Most of us know that S corporations are reasonably tax efficient from an operating standpoint: leaving aside Illinois replacement tax, only one level of tax is paid on company earnings (at the shareholder level). We also know that an S corporation can usually sell its assets (or its shareholders can sell their shares) in a tax efficient way. And Medicare taxes can be controlled with an S corporation more readily than with an LLC.

But we also know that S corporations have constraints, and in back of mind we know that the client would have greater long term flexibility if it operated as an LLC or other tax partnership.

While the thought may occur to us convert an S corporation or two into an LLC, the tax upon conversion of the S corporation is a hurdle we may not know how to overcome. Given the tax charge, the relative tax efficiency of an S corporation on a day-to-day basis and that we are all rather busy, leaving matters well enough alone seems fair enough. But read on.

Without going into a long discussion of S
versus LLC advantages and disadvantages, let me note a few of the problems that we see with middle market S corporations:

- Company wants to bring in employees into ownership, but not straight up. Problem: second class of stock rule.
- Shareholder wants to do (should be doing) more sophisticated estate planning involving family holding companies and trusts. Problem: ineligible shareholders (or higher taxes on certain trust shareholders).
- Company wants to bring in a strategic partner to grow the business. Problem: ineligible shareholders and/or second class of stock rule.
- Shareholder wants to do (should be doing) asset protection planning and not leave all non-business assets exposed to creditor claims or claims of potentially divorcing spouses. Problem: ineligible shareholders and/or higher taxes on certain trust shareholders.
- Retiring shareholder does not want to get bought out, but is to have a reduced and controlled share of distributions. Problem: second class of stock rule.
- Client finally agrees that the company real estate does not belong in the operating agreement (where it is subject to creditor claims). Problem: distributing the real estate to the shareholder triggers tax.
- Cyclical business generating losses during an economic downturn. Problem: losses limited to stock basis (unlike in a tax partnership, outside basis does not include company indebtedness).

If you do not see these issues for your client, you may not have had time to look, or they are just around the corner. Each of these problems would not be a problem (or would be a more manageable problem) in a tax partnership such as an LLC. So how do we get to the solution?

The technique we often use is the so-called LLC drop down (see the illustration below). It avoids the tax charge arising from a liquidation of the S corporation because the company is not converted or liquidated. The S corporation transfers its assets to a new LLC subsidiary. The S corporation remains, initially, as the sole owner of the LLC. Over time, ownership of the LLC migrates away from the S corporation to the new owners (members) of the LLC.

The migration of LLC ownership away from the S corporation occurs in a variety of ways. Often it is part of traditional estate or asset protection planning. Sometimes the accountants will value the business and then use "freeze" techniques to limit the future
growth of the S corporation - growth inures to family trusts instead. Sometimes the migration is driven by external events, such as by bringing employees into ownership or a recapitalization with new money.

How to start the process? Having identified an S corporation client or two who would benefit from a drop down, experienced counsel should be brought in to confirm the strategy and help identify both the tax and non-tax issues to consider. Tax issues include situations where assets are subject to liabilities that exceed basis, incremental Medicare taxes (usually not a material issue) and deferred gain situations. Non-tax issues include lender approvals, key contracts that are not assignable and regulatory constraints.

Costs of implementation are modest and vary depending on the type of business. There is of course the basic legal work of setting up the new LLC and asset transfers, an additional tax return for the LLC and the cost of the valuation you might do in a freeze context, etc. From there it is a matter of working together to outline the benefit in a way that is meaningful to the client, both short term and long term.

Our experience is that the drop down can be
presented to a client in a compelling way. And the timing for a drop down is particularly good right now. A softer economy allows for more modest valuations, which can mitigate some of the tax issues. And better loss flow-through options with an LLC may create tax benefits that offset some of the losses.

A drop down is not rocket science. What is needed is a combination of business insight from the accountants, tax and corporate knowledge from experienced counsel and a good push to finally get it done. Whatever way you see fit to approach this, there is little reason to leave most old S corporations well enough alone.

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