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Larry's Tax Law

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part X - Converting a C Corporation to an S Corporation/Nothing Could Go Wrong or Could It?

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Introduction

When considering converting a C corporation to an S corporation, tax advisers and taxpayers need to pay careful attention to the many perils that exist. Failure to pay close attention to the road in this area could result in a disaster. This Part X of my multi-part series on Subchapter S is designed to illuminate some of the road hazards that exist along the roadway traveling from Subchapter C to Subchapter S.

Before converting an existing C corporation to an S corporation, an analysis of several matters should be undertaken, including the impact of the election on the shareholders and the corporation. These matters include, but are not limited to, the topics briefly discussed below.

Shareholder Eligibility

As discussed in Part III and Part VIII of my multi-part blog series on Subchapter S, only "eligible" persons may be shareholders of S corporations. Generally, this means only individuals who are U.S. residents or citizens, and certain specific types of trusts and estates may be shareholders. Before making an S election for an existing C corporation, a careful survey of the current shareholders of the corporation is required. Failure to meet the shareholder eligibility requirements at the time of election will invalidate the election. Further, failure to understand (or keep a keen eye on) the shareholder eligibility requirement could cause the corporation down the road, especially when an existing eligible shareholder transfers shares to a trust or third party for estate planning or other purposes, to experience an inadvertent termination of the S election.

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Number of Owners

As discussed in Part V and Part VIII of my multi-part blog series on Subchapter S, S corporations are generally limited to 100 shareholders. The family election is an exception to this rule. That said, before converting a C corporation to S status, the 100-shareholder rule cannot be ignored.

Single Class of Shares

S corporations may only have one class of shares. Voting and non-voting shares are, however, allowable. Subchapter S requires that each share of the corporation that is outstanding has identical rights to distribution and liquidation proceeds.

Tax Year

Generally, S corporations use a calendar taxable year. Under IRC §444, however, an S corporation may elect to adopt a fiscal year. However, adoption of a fiscal year usually has a cost associated therewith (*e.g.*, required tax deposits).

Distributions

Distributions from an S corporation must be made in proportion to share ownership. If distributions are not made in proportion to share ownership, however, a second class of stock will be deemed to exist and it will terminate the S election.

Passive Activity

Careful attention must be placed on the activities of the corporation and whether it has any retained C earnings and profits ("C E&P"). Two code sections need special consideration.

As discussed in Part II of my multi-part blog series on Subchapter S, under IRC §1375, if an S corporation's passive income exceeds 25 percent of its gross receipts and, at the close of the taxable year, it has C E&P, it is subject to a corporate level tax. Imposition of this tax in essence creates a double tax on an S corporation's current earnings.

Likewise, as discussed in Part II of my multi-part blog series on Subchapter S, under IRC §1362(d)(3), if an S corporation's passive income exceeds 25 percent of its gross receipts for three consecutive taxable years, while the corporation has C E&P, the S election is terminated on the first day of the fourth taxable year.

As a consequence of these two code provisions, if the corporation's income sources include passive activities, it is imperative that a careful analysis of C E&P is conducted before an S election is made.

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To avoid the IRC §1375 tax, where passive income may exceed the permitted threshold, all of the C E&P must be distributed out prior to the end of the first taxable year of the S corporation.

If all of the C E&P is distributed out on or before the end of the first taxable year of the S corporation, unless the corporation merges with another corporation that has C E&P, it should not be subject to termination under IRC §1362(d)(3).

Built-In-Gains Tax

As discussed in Part I of my multi-part blog series on Subchapter S, IRC §1374 imposes a corporate level tax upon certain gains realized by an S corporation within five years of the effective date of the S election. The IRC §1374 tax generally, however, is limited to gains attributable to C corporation years (*i.e.*, built-in gains existing at the S election effective date). For cash basis taxpayers, it also extends to the collection of accounts receivable generated during C corporation years. It does not generally apply to post-S election appreciation. Like the IRC §1375 tax, this tax creates a double tax.

The "BIG" tax is complex in its application. It requires a detailed analysis of the fair market value of all assets of the corporation (including goodwill) existing on its last day of C corporation existence. The assistance of a qualified appraiser may be required.

LIFO Recapture

If the corporation used the LIFO method of accounting for inventory during the last C corporation taxable year, the corporation may be subject to LIFO recapture under IRC §1363(d). The LIFO tax may not be expected. Careful attention is necessary.

Conclusion

While this is certainly not an exhaustive list or discussion of matters that need attention prior to making an S election, it should serve as a useful roadmap for tax advisers to use as they consider the journey from Subchapter C to Subchapter S. Other issues may arise as these specific matters are reviewed. Caution is required.

Stay tuned for more blog posts in this multi-part series on Subchapter S.

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