Valuation Issues in the C Corporation to S Corporation Conversion

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This discussion addresses the valuation issues related to the federal income tax conversion from C corporation status to S corporation status. These valuation issues include (1) the eligibility requirements for a C corporation taxpayer to convert to S corporation status, (2) the application of a valuation discount for lack of marketability, (3) the valuation consideration of the built-in gains tax liability, and (4) the appropriate standard of value to apply in the C corporation to S corporation conversion valuation.

Introduction

The popularity of a U.S. company structuring itself as a tax pass-through entity has increased materially during the last 25 years.

Based on the latest data available from the Internal Revenue Service (the "Service"), tax pass-through entities (excluding partnerships and sole proprietorships) have increased from 24 percent of all U.S. corporations in 1986 to 69 percent of all U.S. corporations in 2008.[1]

The increase in the number of companies implementing a tax pass-through structure can be mainly attributed to the elimination of one layer of federal income taxation (i.e., the avoidance of corporate level taxation) in such a tax structure. As a result, many companies that were previously taxed as C corporations have elected to convert to S corporation tax status.

A "regular" C corporation is taxed at the corporate level for federal income tax purposes. In addition, the C corporation shareholders are also taxed on any capital gains realized by the shareholder and on any dividend income distributed from the C corporation.

In contrast, the shareholders of an S corporation only pay one level of federal income tax. This is because the S corporation will pass-through all of its income (and its losses) to the S corporation shareholders.

S Corporation Conversion Issues

The S corporation itself is not subject to federal income tax. The S corporation income (or losses) that flows to the shareholder is reported on the shareholder's personal income tax return. This income is taxed at the shareholder's individual income tax rate.

There are several issues that should be considered related to the C corporation conversion to S corporation federal income tax status. The following discussion summarizes the valuation issues regarding an S corporation election.

S Corporation Eligibility Requirements

A C corporation must meet several statutory requirements in order to convert to S corporation status.

According to Internal Revenue Code Section 1361 ("Section 1361") and the corresponding

> **"For a period of 10 years after the C corporation to S corporation conversion date, . . . the converted S corporation is subject to built-in gains tax."**

Regulations, a company electing S corporation status must meet the following eligibility requirements:

1. The company must be a domestic corporation.
2. The company must have shareholders that consist only of individuals, certain trusts, and estates. Nonqualified shareholders include partnerships, corporations, and foreign individuals or entities.
3. The company must have no more than 100 shareholders.
4. The company must have only one class of stock, although the stock can be differentiated with voting and nonvoting characteristics. Furthermore, distributions and liquidations to shareholders must be conducted on a pro rata basis.
5. The company must not be an ineligible corporation; ineligible corporations include certain financial institutions, insurance companies, and domestic international sales corporations.

Due to these eligibility requirement, many companies simply do not qualify to elect S corporation federal income status.

Also, in order to maintain the company's S corporation election, the pool of potential shareholders and potential buyers is often reduced. This reduction is due to any tax-status-related shareholder restrictions stated in the corporation's shareholder agreement.

For example, the sale of the S corporation stock to a nonqualified shareholder of an S corporation would immediately revoke the S corporation status, resulting in the loss of the income tax benefit.

Discount for Lack of Marketability

The consensus of valuation analysts, judicial decisions, and empirical studies is that an investment is worth more if it is readily marketable. Conversely, an identical investment is worth less if it is not readily marketable.

The difference in price that an investor will pay for a liquid asset compared to an otherwise identical illiquid asset is often substantial. This price difference is commonly referred to as the discount for lack of marketability (DLOM).

As previously mentioned, S corporation shareholders are limited by:

1. the specified types of shareholders that qualify for S corporation ownership and
2. the number of shareholders that are permitted in an S corporation.

As a result, the potential buyers of S corporation shares are limited as to (1) the specified types of shareholders and (2) the number of shareholders. This statutory limitation allows the taxpayer corporation to maintain its S corporation income tax status.

Due to the restriction of types and number of buyers, a discount for lack of marketability is often appropriate in the fair market value valuation of the S corporation shares.

Valuation Adjustment for Built-in Capital Gains

For a period of 10 years after the C corporation to S corporation conversion date (also called the "recognition period"), the converted S corporation is subject to built-in gains tax.

The built-in gains tax relates to the sale or transfer of either the entire company or certain assets.

There is a limitation to the recognition of the built-in gain. This limitation is based on the net unrealized built-in gain (NUBIG) of the company or the assets as of the conversion date.

NUBIG Calculation

According to Regulations Section 1.1374-3, the S corporation NUBIG is calculated as follows:

> the amount that would be realized if the taxpayer corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities
>
> *decreased by*

any liability of the corporation that would be included in the amount realized on the sale, but only if the corporation would be allowed a deduction for the payment of the liability

decreased by

the aggregate adjusted bases of the corporation's assets at the time of the sale

increased or decreased by

the corporation's Section 481 adjustments that would be taken into account on the sale

increased by

any recognized built-in loss that would not be allowed as a deduction under Sections 382, 383, or 384 on the sale.

Income Tax Amount

The federal income tax amount to be paid is determined by multiplying:

1. the lesser of the net recognized built-in gain or the net unrealized built-in gain by
2. the maximum federal corporate income tax at the time of the company (or asset) sale.

For a C corporation converting to an S corporation, it is important for the taxpayer to calculate the NUBIG. Otherwise, the corporation runs the risk of subjecting the entire gain from the sale to corporate level tax during the entire recognition period.

In addition, tax advisers recommend that the conversion corporation should allocate NUBIG among all of the taxpayer corporation assets. Such an allocation will be extremely useful if certain corporation assets are sold or transferred at any time during the recognition period.

Selecting the Appropriate Standard of Value

As discussed in the Treasury Regulations, the S corporation should be valued as if it "remained a C corporation and had sold all its assets at fair market value to an unrelated party."

Therefore, the appropriate standard of value for the C corporation converting to an S corporation should be fair market value. And, the appropriate level of value for the C corporation to S conversion should be a marketable controlling ownership interest level of value.

The Fair Market Value Standard of Value

According to Regulation Section 20.2031-1(b), fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

Further Reading

Bertrans, Robertson, "C to S Conversions: Partnership Interests at BIG Discounts" *Business Entities* (September/October 2007): 18–25.

Summary and Conclusion

For a C corporation seeking to convert to S corporation federal income tax status, the valuation analyst can assist both the taxpayer corporation and the taxpayer's legal counsel with the above-mentioned valuation issues.

These C corporation to S corporation conversion valuation issues consist of:

1. the eligibility requirements to convert from a C corporation to an S corporation,
2. the application of a valuation discount for lack of marketability,
3. consideration of the built-in gains tax liability, and
4. the appropriate standard of value to be applied in the conversion date valuation.

Notes:

1. John D. McKinnon, "More Firms Enjoy Tax-Free Status," *Wall Street Journal* (January 10, 2012).

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