Although S corporations can provide significant tax advantages over C corporations in the right circumstances, there are a number of potentially costly tax problems that you should assess before making a decision to convert your C corporation to an S corporation.

Built-in gains tax. Although S corporations generally aren't subject to tax, those that were formerly C corporations are taxed on built-in gains (such as appreciated property) that the C corporation had when the S election becomes effective, if those gains are recognized within 10 years (7 years for tax years beginning in 2009 or 2010) after the corporation becomes an S corporation. This generally is unfavorable, although there are situations where the S election still can produce a better tax result despite the built-in gains tax.

LIFO inventories. C corporations that use LIFO inventories have to pay tax on the benefits they derived by using LIFO if they convert to S corporations. The tax can be spread over four years. This cost must be weighed against the potential tax gains from converting to S status.

Passive income. S corporations that were formerly C corporations are subject to a special tax if their passive investment income (such as dividends, interest, rents, royalties, and stock sale gains) exceeds 25% of their gross receipts, and the S corporation has accumulated earnings and profits carried over from its C corporation years. If that tax is owed for three consecutive years, the corporation's election to be an S corporation terminates. You can avoid the tax by distributing the earnings and profits, which would be taxable to shareholders. Or you might want to avoid the tax by avoiding recognition of passive income.

Unused losses. If your C corporation has unused net operating losses, the losses can't be used to offset its income as an S corporation, and can't be passed through to shareholders. If the losses can't be carried back to an earlier C corporation year, it will be necessary to weigh the cost of giving up the losses against the tax savings expected to be generated by the switch to S status.

There are other factors to consider in switching from C to S status. Shareholder/employees of S corporations can't get the full range of tax-free fringe benefits that are available with a C corporation. And there may be complications for shareholders who have outstanding loans from their qualified plans. All of these factors have to be considered to understand the full effect of converting from C to S status.