Tax Benefits of Converting a C Corporation with Undervalued Assets

By Janet A. Meade

As a result of the recent economic downturn, many businesses have sustained significant declines in the value of their assets, particularly those holding real estate or certain intangible assets. The future of these businesses, while promising over the long term, may be dependent on attracting additional capital or financing. In cases where the business is taxed as a C corporation, it may be beneficial to convert the corporation to an entity taxed as a partnership. Such a conversion can provide significant tax benefits to current owners by triggering a tax loss with respect to their interests. Care must be taken as to the form of the conversion, because the tax consequences can differ significantly.

For tax purposes, there are three standard approaches to converting one business entity to another. First, there is the "assets up" approach, whereby the old entity makes a liquidating distribution of its assets and liabilities down to its owners. The owners then contribute the assets and liabilities up to the new entity in return for its ownership interests. Second, there is the "interests over" approach, whereby the owners exchange their interests in the old entity over for interests in the new entity. The old entity then dissolves, and all of its assets and liabilities become assets and liabilities of the new entity. Third, there is the "assets over" approach, whereby the old entity transfers its assets and liabilities over to the new entity in exchange for ownership interests in the new entity. The old entity then makes a liquidating distribution of those interests to its owners.

An alternative fourth approach is a statutory conversion, whereby a business entity transforms itself into another entity by filing a single document with the relevant state authorities. This type of formless conversion is popular, not only because of its simplicity, but also because most states allow the transferring entity to claim an exemption from real property transfer taxes. The tax consequences of this approach, however, are less certain than with any of the three standard approaches. Thus, before undertaking a statutory conversion, it is advisable to make sure that its tax characterization produces the desired result.

Formal Conversions

When the assets of a C corporation have declined in value markedly, the conversion of the corporation to an entity taxed as a partnership can provide significant tax benefits to current shareholders by triggering a tax loss with respect to their stock. For individual shareholders, part or all of this loss frequently can be deducted against ordinary income. For corporate shareholders, the loss can offset capital gains. In some cases, the duplication of losses can also be achieved. In addition, losses from future operations can be passed through to the owners, and the profits can avoid double taxation.

Example. A and B are shareholders of a C corporation called CC. CC's assets consist of property with a fair market value (FMV) of $100 and a tax basis of $140. CC has liabilities of $30. A and B have a collective basis in their CC stock of $120. Seeking cash, they bring in E, an outside investor who, for business reasons, wishes to hold his interest in an entity taxed as a partnership. E exchanges $35 of cash for a one-third membership interest in a new LLC, while A and B receive the remaining membership interests. The new LLC elects to be taxed as a partnership.

Assets-up approach. If the conversion is effected under the assets-up approach, CC is deemed to make a proportionate distribution of its assets and liabilities to A and B, who then join E in contributing these to the LLC. Under IRC section 336(a), CC recognizes a loss of $40, equal to the difference between the FMV and the basis of the assets. If the assets are trade or business property, the loss is an ordinary loss, deductible against CC's operating income. If CC is not part of a consolidated or affiliated group, the general liquidation rules of

IRC section 331(a) apply, and shareholders A and B recognize a collective loss of $50, equal to the difference between the FMV of the assets received (less liabilities assumed) and the basis in their stock. Under IRC section 334(a), A and B take an FMV basis in the assets and liabilities of $100 and $30, respectively.

When A, B, and E contribute the assets, liabilities, and cash to the new LLC, no gain or loss is recognized either by them or the LLC, pursuant to IRC section 721(a). Instead, under IRC sections 722 and 752, A and B take a collective basis in their ownership interests in the LLC of $90, equal to their $100 basis in the contributed assets, reduced by the $30 of liabilities assumed by the LLC and increased by their two-thirds membership share of these liabilities. Likewise, E takes a basis in the LLC ownership interest of $45, equal to the cash contribution plus the one-third membership share of the LLC liabilities. Under IRC section 723, the LLC takes a carryover basis in the contributed assets and liabilities of $100 and $30, respectively.

Interests-over approach. If the conversion is effected under the interests-over approach, the tax consequences are the same as under the assets-up approach. Shareholders A and B are deemed to contribute their shares of CC to the new LLC in a nontaxable exchange under IRC section 721(a). At the same time, E exchanges cash for an ownership interest in the LLC. Upon liquidation, CC recognizes a loss of $40, and shareholders A and B recognize a combined loss of $50. The basis of the ownership interests in the LLC is $90 for A and B, collectively, and $45 for E.

Assets-over approach. If the conversion is effected under the assets-over approach, CC is deemed to exchange its assets and liabilities for ownership interests in the new LLC. Concurrently, E exchanges cash for an ownership interest. CC then distributes its ownership interests in the LLC pro rata to A and B in complete liquidation, recognizing a loss of $40. Shareholders A and B recognize a collective loss of $50, equal to the difference between the FMV of the LLC interests and the basis in their stock. Similar to the earlier approaches, A and B take a combined basis in their ownership interests in the LLC of $90, while E takes a basis of $45.

The tax consequences of the assets-over approach differs from those of the earlier approaches in that CC's tax basis in the assets and liabilities carries over to the new LLC. Thus, absent an optional basis adjustment under IRC section 754, the LLC takes a tax basis in the assets and liabilities of $140 and $30, respectively. The potential advantage of this approach is that it can preserve the built-in loss in the value of the assets, as well as the higher basis for depreciation. If the LLC later sells the assets for $100, the loss of $40 passes through to the owners and is deductible by them to the extent of their basis in the LLC. Therefore, it may in some cases be possible to duplicate the loss.

Formless Conversion

If the shareholders use their state's formless conversion law to effect the conversion, the tax characterization is unclear. State law views the converted entity as the same entity as the predecessor corporation. This suggests that the assets-up approach properly characterizes the conversion, because there is no transfer of assets or interests over to a new entity. Taxing authorities are not, however, bound by the state law characterization; herein lies the uncertainty. Under the "check the box" regulations of Treasury Regulations section 301.7701-3(g)(1)(ii), when an association that is taxable as a corporation elects to change its classification to that of a partnership, the corporation is treated as making a liquidating distribution of all its assets and liabilities to its shareholders who immediately contribute these to a newly formed partnership. As such, the regulations characterize the conversion the same as state law, using the assets-up approach.

A formless conversion, however, does not technically involve an election under the check-the-box regulations. In Letter Rulings 9543017, 9701029, and 200214016, the IRS characterized state law mergers of corporations into LLCs using the assets-over approach. The LLCs in these rulings were allowed to adjust the basis of their assets under IRC section 754. This characterization is consistent with Treasury Regulations section 1.708-1(c)(3)(i), which prescribes the assets-over approach as the default treatment for all state law mergers of partnership entities unless an alternative approach is specified.

Loss Recognition

When a corporation liquidates, IRC section 336(a) provides that the corporation generally recognizes gain or loss on the distribution of property to its shareholders, computed as if the property were sold to the shareholders at its FMV. Similarly, the basic rule of IRC section 331(a) provides for gain or loss recognition by the shareholders in an amount equal to the difference between the FMV of the property received less their tax basis in the stock. Recognition of gain or loss is deferred, however, when 80% or more of the liquidating corporation is owned by a single corporate shareholder or affiliated group. In these situations, IRC section 332 requires the corporate shareholder to carry over the basis of the liquidating corporation's assets. Converting such a corporation to an entity taxed as a partnership, therefore, will not trigger a tax loss to the single corporate shareholder or affiliated group unless the converting corporation's ownership is first altered in such a way so as to avoid IRC section 332.

Corporate and individual shareholders generally characterize their loss as capital, with a holding period dependent upon the ownership term of their stock. Capital losses, however, are often less than ideal because they are deductible only against capital gains (and up to $3,000 of ordinary income for individual shareholders). Corporate shareholders are allowed a three-year carryback against past capital gains, as well as a five-year carryforward. Thus, while corporate shareholders having sizable capital gains in earlier years may reap substantial tax benefits from a conversion, those lacking prior gains may not.

Greater tax benefits often are realized by individual shareholders. Under IRC section 1244, losses on qualifying stock are treated as ordinary and deductible against compensation and other ordinary income in an amount up to $50,000 (single) or $100,000 (joint) annually. To qualify for IRC section 1244 treatment, the corporation's initial capitalization must not exceed $1 million and the shareholder must be one of the original investors. Losses in excess of the annual limits are treated as capital losses.

After the conversion, if the business continues to sustain operating losses, those losses can be passed through to the investors and deducted to the extent of their tax bases in the converted entity. Losses in excess of an investor's basis, however, are not deductible unless the investor contributes additional cash or property to the entity or otherwise constructively increases the basis via entity-level debt. Any future income earned by the business is likewise passed through and taxable to the investors.

Tax Attributes

When a C corporation converts to an entity taxed as a partnership, it files a final tax return. Any tax attributes not used on that return are lost. Planning may consequently be required to avoid wasting net operating loss (NOL) and capital loss carryovers. Likewise, planning may be needed to ensure that the new partnership entity makes the appropriate entity-level elections. If the new partnership entity is required to select a year-end different from that of the converting corporation, an additional consideration is the tax effect of a short period. The legalities of the conversion also need to be addressed, including issues related to asset valuations, title documents, sales tax identification numbers, debt assumptions, and business registrations.

Conversion Opportunities

When a business taxed as a C corporation has sustained a marked decline in the value of its assets, significant tax benefits often can be realized by converting the corporation to an entity taxed as a partnership. In some circumstances, however, such a conversion may be undesirable. For example, some shareholders may not be able to utilize the capital losses or some may have gain on their stock. Rather than liquidate the entire corporation, the better option in these cases may be to transfer the business to a newly formed partnership entity, with some of the shareholders retaining their ownership in the corporation and other shareholders exchanging their shares for interests in the partnership entity.

Another consideration is the business's future prospects. Certain types of investors, such as pension funds, charitable organizations, and foreigners, generally prefer to invest in corporations rather than partnership entities so as to avoid the pass-through of potentially taxable income. If the business intends to seek funds from these kinds of investors in the future, retention of the corporate form is advisable. Likewise, if the business plans to issue public stock or incentive stock options, it is advisable to retain the corporate form. Absent such prospects, however, C corporations holding undervalued assets may find it beneficial, in certain circumstances, to convert the business to an entity taxed as a partnership. ❑

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