

TYPES NOT MAPPED YET March 12, 2018 | TTR not mapped yet | Steve B. Gorin

Converting from an S corporation to a C corporation - Don't do it the simple but wrong way

[Effect of 2017 Tax Reform on Choice of Business Entity](#) summarizes considerations in choosing whether to continue being an S corporation or convert to a C corporation. In most cases, exit planning suggests remaining an S corporation. However, in some cases, one may decide to convert to being a C corporation.

For those who have decided that such a conversion is the way to go, it's tempting simply to revoke the S election as of January 1, 2018, to get the benefits of lower C corporation income taxation for the entire year. However, that idea can leave on the table many tax benefits. Instead, consider recapitalizing the corporation into an S corporation parent and one or more C corporation subsidiaries (which cannot be done retroactively to January 1).

First, converting to a C corporation can impair making a tax-free distribution of previously taxed S corporation earnings, which are tracked through an "accumulated adjustments account" (AAA). Generally, electing taxation as a C corporation wipes out AAA. However, in the first C corporation taxable year, the corporation may make cash distributions using AAA, and in later years it may be possible to make limited cash distributions using AAA. Consider in the last S corporation taxable year distributing a promissory note the shareholders using part or all of the remaining AAA, so that later the corporation can get cash to shareholders by repaying the note, rather than making taxable dividends. However, such a note has the disadvantage of interest being deductible at lower C corporation rates (if deductible at all) and taxable to shareholders as highly-taxed ordinary income. One needs to weigh carefully the advantages and disadvantages of such a note, including any restrictions on debt imposed by third party lenders.

Also consider whether the corporation may one day want to convert back to being an S corporation. Tax laws may change to reduce the tax differential between C corporations and pass-through business income, or the shareholders may decide to distribute more income than previously planned. The tax-free recapitalization described above would preserve AAA to facilitate future distributions after a conversion back to S corporation status. Also, revoking an S election results in a 5-year waiting period before converting back to being an S corporation. However, the tax-free recapitalization described above would preserve the underlying S election and would appear to allow converting back to being an S corporation without that waiting period.

Finally, stock in a C corporation that engages in certain types of business activities may be sold income tax-free, within particular limits. This benefit does not apply to a C corporation that revoked a prior S election but appears to apply to a C corporation formed in the tax-free recapitalization described above.

The tax-free recapitalization described above may also be used to provide a hybrid result. Perhaps one business activity may be done inside a C corporation subsidiary, whereas another might be conducted within an S corporation environment, so that some income from operations may be distributed to shareholders with one layer of tax, while the income from other operations might be reinvested at favorable C corporation rates.

As described in [Effect of 2017 Tax Reform on Choice of Business Entity](#), the decision to convert to a C corporation can have adverse long-term effects. Before doing that, one may want to check out whether the tax-free recapitalization described above will help one keep one's options open.

This article is intended for informational purposes only. It is not intended to provide legal or tax advice to be relied upon without further consultation. If you desire legal or tax advice for your particular circumstances, please consult an attorney or tax professional. Tax professionals are welcome to email me for a free copy of my business structuring materials and look at part II.E.2.B. Converting from S Corporation to C Corporation to review these issues themselves.

[Steve Gorin](#) is a practitioner in the areas of estate planning and the structuring of privately held businesses.

About Business Succession Solutions

A message from [Steve Gorin](#):

[This blog](#) is intended to help business owners – and those who advise or support them – consider strategic issues, avoid tax traps, or spot tax opportunities.

It is an offshoot of my popular quarterly newsletter, “[Gorin’s Business Succession Solutions](#),” which dives more deeply into the issues highlighted on this blog and is specifically written for CPAs, lawyers, trust officers, family office professionals, and financial advisors. Each newsletter also includes a link to the most recent version of a few thousand pages of technical materials on nearly every aspect of business succession planning. Each newsletter in that series is followed a few weeks later by a webinar for which continuing education credit may be available. [Click here to sign up for the newsletter](#).

Additionally, each January, reporters for the American Bar Association’s [Real Property Trust & Estate Law Section](#) cover the University of Miami’s [Heckerling Institute on Estate Planning](#), the largest such conference in the country, producing a dozen or so summaries. I forward their summaries, along with some brief commentary, to those who [subscribe to my Heckerling Newsletter](#).

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In addition to helping clients directly through my law practice at Thompson Coburn LLP, I also consult with advisors throughout the country, adding value to the services that they provide to their clients as a strategic consultant for services they provide or as a provider of specialized services.

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