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Hazards in Electing S Corporation Status After a Merger

-by Neil E. Hart

The potential for triggering painful income tax liabilities from the “built-in gains” tax upon shifting from C corporation status to S corporation status is well known. The built-in gains tax is imposed in an effort to thwart attempts by C corporations to elect S corporation status to minimize the effects of the modification of the corporate liquidation rules in the 1986 Act. However, a recent private letter ruling has focused attention on the imposition of the built-in gains tax in the event of a merger without regard to the date of the corporation’s election to be an S corporation.

What is the “built-in gains” tax?
The built-in gains tax is imposed on sales or exchanges of appreciated assets which are disposed of within 10 years after the corporation becomes an S corporation. The tax is imposed at the maximum corporate rate for the year in which the disposition occurs applied to the lesser of– (1) the net recognized built-in gains (the net of built-in gains and built-in losses); or (2) the amount of taxable income if the corporation were not an S corporation.

It is important to note that the corporate-level built-in gains tax applies to all assets, including inventory property. Moreover, there is no de minimis rule applicable. A corporation becoming an S corporation must add the difference between the value of inventory on the date of the S corporation election using the FIFO (first in, first out) method inventory valuation and the value using the FIFO method.

The gains on sale or distribution of assets are presumed to be built-in gains except to the extent the taxpayer can establish that the appreciation occurred after the conversion. Therefore, it is desirable to obtain an appraisal of a C corporation’s assets at the time the C corporation converts to an S corporation in order to establish the amount of built-in gain potentially subject to the corporate level tax.

If an S corporation holds an interest in a partnership, a “look-through” approach has been adopted with the distributive share of the partnership items treated as recognized built-in gain or loss to the extent the distributive share would have been treated as recognized built-in gain or loss had the items been taken into account directly by the S corporation. Installment reporting may not be used for net unrealized built-in gains.

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gains of S corporations. Income or deductions taken during the first year of the recognition period as discharge of indebtedness or as a bad debt deduction are recognized as built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period. Adjustments under I.R.C. § 481 (such as for change of accounting method) are subject to the built-in gains tax.

Applicability to mergers, consolidations and reorganizations

Transferred basis property acquired by an S corporation from a C corporation or a former C corporation, such as in a tax-free merger of a C corporation into an S corporation generally is subject to the built-in gains tax notwithstanding that the transferee corporation always has been an S corporation or that the assets were not held as of the beginning of that corporation’s first taxable year as an S corporation. This applies to any transaction occurring after December 27, 1994, without regard to the date of the corporation’s election to be an S corporation.

In a 2006 private letter ruling, a merger was proposed of a not-for-profit corporation (which was not tax-exempt and had not met the definitional requirements of Section 501(c)(3) of the Internal Revenue Code) into a newly formed corporation which would elect to be treated as an S corporation. While the merger was approved as tax-free in nature, the Internal Revenue Service ruled that if the resulting corporation becomes an S corporation, the corporation would be subject to the built-in gain provisions. The ruling notes that the 10-year recognition period would begin on the first day that the resulting corporation was an S corporation. The property acquired from the non-S corporation would be subject to the built-in gains tax if disposed of by the transferee corporation within 10-years of receipt of the assets by the S corporation.

Prior to the 1994 amendment to the regulations, it was generally believed that this outcome would not apply to corporations whose S elections were filed before January 1, 1987. However, IRS warned that regulations would provide that transferred basis property acquired from an S corporation for a C corporation or former C corporation such as in a tax-free merger generally would be subject to the built-in gains tax even though the transferee corporation had always been an S corporation or that the assets were not held as of the beginning of that corporation’s first taxable year as an S corporation.

While the facts of the 2006 letter ruling were unique in that the merging corporations were both non-profit ventures, the key point is that a non-S corporation merged into a corporation that proposed to elect to be an S corporation. Whenever that occurs, the assets passing into the S corporation trigger the 10-year recognition rule. The same outcome, of course, would apply if the transferor corporation had been a traditional C corporation organized as a for-profit corporation under state law.

In conclusion

The important point to note is that every merger, consolidation or reorganization that involves assets from a non-S corporation passing into a corporation that proposes to elect to be taxed under Subchapter S of the Internal Revenue Code is effectively “tainted” as to those acquired assets with potential built-in gains tax liability for a decade after the resulting corporation becomes an S corporation.

Footnotes

2 See generally 8 Harl, Agricultural Law § 56.02[1][a] (2006); Harl, Agricultural Law Manual § 7.02[3][c][iii] (2006); Harl, Farm Income Tax Manual § 1009(a) (2006 ed.).
4 I.R.C. § 1374(d)(3).
5 I.R.C. § 1374(b)(1).
8 See I.R.C. § 1374(d)(1).
9 Treas. Reg. § 1.1374-4(h).
11 Treas. Reg. § 1.1374-4(e).
15 Id.
16 Id.
17 I.R.C. § 1374.
20 Id., part III.