
The New Reversionary Conversion Doctrine?

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A few months ago I found myself playing checkers with my six-year-old niece. During the course of the game, she moved a piece, and then gingerly pulled her finger back. For those of you who can't remember the finer points of checkers, once your finger fully leaves your piece, your turn is officially over, and your opponent's turn begins. Yet, depending on the grace of your opponent, it is not uncommon to

ask for (and receive) a "take-back," even long after one's finger has been removed. As long as your opponent has not yet moved, asking for a take-back is fair game.

Many M&A TAX REPORT readers may wish that they could take-back tax advice. I know I do. It is not uncommon for a client to tell me that he forgot to mention facts that he believed to be unimportant. Often, this

newly revealed information can materially alter my prior advice.

Perhaps just as common is the situation where a third party changes his mind (or even dies) or some other uncontrollable variable shifts. Any of these unexpected events can cause the cost of the transaction to become excessive or the contemplated tax benefits to evaporate. I have even seen the situation where the occurrence of unforeseen events has made the completion of a transaction technically not feasible. It's these mid-transaction, or even post-transaction, changes that make me wish I had a take-back.

IRS Generosity

Recently, the IRS announced its own version of the take-back. Clearly, this is significant, and prudent advisors should take heed. In LTR 200613027 (Dec. 16, 2005), the IRS allowed a taxpayer to take back a taxable entity conversion a few months after the transaction had been executed.

In the ruling, the taxpayer was originally an LLC classified as a partnership for federal income tax purposes. It had converted to a corporation under a state law conversion statute. Under this type of conversion, an LLC usually only has to file a few pieces of paper with the appropriate state agency to effectuate a conversion. Here, the LLC converted into a corporation by filing a certificate of conversion and a certificate of incorporation.

Express Conversions

Changing from an LLC to a corporation under a conversion statute is simple and fast. Compared to the old days when taxpayers actually had to undertake multiple steps to convert an entity, conversion statutes reduce the time, cost and administrative hassles of changing legal form. This can create a great deal of flexibility for most businesses.

Yet, it is these same beneficial statutes that may be indirectly responsible for creating the mess for which the taxpayer had to ask the IRS for assistance. In other words, if it weren't so easy to change entity types, perhaps the taxpayer would have given more careful thought to the conversion and would not have needed to ask for a take-back.

Prior to the conversion, the taxpayer was an LLC with two members. As a result of the conversion, the LLC became a corporation,

and its two members became shareholders of the newly formed corporation. In LTR 200613027, the owners of the LLC seemed to have legitimate reasons for undertaking the conversion to a corporation. They anticipated making an initial public offering (IPO) of the corporation's stock. An LLC is generally not an entity which can undertake an IPO.

Initially, life as a corporation went smoothly. The corporation made a distribution to its owners, which it called an "LLC Tax Distribution Payment." The shareholders were entitled to the distribution based on the period up to the conversion, although it is not clear if their right came from the former LLC operating agreement or from some new corporate document. It is fairly common for an LLC to make a tax distribution payment, since LLC members (or former members, as in this case) must pay tax currently on the LLC's profits, whether or not those profits are distributed.

The corporation also made certain redemptions of its outstanding stock as a result of the death or separation from service of members of its management team. Presumably, the corporation gave stock to some of its key employees in anticipation of the IPO. As discussed below, when the IPO was shelved, it appears that the corporation redeemed the shares from its management team.

Shortly after the conversion, market conditions unexpectedly deteriorated. The plans for the IPO were cancelled, and the corporation had no further plans to re-attempt another IPO "in the near future." Of course, this begs the question of precisely what constitutes the "near future." Is it six months, 12 months, 18 months?

Converter's Remorse

The taxpayer had converted from a pass-through entity to a corporation for a specific purpose, and now that purpose was frustrated. The owners didn't want to operate their business in corporate form unless their business was public, or on-route to becoming public. Who would? They desired to convert their corporation back to an LLC.

Moreover, since the taxpayer had the ability to convert back to an LLC prior to the closure of the original LLC's tax year (all of the entities and owners were calendar-year taxpayers), it wanted the IRS to allow it to treat the two conversions as if neither had actually occurred. In fact,

the proposed conversion back to LLC form is referred to as the “Rescission Transaction.”

The Rescission Transaction intended to restore the legal and financial arrangements between the owners and the LLC as would have existed had the corporation not converted, but had remained an LLC the entire time. All parties agreed to take positions on their tax returns reflecting the continuity of the LLC.

The Take-Back Allowed

Like a fairy tale come true, the IRS waived its magic wand, and granted the taxpayer’s wish, allowing it to rescind the conversion. The IRS ruled that the taxpayer could treat itself as a partnership as if it had never converted. Moreover, both owners can be treated as partners in a partnership. Thus, the “LLC Tax Distribution Payment,” which technically was a corporate distribution, could be treated as a partnership distribution. To round out its largesse, the IRS allowed the conversion back to LLC to be tax-free.

Normally, converting from a corporation to an LLC is a taxable event (unless there is an 80-percent corporate shareholder), since the corporation will necessarily be liquidated in the conversion. The liquidation causes the corporation to be taxed on any inside gain and the shareholders to be taxed on any outside gain.

Nonetheless, it is possible (if not probable) that there was little gain, inside or outside, given that there was such a short window between the two conversions. Yet, the IRS does not mention this lack of potential gain as a reason for allowing the rescission to be completely tax-free. The ruling only notes that the Rescission Transaction will not be treated as a liquidation for either the corporation or its shareholders.

Conclusion

Many of us have yearned for take-back. While I don’t believe we are quite there yet, the take-back seems closer today than ever before. I wonder whether any portion of the IRS’s motivation in issuing LTR 200613027 is based on the notion that taxpayers are already taking positions similar to that described in the ruling. Taxpayers may be rescinding conversions and other transactions without even alerting the IRS to the matter.

Although this particular ruling is fairly innocuous, it may signal the beginning of a more expansive position by the IRS. Now that we know that the IRS is not completely opposed to allowing a take-back, practitioners may start asking, and the IRS may start blessing, the take-back for all sorts of transactions. Perhaps the IRS is going to create a new area of jurisprudence, delineating which transactions can be subject to the take-back.