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Is a Conversion from Subchapter S to Partnership Right for Your Company?

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One truism about the current market is that the cost of converting from a subchapter-S corporation ("sub-S") to partnership form is becoming, at least temporarily, less burdensome. In some cases, the usual tax load of converting a sub-S will even be non-existent for the present time.

While the use of LLCs, LPs, general partnerships and other entities taxed as partnerships have certain advantages in many settings, sub-S corporations are also used to achieve similar tax results. Nevertheless, certain activities are clearly better pursued in a partnership structure, rather than through a sub-S corporation, such as owning real estate or other passive investments, activities which may produce losses, certain estate planning strategies, and investment activities requiring multiple types of ownership or equity rights.

The format for converting a sub-S to a partnership involves one of three methodologies: (1) an asset transfer, (2) a stock transfer or (3) a change in election, under the "check-the-box" regulations, to partnership treatment (Treas. Reg. § 301.7701-3).[1] This alert focuses on the third route, since in many cases lender and third party consents generally are not necessary, or desirable, for a simple change under the check-the-box regulations.[2]

The IRS views a change in election, from an association (i.e., the sub-S) to a partnership, as resulting in the following deemed consequences: "The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership." Treas. Reg. § 301.7701-3(g)(ii). One effect of this sequence is that each shareholder will receive his or her share of corporate level gain, under Internal Revenue Code (IRC) § 1366.[3] Given the falling appraised asset values (some observers report losses in the last 24 months at 40%, or more, depending on the type of property, the region, and other factors), any gain that accumulated over earlier years may be significantly reduced now.

A change in election can be made by filing Internal Revenue Service Form 8832 and will be effective on the date specified by the entity. The effective date cannot be more than 75 days prior to, or more than 12 months after, the date on which the election is filed. Treas. Reg. § 301.7701-3(c)(iii). A change in election must be approved by all of the shareholders. A new deprecation period will start, for the partnership, using an adjusted basis equal to the fair market value of the distributed assets.

The shareholders would be best advised to have the assets formally appraised in connection with a proposed check-the-box conversion. Unlike charitable contributions, including conservation easements, there are no applicable "qualified" appraisal rules as to when an appraisal should be prepared (or even requiring that one be completed). Shareholders might choose to wait until they believe the market has hit the bottom before implementing this strategy.

The planning opportunities associated with the conversion discussed above require specific facts and circumstances. Should you have any questions or want additional information regarding this planning opportunity, please contact any of the attorneys in the Firm's Tax Department.

1. A change in election to be taxed as a partnership under the "check-the-box" regulations changes the entity classification for federal income tax purposes only. Corporate formalities must still be observed, since the entity maintains its legal status as a corporation for all other purposes. In addition, state law must be consulted with respect to tax

consequences.

2. A quick review of a sampling of the "negative" covenants found in portfolio loans, life company loans and commercial mortgage backed securities loans did not disclose any potential defaults, but in every case this should be checked specifically. This alert assumes that no negative loan covenants will be violated by using the approach set forth herein. If consents are required, such consents may be difficult to obtain, particularly while the market remains somewhat unsettled.

3. The corporation will recognize gain under IRC § 311 equal to any excess of the fair market value of its assets over their adjusted basis to the corporation.