

# JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

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## IF YOU CONVERT YOUR BUSINESS CORPORATION TO AN LLC, WILL YOU LOSE YOUR S ELECTION?

As I wrote in last month's newsletter, there are two strong reasons why New Hampshire business corporations should consider converting to New Hampshire limited liability companies under the New Hampshire Limited Liability Company Act (the "LLC Act"):

1. Charging order protections. Under the "charging order" provisions of Section 47 of the LLC Act, multi-member LLCs provide business assets and other key protections that no corporate statute, including the New Hampshire Business Corporation Act, can provide. For many closely held New Hampshire corporations, these "charging order" protections can provide crucial legal advantages. (For more information about LLC charging order protections, visit [www.llcformations.com](http://www.llcformations.com); click on the FAQ tab; and click on the links for Questions 3.1 and 3.6.)
2. Avoidance of I&D Tax. Under Section 77:4,III of the New Hampshire Interest and Dividends Tax, New Hampshire residents who are members of multi-member LLCs are exempt from that tax as long as the LLCs have "nontransferable shares" (something which is easily provided for in a properly drafted LLC operating agreement). Distributions from business corporations to these distributees are subject to the I&D Tax - and this is true *whether or not* these corporations have nontransferable shares.

In last month's newsletter, I stated what I believe is a compelling case that the conversion of a New Hampshire business corporation to an LLC is an "F reorganization" under Internal Revenue Code Section 368(a)(1)(F) and thus cannot trigger any federal income tax either to the shareholders of the corporation or to the corporation itself. In other words, by reason of Section 368(a)(1)(F), the IRS will not treat the conversion as a sale of corporate stock or assets.

However, many New Hampshire corporations, including some very large ones, have made S elections, and the status of these corporations as S corporations is extremely important to their shareholders as a protection against double taxation in the event of an asset sale (and in various other situations).

Hence the importance of the following question: If a New Hampshire business corporation that is an S corporation converts to an LLC, will this conversion have any adverse effect on its S election? More particularly, will the conversion affect the effective date of its S election?

I'm happy to be able to tell you that, assuming that after the conversion, the former business corporation (now an LLC) files Internal Revenue Service Form 8832 and checks Box 2a of that form to elect to be an "association taxable as a corporation," the answer will be a resounding "no."

The basic reason for this answer is rooted in the theory underlying Section 368(a)(1)(F). As you'll recall, in a reorganization under Section 368(a)(1)(F), a corporation merely changes its name, business organization form or place of incorporation. When it does so, it is the same entity and, for all federal tax purposes, it is the same "tax corporation" after the change as before.

This means, in particular, that none of its tax attributes change – including its S election. This tax theory was reflected 40 years ago in a famous IRS revenue ruling known as Rev. Rul. 64-250. Rev. Rul. 64-250 has been followed in dozens of subsequent IRS administrative rulings.

The most recent such ruling is PLR 200248023, in which the IRS has ruled, among other things, that when an entity that was a business corporation and had an S election merged into an LLC in a reincorporation transaction, the entity in its new business organization form as an LLC would retain its S election and the effective date of this election would be unchanged as long as the entity, after the merger, filed the above IRS Form 8832.

The bottom line: If clients of yours who own a business corporation want to update their business organization form, avoid I&D Tax and enhance their business asset protection by converting to an LLC, they can rest assured that this conversion will have no effect whatsoever on their S election.