THE BUILT-IN GAINS TAX

THE IMPORTANCE OF STARTING WITH THE PROPER ENTITY STRUCTURE

FP Transitions is experienced in working with financial advisors who operate as C-Corporations ("C-Corps"). The C-Corp is one of the longest-running forms of business organization—it is what most people refer to when they simply say corporation—and is the preferred entity for both publicly-traded companies and startup companies seeking venture capital. However, it is not the best choice for the vast majority of advisors. Most advisors who incorporate can meet the requirements to make an election for tax treatment as an S-Corporation ("S-Corp"). While C-Corps are subject to double taxation, an S-Corp provides its owners the benefit of only one level of taxation. This preferential tax treatment can lead to both substantial income savings and increased business value.

KEY POINTS

1. Although a C-Corp is the preferred entity for both publicly-traded companies and startup companies seeking venture capital, it may not the best choice for the vast majority of advisors.

2. 2.) Advisors who have recently converted from a C-Corp to S-Corp, who plan to sell their assets externally, should be aware of the possible BIG taxes, or be prepared to postpone their sale by a length of time known as the "holding period."

3. The BIG tax does not apply to any gain on the sale of assets acquired by the S-Corp after the "C" to "S" conversion, or on the sale of S-Corp stock.

So long as a C-Corp meets the requirements for an S-Corp election, a C-Corp may convert to an S-Corp at any time.* Yet if the C-Corp owns appreciated assets (including intangibles such as client relationships and goodwill) whose fair market value is greater than their adjusted basis, at the time of the S-Corp election, then there is the potential for adverse tax consequences that would not exist had the C-Corp owned no assets at all. The assets previously held by the C-Corp become subject to the built-in gains ("BIG") tax for 5 years. This length of time, known as the "holding period," was 10 years before Congress reduced it in several temporary steps after the 2008 financial crisis, and made a permanent reduction to 5 years in late 2015.

During the holding period, the BIG tax is based upon the "built-in gain" on the S-Corp's sale of assets previously held by the C-Corp. The BIG tax applies to the appreciation (difference between the fair market value and the adjusted basis) of the assets at the time of the corporation's conversion from "C" to "S" status. The BIG tax rate equals the highest-bracket corporate tax rate currently in effect (35% for 2017). The income remaining after the BIG tax is taxed a second time at the shareholder rate. It is important to note that the BIG tax does not apply to any gain on the sale of assets newly acquired by the S-Corp or on the sale of S-Corp stock.

Congress's reason for imposing the BIG tax can be summarized as follows: ordinarily, if a C-Corp converts to a different entity, such as a partnership or LLC, the IRS deems a liquidation to have occurred, and taxes any gain or loss as a constructive sale of the C-Corp assets at both the corporate and shareholder level. Congress did not find this treatment appropriate for a C-Corp to S-Corp conversion, since both entities are corporations. At the same time, Congress did not intend to create a loophole by which a C-Corp could liquidate free of corporate tax by converting to an S-Corp, which is taxed only at the shareholder level. Therefore, Congress enacted the BIG tax as a compromise.

Advisors who operate their businesses as C-Corps can immediately take advantage of the tax benefits available to S-Corps by making the S-Corp election. However, such advisors may find their long-term strategies impaired by the BIG tax if they plan to sell their business assets during the holding period. The

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most valuable assets held by businesses—their client lists and goodwill—frequently have an adjusted basis of zero, which means their entire income upon sale is subject to the BIG tax. If such businesses are sold externally in an asset sale—the most common deal structure for a third-party transaction—the owners will have to either postpone the sale for 5 years or pay a significant amount in BIG taxes. They may sell externally via a stock sale and avoid the BIG tax, but should expect a lower sale price due to the disadvantages that a stock sale presents to an external buyer (e.g., acquired liabilities, no step-up in basis).

Despite its adverse effects on external sales, the BIG tax will not affect most succession plans executed through FP Transitions' Succession Management Program, since they are almost always structured as internal stock sales. That said, long-term business planning begins with the choice of an entity, and advisors should be aware of the tax repercussions associated with each entity type. FP Transitions offers its EntityBuilder service to help advisors choose the entity that's most suitable for them, given their future succession and continuity plans, and to assist in the formation of the entity, working in conjunction with each advisor's tax and legal counsel where appropriate.

**At the beginning of each year, the IRS provides a 2 month and 15 day window for a C-Corp to convert to an S-Corp. If a C-Corp misses that period, it may still convert to an S-Corp, but the election will not be effective until the following year unless the corporation obtains relief from the IRS for a late filing.*

FP Transitions is the nation's leading provider of equity management, valuation and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

Since opening its doors in 1999, FP Transitions has completed more financial service transactions than any investment banker or business-broker in the country. FP Transitions' expertise also includes continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

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