Considerations in the Health Care Company Tax Status Conversion from C Corporation to Pass-Through Entity

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For a variety of economic and taxation reasons, now may be a good time for a health care entity C corporation to convert to pass-through entity tax status. As summarized in this discussion, there are both tax costs and tax benefits associated with such a health care entity tax status conversion. However, both the costs and benefits are affected by the conversion date valuation of the health care entity assets. Therefore, a contemporaneous valuation of the health care entity assets is an important component of the tax status conversion decision.

Introduction

For many closely held health care entities that operates with C corporation federal income tax status, this may be a good time for the practice or entity owners to consider converting to a pass-through entity tax status.

This tax status conversion decision is timely because of the general unfavorable economic environment in the health care industry, the current low asset values in many health care entities, and the low income tax rates on C corporation dividend distributions to individuals. These factors may provide the appropriate conditions for health care entity owners to convert the practice's or entity's federal income tax status.

This tax status conversion decision could affect the privately held (and for-profit) hospital, nursing home, ambulatory care center, ambulatory surgical center, MRI center, dialysis center, urgent care center, clinic, laboratory, medical supply company, home health care services provider, rehabilitation center, physicians' practice, or dentists' practice.

One factor in this tax status conversion decision is the current relatively low income tax rate on qualified dividends. Valuation analysts should advise their health care entity clients with regard to the tax status conversion decision.

The health care entity owners (in consultation with their legal, accounting, and valuation advisers) should consider both the costs and the benefits of converting from C corporation tax status to pass-through entity tax status.

C Corporation Income Tax Levels

C corporations are taxed on taxable income at federal income tax rates of up to 35 percent. With the new American Taxpayer Relief Act tax rates, qualified dividend distributions to the health care entity shareholders are taxed again at a federal income tax rate of up to 20 percent. And, such individual shareholder dividends are not tax deductible by the C corporation.

Therefore, the total federal income tax rate on the distributed earnings from the C corporation to the health care company shareholders is up to 48 percent. That total federal income tax rate is calculated as follows:

$$35\% + (20\% \times (1 - 35\%)) = 48\%$$

If the C corporation converted to an S corporation form or to a business that is not in corporation form (e.g., a partnership, limited partnership, or limited liability company), then there would only be one level of taxation that would be paid at the entity owner level. Such a tax status conversion would result in a savings of up to 13 percent of the practice or entity taxable income.

That 13 percent income tax rate savings assumes that the entity or practice owners are individuals who are taxed at the highest individual income tax rate. The potential income tax savings from a tax status conversion is even greater when state corporation income taxes are considered.

Minimizing the C Corporation Taxable Income

One common tax planning strategy that health care entity or professional practice owners use to minimize the C corporation taxable income is to pay out as much as possible of the entity's income as compensation to shareholder/employees. Unlike dividend distributions, shareholder/employee compensation is tax deductible to the C corporation.

Such a tax planning strategy may accomplish the following:

1. Reduce the C corporation taxable income to an acceptable level
2. Result in the entity or practice earnings only being taxed once—at the shareholder/employee level

However, the use of this tax planning strategy has several practical limitations.

The Reasonableness of Shareholder/Employee Compensation

Internal Revenue Code Section 162 allows a tax deduction for compensation paid by a corporation that is (among other things) "reasonable." When a large percentage of the C corporation's income is paid out as compensation to shareholder/employees, particularly when the compensation is proportionate to their share ownership, then the Internal Revenue Service ("the Service") may challenge the reasonableness of the compensation tax deduction.

In some types of health care entities, high amounts of compensation expense as a percentage of total company income is considered normal. Such a high compensation percentage often occurs when personal services are the principal contributor to the entity income.

For example, this level of expense may be normal in a medical practice or a dental practice. In other businesses, capital is the principal contributor to the company's income. A medical products distribution company or an MRI center is more in line with this type of capital-intensive business.

In such a capital-intensive company, shareholder/employee compensation that is a very high percentage of the total entity's income may be more difficult to justify.

Nonemployee Shareholders May Object to the Compensation Amount

Minimizing the amount of the entity's taxable income by paying shareholder/employee compensation may be difficult to implement where there is more than one shareholder. This tax planning strategy may be particularly difficult to implement when there is one (or more) shareholder/employees and one (or more) nonemployee shareholder.

In that instance, the nonemployee shareholders will expect to receive dividend (i.e., earnings) distributions in proportion to their equity ownership interest in the health care entity. And, such nonemployee shareholders may not tolerate the scenario that the shareholder/employees receive all (or most) of the health care entity's earnings in the form of employee compensation.

Other Compensation-Related Taxes

Of course, shareholder/employee compensation is subject to payroll taxes, including Social Security and Medicare tax. In 2013, the combined payroll tax rate of Social Security and Medicare taxes, payable by the employer is 7.65 percent (on the first $113,700 of employee wages).

And, in 2013, the combined Social Security and Medicare payroll rate payable by the employee is 5.65 percent. For employee compensation amounts over $113,700, both the employer and the employee are subject to a Medicare payroll tax of 1.45 percent. And, in 2013, the employee portion of the hospital insurance part of FICA (normally 1.45 percent of covered wages) is increased by 0.9 percent on wages that exceed a threshold amount.

In addition, the shareholder/employee compensation is subject to federal unemployment and state unemployment (i.e., FUTA and SUTA) taxes.

Even if double taxation of C corporation taxable income can be minimized through the payment of shareholder/employee compensation, there is another C corporation double taxation problem.

That is, there is the problem of minimizing the double taxation of C corporation earnings when the health care entity owners ultimately sell the C corporation itself (or sell its underlying business assets).

Minimizing the Income Tax on the Sale of the Health Care Entity

The double taxation of C corporation income on the sale of the health care entity relates to what is typically called "inside" gain and "outside" gain. Gain on the sale of the entity assets (including the company's goodwill) is called inside gain.

The inside gain is taxed at the corporation level. The outside gain is recognized by the entity shareholders on the distribution of the after-tax proceeds from the sale of the entity's assets.

Both inside gain and outside gain also occur where appreciated entity assets are distributed to the health care entity shareholders in exchange for their shares.

Double Taxation on the C Corporation Liquidating Distributions

If the C corporation sells all of its assets and then distributes the sale proceeds to its shareholders in a liquidating distribution, the entity is subject to tax on the asset sale. In addition, the health care entity shareholders are then subject to income tax on that sale proceeds distribution.

The distribution of the entity assets in liquidation is treated at the corporation level the same way as if:

1. the entity assets were sold for cash and
2. the cash proceeds were distributed to the shareholders in exchange for their shares.

The shareholders would also incur a tax on their gain, measured as the difference between:

1. the liquidation proceeds (or the net fair market value of the entity assets, if the assets are distributed in kind) and
2. the tax basis of the entity shares in the shareholders' hands.

Therefore, the tax consequences to the health care entity and to its shareholders are substantially the same if either of the following occur:

1. The C corporation sells all of its assets and distributes the sale proceeds in liquidation.
2. The C corporation distributes all of its assets in liquidation.

In both instances, the transaction is subject to double taxation.

In general, the federal double tax rate of up to 48 percent (plus applicable state tax, net of any federal tax benefit) should apply if the corporation shares are a long-term capital asset in the hands of the shareholders.

In analyzing these transactional alternatives, the health care entity owners should consider both of the following:

1. The corporation tax attributes
2. The shareholder tax attributes

Such tax attributes may include net operating loss or capital loss carryovers.

Reluctance of the Health Care Entity Buyer to Buy Stock

Typically, there is a general reluctance of a medical practice or other health care entity acquirer to buy the corporation's shares—instead of the corporation's assets.

This is because the entity buyer that buys the corporation shares could inherit any undisclosed or unrecorded liabilities. Such liabilities include financing, litigation, environmental, tax, and (most importantly) professional liabilities.

Of course, seller warranties (related to the undisclosed liabilities) are common in the purchase/sale of a practice or other health care entity. However, such seller warranties are only as useful as the seller's ability to make good on them.

There are instances where an entity buyer may have no choice but to buy the corporation shares—rather than the entity assets. For example, this stock purchase transaction structure may be appropriate where:

1. the corporation holds a valuable asset such as a lease, permit, franchise, or license that is not transferable or
2. the corporate charter itself has a special value (such as in the case of a hospital or an insurance company).

If the practice or other entity sale transaction takes the form of a sale of stock rather than a sale

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of assets, it may appear that there is only one level of taxation. That is, the selling shareholders will pay income tax on their gain equal to the difference between:

1. the stock sales price and
2. the shareholders' tax basis in the entity shares.

Assuming that the entity shares are long-term capital gain property, then the selling shareholders would only incur up to a 20 percent federal tax rate. However, such a tax liability analysis does not consider what is sometimes called the "economic" double taxation. This is because the stock sale transaction structure shifts the problem of the "inside" (or corporation level) gain to the health care entity buyer.

The buyer of the C corporation shares now has a tax basis in the acquired shares equal to the amount paid (assuming that fair market value was paid for the shares). However, the inside basis of the C corporation assets remain at the entity's historical tax basis level.

Therefore, the difference between the entity's historical tax basis and the assets' fair market values remains subject to tax upon the new owner's ultimate disposition of the acquired assets.

In other words, the practice or entity assets carry an implicit tax cost in the form of reduced future depreciation or amortization tax deductions. Generally accepted accounting principles recognize this impact by requiring that a deferred tax liability account be set up on the acquired entity's post-acquisition balance sheet.

In essence, the health care entity buyer that buys the corporation shares inherits a deferred tax liability. That deferred tax liability is in the form of either of the following:

1. A future tax on the ultimate sale of the low basis assets
2. A reduced tax-deductible asset cost recovery

And, that health care entity buyer will expect to be compensated for that increased future tax cost in the form of a reduced purchase price for the entity shares. That buyer may negotiate a reduced purchase price considering the amount of what would otherwise be the present value of the entire deferred tax liability.

Such a purchase price reduction would put the entity buyer and entity seller in approximately the same economic position as they would have been in had the following occurred:

1. The C corporation sold its assets.
2. The selling shareholders absorbed the corporation level income tax.

Alternatively, the entity buyer and the entity seller may agree on a reduced purchase price that results in each party bearing some portion of the deferred tax liability.

The greater the difference between the C corporation assets' fair market value and the assets' tax basis in the hands of the C corporation (i.e., the inside appreciation), the greater the potential problem of double taxation related to that inside appreciation. And, such inside appreciation may increase over time. Such inside appreciation would increase if the current values of the health care entity assets are generally depressed.

If that scenario is the case with the subject practice or entity, then now may be the appropriate time to change the entity's C corporation status.

Changing the C Corporation Tax Status

There are two common procedures for changing the health care entity's C corporation tax status. Each of these two common procedures involves the conversion of the subject C corporation to a tax pass-through entity.

Generally, the income, deductions, gains, losses, and credits of the tax pass-through entity pass through to the entity owners. And, the entity itself is not subject to federal income tax.

The first procedure is to convert the C corporation to S corporation tax status. For various technical reasons, S corporation status may not be a suitable alternative for every health care entity (or for every group of shareholders).

When S corporation status is not practical, then a second procedure may be considered. The C corporation may convert to a limited liability company (LLC) and then continue its operations in that business form.

The S Corporation Election

The most common procedure that a practice or other entity may use to change its C corporation tax status is to convert to an S corporation. However, an S corporation election does have limitations, and it may not be an appropriate tax planning strategy for all health care entities.

Electing the S Corporation Tax Status

Generally, the S corporation will avoid the corporation level federal income tax (1) on its operating income and (2) on any gain resulting from the ultimate sale of the health care entity.

Generally, items of income, deduction, gain, loss, and credit are taken into account in computing taxable income and tax only by the corporation's shareholders—and not by the corporation itself.

One favorable aspect of the S election is that, in many cases, it takes the subject corporation out of C corporation tax status—and its attendant double income taxation—without an immediate negative tax consequence.

Qualification of an Eligible C Corporation

Not every C corporation is eligible to make an S corporation election. There are numerous specific requirements for the C corporation, including the following:

1. Shareholder requirements
2. A capitalization requirement
3. Requirements for corporations with accumulated earnings and profit (E&P) when the corporation has certain levels of passive income
4. Requirements relating to the corporation itself

The Corporation Requirements

To qualify as an S corporation, the subject entity must be a domestic corporation that is not any of the following:

1. A financial institution using the Section 585 reserve method of accounting for bad debts
2. An insurance company taxable under Internal Revenue Code subchapter L
3. A possessions corporation
4. A DISC or former DISC

These restrictions will rarely affect the typical medical practice or other health care entity.

The Individual Shareholder Requirements

An S corporation cannot have more than 100 shareholders. Only the following types of individuals qualify as S corporation shareholders:

1. U.S. citizens or residents
2. Certain estates
3. Certain trusts
4. Certain tax-exempt organizations

The Corporation Capitalization Requirements

The S corporation election is only available to corporations with one class of stock outstanding. However, differences in voting rights among the shares of common stock typically do not violate the one class of stock statutory requirement.

The one class of stock requirement can become a practical limitation in instances where the health care entity needs to make a special allocation of its corporation earnings to certain shareholders. This situation may occur, for example, when certain shareholders desire a preferred rate of return on their stock ownership.

Generally, the corporation is considered to have only one class of stock for S corporation purposes if all outstanding shares confer identical rights to (1) distributions and (2) liquidation proceeds.

The corporation owners should note that otherwise ordinary commercial transactions between the corporation and a shareholder (such as compensation arrangements and leases) with the principal purpose to circumvent this S corporation requirement can violate the one class of stock requirement.

Unless certain safe-harbor requirements are met, the S corporation one class of stock requirement can become a problem where the entity's financing arrangements include consideration in the form of equity-based payments.

Such payments may include either of the following:

1. An equity kicker to the financial institution
2. The financial institution's options to buy the entity's shares

In addition, the S corporation should exercise caution for the following:

1. When all of the shareholders are not treated identically
2. When financing arrangements include some form of future equity interest

S Corporations with E&P or Passive Income

An S corporation can be subject to income tax at the corporation level—and its S corporation status can be terminated—if either of the following occur:

1. The corporation has certain amounts of passive income.
2. The corporation has earnings and profits (E&P) accumulated during years when it was a C corporation.

For these S corporation requirements, passive income is defined as: rents, royalties, interest, annuities, and dividends.

This S corporation election may be avoided if the entity's E&P are purged by making a distribution in the form of a dividend to the shareholders. With the up to 20 percent federal income tax rate on dividends in effect for 2013, such an E&P purge in 2013 may still be a relatively low cost way to remove those accumulated earnings from the S corporation at a reasonable tax cost.

Limitations on the S Corporation Tax Benefits

The Corporation Level Tax on Built-in Gain

The excess of the fair market value of the corporation's assets over their adjusted tax basis at the time of the S election is counted as built-in gain. Any amount of this built-in gain that is recognized during the 10-year period beginning with the first day of the first tax year for which the corporation is an S corporation is subject to a corporation level tax.

Only the excess of the fair market value of the health care entity assets over their adjusted tax basis is subject to this corporation level tax. However, any post-S election asset value appreciation is only subject to one (i.e., shareholder) level of taxation.

Therefore, it is a common procedure for the health care entity to obtain a valuation of all of the entity's assets at the time that the S tax status election is made. The purposes of this asset valuation are two-fold:

1. To document all of the entity's individual assets in place on the S election date
2. To keep track of any of the future sale of those individual assets

This S election date valuation of the health care entity assets should encompass all of the entity's individual assets. In other words, this valuation should include both:

1. all of the tangible assets that are recorded on the entity's balance sheet and
2. all of the intangible assets that are not recorded on the entity's balance sheet.

Such health care entity intangible assets may include goodwill, contracts, licenses and permits, computer software, patient charts and records, workstation manuals and procedures, an assembled workforce, and trade secrets. Such intangible assets should be included in the entity's asset valuation even though the historical development costs of such intangible assets were expensed.

This S election asset valuation process is similar to the asset valuation process that is performed when a health care entity acquirer allocates the overall purchase price for a practice or entity among its various tangible assets and intangible assets. Such a purchase price allocation is based on the appraised fair market values of the individual acquired assets.

A comprehensive S corporation election date valuation of the entity assets (both tangible assets and intangible assets) is an important procedure in the S election process. This is because there are severe civil penalties related to the misstatement of the values of the conversion corporation property.

S Corporation Tax Aspects of Income from Company Operations

Generally, S corporation earnings are subject to income tax only at the shareholder level. This statement is true except for the corporation-level tax on built-in gains. However, the tax on built-in gains is not necessarily a tax problem for all corporations.

For example, this built-in gain may not be an issue for the following:

1. A service company (e.g., a home health services provider) where income is not earned through the sale of property
2. A medical equipment rental business (where income is earned from an active trade or business) and the corporation does not sell off its equipment

Salaries and wages paid to S corporation shareholder/employees are subject to payroll tax. This payroll tax may motivate some S corporations to pay little or no salary to shareholder/employees (i.e., in order to minimize the payroll tax).

However, the Internal Revenue Service is well aware of this tax planning strategy. And, the Service will typically review this issue during the audit of an S corporation.

Therefore, unreasonably low salaries paid to S corporation shareholder/employees may be challenged by the Service. Such a challenge could result in the recharacterization of some portion of the entity's dividend distributions as compensation to the shareholder/employees.

S Corporation Tax Aspects of Income from the Disposition of the Business

Except for the corporation-level tax on built-in gain, the sale of the S corporation's assets generally is not subject to a corporation level federal income tax. The post-S election appreciation in the value of the entity assets is not subject to the corporation level built-in gain tax. Also, after the S election has been in effect for 10 years, the built-in gain tax liability will no longer apply.

In addition to only one level of tax on the sale of the entity assets, it is possible to sell the S corporation shares and have the buyer and seller jointly elect to treat the stock sale transaction as an asset sale transaction. This mutual election is called the Section 338(h)(10) election.

This Section 338(h)(10) election allows for instances where:

1. certain S corporation assets are not transferable or
2. the S corporation's charter has a measurable value of and by itself (e.g., related to a hospital CON).

Other S Corporation Election Issues

The S election requires the unanimous consent of all of the health care entity shareholders. The S election is effective for any year if it is made:

1. in the prior year or
2. on or before the fifteenth day of the third month of the year.

The documentation of the S election should be made a part of the entity's permanent legal records.

Generally, the S corporation will use the calendar year as its tax reporting year. However, a different tax reporting fiscal year end is possible in certain circumstances.

For any S corporation, there should be a shareholder agreement that prohibits a unilateral action by a shareholder that would cause the S election to be revoked. Such an S revocation could occur, for example, if a shareholder transferred his or her shares to an ineligible person, such as a nonqualifying trust.

In addition, the S corporation shareholder agreement will typically deal with distributions of cash to pay the individual shareholder's income tax on the S corporation earnings. The shareholders are liable for income tax on their distributable shares of the S corporation earnings—whether or not the corporation income is actually distributed.

Typically, the S corporation shareholders agreement will require the entity to distribute at least a sufficient amount of cash for each shareholder to pay his/her income tax liability.

The S corporation shareholders are taxed on the income of the S corporation. Accordingly, the entity shareholders' tax-compliance burden may be increased after the S corporation election. Each entity shareholder may have to file individual income tax returns and pay individual taxes and estimated taxes in each state in which the S corporation does business.

It is also important to determine how each state in which the S corporation operates will handle the S corporation. For example, some states do not recognize an S corporation as a tax pass-through entity.

In those states, all practice or entity income is still taxed at the corporation level for state income tax purposes. And, some states require the withholding of income tax on the S corporation earnings related to any nonresident shareholders.

It is also important for each entity shareholder to determine whether he or she may claim a credit on his/her resident state income tax return for the nonresident state income tax that is paid on his/her share of the S corporation income.

The S Corporation Conversion from C Corporation Status

For many health care entities, the S corporation election may be an efficient and inexpensive way to change the C corporation status and to avoid the double taxation on operating income and gain on the sale of the entity. However, the S corporation election is not the ideal solution for every health care entity.

There are limitations on the number of S corporation shareholders and on the types of persons who can be shareholders. Also, there are restrictions on the health care entity's capital structure that impose limitations on the availability of S corporation status.

However, if S corporation status is not practical for a particular entity, then that entity may be able to achieve the desired taxation results by converting from a C corporation to an LLC.

Converting the C Corporation Status to LLC Status

Let's assume that the C corporation is not a candidate for an S corporation election because of the requirements for S corporation status summarized above.

In that case, the uncertain industry economic environment, the entity's currently depressed asset values, and the currently low individual income tax rates on qualified dividends and long-term capital gains may make conversion to an LLC form an alternative tax strategy solution.

However, the conversion from C corporation status to LLC status has immediate negative tax consequences. Accordingly, the health care entity and its owners should contrast the current tax costs of LLC conversion to the future potential income tax savings of LLC tax status.

Negative Tax Consequences for Converting to the LLC Status

Generally, an LLC with only one owner is disregarded for federal income tax purposes. In other words, the LLC is treated as a sole proprietorship. Generally, an LLC with more than one owner is treated as a partnership for federal income tax purposes.

Therefore, a conversion from C corporation status to LLC status is not merely a change in the tax status of the practice or other entity. Such a tax status conversion actually involves liquidating the C corporation and transferring the C corporation's assets to an entity that will be treated as either of the following:

1. A partnership (if the C corporation has more than one shareholder)
2. A disregarded entity (if the C corporation only has one shareholder)

The mechanics of a conversion from a C corporation tax status to LLC tax status can take one of four structural forms:

1. Assets up
2. Interests over
3. Assets over
4. Merger or statutory conversion

Each of these four tax status conversion forms is summarized next.

The Assets Up Form

In the assets up form of conversion, the subject C corporation is liquidated. The C corporation assets are transferred to the corporation shareholders, who then transfer the entity assets to the LLC.

The Interests Over Form

In the interests over form of conversion, there is an actual transfer of the C corporation shares to an LLC. At that point, the LLC is then the sole shareholder of the C corporation. This stock transfer is followed by an actual liquidation of the C corporation, with the C corporation assets being distributed to the LLC.

The Assets Over Form

In the assets over form of conversion, the C corporation transfers its assets to an LLC in exchange for all the ownership interests in the LLC. This transfer is followed by an actual liquidation of the C corporation. After the liquidation, the C corporation distributes the LLC ownership interests to its former shareholder(s).

The Merger or Statutory Conversion under State Law Form

The merger of a C corporation into an LLC or its statutory conversion into an LLC under applicable state law are forms of conversion only available in some states. Where it is allowed, the C corporation can merge into an LLC, or the C corporation can be converted to an LLC by election.

LLC Conversion Income Tax (and Other) Consequences

The Assets Up Form

The assets up form involves a liquidation of the C corporation. Such a liquidation is a taxable event at the corporation level. The taxable event is measured by the difference between the following:

1. The fair market values of the corporation's assets

2. The assets' respective tax bases

The health care entity shareholders will recognize gain to the extent of the excess of the fair market value of the assets distributed in liquidation over the shareholders' tax bases in their shares. The tax bases of the entity assets in the hands of the shareholders are the assets' fair market values upon distribution from the C corporation.

The shareholders' contribution of the distributed property to the LLC is generally not a taxable event. The contributed property's new tax basis in the hands of the LLC is the same as it was in the hands of the new LLC member (i.e., the former C corporation shareholder).

The Interests Over Form

In the interests over form, the shareholders' transfer of their C corporation shares to the LLC is generally not a taxable event. The tax basis of the C corporation shares in the hands of the LLC is the same as the shareholders' tax bases in those C corporation shares. The members' (i.e., the former shareholders) tax bases in their LLC interests is the same as the shareholders' tax bases in the C corporation shares.

Upon the liquidation of the C corporation, the tax consequences are the same as the liquidation of the C corporation in the assets up form. That is, the C corporation will recognize gain. The LLC will also recognize gain.

However, that gain will be taxable only at the member level. And, the members' tax bases in their membership interests will increase by the members' share of that taxable income.

Therefore, the tax basis of the assets of the C corporation in the hands of the LLC will be the fair market values of the entity assets. And, the tax basis of the LLC ownership interests in the hands of the member(s) will reflect the fair market values of the company assets.

If there is only one shareholder of the C corporation (so that the LLC is disregarded), the conversion result should be the same—and the assets up analysis should apply.

The Service often takes the position that the assets up conversion form requires an actual transfer of the company assets (rather than a transfer of an ownership interest in the LLC). In the case of the interests over form, the C corporation assets are actually transferred to the LLC, whether or not the LLC is a disregarded entity.

The only difference is whether the LLC members (i.e., the former C corporation shareholders) will be taxed on the following:

1. The distributions from the liquidating corporation directly (because the LLC is disregarded)
2. As partners in a partnership (because the LLC is classified as a partnership)

> **"The Service often takes the position that the assets up conversion form requires an actual transfer of the company assets. . . ."**

Assets Over and Statutory Merger or State Law Elective Conversion Form

In a relatively recent Letter Ruling (i.e., Letter Ruling 200214016), the Service concluded that a statutory merger of a C corporation into an LLC under applicable state law should be analyzed as an assets over form transaction.

In that Letter Ruling fact set, the C corporation was considered to have transferred all of its assets to a newly formed LLC in exchange for the LLC ownership interests. At that point in the transaction, the C corporation was the only LLC member. In addition, the LLC assumed all of the C corporation's liabilities.

The LLC ownership interests were considered to be distributed to the shareholders in liquidation of the C corporation. The C corporation had more than one shareholder. And, the Service held that the resulting entity was a partnership.

Self-Employment Tax Conversion Consequences

Where the C corporation continues to operate as an LLC, it is possible that all of the entity's income can be subject to self-employment tax. This may not be a substantial tax expense if the C corporation shareholders were already paid compensation at or above the self-employment tax wage base.

Summary of the Tax Cost of the LLC Conversion

The form of the C corporation to LLC conversion has an important impact on the conversion tax outcome for the health care entity shareholders. Since the LLC conversion is a taxable event at both the corporation level and the shareholder level, the selected conversion form should allow a step-up in the assets' basis to fair market value for the assets formerly held by the C corporation.

In a multishareholder C corporation conversion, the Service has taken the position that the merger of a corporation into an LLC should be analyzed as an assets over form of transaction. The Service may take this same position for an elective statutory conversion.

The conversion of the C corporation to the LLC status is a taxable event. Therefore, it is appropriate to analyze whether the current tax cost of the LLC conversion is less than:

1. the present value of the future tax cost of C corporation earnings double taxation plus
2. the present value of the future tax cost on the ultimate sale of the C corporation's assets.

In this tax cost/benefit analysis, it is appropriate for the health care entity owners to consider:

1. whether (and to what extent) the C corporation assets will appreciate in value and
2. how much operating income the C corporation will generate over a period of years.

In addition, it is appropriate for the practice or entity owners to consider the possibility of managing the double taxation on C corporation income by paying tax-deductible compensation to shareholder/employees.

The cost of conversion and the opportunity cost of the current payment of tax may not be too expensive—in light of the tax savings on future appreciation if (1) the value of the C corporation assets in excess of their tax basis is sufficiently small and (2) those asset values are expected to appreciate over time.

Also, the existence of any favorable tax attributes at the corporation level may reduce the current tax cost.

The tax consequences of conversion are based on the entity assets' fair market values. And, it is noteworthy that the tax conversion transactions are not between unrelated parties dealing at arm's length.

Therefore, it is important for the health care entity to obtain a comprehensive valuation to support the fair market value that is used to determine the transaction gain. As mentioned above, there are severe tax penalties related to the misstatement of the value of the converting C corporation's assets.

Summary and Conclusion

The double taxation of C corporation income from operations and from the ultimate sale of its assets make the C corporation tax status inefficient. The American Taxpayer Relief Act changes in the federal tax law that took effect in 2013 increased this level of double-taxation inefficiency.

The owners of a health care entity C corporation can avoid the C corporation status tax inefficiency by converting the practice or other entity to either of the following:

1. S corporation status
2. LLC status

The conversion of the C corporation to an S corporation may be accomplished without a current tax cost. However, the conversion of a C corporation to an LLC status can result in a current tax at both the corporation level and the shareholder level.

Nonetheless, the current conversion tax cost may be less than the future tax cost:

1. of operating the health care entity as a C corporation and incurring double taxation at what may be higher tax rates or
2. of incurring the higher tax cost (or reduced price) on the ultimate disposition of the entity assets and the attendant double taxation of the appreciation in the value of the entity assets.

Since individual income tax rates on qualifying dividends from C corporations and on capital gains are currently at relatively low rates, this may be a good time for health care C corporation owners to consider the costs and benefits of a conversion to either S corporation status or LLC status. The health care entity owners should consult with their legal and accounting advisers in order to consider all of the costs and benefits of a possible corporate tax status conversion.

The health care entity owners should consult with a valuation specialist before considering the corporate tax status conversion decision. This is because an estimation of both the costs and benefits of the corporate tax status conversion depends on the concluded fair market values of the converting C corporation's assets.

That health care entity asset valuation should encompass all of the entity's assets, both tangible assets and intangible assets.

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