Pa. Conversion Statute Could Spur Reorganizations

By William G. Ruffner, CPA, and Kevin Wilkes, JD

While reviewing a possible reorganization involving a traditional merger, savvy consultants consider whether the restructuring could be accomplished more efficiently through one or more corporation-to-limited liability company (LLC) conversions. For numerous reasons discussed later in this article, a direct conversion of a corporate entity to a disregarded single-member LLC can often accomplish the purposes of a reorganization more expeditiously than a merger and at a fraction of the cost. Practitioners reviewing a corporate conglomerate's organizational structure might also consider a corporation-to-LLC conversion if they identify tax and regulatory inefficiencies within an organization's structure. Examples of structural inefficiencies include increased regulatory and compliance costs associated with maintaining separate corporate entities, tax losses trapped within a corporate entity lacking nexus with states requiring separate corporate income tax filings, among others. For corporations organized in Pennsylvania, the lack of a statute permitting a corporation to directly convert to an LLC has been an impediment to corporation-to-LLC conversions, and placed domestic Pennsylvania corporations at a relative disadvantage to those formed in states with more permissive business organizational laws.

Pennsylvania's recent overhaul of its statutory authority pertaining to entity conversions has removed numerous archaic barriers. So, effective July 1, 2015, pursuant to Section 351 of Title 15, a domestic entity organized in Pennsylvania is now permitted to become a domestic entity of a different type. Also by virtue of Section 351, a domestic entity organized in Pennsylvania is permitted to become a foreign association of a different type,

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provided the conversion is permitted in the foreign jurisdiction. Section 351 also allows a foreign association (business entities organized in a jurisdiction other than Pennsylvania) to convert to a different type of domestic association. Section 102 of Title 15 broadly defines "entity" to include a business corporation, a limited partnership, an LLC, and numerous other types of entities. Similarly, Section 102 broadly defines "association" to include for-profit corporations, LLCs, partnerships, and other types of entities. The new conversion regime does contain exclusions, however. For instance, Section 318 of Title 15 prohibits cooperative corporations and certain beneficial, benevolent, fraternal, or fraternal benefit societies from participating in conversions, and excludes certain nonprofits. Overall, the new statutory regime offers much more flexibility within the state than before.

Traditional mergers or dissolutions frequently result in property transfers, liability transfers, contractual assignments and transfers, etc. Section 356 of Title 15 provides that when a conversion becomes effective the converted association (the "resulting association") is deemed to be the same association as the converting association, without interruption. The resulting association's existence is deemed to have commenced on the same date as the converting association, except for purposes of determining the manner in which the converted entity is taxed. Consequently, all property of the converting association continues to be vested in the converted association without reversion or impairment, and the conversion does not constitute a transfer of any of that property. All debts, obligations, and other liabilities of the converting association continue as debts, obligations, and other liabilities of the converted association. Liens on the property of the converting association are not to be impaired by the conversion. With certain exceptions under the law, all of the rights, privileges, immunities, and powers of the converting association continue to be vested without change in the converted association. To summarize, for reorganizations accomplished via a conversion, generally it is not necessary to assign or transfer contracts, property, etc., so the cost associated with a conversion is a fraction of the cost associated with undergoing a merger.

For businesses with large workforces, one potential benefit associated with undergoing a conversion rather than a merger relates to reduced administrative headaches associated with federal payroll tax reporting and federal employer identification numbers (FEINs). The consummation of a merger generally results in the transfer of employees from the nonsurviving entity to the surviving entity, causing extra paperwork to correctly account for the transferred employees under a new FEIN for federal payroll tax purposes. Conversely, when a corporation converts to a single-member LLC, the IRS will generally update its records to reflect that the LLC has retained its existing FEIN. This results in the entity circumventing the large workforce transfers that are often associated with mergers. Furthermore, given that the entity has retained its FEIN, the IRS generally permits the entity to continue reporting its payroll taxes in the same manner in which the entity did prior to the conversion.

There are additional benefits for a subsidiary corporation converting to an LLC. For federal income tax purposes, pursuant to the so-called check-the-box regulations, the converted entity can choose to be classified under applicable default rules or it can elect to be classified under a different permissible classification. Under the default rule, a corporation that has been converted to a single-member LLC will be disregarded as a taxpayer for federal income tax purposes, thus the entity will effectively be combined with its parent corporation. It also may be beneficial from a transfer tax perspective.

In light of the numerous administrative tax and nontax benefits associated with Pennsylvania's statutory overhaul, practitioners should consider Pennsylvania's recently enacted conversion statute when contemplating a reorganization.

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