BARNES & THORNBURG LLP

INSIGHTS

S Corporation Countermeasures

December 19, 2019 | Southeast Michigan | Atlanta | Chicago | Columbus | Dallas | Delaware | Elkhart | Fort Wayne | Grand Rapids | Indianapolis | Los Angeles | Minneapolis | Raleigh | Salt Lake City | San Diego | South Bend | Washington, D.C.

In a prior article, The Perils of Electing S Corporation Status, I detailed the disadvantages of an S corporation relative to a limited liability company that is classified as a partnership for U.S. federal income tax purposes (LLC), challenged two common tax justifications for using S corporations, and concluded that an S corporation is rarely a wise choice of legal entity for an operating business. But what about an operating business that has already elected to be treated as an S corporation and now recognizes that the disadvantages outweigh the advantages (if any)? Is there any escape from the perils of S corporation status?

This article explores some of the common options for escaping or mitigating the potential disadvantages of S corporation status.

Conversion to an LLC

If the business is still in its infancy and has not yet accrued any significant net unrealized gain, one option for escaping from S corporation status is to convert the S corporation to an LLC under state law, thereby terminating the S corporation election as of the conversion date. For example, if the S corporation is an entity organized as a corporation under state law, the corporation could file a certificate of conversion with the applicable Secretary of State changing the corporation to an LLC. The conversion would terminate the corporation's S corporation election effective as of the date of the conversion. If the corporation's state of organization does not allow for a direct conversion to a limited liability company, the same result can generally be achieved through a merger or

RELATED PEOPLE

James R. Browne
Partner
Dallas

P 214-258-4133
F 214-258-4199
jim.browne@btlaw.com

RELATED PRACTICE AREAS

Corporate
Securities and Capital Markets
Tax

other type of reorganization. If the S corporation is organized as a limited liability company the company could simply revoke its S corporation election (provided the S corporation election was effective as of the company's formation date or more than 60 months prior to the revocation date).

The usual problem with converting an S corporation to an LLC is that the conversion is treated as a taxable liquidation of the S corporation for federal income tax purposes. The deemed liquidation triggers a deemed sale of the corporation's assets for their fair market value, and the resulting deemed sale gain flows through to the S corporation shareholders. The assets obtain a fair market tax basis in the hands of the resulting LLC. Triggering a deemed taxable liquidation is generally not a desirable outcome where the S corporation has substantial amounts of net unrealized gains on which tax must be paid. But if the S corporation either has no substantial net unrealized appreciation in its assets, or if any gain on the deemed liquidation is offset by suspended losses, a conversion may be a viable option. In that regard, in evaluating whether the corporation holds appreciated assets in the form of goodwill or similar intangibles, it might be possible to argue that any such assets are owned by the S corporation shareholder or shareholders and not by the S corporation.

The additional options discussed below all assume that there is significant net unrealized gain in the S corporation's assets, which would not be fully offset by any suspended loss carryforwards, such that the option of converting the S corporation to an LLC or partnership is not feasible (due to the tax that would be triggered on an actual or deemed liquidation of the S corporation).

LLC Subsidiary (F Reorganization)

Some of the disadvantages of operating as an S corporation can be mitigated, but not eliminated, by putting the S corporation business into an LLC subsidiary. The subsidiary can then issue membership interests to new investors or to employees or other service providers without regard to whether they are eligible to hold shares in an S corporation and without the disadvantages (to the new owners) of owning the business through an S corporation. Unfortunately, the existing S corporation shareholders are generally stuck with holding their existing ownership interest in the business through the existing S corporation.

Structuring Mechanics

In some cases, moving the S corporation business into an LLC subsidiary can be easily accomplished by having the S corporation transfer its assets and liabilities to a newly formed and wholly owned LLC subsidiary. The transaction is disregarded for U.S. federal income tax purposes because the LLC subsidiary is classified as a disregarded entity (absent an affirmative election to the contrary). If the LLC subsidiary thereafter issues additional equity interests to investors or service providers, the LLC becomes a partnership for tax purposes. The issuance of new equity interests by the LLC subsidiary generally does not give rise to gain or loss to the S corporation owner or its shareholders, but each transaction needs to be analyzed carefully.

If an actual transfer of assets by the S corporation to the LLC subsidiary is not feasible (for example, because some licenses and business registrations or other assets are not readily transferrable), it is generally possible to effect the LLC subsidiary structure using an “F reorganization.” For an existing S corporation that is organized as a corporation under state law, an F reorganization might be effected through the following steps:

1. The shareholders of the existing S corporation (“Oldco”) create a new corporation (“Newco”) that elects to be classified as an S corporation.
2. The Oldco shareholders transfer their Oldco stock to Newco as a contribution to capital. Newco files an election on IRS Form 8869 to have Oldco classified as a qualified subchapter S subsidiary.
3. Oldco files a certificate of conversion (from a corporation to an LLC) with the secretary of state for its state of formation. Under most state statutes, the resulting entity (“Oldco LLC”) is treated as the owner of Oldco’s assets by operation of law and without any required transfer or assignment of the assets, such that the transaction would generally not constitute a prohibited transfer of any otherwise non-transferrable assets (although this has to be confirmed in each case for all material assets).

After these steps, for federal income tax purposes, Newco is treated as the continuation of Oldco and Oldco LLC is a disregarded subsidiary. It’s as if Oldco just changed its name to Newco. Oldco LLC retains the employer identification number for Oldco (which can be important for some state and federally licensed businesses), and Newco obtains a new taxpayer identification number.[1]

If Oldco is already organized as a limited liability company under state law prior to the steps above, step 3 is not necessary. Oldco may choose to file a protective entity classification election (electing to be classified as a disregarded entity) to make clear that its prior deemed election to be classified as a corporation is revoked once it becomes a subsidiary of Newco and fails to qualify as an S corporation. If Oldco’s S corporation election was filed within the prior 60 months and was not effective as of the date Oldco was formed, Oldco is generally precluded from revoking its election to be classified as a corporation during the 60-month period. However, Newco should be able to classify Oldco as a qualified subchapter S subsidiary during that period, with generally the same effect as treating Oldco as a disregarded entity (so long as Newco owns 100% of Oldco’s membership interests).

Preferred Equity Freeze

After creating of the holding company structure, the S corporation holding company (Newco) might choose to convert its interest in the LLC subsidiary (Oldco LLC) to a preferred equity interest with a limited return and to have Oldco issue new common equity interests to the shareholders. The objective is to limit the value accruing inside the S corporation by causing value accruing in excess of the preferred equity return to attach to the Oldco common equity acquired directly by the S corporation shareholders.

Parallel LLC

A common question is whether it is possible for the shareholders of an existing S corporation to create a new LLC (a parallel LLC) to take over the business previously conducted by the S corporation and simply terminate the S corporation. To the extent assets of the S corporation are needed in the business to be conducted by the LLC, those assets might be sold or leased to the LLC.

A significant risk with this type of planning is that, where the entire business of the S corporation is migrated to the LLC, the IRS might view the transaction as a deemed taxable merger or liquidation of the S corporation into the LLC. Even if the transaction is not recast as a taxable merger or liquidation (for example, where the S corporation continues to exist with some continuing business activities, which might atrophy over time), the IRS might assert that there are unreported taxable transfers of assets, such as goodwill and other intangibles owned by the S corporation but used by the LLC. Except in unusual circumstances, structuring a parallel LLC generally involves too much cost, complexity, and risk to be a viable planning option.

C Corporation (Section 1202)

The combination of the recent reduction in U.S. corporate income tax rates (from 35% to 21%) and the relatively recent expansion of tax benefits for “qualified small business stock” under Section 1202 of the Internal Revenue Code (IRC) has made operating as a C corporation a more attractive choice for many small businesses that might otherwise choose to organize as an LLC. (A discussion of the merits of a C corporation relative to an S corporation or LLC is beyond the scope of this article. For a comparison of a C corporation to an LLC in the context of a start-up or early stage entity, see Legal Insight - Choice Of Entity For A Startup Business After Tax Reform.)

The discussion below explores how an S corporation might be able to reorganize as a C corporation and access the benefits of Section 1202 for its owners.

Section 1202 Requirements

Under Section 1202, a non-corporate shareholder can exclude from income gain from the sale of qualified small business stock (QSBS) held for more than five years, generally subject to a limit equal to the greater of $10 million or 10 times the amount the shareholder paid for the stock at original issuance. This provision is subject to a number of complex requirements, including

- the stock must be issued by a domestic C corporation after August 10, 1993;
- the stock must be acquired by the seller from the issuer at original issuance;
- the stock must be held for more than five-years at the time of sale;
- the corporation must not have not more than $50 million in

aggregate gross assets at any time after August 10, 1993 and prior to the issuance, or immediately following the issuance, of the applicable stock; and

- the corporation must be engaged in a “qualified trade or business” (which is defined to exclude most businesses involving professional services, financial services, oil and gas extraction or production, and lodging, restaurant or similar operations).

A companion rule is provided in Section 1045 of the IRC, which provides for non-recognition of gain from the sale of QSBS held for more than six months to the extent the stock sale proceeds are used within 60 days to purchase other QSBS. The gain not recognized reduces the cost basis of the new QSBS.

Conversion to a C Corporation

An existing corporation that has elected to be treated as an S corporation can convert to a C corporation by simply revoking its S election. In such a case, the resulting C corporation’s outstanding stock will not qualify for the benefits of Section 1202 because the corporation will not have been a C corporation at the time the stock was issued. Only stock issued by the corporation after the conversion to a C corporation can qualify for the benefits of Section 1202, and only to the extent all the associated requirements of Section 1202 are met. Consequently, unless the existing shareholders are expecting to make additional contributions of capital to the corporation that are substantial in relation to the value of their contributions at the conversion date, a simple conversion to a C corporation might not yield material tax benefits (relative to remaining an S corporation).

Contribution of Assets to a C Corporation

If an existing S corporation transfers its assets to a newly formed C corporation in exchange for newly issued stock of the C corporation, the newly issued stock can qualify as QSBS in the hands of the S corporation (if the other requirements of Section 1202 are met). If the S corporation subsequently sells the QSBS at a gain, the S corporation shareholders are generally able to exclude their allocable shares of the S corporation’s gain from their gross incomes (applying the $10 million or 10 times investment limitation at the shareholder level).

For purposes of computing the S corporation’s gain eligible for Section 1202 benefits at the shareholder level, the S corporation’s basis in the QSBS is the greater of the basis or fair market value of the assets contributed (determined on an asset by asset basis). As a consequence, the Section 1202 benefits will generally only apply to any gain accruing after the S corporation contributes its assets to the C corporation. Gain accruing prior to the contribution is deferred, but is not excluded on a subsequent sale of the C corporation stock. Note that while this rule negatively impacts the ability to avoid tax on gain that is accrued and unrealized at the time of the conversion, it may increase the total gain eligible for the exclusion. By increasing the S corporation’s initial basis in the C corporation’s stock, the 10 times investment limitation might also be increased (if the resulting total investment is more than $1 million per

shareholder).

To maximize the Section 1202 benefits in the context of a contribution of assets by an S corporation to a C corporation, the S corporation must continue to hold the C corporation stock, and the S corporation's stock must continue to be owned by the same shareholders. Any distribution of the C corporation stock by the S corporation to its shareholders would trigger gain and/or cut off the holding period for the C corporation stock for Section 1202 purposes. With some limited exceptions, other transfers of the C corporation stock by the S corporation will likewise disqualify the stock or cut off the benefits of Section 1202. In addition, an S corporation shareholder is eligible for the benefits of Section 1202 with respect to QSBS sold by the S corporation only to the extent of the shareholder's interest in the S corporation on the day the QSBS was acquired and held at all times thereafter before the sale. A transferee of S corporation stock cannot claim the benefits of Section 1202 with respect to QSBS acquired by the S corporation before the transferee acquired the S corporation stock.

Collateral Tax Implications

Note that converting an S corporation to a C corporation or transferring an S corporation's assets to a C corporation has collateral federal and state tax consequences. One such collateral tax effect is the inability of a C corporation to sell assets and distribute the net proceeds without incurring both a corporate level tax and, except to the extent section 1202 applies, a shareholder-level tax. The potential benefits of Section 1202 need to be carefully considered in light of the strict requirements and limitations imposed under that section, the collateral tax implications of operating the business through a C corporation, and the risk of future legislative action reducing the benefits of operating as a C corporation relative to operating as an S corporation.

Conclusion

A leading scholar commented that a corporation is like a lobster pot: easy to get into, difficult to live in, and painful to get out of. That metaphor applies well to an S corporation. The best way to stay out of the lobster pot is to avoid using an S corporation in the first place (at least for a business that can generate significant asset appreciation). But for an operating business that is already in the S corporation lobster pot, this article offers some strategies to mitigate the potential perils of that circumstance.

[1] Rev. Rul. 2008-18, 2008-18 I.R.B. 674. Because Newco will file its tax return as a continuation of Oldco but under a new taxpayer identification number, the IRS might notify Oldco (now Oldco LLC), that it has failed to file its tax return. That issue is easily resolved with an explanatory letter (which may be included in Newco's return). Oldco LLC's retention of Oldco's taxpayer identification number can be critical in cases where valuable business licenses are tied to the federal taxpayer identification number.