

## **Is Conversion from Subchapter S Elected Status to Partnership Status Right for Your Business Entity?**

by

William Sylvester and C. Bradley Cherry  
Baker Donelson Bearman Caldwell & Berkowitz, PC

One truism about the current market is that the cost of converting from certain types of entities formed or currently electing to be taxed as a subchapter-S ("sub-S") corporation to the partnership form, is becoming 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 has certain advantages in many settings, sub-S corporations are also used to achieve similar tax results. Accordingly, many unincorporated entities are formed, elect to be taxed as a corporation, then elect sub-S status. Nevertheless, certain activities are clearly better pursued in a partnership structure rather than through a sub-S election, 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, which is available only to unincorporated entities (Treas. Reg. § 301.7701-3).<sup>1</sup> 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.<sup>2</sup>

The IRS views a change in election, from an association (i.e., an unincorporated entity electing sub-S federal tax status) 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 owner will receive his or her share of corporate level gain, if any, under Internal Revenue Code (IRC) § 1366.<sup>3</sup> 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), 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).<sup>4</sup> A change in election must be approved by all of the owners. A new depreciation period will start, for the entity, using an adjusted basis equal to the fair market value of the distributed assets.

The owners 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). Owners 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.

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. 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 entity will recognize gain under IRC § 311 equal to any excess of the fair market value of its assets over their adjusted basis to the entity. In cases where a shareholder's pro rata portion of the inside net asset tax basis is different from the shareholder's basis in the stock or other ownership interest in the sub-S (in each case before the deemed distribution), then additional gain or loss may be incurred due to the deemed receipt of the assets in liquidation. This generally will not occur for persons who have been owners since the inception of sub-S status but may apply to persons purchasing or inheriting sub-S interests after formation.

4. An entity that makes an election under Treas. Reg. § 301.7701-3(c)(1)(i) by filing Internal Revenue Service Form 8832, cannot change its classification by election again during the 60 months succeeding the effective date of the election. An election by a newly formed entity that is effective on the date of formation is not considered a change for purposes of this limitation.

\*\*\*\*\*

**William Rembert Sylvester**

Shareholder

Baker Donelson Bearman Caldwell & Berkowitz, PC

Wachovia Tower 420 20th Street North Suite 1600

**Phone** 205.250.8372

**Fax** 205.488.3772

[bsylvester@bakerdonelson.com](mailto:bsylvester@bakerdonelson.com)

William R. Sylvester, is a shareholder in the Birmingham office of Baker Donelson Bearman Caldwell & Berkowitz, PC. He has a strong background lecturing and writing on advanced techniques involving tax deferred real property exchanges and focuses his practice in the areas of commercial real estate development, business and tax planning. More regarding Mr. Sylvester's practice can be found by clicking on the following link:

<http://www.bakerdonelson.com/Bio.aspx?NodeID=32&PersonID=11739>

**C. Bradley Cherry**

Associate

Baker Donelson Bearman Caldwell & Berkowitz, PC

Wachovia Tower 420 20th Street North Suite 1600

**Phone** 205.250.8376

**Fax** 205.488.3776

[bcherry@bakerdonelson.com](mailto:bcherry@bakerdonelson.com)

C. Bradley Cherry, is an associate in the Birmingham office of Baker Donelson Bearman Caldwell & Berkowitz, PC. He manages a diverse commercial real estate portfolio practice and has guided clients through multifamily and golf course development transactions, acquisitions of manufacturing sites in the southeast, as well as providing banking and financial counsel for clients. More regarding Mr. Cherry's practice may be found by clicking on the following link:

<http://www.bakerdonelson.com/Bio.aspx?NodeID=32&PersonID=11740>