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SELECTED USES OF LLCs IN CORPORATE TRANSACTIONS

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This article discusses selected (not all) uses of limited liability companies ("LLC") in certain corporate transactions. It focuses on two types of LLCs:

- a multi-member LLC ("MMLLC") that, for tax purposes, is treated as a partnership, and thus has not elected to be treated as a corporation under the check-the-box regulations; and
- a single-member LLC ("SMLLC") that, for tax purposes, is "disregarded," and thus has not so elected to be treated as a corporation.

GENERAL REASONS FOR USES

These uses derive from the unique characteristics of the LLCs. A MMLLC is taxed as a partnership with flow-thru taxation, but under state law its members have limited liability like do the shareholders of a corporation. A SMLLC is not a separate entity for tax purposes. For those purposes, it is "disregarded," as if it were an internal branch or division of the member, and its assets and liabilities are treated as owned directly by the member. It is a "tax nothing." However, under state law it is still a separate legal entity with the limited liability for the member.

SELECTED USES OF MMLLC

Flow-Thru Tax Treatment

Unless a consolidated income tax return is filed for the parent corporation and its subsidiary corporation, the subsidiary's earnings are generally subject to a double tax when they are distributed by the subsidiary to the parent. To file a consolidated return, the parent must generally own at least 80% of both the voting power and the value of the subsidiary's stock. In many cases the ownership may be less than that, so that a consolidated return is not available. To receive flow-thru tax treatment and avoid the double tax, the subsidiary can be set up as a MMLLC rather than as a corporation.

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Shift of C Corporation Earnings to Shareholders

The earnings of a C corporation are generally subject to a double tax when they are distributed to its shareholders. The double tax sometimes may be avoided by converting to an S corporation, but such conversion is not always permitted or otherwise advisable. In those cases, a MMLLC might be used to shift the C corporation's earnings to its shareholders without a double tax.

Very generally, the C corporation drops down its selected business or assets into a MMLLC in return for a preferred interest. The shareholders contribute other assets to the MMLLC in return for the common interests. The preferred interest carries fixed, preferential distribution and liquidation rights. Earnings and appreciation of the MMLLC in excess of those rights inure to the holders of the common interests, without a double tax. This is basically an "estate freeze" but in the corporate context. Since an "estate freeze," it must pass muster under the anti-estate freeze rules of IRC Section 2701.

Estate Freeze of S Corporation

In some cases, the shareholders may wish to do an estate freeze of an S corporation, with the older generation shareholders receiving the frozen preferred stock and the younger generation shareholders the unfrozen common stock. This is to freeze the value of the older generation's stock, to pass value to the younger generation free of a gift or estate tax. The problem is, this cannot be done with an S corporation. An S corporation is not permitted under the tax rules to have two such classes of stock.

Generally the same result may be achieved by the S corporation's dropping down its business to a MMLLC in return for a preferred interest. The shareholders then contribute assets to the MMLLC, with the older generation receiving back preferred interests and the younger generation common interests. A freeze is thereby achieved. Again, it must satisfy IRC Section 2701.

Prohibited Shareholder of S Corporation

Under the tax rules, an S corporation may only have individuals and certain trusts and estates as shareholders. A corporation (whether C or S), partnership, or LLC, for example, may not be a shareholder of an S corporation. But in some cases it may be desired that an otherwise prohibited shareholder hold an interest in an S corporation.

The desired end may generally be accomplished with a MMLLC. The S corporation drops down its business to a MMLLC in return for an interest. Then the otherwise prohibited shareholder (be it a corporation, partnership, or LLC, for example) contributes assets to the MMLLC in return for an interest. (Since the purpose is not an estate freeze, all interests are alike.) Now the prohibited person, though not a shareholder in the S corporation, is nonetheless an owner of its business via the MMLLC.

Avoidance of IRC Section 355(e)

Under various strictures in IRC Section 355, a corporation ("Distributing") may distribute tax free the stock of a controlled subsidiary ("Controlled") to Distributing's shareholders. The distribution is tax free to both Distributing and the shareholders. However, under a complicated set of rules in IRC Section 355(e), the distribution will be taxable to Distributing (but not to the shareholders) if the distribution is "part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest" in Distributing or Controlled. Generally, such a plan will be presumed, subject to rebuttal, if the acquisition of such interest occurs within two years before or after the distribution.

Possibly the application of IRC Section 355(e) may be avoided through the use of a MMLLC. Distributing or Controlled, whichever the one in which the acquisition of the interest is otherwise desired, drops its business

into a MMLLC. The proposed acquirer, instead of acquiring an interest in Distributing or Controlled itself, acquires an interest instead in the MMLLC. The application of IRC Section 355(e) might therefore be avoided.

Reduction of Gain or Dividend on Corporate Distribution

The employment of a MMLLC might result in lower taxes to a corporation and a shareholder to whom it makes a distribution. This requires some background information to explain.

In a liquidation, a corporation recognizes gain (or loss) as if it had sold the distributed assets to the distributee shareholder for fair market value. The shareholder recognizes gain (or loss) as if it had sold its stock for the fair market value of the assets distributed to it.

When the distribution is not in liquidation, the corporation recognizes gain (but not loss) as if it had sold the distributed assets to the distributee shareholder for fair market value. If the distribution is in redemption of the shareholder's stock and the redemption qualifies for sale treatment under IRC Section 302, the shareholder recognizes gain (or loss) as if it had sold its redeemed stock for the fair market value of the assets distributed to it. Otherwise, the amount of the distribution is the fair market value of the distributed assets, and the distribution is taxed to the shareholder in layers. First it is an ordinary dividend to the extent it does not exceed the allocable share of the "earning and profits" of the corporation. Then it is a tax-free return of basis to the extent of it does not exceed the tax basis of the shareholder's stock. Then the remainder is gain as if the stock had been sold.

All of that background is somewhat detailed, but the upshot is this: Such fair market value, as to the corporation or the distributee shareholder, possibly might be reduced through the use of a MMLLC. The reduction will decrease the gain (or in some cases, increase the loss) recognized by the corporation or

shareholder or decrease the amount of the dividend received by the shareholder. The authority on the effectiveness of this gambit appears conflicting, but it should nonetheless be kept in mind.

This is a very general illustration of the arrangement. Corporation intends to liquidate. It has land and other assets with a fair market value of \$1,000,000 and a tax basis of \$400,000. It has two shareholders, each owning 50% of the stock, which has a tax basis of \$80,000 to each. Assume a 40% corporate tax rate (federal and state) and a 20% individual long-term capital gain rate (federal and state). If the corporation distributes its assets, it will recognize \$600,000 of gain, and will pay a tax of \$240,000. Thus each shareholder will receive \$380,000, giving each a gain of \$300,000. Each will pay tax of \$60,000 and net, after tax, \$320,000.

Instead, assume that the corporation contributes the land and other assets to a MMLLC, in return for a 90% *non-voting* interest. The shareholders each contribute \$50,000 to the MMLLC, in return for a 5% *voting* interest each. Then the corporation liquidates, distributing 45% of its interest to each shareholder. Assume that, because of valuation discounts (such as for minority interest and lack of marketability), each 45% *non-voting* interest has a fair market value of \$300,000. Now the tax paid by the corporation will be \$80,000. Thus each shareholder will receive \$260,000 of fair market value, giving each a gain of \$180,000. Each will pay tax of \$36,000 and net, after tax, \$224,000 of fair market value. But, without the valuation discounts, each shareholder will really net \$424,000 (\$500,000 - \$40,000 - \$36,000).

Each shareholder will thus net \$104,000 more through the use of the MMLLC. Before using this arrangement, the competing authorities for its validity must be weighed. The shareholders were also made members. Otherwise it would be a SMLLC, and under Rev. Rul. 99-5 the corporation would be treated as distributing the land and other assets outright, as if they were

not in an LLC. Thus no valuation discounts would be available.

SELECTED USES OF SMLLC

Parent/Subsidiary Liquidations

Often a parent corporation liquidates its subsidiary corporation in order, for example, to get full use of the subsidiary's net operating losses, to avoid the filing of consolidated income tax returns, or to achieve some other result. The liquidation is generally tax free to the parent and the subsidiary (under IRC Sections 332 and 337) if the parent generally owns at least 80% of both the voting power and the value of the subsidiary's stock. A business downside to the liquidation is that the parent's assets thereafter become subject to the liquidated subsidiary's liabilities and operational risks.

A SMLLC may be used to implement the liquidation but avoid that downside. The parent corporation forms a SMLLC and transfers the subsidiary's stock to it; then the subsidiary liquidates into the SMLLC. For tax purposes, the liquidation into the SMLLC is the same as the liquidation into the parent. But, under state law, the SMLLC gives the parent limited liability and protects its assets from the liabilities and operational risks of the SMLLC.

Triangular "A" reorganization

An "A" reorganization under IRC Section 368(a)(1)(A) is the simplest of the tax-free corporate reorganizations, with the least restrictive requirements. In an "A" reorganization, the target corporation merges under state law into the acquiring corporation. The problem is that, by virtue of the merger, the acquiring corporation's assets then become subject to the target's liabilities and operational risks.

Before the advent of SMLLC's, this problem was avoided by doing a forward triangular merger under IRC Section 368(a)(2)(D), another type of tax-free corporate reorganization. This merger is effected by the acquiring corporation's creating a new subsidiary

corporation, with the target then merging into that subsidiary. But an "(a)(2)(D)" reorganization poses a problem of its own. It requires that the subsidiary acquire "substantially all" of the target's assets, which is not a requirement in an "A" reorganization. This may be a problem because, for example, the target may have disposed of some of its assets beforehand in a redemption of a shareholder, so that the subsidiary does not acquire "substantially all" of target's assets.

A solution is this: The acquiring corporation forms a SMLLC, and target merges into the SMLLC. For tax purposes, it is treated as a merger into the acquiring corporation itself. So it is tested as an "A" reorganization, without the "substantially all" requirement. And the interposition of the SMLLC protects the assets of the acquiring corporation from target's liabilities and operational risks.

Avoidance of Consolidated Returns

To file a consolidated income tax return, the parent corporation must generally own at least 80% of both the voting power and the value of the subsidiary corporation's stock. Consolidated returns often are complicated and often give rise to adverse tax consequences.

Assume the parent corporation owns 100% of subsidiary corporation. The consolidated returns can be avoided by having the subsidiary merge into a SMLLC of the parent. This merger is tax free to all the parties (under IRC Section 332 and 337), assuming the other standard tests are met. For tax purposes, the SMLLC is disregarded and treated as an internal division of the parent. Thus operations of the SMLLC are reported directly on the parent's income tax return. But the SMLLC protects the parent from the liabilities and risks of the SMLLC's operations.

"Active Trade or Business" under IRC Section 355

As noted above, under IRC Section 355 a corporation ("Distributing") may distribute tax free the stock of a

controlled subsidiary (“Controlled”) to Distributing’s shareholders. It is tax free to both Distributing and the shareholders. One of the requirements in IRC Section 355 is that each of Distributing and Controlled be carrying on an “active trade or business.” In some cases, it may be desirable that Distributing or Controlled meet this requirement through its own operations rather than through an affiliate’s.

One way to accomplish this result is by doing a tax-free liquidation (under IRC Sections 332 and 337) of the affiliate having the “active trade or business” into Distributing or Controlled, as the case may be. As discussed above, though, this has the downside of subjecting Distributing or Controlled, as the case may be, to the liabilities and operational risks of the affiliate. Again, this result can be achieved without that downside by having the affiliate merge into a SMLLC of Distributing or Controlled, as the case may be.

Partial Redemption Under IRC Section 302(b)(4)

A partial redemption under IRC Section 302(b)(4), generally for a “corporate contraction,” qualifies as a sale of the redeemed stock rather than being an ordinary dividend. The sale may give rise long-term capital gain. Though the income tax rates on ordinary dividends are currently generally the same as those on long-term capital gain, the gain offers an advantage over the dividend: the tax basis of the redeemed stock reduces the amount of the gain but not the amount of the dividend.

One way to qualify as a partial redemption is the corporation’s distribution of the assets of a “qualified trade or business” to a shareholder or shareholders in redemption of their stock. The shareholder or shareholders, however, will take those assets outright, and thus not have limited liability as to them. Instead, the corporation may place the assets in a SMLLC and then distribute the interests in it to the shareholder or shareholders. (See Rev. Rul. 99-5 in this regard.) This gives the shareholder or shareholders the limited liability.

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A shareholder in the Tax Group of Copeland, Cook, Taylor & Bush, P.A., Tom is a Fellow of the American College of Trust and Estate Counsel, is listed in *The Best Lawyers in America* in Tax Law and in Trusts and Estates, and is a member of Attorneys for Family-Held Enterprises. He also is a past president of the Estates and Trusts Section and the Taxation Section of The Mississippi Bar. Also a CPA, Tom has served on the Board of Governors of the Mississippi Society of Certified Public Accountants.

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