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BY RICH SHAVELL

Converting from a C to an S Corporation? Beware the Built-in Gains Tax

To avoid double taxation, a C corporation may consider converting to an S corporation. However, when the fair value of an entity's assets at the relevant date of conversion is more than its tax basis, a C corporation may incur the built-in gains tax,[1] which applies to certain assets that have appreciated or are converted to cash after a C corporation changes to an S corporation.[2]

This extra tax can surprise "converting" businesses, especially contractors that use a more favorable revenue recognition method for tax purposes, such as the cash basis or completed-contract method (CCM). Let's look at the nuances that affect the built-in gains tax.

Impact of Deferred Income & Other Attributes

The unrecognized built-in gains at the time of conversion is not just the unrecognized gain on the sale of appreciated assets. The built-in gains tax is also impacted by deferred income.

Deferred Income Example

Let's assume that a contractor converted from C corporation to S corporation status during 2016. At the time of conversion, the contractor has four contracts in progress, on which $1 million of gross profit would be recognized if the percentage-of-completion method (PCM) had been used.

However, the contractor qualifies for exemption from IRC § 460 under the small contractor's exemption and uses the CCM.[3] The calculation at right shows what taxes would be due if all four contracts were completed during 2017.[4]

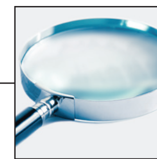
The S corporation and its shareholders pay $607,400 of total tax: $350,000 at the corporate level and another $257,400 at the shareholder level. This represents an effective rate of more than 57% on the $1 million of unrecognized contract profits as of the date of conversion to S corporation status. The effective rate may be even higher if state income taxes are applicable.

Although the details are beyond the scope of this article, other complexities must be considered. For example, the former C corporation could have certain unused beneficial tax attributes carrying over, such as unused net operating losses (NOLs), capital loss carryovers, general business tax credits, and certain other tax credits.[5]

However, not all attributes can be used. Unused charitable contributions and foreign tax credits cannot be carried over.[6] Further, each of these attributes have specific carryover periods. For example, unused NOLs can currently be carried forward 20 years,[7] whereas others may have a shorter carryover period.

In addition, not only are there built-in gains, but there can also be built-in losses to offset the built-in gains.[8] Valuation of the entity's assets (and deferred taxable income) at the time of conversion is critical.

Percentage-of-completion earnings at date of conversion (portion of the unrecognized built-in gain at time of conversion)	$1,000,000
Earnings actually reported for tax purposes as of date of conversion	0
Built-in gains subject to tax	1,000,000
Built-in gains tax rate (highest corporate rate)	x 35%
Built-in gains tax at the corporate level	$350,000
Earnings passed through to the S corporation owners ($1,000,000 less $350,000 built-in gains tax)	$650,000
Personal tax rate (maximum personal rate assumed)	x 39.6%
Personal tax paid by the S corporation owners	$257,400



Recognition Period

Under the *Protecting Americans from Tax Hikes Act*[9] (PATH Act), the built-in gains tax can apply for up to five years after conversion to an S corporation. That is, for each of the five years after a corporation elects S status, it is possible that the tax could apply when built-in gain property is sold or deferred taxable income is recognized.

For example, let's say that an entity that was previously a C corporation owns real estate that has appreciated and a favorable offer arrives in year four. The taxpayer should consider whether the property should be sold now or after the statutory fifth year passes to avoid double taxation.

As demonstrated in the previous calculation, the combined tax could be sizable; but it may not make sense to wait another year if a favorable offering price no longer exists. Or, alternatively, significant tax attributes, such as a carryover of an NOL, could be available; this is unlikely because the S corporation election is generally delayed until the favorable carryovers are consumed. Nonetheless, all facts must be uncovered and understood to make a sensible business decision.

Issues for Small Contractors

Smaller contractors can unknowingly face the built-in gains tax. The regulations focus on potential deferrals from when the entity is a C corporation as well as when income is being recognized in a later year when the entity is an S corporation.

For smaller contractors that use the cash method as a C corporation (compared to the accrual method), the deferral of income is considered a net built-in gain that can be subject to the built-in gains tax.[10] Small C corporations are permitted to use the cash method when revenues average $5 million or less.[11]

For tax purposes, the difference between these methods of reporting for long-term contracts and the PCM becomes part of net unrecognized built-in gains at the time of conversion.[12] As previously mentioned, smaller contractors that use the CCM are affected by the built-in gains tax because of the deferred income when compared to statutorily imposed PCM.

It also impacts contractors that use the cash method for long-term contracts.[13] Here, the deferral is not just computed from the cash method to the accrual method, but also from the accrual method to the PCM. The variance from the accrual method to the PCM could also result in a reduction in the deferral – for example, where net billings-in-excess is greater than net costs-in-excess.

Before converting from a C corporation to an S corporation, the CFM must know what to include in the computation of net unrecognized built-in gains and when the various deferrals could result in corporate-level income tax.

Valuation Issues

If the entity has a built-in gain, then it should track its dispositions over the next five years. Upon sale of their assets, taxpayers need to be able to document which amounts are built-in gains and which amounts are appreciation that occurred after the date of conversion.

For example, let's say that a property was purchased 15 years before the C corporation converted to an S corporation. The asset was valued at $150 at purchase and $175 at conversion. The asset sold for $325 three years after the conversion date.

In this example, $25 ($175 less $150) of the total gain of $175 ($325 less $150) is taxable as built-in gains. Without an appropriate valuation at the time of the conversion, the taxpayer may not be able to defend an IRS auditor's assertion that the entire gain (or even more) is part of the built-in gains.

The IRC states that the net unrecognized built-in gain is the net gain that would have been recognized had a corporation sold its assets at the beginning of the five-year recognition period for the fair market value in a single transaction to an unrelated buyer who also assumed the entity's liabilities. Other adjustments, such as Section 481(a), can add to the complexity.[14]

All assets are considered when the company's assets are valued, including intangibles such as goodwill.

Thus, the valuation professional must have a clear understanding of the scope of the valuation and receive adequate direction of what is and is not to be considered.

Potential Corporate Liability

An interesting issue for business valuations prepared for other purposes (e.g., the gifting of shares or death of a shareholder) is consideration of the pending-potential built-in gains tax to the entity.

This *potential* corporate tax liability could affect the business valuation of the entity, thereby lowering the value

because of the additional potential corporate tax liability. If the current recognition period of five years is exhausted and the entity is not liable for any built-in gains tax, then a theoretical reduction may have made its way into the business valuation yet it never materialized.

However, court cases do not provide clear guidance to the valuation professional for including the built-in gains tax.[15]

Practical Considerations for Avoiding the Built-in Gains Tax

The general process for a C corporation to avoid the double taxation without incurring the built-in gains tax is to 1) elect S corporation status, which if qualified, results in no tax, and 2) either hold the appreciated assets for the requisite five years or sell the appreciated assets for no more than the fair value determined at the date of election. Only the net pass-through gain at the shareholder level will incur tax.[16] Other nuances in the current tax law must also be considered.

For example, C corporations also face state income taxes, so the spread in tax rates between S corporations and C corporations could be higher, depending on location. At the individual level, multiple capital gains rates could also have an impact.[17] Moreover, the Affordable Care Act imposes a 3.8% surtax on net investment income[18] that could impact pass-through income depending on the shareholder's level of involvement.

With proper planning, the built-in gains tax can be avoided in other ways. For instance, an annual taxable income limitation can be applied. The built-in gains are added to taxable income or loss, and the recognized built-in gains subject to the built-in gains tax is the lower of the year's taxable income or the built-in gains.[19] If the company incurs losses during the five years after conversion (in excess of the built-in gains), then the built-in gains tax can be avoided or mitigated because of the taxable income limitation.

Another tax planning consideration when dealing with appreciated assets is to delay the sale of those assets until future years.

Alternative to S Corporation Conversion

The alternative to S corporation election is conversion to another type of pass-through entity, such as a partnership or LLC, but it's a costly option.

In this scenario, the C corporation is liquidated and the after-tax value of cash and assets are contributed to the new partnership entity. However, the built-in gain is taxed at the highest corporate tax rate (currently 35%), ***and*** the residual value is then taxed again as a dividend at the shareholder level at as much as 20% or even higher (for certain ordinary income property).

Summary

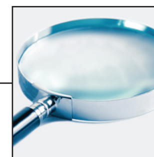
While it is currently more favorable to elect S corporation status to avoid potential double taxation, be aware of potential tax reform from the current administration. Depending on the effect of these new tax proposals (if passed), the shift away from pass-through entities to C corporations could become more attractive. At this time, no reform has been vetted or implemented.

Contractors and closely held businesses considering conversion from a C corporation to an S corporation must perform a detailed analysis. Work with a tax advisor to ensure all aspects are carefully considered before finalizing the conversion. In addition to reviewing the current recognition period, CFMs should ensure the consultant determines the availability and applicability of the various corporate tax attributes that can reduce the built-in gains tax.

Furthermore, engaging a well-qualified independent valuation professional who understands the mechanics of the built-in gains tax is equally important to ensure supporting documentation is on-hand to insulate the company against any future IRS challenges. ■

Endnotes

1. See IRC § 1374(a) and (b).
2. IRC § 1374(c)(1). The tax generally does not apply to an S corporation that has always been an S corporation. An S corporation that acquires a C corporation's appreciated assets in a tax-free transaction may also be subject to the corporate-level tax.
3. IRC § 460(e)(1)(B) generally permits methods other than PCM for contractors with average annual gross receipts under $10 million; other rules may also apply.
4. This example makes certain assumptions, including that the contract deferral was $1 million and no other deferrals exist. To simplify the example, revenue and expenses from sources other than the open contracts are not reflected. The example also assumes that there are no built-in losses to consider and that the pass-through entity has no C corporation carryover tax attributes such as business credits or NOLs available.
5. See IRC § 1374(b)(2) and IRC § 1374(b)(3).
6. Treas. Reg. 1.1374-6(a).
7. IRC § 172(b)(1)(A)(i) and (ii).



8. IRC § 1374(d)(4).

9. IRC § 1374(d)(7).

10. Treas. Reg. §1.1374-4(b).

11. IRC § 448.

12. Treas. Reg. § 1.1374-4(g).

13. Treas. Reg. § 1.1374-4(b).

14. Treas. Reg. § 1.1374-4(d).

15. For example, see Litchfield, TC Memo 2009-21; Estate of Jensen, TC Memo 2010-182.

16. *The Tax Reform Act of 1986* repealed what was known as the General Utilities Doctrine (General Utilities Co. v. Helvering, 296 U.S. 200 (1935)), which enabled corporations to distribute appreciated assets tax free. After this repeal, S corporations with their single-level tax became ubiquitous in order for shareholders to face only one level of tax.

17. IRC § 1(h).

18. IRC § 1411(a)(1).

19. IRC § 1374(d)(2)(A)ii.

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