Thinking about converting from a C corporation to an S corporation?

The right entity choice can make a difference in the tax bill you owe for your business. Although S corporations can provide substantial tax advantages over C corporations in some circumstances, there are plenty of potentially expensive tax problems that you should assess before making the decision to convert from a C corporation to an S corporation.

Here’s a quick rundown of four issues to consider:

LIFO inventories. C corporations that use last-in, first-out (LIFO) inventories must pay tax on the benefits they derived by using LIFO if they convert to S corporations. The tax can be spread over four years. This cost must be weighed against the potential tax gains from converting to S status.

Built-in gains tax. Although S corporations generally aren’t subject to tax, those that were formerly C corporations are taxed on built-in gains (such as appreciated property) that the C corporation has when the S election becomes effective, if those gains are recognized within five years after the conversion. This is generally unfavorable, although there are situations where the S election still can produce a better tax result despite the built-in gains tax.

Passive income. S corporations that were formerly C corporations are subject to a special tax. That tax kicks in if their passive investment income (including dividends, interest, rents, royalties, and stock sale gains) exceeds 25% of their gross receipts, and the S corporation has accumulated earnings and profits carried over from its C corporation years. If that tax is owed for three consecutive years, the corporation’s election to be an S corporation terminates. You can avoid the tax by distributing the accumulated earnings and profits, which would be taxable to shareholders. Or you might want to avoid the tax by limiting the amount of passive income.

Unused losses. If your C corporation has unused net operating losses, they can’t be used to offset its income as an S corporation and can’t be passed through to shareholders. If the losses can’t be carried back to an earlier C corporation year, it will be necessary to weigh the cost of giving up the losses against the tax savings expected to be generated by the switch to S status.

Additional factors

These are only some of the factors to consider when a business switches from C to S status. For example, shareholder-employees of S corporations can’t get all of the tax-free fringe benefits that are available with a C corporation. And there may be issues for shareholders who have outstanding loans from their qualified plans. These factors have to be taken into account in order to understand the implications of converting from C to S status.

Contact us. We can explain how these factors will affect your company’s situation and come up with strategies to minimize taxes.