Is Conversion from a C-Corporation to an S-Corporation Right for your Company?

Keiter
Your Opportunity Advisors

May 2013

By Stephen Kimberlin, CPA

A critical decision for any business is the choice of entity. It is not uncommon for a business to convert from one entity type to another as their business grows and changes. One common conversion is going from a C corporation to an S corporation. The election for this conversion is required to be filed by the 15th day of the 3rd month of the current year. Therefore, C corporations that are considering converting to an S corporation for the 2014 tax year should begin this process prior to the end of 2013.

Converting to an S corporation can bring multiple benefits to the business. The most commonly discussed are minimizing payroll taxes for highly compensated shareholders and employees, the elimination of the 35% flat tax on personal service corporations, and the elimination of double taxation associated with C corporations. The double taxation applies to annual net income as well as the gain recognized upon sale of the company. The convergence of personal income tax rates with corporate income tax rates has mitigated the differences with respect to annual income tax; however, the difference in income tax liability resulting from a sale of the company is still a very significant variable that should be considered anytime a change in entity structure is contemplated. Therefore, the conversion to an S corporation can be very important to business owners considering selling their company as an exit strategy.

As with any situation, there are downsides to this transaction. The built-in-gains (BIG) tax is an additional tax specifically related to an S corporation converted from C status. This tax is imposed on the "built-in-gain" that exists at the time of the conversion and is levied when the company is sold. However, the tax is only required during a 10-year recognition period that starts on the date of conversion As mentioned above, if a business has an exit strategy that includes a sale of the company, they should consider a conversion as soon as possible to begin the 10-year recognition period. Once the 10-year period expires, so does the exposure to the BIG tax.

It is highly recommended that you consult your tax advisor if you are considering converting a C corporation to an S corporation. Your tax advisor can walk you through the advantages and disadvantages of the election, assist in the conversion process, and work through any potential pitfalls of the conversion. If you would like to discuss this conversion, or to obtain additional information from our Professional Services industry team, please contact Stephen Kimberlin, Vince Nadder or George Riegel.

Stay in touch