Summer 2013 Newsletter

How About Switching to a C-corporation ?

In the market place where this appraiser operates, the pass-through organization is overwhelmingly the preferred business form, as private owners would rather have an S-corporation or an LLC over the C corporation. The reason is obvious, as C corporation earnings are taxed directly, and distributions or dividends also trigger a dividend tax, that is to say a double taxation of corporate earnings ensues. This compares, again in this market, unfavorably with having the owners of the pass-through entity pay their share of its earnings at personal rates, which is the status, by far, of the majority of my clients. In fact, I still do quite a few conversion appraisals, i.e. appraisals done at the time of the election, by C-corporations, to be taxed as an S-corporation for federal income tax purposes.

The pass-through status, of course, does not fit all businesses; it limits the number of shareholders, and more importantly it limits to one the classes of stock. This preference for pass-through status does not appear to have been affected by recent increases in personal and dividend tax rates, which place the pass-through at a relative disadvantage. Let’s just say that tax considerations are important to the mid- and lower market business, and that owners are not tempted to fund the government any more than they need to.

We have started to see a movement in the other direction, however, as venture funds and private equity funds will generally not invest in a pass-through principally because of the impossibility of having preferred as well as common classes of stock.

If you have started your business as an S-corporation, but suspect that a venture fund could help you grow it, what do you do ? The answer is called an “acquisitive re-organization” or tax-free re-organization.

Certain types of corporate acquisitions, divisions and other re-structurings can be structured to qualify as tax-free reorganizations. If the requirements of a tax-free reorganization are satisfied, the parties generally defer current federal income tax on gains on their stock and asset transfers. For early stage entrepreneurs who have registered an LLC or S-corporation there is an option to turn the entity into a C corporation via a tax-free reorganization. In these acquisitive reorganizations, one corporation acquires substantially all of the stock or assets of another corporation. So the owner of the LLC can create a new C corporation and have that C corporation acquire all the assets and all the liabilities of the LLC; the resulting entity will be a C corporation. In these transactions, the requirement is that the stock of the acquiring corporation [the newly-formed C corporation] must be used as a significant portion of the consideration, although in some instances parties can be paid using consideration other than qualifying stock [known as "boot."] Thus the owner of the LLC must end up owning a large part of the C corporation stock. The target merges with the acquiring corporation resulting in both groups owning the target.

Requirements are complex, and the transaction must be run by a competent tax lawyer or tax accountant. A transaction must meet specific statutory requirements and must also satisfy three judicial requirements. The first is the "continuity of interest" which requires that stockholders of the initial company [the LLC] receive a substantial equity interest in the acquiring corporation [the newly-formed C corporation.] The second requirement is the "continuity of business enterprise." It is met when after the transaction the acquiring corporation continues to deal in the main business of the acquired corporation. The third requirement is the "continuity of business purpose," which is met if there is a bona fide business reason for the reorganization and not simply for tax savings. In our example, the LLC will have a bona fide business reason as it is reorganizing to gain funding that it otherwise could not receive had it remained an LLC.

Before a tax-free re-organization, the target may have valuable tax attributes that can be used to offset its taxable income and the acquiring corporation may want to obtain access to thee benefits. One example is a net operating loss or NOL. A taxpaying corporation generates an NOL when allowable deductions exceed its gross income in a specific tax year. Typically, the acquiring corporation obtains access to the pre-reorganization tax attributes of the target, subject to several limitations which should be discussed with tax or legal advisors so as to gauge how the rules apply to a proposed transaction. The most significant limitations on the use of a target corporation's tax attributes are in IRC §269 and §382.

While it is preferable to register as a C corporation if you aim to attract venture funding, all entities can use the tax-free re-organization in order to switch and become a C corporation.

ESOP Companies Finally Obtain Relief from Fair Value Disclosures
Proposed legislation Exempts ESOP valuers from Fiduciary status

Accounting Standards Update Fair Value Measurement [Topic 820, formerly FAS 157,] became effective for non-public entities beginning in

December 2011 and thus was to become effective for ESOPs with December 2012 year-end plans. The DOL deadline had been postponed to October 31, 2012. The disclosure was to be part of the ESOP annual filing on form 5500, leaving the information exposed for all to read on the DOL website.

Business appraisers have expressed concern that the required disclosure was to include information which is proprietary. In April of this year, however, FASB decided that ESOPs will receive an indefinite deferral on the requirement to disclose quantitative information on how they value non-traded securities, including the securities of the sponsoring company. The qualitative information, however such as the valuation method[s] used and key inputs still has to disclosed to comply with the standards.

In order to comply with the restated directive of FASB, the valuation method should be presented in such a manner as to prevent “reverse engineering” by competition. Do not hesitate to contact us to review compliance with the standards.

Another victory for ESOPs: the U.S. Department of Labor, which with the IRS oversees ESOPs, has pushed to bestow fiduciary status on their business appraisers. Now two proposed bills [H.R. 2041 and S.273] would specifically exclude appraisers from the fiduciary requirement under ERISA.

Switch to REIT Status: Increase Business Value !

A number of publicly-held firms have or are about to elect REIT status for tax purposes. Real Estate Investment Trusts, which must distribute 90% of their profits to shareholders, are not subject to income taxes. If these corporations have their change from corporation to trust sanctioned, then they would be worth more, everything else being equal. Take the example of Corrections Corp of America [NYSE:CXW] which builds and rents jails to cash-strapped governments. CXW has recently received IRS approval to be taxed as a REIT, which was expected to raise its value by some multiple of the $70 million it expected to pay in income tax had it remained a regular C corporation. In fact, its price on the exchange reached a 10 year peak soon after the announcement. The original reason for REITs and their tax status has - since the fifties - been that they do not operate a business, merely collect rents, which is a passive activity. The distinction between passively collecting rents and operating a real estate business is, of course, blurry.

Of course, as governments everywhere are looking for additional revenues, it is always possible that the privileged status of all REITs can be revoked. In the meantime, IRS is giving approval to document storage companies for the switch, and advocates recommend the REIT structure to cell phone operators, railroads, highways, mines, landfills, vineyards, farmland and other operators of immovable structures which generate revenues. Will there be any corporation left to pay corporate income taxes ?

New Lease Accounting Rules Change Everything !

One of the results of “convergence” of FASB and the International Accounting Standards Board has been a completely new set of rules to account for leasing, in the same manner, worldwide. Valuation analysts, Switch for one, will never look at leases in the same manner. Almost all companies will be affected, and particularly companies which lease equipment out to clients. The lease rules eliminate the old distinction between operating and capital leases; see Topic 842 and 840. All asset and liability resulting from a lease must now be accounted on the balance sheet; following the old rules, many transactions simply became invisible, reducing apparent leverage. Under the new rules, lease expense will fluctuate, since it will be comprised of both interest and depreciation [leases are to be accounted for by the effective interest method, i.e. like a loan.] Certain financial ratios will change, as EBITDA will likely change as well, since lease expense will be replaced with interest and depreciation. The switch, which is momentous and is occurring despite the opposition of most public companies, will also make companies using leasing more comparable.

J.L. Pierson, ASA is an experienced business appraiser who supports the tri-state area business community from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder disputes and divorce, corporate development and transactional support purposes.

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