



## **“C” to “S” — Plan Carefully to Avoid Built-In Gains**

Thinking of changing corporate status from a C to an S corporation? Unlike a C corporation, an S corporation generally does not pay a federal corporate income tax. Instead, the taxable income of the corporation is reported on the returns of its individual stockholders.

However, an S corporation that has previously operated in C corporation status is potentially subject to the “built-in gains” tax — a corporate-level tax on appreciation in the value of assets held on the day a corporation converts to S status. The tax applies during the first 10 years after the S election is effective.

### **To C or Not to C?**

When a C corporation makes the election to operate under S status, it may be beneficial to assess the value of the corporation at the date of conversion for two reasons.

First, if the stockholders sell the corporation before the 10 years have elapsed, a valuation can provide valuable support to limit the amount of built-in gains subject to the tax.

For example, assume a corporation converted from C to S status on January 1, 1997 when its net assets had a basis of \$2 million and its fair market value was determined to be \$3 million. If it sells in 2005 for \$7 million when the basis of the net assets have increased to \$4 million, the built-in gains tax will only be computed based on the \$1 million appreciation in value at the time of the election, not the full \$3 million at the time of sale.

Second, a valuation performed at the time of the S election is helpful because of a tax rule which limits the amount of gain subject to the built-in gains tax to the net unrealized built-in gain. Using the example above, if the corporation sold land and a building with a basis of \$1 million in 2005 for \$4 million, the built in-gains tax would be computed using the \$1 million net gain at the time of conversion. This would be true even if at the time of the conversion the property had a built-in gain of an amount in excess of \$1 million at the time of the election.

Think carefully before converting from C to S. Proper planning may help reduce the built-in gains tax.

*Please contact our firm if you are considering a change in your corporate status. In many cases, a business valuation may be helpful.*

#### **A Little History**

Congress added the built-in gains tax in 1986. They were concerned that stockholders of closely held C corporations intending to liquidate could circumvent a corporate-level tax by converting to S status first, selling appreciated assets and then distributing the proceeds as a liquidating dividend.

If the corporation had retained its C status, the corporation would have paid a tax on the gain on the appreciated assets, and the stockholders would pay a tax on the distribution to the extent that it exceeded their cost basis in the underlying stock. As an S corporation, the stockholders would pay tax on the gain on the sale of assets, but would not pay tax on the dividend distribution attributable to the appreciation in value of the assets.