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Federal Tax ADVISORY ■

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The Attractive C Corporation

In the News

In August a major energy company announced that the corporate managing partner would tender to buy out the publicly traded interests in its master limited partnerships (MLP). It explained that the move would allow it to conserve cash and use it for expansion, rather than paying out excessive distributions to partners. Because partners are currently taxed on the MLP's income, they expect distributions of at least the expected tax liabilities. The only reference in the press release to taxes was a statement that the corporation would save taxes in the future due to increased depreciation.

Of course, what this meant was that the corporation's purchase of the MLP interests would produce a step-up in the cost basis of the assets of the partnerships inside the corporation. The news release did not refer to the fact that the sale would be taxable to the partners, even though part of the consideration would be stock.

The accompanying explanations made publicly traded C corporations sound like some newly discovered invention:

- Simplified structure by having one traded equity
- Lower cost of capital
- Broader pool of capital

Rediscovery

Forty to fifty years ago, most U.S. doctors incorporated as C corporations for the purpose of making larger contributions to corporate retirement plans and related tax benefits. The rate inversion of the Tax Reform Act of 1986, however, caused a race to liquidate many of those corporations (or convert to S corporations) ahead of the *General Utilities* doctrine repeal. For nearly 30 years, Subchapter K has reigned supreme, except offshore.

Now several factors may be contributing to revived interest in the C corporation, including:

- The prospect of Congress reducing the corporate tax rate.
- The apparent indifference of the public owners of entities to recognize the capital gain in their equity.
- The reduced pressure to distribute earnings.
- The potential for refreshing the basis in the corporate assets and reducing future corporate taxable income.
- The cash flow savings.
- The classic attraction of the ability to use tax free corporate reorganizations to provide "acquisition currency" in the future.
- The tax "safety" of corporate transactions relative to partnership transactions.

Indifference of Shareholders

Although it might be possible to structure these deals as Section 351 exchanges, the energy company transaction referred to above contemplates taxable sales by the unit holders. Evidently, that will not be a problem. Similarly, many inversions have occurred that have been taxable to the shareholders of the inverting U.S. corporation.

Presumably the indifference to shareholder-level capital gain taxation reflects a combination of (1) exempt or foreign shareholders, (2) the tax preference for capital gains, (3) churning in the stock, which keeps the basis of many shareholders high, and (4) for those who want to hold their equity, the attraction of future appreciation and lowered inside tax cost.

No Tax Distributions

Profitable partnerships and S corporations are usually compelled to make distributions sufficient to pay the owners' taxes on the entity income that will pass through to them. That compulsion disappears with the conversion to C corporation status; and if the conversion is taxable, the corporation will be able to reduce its future cash losses to income tax by increasing its depreciation.

The resulting increase in net cash available to corporate managers is a potentially potent attraction. It has been a major reason why corporations have not generally embraced various proposals to eliminate the "double taxation" of dividends.

Not for Everyone

Of course, the conversion to C corporation will not be for everyone. It certainly helps MLPs in the energy sector, where tax breaks abound, even for C corporations.

The calculation could become more generally favorable if Congress responds to the various calls for reduced corporate tax rates.

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