KERNUTT STOKES

Moving Assets from an S Corporation to a Partnership
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From an income tax perspective, business owners often view S corporations and partnerships as fungible forms of doing business. Although both entities generally avoid an entity-level tax by "passing-through" their income to their owners, partnerships often have significant advantages over S corporations. Assuming that a taxpayer can otherwise choose between the two types of entities, some of the potential benefits of using a partnership (and other entities that can be treated as partnerships for tax purposes, such as LLCs) include the following:

- A partnership may generally distribute appreciated property to its partners without gain recognition with respect to such property. But (outside of narrow circumstances) an S corporation will trigger gain upon the distribution of appreciated property to its shareholders.
- A partnership's partners include the debt of the partnership in determining their basis in the partnership. This can, for instance, help the partners benefit from any losses incurred by the partnership. But an S corporation shareholder can only obtain a similar benefit if the shareholder makes a direct loan to the corporation.
- Upon the sale or exchange of a partnership interest (or the death of a partner), a transferee of the partnership interest can receive a "step-up" in the basis of the partnership's appreciated assets. But no similar election is permitted with respect to an S corporation.
- A partnership is permitted significant flexibility in allocating its income and loss among its partners. But an S corporation must allocate its income and loss equally across each of its shares.
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"Converting" an S Corporation to a Partnership
Given these and other advantages of doing business through a partnership, one question business owners have is whether an S corporation can convert to a partnership. Unfortunately, a simple conversion of an S corporation to a partnership will be considered a taxable liquidation of the S corporation, resulting in the recognition of gain on the corporation's appreciated assets. Accordingly, such a conversion is generally not advisable.

"Migrating" Assets from an S Corporation to a Partnership
While a simple conversion of an S corporation to a partnership may not be advisable, it is possible for an S corporation to "migrate" its assets into a partnership over time. One way to accomplish this migration without recognizing gain is to (i) transfer the S corporation's assets in a transaction that qualifies as a "reorganization" for federal income tax purposes and (ii) contribute new capital to the business.
For instance, let's assume that the stock of an existing S corporation, Corporation X, has a value of $80 and that the owners of Corporation X desire to migrate into a partnership structure. This could be done using the following steps:

- The owners of Corporation X form a new corporation, Corporation Y (which will be treated as an S corporation), and Corporation Y forms a new limited liability company, New LLC.
- Corporation X then merges with and into New LLC, with New LLC surviving the merger and the owners of Corporation X receiving solely shares of Corporation Y stock in the merger. After the merger, the owners hold all the Corporation Y stock, Corporation Y holds all the units of New LLC, and New LLC holds all the assets formerly held by Corporation X.
- Immediately following the merger, the owners contribute $20 in cash to New LLC (equal to 20% of the value of New LLC, as measured after the contribution), and in exchange for such cash, New LLC issues to the owners all the ordinary units of New LLC. After the $20 contribution, New LLC is

considered a partnership for tax purposes. At the same time, all the New LLC units held by Corporation Y are converted to preferred units, which entitle Corporation Y to a fixed, annual preferred distribution from New LLC. The preferred units have a value of $80 (i.e., the value of the Corporation X stock before the transactions were undertaken), which equates to 80% of the equity in New LLC.

Assuming there is a "good" business purpose for the merger of Corporation X into New LLC, that transaction should qualify as an "F" reorganization for income tax purposes. Accordingly, none of the parties to the merger should recognize any gain or loss. With respect to the $20 capital contribution to New LLC, if the appropriate steps are taken, this transaction may also be executed without the recognition of any gain or loss.

After the dust settles, the owners hold all the stock of Corporation Y and all the ordinary units of New LLC, Corporation Y holds all of the preferred units in New LLC, and New LLC holds all the business assets. What have the owners accomplished? To answer that, let's assume that, in future years, the value of the preferred units of New LLC remains $80, owing to the fixed return on such units, but that the total equity value of New LLC has grown to $200. In that case, the owners would now hold ordinary units in New LLC that have increased in value from $20 to $120. In other words, the owners have gone from holding the entire value of the business through an S corporation to holding 60% of that value through a partnership, New LLC, and 40% (indirectly) through an S corporation, Corporation Y. In this way, the owners have "migrated" a portion of the value into a partnership structure, granting the owners the advantages of holding assets through that structure.