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To LLC or Not To LLC: Here Are Some Questions

by Ken Witt & Eric Zinn

Limited liability companies (“**LLCs**”) have continued to grow in popularity in recent years. The reason for this is clear. LLCs have, since a [1988 Revenue Ruling](#) from the Internal Revenue Service, offered “pass-through” tax treatment, meaning that earnings of the LLC are only taxed once at the member/owner level. In a corporation, by contrast, income is taxed twice: once at the corporate level and again if dividends are distributed to the shareholders.*

Notwithstanding certain tax and other advantages of LLCs, recently we have seen a number of clients elect to convert their LLCs to corporations. Among other reasons for converting, including equity compensation and self-employment tax concerns, LLCs can be disadvantageous in certain types of mergers and acquisition transactions.

Unlike an LLC, a corporation can be acquired in a tax-free reorganization. Both the buyer and the seller may wish to use the buyer’s stock as the consideration for the acquisition, particularly if the buyer’s stock is publicly traded. A buyer may propose a stock-for-stock exchange, a stock-for-assets exchange or a merger. If a number of technical requirements are met, any of these transactions can be tax-free to the sellers who own the target corporation, but not if the target is an LLC.

The obvious solution is for the sellers to convert their LLC to a corporation or elect corporate tax treatment for the LLC prior to the acquisition. However, such a move could result in the IRS applying the “step-transaction” doctrine. Converting to a corporation and, in short order, closing what is intended to be a tax-free reorganization could be viewed by the IRS as all part of one transaction. Relying on a [1970 Revenue Ruling](#) and other authority, the IRS could very well disregard the first step (the conversion to a corporation) and treat the entire transaction as merely the taxable receipt of the buyer’s stock by the sellers.

Note that whether an LLC or a corporation will be the best type of entity in an acquisition depends on the facts and circumstances. For example, an asset purchase from a corporation, as opposed to an LLC, will normally result in substantially higher taxes on the owners.

* “Subchapter S” corporations are only taxed at the shareholder level, but ownership is restricted to individuals who are U.S. citizens; and Sub S corporations cannot have more than one class of stock, among other limitations.

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If you anticipate selling your LLC, we recommend that you start planning as far in advance as possible. You may be able to preserve some of the tax benefits of the LLC by incorporating as a Subchapter S corporation. Or, if that solution is unavailable (if you have non-U.S. owners, for example), you may decide that the tax benefits of the LLC are outweighed by the greater flexibility offered by a corporation in an acquisition.

Kutak Rock's Scottsdale Corporate and Securities Group can help you with these decisions; feel free to contact us. You may also visit us at www.kutakrock.com.

