

What are the Federal Tax Consequences of Converting a C Corporation to a Limited Liability Company?

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A voluntary change in status from a C corporation to an LLC that has elected to be treated as a partnership is deemed to be a complete liquidation of the C corporation. Additionally, the shareholders are deemed to make an immediate contribution of the distributed assets to the newly-formed LLC. **26 C.F.R. § 301.7701-3(g)(1)(ii)**. Several private letter rulings have addressed different ways to convert a corporation into an LLC treated as a partnership, but the ultimate result is that the C corporation is treated as being liquidated. (Letter Ruling 9638047; 9401014; 9644003; 9701029; and 9924064). Corporate liquidation is subject to taxation on two different levels. One level is the corporate level and the other is the shareholder level.

Effects of Liquidation on Shareholders

Amounts received by a shareholder in a complete liquidation of the corporation are treated as a sale of

all outstanding corporate stock in exchange for all of the assets in that corporation. (**§ 331(a)**.) No distributions in a liquidation will be given dividend tax treatment. (**§ 331(b)**.) The gain or loss to a shareholder is to be determined by comparing the amount of the distribution with the adjusted basis of the stock surrendered. (**§ 1.331-1(b)**; **§ 1001**.) Generally, the entire amount of gain or loss will be recognized upon the transfer. (**§ 1001**.) If a shareholder assumes corporate liability or receives property subject to liabilities, the liability reduces the amount realized by the shareholder. (**§ 336(b)**.)

The basis of property received by a shareholder is the fair market value of the property on the date of the distribution. This is done without reduction for any liabilities to which the property is subject. (**§ 334(a)**.)

Generally, with any sale of stock, the shareholder will get capital gain treatment for any gains or losses. However, there is an exception for losses on small business stock that will allow a shareholder to take ordinary losses. (**§ 1244**.) Generally, a business qualifies as a small business if: (1) it received less than \$1 million in cash and property in exchange for its stock; (2) the stock was not issued in exchange for stock or securities; and (3) in the past 5 years it did not receive more than 50% of its gross receipts from royalties, rents, dividends, interests, annuities, or sales and exchanges of stock or securities. (**§ 1244(c)(3)**.)

Effects of Liquidation on Corporation

Gain or loss shall be recognized to the liquidating corporation on the distribution of property in a complete liquidation as if such property were sold to the shareholder at its fair market value. (**§ 336(a)**.) If a shareholder assumes corporate liability or receives property subject to liabilities and the amount of liability exceeds the fair market value of such property, the fair market value is deemed to be equal to the liability. (**§ 336(b)**.) In determining the character of gain or losses it should be noted that regular tax treatment applies. The corporation is still subject to depreciation recapture and capital gain treatment is only afforded to property falling within **§ 1231**.

Generally, losses on transactions between related taxpayers is disallowed (§ 267), however there is an exception for losses realized by a distributing corporation in a complete liquidation. (§ 336(d).) However, this exception is lost if (1) the distribution is not pro rata; or (2) the property being distributed was acquired by the liquidating corporation in a § 351 transaction or as a contribution to capital during the previous 5 years. (d.)

Liquidation expenses, such as the cost, associated with liquidating assets, are generally deductible in computing income tax as ordinary and necessary expenses of carrying on a trade or business. (C.I.R. v. Wayne Coal Min. Co. (3d Cir. 1954) 209 F.2d 152; (citing § 162).) Because the actual costs of the reorganization fall outside of the ordinary and necessary expenses of carrying on a trade or business, they are disallowed. (Kingsford Co. v. C. I. R. (T.C. 1964) 41 T.C. 646, 662 acq., (IRS ACQ 1964) 1964-2 C.B. 3.) These deductions are not available for the costs paid by shareholders. Those costs will be deemed capital expenditures and will be used to adjust the shareholder's gain or loss upon liquidation. (Rev. Rul. 67-411.)

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