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Tax Considerations for LLC Mergers

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During most of the last decade, tax professionals were singing the praises of limited liability companies (LLCs), arguing that an LLC can do anything a corporation can do, with greater tax advantages. The proselytizing worked spectacularly well. Since the New Jersey Limited Liability Company Act became effective in 1994, the number of LLCs in existence each year has followed a geometric progression. For the most part, the promoters' enthusiasm has been well-founded. Nonetheless, from a tax perspective, LLCs are subject to a markedly different series of rules than corporations, and those rules often dictate very different tax consequences.

For example, as the life cycle of an LLC progresses, it may make sense to engage in a business combination. In the corporate world, a combination often is accomplished through a statutory merger. A merger also may make sense for an LLC. New Jersey law permits an LLC to merge into any type of entity and for any type of entity to merge into an LLC. But there are pitfalls to avoid and unique considerations to keep in mind. This article presents a very brief overview of the LLC merger landscape, highlighting some of the principal issues involved. Except as otherwise noted in the section on single-member LLCs, all of the LLCs discussed here are treated for federal income tax purposes as partnerships (and the word "partnership" is used here interchangeably). An LLC electing to be treated as a corporation would be subject to the corporate reorganization regime.

The Merger of Two LLCs

The merger of two LLCs presents at least two potential traps: The surviving LLC under state law may not necessarily be the survivor for federal income tax purposes, and the transaction's ultimate tax consequences may not always follow the parties' chosen form.

The parties to an LLC merger may select one entity to be the survivor for a number of reasons, including state-law-governed issues of liability and change-of-control provisions that may be contained in the parties' existing contracts. They may also factor in federal income tax consequences, including consideration of which LLC's tax elections and method of accounting will remain in effect, and which LLC must file a final tax return following the merger. When partnerships merge, Department of Treasury regulations specify which partnership continues and which terminates under federal tax law. The rules apply to a tax-law "merger," even if the parties file no state-law merger documents.

The survivor of a merger is the partnership where the partners own more than 50 percent of the capital and profits of the resulting partnership. If either of the former partnerships qualifies (which can happen if one partner owned interests in both prior partnerships), the survivor is the entity that contributes the greatest net asset value to the resulting partnership. If neither qualifies, then neither survives; both are terminated, and a new partnership is created. (See Treas. Reg. §1.708-1[c][1].)

Another twist on LLC mergers is that although the parties might choose one of four basic structures to accomplish the transaction, the Internal Revenue Code of 1986 may impose a different series of steps and divergent gain recognition and deduction treatment from what the parties intend. (See Treas. Reg. §1.708-1[c][3].) Consider the following:

- **Assets Over:** LLC1 transfers its assets to LLC2 in exchange for LLC2 membership interests. LLC1 distributes the interests in LLC2 to its members and then dissolves. LLC2 is the survivor for federal income tax purposes. This "assets over" approach is the default structure under federal tax law; any "unintentional" merger is deemed an assets-over merger.
- **Assets Up:** LLC1 distributes all of its assets to its members and dissolves. The former members of LLC1 contribute the distributed assets to LLC2 in exchange for membership interests in LLC2. LLC2 is the survivor for federal income tax purposes. Federal tax law will respect the assets-up form, but only if LLC1 assets actually are retitled in LLC1 members' names, and again in the name of LLC2.
- **Interests Over:** LLC1 members contribute their interests in LLC1 to LLC2 in exchange for LLC2 interests. LLC1 then dissolves, and LLC2 holds the former LLC1 assets. The Internal Revenue Code always treats this form of merger as assets-over.

The Internal Revenue Code treats all mergers under state law as assets-over mergers unless the parties complete the title transfers necessary to validate an assets-up form. An assets-over merger is generally favorable to the merging of LLC members, since this format does not trigger the "mixing-bowl" rules, which otherwise could cause LLC1 members to recognize gain when LLC1 contributes its assets to LLC2. The assets-up format is not exempt from the mixing-bowl rules, so LLC1 members could recognize gain on the deemed distribution of LLC1 assets. The assets-over and assets-up formats may trigger different consequences for basis, holding period and allocation of tax items among partners, each of which needs to be evaluated in determining the best means of accomplishing an LLC merger.

Mergers of LLCs and Corporations

A statutory merger of an LLC into a corporation (whether a C or S corporation) in which the former LLC members receive corporate stock in exchange for the merged LLC assets and liabilities should pose few difficulties. Such a merger does not qualify as a tax-free reorganization under Code §368(a), however, and could create tax liabilities for the members under some circumstances.

For tax purposes, such a merger is characterized as an "assets-over" transaction similar to the LLC-to-LLC merger discussed before. The LLC is deemed to transfer all of its assets and liabilities to the corporation in exchange for corporation stock. Depending on whether the LLC (and any other person contributing assets to the corporation) is deemed to control the corporation, this exchange may qualify as a tax-free contribution to the corporation under Code §351. The LLC is next deemed to distribute the stock to its members in complete liquidation of their LLC interests. Finally, pursuant to the plan of merger, the LLC dissolves.

Merger of Corporations into LLCs

When a corporation distributes its assets in liquidation, it causes gain recognition both to its shareholders (with respect to the deemed exchange of their stock) and to the corporation (with respect to all appreciated assets, including goodwill). Consequently, the tax cost of merging a corporation (especially a corporation) into an LLC is too great to merit consideration in most circumstances. For example:

- **C Corporation:** First, the corporation is deemed to transfer all of its assets and liabilities to LLC in exchange for LLC interests. Second, the corporation is deemed to distribute the LLC interests to its shareholders in complete liquidation of the corporation. Under Code §331 and §336, both the corporation and its shareholders will recognize gain with respect to any built-in appreciation in the corporation's assets or the shareholders' stock.
- **S Corporation:** The consequences involved in the merger of an S corporation into an LLC generally are the same as for a C corporation. However, if S corporation recognizes gain due to the distribution of the LLC units in liquidation, that gain passes through to each shareholder, increasing the shareholder's stock basis and generally preventing the shareholder from recognizing further gain on the deemed exchange of LLC interests for stock.

Single-Member LLC Mergers

Unless the single-member LLC (SMLLC) "checks the box" to be taxed as a corporation, it is treated as a "disregarded entity" for federal income tax purposes. In a slight twist, when the sole member is a corporation, the SMLLC is deemed to be a branch or division of the corporation. When the single member is any entity other than a corporation, the merger rules applying to the owner-entity apply to the SMLLC as though the owner-entity merged directly.

A current hot issue is the use of corporate-owned SMLLCs to accomplish tax-free reorganizations. Recently issued proposed regulations provide that a merger of a corporate-owned SMLLC into another corporation, in which the corporation survives, does not qualify as a reorganization under Code §368(a)(1)(A). (See Prop. Reg. §1.368-2[b][1][ii]; [iv] Example 5.) On the other hand, the merger of a corporation into an SMLLC where the sole member is another corporation (in which merger the SMLLC survives) may qualify as reorganization. (See Prop. Reg. §1.368-2[b][1][ii]; [iv] Example 2.) If the proposed regulations are finalized without substantial change, they may make "triangular mergers" considerably easier to accomplish.

Conclusion

As time passes, it is likely that the LLC merger landscape will become better defined and even more welcoming. For now, it is comforting to remember that your LLC clients probably can achieve all of their merger goals, but you should proceed carefully and with eyes wide open.

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