

Conversion of a partnership to a limited liability company

Dear Reader:

You have informed me that you and your partners have decided to convert your general partnership to a limited liability company (LLC) that would be taxed as a partnership and that you are interested in what will be the tax effects of the conversion itself.

The conversion of a partnership to an LLC taxed as a partnership is not treated as an exchange, regardless of how the conversion is accomplished for state tax purposes. Thus, the conversion of the partners' interests to LLC interests (1) doesn't result in gain or loss to any of the partners, (2) doesn't affect the basis or holding period of any of the partners in his interest, and (3) doesn't terminate the partnership for tax purposes. Accordingly, the LLC will continue to file partnership returns using the partnership's employer identification number and tax year.

If the conversion results in a shift in the partners' shares of partnership liabilities, the partners whose shares are increased are treated as making contributions to the partnership that increase the basis of their partnership interests, and the partners whose shares are decreased are treated as receiving distributions from the partnership that, first, reduce the basis of their partnership interests to zero, and then, cause them to recognize gain to the extent the reduction exceeds their basis.

The conversion of the partnership to an LLC may cause a change in the partners' shares of the partnership's debts. For instance, since no partner will be at risk for the LLC's liabilities, partnership debts that were formerly recourse may become nonrecourse, affecting the allocation of the debts. In addition, the creditors may, as a condition of agreeing to the conversion, demand that some or all of the partners guarantee the partnership's debts; these guarantees may affect the allocation of the debts.

Therefore, in order to determine the effects of the conversion, it is necessary to review the documents relating to the partnership debts (including any loan agreements and guarantee agreements), as well as the partnership agreement and the proposed LLC agreement. With proper planning, we can ensure (subject to the business arrangements among the partners) that any shift in the partners' shares of partnership liabilities will not result in gain to any of the partners.

Please call if you have any questions or if you want us to review the relevant documents in order to ensure that no gain will result from the conversion.