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ACQUISITIONS, DISPOSITIONS & STRUCTURING TECHNIQUES CORNER —
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Statutory mergers and conversions can be used in structuring transactions involving passthrough entities. There are no Internal Revenue Code sections prescribing the treatment of these statutory mergers and conversions. The tax advisor must analyze the tax consequences of these unrecognized forms of transactions by choosing a different transaction whose tax consequences are set forth in the Code and concluding that the merger or conversion will be taxed in the same manner. This column describes statutory merger and conversion techniques for passthrough entities, suggests some circumstances in which they may be helpful, and outlines the emerging guidance on how these transactions will be taxed.

Nature of a Statutory Merger

Corporate mergers and their tax treatment are familiar to the tax advisor. In order to think clearly about the tax consequences of passthrough entity mergers, however, it is helpful to review the basic nature of a statutory merger.

Basic Procedures. State corporate statutes have long contained merger provisions. The terminology and procedures vary from state to state, but the basic elements are constant. Two merging corporations file a merger agreement with the secretary of state. The merger is approved by a majority and sometimes more of each corporation's shareholders. The merger agreement describes what each group of shareholders is transferring and receiving in the merger. The merger agreement typically states that the existence of one of the corporations ceases and that the other corporation survives. State law provides that upon the completion of the merger procedures, the existence of the merging corporation terminates and the surviving corporation succeeds to all of the terminated corporation's rights and obligations by operation of law.

Mergers Used to Effect Conversions. Statutory mergers have long been used to convert a corporation formed in one state into a corporation formed in another state. The parties form the desired entity as a shell with no assets or liabilities. The parties then file a merger agreement in which the shareholders of the old corporation give up their shares of the old corporation in exchange for shares of

the shell. The old corporation terminates, and the shell succeeds to all of the assets and liabilities of the old corporation.

Transfer of Assets and Liabilities. The assets are said to be transferred by operation of law from the terminated corporation to the surviving corporation. This means that the parties do not need instruments of conveyance, such as deeds and assignments, to transfer the assets. The debts and obligations are also transferred by operation of law. Therefore, the parties do not need to enter into assumption agreements with respect to the terminated corporation's obligations. Additionally, the parties may not have to assign contracts for the surviving corporation to succeed to the terminated corporation's rights under contracts.

Transfer of Contract Rights. Unless the contract provides otherwise, contract rights generally may be assigned (*i.e.*, transferred by an instrument of conveyance) or transferred by operation of law (*e.g.*, transferred by merger or transfers in bankruptcy proceedings). If a contract prohibits assignment but does not prohibit transfers by operation of law, the parties may conclude that a merger does not require the consent of parties to contracts for the surviving corporation to succeed to the terminated corporation's contract rights.

Transfer of Licenses. Licenses, such as a government-issued permit to carry on a certain kind of business, generally cannot be transferred by assignment or by merger without the approval of the government agency that issued the license.

Expansion to Passthrough Entities. Led by Delaware, the states have added merger provisions to their partnership and LLC statutes. These provisions work the same way as the corporate merger provisions. Both entities' partners or members must approve the merger and file a merger agreement with the secretary of state. Subsequently, assets and liabilities pass to the surviving partnership or LLC by operation of law.

Expansion to Cross-Entity Mergers. The recent statutes also allow mergers between different kinds of entities. Thus, an LLC can merge into a corporation with the surviving entity being a corporation under state law. A corporation can merge into an LLC with the surviving entity being an LLC.

Cross-Entity Merger Used to Effect Conversions. As noted, mergers into shell corporations have long been used to change the state of organization of an entity. Since the relatively recent application of merger provisions to passthrough entities and to mergers of different kinds of entities, cross-entity mergers into new shell entities have been used to effect conversions. For example, partners wishing to convert their partnership to an LLC would form a new LLC and merge their partnership into it.

Nature of a Statutory Conversion

Delaware now allows entities to change to a different kind of entity by filing a certificate of conversion. A merger into a new shell is no longer necessary. This is an example of how Delaware quickly amends its statutes to make transactions easier and more feasible. The procedure is probably available as a practical matter to Delaware entities only because of doubts over whether a conversion filed in Delaware of an entity organized in another state will be respected by the state of organization. This is an example of the benefits of organizing entities under Delaware law. If a conversion is needed to solve a problem faced by an existing entity, it often can be made only if the entity were formed in Delaware in the first place.

Uses of Statutory Mergers and Conversions

Passthrough entities use merger provisions to accomplish business combinations for the same reasons that corporations have long used corporate merger provisions. Mergers can be accomplished over the objection of dissenting partners or members and can transfer assets, liabilities and contracts by operation of law.

Statutory conversions allow a business to change its tax form with minimum legal disruption. A Delaware partnership wishing to obtain the liability protection of LLC status need not merge into a shell LLC and then worry about whether its contracts are enforceable by the new LLC. The partnership can file a certificate of conversion with the Delaware Secretary of State and thereby become an LLC without transferring any assets or contract rights to a different entity. There is no transfer in a conversion because there is no second entity involved. After the conversion, the LLC is the same legal entity as the partnership before the conversion. It is governed by a different part of the Delaware law governing legal organizations.

Although statutory conversions are too new for there to be a certain answer, it is likely that a conversion does not invoke contract provisions against transfers by operation of law. It is also likely that a license issued to the entity prior to the conversion will remain in force after the conversion.

For an example of the use of a statutory conversion, suppose that two corporations wish to merge businesses conducted in subsidiaries, with each corporation owning 50 percent of the combined business after the merger. The corporations want the combined entity to be in passthrough form to avoid the tax inefficiencies of corporate joint ventures. However, one or both entities have contracts or licenses that cannot be transferred. The subsidiary corporations could be converted to single-member LLCs. One corporation could then contribute its LLC membership interest to the other corporation's LLC in exchange for 50-percent ownership of the other corporation's LLC. Both entities would be intact as legal entities, and both parents would own their half of the

business in passthrough form.

Income Tax Treatment of Mergers and Conversions

Background. There are three basic ways to transfer assets from entity A to entity B:

I **Assets Over.** Entity A could transfer its assets to entity B in exchange for B interests, and then entity A (which now owns nothing but B interests) would transfer the B interests to A's owners. Based on the terminology used in the partnership merger regulations discussed below, this is the assets over method, because the assets are transferred from entity A over to entity B.

I **Assets Up.** Entity A could transfer its assets to A's owners first, and then A's owners could transfer the assets to entity B in exchange for B interests. This is the assets up method, because assets are moved from A up to A's owners.

I **Interests Over.** Entity A's owners could transfer their A interests to B in exchange for B interests. Entity A, which at that point would be owned 100 percent by B, would liquidate by transferring its assets to B. This is the interests over method, because the A interests are transferred to B.

In [Rev. Rul. 70-239](#),¹ the IRS noted that the three above methods were the only ways as a matter of state law form to convert a partnership to a corporation. There were no LLCs at that time and no cross-entity mergers or statutory conversions. The IRS concluded that regardless of which of the three state law forms the taxpayer used, the transaction would be taxed according to the assets over method. In [Rev. Rul. 84-111](#),² the IRS reversed itself and declared that the state law form used would control the tax treatment.

Entity Classification Regulations. [Reg. §301.7701-3\(g\)](#), added in 1999, provides that when an entity taxed as a partnership makes an election to change its classification to an association taxable as a corporation for tax purposes as permitted by the regulations, the assets over method will be applied to determine the tax consequences. That same regulation also provides that if an association taxable as a corporation makes an election to be taxed as a partnership, the assets up method is applied.

Partnership Merger Regulations. [Proposed Reg. §1.708-1\(c\)](#) provides that if two partnerships are merged, the partnership with the larger equity value is deemed to be the survivor for tax purposes regardless which partnership was the survivor in the state law transaction. The regulation also states that if the partnerships merge by having the terminated partnership distribute its assets up to its partners, followed by their contribution of the assets down to the surviving

partnership, the merger will be taxed according to the assets up form. If any other form is used, including a statutory merger, the combination is taxed according to the assets over form.

Private Rulings. The IRS has had occasion to consider the tax treatment of statutory mergers and conversions in a number of private letter rulings, but the law is not fully developed. The IRS applied the assets up form to statutory conversions of corporations into partnerships in at least two rulings.³ Seemingly inconsistently, the IRS applied the assets over form to mergers of corporations into LLCs.⁴ The corporation-to-partnership rulings seemed more concerned with establishing that the merger resulted in a taxable liquidation of the corporation than it did with choosing which of the three possible forms of taxable liquidation applied. Assets over, assets up and interests over all result in a taxable liquidation. The IRS has also applied the assets over form to the merger of a partnership into a business trust taxable as a corporation.⁵

Consequences of Applicable Form. Many times the applicable form will not make much tax difference. One example in which there is a big difference is a merger of a corporate subsidiary into an LLC. The assets over and assets up forms both result in a nontaxable liquidation of a corporate subsidiary under [Code Sec. 332](#). However, application of the interests over form results in a taxable liquidation of the corporate subsidiary because if interests (subsidiary stock) are first transferred to the LLC, the corporation is not 100-percent owned when it liquidates, and 100-percent ownership is required for a [Code Sec. 332](#) liquidation.

Another example of a transaction in which the form makes a difference is the determination of whether a [Code Sec. 754](#) election is needed to increase asset basis after a merger of partnerships in which there is some taxable gain. If the assets over or interests over form is applied, there is no increase in the tax basis of the terminating partnership's assets unless the terminating partnership makes a [Code Sec. 754](#) election on its final return. If the assets up form is used, there is a step-up without a [Code Sec. 754](#) election by operation of [Code Sec. 732](#).

Conclusion

Statutory mergers and conversions are useful in structuring acquisitions of passthrough entities, especially where the acquired entity has contracts or licenses that are difficult to transfer. Until the law prescribing the tax treatment develops further, however, there will be some uncertainty in how these transactions are taxed.

¹ [Rev. Rul. 70-239](#), 1970-1 CB 74.

² [Rev. Rul. 84-111](#), 1984-2 CB 88.

³ [LTR 9638047](#) (June 27, 1996) (conversion effected by modification of articles); [LTR 9401014](#) (Oct. 7, 1993) (conversion effected by statutory conversion).

⁴ [LTR 9644003](#) (July 23, 1996); [LTR 9701029](#) (Oct. 2, 1996); [LTR 199924064](#) (Mar. 17, 1999).

⁵ [LTR 9409035](#) ([Dec. 7](#), 1993).