue Ruling 84-111.

[9] A forward merger in which the target Partnership's legal existence ceases has been ruled to effectively be an "assets-over" transfer. See IRS Private Letter Rulings 9915030 and 9409035.

[10] See Private Letter Ruling 9148041.

[11] If the Partnership interests have a holding period extended back to September 26, 2010, or an earlier date, the interests over method would result in a less than 100% gain exclusion percentage, regardless of whether the Partnership has assets that were acquired after September 27, 2010. If the contribution is

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restructured as an "assets over" contribution, the result may be a much more favorable split holding period applying the rules of Revenue Ruling 85-164.

[12] See Treasury Regulation Section 1.1045-1.

[13] A helpful starting place for looking at EIN issues is the IRS webpage "Do you need a new EIN?" located at: https://www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein.

[14] See Treasury Regulation Section 1.351-1(a)(1).

[15] See Section III.D.1.

[16] Sections 1032 and 118(a).

[17] Section 362(a).

[18] Section 1223(1) governs the holding period for the stock issued in the exchange. The carryover holding period rule applies to contributions of capital assets and Section 1231 assets (i.e. depreciable property or real estate used in trade or business and held for more than one year). The holding period for ordinary income assets such as inventory or accounts receivable commences on the day following the Section 351 exchange. If the transferred assets consist of a mixture of capital assets, Section 1231 assets and other assets, an allocation will need to be made among the assets to determine the holding period of the stock issued in the exchange. These rules apply to the determination of the holding period for stock received in Situations 1 and 2 of Revenue Ruling 84-111. Under Section 1223(1), the holding period of stock received in a Situation 3 includes the former partners' holding period in their respective partnership interest, except that the holding period of stock received by the partners in exchange for their interests in Section 751 (hot assets) that are neither capital assets nor Section 1231 assets begins on the day after the date of the exchange.

But for purposes of Section 1202, Section 1202(i)(A) provides that stock issued in a Section 351 nonrecognition exchange is treated as having been acquired by the taxpayer on the date of the exchange, and Section 1202(i)(B) provides that the basis of the stock in no less

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than the fair market value of the property contributed in exchange. Under Section 1223(2), the corporation's holding period includes the transferor's holding period.

Section 362(e) provides an exception to the general rule that a corporation inherits the tax basis of contributed property in a Section 351 nonrecognition exchange. Section 362(e) provides that if property with a net built-in loss is contributed, the tax basis of the property in the hands of the controlled corporation is its fair market value immediately after the contribution. Section 362(e)(1)(C) provides that there is a net built-in loss if "*the transferee's aggregate adjusted bases of property described in [Section 362(e)(1)(B)] which is transferred in such transaction would (but for this paragraph) exceed the fair market value of such property immediately after such transaction).*"

[19] If the property transferred qualified for depreciation, amortization or other deductions, Section 1245, 1250 and 1239 could result in ordinary income treatment when boot received by a transferor in the exchange.

[20] Revenue Ruling 64-56, 1964-1 CB 133 addresses the transfer of "know-how" to a corporation tax-free under Section 351. The transfer must be complete to fall within Section 351. If know-how is created for the corporation issuing the stock, the stock received in exchange for the know-how is treated as transferred in exchange for services.

[21] Satisfaction of the "control" requirement could also be adversely affected if too many nonqualified options are issued in connection with the corporation's formation.

[22] See Revenue Procedure 77-37, 1977-2 CB 568.

[23] Section 368(c) provides that control means "*the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.*"

[24] See *Bellas Hess, Inc. v. Commissioner*, 20 T.C. 636 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955).

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[25] See Treasury Regulation Section 1.351-1(a)(1) provides that multiple transferors can be treated as a control group so long as there is an agreement that defines the rights of the group and the agreement is effected "*with an expedition consistent with orderly procedure*."

[26] See *Wilgard Realty Co., Inc. v. Commissioner*, 127 F.2d 514 (1942) and *Mojonnier & Sons, Inc. v. Commissioner*, 168 F.2d 957 (5th Cir. 1948).

[27] In order to avoid double dipping, the Section 357(c)(3) exemption doesn't apply if the accounts payable are tied to assets contributed to the corporation in the Section 351 exchange.

[28] Appellate courts in *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998), *rev'g* 71 TCM 2830 (1996) and *Lessinger v. Commissioner*, 872 F.3d 519 (2nd Cir. 1989), *rev'g* 85 T.C. 824 (1985), held that Section 357(c)'s tax bite can be avoided if a taxpayer contributes his own promissory note to cover the excess debt amount.

[29] See Revenue Ruling 55-36, 1955-1 CB 340, Notice 2001-17, 2001-19 IRB 70, *Hempt Bros., Inc. v. United States*, 490 F2d 1172 (3rd Cir1974) and *Caruth v. United States*, 688 F. Supp. 1129 (ND Tex. 1987).

[30] See Treasury Regulation Sections 301.7701-3(g)(1)(i) and (iv).

[31] Under Section 1239(b)(1), a transaction between the partnership or its partners and a controlled entity, would trigger the application of Section 1239. A controlled entity would include a corporation where more than 50% of the value of the outstanding stock of which is owned (directly or indirectly) by the partnership or partners holding more than 50% of the capital interest or profits interest in the partnership. In general, Section 1239 would apply in most Section 351 partnership conversions where the corporation distributes cash in the transaction to the legacy partners.

[32] See *Fish v. Commissioner*, T.C. Memo. 2013-270.

[33] See Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* at ¶3.18[1][a].

[34] Section 351(g)(3)(A).

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[35] Treasury Regulation Section 1.351-1(a)(1).

[36] Either of these options will trigger taxable compensation, but that might be preferable to losing out on Section 1202's benefits.

[37] The making of the Section 83(b) election will trigger taxable compensation, but as mentioned in the previous endnote, this might be preferable to losing out on Section 1202's benefits.

[38] Section 1202(d).

[39] See Revenue Ruling 2004-59, 2004-1 C.B. 1050.

[40] Revenue Procedure 93-27, 1993-2 C.B. 343 and Revenue Procedure 2001-43, 2001-2 C.B. 191.

[41] See *Austin v. Commissioner*, T.C. Memo. 2017-19 and *Qinetiq U.S. Holdings, Inc. v. Commissioner*, T.C. Memo. 2015-123, where the courts held that if it can be established that restrictions won't be enforced, the profits interest will be taxable upon receipt and thereafter treated as being owned under Section 83.

[42] Legislative history includes an express indication by Senator Lieberman that Section 1202(g)'s definition of "interest" is intended to apply to a profits interest. 139 Cong. Rec. S10680-01, S10732-33 (Aug. 6, 1993). Materials prepared for the 2024 May Tax Meeting of the American Bar Association Tax Section on Section 1202 and Partnerships noted that "*while Senator Lieberman was not a manager of the bill, and therefore his statement cannot be considered directly in the determination of whether substantial authority exists for the tax position pursuant to Treas. Reg. § 1.6662-4(d)(3)(iii), it still provides a helpful contextual background.*"

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