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KEY TAX INSIGHTS

MERGERS & ACQUISITIONS NEWSLETTER

Tax Implications of Exiting a Domestic C Corporation

The Tax Cuts and Jobs Act ("**TCJA**") reduced the federal corporate income tax rate from 35 percent to 21 percent. The lower corporate tax rate allows opportunities for businesses to reinvest profits to limit shareholder's taxation and if the business distributes profits, the overall effective tax rate imposed on the company and shareholders is more comparable to operating through a pass-through entity. C corporation status allows for other tax benefits including:

(1) qualified small business stock ("**QSBS**") status *(allowing significant tax savings on exit)*;
(2) U.S. exporters can achieve a federal corporate tax rate of 13.125 percent through the foreign-derived intangible income deduction ("**FDII**"); and
(3) for foreign-owned U.S. businesses, corporate form can allow for favorable tax rates.

A domestic C corporation is subject to federal corporate income tax at a flat rate of 21 percent. The shareholders of the corporation may also be subject to federal income tax on distributions from the corporation. To the extent of the corporation's earnings and profits *(current and accumulated)* ("**E&P**"), distributions are taxed as dividends to the shareholders. To the extent distributions exceed earnings and profits, distributions are treated as a tax-free return of basis to the shareholders. To the extent the distributions exceed the shareholder's tax basis, the distribution is taxed as a capital gain. For individual domestic shareholders, dividends and capital gains are generally subject to tax at a rate of 23.8 percent *(including a 3.8 percent net investment income tax)* **("NIIT")**.

Foreign shareholders of a domestic C corporation are generally subject to a 30 percent withholding tax on dividend income *(with applicable income tax treaties allowing tax rate reduction)* and are generally not subject to tax on capital gains.

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TAX IMPLICATIONS OF EXITING A DOMESTIC C CORPORATION

If a subsidiary corporation makes a distribution to its parent corporation, the parent corporation is not subject to the NIIT and typically can offset the income from the distribution with a 100 percent dividends received deduction.

A shareholder can either sell its stock in the corporation or a corporation can liquidate and distribute the assets to a shareholder to exit the investment in the corporation. If the shareholder sells their stock in the corporation, individuals are generally taxed on the gain at a rate of 23.8 percent.

When a domestic C corporation is liquidated, the liquidating corporation will recognize gain or loss on the assets distributed as if the assets were sold to the shareholders for fair market value. The shareholders will recognize capital gain or loss measured by the cash and fair market value of assets received in the liquidating distribution less the shareholder's basis in the corporation's stock. The shareholder will receive a tax basis in the assets received equal to the fair market value of the assets on the date of distribution. A parent corporation's sale of stock in a subsidiary is subject to corporate federal income tax at a flat rate of 21 percent.

Instead of liquidating the C corporation, the U.S. individual shareholders can convert the C corporation to an S corporation to remove double taxation. Typically, the conversion of a C corporation to a S corporation is a tax-free transaction which avoids tax to the corporation and the shareholder on the conversion. After the conversion, the S corporation would receive the earnings and profits of the C corporation. When distributions are treated as coming from the pre-S corporation election earnings and profits, a shareholder level tax is triggered. Thus, this preserves dividend taxation on pre-S corporation election earnings and profits. If the S corporation sells appreciated property that pre-dates the S corporation election within five years of the election, then a corporate level tax is imposed at the S corporation level on the gain that existed at the time of the conversion **(Built-In Gains Tax)**. If the S corporation holds the property for more than five years from the date of the conversion, then the corporate-level tax is avoided on the sale of the property.

Individual shareholders may exclude 100 percent of the gain on the disposition of QSBS stock if the stock is acquired after September 27, 2010, at its original issue, the stock is held for more than five years, and certain active business requirements are met. The amount of the gain eligible for the exclusion is limited to the greater of $10 million or ten times the taxpayer's basis in the stock.

Prior to exiting a C corporation, the shareholder would be well advised to analyze the tax implications and whether there are any planning opportunities to reduce tax such as QSBS status which will significantly reduce or eliminate any gain on the exit.

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