1988

Operation of and Distributions from S Corporations

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OPERATION OF AND DISTRIBUTIONS FROM S CORPORATIONS[1]

By

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I. Operations--Pass-Through System

A. Calculation of Corporate Income -- Although an S corporation passes through income and loss items to the shareholders, the amount and generally the nature of such items are determined at the corporate level.

1. S corporation treated as individual-- The taxable income of an S corporation is computed in the same manner as in the case of an individual. I.R.C. §1363(b). There are however a number of exceptions which generally, but not completely, conform to the partnership rules.

   a. An S corporation is not permitted to take a deduction for dividends received from a domestic corporation. Section 243 does not apply.

   b. An S corporation is not permitted to take a deduction for personal exemptions. I.R.C. §§1363(b)(2) and 703(a)(2)(A).

   c. An S corporation is not permitted to deduct foreign taxes. I.R.C. §§1363(b)(2) and 703(a)(2)(A). The taxes pass through and the shareholders may either deduct them or elect to take a foreign tax credit.

   d. An S corporation may not take a deduction for amounts given to a charity. I.R.C. §§1363(b)(2) and 703(a)(2)(C).

   e. An S corporation is not permitted to take a deduction for a net operating loss. I.R.C. §§1363(b)(2) and 703(a)(2)(D).

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[1] Much of this material is drawn from Schenk, Federal Taxation of S Corporations (c. Law Journal-Seminars Press, 1985, 1988)

f. Certain deductions which individuals may take are not used in calculating an S corporation's income. I.R.C. §§1363(b)(2) and 703(a)(2)(E). These would include expenses for the production of income, medical expenses, alimony, and moving expenses.

g. Shareholders who own more than 2 percent of the outstanding stock in an S corporation are treated as partners and must include in income benefits otherwise excludible by employees. I.R.C. §1372(b). It is not clear whether the S corporation can deduct these amounts as salary. Legislative history, although not the statute indicates a deduction is not permitted. S. Rep. No. 640, 97th Cong., 2d Sess. 22 (1982).

h. An S corporation may not take a depletion allowance for oil and gas wells. I.R.C. §§1362(b)(2) and 703(a)(2)(F).

i. An S corporation is not permitted to use benefits of I.R.C. §1244.

j. An S corporation is not required to include certain preference items under I.R.C. §291 unless it was a C corporation for any of the prior three years. I.R.C. §1363(b)(4).

k. An S corporation is not required to use the accrual method of accounting if engaged in the business of farming. I.R.C. §§1363(b) and 447(c)(1).

l. Personal use by a shareholder of a residence or vacation home owned by the S corporation triggers the limitation on deductions under I.R.C. §280A.

m. An S corporation, unlike a C corporation may be a farming syndicate and subject to rules governing the timing of deductions for feed, fertilizer and poultry. I.R.C. §§474 and 278(b).

n. An S corporation is not permitted to take the credits for dependent care expenses, the credit for the elderly, the residential energy credit, the credit for interest on home mortgage or the earned income credit.

2. Corporate Expenses

a. An S corporation can deduct organizational expenses. I.R.C. §§1363(b)(3) and 248.

b. An S corporation can probably deduct other ordinary and necessary expenses that only a corporation can incur such as expenses incident to a stock redemption, liquidation or reorganization. Although the statute does say that an S corporation is to compute income as an individual, it is unlikely that these expenses are not deductible.

3. Overlap with Subchapter C

a. Where an S corporation is a shareholder of another corporation, it is treated as an individual. I.R.C. §1371(a)(1). This does not result is substantial differences although there a few open questions. This is mainly due to the provision that Subchapter C shall apply to an S corporation except to the extent inconsistent with Subchapter S. I.R.C. §1371(a)(1).

(1) Legislative history indicates that an S corporation is to be treated as a corporation rather than an individual in transactions involving its own stock. S. Rep. No. 640, 97th Cong., 2d Sess. 15 (1982).

(2) Distributions--The corporation takes a fair market value of the property received. I.R.C. §301(d)(1). This usually results in the same basis that a corporate shareholder would use.

(3) Partial liquidation--The S corporation would report the receipt of a distribution of assets in a partial liquidation as a dividend distribution. I.R.C. §302(b)(4)(A).

(4) Sale to Related Corporation--It is unclear whether I.R.C. §304 would apply to stock transferred in an S corporation.

(5) Liquidation of a Subsidiary--Gain or loss is ordinarily not recognized on the

liquidation of a subsidiary. I.R.C. §332(a). Since an S corporation is only permitted to have an inactive subsidiary, the non-applicability of this section should have little relevance.

(6) Reorganizations--It is not clear whether the non-recognition rules applicable to a corporation which is a party to a reorganization apply to an S corporation.

4. Related Party Provisions--There are a number of provisions which are based on the concept that an S corporation and its shareholders are considered related parties.

   a. Installment sales--If an S corporation sells property on the installment method to a shareholder who owns more than 50 percent of the stock, the installment method does not apply. I.R.C. §453(g).

   b. An accrual basis S corporation is not permitted to take a deduction for salary paid to a shareholder until the taxable year the salary is included in the income of the employee. I.R.C. §267(b)(1) and (e)(1)(B)(ii).

   c. An accrual basis S corporation is also not permitted to deduct interest paid to a shareholder until it is included in the income of the recipient. I.R.C. §267(a)(2).

   d. An S corporation is not permitted to deduct a loss realized on a transfer of property to a shareholder. I.R.C. §267(a)(1) and (e)(1)(B)(ii).

5. Elections

   a. General--Most election made in computing taxable income and credits are to be made at the corporate level. I.R.C. §1363(c)(1).

   b. Elections made at the corporate level

      (1) The election to amortize organizational expenses. I.R.C. §248.

(2) The elections to be made in connection with depreciation. I.R.C. §168.

(3) The election to expense depreciable assets. I.R.C. §179.

(4) The choice of accounting method. I.R.C. §446.

(5) Elections in connection with inventory accounting. See e.g. I.R.C. §§472(a) and 473(a).

(6) The choice of taxable year. See e.g. I.R.C. §444.

(7) The election not to use the installment method. I.R.C. §453(d).

(8) The election to replace property involuntarily converted. I.R.C. §1033.

(9) The election to expense preproduction farming expenses. I.R.C. §263A(d)(3).

(10) The election to treat the cutting of timber as a sale or exchange. I.R.C. §631(a).

(11) The election in connection with the targeted jobs credit. I.R.C. §51(j).

(12) The election not to take the alcohol fuels credit. I.R.C. §40(f).

(13) The election to amortize start-up expenses. I.R.C. §195(b).

(14) The election to amortize pollution control facility costs. I.R.C. §169.

(15) The election to deduct or capitalize intangible drilling and developmental costs. I.R.C. §263(c).

(16) The election to capitalize development expenditures in connection with a mine. I.R.C. §616(a).

(17) The election to capitalize soil and conservation expenditures. I.R.C. §175(a).

(18) The election to capitalize the cost of fertilizer. I.R.C. §180(a).

(19) The election to capitalize taxes and carrying charges. I.R.C. §266.

(20) The election to capitalize circulation expenditures. I.R.C. §173.

(21) The election to deduct research and experimental expenditures. I.R.C. §174.

(22) The election to deduct trademark expenses. I.R.C. §177.

(23) Elections in connection with short-term obligations. I.R.C. §§1282(b)(2) and 1283(c)(2).

c. Elections made at the shareholder level

(1) The election with respect to mining exploration expenditures. I.R.C. §§1363(c)(2)(B) and 617(b).

(2) The election to deduct or a take a credit for foreign taxes. I.R.C. §1363(b)(2)(C).

(3) The election to amortize tax preference items. I.R.C. §58(i).

(4) The election to use the alternative depreciation system for tax preference items. I.R.C. §168(g)(7).

B. <u>Allocation of Corporate Income and Loss</u>

1. Pass Through

a. General--Income, deductions, losses and credits pass through to shareholders who report them whether or not income is distributed. Character of items pass through as well.

b. Separately stated items--Any item of income, deduction, loss or credit which could affect the tax liability for any shareholder must be separately stated. I.R.C. §1366(a)(1).

(1) Credits must generally be passed through separately since limits on the amounts of the credits are generally based on the shareholder's taxable income.

(2) Tax exempt income, such as the interest on municipal bonds must be separately stated.

(3) Interest must be separately stated since the interest may be characterized as either investment interest subject to I.R.C. §163(d), a deduction subject to the passive loss rules of I.R.C. §469 or active business interest. To facilitate the application of sections 163(d) and 469, investment income and business income must also be separately stated.

(4) Property expensed under I.R.C. §179 must pass through separately since the limitations apply both at the corporate and the shareholder level. I.R.C. §179(d)(8). For the same reason, reforestation expenditures [I.R.C. §194(b)(2)], employee business expenses [I.R.C. §67(a)], and possibly soil conservation expenditures [I.R.C. §175] pass through separately.

(5) Capital gains and losses, as well as Section 1231 gains and losses are separately stated since they are combined with the shareholder's similar items to determine the amount of deductible losses.

(6) Items for which an election is available to be made at the shareholder level must pass through separately. See I.A.5.c. supra.

(7) A taxpayer may be subject to the alternative minimum tax if he has alternative minimum taxable income which is made up in part of tax preference items. Consequently those items must pass through separately. They include depreciation on real property, amortization on pollution control facilities, losses from tax shelter farm activities, passive activity losses,

installment sales, long term contracts, circulation expenditures, research and experimental expenditures, intangible drilling costs, mining exploration and development costs, depletion, and tax exempt interest.

c. Non-Separately Stated Items--Items of income, deduction, or loss whose separate treatment would not affect any shareholder, can be passed through as net income or loss.

2. Method of Allocation

a. General Method--Income, deductions, losses and credits are allocated on a daily pro rata basis. Each separately state item and the net non-separately stated income is allocated equally to each day of the taxable year and each day's portion is allocated on a pro rata basis to each shareholder holding stock on that day.

b. Election to close books--If a shareholder completely terminates his interest, the corporation may close its books on the date of termination. I.R.C. §1377(a)(2).

(1) If an election is filed, it is as if there were two taxable years, the first one ending on the date of the disposition. Although the taxable year does not actually end, closing the books has the effect of allocating the income, deductions, losses and credits to the two periods.

(2) Although the corporation files the election, all persons who are shareholders at any time during the taxable year must consent. I.R.C. §1377(a)(2).

c. Allocations in year of termination

(1) If the termination is effective at the end of the taxable year, the allocations are made in the same manner as if the election had not terminated.

(2) If the termination is effective mid-year, two short taxable years are

created. I.R.C. §1362(e)(1). The income and deductions are computed as if the election were in effect for the entire taxable year. Each item is allocated on a daily basis. Amounts attributable to the S short year pass through to the shareholders.

(3) Election to Close Books

(a) Since a daily pro rata allocation can cause distortions, the shareholders may elect to close the books as of the termination date and account for all items in accordance with the corporation's normal accounting procedures. I.R.C. §1362(e)(3).

(b) All shareholders who held stock any time during the S short year as well as all shareholders holding stock on the first day of the C short year must consent to the election. I.R.C. §1362(e)(3)(B).

(c) An election to close the books assures that pre-revocation losses pass through but post-revocation income does not.

(4) Mandatory Closing

(a) Where there is a 50 percent change in the ownership of the stock in an S termination year, the books must be closed. I.R.C. §1362(e)(6)(D).

(b) Income and deductions that actually arose in the S short year are allocated to that year and pass through.

d. Reallocations

(1) The Service may reallocate income among family members where one of them has not been fully compensated for services or the use of capital. I.R.C. §1366(e). There is an analogous rule in Subchapter K. I.R.C. §704(e).

(2) The family member rendering services or furnishing capital must be a spouse, ancestor, or lineal descendant of one or more shareholders. I.R.C. §704(e)(3). The undercompensated family member need not be a shareholder nor need he have transferred stock to the family member. Compare I.R.C. §704(e)(1) which requires that the family member must be a partner who received his partnership interest as a gift from another family member.

(3) Application of this provision requires that the shares of corporate income reported by the family shareholders must be reallocated and the employee would have additional income.

3. Timing of Pass Through

a. Accounting Method--The corporation determines the income using its accounting method.

b. Taxable Year--Each item is allocated to the proper taxable year of the corporation.

c. Inclusion by shareholders

(1) Generally--A shareholder reports passed-through items in his taxable year in which the taxable year of the corporation ends. I.R.C. §1366(a)(1).

(2) Termination Shareholder's interest--If a shareholder terminates his interest and all the shareholders consent to close the books, the pass-through does not accelerate--even though the income can be specifically attributed to an earlier period--because the corporation's taxable year has not ended.

(3) Death of Shareholder--The return for the decedent's final taxable year includes his pro rata share of corporate income up to the date of death. S. Rep. No. 640, 97th Cong., 2d Sess. 17 (1982). The estate reports the income after the date of death to the end of the corporation's taxable year. <u>Ibid</u>. The books are not necessarily closed.

C. <u>Limits on Losses</u>

1. Basis Limitation

a. General rule--The amount of loss and deduction that can be reported by a shareholder in any one taxable year cannot exceed the shareholder's adjusted basis in this stock and debt of the S corporation for the taxable year. I.R.C. §1366(d).

b. Basis in Stock

(1) Original Basis

(a) If the stock was acquired in a taxable purchase, the basis is the amount of cash paid or the fair market value of the property transferred. I.R.C. §1012.

i) If debt is used to purchase stock, the amount of the debt is included in basis, whether recourse or nonrecourse. The debt, however, must be real, i.e. there must be a likelihood that the taxpayer will actually make payment on the debt. See, e.g. Chamberlain v. Comm., 52 T.C.M. 1348 (1987).

(b) If the stock was acquired in a tax-free incorporation [I.R.C. §351], the basis of the stock is the carryover basis of the property transferred minus the fair market value of any cash transferred plus any gain recognized on the transfer. I.R.C. §358.

(c) If the stock was inherited, the basis os ordinarily the fair market value of the stock at the date of the decedent's death. I.R.C. §1014.

(d) If the stock was received as a gift, the basis is ordinarily the donor's basis at the date of the gift. I.R.C. §1015.

(e) If the stock was received in a non-taxable reorganization, the basis of the stock is generally the basis of the stock exchanged. I.R.C. §358.

(f) If the stock is received as a non-taxable stock dividend, the basis of the stock on which the dividend is distributed is allocated between the old stock and the new stock based on their relative fair market values. I.R.C. §307(a). If the stock is received as a taxable stock dividend, the basis of the stock is the fair market value. I.R.C. §301(d).

(g) If the stock is paid as compensation for services, the fair market value of the stock is the basis. I.R.C. §Treas. Reg. §1.61-2(d)(1). If the stock is subject to restrictions and is not included in gross income on receipt, the basis is the fair market value when included in income. Treas. Reg. §1.83-1(e).

(2) Adjustments Not Attributable to Subchapter S--The basis of the stock may be adjusted for various corporate events under Subchapter C. See, e.g. I.R.C. §301(c)(2), 307(a), 304.

(3) Adjustments Attributable to Subchapter S

(a) Increases to Basis

i) Separately Stated Income. The basis of the shareholder's stock in an S corporation is increased each taxable year by the separately stated items of corporate income that pass through. I.R.C. §1367(a)(1). Tax-exempt items increase basis even though not included in income. A taxable item increases basis only to the extent it is actually shown on the return. I.R.C. §1367(b)(1).

ii) Non-separately Stated Items. The stock basis is increased by the pro rata share of separately stated items. I.R.C. §1367(a)(1)(B).

iii) Depletion. The basis is increased by the excess of the deductions for depletion over the basis of the property subject to depletion. I.R.C. §1367(a)(1)(C).

iv) Contribution of Debt. If shareholders contribute outstanding debt to the corporation as a contribution to capital, the basis of the shareholder's stock probably increases.

(b) Decreases to Basis

i) Separately Stated Items. The basis of the stock is increased (but not below zero) by each separately stated item. I.R.C. §1367(a)(2)(B).

ii) Non-Separately Stated Loss. The loss decreases the basis but not below zero. Ibid.

iii) Non-deductible Corporate Expenses. Any corporate expenses that is not deductible and is not properly chargeable to capital account reduces basis. I.R.C. §1367(a)(2)(D).

iv) Depletion. The shareholder must reduce the basis of stock by the amount of the deduction for depletion with respect to oil and gas wells to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to the shareholder. I.R.C. §1367(a)(2)(E).

v) Non-taxable Distributions. Non-taxable distributions reduce basis. For discussion, see IV.A.1. <u>infra.</u>

c. Basis in Debt

(1) Original Basis

(a) The shareholder's basis in debt is ordinarily the amount of the money loaned to the corporation.

(b) Debt received on a non-taxable incorporation takes a basis with reference to the property transferred if the note is a security. I.R.C. §358(a)(1). If boot, the basis is the fair market value. I.R.C. §358(a)(2).

(c) A note received in exchanged for services or the use of property takes as its basis, the amount included in gross income.

(d) If the shareholder receives a note in a corporate reorganization in exchange for debt of the same principal amount, the basis of the original debt becomes the basis of the new debt. I.R.C. §358(a)(1). If, however, the notes are boot, their basis is the fair market value.

(2) Adjustments to Debt Basis not Attributable to Subchapter S

(a) Payments on a Guarantee. A shareholder increases basis when he is forced to make good on a guarantee on corporate debt. Rev. Rul. 70-50, 1970-1 C.B. 178. The basis does not increases retroactively. Rev. rul. 71-288, 1971-2 C.B. 319.

(b) Basis increases if a shareholder substitutes his personal note to the lender for a guarantee. Rev. Rul. 75-144, 1975-1 C.B. 319.

(c) Original Issue Discount. If the corporation issued an OID note to the shareholder, the basis of the note in the hands of the shareholder is increased by the amount of OID included in income. I.R.C. §1272(d)(2). Note, however, that at the same time, the corporation should have a deduction for the accrued interest, which should pass through and proportionately reduce the shareholder's basis in the stock. I.R.C. §§163(e), 1366(a) and 1367(a).

(3) Decreases in Debt Basis Under Subchapter S

(a) If in any taxable year, the permissible decreases to stock basis [see I.C.1.b.(3).(b) <u>supra</u>], the excess reduces the basis of debt, but not below zero. I.R.C. §1367(b)(2)(A).

(4) Increases in Debt Basis Under Subchapter S

(a) If, in a prior taxable year, the basis of indebtedness of the S corporation to any shareholder has been decreased by passed-through deductions or losses, any net increase in passed-through items in a subsequent taxable year restores the basis of the indebtedness before it increases stock basis. I.R.C. §1367(b)(2)(B).

(b) Open questions

i) It is unclear what happens if the debt has been partially or totally repaid in the interim.

ii) The Code does not indicate whether subsequently acquired debt would be effected.

iii) The Code specifies that the restoration rule applies to a prior reduction in <u>the shareholder's</u> basis. If the shareholder has given the note away, not restoration rule may not apply.

d. Timing of Adjustments

(1) General order. Basis adjustments for the pass-through of corporate income and losses are made before adjustments for non-taxable distributions. I.R.C. §1368(d)(1). This priority rule enables a corporation to make tax-free distributions to the extent of its net income each taxable year.

(2) Order. Adjustments are made in the following order:

(a) The basis of stock is increased by income and the depletion adjustment.

(b) The basis of stock is decreased by losses and deductions, non-deductible expenditures and the depletion deduction (but not below zero).

(c) If the increases exceed the decreases the basis of debt has been decreased in a prior year, the net corporate income increases the debt basis first and the remainder increases stock basis.

(d) If the decreases exceed the basis of the stock for the taxable year, the excess reduces the basis of indebtedness (but not below zero).

(e) Non-taxable distributions decrease stock basis.

e. Corporate Level Debt

(1) A shareholder in an S corporation <u>does not</u> increase the basis in either his stock or his debt by debt incurred at the corporate level. Compare .

(2) Guarantee of Corporate Debt

(a) A guarantee of corporate debt by a shareholder does not give the shareholder either stock or debt basis. See, e.g. Underwood v. Comm., 535 F.2d 309 (5th Cir. 1976).

(b) Securing the corporate debt with the shareholder's personal property does not increase basis. See, e.g. Blum v. Comm., 59 T.C. 436 (1972), modified 32 T.C.M. 158 (1973).

(c) Basis increases if a shareholder substitutes his personal note to the lender for a guarantee. Rev. Rul. 75-144, 1975-1 C.B. 319.

(3) Direct Shareholder Borrowing

(a) If the shareholder borrows the money directly and then re-lends it to the corporation, the basis in his corporate debt increases. See Millar v. Comm., 34 T.C.M. 554 (1975), <u>rev'd on another issue,</u> 540 F.2d 184 (3rd Cir. 1976).

(b) In some circumstances the court may be willing to treat the shareholder's guarantees to the actual lender as constructive loans to them which they in turn made to the corporation. See e.g. Selfe v. United States, 778 F.2d 769 (11th Cir. 1985) in which the court refused to say that the shareholder had to actually borrow the money directly and relend it to the corporation. It found the transaction was in substance, a loan to the shareholder. The court instructed the trial court to look at the capitalization of the corporation, where the bank would look for repayment, and whether the bank would have made the loan to the corporation ab initio.

(c) In most cases, however, there is unlikely to ba a basis increase unless there has been an actual increase in the shareholder's investment in the corporation. See, e.g. Estate of Daniel Leavitt v. Comm., 90 T.C. No. 16 (1988) where the court rejected Selfe, supra, finding that, without an actual capital outlay, there could be no basis increase.

f. Carryover of Unused Losses

(1) Carryover to S Year. Losses which exceed the adjust basis in stock and debt for the taxable year may be carried over to any taxable year in which sufficient basis is acquired. I.R.C. §1366(d). It is likely that a pro rata portion of all deductions and losses carry over.

(2) Carryover to Post-Termination Transition Period.

(a) Unused losses are treated as if incurred on the last day of any post-termination transition period. I.R.C. §1366(d)(3)(A). The shareholder may deduct the losses limited by the adjusted basis in the stock at the end of the transition period. I.R.C. §1366(d)(3)(B). Stock basis acquired during the transition period can be used to offset losses. Basis of debt may not be used.

(b) Post-Termination Transition Periods

i) The first period begins on the day after the last day of the corporation's last day as an S corporation and ends the later of one year from the starting date or the due date (plus extensions) for filing the return for the last year as an S corporation. I.R.C. §1377(b)(1)(A).

ii) A second possible period is the 120 days beginning on the date of a determination that the corporation's election terminated for a previous year. I.R.C. §1377(b)(1)(B). A determination includes a final court decision, a closing agreement or an agreement between the corporation and the Service that the corporation failed to qualify as an S corporation. I.R.C. §1377(b)(2).

2. Passive Loss Rules

a. Limitation. A shareholder may deduct losses from a passive activity only to the extent of income from passive activities. I.R.C. §469(a). The excess of the PAL cannot be deducted and is suspended.

b. Passive Activity. In brief a passive activity is one in which the shareholder does not materially participate or any rental activity. I.R.C. §469(c).

c. Characterization of income and deductions. Income and deductions attributable to each activity conducted by an S corporation must be characterized and passed through separately.

d. Carryover. Disallowed losses are carried over and are deductible when the taxpayer produces passive income or when the activity which generated the losses is entirely disposed of in a taxable disposition. I.R.C. §469(g).

e. Relationship to Basis Limitation.

(1) If losses exceed the income from the activity, the shareholder has a PAL

which can be deducted to the extent the shareholder has income from other passive activities <u>and</u> has an adjusted basis in the stock and debt.

(2) If the losses generated by the S corporation exceed the basis of the stock and debt, the loss is supended until basis is acquired even though there is sufficient passive income. The Subchapter S rules take priority.

(3) If the losses generated exceed the amount of passive income, the loss is permitted under Subchapter S and basis is reduced, but it is then suspended under section 469 until passive income is generated or the activity is terminated. Thus the loss is not deductible even if the taxpayer had adequate basis.

II. <u>Operations--Tax Year Rules</u>

A. The permitted year rules for S corporations were substantially tightened by the Tax Reform Act of 1986. As a practical matter, most S corporations will be required to use a calendar year. This provision has been quite controversial and Congress is currently considering several options for amendment. The most likely to succeed is a proposal to permit "small" corporations and partnerships to use a fiscal year.

B. General rules

1. Taxable year of an S corporation must be a "permitted year." I.R.C. §1378(a).

2. A permitted year is either a calendar year or another year for which the S corporation establishes a business purpose. I.R.C. §1378(b).

3. Instructions for obtaining approval for a tax year other than a calendar year are found in Rev. Proc. 87-32, 1987-2 C.B. 396

a. Objective test for Natural Business Year--If 25% or more of the taxpayer's gross receipts for the 12 months in question are recognized in the final two months and the 25% test has been met for the most recent three consecutive 12-month period, a fiscal year may be used.

b. Ownership Tax Year -- If a majority of shareholders use a fiscal year or are changing to a fiscal year, the S corporation is permitted to use a fiscal year. Rev. Proc. 87-32, 1987-2 C.B. 396

c. The old rule that a deferment of income for three months was permissible is abolished.

d. Non-Objective Test. Both tax and non-tax factors are taken into account in determining if there is an adequate business purpose. However, if a requested tax year creates deferral or distortion, the nontax factors must demonstrate compelling reasons for the change. Rev. Rul. 87-57, 1987-2 C.B. 117. The revenue ruling indicates that the tax consequences to be considered include:

   (1) deferring a substantial portion of a taxpayer's income or shifting a substantial portion of a taxpayer's deductions from one year to another to reduce substantially a taxpayer's tax liability

   (2) causing a similar deferral or shift in the case of a S corporation shareholder

   (3) creating a short period in which there is a substantial net operating loss.

e. Reasons of convenience--such as to take advantage of an accountant's reduced rate, to have recordkeeping consistency and to issue timely tax information forms to shareholders--are not sufficient. Rev. Rul. 87-57.

f. Conversely the failure to meet the 25 percent test if it is not within the control of the taxpayer, may be ignored. For example, if the amount of gross receipts is distorted for a particular year due to a strike, but would otherwise cause the requested tax year to be a natural year, permission to use the year may be granted.

C. Practical Effects

1. Many C corporations using a fiscal year will have to switch to a calendar year upon conversion to Subchapter S status.

2. Corporations using a fiscal year that must switch will continue with the present fiscal year through the 12-month period which ends during the year of election. They will then switch to a calendar year and will have a short taxable year ending December 31.

D. Failure to Use Permitted Year. If a corporation fails to use a permitted taxable year, the Subchapter S election will not be effective.

III. Operations--Corporate Level Taxes

A. General--When a C corporation converts to Subchapter S status, it may be subject to two taxes which are not imposed on an S corporation which has always had an election in effect. One of those is the tax on passive investment income, which is discussed in this section. The other is the tax on built-in gain which is discussed in the section on distributions.

B. Tax on Passive Investment Income.

1. General--A tax is imposed when a Subchapter S corporation has Subchapter C earnings and profits and more than 25% of its gross receipts are from passive investment income. I.R.C. §1375.

2. Passive income includes gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. I.R.C. §1362(d)(3)(D)(i).

3. Subchapter C earnings and profits include accumulated E&P for any prior year when an election was not in effect. This would include

   a. E&P earned before an election was made

   b. E&P earned between elections and

   c. E&P acquired from another corporation (e.g. in a reorganization).

d. An S corporation accumulates no E&P while the election is valid. I.R.C. §1371(c)(1).

4. Computation of the Tax.

a. The tax is calculated by multiplying the current highest corporate tax rate by the excess net passive income. I.R.C. §1375(a)(2).

b. Net passive income

(1) NPI is passive investment income reduced by deductions directly connected with the production of such income. I.R.C. §1375(b)(2). Such deductions are expenses which have a proximate and primary relationship to the income. Treas. Reg. §1.1375-1A(b)(3)(i). The S corporation must have net passive income for the tax to apply even if the passive investment income exceeds 25 percent of its gross receipts.

(2) Example: S Corporation has gross receipts of $100,000 of which $40,000 is attributable to rental income. Since no significant services are provided to tenants, the rental income is passive investment income. The corporation has $45,000 of expenses attributable to the rental property. Although S's passive investment income of $40,000 exceeds 25 percent of the gross receipts of $100,000, it is not subject to the Section 1375 tax because it has no net passive income.

c. Excess net passive income

(1) ENPI is an amount which bears the same ratio to the net passive income (NPI) as the amount by which the passive investment income exceeding 25 percent of the gross receipts bears to the passive investment income. Expressed as a formula it is

$$\text{ENPI} = \text{NPI} \times \frac{\text{Passive Investment Income} - 25\% \text{ Gross Receipts}}{\text{Passive Investment Income}}$$

(2) ENPI is limited to the amount of the corporation's taxable income for the taxable year in question. I.R.C. §1375(b)(1)(B).

(3) Example: S Corporation has $100,000 of gross receipts, of which $75,000 is passive investment income. Expenses of $15,000 are attributable to passive investment income. Therefore the net passive income is $60,000. The excess net passive income is $40,000:

$$\$60,000 \times \frac{\$75,000 - [\$100,000 \times 25\%]}{\$75,000} = \$40,000$$

d. Allocation

(1) Any tax levied under Section 1375 is allocated ratably to and subtracted from each item of passive investment income passed through to the shareholders. I.R.C. §1366(f)(3). Only the tax is deducted from the amount passed through; the passive income itself is subject to tax twice even if it is not distributed.

(2) Example: S corporation has gross receipts of consisting of $15,000 of gain on the sale of stock and $25,000 of rent. The $40,000 is passive investment income and a tax of $13,800 is levied on the excess passive investment income of $30,000. The tax is allocated three-quarters to the rent and one quarter to the stock. Thus S passes through $11,550 of gain on the stock [$15,000 - $3450] and $14,650 of rent [$25,000 - $10,350].

5. Avoiding the Tax

a. The corporation can avoid imputation of the tax by distributing the Subchapter C E&P before the conversion.

b. Alternatively the corporation can make a distribution after the election which exceeds the accumulated adjustments account. I.R.C. §1371(c)(3).

c. The S corporation can elect to treat a Subchapter S distribution as out of Subchapter C E&P. All shareholders must agree to have the distribution treated as a dividend. I.R.C. §1368(e)(3).

6. Mistake as to E&P

a. Obviously it is important that a C corporation know if it has earnings and profits at the date of conversion. Occasionally despite best efforts, that may not be possible, or the corporation might mistakenly believe that all profits have been distributed.

b. The Service has the authority to waive the tax on passive income. I.R.C. §1375(c). The corporation must establish that

(1) It determined in good faith that it has no Subchapter C earnings and profits at the close of a taxable year. I.R.C. §1375(d)(1). The Regulations also establish a "due diligence" requirement. Treas Reg. §1.1375-1A(d)(1).

and

(2) During a reasonable period of time after it determined it did have E&P, they were distributed. I.R.C. §1375(d)(2). Presumably this means that the shareholders agree to have the distribution treated as a taxable dividend.

IV. <u>Distributions</u>

A. <u>Distributions of Cash</u>

1. Virgin S Corporation.

a. A distribution by an S corporation that has never been a C corporation is tax-free to a shareholder to the extent of the basis in his stock. I.R.C. §1368(b)(1). The basis is reduced by the amount of the distribution. I.R.C. §1367(b)(2)(A).

b. Any amount distributed which exceeds basis is treated as gain from a sale or exchange. I.R.C. §1368(b)(2).

c. The basis of corporate debt may not be used to offset a distribution. I.R.C. §1368(b)(1).

d. The actual date on which a distribution occurs is irrelevant. The basis is first adjusted by income and loss for the taxable year [I.R.C. §1368(d)] and then offset by distributions.

2. Former C corporation

a. If the S corporation does not have accumulated earnings and profits, the rules are the same as for virgin S corporations.

b. If the S corporation has accumulated earnings and profits

(1) the distribution is tax-free to the extent of the lesser of the corporation's accumulated adjustments account or the shareholder's basis. I.R.C. §1368(c)(1) and (b)(1).

(2) Where the basis is less than the AAA, the distribution is taxed as capital gain. I.R.C. §1368(c)(1) and (b)(2).

(3) Where the distribution exceeds the AAA, the excess is a dividend to the extent of the accumulated earnings and profits. I.R.C. §1368(c)(2).

(4) Where the amount distributed exceeds the amount treated as a dividend, the excess is a tax-free recovery of stock basis. I.R.C. §1368(c)(3) and (b)(1).

(5) Where the amount distributed exceeds the basis, the excess is capital gain. I.R.C. §1368(c)(3) and (b)(2).

c. Where the distributions for the year exceed the accumulated adjustments account, the AAA must be allocated among the distributions in proportion to their relative sizes. I.R.C. §1368(c). See also S. Rep. No. 432, 98th Cong., 2d Sess. 1645 (1984).

d. If the distribution exceeds both the AAA and the E&P account, the E&P is divided among the distributions and the shareholders under the usual Subchapter C rules.

e. Earnings and Profits Account.

(1) An S corporation creates no earnings and profits while an election is in effect. I.R.C. §1371(c)(1). It can have E&P in the following ways:

(a) E&P generated in years prior to the effective date of a Subchapter S election, while the corporation was a C corporation.

(b) E&P generated in taxable years beginning before 1983, when a Subchapter S corporation could accumulate E&P.

(c) E&P acquired from a C corporation in a tax-free acquisition.

(d) E&P acquired in a corporate division.

(2) Eliminating the E&P Account

(a) The E&P account is adjusted for distributions to the extent the amount distributed is treated as dividend income to the shareholders. I.R.C. §1371(c)(3). It is not adjusted for amounts treated as coming from the AAA or those which exceed the E&P account. I.R.C. §1371(c)(1).

(b) Taxable stock dividends decrease the E&P account to the extent of the fair market value of the stock distributed. Treas Reg. §1.312-1(d). Non-taxable stock dividends do not reduce E&P.I.R.C. §312(d)(1)(B).

(c) A distribution of the corporation's own debt obligations reduces the E&P by the principal amount of the obligations. I.R.C. §312(a)(2).

(d) The E&P account is reduced by any taxed owed by the corporation due to recapture of any investment tax credit taken during C years. I.R.C. §1371(d)(3).

(e) Election to accelerate dividends

i) The corporation can elect to have a distribution come directly out of accumulated E&P, by-passing the accumulated adjustments account. I.R.C. §1361(e)(3).

ii) If the election is made, distributees are taxed as follows:

A) The amount distributed is ordinary income to the extent of accumulated E&P.

B) Amounts in excess of E&P are a tax-free recovery of the distributee's stock basis.

C) Amounts in excess of stock basis are treated as capital gain.

iii) All shareholders who receive a distribution during the taxable year must consent to the election. I.R.C. §I.R.C. §1368(e)(3)(B). The election applies to all distributions and to all distributees for the taxable year.

f. Accumulated Adjustments Account

(1) The AAA is used to determine the extent to which a distribution is tax-free and approximates previously taxed income.

(2) The AAA is adjusted in the same manner as the basis of the shareholder's stock.

(a) The AAA is increased by

i) all separately computed items of income which are not tax-exempt.

ii) any nonseparately computed income

iii) the excess of depletion deduction over the basis of the property subject to depletion. I.R.C. §(1368(e)(1)(A) and 1367(a)(1).

(b) The AAA is decreased by

i) separately computed losses

ii) non-separately computed losses

iii) any nondeductible expense of the corporation which is not properly chargeable to capital other than expenses attributable to tax-exempt income.

iv) depletion deductions for corporate oil and gas property, not in excess of the basis of the property allocated to shareholders.

v) corporate distributions to the extent treated as a tax-free recovery of the shareholders' stock basis. I.R.C. §(1368(e)(1)(A) and 1367(a)(2).

vi) for redemptions treated as exchanges of stock, a proportion of the account balance equal to the proportion of stock redeemed. I.R.C. §1368(e)(1)(B).

(3) There are three exceptions to complete parallelism between adjustments to basis and adjustments to AAA are:

(a) Tax-exempt income, which increases the basis of a shareholder's stock, does not increase the AAA.

(b) Expenses related to tax-exempt income, which decrease stock basis, do not decrease the AAA.

(c) Adjustments do not cause the shareholder's basis to go below zero, but may create a deficit in the AAA.

B. <u>Distributions of Property</u>

1. Distributions by a Virgin S Corporation

a. Distributions of Appreciated Property

(1) Recognition of Gain. When an S corporation distributes appreciated property with respect to its stock, gain is recognized and passed through to the shareholders as though the corporation had sold the property instead of distributing it. I.R.C. §1363(d).

(2) Shareholders increase basis by the amount of gain recognized and decrease basis by the fair market value of the property distributed.

b. Distributions of Depreciated Property

(1) A distribution of property whose fair market value has decreased below its basis does not generate a recognized loss. I.R.C. §311(a).

(2) Since the basis of such property in the hands of the shareholder is its fair market value, it is disadvantageous from a tax standpoint to distribute depreciated property instead of selling it and distributing the proceeds.

2. Distributions by a former C Corporation--Tax on Built-in Gain

   a. Purpose: A C corporation is taxed on the sale or distribution of appreciated property as a dividend or on liquidation. Since an S corporation is not itself taxed on the gain on appreciated property there is an incentive for C corporations to elect Subchapter S to avoid the double tax. The tax on built-in gain is designed to prevent avoidance of the corporate level tax on pre-conversion gains.

   b. Scope: The tax applies only to an S corporation that was formerly a C corporation. A corporation that was always an S corporation is not subject to the tax. I.R.C. §1374(c)(1).

      (1) An S corporation and a predecessor corporation are treated as one corporation for purposes of the built-in gain rules. I.R.C. §1374(c)(1).

      (2) Thus if an S corporation acquires a C corporation in a reorganization, it would be subject to the built-in gain tax since it was not always an S corporation.

      (3) It is not clear, however, which gains are subject to the rule where the S corporation is tied to a predecessor corporation.

      (4) Example: If the S corporation acquires a C corporation in a reorganization, the C corporation's gain prior to the acquisition should probably be subject to tax.

      The Service has announced that it will take the position in regulations that the transferred basis property received from the C corporation will be subject to the tax. Ann. 86-128, I.R.B. 1986-51. It notes that it will so hold even though the transferee corporation has always been an S corporation and the assets were not held at the beginning of the corporation's first taxable year as an S corporation. The acquisition of such transferred basis property is to be treated as a conversion to S corporation status with the built-in gain as of the date of the transfer being subject to tax during the following 10 years.

Although this clearly goes beyond the literal statutory language, it seems reasonable to avoid wholesale avoidance of the built-in gain rules through the creation of a new S corporation into which a C corporation could merge. The proposed rule apparently has the effect of not subjecting to the tax the gain on property held by the S corporation before the reorganization. Presumably none of the original S corporation's gains or losses will be used to calculate net built-in gain. The tax apparently comes into play only if the C corporation has net built-in gain at the reorganization date.

(5) Example: An S corporation which has always had an election in effect is acquired by a C corporation in a reorganization and the C corporation elects Subchapter S status at a later date.

Should the unrealized appreciation of the first S corporation be subject to the rule?

(6) Example: An S corporation which is already subject to the built-in gain tax merges into another S corporation in a non-taxable transfer.

In Ann. 86-128, I.R.B. 1986-51, the Service states that the Regulations will take the position that the built-in gain tax will apply to the transferee S corporation and that as to the transferred assets the 10-year recognition period will be reduced by the portion of the period of the transferor that had expired. If the transferee is also subject to the built-in gain tax, there will presumably be two recognition periods--one for the transferee's own assets and the other for the transferred assets.

(7) Note that in all of these examples, there is a non-recognition event with carryover basis. If the gain is recognized, there is no need to impose the built-in gains tax on the S corporation.

c. Built-In Gain. The S corporation must have a built-in gain at the time of the conversion. A built-in gain is the excess of the aggregate fair market value of the assets over the adjusted bases on the first day the election is effective. I.R.C. §1374(c)(2)(A).

(1) Example: C corporation has three assets:

Machinery	AB 100	50 FMV
Land	AB 150	175 FMV
Building	AB 200	235 FMV

Upon conversion to S corporation status, C corporation would be subject to the built-in gain rules since the aggregate FMV of the assets of 460 exceeds the aggregate basis of 450.

(2) Contribution of loss assets.

(a) There is an obvious incentive to contribute loss assets to a C corporation prior to conversion to eliminate a net built-in gain. The Service has announced that it will issue regulations which in "appropriate cases" will prohibit the reduction of the corporation's net unrealized built-in gain by such contributions if the contributions are undertaken "to limit or avoid the application of the built-in gain tax." Ann. 86-128, I.R.B. 1986-51.

(b) Specifically the Service proposes to issue rules which disallow the reduction of the gain by the contribution of loss property within two years of the earlier of filing of an S election or the beginning of the first taxable year as an S corporation.

(c) This rule can be avoided by a demonstration of a clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprise.

(d) Note also that upon a redistribution of the property in a liquidation, the loss may be disallowed. I.R.C. §336(b).

(3) In calculating the amount of the built-in gain, all assets must be taken into account. This requires contemporaneous documentation of the value. It is not clear how goodwill is to be treated. Must some value be attributed to goodwill? If so this can only increase the net built-in gain.

d. Computation of the Tax

(1) The amount of tax is the lesser of a tax on any recognized built-in gain during the ten year recognition period computed using the highest corporate rate or the amount of tax that would have been owed if a Subchapter S election were not in effect. I.R.C. §1374(b).

(2) Recognition Period

(a) A former C corporation is subject to the tax on built-in gain for a 10 year period beginning on the date of conversion. I.R.C. §1374(d)(3). This is the first day of the taxable year the election is effective, not the date the election is filed.

(b) It is not clear whether there are two ten year periods if the Subchapter S election subsequently terminates a new election is filed.

Example: C Corporation elects Subchapter S status, effective Year One. It has a net built-in gain and thus is subject to the tax for years one through ten. The election terminates in year three and five years later in year nine, a new election is filed. The corporation may be subject to the tax for another ten years following re-election with the additional appreciation on the assets which accrued before the second election subject to the tax.

(c) Any recognized gain during the period is subject to tax even if no tax avoidance is involved. For example, if the S corporation sells inventory it held before the election, a tax will be imposed at the corporate level.

(3) Recognized built-in gain

(a) Any gain recognized by the S corporation during the recognition period is subject to the tax. Examples include a sale, distribution or a liquidation of corporate assets. I.R.C. §1374(d)(2). See also I.R.C. §1001(a), 1363(d) and 336(a).

i) The Service has announced it will issue regulations defining dispositions as including "other income-recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income." They give two examples: the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract by a taxpayer using the completed contract method of accounting. Ann. 86-128, I.R.B. 1986-51. Thus a cash basis C corporation with a significant amount of receivables at the time of conversion may face a large potential built-in gain tax.

ii) A non-recognition event does not trigger the gain, but the "built-in gain taint" carries over. For example, if an S corporation transfers a tainted asset in a 1031 exchange, the asset received in exchange will be subject to the built-in gain tax. Apparently the amount of the taint and the length of the recognition period will carry over to the new asset. Ann. 86-128, I.R.B. 1986-51.

(b) Exception for Post-Conversion Assets.

i) The corporation is not liable for a tax on a recognized gain on an asset acquired subsequent to the conversion. I.R.C. §1374(d)(2)(A).

ii) The Service has announced that the inventory method used for tax purposes will be used to identify whether goods disposed of following conversion were held by the corporation at the time of conversion. Ann. 86-128, I.R.B. 1986-51. They give as an example: a corporation using LIFO will only be subject to the built-in gains tax to the extent that a LIFO layer existing prior to the beginning of the first taxable year as an S corporation is invaded after the beginning of that year.

(c) Exception for Post Conversion Gain.

i) The gain is not subject to the tax to the extent it is attributable to post-conversion appreciation. I.R.C. §1374(d)(2)(A).

ii) The taxed gain is only the extent to which the fair market value at the date of the conversion exceeds the adjusted basis. I.R.C. §1374(d)(2)(B).

A) Example: S corporation acquires a machine for \$60 and takes \$20 in depreciation by the time it elects to be taxed as an S corporation. The FMV at the date of conversion is \$50. The corporation subsequently sells the asset for \$50 at a time when the AB is \$25. Of the \$25 gain, \$10 is taxed to the corporation as built-in gain.

Note that there is no actual appreciation in value in the asset at the time of conversion; it has declined in value. Nevertheless there is built-in gain due to depreciation. Note also that the asset has not increased in value since the date of conversion, but some of the gain is post-conversion gain and not subject to tax at the corporate level.

iii) In most cases where a C corporation converts to Subchapter S status, an appraisal of the assets will be essential to avoid tax on post-conversion appreciation. This may be an expensive proposition making an election less attractive.

iv) The statute does not indicate that the method of post-conversion acquisition is relevant. Legislative history, however, gives as an example, a taxable acquisition raising the spector that a non-taxable acquisition such as a contribution to capital might not qualify. H. Rep. No. 99-841, 99th Cong. 2d Sess. 203 (1986).

(d) If an asset with built-in gain at the time of conversion subsequently declines in value, such that there is a recognized loss, there is no tax.

(e) The S corporation will not recognize at the corporate level losses on distributed or sold assets. Losses do not offset gains subject to the tax.

(4) Ceiling on Gain

(a) The aggregate amount of gain recognized to the S corporation during the 10 year period is limited to the net built-in gain on all assets held at the date of conversion. I.R.C. §1374(c)(2).

i) Example: At the time of conversion the S corporation has two assets:

Asset A	40 AB	60 FMV
Asset B	45 AB	30 FMV

Since S corporation has a net built-in gain of 5, it is subject to the built-in gain rules. It subsequently sells Asset A for 65. Although there is a recognized gain of 25 and a built-in gain of 20 (at the date of conversion), only 5 of gain is taxed to the corporation, since the amount of gain is limited to the net built-in gain on all assets at the date of conversion.

(b) For any taxable year, the taxable gain is limited to the net built-in gain minus gain recognized in previous years.

(5) Amount of Tax

(a) The amount of tax is the lesser of a tax on the recognized built-in gain computed at the highest corporate rate or the tax that would have been owed for the taxable year if the corporation did not have a Subchapter S election in effect. I.R.C. §1374(b)(1).

(b) The corporation may reduce the tax on the built-in gain by any net operating loss carryforward from a C corporation year. I.R.C. §1374(b)(2). It can also take any business credit carryforward from C corporation years against the tax. I.R.C. §1374(b)(3)(B). The Committee Report mentions that other Subchapter C attributes such a capital loss carryovers and minimum tax carryover credits may be used against the tax liability, but the statute fails to mention either of these. H. Rep. No. 99-841, 99th Cong., 2d Sess. 203 (1986).

(6) Reduced Pass-Through

(a) Where a tax is imposed on built-in gains, the amount of gain passed through to the shareholders is reduced by the tax imposed at the corporate level. I.R.C. §1366(f)(2). Note that because the tax is imposed on recognized gains, there will be a gain pass-through to the shareholders in all circumstances.

(b) Each gain is reduced by the proportionate amount of the tax attributable to the gain.

e. Effective Date

(1) The built-in gain rules apply to taxable years beginning after December 31, 1986 "but only in cases where the 1st taxable year for which the corporation is an S corporation is pursuant to an election made after December 31, 1986." P.L. 99-514 §633(b).

(2) Thus a corporation which filed an election on or before December 31, 1986 is not subject to new Section 1374 even if the election is effective for a future taxable year. Conference Report at II-203.

(3) The Service's position is that a corporation making an election during 1986 must have been an eligible corporation at the time the election is effective. Rev. Rul. 86-141, I.R.B. 86-159. Note that Section 1362(b)(1) requires that an election may be made by a "small business corporation," a term of art denoting eligibility. Thus the corporation must have been eligible on the date the election was filed and on the first day of its taxable year for which the election became effective. See Prop. Reg. §1.1372-1(a).

(4) Ordinarily a corporation cannot re-elect Subchapter S status for 5 years after a revocation or termination. The IRS agreed to consent to the election under Section 1362(g) of any corporation which filed an election prior to January 1, 1987 and whose revocation or termination occurred before October 22, 1986 (the date of TRA 86 enactment). Rev. Rul. 86-141, I.R.B. 86-159.

f. Transition Rule

(1) Certain small, closely held corporations are not subject to the built-in gain rule. P.L. 99-514 §633(d)(8).

(2) A qualifying corporation is one whose value does not exceed $10 million and at all times until the disposition, more than 50 percent of the value of the stock of the corporation is held by 10 or fewer persons. P.L. 99-514 §633(d)(1).

   (a) The value of the corporation is the greater of the fair market value of all of the stock of the corporation on either the date a valid S election is made or August 1, 1986. Rev. Rul. 86-141, I.R.B. 86-159.

   (b) For purposes of the 10-owner rule, an individual, estate or a trust qualifying as a shareholder in an S corporation is considered a person. P.L. 99-514 §633(d)(6)(A).

   (c) Attribution rules under I.R.C. §318 apply. P.L. 99-514 §633(d)(6)(B)(ii).

   (d) Legislative history indicates that the stock must have been held for 5 years or longer. H. Rep. No. 99-841, 99th Cong. 2d Sess. 206 (1986). The statute does not impose that requirement. It was included in H. Con. Res. 395 which was never passed.

(3) If the value of the corporation exceeds $5 million, a portion of any built-in gain is recognized. P.L. 99-514 §633(d)(6)(A).

(4) The transition rule does not apply to any gain which is treated as ordinary or a short term capital gain. P.L. 99-514 §633(d)(2). Thus the built-in gains rules apply to any pre-conversion ordinary income gain recognized by an S corporation which did not file a Subchapter S election by December 31, 1986.

(5) Unlike the <u>General Utilities</u> transition rule, the S corporation does not have to

completely liquidate to avoid the built-in gain rules.

(6) In order to use the transition rule, the corporation must have an election in effect before January 1, 1989.

(a) For example, for a calendar year corporation, the last date on which an election could be filed is March 15, 1988.

(b) Ordinarily a corporation cannot re-elect Subchapter S status for 5 years after a revocation or termination. The IRS agreed to consent to the election under Section 1362(g) of any corporation which became an S corporation before January 1, 1989 and whose revocation or termination occurred before October 22, 1986 (the date of TRA 86 enactment). Rev. Rul. 86-141, I.R.B. 86-159.

g. Old Section 1374

(1) A former C corporation that filed an election after December 31, 1986 but became an S corporation before January 1, 1989 may be a qualifying corporation eligible for transitional relief from the built-in gain rules.

(2) New section 1374 applies to built-in gains which are ordinary income and short term capital gains recognized by a qualified corporation.

(3) Old section 1374 applies to long-term capital gain.

(4) The corporation is liable for a tax on capital gain for any taxable year in which the net capital gain exceeds $25,000 and 50 percent of the S corporation's income. The corporation's net taxable income must exceed $25,000.

(a) The tax is the lower of the section 1201(a) tax on the excess of the net capital gain over $25,000 or the section 11 tax on the income if no Subchapter S election was in effect.

(b) The tax is only applicable for the first three years the corporation is an S corporation. Once it has been an S corporation for the three immediately preceding taxable years, the corporation is not subject to the tax.

(c) The tax can often be avoided by selling capital gains property on the installment method so as to decrease the amount of net gain in any one year.

(d) The tax would not apply to the sale of property producing ordinary income. Apparently a sale of property to a shareholder which is subject to section 1239 would not trigger the tax.

(5) Where the corporation is valued at between $5 and $10 million, a portion of the long term capital gains will be subject to new section 1374 and a portion to old section 1374. Rev. Rul. 86-141, I.R.B. 86-157.

(6) Usually old section 1374 is preferable because there must be a significant amount of capital gains in any one year, and it only applies to a three year period. However, old section 1374 is not limited to pre-conversion appreciation. Furthermore, under old section 1374 a net operating loss carryover could not be used to reduce the amount of capital gain or the taxable income. Thus a corporation which elected before December 31, 1986 or a qualifying corporation which is an S corporation before January 1, 1989 can be subject to harsher treatment under old 1374 than under new section 1374.

It is peculiar that corporations available to use the supposedly more lenient transition rules could end up paying more tax than those not eligible to use transition rules.

(7) An unanswered question is the extent to which the transition rules apply. It is clear that a qualifying corporation filing an election in 1987 effective for 1988 is not subject to new section 1374 for a recognized built-in gain during 1988. The gain however (if significant) could be subject to old section 1374. What about gains recognized in 1990? Does new section 1374 apply because we are outside the transition window (i.e. January 1, 1989) or does old 1374 continue to apply for the three year period because the S election was effective before January 1, 1989?

Technical Corrections Act and S Corporations

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I. General

Although the Technical Corrections Act made a number of changes to the statutory provisions covering S corporations, by far the most important were the amendments to the Section 1374 tax on built-in gains.

II. Changes in the Built-in Gain Tax

A. Purpose of the tax: A C corporation is taxed on the sale or distribution of appreciated property as a dividend or on liquidation. Since an S corporation is not itself taxed on the gain on appreciated property, there is an incentive for C corporations to elect Subchapter S to avoid the double tax. The tax on built-in gain is designed to prevent avoidance of the corporate level tax on pre-conversion gains.

B. Thrust of the amendments: Under prior law a converting C corporation could circumvent the tax if the recognition of the built-in gain occured in a year in which its taxable income was less than the built-in gain. This could be accomplished by recognizing a loss--built-in or post conversion--in the same year as a gain was recognized. The potential loss of revenue that had been anticipated arising from the section 1374 tax was of concern to Congress.

C. Scope: The tax applies only to an S corporation that was formerly a C corporation. Although the statute provides that a corporation that was always an S corporation is not subject to the tax, [I.R.C. §1374(c)(1)] that is not completely true.

1. The Technical Corrections Act addresses the Service's concern regarding the potential use of the corporate reorganization provisions to avoid the application of Section 1374. Announcement 86-128, I.R.B. 1986-51.

   The built-in gain could permanently escape tax if the shareholders of a C corporation established a new S corporation with which it merged.

2. Change: The tax now applies not only upon a conversion but also where an S corporation acquires an asset from a C corporation and the

basis of the asset in the hands of the S corporation is determined in whole or in part by reference to the basis of the asset in the hands of the C corporation. Section 1374(d)(8).

a. An S corporation and a predecessor corporation are treated as one corporation for purposes of the built-in gain rules. I.R.C. §1374(c)(1).

b. Thus if an S corporation acquires a C corporation in a reorganization, it would be subject to the built-in gain tax since it was not always an S corporation.

(1) On the acquisition the amount of built-in gain on the acquired C corporation's assets is calculated. I.R.C. §1374(d)(8)(A).

(2) A ten-year recognition period begins on the date of the acquisition. I.R.C. §1374(d)(8)(B)(i). This is so even though the transferee corporation has always been an S corporation and the assets were not held at the beginning of the corporation's first taxable year as an S corporation.

(3) The proposed rule apparently has the effect of not subjecting to the tax the gain on property held by the S corporation before the reorganization. Presumably none of the original S corporation's gains or losses will be used to calculate net built-in gain. The tax comes into play only if the C corporation has net built-in gain at the reorganization date.

(4) Example: S corporation which has always had an election in effect merges with a C corporation in a tax-free Type A reorganization. The basis of the assets formerly held by the C corporation is the same in the hands of S as it was in the hands of C. Thus the net built-in gain on the C assets is subject to tax for a ten year period beginning of the date of the reorganization.

(5) Example: An S corporation which has always had an election in effect is acquired by a C corporation in a

reorganization and the C corporation elects Subchapter S status at a later date.

Although the statute does not specifically address this situation, it is reasonable to assume that the appreciation attributable to the period of the original election is part of the built-in gain of the converting C corporation.

(6) Example: An S corporation which is already subject to the built-in gain tax merges into another S corporation in a non-taxable transfer.

In Ann. 86-128, I.R.B. 1986-51, the Service states that the Regulations will take the position that the built-in gain tax will apply to the transferee S corporation and that as to the transferred assets the 10-year recognition period will be reduced by the portion of the period of the transferor that had expired. If the transferee is also subject to the built-in gain tax, there will presumably be two recognition periods--one for the transferee's own assets and the other for the transferred assets.

(7) Note that in all of these examples, there is a non-recognition event with carryover basis. In order to maintain its Subchapter S election, the acquiring corporation can generally use only a Type A or Type C reorganization which requires that the target corporation cease to exist. Furthermore gain will not be recognized on the target's assets which are transferred to the acquiring S corporation. Since none of the built-in gain on the transferred assets will have been recognized on the reorganization, all of it will be subject to tax.

D. Net Built-In Gain. In order to be subject to the tax the S corporation must have a net built-in gain at the time of the conversion. A built-in gain is the excess of the aggregate fair market value of the assets over the adjusted bases on the first day the election is effective. I.R.C. §1374(c)(2)(A).

1. Example: C corporation has three assets:

Machinery	AB 100	50 FMV
Land	AB 150	175 FMV
Building	AB 200	235 FMV

Upon conversion to S corporation status, C corporation would be subject to the built-in gain rules since the aggregate FMV of the assets of 460 exceeds the aggregate basis of 450.

2. In calculating the amount of the built-in gain, all assets must be taken into account. This requires contemporaneous documentation of the value. It is not clear how goodwill is to be treated, but presumably some value be attributed to goodwill. If so, this can only increase the net built-in gain.

E. Net Recognized Built-in Gain.

1. Under prior law the tax was levied on the built-in gain recognized in any taxable year. No offset was permitted for built-in losses.

2. When Congress decided to change the taxable income limitation to prevent the use of post-conversion losses to offset the tax, it simultaneously decided to permit the use of pre-conversion losses.

3. In any taxable year, a recognized built-in gain may be offset by a recognized built-in loss. I.R.C. §1374(d)(2).

4. Taxpayers should thus, to the extent possible, plan to match recognition of built-in losses and gains.

F. Contribution of loss assets.

a. There is an obvious incentive to contribute loss assets to a C corporation prior to conversion to eliminate a net built-in gain. The Service had previously announced that it will issue regulations which in "appropriate cases" will prohibit the reduction of the corporation's net unrealized built-in gain by such contributions if the contributions are undertaken "to limit or avoid the application of the built-in gain tax." Ann. 86-128, I.R.B. 1986-51. The legislative history to TAMRA concurs. House Report at p. 65.

b. The Service proposes to issue anti-stuffing rules similiar to I.R.C. §336(d)(2). Specifically they will disallow the reduction of the gain by the contribution of loss property within two years of the earlier of filing of an S election or the beginning of the first taxable year as an S corporation.

c. This rule can be avoided by a demonstration of a clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprise.

d. Note also that upon a redistribution of the property in a liquidation, the loss may be disallowed. I.R.C. §336(b).

G. Recognition Period

1. A former C corporation is subject to the tax on built-in gain for a 10 year period beginning on the date of conversion. I.R.C. §1374(d)(3). This is the first day of the taxable year the election is effective, not the date the election is filed.

2. It is not clear whether there are two ten year periods if the Subchapter S election subsequently terminates a new election is filed.

Example: C Corporation elects Subchapter S status, effective Year One. It has a net built-in gain and thus is subject to the tax for years one through ten. The election terminates in year three and five years later in year nine, a new election is filed. The corporation may be subject to the tax for another ten years following re-election with the additional appreciation on the assets which accrued before the second election subject to the tax.

3. One obvious way to avoid the tax is to sell an asset with built-in gain on the installment method with payment to occur outside the recognition period. It is uncertain whether the Service would sanction this procedure. The Service's hand was strengthened by TAMRA's addition of I.R.C. {1374(e) which gives the Service to issue

regulations "as may be necessary to carry out the purposes of this section..."

H. Recognition Events

1. Any net built-in gain recognized by the S corporation during the recognition period is subject to the tax.

2. Special rule for income items

   a. The IRS had previously taken the position that not only would sales, distributions or a liquidation of corporate assets trigger the tax, but also other income recognition events. Ann. 86-128, I.R.B. 1986-51.

   b. TAMRA provides statutory authority for this position:

      "Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the 1st taxable year for which the corporation was an S corporation shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account." I.R.C. §1374(d)(5).

   c. The Service had announced the regulations would define dispositions as including "other income-recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income." They give two examples: the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract by a taxpayer using the completed contract method of accounting. Ann. 86-128, I.R.B. 1986-51. Thus a cash basis C corporation with a significant amount of receivables at the time of conversion may face a large potential built-in gain tax.

   d. This new rule followly closely I.R.C. §382(h). The legislative history for the TAMRA changes to that section also mentions income attributable to periods before the change date pursuant to section 481 adjustments. H. Rep. No. 795, 100th Cong., 2d Sess. 46 (1988).

3. Special rule for deduction items

   a. TAMRA provides a similar rule for deduction items:

      "Any amount which is allowable as a deduction during the recognition period but which is attributable to periods before the 1st taxable year ... shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction." I.R.C. §1374(d)(5)(B).

   b. Examples would include deductible compensation paid by a cash basis corporation after the conversion which is attributable to pre-conversion services, or a deduction for compensation or interest which arose prior to conversion but is delayed under section 267.

4. Non-recognition Events

   a. A non-recognition event does not trigger the gain, but the "built-in gain taint" carries over. Similarly any built-in loss carries over to the new asset.

   b. TAMRA contains a new provision dealing with exchanged basis property, i.e. property whose adjusted basis is determined in whole or in part by reference to the adjusted basis of another asset held by the S corporation at the time of conversion. The exchanged basis asset is treated as if it was held by the S corporation at the date of conversion. I.R.C. §1374(d)(6). Thus a new recognition period is not created.

   c. Example: An S corporation exchanges an asset which it held at the time of conversion for another asset in a section 1031 like-kind exchange. Since the basis of the old asset becomes the basis of the asset received in exchange, the recognition of gain on the new during the recognition period triggers the tax. The amount of the taint and the length of the recognition period will carry over to the new asset. Ann. 86-128, I.R.B. 1986-51.

I. Limitations

1. Exception for Post-Conversion Assets.

   a. The corporation is not liable for a tax on a recognized gain on an asset acquired subsequent to the conversion. I.R.C. §1374(d)(3)(A).

      (1) The Service has announced that the inventory method used for tax purposes will be used to identify whether goods disposed of following conversion were held by the corporation at the time of conversion. Ann. 86-128, I.R.B. 1986-51. They give as an example: a corporation using LIFO will only be subject to the built-in gains tax to the extent that a LIFO layer existing prior to the beginning of the first taxable year as an S corporation is invaded after the beginning of that year.

   b. Similary the corporation may not use post-conversion losses to offset built-in gains except to the extent used in calculating the taxable income limitation discussed below. I.R.C. {1374(d)(4)(A)

2. Exception for Post Conversion Gain.

   a. The gain is not subject to the tax to the extent it is attributable to post-conversion appreciation. I.R.C. §1374(d)(3)(B).

      (1) The taxed gain is only the extent to which the fair market value at the date of the conversion exceeds the adjusted basis. I.R.C. §1374(d)(3)(B).

         (a) Example: S corporation acquires a machine for $60 and takes $20 in depreciation by the time it elects to be taxed as an S corporation. The FMV at the date of conversion is $50. The corporation subsequently sells the asset for $50 at a time when the AB is $25. Of the $25 gain, $10 is taxed to the corporation as built-in gain.

         Note that there is no actual appreciation in value in the asset at the time of conversion; it has declined in value. Nevertheless, there is built-in gain due to depreciation. Note also that the asset has not increased in value since the date of conversion, but some of the gain is post-conversion gain and not subject to tax at the corporate level.

(2) The statute does not indicate that the method of post-conversion acquisition is relevant. Legislative history, however, gives as an example, a taxable acquisition raising the spector that a non-taxable acquisition such as a contribution to capital might not qualify. H. Rep. No. 99-841, 99th Cong. 2d Sess. 203 (1986).

(3) If an asset with built-in gain at the time of conversion subsequently declines in value, such that there is a recognized loss, there is no tax.

b. Similarly built-in loss does not include any post-conversion decline in value. I.R.C. {1374(d)(4)(B).

3. Overall Ceiling on Gain

a. The aggregate amount of gain recognized to the S corporation during the 10 year period is limited to the net built-in gain on all assets held at the date of conversion. I.R.C. §1374(c)(2). Note that the overall ceiling is could be increased or decreased by the TAMRA changes relating to income and deduction items discussed above in H.2 and 3.

b. Example: At the time of conversion the S corporation has two assets:

Asset A	40 AB	60 FMV
Asset B	45 AB	30 FMV

Since S corporation has a net built-in gain of 5, it is subject to the built-in gain rules. It subsequently sells Asset A for 65. Although there is a recognized gain of 25 and a built-in gain of 20 (at the date of conversion), only 5 of gain is taxed to the corporation, since the amount of gain is limited to the net built-in gain on all assets at the date of conversion.

4. Annual Ceiling

   a. For any taxable year, the taxable gain is limited to the net built-in gain minus gain recognized in previous years. I.R.C. {1374(c)(2).

5. Taxable Income Limitation

   a. Reasons for change--Under prior law the tax was based on the lesser of the recognized built-in gain or taxable income. By taking losses or deductions in the year gains were recognized, the corporation could effectively negate the tax. Furthermore the tax could be eliminated through the use of post-conversion losses.

   b. TAMRA retains the taxable income limitation, but requires the corporation to carry over the excess built-in gain to the next taxable year. Thus an S corporation continues to pay no tax on built-in gain in any year in which post-conversion losses cause taxable income to be less than the gains, but when the corporation has post-conversion taxable income within the recognition period, the suspended built-in gain will be taxed.

   c. Examples:

      1) At the time X corporation's Subchapter S election becomes effective, it has a net built-in gain of $100. In year one, it recognizes a $20 gain on the disposition of a pre-conversion asset all of which is a built-in gain. X's taxable income is $30. All of the gain is subject to tax.

      2) In year two, X recognizes a $25 built-in gain as well as a $15 built-in loss. X has taxable income of $18. The <u>net</u> built-in gain of $10 is recognized.

      3) In year three, X recognizes a $12 built-in gain and a $20 loss on the disposition of a post-conversion asset. Since the taxable income is less than the built-in gain, the built-in gain is carried over. [N.B. Although the statute is less than crystal

clear, presumably the taxable income for this purpose is 0.]

4) In year four, X has taxable income of $20. The suspended built-in gain of $12 is now taxed.

d. Note that built-in losses which are recognized in a year with no recognized built-in gains are not carried over. A built-in gain in a subsequent year will be fully recognized subject to the overall limitation. Therefore matching is advised.

J. Amount of Tax

1. The amount of tax is the lesser of a tax on the recognized built-in gain computed at the highest corporate rate. I.R.C. {1374(b)(1). Note, as discussed above, that if the taxable is less, the tax will be computed using that figure. I.R.C. {1374(d)(2)(A).

2. The corporation may reduce the tax on the built-in gain by any net operating loss carryforward from a C corporation year. I.R.C. §1374(b)(2). TAMRA also provides that capital loss carryovers may be used. The corporation can also take any business credit carryforward from C corporation years against the tax.

3. Reduced Pass-Through

a. Where a tax is imposed on built-in gains, the amount of gain passed through to the shareholders is reduced by the tax imposed at the corporate level. I.R.C. §1366(f)(2). Note that because the tax is imposed on recognized gains, there will be a gain pass-through to the shareholders in all circumstances.

(1) Each gain is reduced by the proportionate amount of the tax attributable to the gain.

K. Effective Dates

1. The built-in gain rules apply to taxable years beginning after December 31, 1986 "but only in cases where the 1st taxable year for which the corporation is an S corporation is pursuant to an election made after December 31, 1986." P.L. 99-

514 §633(b).

a. Thus a corporation which filed an election on or before December 31, 1986 is not subject to new Section 1374 even if the election is effective for a future taxable year. Conference Report at II-203.

   (1) The Service's position is that a corporation making an election during 1986 must have been an eligible corporation at the time the election is effective. Rev. Rul. 86-141, I.R.B. 86-159. Note that Section 1362(b)(1) requires that an election may be made by a "small business corporation," a term of art denoting eligibility. Thus the corporation must have been eligible on the date the election was filed and on the first day of its taxable year for which the election became effective. See Prop. Reg. §1.1372-1(a).

2. The changes made by TAMRA relating to the carryover of net built-in gain pursuant to I.R.C. {1374(d)(2)(B) do not apply to corporations who made a Subchapter S election prior to March 31, 1988.

   a. Thus there are three regimes: corporations who filed an election before December 31, 1986 are not subject to new section 1374. Corporations which made an election between January 1, 1987 and March 30, 1988 are subject to section 1374 but not to the carryover provision. All other corporations are subject to the full impact of the rules.