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New Opportunity for 'C' Corporations to Convert to 'S' Corporations Under Recent Tax Law

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Since 1986, when the *General Utilities* doctrine (permitting corporate liquidations of regular or 'C' corporations to be tax-free to the corporation) was repealed, a barrier existed for 'C' corporations to convert to pass-through or 'S' corporation status and then sell its assets with a single level of income taxation (being the same result obtained by a tax-free liquidation of a 'C' corporation). That barrier is the built-in gains tax, or "BIG tax." As originally enacted, the BIG tax required an 'S' corporation, which is the result of the conversion of a 'C' corporation, to pay an entity level income tax (using the highest rate of tax imposed on 'C' corporations) on the assets it held at the date of the conversion, which it sells within a ten-year period following the date of conversion. While the rules were somewhat complicated, the short explanation is that each asset the 'C' corporation held at the date of the conversion had to be valued at its fair market value as of such date, and the excess of that value over the corporation's adjusted tax basis constituted the "built-in" gain subject to entity-level taxation if sold within the ten-year period. The same results applied to the assets of a historic 'S' corporation which were acquired assets of a 'C' corporation in a tax-free acquisition.

The Protecting Americans from Tax Hikes Act (PATH), P.L. 114-113, was signed by the President in late 2015, provides some relief from the BIG tax. PATH permanently made the BIG tax recognition period five years, as opposed to ten years, as enacted in 1986 (or seven years, which was the recognition period temporarily from 2009 through 2011). This change is important and beneficial to existing 'C' corporations because it permanently reduces the number of years that an 'S' corporation's assets are subject to the BIG tax. While a horizon of ten years (and even seven years) might be too long to determine if a sale of the assets of a corporation is likely to occur, the five-year period is within the durational scope of strategic long-term planning and PATH now provides an alternative to such planning that must be taken into account by management and shareholders. The new five-year recognition period is effective for tax years beginning after 2014.

For more information on how this issue may affect your business or related matters, contact the author of this alert, Ross Cohen, or any members of the Firm's Tax Group.