

# Converting a Corporation to an LLC

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Limited Liability Companies (LLCs) are almost always a better choice of entity than Corporations, yet not all businesses had the good fortune of being born as LLCs. There is hope for these corporate dinosaurs, however, as relatively recent changes in the law have made it easier to convert a corporation into an LLC.

## Background

For a long time, the S-Corporation (S-Corp.) was the optimal legal structure for a private company. An S-Corp. is simply a corporation formed under state law that elects to be taxed under Subchapter S of the Internal Revenue Code by filing IRS Form 2553. Subchapter S was passed specifically to promote small business by providing qualifying small businesses (e.g. no more than 100 shareholders) with “flow through” tax benefits like those of a partnership, while at the same time shielding their owners from liability just as much as any other corporation. Although the Florida LLC Act was originally passed in 1982, S-Corps. continued to be the optimum entity choice for many years. Accordingly, many businesses that are more than a few years old were formed as corporations. In light of a relatively recent statutory mechanism for conversion and the compelling superiority of the LLC, there is no good reason why these corporations should remain in their current form. Indeed, the law specifically provides that all rights and obligations, assets and liabilities automatically carry over from the converted corporation to the “new” LLC and its date of formation “relates back” to the original formation date of the corporation. Therefore, there is no need to transfer any assets, licenses or contracts. The LLC is the same creature as the converted corporation; just with a new form. Even the IRS respects the conversion when completed properly.

## Asset Protection Benefits

Over the years, the federal S-Corp. law and Florida corporate statutes adapted to accommodate various aspects of small business, however, they never evolved to provide asset protection for stock held by shareholders with personal judgments against them. These judgment creditors can seek to satisfy their judgment by taking the shareholder’s stock, regardless of whether the stock is part of an investment portfolio or constitutes the family business. Such a judgment could result from, for example, a personal injury lawsuit against one of the shareholders unrelated to the business that was not sufficiently insured against. Once the judgment creditor takes the stock, it can vote the stock and exercise whatever powers the “former” owner had as a shareholder. In many cases, this power is used to force a liquidation of the company and a sale of its assets to satisfy the judgment, demand inspection of the corporation’s books and records or sell the stock to a competitor. In this sense, corporations provide no asset protection at all.

Limited Liability Companies, on the other hand, can provide their owners with both asset protection and flow through taxation. Specifically, the LLC statute prohibits the levy or “taking” of a LLC owner’s interest by limiting the judgment creditor to a charging order remedy, unless

otherwise provided in the LLCs governing documents. In a properly structured and maintained LLC, this means that the judgment creditor can never acquire the right to exercise the owner's vote; it only has the right to receive any distribution the owner would have been entitled to, if any. Of course, waiting for a distribution is not a good position for most creditors. Since the judgment is not against the LLC, it remains free in the meantime to continue paying its normal operating expenses, including salaries.

(Note: the above asset protection benefit is not fully available to LLCs that have only one member. In such cases the law allows to single member's ownership interest to be seized similar to as if were stock in a corporation).

### **Some Other Benefits of Converting to an LLC**

- The LLC operating agreement is a hybrid document that contains governance provisions you would normally find in corporate bylaws, as well as the major elements of a good shareholders' or partnership agreement. If the shareholders don't already have shareholders' agreement, they should consider just going directly to an operating agreement as part of the conversion process.
- Corporations must spell out the provisions for any preemptive rights of shareholders in their Articles of Incorporation, a public document. An LLC need not publicly disclose any relative rights of owners.
- Under the right circumstances and with careful tax planning, the business can secure more flexible partnership tax treatment to better allocate specific items of income and loss disproportionately among the owners
- The LLC statute specifically applies to LLCs all the corporate case law regarding protection against "piercing the corporate veil".

### **Conversion Procedure**

Thanks to some changes to Florida business law, a Florida Corporation can be metamorphosed relatively painlessly by a trained professional carefully drafting the necessary documents that go beyond a simple Certificate of Conversion and Articles of Organization for public filing. I always recommend the additional execution of an Agreement to Convert and an Operating Agreement, as well as Board Resolutions and Shareholder Consents of the converting Corporation.

If the conversion is completed properly the LLC that results from the conversion is for all purposes and by operation of law the same entity as the corporation; it can even keep the same tax identification number. Of course, if not handled properly by an experienced attorney, a conversion can create various unwanted consequences. For example, the IRS could treat the conversion as if the corporation had liquidated and distributed its assets to the owners who then contributed the assets to a new LLC. This liquidation triggers taxation of the hypothetical "gains" of any appreciated assets. Nevertheless, a properly structured conversion can avoid this treatment by qualifying as a tax-free reorganization pursuant to the tax code.

Since LLCs are hybrid entities, under the right circumstances the LLC can choose between being taxed as a partnership, sole proprietorship, C Corporation or S Corporation. Thus, a partnership can convert to a LLC taxed as a partnership, and an S-Corp. can convert into an LLC that continues to be treated by the IRS as an S-Corp. In the case of an S-Corp to LLC conversion, among other things, care must be taken when drafting the LLC operating agreement so as not to inadvertently give any owners rights that the IRS would consider a “second class of stock” which would terminate the corporation’s “S” status. The LLC must also make certain IRS filings to continue being treated as an S-Corporation by the IRS.

#### What Are You Waiting For?

If your insurance company offered to convert your existing policy to a new program that provides substantially better coverage with added flexibility for a relatively small, one-time fee, would you even think twice? Recommending that a Corporation’s owner(s) consider converting their business to an LLC is a compelling value proposition. Despite the complex tax and legal issues that an experienced lawyer must be address to successfully complete a conversion, as far as the owners are concerned, it’s a small amount of paperwork to obtain a large amount of protection against someone trying to take away their business.