ISSUES TO CONSIDER BEFORE ELECTING TO CONVERT FROM A C CORPORATION TO A LIMITED LIABILITY COMPANY OR BEFORE ELECTING S CORPORATION STATUS

May 1, 2012

INTRODUCTION

The new Michigan Corporate Income Tax ("CIT") modifies the corporate tax structure for our State. One aspect of the Michigan CIT is that the new tax applies only to traditional corporations ("C Corporations"). Pass-through tax entities, such as S corporations, limited liability companies, and partnerships (both general and limited) avoid the six percent corporate income tax rate.

This aspect of the CIT may lead certain C Corporations to consider converting away from C Corporation status, converting or electing to become a pass-through tax entity.

Given recent changes to the Michigan Limited Company Act, converting from a corporation to an LLC (and vice versa) has become relatively simple to accomplish.[1] While the process of converting from a corporation to an LLC with the State of Michigan is simple to achieve, and requires only the filing of a relatively straightforward certificate of conversion, several consequences result from a conversion or election.

Following is a list of issues to be considered by an entity considering conversion or election. These issues are divided into "non-tax" and "tax" issues. Before making any conversion or election, you are strongly encouraged to consult with qualified legal and tax counsel and advisors.

Presented by the Ad Hoc Committee formed among certain members of the legal and accounting professions, including: Anthony Antoun, G. Ann Baker, James Cambridge, Julia Dale, Daniel Minkus (Chair), Dean Rocheleau, and Douglas Toering,

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[1] Prior to recent changes to the Michigan Limited Liability Company Act, the traditional form of "converting" from one business entity structure to another was by use of a cross-entity merger.

NON-TAX ISSUES

DISCLAIMER: The information provided below is intended to assist in determining whether to convert from a corporation to a limited liability company ("LLC") and, if a C corporation, whether to elect to become an S corporation. The information below does not take the place of legal advice, accounting advice, or tax advice. To protect against undesired and unintended consequences, one should consult with competent legal, accounting and tax advisors before deciding whether to convert from one form of entity to another.

A. To Convert or Not To Convert [from a Corporation to an LLC]

1. LLC

a. What is an LLC?

- http://www.michigan.gov/lara/0,4601,7-154-35299_35413_35429-115005--,00.html

b. Foreign LLC

- http://www.michigan.gov/lara/0,4601,7-154-35299_35413_35429-120092--,00.html

2. Corporation

a. What is a corporation?

- http://www.michigan.gov/lara/0,4601,7-154-35299_35413_35426-114724--,00.html

b. Foreign Corporation

- http://www.michigan.gov/lara/0,4601,7-154-35299_35413_35426-120069--,00.html

c. S Corporation

- http://www.irs.gov/businesses/small/article/0,,id=98263,00.html

d. C Corporation

- http://www.irs.gov/businesses/small/article/0,,id=98240,00.html
- Changing from an C Corporation to an S Corporation:

  http://www.irs.gov/businesses/corporations/article/0,,id=179841,00.html

B. Do the applicable governing jurisdictions allow for conversion?

The Michigan statutes permit conversion between business entities, however if the entity is foreign LLC or a foreign corporation, you must ensure that the governing laws of the entity's state of formation permits conversion.

C. In deciding whether to convert, you want to consider or confirm that:

1. The entity will continue to qualify for a pass-through taxation treatment.

2. The owners qualify as owners of the converted form of entity under the relevant business statute.

3. Converting to a different entity will not result in unintended adverse federal income tax consequences (See Tax Issues discussion below).

4. Conversion will not result in the revocation of any licenses held by the enterprise.

5. Conversion will not trigger any "change in control" or "change in business structure" provisions of any contracts or relationships of the business. Such contracts or relationships include:

a. Bank documents

b. Lease documents

c. Licenses or permits

d. Insurance contracts and policies

e. Intellectual property filings or registrations

f. Franchise agreements

g. Employment agreements

h. Long-term contracts

6. Will conversion nullify any title insurance in place?

7. Will conversion nullify any government-related benefits (qualification for incentives, etc.)?

8. Will conversion trigger or otherwise affect any stock rights, such as stock option plans or stock options?

D. Immediate issues to address if electing to convert.

1. Required resolutions of shareholders to approve the conversion.

2. Required adherence to any shareholder agreements.

3. Required collection of share certificates.

4. Required Plan of Conversion.

5. Required submission and filing of revised formation document (from Articles of Incorporation to Articles of Organization (and any appropriate changes in such document)).

- http://www.dleg.state.mi.us/bcsc/forms/corp/corp/500.pdf
- http://www.dleg.state.mi.us/bcsc/forms/corp/corp/501.pdf

6. Required submission and filing of Certificate of Conversion.

- http://www.michigan.gov/lara/0,4601,7-154-35299_35414---,00.html

7. Recommended Operating Agreement. The LLC should immediately adopt an Operating Agreement executed by all of the members.[2]

8. Required appointment of managers or managing members.

9. Required confirmation for professional LLCs that all members qualify as members of the PLLC.

10. Re-title assets of the converted entity in the name of the LLC.[3]

E. Other issues to consider:

1. Creditors. A creditor technically obtains more rights by attaching corporate shares than an LLC or partnership interest because the creditor is entitled to vote the shares. This may or may not be significant depending on the percentage of votes. A creditor could liquidate an LLC interest by withdrawal if the operating agreement allows it. The Michigan LLC statute limits a creditor's rights to a "charging order," so the creditor may receive only those distributions which would otherwise go to the owner.

2. Free Transferability. In the absence of a shareholder agreement, it is generally more difficult (more restrictive) to transfer ownership interests in an LLC than in a corporation.

3. Ability to Raise Capital. In a corporation, the Board of Directors can generally determine how to raise additional capital. In an LLC, this right is generally reserved to the members (owners). This may make it more difficult to authorize such an action.

4. Fiduciary Duties. Corporate shareholders generally do not owe fiduciary duties to each other.[4] In a member-managed LLC, the members have all the duties and liabilities of managers, including the duties of loyalty and due care.

5. Voting. In the absence of other writings, each corporate share is entitled to one vote. In the absence of other writings, each member is entitled to an equal vote. This is irrespective of the percentage of ownership of such member!

6. Ability to Bind the Entity. In a corporation, a shareholder has no authority to bind the entity. Individual Board members similarly do not have any authority to bind the entity, but act only together as a board. The officers have whatever authority is given them in the bylaws or by a board resolution. In a member-managed LLC, each member has authority to bind the LLC. In a manager-managed LLC, the members have no such authority, but each manager has the authority to bind the LLC (unless restricted by the operating agreement).

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[2] Unless an Operating Agreement is adopted by the members of the LLC, the default provisions of the Michigan Limited Liability Company Act, as amended (the "MLLCA") will dictate various of the rights of the members. These default provisions may result in adverse consequences to certain of the members of the LLC. Among other concerns, the default provisions of the MLLCA provide that in the absence of an Operating Agreement, the ownership interests, the voting interests and the management interests of the members will be equal.

[3] Upon the filing of the Certificate of Conversion, all of the attributes of the corporation will instantly become the attributes of the LLC as a matter of law.

[4] In certain instances, a majority shareholder or a shareholder who possesses control of the corporation may be found to have certain fiduciary duties to the other shareholders.

7. A corporation may provide certain fringe benefits to its shareholder-employees on a deductible basis and this benefit may not be available to an LLC.

8. A C corporation may use any fiscal year.

TAX ISSUES

F. When is a business subject to Michigan Corporate Income Tax ("CIT")?

1. When Michigan annual gross receipts exceed $350,000 and
2. Business is a C corporation. Pass-through entities (LLCs and S corporations) are exempt from the CIT.

G. Are there tax consequences upon converting from a C corporation to an LLC?

1. At the corporation level, the conversion is generally considered a liquidation event. A liquidation event usually has tax consequences for both federal income tax and Michigan CIT. If the corporation has any of the following assets with values greater than the asset's tax basis, then additional taxes are generally likely:
   a. Tangible assets with a fair market value ("FMV") greater than the tax basis of the assets.
   b. Intangible assets with a FMV greater than the tax basis of the assets.
   c. Liabilities assumed by the LLC in excess of the FMV of the assets contributed may be taxable.

At the individual level, if the FMV of the assets, including intangible assets, exceeds the tax basis of the shareholder's stock, there will be a taxable gain on the difference. The holding period of the stock will determine whether the gain is a short-term capital gain or long-term capital gain.

H. Which income tax form is filed for an LLC and for final corporate returns?

1. Form 1065, U.S. Return of Partnership Income, if there are two or more members.
2. Schedule C or E, Form 1040, if the LLC only has a single individual member. A single member LLC is treated as a disregarded entity for federal tax purposes and reports its income on its sole member's tax return. Consult your tax advisor to determine which form to prepare if the LLC only has a single member.
3. Final Form 1120, U.S. Corporation Income Tax Return, for the last year as a corporation.
4. File Form 966, Corporate Dissolution or Liquidation, within 30 days after adopting the resolution to convert the corporation to an LLC.
5. A new tax identification number will be needed for the newly-created LLC.

I. Are there tax consequences if a C corporation elects to become an S corporation?

Generally yes, however each business is different. As a result of electing S corporation status, an appraisal is usually required to value the assets of the corporation. The difference between the value of the assets and the tax basis of those assets is considered a built-in gain. Generally, if any of those assets are sold within ten years from the effective date of becoming an S corporation, then the corporation must pay tax on the built-in gain. This provision allows for deferral of the tax when compared to converting to an LLC. However, certain situations may not provide for tax deferral such as:

1. A C corporation that values its inventory under the last-in first-out ("LIFO") method will pay the built-in gains tax on its LIFO reserve in the year it converts to an S Corporation. This tax is paid ratably over 4 years commencing with the year of the conversion.

2. A cash basis C corporation will pay the built-in gains tax as it collects its accounts receivables (less certain accounts payable) that would have been recorded on an accrual basis balance sheet as of the effective date of the S corporation election.

3. An accrual basis and cash basis C corporation will pay the built-in gains tax on the FMV of its inventory over the cost basis of the inventory as of the effective date of the S corporation election as it sells the inventory in its first year as an S corporation.

4. There may be other taxable situations when converting to an S corporation and, therefore, it is prudent to seek tax advice from a knowledgeable professional.

J. How do I make the election to convert to an S Corporation and which income tax form is filed for an S Corporation?

1. File Form 2553, Election by a Small Business Corporation, to elect S corporation status. See the IRS website for more information: Requesting a Change to File as an S Corporation.

2. File Form 1120S, U.S. Income Tax Return for an S Corporation.

K. What are the general income tax advantages of converting to an LLC?

1. Generally, an LLC is taxed as "pass-through" entity so the LLC itself does not pay federal income tax. Rather, the members of the LLC are taxed on the income of the LLC at the member level in proportion to their respective interests.

2. Single level of taxation (member level).

3. The LLC is exempt from the Michigan CIT of 6%. (But will pay individual income tax of 4.35% on the pass-through of income to the members' individual Michigan tax returns).

4. Generally, income distributions can be made to members using a formula other than in proportion to ownership interests.

5. In general, property distributions can be made to a member without incurring an immediate tax consequence if the FMV is greater than the tax basis of the distributed property.

6. Generally pass-through losses can be used to offset other income of the members subject to limitations governed by "at-risk" and passive activity loss rules.

7. Qualified non-recourse financing and recourse debt of the LLC will increase the member's tax basis which generally expands the ability to claim pass-through losses.

L. What are the general income tax disadvantages of converting to an LLC?

1. An active member may be subject to self-employment tax on pass-through income.

2. A passive member will be subject to IRS passive activity loss rules that may limit the immediate use of passive activity losses on an individual tax return.

3. In general, employee benefits are taxable for LLC members. Under current law, healthcare premiums paid by a self-employed person are tax deductible.

4. A passive member in an LLC may be subject to the "unearned" investment income Medicare tax of 3.8%, which becomes effective January 1, 2013 due to the Patient Protection and Affordable Care Act. Generally this tax applies to single filers with adjusted gross income ("AGI") exceeding $200,000 and joint filers with AGI exceeding $250,000.

5. An LLC has no IRC provisions for a tax-free reorganization similar to a corporation.

6. The Michigan CIT has additional tax withholding requirements for non-resident individuals and entities that are members in a Michigan limited liability company that do not apply to shareholders of a corporation.

M. What are the general income tax advantages of converting to an S Corporation?

1. With few exceptions, S corporations do not pay federal income taxes. Rather, the shareholders of the corporation will pay a single level of tax at the individual shareholder level based on their proportionate interests in the corporation. One exception to this rule is if an S corporation had been a C corporation before electing S corporation status. See discussion in Section I, above.
2. Generally exempt from Michigan CIT of 6%. (But shareholders will pay individual income tax of 4.35%).
3. Generally pass-through losses can be used to offset other income of the shareholders subject to limitations governed by "at-risk" and passive activity loss rules.
4. Sale of assets including intangible assets that generate long term capital gain is passed through to the shareholder's individual income tax return and the gain is taxed at the current federal long-term capital gain rate of 15%.
5. S corporation dividend distributions are not subject to self-employment tax as long as the shareholder is paid a reasonable salary for the services performed for the corporation.

N. What are the general income tax disadvantages of converting to an S Corporation?

1. A passive member will be subject to IRS at-risk basis loss rules and passive activity loss rules that may limit the immediate use of passive activity losses on individual tax return.
2. In general, employee benefits are taxable for shareholders with ownership greater than 2%.
3. A passive shareholder in an S corporation may subject to the "unearned" investment income Medicare tax of 3.8% which becomes effective January 1, 2013. Generally this tax is applicable to single filers with AGI exceeding $200,000 and joint filers with AGI exceeding $250,000.

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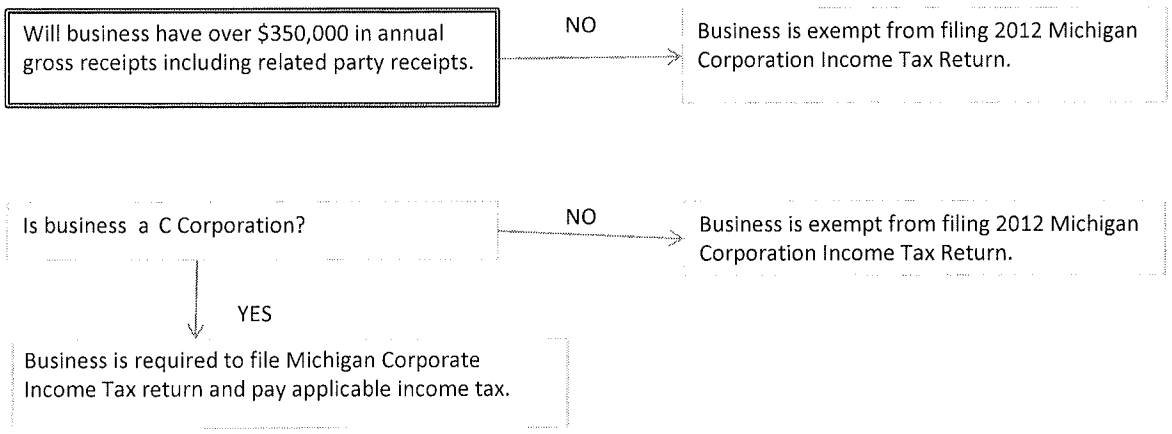
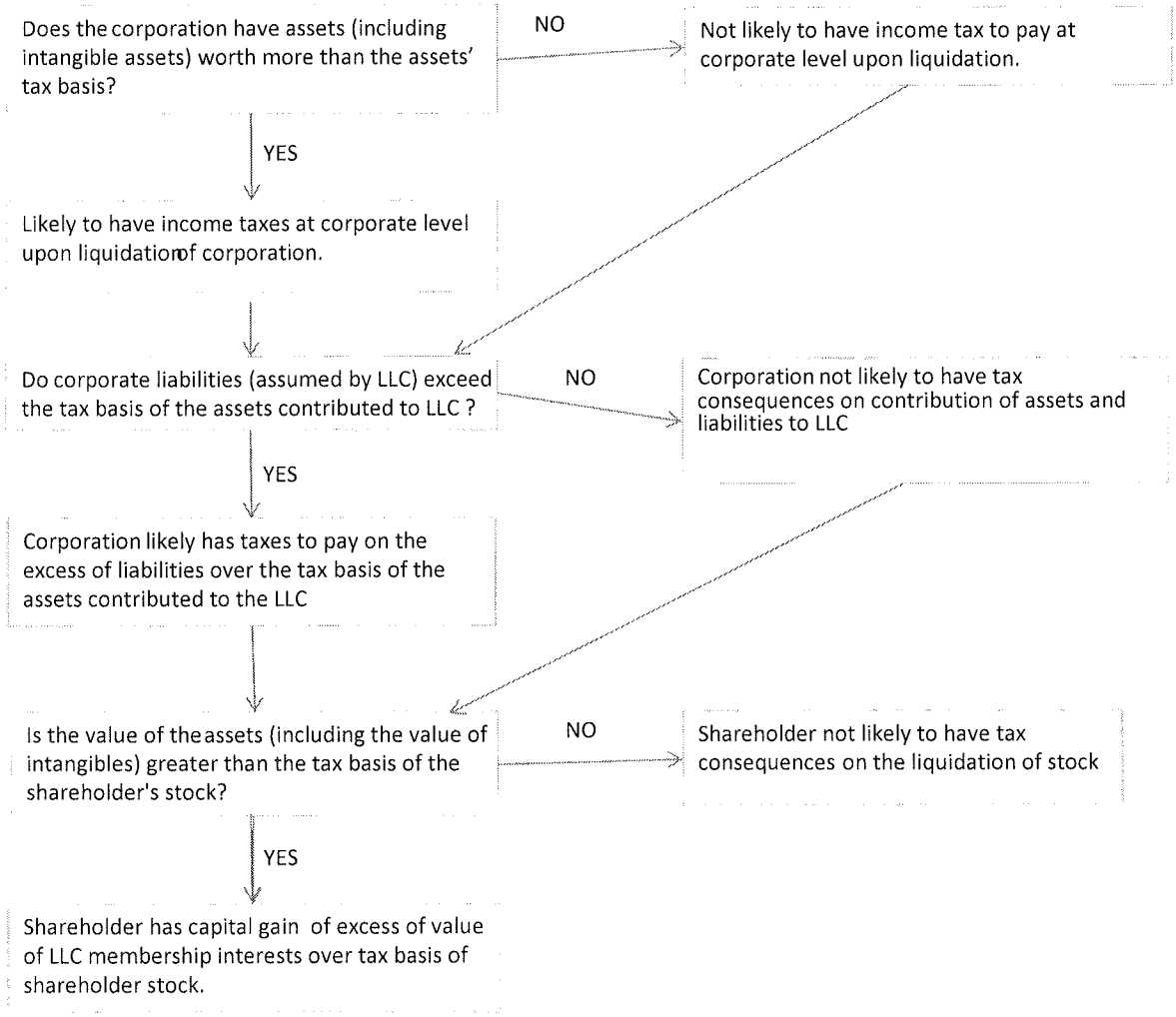
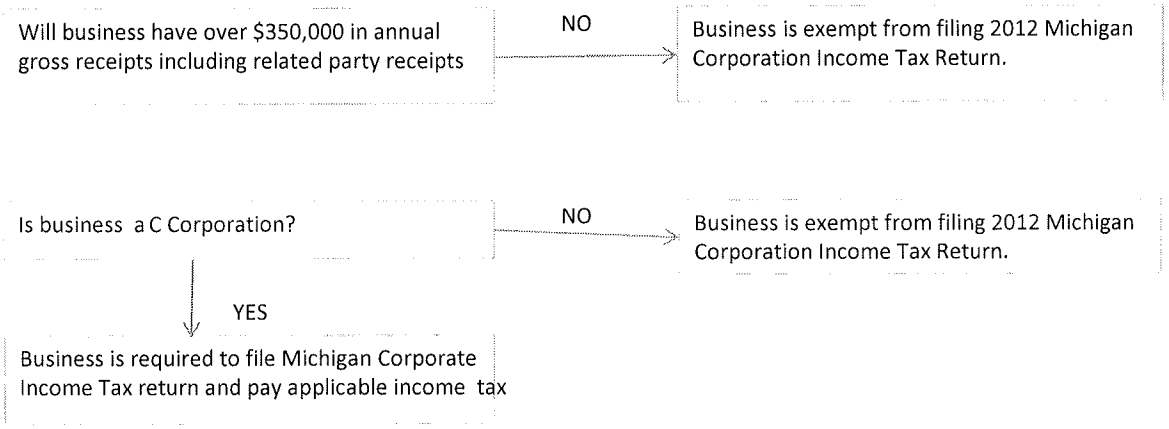


Should the business convert to a Limited Liability Company?

Are there tax consequences from converting a C Corporation to a Limited Liability Company?

Decision tree based on C corporation creating LLC and contributing its Assets and Liabilities to the LLC as part of its capital contribution then immediately liquidating corporation and distributing LLC member interests in exchange for the shareholders stock.





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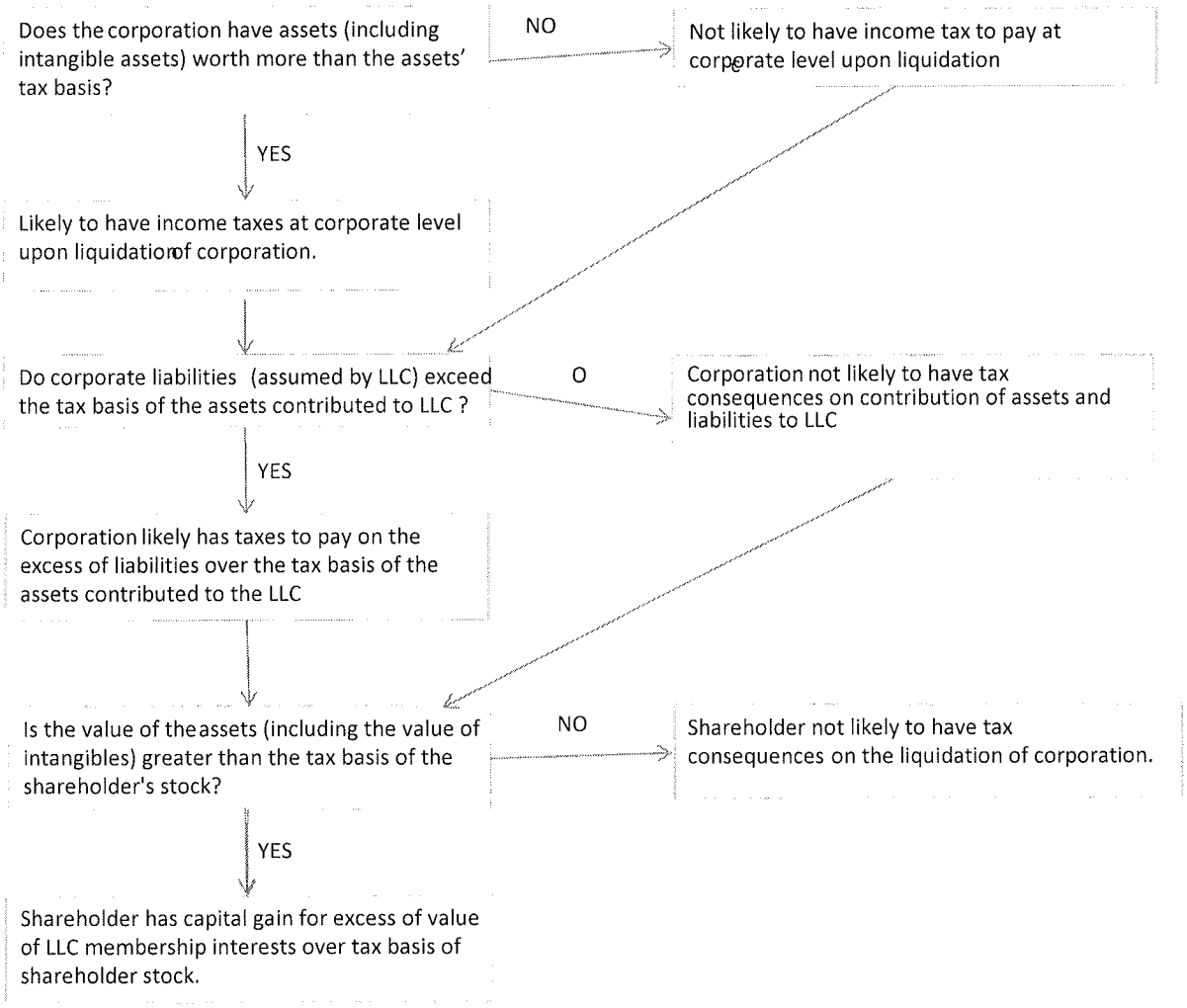
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