ROCHESTER BUSINESS JOURNAL
RBJ
VOLUME 31, NUMBER 51 WWW.RBJDAILY.COM MARCH 18, 2016

New rules shorten wait for S corporation asset sales

TAXING MATTERS
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Congress has passed a new rule that shortens the length of time that small business corporations must wait before they can sell certain assets free of corporate tax.

The change presents planning opportunities for owners of corporations looking to sell assets without paying double tax.

There are two types of corporations for federal income tax purposes: C corporations and S corporations.

In general, C corporations pay corporate income tax at rates approaching 40 percent. There is no capital gains rate for C corporations. When after-tax profits are distributed as dividends, shareholders pay tax at a rate of 15 or 20 percent. Even without considering state taxes and federal Obamacare taxes, the total rate of taxation can exceed 50 percent.

Recognizing the burden of this double tax regime for small business owners, Congress created the S corporation. Owners of S corporations pay only a single level of tax and enjoy the benefit of capital gains rates. The effective federal income tax rate for sale of an item of capital gain property is a mere 20 percent for an S corporation as compared to over 50 percent for a C corporation.

Not all corporations can elect S corporation treatment. There are many restrictive rules on the allowable shareholders, who are limited to individuals as well as certain trusts and estates. In addition, S corporations may have no more than one hundred shareholders and only one class of stock.

Because S corporations pay only a single level of tax, there is a great incentive for eligible C corporations to elect S status before selling appreciated assets. This election effectivity can reduce the federal tax rate by 30 percentage points. However, Congress has restricted the ability of C corporations to convert to S status prior to an asset sale. Specifically, the tax code provides that an S corporation must pay corporate-level tax on "built-in gain" attributable to the period for which the S corporation was a C corporation.

For example, assume that a C corporation owned an office building that was purchased for $100,000 in 1980 that is now worth $1 million. If the corporation elected to be treated as an S corporation and then sold the building immediately thereafter, the first $900,000 of gain would be subject to corporate tax and the shareholders would therefore not receive any benefit from the S election.

Because S corporations pay only a single level of tax, there is a great incentive for eligible C corporations to elect S status prior to an asset sale. This election can effectively reduce the federal tax rate by 30 percentage points.

Any further appreciation would be subject only to a single layer of tax. For example, if the building were sold two years from now for $2 million, only the first $900,000 would be subject to corporate tax. The remaining $1 million would only be taxed to the shareholders.

There has always been a time limitation on the period in which corporate tax on built-in gain applies. Historically, that time limitation was 10 years. Under the historic rule, if the building in our example were sold in April 2026 the double tax would not apply if the S corporation election were made this month. The theory is that the 10-year waiting period would prevent people from electing S corporation treatment in anticipation of an asset sale.

During the Great Recession, Congress shortened the waiting period to spur economic activity. However, in recent years, it was restored to its original 10-year length.

In the Path Act, passed in December, Congress shortened the waiting period to five years. This decrease is significant as it sharply reduces the period that a shareholder must wait to avoid double tax on sales of assets by a C corporation electing S status.

Shareholders of eligible corporations that are considering a sale of appreciated assets may wish to consider making an S election in anticipation of the sale. Not only does the S corporation election reduce tax on operating income, but if the asset is sold after the five-year period all of the gain, including gain from the period in which the corporation was a C corporation, escapes double tax.

The most significant benefit of the new law may be for corporations considering selling all of their assets in a so-called asset sale.

There are two ways to purchase a business: (1) by buying its stock or (2) by buying all of its assets but leaving the corporate entity behind. Many buyers of businesses insist on purchasing assets instead of stock as this reduces potential exposure to the selling businesses' liabilities and other potential complications.

However, for C corporations, asset sales can be highly tax inefficient for the seller due to the double taxation discussed above.

Electing S corporation status allows an eligible corporation to avoid this double tax. However, the past 10-year waiting period was so long that this was rarely an effective planning technique where an exit was contemplated. The reduced five-year waiting period makes the technique much more viable.

In sum, Congress' reduction of the waiting period in which S corporations must pay tax on built-in gain presents an important opportunity for businesses organized in the C corporation form. Where eligible, these businesses can avoid the extraordinarily high effective rate of taxation on sales of assets by electing S corporation status. After the new five-year waiting period has expired, these assets can be sold with only a single level of tax.

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