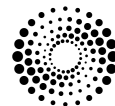


SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

**1120S
DESKBOOK**



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Interactive Self-study CPE

Companion to PPC's 1120S Deskbook

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INTRODUCTION

Companion to *PPC's 1120S Deskbook* consists of two interactive self-study CPE courses. These are companion courses to *PPC's 1120S Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S 1120S DESKBOOK

COURSE 1

S Corporation Start Up and Wrap Up (T2STG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to how to set up a S corporation. In lesson 1, learn the list of requirements for S corporation eligibility. These requirements must be met both at the time of initial election and continuously throughout the period of S status to preserve the election. In lesson 2, learn how to elect S status, when the initial S tax year begins, repairing a late or invalid S election, and requirements for a limited liability company (LLC) to elect S status. In lesson 3, learn how a corporation's S status can be terminated, both voluntarily and involuntarily, by corporate-level events and shareholder-level events. When the S election is terminated, a number of tax return reporting issues arise.

PUBLICATION/REVISION DATE: December 2010

RECOMMENDED FOR: Users of *PPC's 1120S Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Experience with the preparation of Form 1120S

CPE CREDIT: 7 QAS Hours, 7 Registry Hours

7 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Eligibility

Completion of this lesson will enable you to:

- Identify the S Corporation eligibility requirements and what type of shareholders are eligible to be a S corporation shareholder.
- Recognize which trusts and estates qualify to hold S Corporation stock and the requirements of each.
- Determine how small business corporations meet the one class of stock requirement and how debt is treated by the shareholder as a potential second class of stock.

Lesson 2—Filing and Repairing the S Election

Completion of this lesson will enable you to:

- Identify the deadlines and forms required when filing an S election and determining when the initial tax year begins for the new S corporation.
- Recognize the methods for obtaining relief from a late or invalid S election.
- Determine the requirements for an LLC to elect S status.

Lesson 3—Termination of S Status

Completion of this lesson will enable you to:

- Determine the process for a voluntary revocation of an S election and how to waive an inadvertent termination of an S election.
- Identify the advantages and tax consequences of the S termination year and post-termination transition period.
- Identify the process for reelecting S status after termination and exceptions to the five-year reelection rule.
- Determine the estimated tax requirements for the corporation following a termination of an S election.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
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Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Eligibility

INTRODUCTION

Although filing an S election on Form 2553 (Election by a Small Business Corporation) is often viewed as a straightforward task, there is a lengthy list of criteria for S eligibility. These requirements must be met both at the time of initial election and continuously throughout the period of S status to preserve the election.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the S Corporation eligibility requirements and what type of shareholders are eligible to be a S corporation shareholder.
- Recognize which trusts and estates qualify to hold S Corporation stock and the requirements of each.
- Determine how small business corporations meet the one class of stock requirement and how debt is treated by the shareholder as a potential second class of stock.

THE REQUIREMENTS FOR S CORPORATION ELIGIBILITY

Eligibility Requirements

Small Business Corporation. To elect and continue S corporation status, the corporation and its shareholders must meet a number of basic requirements. Under IRC Sec. 1361, only a “small business corporation” can operate as an S corporation. To qualify as a small business corporation, the corporation must:

1. Be a domestic corporation.
2. Have no more than 100 shareholders. (Husband and wife and certain family members are treated as one shareholder.)
3. Have as shareholders only:
 - a. individuals who are citizens or residents of the U.S.;
 - b. estates;
 - c. certain types of trusts; or
 - d. certain tax-exempt charitable organizations (see discussion later in this lesson).
4. Have only one class of stock.
5. Not be an ineligible corporation by definition (see discussion later in this lesson).

Banks. A bank (i.e., a depository financial institution as defined in IRC Sec. 581) is eligible to elect S status if it uses (or changes to) the specific charge-off method of accounting for bad debts.

Certain Tax-exempt Charitable Organizations. Section 501(c)(3) charitable organizations that are exempt from taxation under IRC Sec. 501(a) (item 3.d. in the preceding list) are eligible S corporation shareholders. IRC Sec. 512(e) provides that all items of income, loss, and deduction passed through by the S corporation and gains and losses from the disposition of the S corporation stock must be taken into account in computing the charitable organization's unrelated business taxable income (UBTI).

Retirement Plans. Certain tax-exempt qualified retirement plan trusts (but generally not IRAs and SEPs) are eligible to hold stock in S corporations. However, certain grandfathered IRAs and Roth IRAs are allowed to hold stock in an S corporation that is a bank. Also, certain IRAs are allowed to hold stock that has been rolled over from an ESOP.

Personal Service Corporations and Personal Holding Companies. Personal service corporations and personal holding companies that meet the S corporation requirements are eligible to elect S status. If the corporation is a personal holding company that has accumulated earnings and profits (AE&P), the practitioner must consider whether electing S status will cause the corporation to be subject to the tax on excess net passive income. Furthermore, the S election will terminate if an S corporation has both AE&P and passive investment income in excess of 25% of gross receipts for three consecutive tax years.

Ineligible Shareholders

As stated in item 3 in the preceding list, an S shareholder must be an individual, estate, a certain type of trust, or Section 501(c)(3) charitable organization. Thus, S corporation stock generally cannot be owned by a corporation, partnership, ineligible trust, nonresident alien, LLC, or LLP. (Certain single-member LLCs can be S corporation shareholders.)

Charitable Remainder Trust. Charitable remainder annuity trusts and charitable remainder unitrusts are not eligible to hold S corporation shares.

Individual Retirement Accounts. Generally, IRAs are not eligible shareholders.

S Corporations Can Own Interests in C Corporations and Certain Other Entities. The eligible shareholder rules discussed in the preceding paragraphs establish the types of entities that can hold S corporation stock, but do not restrict the ownership interests that the S corporation itself can hold. Thus, an S corporation can own shares in a C corporation or hold an interest in a LLC. Furthermore, an S corporation can be a partner in a partnership, and the other partners can be individuals or entities that would be ineligible to be shareholders of the S corporation.

Affiliated Group. An S corporation can own up to 100% of another corporation, and it can elect to treat certain subsidiaries as "qualified Subchapter S subsidiaries" (QSubs).

Number of Shareholders

An S corporation must not have more than 100 shareholders at any one time (item 2 in the preceding list).

Husband and Wife. A husband and wife (and their estates) are treated as one shareholder.

Family Members. Family members and their estates are treated as one shareholder.

Tenants in Common or Joint Tenants. Two or more individuals can own stock as tenants in common or as joint tenants with the right of survivorship. Provided the joint owners are not spouses and are unrelated, each individual is a separate shareholder for the 100-shareholder limit.

Trusts. The treatment of trusts under the "number of shareholders" rule is discussed later in this lesson.

Forming a Partnership of S Corporations. Two or more S corporations can form a partnership without violating the 100-shareholder limit, so long as each S corporation has fewer than 100 shareholders. (See Example 1E-1.)

Beneficial Owner of Stock Is Considered the Shareholder

The beneficial owner, rather than the owner of record, is considered the shareholder (i.e., the owner of the S corporation stock). Thus, the person for whom S corporation stock is held by a nominee, guardian, custodian, or agent is considered the shareholder. Even though a partnership is not an eligible shareholder, a partnership may be a nominee of S corporation stock for a person who is considered the shareholder. However, if the partnership is the beneficial owner of the stock, the partnership will be considered the shareholder and the corporation will not be eligible for S status. Furthermore, a minor child is considered the owner of any stock held by a custodian under the Uniform Gifts to Minors Acts (UGMA).

Domestic Corporation Requirement

An S corporation must be a domestic corporation (item 1 in the preceding list). However, a domestic corporation can retain or elect S status, even if it is registered as a corporation in a foreign country, if the corporation meets the

other requirements [e.g., it has one class of stock and has no nonresident alien shareholders]. Furthermore, an entity such as an LLC that uses the check-the-box election to be taxed as a corporation can elect S status if it is eligible to be treated as an S corporation.

Ineligible Corporations

A corporation can be ineligible for S status (item 5 in the preceding list) because it is classified as:

1. a financial institution that uses the reserve method of accounting for bad debts under IRC Sec. 585,
2. an insurance company subject to taxation under Subchapter L of the Code,
3. a corporation electing to use the possessions tax credit under IRC Sec. 936,
4. a domestic international sales corporation (DISC) or former DISC, or
5. a "taxable mortgage pool" (TMP). A TMP is any entity other than a real estate mortgage conduit (REMIC) if:
 - a. substantially all of the entity's assets consist of debt obligations and more than 50% of such obligations consist of real estate mortgages,
 - b. the entity is the obligor under debt obligations with at least two maturities, and
 - c. payments on the debt obligations on which the entity is the obligor bear a relationship to payments on the debt obligations held by the entity.

If a portion of a corporation is a TMP, that portion is considered a separate corporation. Evidently, this means the non-TMP portion of the S corporation is eligible for S status (if it meets the other requirements) but the TMP portion cannot elect or maintain S status.

Reelecting S Status after Termination of the S Election

If a corporation was formerly an electing S corporation but has reverted to C status, it generally must wait five years before it can reelect S status, unless IRS consent is received. (The IRS will grant such consent under certain conditions.)

Other Qualification Issues

In addition to these eligibility rules, the following restrictions may prevent either electing or maintaining S status:

1. If an S corporation has accumulated earnings and profits and has passive investment income in excess of 25% of its gross receipts for three consecutive years, IRC Sec. 1362(d)(3) requires that S status be terminated as of the beginning of the fourth year.
2. If a C corporation has assets with fair market values in excess of their adjusted tax bases, the threat of liability for the Section 1374 built-in gains tax can effectively make it impractical to elect S status.
3. If a C corporation has used the LIFO inventory valuation method, election of S status requires LIFO recapture (i.e., taxation of the LIFO reserve), with the tax levied in the final C return.

Using a Checklist to Ensure S Corporation Eligibility

Because the criteria for electing and maintaining S status are lengthy and detailed, the use of a checklist can efficiently ensure that all of the eligibility requirements are met. Also, by reviewing this list with the client, information is passed on to the officers/shareholders as to the eligibility rules, which must be followed as long as the corporation remains in S status.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. To elect small business corporation status, a corporation must meet several basic requirements Which of the following is a qualification required by a small business corporation?
 - a. Less than 200 shareholders.
 - b. Less than two classes of stock.
 - c. Be a domestic corporation.
 - d. Stock held by a corporation.
2. Which of the following would **not** be allowed to be a S corporation shareholder?
 - a. Charitable remainder trust.
 - b. A bank using the specific charge-off method of accounting for bad debts.
 - c. Qualified pension retirement plan trust.
 - d. Personal service corporation.
3. Which of the following situations may make it impractical for a corporation to elect S corporation status?
 - a. Excess passive investment income for three consecutive years in an S corporation without accumulated earnings and profits.
 - b. Potential built-in gains tax when a corporation has assets with net unrealized appreciation.
 - c. Potential recapture when a C corporation has used the FIFO method of inventory valuation.
 - d. Transfer of S corporation stock to the estate of a deceased shareholder.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. To elect small business corporation status, a corporation must meet several basic requirements Which of the following is a qualification required by a small business corporation? **(Page 3)**
 - a. Less than 200 shareholders. [This answer is incorrect. According to IRC Sec. 1361, a small business corporation may have no more than 100 shareholders.]
 - b. Less than two classes of stock. [This answer is incorrect. A small business corporation must, by definition, have only one class of stock as stated in IRC Sec. 1361.]
 - c. **Be a domestic corporation. [This answer is correct. Under IRC Sec. 1361, one of the requirements to qualify as a small business corporation is to be a domestic corporation.]**
 - d. Stock held by a corporation. [This answer is incorrect. Permissible shareholders allowed to hold stock in a small business corporation as detailed in IRC Sec. 1361 include individuals who are citizens and residents of U.S., estates, certain types of trust, and certain tax-exempt charitable organizations S corporation stock generally cannot be owned by a corporation, partnership, ineligible trust, nonresident alien, LLC or LLP.]
2. Which of the following would **not** be allowed to be a S corporation shareholder? **(Page 3)**
 - a. **Charitable remainder trust. [This answer is correct. Charitable remainder annuity trusts and charitable remainder unitrusts are not eligible to hold S corporation shares as stated in IRC Sec. 136150(a)(B).]**
 - b. A bank using the specific charge-off method of accounting for bad debts. [This answer is incorrect. According to IRC Sec. 1361(b)(2), a bank (i.e., a depository financial institution as defined in IRC Sec. 581) that does not use the reserve method of accounting for bad debts can elect S corporation status.]
 - c. Qualified pension retirement plan trust. [This answer is incorrect. As stated in IRC Sec. 1361(c)(6), certain tax-exempt qualified retirement plan trusts, including a qualified pension, profit-sharing, and stock bonus plan are eligible to hold stock in S corporations. Generally, IRAs and SEPs are not eligible shareholders.]
 - d. Personal service corporation. [This answer is incorrect. Personal service corporations and personal holding companies that meet the S corporation requirements are eligible to elect S status according to the IRS rules.]
3. Which of the following situations may make it impractical for a corporation to elect S corporation status? **(Page 3)**
 - a. Excess passive investment income for three consecutive years in an S corporation without accumulated earnings and profits. [This answer is incorrect. The excess passive investment income test applies when an S Corporation has accumulated earnings and profits; therefore, the S corporation was previously a C corporation or acquired a previous C corporation. The test does not apply when an S corporation lacks accumulated earnings and profits.]
 - b. **Potential built-in gains tax when a corporation has assets with net unrealized appreciation. [This answer is correct. If a C corporation has assets with fair market values in excess of their adjusted bases, the threat of liability for the Section 1374 built-in gains tax can effectively make it impractical to elect S status.]**
 - c. Potential recapture when a C corporation has used the FIFO method of inventory valuation. [This answer is incorrect. If a C corporation has used the LIFO inventory valuation method, as opposed to FIFO, election

of S status requires LIFO recapture (i.e. taxation of the LIFO reserve), with the tax levied on the final C return.]

- d. Transfer of S corporation stock to the estate of a deceased shareholder. [This answer is incorrect. According to IRC Sec. 1361(b)(1), an estate of a deceased shareholder is a permissible S corporation shareholder. In addition, transferring shares to a shareholder's estate will not increase the number of shareholders for purposes of the 100-shareholder limit.]

IDENTIFYING TRUSTS AND ESTATES QUALIFIED TO HOLD S CORPORATION STOCK

IRC Sec. 1361(b) specifically allows estates and certain trusts as eligible S corporation shareholders.

Estates

Estates of deceased individuals are eligible S corporation shareholders.

Estates of minors, incompetents, and persons under a disability are eligible shareholders.

Bankruptcy estates of individuals are eligible shareholders.

Shareholder's Estate. The estate of a deceased shareholder is eligible to hold stock in an S corporation, and the shareholder and his or her estate are considered to be one shareholder. Also, family members and their estates are treated as one shareholder. Thus, transferring shares to a shareholder's estate will not increase the number of shareholders for purposes of the 100-shareholder limit.

Example 1B-1 Deceased shareholder's estate is counted as a shareholder.

Cards, Inc., is a family controlled publishing company. Jane owns stock in the corporation, as does her husband, Jack, and a number of their children, grandchildren, and various spouses of the children and grandchildren. Jack dies and, according to his will, the stock will pass directly to Jane, but only after an anticipated two-year period of estate administration.

Jack, Jane, the family members, and spouses are counted as one shareholder. Upon Jack's death and the passage of his stock into his estate, the S corporation will still be considered to have one shareholder. All of the stock will be transferred to Jane when the estate terminates.

Trusts

Permitted trusts include:

1. Voting trusts, which are created primarily to exercise the voting power of the owned stock. Each beneficiary of the trust is considered to be a shareholder for purposes of the 100-shareholder limitation.
2. Testamentary trusts that receive S stock pursuant to the terms of a will (but, in general, eligibility is limited to a two-year period of ownership). The estate is considered to be the shareholder for purposes of the 100-shareholder limitation.
3. Grantor trusts in which all income and corpus is treated as being owned by a U.S. citizen or resident. When the owner of the trust is the grantor, the trust is referred to as a "grantor trust." The grantor is considered to be the shareholder for purposes of the 100-shareholder limit. When the owner of all income and corpus is someone other than the grantor, the trust is referred to as a "Section 678 trust." While there is no limit on the number of income beneficiaries a Section 678 trust can have, one person (the "deemed owner") must have the power to vest trust income and corpus in himself. The deemed owner is considered to be the shareholder for purposes of the 100-shareholder limitation.
4. Trusts existing before death that met the grantor trust requirements of item 3 and that continue to exist after death (although eligibility is limited to a maximum two-year period of ownership). The estate is considered to be the shareholder for purposes of the 100-shareholder limitation.
5. Qualified Subchapter S trusts (QSSTs) that own stock in one or more S corporations and are treated as trusts described in item 3. The income beneficiary is considered to be the shareholder for purposes of the 100-shareholder limit. (The QSST rules are discussed in more detail later in this lesson.)

6. Electing small business trusts (ESBTs) that own stock in one or more S corporations. Each potential current beneficiary is considered to be a shareholder for purposes of the 100-shareholder limitation. However, as stated previously, a potential current beneficiary of an ESBT and that beneficiary's family members are counted as one shareholder for purposes of the 100-shareholder limit. (The ESBT rules are discussed in more detail later in this lesson.)
7. Tax-exempt qualified retirement plan trusts under IRC Sec. 401(a) [e.g., an employee stock ownership plan (ESOP)]. (Qualified retirement plan trusts as S corporation shareholders are discussed later.)

Individual retirement accounts (including SEPs, SIMPLE IRAs, and Roth IRAs), however, are not qualified retirement plans under IRC Sec. 401(a) and thus are generally not eligible to hold S corporation stock.

Foreign trusts are not permitted trusts.

Estate Planning. Trusts can be effective devices for reaching estate planning objectives of S corporation shareholders.

Testamentary Trusts

A trust created by the terms of a will is known as a testamentary trust. The wills of many married couples direct the assets of the first decedent into a testamentary trust that provides an income stream to the surviving spouse while preserving the corpus for distribution to children after the surviving spouse dies. During the period of administration when S corporation shares are held by the estate, S eligibility is not a problem. However, upon transfer of the shares from the estate into such a testamentary trust, IRC Sec. 1361(c)(2) provides that a corporation's S status terminates if the trust continues to be a shareholder for longer than a two-year period. (A testamentary trust will remain an eligible shareholder beyond the two-year limitation if the trust is a QSST or an ESBT. These trusts are covered in the following discussion.)

Only Certain Trusts Are Allowed to Name Successive Beneficiaries

Trusts eligible to hold S corporation stock are listed earlier in this lesson. These trusts are subject to special rules and restrictions; for example, testamentary trusts can be S corporation shareholders for only two years. Of the remaining types of eligible trusts, only two allow the trust to name successive beneficiaries—a qualified Subchapter S trust (QSST) and an electing small business trust (ESBT). The following discussion covers these trusts.

Qualified Subchapter S Trusts

A trust qualifies as a QSST if all the following criteria are met:

1. The trust has only one income beneficiary during the life of the current income beneficiary, and that beneficiary is a U.S. citizen or resident.
2. All of the income of the trust is, or is required to be, distributed currently to the one income beneficiary. [However, a trust provision authorizing the trustee to accumulate income if the trust no longer holds S corporation stock does not preclude the trust from being a QSST.]
3. Any corpus distributions that might occur, including a terminating distribution, must also go to that one income beneficiary if made during the beneficiary's lifetime.
4. The income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the trust's termination.
5. An election to be treated as an eligible S corporation shareholder is made separately for the stock of each S corporation held by the trust.

Once a QSST election is made, it is revocable only with the consent of the IRS.

A QSST works particularly well when (1) the objective of the trust is to provide income to a beneficiary but not allow control and access to corpus (as is often true when a minor child is the beneficiary), or (2) the objective is to provide income to one beneficiary but reserve corpus for another beneficiary following the death of the first beneficiary.

S Corporation Pass-through Items Are Included on Beneficiary's Personal Income Tax Return. The QSST income beneficiary is treated as the shareholder for purposes of the pass-through rules, distributions, and adjustments to stock basis. Thus, the income beneficiary reports the S corporation's pass-through items of income, gain, loss, or deduction on his or her individual Form 1040. (See also "Sale of Stock by a QSST" later in this lesson.)

Current Distribution Rule. For purposes of the current distribution rule (item 2 in the preceding list), income of the trust includes distributions from the S corporation but does not include the trust's prorata share of S corporation items of income, loss, deduction or credit (i.e., pass-through items). Thus, pass-through items do not have to be distributed annually. Distributions from the S corporation to the trust and income from sources within the QSST (other than S corporation pass-through items) are subject to the annual distribution requirement.

Example 1B-2 Complying with the QSST current distribution rule.

Dottie is the sole beneficiary of the Burns Trust, a QSST. During the current year, ABC Inc. passes through \$20,000 of income to the Burns Trust and makes distributions to the trust of \$15,000.

The trust is required to distribute \$15,000 to the beneficiary. The \$20,000 of pass-through income is not under the annual distribution requirement. Dottie includes the \$20,000 in gross income on her Form 1040, however.

Making the Qualified Subchapter S Trust Election. The following two examples illustrate the election procedures necessary to qualify a trust as a QSST.

Example 1B-3 Making the QSST election.

Andy Baer is a shareholder in Alamo Corp., a successful S corporation. His mother, Doris, is an elderly widow requiring expensive nursing care. Andy has decided to establish a trust to hold about 20% of his Alamo stock to deflect a stream of income to support Doris. Andy's minor child will be the successor income beneficiary, with the trust terminating and the stock distributed to him when he reaches age 25.

Andy's objectives can be met through the use of a QSST. For the QSST to be treated as an eligible S corporation shareholder, a special election must be made and signed either by the current income beneficiary of the trust (Doris) or her legal representative. This election must be filed within the 2-month-and-16-day period beginning on the date the stock of the S corporation is initially transferred to the trust. This election is submitted as a separate statement. If the S corporation were a newly electing entity, the separate QSST election could be made as part of the election of S status on IRS Form 2553 (i.e., Part III of Form 2553 allows a QSST election, but only if the stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation).

Variation: Assume now that Andy has two minor children and he would like to designate them as successor income beneficiaries, with the trust terminating and the stock distributed to them at age 25.

Two QSSTs are necessary, because at Doris's death Andy's two minor children would become income beneficiaries, and a QSST is permitted to have only a single income beneficiary. Each trust would be drafted to provide income to Doris during her lifetime, income to a successor minor child of Andy's following Doris's death, and eventual corpus distribution of the stock to the child at the specified age. [As discussed later in this lesson, an electing small business trust (ESBT) can also hold S corporation stock. In this example, an ESBT would not meet Andy's tax-saving objective because the trust is taxed at the highest individual rate on its share of the corporation's pass-through income.]

Example 1B-4 Treating separate shares of one QSST as multiple QSSTs.

Substantially separate and independent shares of a single trust can each qualify as a QSST. Therefore, if Andy in Example 1B-3 had two minor children, he could create a single trust for Doris's benefit that is comprised of

two separate subtrusts. Doris would be the sole income beneficiary of each subtrust, and upon her death, one child would be the successor income beneficiary of each subtrust.

However, upon Doris's death, the trust cannot authorize the distribution of trust assets from one subtrust to the child who is not the income beneficiary of that subtrust. The IRS has ruled that a separate and independent share of a trust cannot qualify as a QSST if there is even a remote possibility that the trust assets will be distributed during the lifetime of the current income beneficiary to someone other than the beneficiary.

New Income Beneficiary. A new (successor) income beneficiary is not required to file an election to continue QSST status, just as a new shareholder in an existing S corporation is not required to consent to the S status. However, a new QSST beneficiary may affirmatively refuse to consent to the QSST election within the 2-month-and-15-day period after the date of becoming the successor income beneficiary. If the affirmative refusal is filed, the trust generally becomes an ineligible shareholder, which terminates the S corporation election. This capability of a new beneficiary of a QSST which may hold only a small amount of stock can be contrasted with the Section 1362(d)(1)(B) general revocation procedures for S corporations, which require more than 50% of the shareholders to consent to a termination of S status.

Example 1B-5 Beneficiary's refusal to consent to QSST election.

Continuing with the facts in Example 1B-3 assume that Doris Baer, as income beneficiary of Doris Baer Trust A (a QSST) dies on August 18 of the current year. Under the terms of this trust, Doris's granddaughter, Susie, becomes the successor and sole income beneficiary of the Doris Baer Trust A. For the 2-month-and-15-day period following this change in the QSST income beneficiary, Susie (or her parent acting on her behalf, if she is still a minor) can file an affirmative refusal to consent to the QSST election. The refusal to consent becomes effective on the day on which Susie becomes the income beneficiary of the QSST.

The beneficiary may refuse to consent to the S election because, for example, the corporation is passing through income but not making distributions, and she does not want to pay tax currently on the trust's share of the corporation's income.

Trust Cannot Be Retroactively Changed to Meet QSST Requirements. The IRS has ruled that retroactive changes to a trust instrument to qualify for QSST treatment will not be recognized for federal tax purposes.

Example 1B-6 Trust cannot be retroactively changed to meet QSST requirements.

Adam, Inc., a C corporation, filed an S election on March 15, 2009, to become effective on January 1, 2009. A trust held a portion of the corporation's stock on January 1, 2009, but the trust did not meet the definition of a QSST because its corpus could, under some circumstances, be distributed to a person other than the current income beneficiary. On January 31, 2010, the trust instrument was amended to fit the definition of a QSST by providing that only the current income beneficiary could receive distributions of corpus. On February 15, 2010, the appropriate state court issued an order ruling that the trust was reformed retroactive to December 31, 2008.

Rev. Rul. 93-79 sets out facts similar to those in this example, and holds that the retroactive effect of a state court order reforming a trust will not be recognized for federal tax purposes. Therefore, Adam, Inc.'s S election never became effective because an ineligible trust held shares at the time the S election was filed. Under some circumstances, an ineffective election would take effect at the beginning of the corporation's next tax year, but the provisions of IRC Sec. 1362(b)(2) do not apply in this example because the corporation was not an eligible small business corporation when the election was filed.

The ruling further states that the corporation is an eligible small business corporation beginning on the date the trust amendments were made, January 31, 2010, and the corporation can file a new S election for the tax year beginning January 1, 2011. Adam, Inc. is not required to wait five years before filing the new election because the waiting period under IRC Sec. 1362(g) does not apply to a corporation that has never been an S corporation.

The practitioner should be sure to discuss the QSST election with the attorney responsible for drafting and funding the trust. Many overlooked QSST elections are the result of a lack of communication between attorneys and

practitioners. Also, the practitioner should note that when an S election is made by a corporation that has a QSST as a shareholder, the income beneficiary of the trust must make a special election to qualify the trust as an S shareholder in addition to the shareholder consent required on Form 2553.

Substantial Compliance. The IRS has employed the “substantial compliance” rationale to conclude that QSST elections not meeting the literal requirements of the regulations were still valid. For example, in one letter ruling the IRS held that a QSST election signed by the trustee, but not signed by the “deemed owner” of the QSST (a minor child), was valid where the child’s parents indicated by their signatures on the S corporation election form (Form 2553) that the child was to be taxed as the owner of the shares held by the QSST.

Sale of Stock by a QSST. A QSST is treated as a grantor trust (at least with regard to the S corporation stock it owns). The QSST (rather than the income beneficiary) must recognize gain or loss if the QSST sells its S corporation stock. The trust reports the sale of the S stock on Schedule D of Form 1041.

If all S corporation stock held by a QSST is sold or redeemed, IRC Sec. 1361(d)(1)(A) may no longer subject the QSST to the grantor trust rules. Unless some other power or right of the income beneficiary subjects the QSST to the grantor trust rules of Subpart E, the QSST may then revert (that is, be “converted”) to nongrantor trust status.

The conversion of a grantor trust to a nongrantor trust is treated for tax purposes as a disposition by the grantor (or the income beneficiary, in the case of a QSST) of the trust assets with respect to which he was treated as the owner. [See *Madorin*, where the Tax Court determined that gain was recognized under Reg. 1.1001-2(c), Ex. 5, when the grantor of a grantor trust renounced the power to add beneficiaries, thereby terminating the trust’s status as a grantor trust.]

Another issue arises if the QSST sells the S corporation stock on the installment basis. The regulations provide relief from the potential loss of ability to use installment sale reporting by treating the QSST as a separate taxpayer under IRC Sec. 641, according to the preamble to the Section 1361 regulations. The trust is treated as receiving the consideration for the sale (including an installment obligation) in its status as a separate taxpayer. Accordingly, any gain recognized by the trust on the sale of its S corporation stock is included in the trust’s gross income. Thus, the trust can use the installment sales method to report any gain from the sale of its S stock.

Use of Passive Activity Losses and At-risk Amounts by QSST Beneficiaries. The disposition of S stock by a QSST is treated as a disposition by the QSST beneficiary for purposes of the Section 465 at-risk rules and the Section 469 passive activity loss rules. Thus, the QSST beneficiary is allowed to deduct losses previously suspended under the at-risk rules or the passive activity loss rules upon disposition of S stock by the QSST. Note that this provision applies only for purposes of the at-risk and passive loss rules, so the gain on the sale of the S corporation stock is still taxable to the trust, rather than the beneficiary.

A Testamentary Trust’s QSST Election Can Preserve S Corporation Status. Electing QSST or electing small business trust (ESBT) status for a qualifying testamentary trust can keep the S election in effect after the two-year

Improper Reporting of Tax by QSST Did Not Terminate S Election. QSST reported on its income tax return the items shown on the Schedule K-1 it received from an S corporation in which it held stock. The trust paid the resulting taxes rather than having the beneficiary report the items on his individual income tax return and pay the taxes as required under IRC Sec. 1361(d)(1)(B). The filing of an improper tax return and the payment of taxes by the QSST rather than the beneficiary were not circumstances described in IRC Sec. 1361(d)(4) (relating to trust disqualification) or IRC Sec. 1362(d)(2) (ceasing to operate as a small business corporation). Thus, improper filing and payment of the taxes by the QSST itself did not terminate either its QSST election or the corporation’s S election.

Relief from Missed QSST Election

A trust that meets the requirements of a qualified Subchapter S trust (QSST) under IRC Sec. 1361(d) is permitted to own S corporation stock. As explained earlier in this lesson, a beneficiary of a QSST is required to file an election to have the trust treated as an eligible S shareholder. The election must be filed within 2 months and 16 days of the trust’s receipt of stock. However, the IRS provides relief from inadvertent termination of S status caused by the beneficiary’s failure to timely file a QSST election.

Relief under Rev. Proc. 2003-43 for an inadvertent termination of the S election is available if all of the following requirements are met:

1. The corporation's S status is terminated solely because the beneficiary of a QSST (or the beneficiary's legal representative) failed to file a timely QSST election.
2. Less than 24 months have passed since the original due date of the QSST election.
3. The failure to file a timely QSST election was inadvertent.
4. All taxpayers whose tax liability or tax returns would be affected by the election (including all shareholders of the S corporation and the beneficiary of the QSST) have reported consistently with the S corporation and QSST elections on all affected returns for the year the election was intended, and for any subsequent years. (This basically means that proper Schedules K-1 have been issued to the shareholders and they have reported the pass-through items on their tax returns as if a valid S election was in effect.)

The deadline for filing for late QSST relief depends on whether the QSST has filed a tax return (Form 1041).

If the QSST has not filed a Form 1041, the QSST election must be filed under Rev. Proc. 2003-43 by the earlier of (1) 18 months after the original due date for the QSST election, or (2) six months after the due date of the Form 1041 (excluding extensions) for the first year the election was intended.

If the QSST has filed a Form 1041 for the first year in which the election was intended, the application for relief is filed under Rev. Proc. 2003-43 within 24 months of the original due date for the QSST election. To qualify for this relief, the Form 1041 must have been filed within six months of the due date of the Form 1041 (excluding extensions).

The late QSST election must be filed with the IRS Service Center where the corporation files its return and must state at the top of the election, "FILED PURSUANT TO REV. PROC. 2003-43."

In addition to the information required in the QSST election, affidavits must be provided to substantiate that all of the corporation's shareholders, the trust, and the trust's income beneficiary file all of their tax returns as though the election had been timely filed. The following must be submitted in addition to the QSST election:

1. An affidavit from the trustee stating that the trust satisfies the QSST requirements of IRC Sec. 1361(d)(3) and that the income distribution requirements have been and will continue to be met.
2. An affidavit from the current income beneficiary stating that the failure to file the QSST election was inadvertent, and that he or she acted diligently to correct the mistake when it was discovered.
3. Affidavits from all shareholders during the termination period (including the trust itself and the current income beneficiary of the electing QSST), stating that they have reported their income on all affected returns consistent with the S election for the year the QSST election should have been made and for all subsequent years. (Effectively, the shareholders are affirming that proper Schedules K-1 have been issued and they have reported the pass-through items on their tax returns as if a valid S election was in effect.)
4. A dated declaration, signed by the current income beneficiary, that states, "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

Relief under Rev. Proc. 2003-43 does not require the payment of a user fee because Rev. Proc. 2003-43 applies in lieu of the private ruling request procedure used to obtain relief from inadvertent termination relief under IRC Sec. 1362(f).

Example 1B-7 Missed QSST election.

John Smith, an S shareholder, died in January of the current year. John's estate transferred his S stock to two trusts created under his will. Marta Smith, John's widow, was the beneficiary of both trusts, and intended the trusts to meet the requirements of a QSST under IRC Sec. 1361(d).

As previously discussed, a beneficiary of a QSST is required to file an election to have the trust treated as an eligible S shareholder. Marta was not aware of this requirement until six months after the S stock was transferred to the trust. Upon discovery of the omission, the corporation requested Marta and the trusts comply with the QSST election requirements and requested relief from inadvertent termination pursuant to Rev. Proc. 2003-43. The IRS will examine the application for relief to determine whether the requirements for waiving the inadvertent termination have been satisfied and will notify the corporation of its decision.

A QSST that is ineligible for relief under Rev. Proc. 2003-43 or that is denied relief can still request a letter ruling granting relief from the inadvertent termination and loss of QSST status. Such a request, however, requires payment of a user fee.

Electing Small Business Trusts

An ESBT can own S corporation shares. An ESBT can provide that income will be distributed to (or accumulated for) one or more beneficiaries. Thus, an individual can establish a trust to hold S corporation stock and split income among family members or others who are trust beneficiaries. The price paid for this flexibility is that the trust (not the beneficiaries) is taxed on income related to the S corporation stock at the highest individual rate (35% on ordinary income), unless the income qualifies as long-term capital gains, in which case a maximum 15% rate applies (25% for unrecaptured Section 1250 gain and 28% for collectibles gain).

To qualify as a small business trust, all trust beneficiaries must be individuals, estates, or charitable organizations eligible to be S shareholders. In addition, certain political entities are permitted as contingent beneficiaries so long as they are not potential current beneficiaries.

An ESBT beneficiary does not include the following:

1. A trust that is receiving or may receive a distribution from an intended ESBT, i.e., a “distributee trust” (but does include those persons who have a beneficial interest in the property held by the distributee trust).
2. A person in whose favor a power of appointment could be exercised.

Interest in ESBT Cannot Be Acquired by Purchase. No interest in the trust can be acquired by purchase (that is, with a cost basis determined under IRC Sec. 1012). Thus, an interest in the trust must generally be acquired by gift, bequest, or transfer in trust. (This provision means that the beneficiary cannot acquire an interest in the trust by purchase. However, the trust can purchase S corporation shares or other property to hold in the trust.)

Potential Current Beneficiaries. Each “potential current beneficiary” of the trust (and that beneficiary's family members) is counted as one shareholder for the 100-shareholder limitation. If there are no potential current beneficiaries, the trust is treated as the shareholder. A potential current beneficiary generally is any person who is entitled to a distribution from the principal or income of the trust. A person entitled to receive a distribution only after a specified time or when a specified event occurs (such as the death of a holder of a power of appointment) does not become a potential current beneficiary until the time arrives or event occurs. Additionally, an ESBT has one year to dispose of the S stock to avoid disqualification after an ineligible shareholder becomes a potential current beneficiary.

Current Powers of Appointment. Any unexercised powers of appointment are disregarded in determining the potential current beneficiaries of an ESBT.

Taxable Income. The taxable income of an ESBT consisting solely of stock in one or more S corporations includes: (1) the S corporation items of income, loss, or deduction allocated to it (i.e., passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder; (2) gain or loss from the sale of the S corporation stock; and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses. Capital losses are allowed only to the extent of capital gains.

Under the “ordinary” trust rules, a trust is taxed on its taxable income reduced by a distribution deduction. A deduction for distributions to beneficiaries is allowable when calculating taxable income because the beneficiaries will include those distributions in income. An ESBT, however, is taxed on its income *before* considering

distributions to beneficiaries. Therefore, distributions from an ESBT holding only S corporation stock are *not taxable at the beneficiary level*.

Grantor Trusts. Grantor trusts are permitted to make ESBT elections. However, an ESBT election does not alter the established tax treatment of items attributable to the grantor portion of the trust. Accordingly, IRC Sec. 671 requires that items of income, deduction, and credit attributable to the portion of the trust treated as owned by the grantor must be taken into account by the grantor. The ESBT rules of IRC Sec. 641(c), discussed earlier in this key issue, apply to the S portion of the trust, while normal trust taxation rules apply to the non-S portion of the trust.

Making the ESBT Election. The trustee files the ESBT election with the IRS Service Center where the corporation files its income tax return. If the corporation is electing S status simultaneously with making the ESBT election, the election may be attached to the corporation's Form 2553 (Election by a Small Business Corporation). The ESBT election must be filed within the 16-day-and-2-month period beginning on the date S corporation stock is transferred to the trust.

Example 1B-8 Making the electing small business trust election.

Jean Norman is chief executive officer and one of 15 shareholders in JN Corp., a successful S corporation. Jean's mother Myrna is an elderly widow who requires expensive, long-term nursing care. Jean is paying individual income tax at the top rates. She wants to place 20% of her JN stock in a trust providing income to Myrna as she needs it. Income not used for Myrna's care will accumulate in the trust. At Myrna's eventual death, the trust will specify Jean's two minor children as successor beneficiaries, and the trust will terminate by distributing the stock to the children when they reach the age of majority. No distributions will be made to the children until the trust terminates.

By using a trust that meets the criteria for an ESBT and properly electing ESBT status, Jean will meet her objectives.

Once an ESBT election is made, it is revocable only with the consent of the IRS.

Protective ESBT Elections Prohibited. Protective ESBT elections are not permitted. This means that a trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to otherwise qualify as a trust that is eligible to hold S corporation stock.

Consent to S Election. The trustee makes the ESBT election (discussed earlier) and also consents to the S election. As covered in the next lesson, all shareholders must consent when a corporation elects S status. Even though each potential current beneficiary of an ESBT counts as a shareholder for the 100-shareholder limit, only the trustee is required to consent to the S corporation election. If the ESBT has more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S election. Further, if the ESBT is a grantor trust, both the trustee and the deemed owner of the trust are required to consent to the S election.

Trust Holding Assets Other Than S Corporation Stock. When an ESBT holds other property as well as S corporation stock, the portion of the trust consisting of stock in one or more S corporations is treated as a separate trust when figuring the income tax attributable to the S corporation stock. The taxable income attributable to this portion includes the three items listed previously under the heading, "Taxable Income." Thus, the trust consists of two portions, which, for the sake of convenience, will be identified here as the "S Portion" and the "Non-S Portion". The S Portion items are disregarded when figuring the tax liability of the Non-S Portion. Distributions from the Non-S Portion are deductible in computing the taxable income of that portion, but no distribution deduction is allowed in arriving at the S Portion's taxable income. The regulations also provide that a "Grantor Portion" may exist in certain situations.

Example 1B-9 ESBT holding assets other than S corporation stock.

The Smith Trust holds S corporation stock as well as other assets and has elected to be an ESBT for the current tax year ended December 31. The trust is considered to be two portions, S Portion and Non-S Portion. The S Portion was allocated \$10,000 of ordinary income from the S corporation, and \$4,000 was distributed by the S Portion to the beneficiary. The Non-S Portion received \$15,000 in interest income and distributed that amount to the beneficiary.

The S Portion is taxed on \$10,000 at 35% and pays \$3,500 in tax. The beneficiary receives the \$4,000 distribution tax-free.

The Non-S Portion receives a \$15,000 deduction for the distribution in arriving at taxable income. Thus, the trust pays no tax on Non-S Portion's income, but the beneficiary includes the \$15,000 distribution in income.

Pass-through in Year Trust Terminates. If the trust terminates before the end of the S corporation's tax year, the trust takes into account its prorata share of S corporation items of income, loss, and deduction for its final year.

Charitable Contributions Passed through to an ESBT. Generally, charitable contributions made by estates and trusts are only limited by the amount of the gross income of the estate or trust paid for charitable purposes. If an ESBT owns S corporation stock and the S corporation passes through a charitable contribution deduction, the contributions are deemed to be paid by the S portion of the trust. The unrelated business income limitations of IRC Sec. 681 apply when computing the taxable income of the S portion to determine the amount of the deductible contribution. Thus, charitable contributions passing through to an ESBT from an S corporation offset the ESBT's ordinary income (subject to the unrelated business income rules), and the resulting net taxable income is subject to income tax at 35%.

Sale of ESBT's S Corporation Stock. An ESBT recognizes gain or loss at the trust level if it sells its S corporation stock. However, no deduction is allowed for capital losses that exceed capital gains. If the trust reports income from the sale of its S corporation stock on the installment method, the income recognized in each installment is reported by the S portion of the trust. Conversely, interest income on the installment obligation is included in the non-S portion of the trust.

An ESBT that disposes of all of its S corporation stock is not considered to be an ESBT on the day following the day of disposition unless it reports the income from the stock sale on the installment method. If the installment method is used, the trust continues to be an ESBT until the last installment payment is received or the trust disposes of the installment obligation.

Interest on Debt Used to Acquire S Shares. An ESBT can deduct interest on debt used to acquire S corporation shares in determining the amount of its taxable income attributable to its S corporation ownership. That income is automatically taxed at the trust level at the maximum individual rate (currently 35%). This is a favorable provision because it reduces the amount of income subject to the 35% trust-level tax.

Relief from Inadvertent Termination Due to Failure to File ESBT Election

A trust that meets the requirements of an electing small business trust (ESBT) under IRC Sec. 1361(e) is permitted to own S corporation stock. As explained earlier in this lesson, the trustee of an ESBT must file an election to have the trust treated as an eligible S shareholder. The election must be filed within two months and 16 days of the trust's receipt of the stock. Under Rev. Proc. 2003-43, the IRS provides inadvertent termination relief under IRC Sec. 1362(f) to corporations whose S status has been terminated because stock in the corporation was transferred to a trust whose trustee inadvertently failed to file a timely ESBT election under IRC Sec. 1361(e)(3). Under Rev. Proc. 2003-43, the corporation is treated as if its S status had not terminated.

Relief under Rev. Proc. 2003-43 for an inadvertent termination of the S election is available if all of the following requirements are met:

1. The corporation's S status is terminated solely because the trustee of an ESBT failed to file a timely ESBT election.
2. Less than 24 months have passed since the original due date of the ESBT election.
3. The failure to file a timely ESBT election was inadvertent.
4. All taxpayers whose tax liability or tax returns would be affected by the election (including all shareholders of the S corporation and the beneficiaries of the ESBT) have reported consistently with the S corporation and ESBT elections on all affected returns for the year the election was intended, and for any subsequent

years. (This basically means that proper Schedule K-1s have been issued to the shareholders and they have reported the pass-through items on their tax returns as if a valid S election was in effect.)

The deadline for filing for late ESBT relief depends on whether the ESBT has filed a tax return (Form 1041).

If the ESBT has not filed a Form 1041, the ESBT election must be filed under Rev. Proc. 2003-43 by the earlier of (1) 18 months after the original due date for the ESBT election, or (2) six months after the due date of the Form 1041 (excluding extensions) for the first year the election was intended.

If the ESBT has filed a Form 1041 for the first year in which the election was intended, the application for relief is filed under Rev. Proc. 2003-43 within 24 months of the original due date for the ESBT election. To qualify for this relief, the Form 1041 must have been filed within six months of the due date of the Form 1041 (excluding extensions).

The late ESBT election must be filed with the IRS Service Center where the corporation files its return and must state at the top of the election, "FILED PURSUANT TO REV. PROC. 2003-43."

In addition to the information required in the ESBT election, affidavits must be provided to substantiate that all of the corporation's shareholders, the trust, and the trust's income beneficiaries file all their tax returns as though the election had been timely filed. The following must be submitted in addition to the ESBT election:

1. An affidavit from the trustee stating that all potential current beneficiaries are eligible S corporation shareholders under IRC Sec. 1361(b)(1) and that the trust satisfies the requirements to be an ESBT under IRC Sec. 1361(e)(1) other than the requirement to make an ESBT election.
2. An affidavit from the trustee stating that the failure to file the ESBT election was inadvertent and that the trustee acted diligently to correct the mistake upon its discovery.
3. Affidavits from all shareholders during the termination period (including the trust itself) stating that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and for all subsequent years. (Effectively, the shareholders are affirming that proper Schedule K-1s have been issued to the shareholders and they have reported the pass-through items on their tax returns as if a valid S election was in effect.)
4. A dated declaration, signed by the trustee, that states, "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

Relief under Rev. Proc. 2003-43 does not require the payment of a user fee because Rev. Proc. 2003-43 applies in lieu of the private letter ruling procedure used to obtain inadvertent termination relief under IRC Sec. 1362(f).

Example 1B-10 Missed ESBT election.

Will Johnson, an S shareholder, died in January of the current year. Will's estate transferred his S stock to a trust that meets the requirements of an ESBT under IRC Sec. 1361(e).

As previously discussed, a trustee of an ESBT is required to file an election to have the trust treated as an eligible S shareholder. The trustee was not aware of this requirement until six months after the S stock was transferred to the trust. Upon discovery of the omission, the corporation requested the trustee and the trust to comply with the ESBT election requirements and requested relief from inadvertent termination under Rev. Proc. 2003-43. The IRS will examine the application for relief to determine whether the requirements for waiving the inadvertent termination have been satisfied and will notify the corporation of its decision.

An ESBT that is ineligible for relief under Rev. Proc. 2003-43 or that is denied relief can still request a letter ruling granting relief from the inadvertent termination and loss of ESBT status. Such a request, however, requires payment of a user fee.

A Testamentary Trust's ESBT or QSST Election Can Preserve S Corporation Status

A testamentary trust that receives S stock pursuant to the terms of a will is permitted to hold the stock for a two-year period beginning on the date the stock is transferred to it. Similarly, a trust existing before death that met the

requirements to be treated as a grantor trust is permitted to hold S stock for a two-year period beginning on the date of the death of the deemed owner of the trust. Electing ESBT or QSST status can keep the S election in effect after the two-year period expires. An ESBT or QSST election can be filed at any time during the two-year period or the two-month-and-16-day period following the end of the two-year period.

Example 1B-11 Preserving the S election by electing ESBT status for a testamentary trust.

Wesley was a 25% shareholder of Web, Inc., an S corporation, at the time of his death. His will provides that the S corporation stock is to be distributed to a trust for the benefit of his wife, Lynne. Their adult daughter, Vanessa, also has the right to receive distributions of income from the trust. When Lynne dies, the trust beneficiaries will be Vanessa and her two children. The trust will terminate and the stock will be distributed to the children at the later of (1) Vanessa's death, or (2) when the children reach the age of majority.

The trust is a testamentary trust and, as such, is eligible to hold S stock for only two years after the stock is transferred to the trust. Web's S status terminates if the testamentary trust continues to be a shareholder for longer than a two-year period.

If the trust qualifies and elects QSST or ESBT status, the two-year rule does not apply and the trust can hold S corporation stock as long as it remains an eligible S shareholder. Here, the trust does not qualify as a QSST because there is more than one income beneficiary. The trust does, however, qualify as an ESBT. By the end of the two-year period, it will be necessary to either distribute the stock to a qualifying shareholder or elect ESBT treatment if the corporation is to remain an S corporation.

Converting from One Type of Eligible Trust (QSST or ESBT) to the Other

A QSST or ESBT can be converted to the other type of trust if certain requirements are met. These conversions are covered in *PPC's Tax Planning Guide—S Corporations*.

Conversion of a QSST to an ESBT usually does not result in the trust terminating its entire interest in the S corporation. Thus, the corporation cannot make an election to use specific accounting when a shareholder's entire interest is disposed of. However, if the trust was (1) a testamentary trust that received S stock pursuant to the terms of a will or (2) a trust existing before death that was treated as a grantor trust, the shareholders of the S corporation are considered to change from the deemed owner or testator to the potential current beneficiaries. In either situation, the corporation can make an election to use specific accounting because a shareholder's entire interest was disposed of.

Qualified Retirement Plan Trusts

A tax-exempt qualified retirement plan trust under IRC Sec. 401(a) [i.e., an employer's qualified pension, profit-sharing, or stock bonus plan, such as an employee stock ownership plan (ESOP)] is eligible to own S corporation stock. However, if such a trust (other than an ESOP) owns S shares, it may be subject to the tax on unrelated business taxable income (UBTI).

IRAs and SEPs. Individual retirement accounts (including SEPs, SIMPLE IRAs, and Roth IRAs) are generally not qualified retirement plans under IRC Sec. 401(a) and thus are not eligible to hold S corporation stock.

FAMILY MEMBERS AND THE SHAREHOLDER RULES

Treating a Family Group as One Shareholder

All family members, including spouses, former spouses, and all their estates are treated as one shareholder solely for purposes of determining the number of shareholders in the corporation.

Defining the Family. A *family* is defined as the common ancestor and all lineal descendants of the common ancestor, as well as the spouses, or former spouses, of these individuals. An adopted child, child lawfully placed with an individual for adoption, or foster child is treated as a natural child.

Form 2553. Line G on Page 1 of the S election Form 2553 contains a box to check if the corporation actually has more than 100 shareholders but is still eligible for S corporation status because it meets the 100-or-less shareholder limit when family members are counted as one shareholder.

Identifying Family Members

Family members include:

- A common ancestor and all of that ancestor's lineal descendants, as well as the ancestor's and descendants' spouses and former spouses (see Examples 1C-1 and 1C-3).
- A husband and wife, as discussed later in this lesson.
- The estate of a deceased family member during the period in which the estate or a testamentary trust holds stock in the S corporation. (See "Shareholder's Estate" later in this lesson.)

The following are also treated as family members:

- The income beneficiary of a qualified subchapter S trust (QSST) who makes the QSST election, if that income beneficiary is a family member.
- Each potential current beneficiary of an electing small business trust (ESBT) who is a family member.
- Each family member who is a beneficiary of a trust created primarily to exercise the voting power of stock transferred to it.
- The family member for whose benefit an IRA was created to hold stock in a certain S corporation bank.
- The deemed owner of a grantor trust, if the deemed owner is a family member.
- The owner of a disregarded entity, such as a single-member LLC, if the owner is a family member.

Six-generation Limitation. An individual is not a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this rule) be members of the family. A spouse or former spouse is treated as in the same generation as the person to whom the individual is (or was) married.

The applicable date is the latest of (1) the effective date of the corporation's S election, (2) the earliest date that a family member holds stock in the S corporation, or (3) October 22, 2004.

The six-generation limitation applies only as of the applicable date. Lineal descendants (and spouses) who acquire stock after the applicable date will be treated as members of the family, even if they are more than six generations removed from the common ancestor.

Example 1C-1 Illustrating how a family group is treated as one shareholder.

ABC Corp. is an S corporation that has 99 unmarried and unrelated shareholders. On July 1, 2010, Bob transfers shares to his four children, his ex-spouse, his father, and his grandmother. Bob's grandmother is the common ancestor because Bob, his father, and his children are the grandmother's lineal descendants. The spouses and former spouses of these individuals are also considered to be family members. The six-generation test is applied on the applicable date, which is the latest of (1) the effective date of the S election, (2) the earliest date that a family member holds stock in the S corporation, or (3) October 22, 2004. In this example, the applicable date is July 1, 2010, the date that a family member first holds stock in the S corporation. No family member is more than six generations removed from the common ancestor. Because all of the transferred shares go to family members who are treated as one shareholder, the corporation is still considered to have 99 shareholders for purposes of the maximum-number-of-shareholders test.

Family Member Rule Applies Only for Counting Shareholders. Treating separate shareholders as one shareholder applies only for the purpose of determining whether the corporation has exceeded the allowable number of shareholders. Shareholders are treated separately for other purposes, such as the pass-through of the S corporation's items of income, gain, loss, or deduction. Furthermore, if a corporation is making the S election, each person holding shares must separately consent to the S election.

Example 1C-2 Illustrating pass-through when a family group is treated as one shareholder.

Assume the same facts as in Example 1C-1. The corporation has 99 shareholders for purposes of the maximum-number-of-shareholders test. However, the corporation's pass-through items of income, gain, loss, deduction, and credit are allocated to all 106 stockholders on a per-share, per-day basis.

As illustrated in Examples 1C-1 and 1C-2, an S corporation can have significantly more than 100 shareholders because of the family-members-count-as-one-shareholder rule.

Example 1C-3 Counting family members as one shareholder.

Oval, Inc. is a very successful calendar year S corporation founded years ago by Frank Jones. Over the years, Frank transferred a large portion of his stock in Oval to his children Eve and Pete.

Variation 1: The Jones family treats Frank as their common ancestor and treats all of Frank's descendants as one shareholder for purposes of the 100-shareholder limit. Under the facts of this variation, Oval is treated as having one shareholder (composed of the Frank, Eve, and Pete family group) for purposes of counting shareholders.

Variation 2: Assume now that Frank dies and Eve and Pete inherit his shares in the S corporation. Oval is still considered to have one shareholder because Eve and Pete are lineal descendants of a common ancestor, Frank.

Variation 3: Assume now that Eve and Pete formed the S corporation after Frank died. There is no requirement that the common ancestor be alive when determining the number of S corporation shareholders. Thus, Oval has one shareholder because Eve and Pete are Frank's lineal descendants.

Variation 4: Assume now that Eve and Pete each have children who own shares in the S corporation. Because Frank is a common ancestor of both Eve and Pete and their children, Oval still has one shareholder. This would continue to be true, even if Eve, Pete, or one of their children died and left his or her shares to the other stockholders. All of the remaining shareholders would be Frank's lineal descendants and would be counted as one shareholder. If the decedent, however, left the shares to an individual who was not a lineal descendant of Frank, Oval would be considered to have two shareholders. Frank's lineal descendants would be counted as one shareholder and the individual would be the other.

Variation 5: Assume now that Oval was founded by Frank Jones and Mike Smith, who are not related. They each transfer stock to their children. Here, Frank and Mike are common ancestors of their respective families. For counting purposes, the S corporation is considered to have two shareholders: Frank and his family and Mike and his family.

Husband and Wife

A husband and wife (and their estates) are automatically counted as one shareholder for purposes of the 100-shareholder limit. This is true whether or not they file a joint return or own the stock individually, or in a form of joint ownership (joint tenancy, community property, etc.).

Example 1C-4 Counting husband and wife as one shareholder.

Free Spirit, Inc. is an S corporation. Throughout the corporation's tax year, the corporation has 99 unmarried and unrelated shareholders. In addition, Roger and Rhoda Ranger are married and each spouse owns shares of Free Spirit's stock. Since Roger and Rhoda count as one shareholder, the 100-shareholder limit has not been exceeded.

Counting Shareholders When Shareholders Are Divorced

The rule that a shareholder and his or her spouse are counted as one shareholder ceases to apply on the dissolution of the marriage for any reason other than death. Therefore, a divorced couple is generally treated as two separate shareholders in determining the number of shareholders. These provisions only apply in determining the number of shareholders for S corporation eligibility purposes and do not apply for other purposes. (See Example 1C-5 for treatment of shareholders who are family members.)

Example 1C-5 Divorce can cause involuntary termination of S status.

Penn, Inc. has operated as an S corporation for ten years. It has 110 shareholders, made up of 90 unmarried and unrelated shareholders and 10 unrelated husbands and their wives who each own stock in Penn. For purposes of the 100-shareholder limit, Penn is considered to have 100 shareholders because each married couple counts as one shareholder. In the middle of the current year, Mel and Melba divorce, and each continues to own S corporation stock. Penn is considered to have 101 shareholders when the divorce becomes final. The S election terminates, effective on that day. (See Example 1C-7.)

This undesirable result can be avoided if one of the divorcing shareholders transfers his or her stock to an existing shareholder or to the corporation before the divorce becomes final. This transfer could be ensured if the corporation required shareholders to sign a buy/sell agreement when they acquired the corporation's stock. For more on buy/sell agreements, see *PPC's Tax Planning Guide—S Corporations*.

When an S corporation's shareholder count reaches 100, the introduction of even one new stockholder, other than a family member, will cause the S election to terminate.

Example 1C-6 Transfer of stock to unrelated party can cause involuntary termination of S status.

Assume the same facts as in Example 1C-5, except that Mel and Melba remain married and one of Penn's shareholders transfers a portion of his or her stock to an unrelated party during the year. The S corporation is now considered to have 101 shareholders (91 unrelated shareholders plus 10 married couples that count as one shareholder per couple). The S election terminates on the day the stock transfer to the unrelated party takes place. To help control the number of shareholders, an S corporation and its shareholders should consider adopting a shareholders' agreement, see *PPC's Tax Planning Guide—S Corporations*.

Variation: Assume now that the shareholder transfers shares to his or her child instead of to an unrelated party. The child is a lineal descendent of the parent, so parent and child are family members and are counted as one shareholder for purposes of the 100-shareholder test. (The parent or a previously designated person will be the common ancestor.) The S corporation is still considered to have 100 shareholders.

Counting Divorced Family Members. As illustrated in Example 1C-5, a divorced couple is treated as two separate shareholders for purposes of the 100-shareholder rule. However, this provision evidently applies only to husbands and wives who are not family members. Members of a family include a common ancestor, any lineal descendant of the common ancestor and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. The "or former spouse" wording in the Code and regulation evidently includes a divorced spouse under the "family member" umbrella, which allows spouses and former spouses of family members, together with the other family members, to be counted as one shareholder.

Example 1C-7 Divorced family members count as one shareholder.

Assume the same facts as in Example 1C-5, except that 10 of the shareholders, including Mel and Melba, are "members of a family" as defined in IRC Sec. 1361(c)(1)(B)(i) and Reg. 1.1361-1(e)(3). Because family members under that definition include former spouses, Mel and Melba evidently continue to be counted as one shareholder for purposes of the 100-shareholder limit. The S corporation is considered to have 100 shareholders after the divorce is final and the S election does not terminate.

Variation: Assume now that neither Mel nor Melba are related to any of the other shareholders. In this situation, they do not fall under the "family member" umbrella. After their divorce becomes final, they will be counted as two separate shareholders under the shareholder counting rules. (See Example 1C-5.)

Shareholder Estate

A husband and wife (and their estates) are automatically treated as one shareholder. Furthermore, all members of a family (including spouses and former spouses) and their estates are treated as a single shareholder without the need to make an election.

Example 1C-8 Treating deceased shareholder's estate as a shareholder.

Gordon, Inc. is a family controlled publishing company that operates as an S corporation. It was formed about 25 years ago by three brothers who are now quite elderly. The stock is held by the three Gordon brothers and an assortment of their children, grandchildren, and various spouses of the children and grandchildren.

One of the elderly brothers is terminally ill. According to his will, the stock will pass directly to his surviving spouse, but only after an anticipated one-year period of estate administration. His wife is already a direct shareholder on her own.

The terminally ill brother and his wife are currently counted as one shareholder. Upon his death and the passage of his stock into his estate, the surviving spouse and the estate will still be considered one shareholder. Upon the termination of the estate and transfer of the stock to the surviving spouse, she will hold all shares as an individual.

QUALIFIED RETIREMENT PLAN TRUSTS

Tax-exempt qualified retirement plan trusts are eligible to hold stock in S corporations. For purposes of the 100-shareholder limitation, a qualified retirement plan counts as one shareholder. In general, when a qualified retirement plan trust holds stock in an S corporation, the corporation's pass-through income flows through to the trust and is taxed under the unrelated business taxable income (UBTI) rules. However, special rules are provided for employee stock ownership plans (ESOPs) that exempt such plans from the UBTI rules.

Qualified Retirement Plans

A qualified retirement plan trust described in IRC Sec. 401(a) that is exempt from tax under IRC Sec. 501(a) is eligible to hold stock in an S corporation. Thus, qualified pension, profit-sharing, and stock bonus plans can hold stock in an S corporation.

S stock held by a qualified retirement plan trust is treated as an unrelated trade or business. The trust's share of the S corporation's pass-through income as well as any gain or loss on a disposition of the S stock is subject to taxation under the unrelated business taxable income (UBTI) rules.

If the qualified plan trust purchases stock in an S corporation (whether the stock was acquired when the corporation was a C or an S corporation) and receives a dividend distribution (i.e., a distribution of E&P), the trust must reduce its basis in the stock by the amount of the dividend. However, the IRS is permitted to issue regulations providing that the basis reduction would apply only to the extent the dividend is deemed to be allocable to E&P that accrued by the date of the acquisition.

Employee Stock Ownership Plans (ESOPs)

ESOPs are eligible to hold S corporation stock. An ESOP is a special type of defined contribution plan that invests primarily in employer securities. An ESOP may be a stock bonus plan or a combination of a stock bonus plan and a money purchase plan, which has been modified to include the various tax and regulatory requirements of an ESOP [IRC Sec. 4975(e)(7)]. S corporation ESOPs are not subject to the unrelated business taxable income (UBTI) rules.

An ESOP is counted as a single shareholder for the 100-shareholder limit, regardless of the number of ESOP participants.

Individual Retirement Accounts

General Rule Prohibits Holding S Stock in IRA. In general, a trust that constitutes a traditional or Roth individual retirement account (IRA) is not eligible to hold S corporation stock.

Grandfather Rule Permits Certain IRAs to Hold Stock in S Corporation Banks. An IRA or Roth IRA is allowed to hold shares of an S corporation that is a bank (as defined in IRC Sec. 581) if the shares were held in the IRA or Roth IRA on October 22, 2004. If the IRA or Roth IRA holds such bank S stock, the individual for whose benefit the IRA or Roth IRA was created is treated as the shareholder.

The unrelated business taxable income (UBTI) rules that apply to other tax-exempt entities (other than ESOPs) will apply to IRAs and Roth IRAs holding S corporation stock. However, the prohibited transaction rules of IRC Sec. 4975 (imposing an excise tax on certain transactions between a retirement plan and a disqualified person) do not apply to the sale of stock by an IRA or Roth IRA to the individual beneficiary of the trust if certain requirements are met.

Limited Exception for S Stock Rolled Over from an ESOP to an IRA. An ESOP can make a direct rollover of S corporation stock to an IRA if (1) the terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA; (2) the S corporation actually repurchases the S corporation stock on the same day as the distribution; and (3) no income, loss, deduction, or credit items are passed through by the S corporation to the IRA.

HANDLING A PARTNERSHIP WITH S CORPORATIONS AS PARTNERS

An S corporation is limited in the types of individuals and entities that can hold shares and in the number of allowable shareholders. The 100-shareholder limit can particularly present a problem when a larger group of investors joins together in a business venture.

An S Corporation Can Own an Interest in a Partnership

Rev. Rul. 94-43 provides that the purpose of the shareholder limit is to "obtain administrative simplicity in the administration of the corporation's tax affairs." The ruling holds that administrative simplicity is not affected by the corporation's participation in a partnership with other S corporation partners, so the S election will be respected when separate S corporations combine to form a partnership. If each S corporation has fewer than 101 shareholders, the 100-shareholder limit is not exceeded when two or more corporations combine to operate a single business as a partnership.

Example 1E-1 Two or more S corporations can form a partnership without violating the 100-shareholder limit.

Two groups of 55 unrelated individuals want to join together in a single active business. They recognize that a general partnership is not desirable because of liability aspects; similarly, they have discarded the idea of a limited partnership because none of the individuals are willing to act as general partner. Each group of 55 individuals forms an S corporation, and the two S corporations then form a partnership. The shareholder limit is not exceeded because each S corporation partner has only 55 shareholders.

Tiered Structures

Generally, an S corporation is a member of a tiered structure if it owns any portion of a partnership, personal service corporation, or trust. A member of a tiered structure may be barred from using a fiscal year because it is ineligible to make the Section 444 election, except under certain conditions.

USING A LIMITED LIABILITY COMPANY WITH AN S CORPORATION

A single-member limited liability company (LLC) will generally be disregarded as an entity separate from its owner for federal tax purposes. However, an LLC with two or more members will generally be classified as a partnership

for federal tax purposes. The unique advantage of LLCs under state law is that they can provide limited liability to all members (owners) even if they fully participate in the management of the enterprise. At the same time, many of the federal tax law restrictions that apply to S corporations can be avoided. However, S corporations still carry some advantage over LLCs.

LLCs May Elect to Be Treated as Corporations and May Elect S Status.

An LLC can file a check-the-box election to be taxed as a corporation. An LLC can make such a check-the-box election and elect S status, assuming the entity's members are eligible to hold S corporation stock, and the LLC meets the other eligibility requirements to be an S corporation. (The next lesson discusses how an LLC elects S status.)

A Single-member LLC Can Hold S Corporation Stock

An LLC generally is not an eligible shareholder and cannot hold S corporation stock. However, the IRS has ruled that a single-member LLC can be an S corporation shareholder. The LLC must be a domestic entity that is not classified as a corporation and must be disregarded as an entity separate from its owner. Furthermore, the owner of the LLC must be an individual or other entity eligible to hold S stock. If these requirements are met, the owner of the LLC is treated as owning the LLC's assets directly, so any S corporation shares held by the single-member LLC are treated as being owned by the LLC's owner. Thus, if the shares are transferred to the LLC before the S election is filed, the owner of the LLC (rather than the LLC itself) evidently consents to the S election.

An S Corporation Can Own an Interest in an LLC

S corporation restrictions generally revolve around the types of entity that can hold S corporation stock, not the types of investments that an S corporation can hold. Thus, as discussed earlier, an S corporation can hold stock in another corporation, a partnership interest, or an interest in an LLC.

Changing from S Corporation to LLC

If S corporation shareholders decide to change the entity's form of business to an LLC, the corporation generally must be liquidated and a new entity formed. (Under certain circumstances, it may be possible to use a tax-free Type F reorganization to convert an existing S corporation to an LLC or limited partnership taxed as an S corporation for federal tax purposes.)

If an S corporation reorganizes to become an LLC that operates as an S corporation, it must have only one class of stock. The IRS has ruled that an LLC agreement is a governing provision for purposes of the one-class-of-stock rules (Ltr. Rul. 200548021). Thus, it is important for the LLC to execute an agreement that defines the members' rights to distribution and liquidation proceeds. Each percentage of ownership should be given identical rights to these proceeds.

MAKING THE QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTION

A Corporation's S Election Terminates When Its Shares Are Acquired by Another Corporation

An S corporation can own stock of another corporation. However, as discussed earlier, a corporation is generally not an eligible S corporation shareholder. (An exception allows charitable organizations under IRC Sec. 501(c)(3) to hold S corporation stock.) This means that a corporation's S election will terminate on the day another corporation (other than an eligible charitable organization) acquires its shares.

Example 1G-1 An S corporation's election terminates when another corporation acquires its stock.

On January 1, 2010, Bracket, Inc., an S corporation, purchased 80% of the stock of Sacket, an S corporation. Can Bracket and Sacket remain S corporations?

Bracket's S election is not affected by the stock purchase because an S corporation can hold the stock of another corporation. Since a corporation is not an eligible S shareholder, however, Sacket's S election

terminates on January 1, 2010, the date its stock is acquired by Bracket. The last day of the S year is December 31, 2009, the day before the terminating event occurs.

Variation: If Bracket had bought 100% of Sacket, termination of the S election may have been avoided. See the discussion of qualified Subchapter S subsidiaries following this example.)

Qualified Subchapter S Subsidiaries

If an S corporation owns all the shares of another corporation, it can elect to treat the wholly-owned corporation as a qualified subchapter S subsidiary (QSub). A QSub is a corporation that is owned 100% by an S corporation that has made the QSub election for that subsidiary. (An S corporation, for example, can own 100% of the stock of two subsidiaries and make a QSub election for either, neither, or both of them.) A QSub is technically neither a C corporation nor an S corporation. A QSub is not treated as a separate corporation for federal tax purposes but is treated as a separate corporation for other purposes.

Effect of the QSub Election. A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation. Therefore, transactions between the S corporation parent and QSub are not taken into account, and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, and debt basis) are considered items of the parent.

Only the parent is required to file a tax return, Form 1120S, and that return includes the QSub's assets, liabilities, and items of income, deduction, and credit. However, a QSub will be treated as a separate corporation for employment tax (including FICA, FUTA, wage withholding) purposes.

CERTAIN BANKS ELECTING S STATUS

Banks Not Using the Reserve Method for Bad Debts Can Elect S Status

A bank (i.e., a depository financial institution as defined in IRC Sec. 581) that does not use the reserve method of accounting for bad debts can elect S corporation status.

Automatic Accounting Change Procedure

The IRS provides an automatic change procedure for banks electing S status. According to the automatic change procedure, the filing of an S election (Form 2553) by a bank constitutes an agreement by the bank to change its method of accounting for bad debts from the Section 585 reserve method to the Section 166 specific charge-off method. The bank must comply with all applicable provisions of Rev. Proc. 2008-52 including filing Form 3115 (Application for Change in Accounting Method). The accounting method change number "127" should be shown in Part 1, line 1(a) of Form 3115. A copy of the Form 3115 must also be filed with the National Office of the IRS.

The change in accounting method is effective as of the first tax year for which the S election is effective. The amount of this change-in-accounting-method adjustment generally equals the amount of the bank's bad debt reserve as of the close of the tax year preceding the change. A positive Section 481(a) adjustment, such as the adjustment to remove a bank's bad debt reserve, is generally spread over four tax years beginning with the year of change. As a result, if the year of change is the S corporation's first tax year, one-fourth of the increase to income is reported on each of the first four S corporation returns.

The Section 481(a) adjustments reported on the S corporation returns are subject to the built-in gains tax. This can result in taxation at both the corporate and shareholder levels.

A bank that changes from the reserve method of accounting for bad debts for its first S corporation tax year can elect to take the entire income adjustment into account on its final C corporation tax return. This means that a bank changing to the specific charge-off method for its first S year has the choice of (1) spreading the income over four years, with the income being subject to the built-in gains tax over those years, or (2) taking the entire adjustment into account on its final C corporation tax return and avoiding the built-in gains tax.

Restricted Bank Director Shares

Restricted bank director shares are not counted as outstanding S corporation stock. Thus, they are not counted for purposes of the 100-shareholder limit. Furthermore, such shares are not considered when determining whether the S corporation has a second class of stock. Certain distributions paid to the owner of restricted bank director stock are taxable income for the recipient director and a deductible expense for the S corporation..

Other Considerations for Banks

The Code includes a number of special bank rules, including IRC Secs. 582(c) (capital asset treatment disallowance), 265(b) (interest expense disallowance), and 291(a)(3) and (e)(1)(B) (preference item reduction). There has been some speculation that the S corporation requirements supersede the special bank rules. However, the IRS has issued proposed regulations stating that the special bank rules apply to banks that operate as S corporations. The regulations are proposed to apply to tax years beginning on or after August 24, 2006.

The IRS has also provided information on (1) how the S corporation passive investment income rules will apply to an S corporation bank; (2) the effect of the qualified Subchapter S subsidiary (QSub) election on banks affiliated with nonbanks; and (3) the application of the Section 265 interest expense disallowance rules to shareholders of a bank taxed as an S corporation.

A grandfather rule that allows certain IRAs and Roth IRAs to hold stock an S corporation bank was discussed earlier. Also, passive investment income does not include interest income earned by a bank or dividends on assets that must be held by a bank.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Certain types of trusts are permissible shareholders. Which of the following trusts is generally limited to a two-year period of stock ownership in a S corporation?
 - a. Voting trust.
 - b. Grantor trust.
 - c. Testamentary trust.
 - d. Tax-exempt qualified retirement plan trust.
5. When considering a trust, a shareholder is defined differently for purposes of the 100-shareholder limit. Which of the following correctly identifies a shareholder in relation to the type of trust?
 - a. Voting trust: each beneficiary of the trust is considered a shareholder.
 - b. Testamentary trust: the trust is considered the shareholder.
 - c. Qualified Subchapter S trust: the principal beneficiary is considered the shareholder.
 - d. Grantor trust: the trustee is considered the shareholder.
6. George is setting up a trust using the stock of numerous investments for his sole grandchild, Eric, and would like to design the trust to be a qualified subchapter S trust (QSST) so that the interest on the trust will pay for Eric's college, but the original trust money will go to George's daughter, Stacy, upon his death. QSSTs have numerous criteria that must be met to qualify. Which of the following is an accurate requirement of a QSST?
 - a. The trust will provide income to both Eric and Stacy before George's death.
 - b. Eric's income distribution from the QSST will terminate when George passes away.
 - c. The trust may allocate income to the Eric or Stacy at the trustee's discretion.
 - d. Eric will receive all income distributions from the trust, but Stacy will receive the terminating distribution.
7. Rhonda Greenbrier established the Greenbrier Trust for the sole benefit of her mother, Abigail, during her lifetime and names her son, Jonathan, as the successor beneficiary. Abigail makes an election to treat the trust as a QSST. Abigail dies six years later on June 23. Which of the following statements is correct?
 - a. John is not a permissible shareholder.
 - b. John may not revoke the QSST election.
 - c. A QSST may not name a successive beneficiary.
 - d. John is not required to file an election to maintain the trust as a QSST.

8. Which of the following is a characteristic of an elected small business trust (ESBT)?
- a. All beneficiary's of an ESBT are counted as one shareholder for the 100-shareholder limitation.
 - b. Beneficiaries will be taxed on the income related to S corporation stock held in the ESBT.
 - c. Income from an established ESBT can be distributed to numerous family members or other who are trust beneficiaries.
 - d. Trust beneficiaries can only be family members of the person establishing the trust.
9. Stephanie is the sole shareholder of Walden, Inc., a calendar year S corporation. Stephanie desires to transfer shares to her children and employees of the company. Her goal is to transfer the shares in a way to allow flexibility as to whether income be distributed or accumulated for the benefit of the new shareholders, but not favor a particular shareholder. If the proper election is made, which entity allows Stephanie to meet her objectives?
- a. Qualified subchapter S trust.
 - b. Voting trust.
 - c. Grantor trust.
 - d. Electing small business trust.
10. A trust may elect treatment as an electing small business trust (ESBT). Which of the following statements is correct regarding the election?
- a. Beneficiaries owning more than 50% interest in trust may revoke the ESBT election.
 - b. All potential current beneficiaries must consent to the ESBT election.
 - c. A grantor trust may elect to be treated as an ESBT.
 - d. An ESBT election must be made by the due date of the initial trust tax return, excluding extensions.
11. Which of the following statements correctly describes treatment of family members with regards to the 100-shareholder limit?
- a. The income beneficiary of a qualified subchapter S trust is treated as a separate shareholder, even if the beneficiary is a family member.
 - b. A family member may include the owner of a disregarded entity, if the owner is a family member.
 - c. Once a family member divorces, the former spouse is no longer treated as a family member.
 - d. A foster child is not included in the definition of family member.
12. An S corporation may elect to treat a subsidiary as a qualified subchapter S subsidiary (QSub). Which of the following statements correctly states QSub treatment?
- a. A QSub's assets and liabilities are treated as owned by the parent S corporation.
 - b. An S corporation owning more than 80% of the outstanding stock of another corporation may make a QSub election for its subsidiary.
 - c. The S Corporation and QSub are required to file separate federal income tax returns.
 - d. Accumulated earnings and profits and passive investment income of the QSub do not impact the parent S corporation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Certain types of trusts are permissible shareholders. Which of the following trusts is generally limited to a two-year period of stock ownership in a S corporation? **(Page 10)**
 - a. Voting trust. [This answer is incorrect. Voting trusts are created primarily to exercise the voting power of the owned stock as stated in IRC Sec. 1361(c)(2)(iv). There is no time limit on ownership by a voting trust.]
 - b. Grantor trust. [This answer is incorrect. As described in IRC Sec. 1361(c)(2)(i), a grantor trusts in which all income and corpus is treated as being owned by a U.S. citizen or resident is a permissible shareholder. When the owner of the trust is the grantor, the trust is referred to as a "grantor trust." There is no time limit on how long a grantor trust may be an eligible shareholder.]
 - c. **Testamentary trust. [This answer is correct. According to IRC Sec. 1361(c)(2)(iii), testamentary trust that receive S stock pursuant to the terms of a will is eligible to be a S corporation shareholder, but eligibility is limited to a two-year period of ownership.]**
 - d. Tax-exempt qualified retirement plan trust. [This answer is incorrect. Tax-exempt qualified retirement plan trusts under IRC Sec. 401(a) is a permitted shareholder [e.g., an employee stock ownership plan (ESOP)]. There is no time limitation on ownership by this type of trust.]
5. When considering a trust, a shareholder is defined differently for purposes of the 100-shareholder limit. Which of the following correctly identifies a shareholder in relation to the type of trust? **(Page 10)**
 - a. **Voting trust: each beneficiary of the trust is considered a shareholder. [This answer is correct. A voting trust is created to combine the voting power of shareholders. As such, each beneficiary of the trust is considered a shareholder for the 100-shareholder limit.]**
 - b. Testamentary trust: the trust is considered the shareholder. [This answer is incorrect. With a testamentary trust, the estate is considered the shareholder for purposes of the 100-shareholder limit, not the trust.]
 - c. Qualified Subchapter S trust: the principal beneficiary is considered the shareholder. [This answer is incorrect. For a qualified subchapter S trust (QSST), the income beneficiary is considered the shareholder for purposes of the 100-shareholder limit.]
 - d. Grantor trust: the trustee is considered the shareholder. [This answer is incorrect. All income and corpus is treated as owned by the grantor in a grantor trust and thus, the grantor is treated as the shareholder for purposes of the 100-shareholder limit.]
6. George is setting up a trust using the stock of numerous investments for his sole grandchild, Eric, and would like to design the trust to be a qualified subchapter S trust (QSST) so that the interest on the trust will pay for Eric's college, but the original trust money will go to George's daughter, Stacy, upon his death. QSSTs have numerous criteria that must be met to qualify. Which of the following is an accurate requirement of a QSST? **(Page 10)**
 - a. The trust will provide income to both Eric and Stacy before George's death. [This answer is incorrect. The trust may only have one income beneficiary during the life of the current income beneficiary, and that beneficiary must be U.S. citizen or resident as stated in IRC Sec. 1361(d).]
 - b. **Eric's income distribution from the QSST will terminate when George passes away. [This answer is correct. According to IRC Sec. 1361(d), one of the criteria that must be met for a trust to qualify as a QSST is that the income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the trust's termination.]**

- c. The trust may allocate income to the Eric or Stacy at the trustee's discretion. [This answer is incorrect. All of the income of the trust is, or is required to be, distributed currently to the income beneficiary. However, a trust provision authorizing the trustee to accumulate income if the trust no longer holds S corporation stock does not preclude the trust from being a QSST according to Rev. Rul. 92-20.]
- d. Eric will receive all income distributions from the trust, but Stacy will receive the terminating distribution. [This answer is incorrect. A criteria of a QSST is that any corpus distributions that might occur, including a terminating distribution, must also go to that one income beneficiary if made during the beneficiary's lifetime as detailed in IRC Sec. 1361(d).]
7. Rhonda Greenbrier established the Greenbrier Trust for the sole benefit of her mother, Abigail, during her lifetime and names her son, Jonathan, as the successor beneficiary. Abigail makes an election to treat the trust as a QSST. Abigail dies six years later on June 23. Which of the following statements is correct? **(Page 10)**
- a. John is not a permissible shareholder. [This answer is incorrect. As the beneficial owner of the QSST upon Abigail's death, John is considered the S corporation shareholder. He is a permissible shareholder since he is a citizen or resident of the U.S.]
- b. John may not revoke the QSST election. [This answer is incorrect. John has 2 months and 15 days following the change in the QSST income beneficiary to file an affirmative refusal to consent to the QSST election. The refusal to consent becomes effective on the day on which John becomes the income beneficiary of the QSST.]
- c. A QSST may not name a successive beneficiary. [This answer is incorrect. A qualified subchapter S trust (QSST) is one of two types of trusts eligible to hold S corporation stock which may name successive beneficiaries. An electing small business trust (ESBT) may also name successive beneficiaries.]
- d. **John is not required to file an election to maintain the trust as a QSST. [This answer is correct. A new (successor) income beneficiary is not required to file an election to continue QSST status, just as a new shareholder in an existing S corporation is not required to consent to the S status.]**
8. Which of the following is a characteristic of an elected small business trust (ESBT)? **(Page 10)**
- a. All beneficiary's of an ESBT are counted as one shareholder for the 100-shareholder limitation. [This answer is incorrect. Each "potential current beneficiary" of the trust (and that beneficiary's family member) is counted as one shareholder for the 100-shareholder limitation. If there are no potential current beneficiaries, the trust is treated as the shareholder. A potential current beneficiary generally is any person who is entitled to a distribution from the principal or income of the trust.]
- b. Beneficiaries will be taxed on the income related to S corporation stock held in the ESBT. [This answer is incorrect. The trust (not the beneficiaries) are taxed on income related to the S corporation stock at the highest individual rate (35% on ordinary income), unless the income qualifies as long-term capital gains, in which case a maximum 15% rate applies as detailed in IRC Sec. 1361(e)(1)(A)(i).]
- c. **Income from an established ESBT can be distributed to numerous family members or other who are trust beneficiaries. [This answer is correct. An individual can establish an ESBT to hold S corporation stock and split income among family members or other who are trust beneficiaries as stated in IRS rules.]**
- d. Trust beneficiaries can only be family members of the person establishing the trust. [This answer is incorrect. To qualify as a small business trust, all trust beneficiaries must be individuals, estates, or charitable organizations eligible to be S shareholders. They do not have to be related to whoever is establishing the trust.]

9. Stephanie is the sole shareholder of Walden, Inc., a calendar year S corporation. Stephanie desires to transfer shares to her children and employees of the company. Her goal is to transfer the shares in a way to allow flexibility as to whether income be distributed or accumulated for the benefit of the new shareholders, but not favor a particular shareholder. If the proper election is made, which entity allows Stephanie to meet her objectives? **(Page 10)**
- a. Qualified subchapter S trust. [This answer is incorrect. A qualified subchapter S trust may only have one income beneficiary during the life of the current income beneficiary, and that beneficiary is a U.S. citizen or resident. Furthermore, all of the income of the trust is, or is required to be, distributed currently to the one income beneficiary. This type of trust does not meet Stephanie's objective.]
 - b. Voting trust. [This answer is incorrect. Voting trusts are created primarily to exercise the voting power of the owned stock. Each beneficiary of the trust is considered to be a shareholder for purposes of the 100-shareholder limitation and S corporation pass-through items flow directly to the shareholders, including distributions.]
 - c. Grantor trust. [This answer is incorrect. When the owner of all income and corpus is someone other than the grantor, the trust is referred to as a "Section 678 trust." While there is no limit on the number of income beneficiaries a Section 678 trust can have, one person (the "deemed owner") must have the power to vest trust income and corpus in himself. Stephanie desires a trust which does not favor a particular shareholder.]
 - d. **Electing small business trust. [This answer is correct. An ESBT can provide that income will be distributed to (or accumulated for) one or more beneficiaries. Thus, an individual can establish a trust to hold S corporation stock and split income among family members or others who are trust beneficiaries.]**
10. A trust may elect treatment as an electing small business trust (ESBT). Which of the following statements is correct regarding the election? **(Page 10)**
- a. Beneficiaries owning more than 50% interest in trust may revoke the ESBT election. [This answer is incorrect. Once an ESBT election is made, it is revocable only with the consent of the IRS as stated in IRC Sec. 1361(c)(1)(B).]
 - b. All potential current beneficiaries must consent to the ESBT election. [This answer is incorrect. The trustee makes the ESBT election and also consents to the S election. As detailed in Reg. 1-1361-1(m)(2), only the trustee is required to consent to the S corporation election.]
 - c. **A grantor trust may elect to be treated as an ESBT. [This answer is correct. Grantor trusts are permitted to make ESBT elections. However, an ESBT election does not alter the established tax treatment of items attributable to the grantor portion of the trust. Further, if the ESBT is a grantor trust, both the trustee and the deemed owner of the trust are required to consent to the S election.]**
 - d. An ESBT election must be made by the due date of the initial trust tax return, excluding extensions. [This answer is incorrect. The ESBT election must be filed within the 16-day-and-2-month period beginning on the date S corporation stock is transferred to the trust. If the corporation is electing S status simultaneously with making the ESBT election, the election may be attached to the corporation's Form 2553 (Election by a Small Business Corporation).]

11. Which of the following statements correctly describes treatment of family members with regards to the 100-shareholder limit? **(Page 20)**
- a. The income beneficiary of a qualified subchapter S trust is treated as a separate shareholder, even if the beneficiary is a family member. [This answer is incorrect. According to Reg. 1.136-1(e)(3)(ii), a family member includes the income beneficiary of a qualified subchapter S trust (QSST) who makes the QSST election, if that income beneficiary is a family member.]
 - b. A family member may include the owner of a disregarded entity, if the owner is a family member. [This answer is correct. A family is defined as the common ancestor and all lineal descendants of the common ancestor, as well as the spouses, or former spouses, of these individuals. The owner of a disregarded entity, such as a single-member LLC, is also treated as a family member if the owner is a family member as stated in Reg. 1.136-1(e)(3)(ii).]**
 - c. Once a family member divorces, the former spouse is no longer treated as a family member. [This answer is incorrect. Members of a family include a common ancestor, any lineal descendant of the common ancestor and any spouse (or former spouse) of the common ancestor as explained in Reg. 1.136-1(e)(3)(i).]
 - d. A foster child is not included in the definition of family member. [This answer is incorrect. As detailed in Reg. 1.136-1(e)(3), an adopted child, child lawfully placed with an individual for adoption, or foster child is treated as a natural child and included in the definition of family member.]
12. An S corporation may elect to treat a subsidiary as a qualified subchapter S subsidiary (QSub). Which of the following statements correctly states QSub treatment? **(Page 26)**
- a. A QSub's assets and liabilities are treated as owned by the parent S corporation. [This answer is correct. A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation according to IRC Sec. 1361(b)(3). Therefore, transactions between the S corporation parent and QSub are not taken into account.]**
 - b. An S corporation owning more than 80% of the outstanding stock of another corporation may make a QSub election for its subsidiary. [This answer is incorrect. A QSub is a corporation that is owned 100%, not 80%, by an S corporation that has made the QSub election for that subsidiary. (An S corporation, for example, can own 100% of the stock of two subsidiaries and make a QSub election for either, neither, or both of them.)]
 - c. The S Corporation and QSub are required to file separate federal income tax returns. [This answer is incorrect. Only the parent is required to file a tax return, Form 1120S. However, a QSub will be treated as a separate corporation for employment tax (including FICA, FUTA, wage withholding) purposes.]
 - d. Accumulated earnings and profits and passive investment income of the QSub do not impact the parent S corporation. [This answer is incorrect. Items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, and debt basis) are considered items of the parent.]

MEETING THE ONE-CLASS-OF-STOCK REQUIREMENT

A small business corporation must, by definition, have only one class of stock. This section covers shareholder debt as a potential second class of stock and summarizes the one-class-of-stock rules set forth in the regulations. It also discusses when disproportionate distributions to shareholders can be treated as a second class of stock.

Voting and Nonvoting Shares

Differences in voting rights among shares of common stock do not cause the S corporation to lose its eligibility.

Governing Provisions

An S corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock.

The determination of whether all outstanding shares of stock confer identical distribution and liquidation rights is based on the "governing provisions," which include the corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to distribution and liquidation proceeds.

Stock versus Debt in an S Corporation

It is well established under IRC Sec. 385 and related case law that corporate debt can at times be treated as equity by the IRS. Problems that can arise when debt is recharacterized by the IRS as equity is covered in the following discussion.

Debt as a Second Class of Stock

Under certain circumstances, debt owed by the S corporation to one or more shareholders will be a second class of stock. An obligation (whether or not designated as debt) generally will be treated as a second class of stock if:

1. it constitutes equity or otherwise results in the holder being treated as a shareholder under general tax law, and
2. a principal purpose of the obligation is to circumvent the distribution or liquidation rights conferred by the outstanding stock or to circumvent the maximum shareholder limitation.

The S election terminates if an obligation "fails" the two previous tests and is determined to be a second class of stock. For this reason, the practitioner should be aware of factors the courts consider in determining whether an obligation is debt or equity. The Tax Court has applied various factors in concluding that the obligation under consideration was equity, including the intent of the parties, thin versus adequate capitalization, the source of repayment, and the right to enforce repayment.

Straight Debt Safe Harbor. Debt that meets the definition of "straight debt" is not a second class of stock, regardless of whether such debt is classified as equity under general tax law principles. Debt must meet the following four requirements to qualify as straight debt:

1. The debt must be a written, unconditional obligation to pay a sum certain on demand (or on a specified due date).
2. The interest rate and payment dates must not be contingent on profits, the borrower's discretion, or similar factors.
3. The debt cannot be directly or indirectly convertible into stock (or any other equity interest of the S corporation).
4. The debt must be held by (a) an individual, estate, or trust that is an eligible S corporation shareholder; or (b) creditors, other than individuals, that are actively and regularly engaged in the business of lending money (e.g., banks).

Debt does not have to be issued by an S corporation to meet the straight debt safe harbor. An obligation issued by a C corporation that satisfies the definition of straight debt is not treated as a second class of stock if the corporation later elects S status, even if the debt is considered equity under general tax law principles. In addition, conversion to S status is not treated as an exchange of debt for stock with respect to such an obligation.

Interest paid or accrued with respect to a straight debt obligation generally is treated as interest by both the corporation and the recipient, and does not constitute a distribution to the shareholder that would be taxable or nontaxable under IRC Sec. 1368. If the obligation bears an unreasonably high interest rate, a portion of the interest may be recharacterized and treated as a payment that is not interest. However, this recharacterization will not result in a second class of stock.

Example 11-1 Meeting the safe harbor debt requirements.

Pontiac, Inc., is incorporated on May 15 and immediately elects S status. Jo and Bob each buy half of the stock for \$5,000. Jo loans the corporation \$100,000, and Bob loans it \$75,000. The loans are evidenced by written notes that bear 6% interest and call for payment on demand. The debt is not convertible into stock.

The notes fulfill all of the straight debt requirements. Therefore, under the straight debt safe harbor rules of IRC Sec. 1361(c)(5) and Reg. 1.1361-1(l)(4)(i), the debt will not be classified as a second class of stock.

Example 11-2 How debt can be recharacterized as stock.

Assume the same facts as in Example 11-1 except the loans are not evidenced by written notes.

Now, the corporate debt could be considered equity because of the high ratio of debt to stock investment. Also, the debt does not meet the straight debt requirements because there are no written notes. This renders the corporation vulnerable to an IRS argument that the debt is a second class of stock. The notes will not be considered a second class of stock, however, unless (1) the debt is considered equity under general tax law principles, and (2) a principal purpose of the debt is to circumvent the single class of stock limitation. To avoid any possibility that a second class could exist, the notes should be in writing and meet the other requirements of the straight debt safe harbor contained in IRC Sec. 1361(c)(5).

Short-term Unwritten Advances (Open Accounts Loans) and Proportionately Held Debt. In addition to the safe harbor for straight debt obligations, Reg. 1.1361-1(l)(4)(ii)(B) provides the following safe harbors to prevent having certain debt treated as a second class of stock:

1. *Unwritten Advances.* Unwritten advances that: (a) do not exceed \$10,000 in the aggregate at any time; (b) are treated as debt by the parties; and (c) are expected to be repaid within a reasonable time are not treated as a second class of stock (even if considered equity under general tax law principles).
2. *Proportionately Held Debt.* Proportionately held debt includes any class of obligations that is considered equity under general tax law principles and held by the shareholders in the same proportion as the S corporation's outstanding stock. Note that debt held by a sole shareholder of an S corporation always meets the definition of proportionately held debt. Thus, debt held by shareholders in the same proportions as their stock ownership (including debt owed by the corporation to a sole shareholder) will not be considered a second class of stock.

Example 11-3 Safe harbor for unwritten advances and proportionately held debt.

Jane organizes Newco, Inc. and causes Newco to elect S status as of the beginning of its first tax year. She contributes \$50,000 in exchange for all its outstanding stock. In addition, Jane makes several advances for Newco's working capital needs. These advances are unwritten, "open account" loans and have never exceeded \$10,000 in the aggregate. The advances are recorded as shareholder loans on Newco's books, and Jane expects to be repaid within the company's normal working capital cycle. The advances are not treated as a second class of stock, even if they are treated as equity under general tax law principles. The loans satisfy the safe harbor for unwritten short-term advances (as well as the safe harbor for proportionately held debt).

If the advances did not meet requirements for either the safe harbor for unwritten advances or the safe harbor for proportionately held debt, they would not automatically be treated as a second class of stock, even if they are considered equity under general tax law principles. Debt is not treated as a second class of stock unless it has a principal purpose of circumventing the rights conferred by the corporation's outstanding stock or the limitations on eligible shareholders (including the 100-shareholder limitation).

Disproportionate Distributions to Shareholders

Although a corporation is not treated as having more than one class of stock if the governing provisions (discussed earlier in this key issue) provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given "appropriate tax effect" in accordance with the facts and circumstances.

For example, a payment of excessive compensation may be recharacterized as a distribution for which no deduction is allowed; however, neither the payment nor the distribution created by the recharacterization results in a second class of stock. Similarly, a distribution may be recharacterized in whole or in part as deductible compensation (on which FICA and FUTA taxes may be due), but any difference in distribution rights resulting from such a recharacterization will not result in a second class of stock. This may lead one to believe that the corporation can make disproportionate distributions to shareholders without terminating the corporation's S election. However, the "binding agreement" language in the regulations presents a formidable barrier.

The regulations do not require a binding agreement to be in writing. Although not explicitly stated in the regulations, it seems possible that a systematic pattern of distributions favoring one shareholder over another may create a binding agreement relating to distributions, and so terminate the corporation's S election. Furthermore, an effort to avoid classification as a "binding agreement" by including the distribution requirement in a commercial contract will not work because such a contract will be considered a "governing provision" if entered into to circumvent the one-class-of-stock requirement. Therefore, an S corporation should not make disproportionately large distributions to a shareholder on an ongoing basis.

Distributions Should Be Proportionate to Stock Ownership. Because distributions are based on the number of shares held by each shareholder, distributions should be, by their nature, proportionate to stock ownership. Aside from the possibility that disproportionate distributions will create a second class of stock, it is not clear how the accumulated adjustment account (AAA) and accumulated earnings and profits (AE&P) are treated when disproportionate distributions are made.

Example 11-4 Determining whether stock confers identical rights to distribution and liquidation proceeds.

State X's law requires corporations to pay state income taxes on behalf of nonresident shareholders, but not on behalf of resident shareholders. Under that state's law, resident shareholders have the right to distributions that take into account the payments made on behalf of nonresident shareholders (e.g., if the corporation pays \$2,000 state income tax for a nonresident shareholder, it would distribute \$2,000 to a resident shareholder who owns the same number of shares). Because all shareholders have the right to equal distributions, state law is disregarded and the S corporation does not have a second class of stock.

Variation: The shareholders of an S corporation reside in different states that levy state income tax at various rates. To equalize after-tax distributions, the corporation and shareholders agree to increase distributions to shareholders who bear a heavier state income tax burden (e.g., the corporation distributes \$2,000 to a shareholder who pays no state tax and \$2,200 to an equal shareholder who will pay \$200 state tax on the distribution). The agreement alters the rights to distributions conferred by the outstanding stock, and thus is a binding agreement relating to distributions. The S corporation is treated as having a second class of stock.

Distributions That Differ in Timing. As stated earlier, an S corporation is treated as having only one class of stock if the governing provisions provide all outstanding shares with identical rights to distribution and liquidation proceeds. Differences in the timing of distributions do not result in a second class of stock unless they occur because of a binding agreement that relates to distribution or liquidation proceeds.

Example 11-5 Distributions that differ in timing.

Essco, Inc., an S corporation, has two equal shareholders, Al and Bill. Under Essco's bylaws, Al and Bill are entitled to equal distributions. Essco distributes \$50,000 to Al during the year, but does not distribute \$50,000 to Bill until the following tax year. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

Under the regulations, the difference in timing of the distributions to Al and Bill does not cause Essco to be treated as having more than one class of stock. While the S election is unaffected, Bill may be treated as making a non-interest-bearing \$50,000 loan to the corporation for the period between the dates of the two distributions. (On the other hand, it is important to note that a systematic pattern of distributions favoring one shareholder or group of shareholders could be considered a "binding agreement relating to distributions" that would terminate the corporation's S election.)

Correcting Erroneous Disproportionate Distributions. The IRS has held that erroneous disproportionate distributions do not cause a second class of stock if the governing provisions provide for identical distributions and liquidation rights. In these letter rulings, the shareholders were unaware that distributions had to be proportionate to stock ownership and the corporation incorrectly made disproportionate distributions for a period of years. After the errors were discovered, distributions were made to even out the original disproportionate distributions. The IRS ruled that neither the original nor the correcting disproportionate distributions resulted in a second class of stock because the shareholders were entitled to equal distributions under the corporation's governing provisions.

Example 11-6 Correcting erroneous disproportionate distributions.

ABC Corp, an S corporation, has two equal shareholders, Art and Brenda. The corporation's governing provisions provide that each shareholder has equal distribution and liquidation rights. Each year for three years, the corporation distributes \$10,000 to Art and \$25,000 to Brenda. In the fourth year, the error is discovered and the corporation distributes \$45,000 to Art and nothing to Brenda, so that over the three years, each shareholder received distributions of \$75,000. Under the letter rulings referred to in the previous paragraph, the corporation does not have a second class of stock.

Employment Agreements and Other Commercial Contractual Agreements

A commercial contractual agreement (such as an employment agreement, lease, or loan agreement) is not a governing provision (discussed under "One Class of Stock—General Rules" earlier in this lesson) unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

Example 11-7 Waiver of distribution rights by shareholders contributing property.

Al, Brad, and Charlotte are unrelated individuals who agree to form ABC, Inc., which they intend to be an S corporation. Their agreement calls for Al and Brad each to contribute \$20,000 cash and for Charlotte to contribute office equipment worth \$20,000.

ABC, Inc. is organized in State A, which requires permission before the corporation can issue stock. ABC is granted permission to issue stock, subject to the restriction that any person who is issued stock in exchange for property other than cash must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions. How will this restriction affect ABC's proposed S election?

The conditions imposed by State A are "governing provisions" that alter the rights to distribution and liquidation proceeds so that those rights are not the same with respect to each outstanding share of stock. ABC is treated as having more than one class of stock and does not qualify as a small business corporation.

Variation: If Charlotte contributed \$20,000 cash instead of office equipment, ABC would qualify for S status. The corporation could then use \$20,000 of the contribution to buy the office equipment from Charlotte. The rules covering sales to related parties would not apply because Charlotte is not related to the other shareholders and does not own more than 50% of the corporation's shares.

Example 11-8 Employment agreement is not a second class of stock.

Jane is the sole shareholder of JJ, Inc., an S corporation, and has been the corporation's chief executive officer for the last five years. JJ enters into an agreement with Jane that provides she will serve as the CEO for the next 10 years. She will receive a salary of \$90,000 the first year, which will be adjusted to reflect the cost of living during the agreement's remaining years. Jane will continue to receive benefits existing at the date the agreement was signed and may receive bonuses as determined by the board of directors.

Jane will receive certain payments if she dies or becomes disabled or if there is a change in the control of JJ. If her employment is terminated for other reasons, she will receive no payments after the termination.

Under these facts, the IRS ruled that the agreement did not represent a second class of stock. An employment agreement is not a binding agreement relating to distribution and liquidation proceeds. The ruling did state, however, that the shareholder/employee (Jane) and the corporation (JJ) represented that the principal purpose of the agreement was not to circumvent the one-class-of-stock requirement.

Shares Taken into Account

All outstanding shares of stock are taken into account in determining whether a corporation has more than one class of stock. Authorized but unissued shares are not considered outstanding stock. Therefore, they are not taken into account when determining if a corporation has a second class of stock.

Example 11-9 Unissued shares are not outstanding stock.

Keyco was incorporated May 25 of the current year and immediately filed an S election. Keyco's organizing documents provided for Class A and Class B stock. The Class A stock was voting common stock with a right to distributions. The Class B stock was nonvoting common stock with no right to distributions. On May 25, Keyco issued 100 shares of Class A stock to each of its shareholders. No Class B stock was issued on May 25 or at any time thereafter. On December 10, Keyco eliminated all distribution preferences between the Class A stock and Class B stock. Because no Class B stock was outstanding from the date of incorporation to the date all distribution preferences were eliminated, it is disregarded in determining whether Keyco had a second class of stock outstanding.

Restricted Stock. Stock governed by IRC Sec. 83, commonly referred to as "restricted stock," may or may not be treated as outstanding. That is, stock issued in connection with the performance of services (including services that are not performed for the corporation) and substantially nonvested [within the meaning of Reg. 1.83-3(b)] is not treated as outstanding unless the holder makes a Section 83(b) election.

Existing substantially nonvested stock that has been treated as outstanding is treated as outstanding for purposes of Subchapter S. However, the fact that such stock is substantially nonvested and no Section 83(b) election has been made does not cause the stock to be treated as a second class of stock. A history of issuing a Schedule K-1 with respect to the stock is evidence that the corporation has treated the nonvested stock as outstanding.

Shareholder Buy/Sell Agreements and Redemption Agreements

The following types of shareholder buy/sell or corporate redemption agreements are *disregarded* when determining whether the corporation has more than one class of stock:

1. *Bona fide* agreements to redeem or purchase stock on account of a shareholder's death, divorce, disability, or termination of employment.
2. Buy/sell agreements among the shareholders, agreements restricting the transfer of stock, and redemption agreements, unless a principal purpose of the agreement is to circumvent the one-class-of-stock requirement and the agreement establishes a purchase or redemption price (at the time the agreement is entered into) that is significantly in excess of or below the FMV of the stock. A safe harbor is provided for agreements that establish a purchase or redemption price between the book value and FMV of the stock. A determination of book value is respected if computed in accordance with Generally Accepted Accounting

Principles (GAAP), or if used for any substantial nontax purpose. Furthermore, a good faith determination of FMV is respected unless the value is substantially in error and was not determined with reasonable diligence.

3. Buy/sell agreements, agreements restricting the transfer of stock, and redemption agreements that are entered into before May 28, 1992 and are not materially modified after that date. For example, a buy/sell agreement entered into before May 28, 1992, will evidently be disregarded when determining whether there is more than one class of stock, as long as the agreement was not materially modified after May 28, 1992.

Example 11-10 Stock redemption agreement triggered by termination of employment.

Alice owns 25% of the outstanding shares of ABC, Inc., an S corporation. She is also an employee of ABC. (Alice's stock was not issued to her in exchange for services.) By agreement, ABC will redeem Alice's shares for an amount significantly below their FMV if Alice's employment is terminated or if ABC's sales fall below specified levels.

The portion of the agreement providing for the redemption of ABC's stock upon termination of employment is disregarded for purposes of the one-class-of-stock requirement. The portion of the agreement providing for the redemption of ABC's stock if sales fall below certain levels is also disregarded unless a principal purpose of that stipulation is to circumvent the one-class-of-stock requirement.

Options and Warrants

Under the regulations, a call option, warrant, or similar instrument will be treated as a second class of stock if it is substantially certain to be exercised and has a strike price substantially below the FMV of the underlying stock on the date the option is issued, transferred to an ineligible S corporation shareholder, or materially modified.

Safe harbors are provided for the following options or warrants:

1. An option or warrant that has a strike price of at least 90% of the FMV of the underlying stock on the date the option is issued, transferred to an ineligible shareholder, or materially modified. The IRS must respect a good faith determination of FMV unless the value is substantially in error and was not determined with reasonable diligence. An option that does not meet this safe harbor will not automatically be treated as a second class of stock—for this to happen it must also be proven that the option is substantially certain to be exercised, based on all of the facts and circumstances.
2. An option or warrant issued to an employee or independent contractor in connection with the performance of services for the corporation (or a related corporation) that is nontransferable and does not have a readily ascertainable FMV on the date that it is issued. (For these purposes, the regulations state that a corporation is "related" to the issuing corporation if more than 50% of the total voting power and total value of its stock is owned by the issuing corporation.)
3. An option or warrant issued to a commercial lender in connection with a commercially reasonable loan to the corporation. (A call option and accompanying loan can be transferred from one lender to another lender and remain within the scope of this safe harbor.)

Example 11-11 Stock option with strike price less than FMV of underlying stock.

An S corporation issues an option to an individual who is neither a shareholder nor an employee of the corporation. The option has a strike price of \$50 per share and is issued on a date when the FMV of the corporation's stock is also \$50 per share. One year later the option is sold to a partnership at a time when the FMV of the corporation's stock is \$70 per share. Since the strike price is less than 90% of the FMV of the underlying stock on the date the option is transferred to an ineligible shareholder, the call option is treated as a second class of stock if it is substantially certain to be exercised, based on the facts and circumstances.

Example 11-12 Employee incentive stock option plans.

Swan Lake, Inc., an S corporation, adopted an incentive stock option plan. When the employees exercise their options, Swan Lake will issue common shares (the "Option Shares"). The Option Shares will be identical

to all other outstanding shares and will entitle employees to the same voting, liquidation, title, and other rights held by all other shareholders. Option Shares, however, will be subject to a buy-back agreement that allows Swan Lake to repurchase the Option Shares at the option exercise price if an employee terminates employment before a certain date. The employee's right to transfer or pledge the Option Shares will be restricted until Swan Lake's right to repurchase expires.

Under similar facts, the IRS ruled that an employee who exercised the option and purchased Option Shares would be treated as a shareholder. Furthermore, the restrictions imposed on the Option Shares are disregarded when determining whether the shares confer identical rights to distribution and liquidation proceeds because they arise from a *bona fide* buy/sell agreement to redeem or purchase stock at the time of death, divorce, disability, or termination of employment. (See discussion earlier in this lesson.) Thus neither the option plan nor the Option Shares represent a second class of stock.

Example 11-13 Stock option issued to employee.

An S corporation issues an option to an employee in connection with the performance of services for the corporation. At the time it is issued, the option is not transferable and does not have a readily ascertainable FMV; however, the option becomes transferable before it is exercised. Once the option becomes transferable, the safe harbor no longer applies, and the general rules apply. Accordingly, the option will create a second class of stock if it: (1) is transferred to an ineligible S corporation shareholder or materially modified; or (2) is substantially certain to be exercised and has a strike price substantially below the FMV of the underlying stock on the date the option is transferred or modified.

The regulations clarify that the safe harbor is not affected by termination of employment (or independent contractor status). If the employee terminates employment with the S corporation prior to the date the option becomes transferable, the safe harbor will continue to apply until the date the option becomes transferable.

Nonqualified Deferred Compensation Plans

The IRS has ruled that certain types of nonqualified deferred compensation plans do not create a second class of stock.

Effective Date of One-class-of-stock Regulations

The one-class-of-stock regulations do not apply to instruments, obligations, or agreements issued or entered into before May 28, 1992 (and not modified on or after such date). Corporations and their shareholders may apply these regulations to prior tax years. Apparently, there is no formal election or notification requirement in order to apply the regulations to prior tax years.

Availability of Inadvertent Termination Relief

A corporation that has elected S status and subsequently is treated as having more than one class of stock loses its S corporation status. In such a case, the corporation's S election terminates on the date the corporation is treated as having more than one class of stock. Inadvertent termination relief pursuant to IRC Sec. 1362(f) will be available in appropriate cases. In general, a corporation that qualifies under IRC Sec. 1362(f) will have its S status restored retroactive to the date the S election was terminated.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Starlight, Inc. is a start-up company which elected to be treated as a small business corporation for their initial tax year. Starlight has two unequal shareholders, Bob and Clara. Clara loaned Starlight \$100,000 for use in the business. Clara is an eligible S corporation shareholder. The loan is evidenced by written documentation, pays a variable interest rate based on prime, payment dates not contingent on profits, and convertible into stock if not repaid within five years. Does the loan meet the definition of straight debt and qualify for a straight debt safe harbor?
 - a. Yes.
 - b. No.
14. Joanne and Ellen form Mina's Studio, Inc., and elect to be treated as a small business corporation. Joanne and Ellen own the company equally and each pay \$5,000 for their stock. In addition, each shareholder loans the S corporation \$20,000 to start up the business. The shareholders do not have a written loan agreement but agree on a marketable interest rate and payment terms. Which of the following safe harbor provisions would this loan satisfy?
 - a. Unwritten advances.
 - b. Proportionately held debt.
15. Which of the following shareholder agreements would keep the company from qualifying for one class of stock?
 - a. Jackie is a 10% shareholder in White Enamel. She signs an agreement with the company to redeem her stock at termination of employment for its fair market value.
 - b. Ron and his son, Jack, own Howard Enterprises. Ron contributed all the upfront capital to start the business. As opposed to providing Ron a preferred return on his investment, the corporation enters into an agreement to purchase his stock at retirement for 150% of its fair market value.
 - c. Bark Unlimited is owned by 100 unrelated shareholders. It enters into an agreement with each shareholder to purchase his or her stock in the event a shareholder divorces their spouse.
 - d. Jerry and Bobby are equal shareholders in Blue Ridge Excursions. Both shareholders enter into agreement with the corporation to purchase their stock at death or disability at a purchase price equal to the corporation's net book value.
16. Which of the following options or warrants will be treated as a second class of stock?
 - a. Skylar, a 10% shareholder of Aircraft Systems, is issued an option to purchase 500 shares at a strike price of 100% of the fair market value of the underlying stock.
 - b. Brett, an independent contractor, is issued a nontransferable option to purchase 1,000 shares in connection with the performance of services for Duckies, Inc., a non-publicly traded corporation.
 - c. Anne, an employee of Clean Water, is issued an option to purchase 250 shares of Wyatt, Inc. at a strike price of 80% of the fair market value of the underlying stock.
 - d. New Crest Bank is issued a warrant to purchase 10,000 shares of Bedford Inc. in connection with a short-term loan at a competitive market rate and payment terms.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Starlight, Inc. is a start-up company which elected to be treated as a small business corporation for their initial tax year. Starlight has two unequal shareholders, Bob and Clara. Clara loaned Starlight \$100,000 for use in the business. Clara is an eligible S corporation shareholder. The loan is evidenced by written documentation, pays a variable interest rate based on prime, payment dates not contingent on profits, and convertible into stock if not repaid within five years. Does the loan meet the definition of straight debt and qualify for a straight debt safe harbor? **(Page 35)**
 - a. Yes. [This answer is incorrect. For a loan to qualify for the straight debt safe harbor, it must meet four requirements. Clara's loan to Starlight meets three out of four of the requirements detailed in IRC Sec. 1361(c)(5)(B). By not meeting the forth requirement, Clara does not qualify for the straight debt safe harbor.]
 - b. **No. [This answer is correct. As explained IRC Sec. 1361(c)(5)(B), there are four requirements that must be met for debt to qualify as straight debt. Clara's loan to Starlight meets three of the requirements: (1) the debt evidenced by written documentation, (2) the payment dates were not contingent on profits, and (3) the debt was held by Clara, who is an eligible S corporation shareholder. The debt did not meet the fourth requirement. The debt was convertible into stock if not repaid within five years, and this is not allowed to be considered straight debt and qualify for the safe harbor.]**
14. Joanne and Ellen form Mina's Studio, Inc., and elect to be treated as a small business corporation. Joanne and Ellen own the company equally and each pay \$5,000 for their stock. In addition, each shareholder loans the S corporation \$20,000 to start up the business. The shareholders do not have a written loan agreement but agree on a marketable interest rate and payment terms. Which of the following safe harbor provisions would this loan satisfy? **(Page 35)**
 - a. Unwritten advances. [This answer is incorrect. Unwritten advances that: (a) do not exceed \$10,000 in the aggregate at any time; (b) are treated as debt by the parties; and (c) are expected to be repaid within a reasonable time are not treated as a second class of stock (even if considered equity under general tax law principles). Joanne and Ellen each loaned the S corporation \$20,000 which is greater than the safe harbor amount.]
 - b. **Proportionately held debt. [This answer is correct. According to Reg. 1.1361-1(l)(4)(ii)(B), proportionately held debt includes any class of obligations that is considered equity under general tax law principles and held by the shareholders in the same proportion as the S corporation's outstanding stock. Proportionately held debt is another safe harbor to prevent debt treated as a second class of stock.]**
15. Which of the following shareholder agreements would keep the company from qualifying for one class of stock? **(Page 35)**
 - a. Jackie is a 10% shareholder in White Enamel. She signs an agreement with the company to redeem her stock at termination of employment for its fair market value. [This answer is incorrect. Bona fide agreements to redeem or purchase stock on account of a shareholder's termination of employment are disregarded when determining whether the corporation has more than one class of stock as detailed in Reg. 1.1361-1(l)(2)(iii).]

- b. **Ron and his son, Jack, own Howard Enterprises. Ron contributed all the upfront capital to start the business. As opposed to providing Ron a preferred return on his investment, the corporation enters into an agreement to purchase his stock at retirement for 150% of its fair market value. [This answer is correct. This agreement will be considered when determining whether the corporation has more than one class of stock. The principal purpose of the agreement is to circumvent the one-class-of-stock requirement (provide Ron with a preferred return) and the agreement establishes a purchase or redemption price (at the time the agreement is entered into) that is significantly in excess of or below the FMV of the stock.]**
 - c. Bark Unlimited is owned by 100 unrelated shareholders. It enters into an agreement with each shareholder to purchase his or her stock in the event a shareholder divorces their spouse. [This answer is incorrect. A corporation may enter into an agreement with shareholders to purchase or redeem their stock in the event of divorce in order to avoid an inadvertent termination of the S election as stated in Reg. 1.1361-1(l)(2)(iii).]
 - d. Jerry and Bobby are equal shareholders in Blue Ridge Excursions. Both shareholders enter into agreement with the corporation to purchase their stock at death or disability at a purchase price equal to the corporation's net book value. [This answer is incorrect. A safe harbor is provided for agreements that establish a purchase or redemption price between the book value and FMV of the stock. A determination of book value is respected if computed in accordance with Generally Accepted Accounting Principles (GAAP), or if used for any substantial nontax purpose as determined by Reg. 1.1361-1(l)(2)(iii).]
16. Which of the following options or warrants will be treated as a second class of stock? **(Page 35)**
- a. Skylar, a 10% shareholder of Aircraft Systems, is issued an option to purchase 500 shares at a strike price of 100% of the fair market value of the underlying stock. [This answer is incorrect. An option issued at a strike price equal to the fair market value of the underlying stock will not constitute a second class of stock. It is uncertain as to whether the option will be exercised since the two values are equal. Options are generally exercised once the fair market value of the underlying stock exceeds the strike price.]
 - b. Brett, an independent contractor, is issued a nontransferable option to purchase 1,000 shares in connection with the performance of services for Duckies, Inc., a non-publicly traded corporation. [This answer is incorrect. A second class of stock does not include an option or warrant issued to an employee or independent contractor in connection with the performance of services for the corporation (or a related corporation) that is nontransferable and does not have a readily ascertainable FMV on the date that it is issued. Readily ascertainable value generally means an option which is publicly traded.]
 - c. **Anne, an employee of Clean Water, is issued an option to purchase 250 shares of Wyatt, Inc. at a strike price of 80% of the fair market value of the underlying stock. [This answer is correct. An option or warrant that has a strike price less than 90% of the FMV of the underlying stock on the date the option is issued, transferred to an ineligible shareholder, or materially modified is considered a second class of stock as stated in Reg. 1.136-1(l)(4)(iii).]**
 - d. New Crest Bank is issued a warrant to purchase 10,000 shares of Bedford Inc. in connection with a short-term loan at a competitive market rate and payment terms. [This answer is incorrect. A second class of stock will not include an option or warrant issued to a commercial lender in connection with a commercially reasonable loan to the corporation. (A call option and accompanying loan can be transferred from one lender to another lender and remain within the scope of this safe harbor.)]

EXAMINATION FOR CPE CREDIT**Lesson 1 (T2STG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following entities is an ineligible shareholder of an S Corporation?
 - a. Tax-exempt charitable organization.
 - b. Individual retirement account.
 - c. Estate of a deceased shareholder.
 - d. An individual who is a citizen of the United States.
2. Which of the following situations violate the 100 shareholder rule?
 - a. Avista, Inc. is owned by 100 unrelated individuals. Jim transfers 10 of his 50 shares to Scott, a business associate, as tenants in common.
 - b. Windstorm Electronics, Inc. is owned by 99 unrelated shareholders. Rob transfers 100 shares to his wife, Kim, as joint tenants, and 100 shares to a custodial account for the benefit of his minor child.
 - c. Black, Inc. is owned by 55 shareholders and White, Inc. is owned by 60 shareholders (all unrelated shareholders). Black, Inc. and White, Inc. form a partnership to manage their rental properties.
 - d. Birdie Development is owned 100% by John Armstrong. John dies two months into the calendar year and his estate succeeds to his interest.
3. Certain corporations are statutorily ineligible to elect S status. These corporations include all of the following, **except**?
 - a. A corporation electing to use the possessions tax credit under IRC Sec. 936.
 - b. A domestic international sales corporation (DISC) or former DISC.
 - c. A financial institution that uses the reserve method of accounting for bad debts under IRC Sec. 585.
 - d. A corporation registered in a foreign country which meets all of the other small business corporation requirements.
4. Which of the following trusts may name successive beneficiaries?
 - a. Voting trust.
 - b. Grantor trust.
 - c. Electing small business trust (ESBT).
 - d. Testamentary trust.

5. Matthew is the sole beneficiary of the Potter Trust, a qualified subchapter S trust (QSST). During the year, Lightyear International, Inc. passes through ordinary income of \$25,000 and tax-exempt income of \$10,000 to the Potter Trust and makes distributions to the trust of \$17,000. What amount is the trust required to distribute to Matthew to comply with the current distribution rule?
- a. \$10,000.
 - b. \$17,000.
 - c. \$25,000.
 - d. \$35,000.
6. Purple Puddle, Inc., an S Corporation, inadvertently terminated its S election because the income beneficiary of the Poole Trust failed to timely file a QSST election. Which of the following items is **not** a requirement for relief under Rev. Proc. 2003-43 for the late QSST election?
- a. The corporation's S status is terminated solely because the beneficiary of the QSST failed to file a timely QSST election.
 - b. Less than 36 months have passed since the original due date of the QSST election.
 - c. The shareholder's have reported all pass-through items of income and loss on their tax returns.
 - d. Schedule K-1s have been issued to the shareholders.
7. John Keyes purchased a 10% income interest in Blue Water Trust on June 15. The trust provisions provide income will be distributed or accumulated at the discretion of the trustee. John requests the trustee file an electing small business trust (ESBT) election. The trustee files the election by August 1. The trust does not qualify as an electing small business trust for one of the following reasons?
- a. The trust may not have multiple income beneficiaries.
 - b. The trustee failed to file the election within the time period required by the IRS.
 - c. An interest in trust may not be acquired by purchase.
 - d. The trustee may not have discretion as to the distribution or accumulation of trust income.
8. Livewell Trust owns various marketable securities and fixed income positions as well as an interest in Veggies Galore, Inc., a locally owned and operated S corporation. The trust elected to be treated as an ESBT. Livewell Trust earned \$5,000 dividend income and \$15,000 interest income from non-S corporation assets and distributed \$20,000 to its beneficiary. In addition, the trust was allocated \$30,000 ordinary income from Veggies Galore and distributed \$17,500 to its beneficiary. What amount will the trust be taxed on from its income from Veggies Galore?
- a. \$12,500.
 - b. \$17,500.
 - c. \$20,000.
 - d. \$30,000.

9. A trust was set up on January 1, 2010 as an ESBT. The trustee of the trust decided for the trust to purchase stock in an S corporation on February 1, 2010. The trust received the stock from the S corporation on March 1, 2010. For the trust to be eligible to be treated as an eligible S shareholder, when must the trustee file the election by?
- a. January 1, 2010.
 - b. February 14, 2010.
 - c. May 16, 2010.
 - d. December 31, 2010.
10. Family members are treated as one shareholder for which of the following purposes?
- a. 100-shareholder limit.
 - b. Consent to the S election.
 - c. Pass-through of S corporation income/(loss).
 - d. S corporation distributions.
11. Dew Corp. is a calendar year S Corporation with 102 shareholders, made up of 88 unmarried and unrelated shareholders and 7 unrelated husbands and their wives who each own stock in the company. In the last month of the calendar year, Charlie and Sue finalize their divorce and each continues to own shares in Dew. How many shareholders does Dew have for purposes of the 100-shareholder limit after the divorce is finalized?
- a. 95.
 - b. 96.
 - c. 102.
 - d. 103.
12. Which of the following statements is correct regarding an S corporation's ownership structure?
- a. An employee stock ownership plan (ESOP) may hold S corporation stock and is subject to the unrelated business taxable income (UBTI) rules.
 - b. Separate S corporations may combine to form a general partnership.
 - c. An S corporation may not be a member of a tiered ownership structure.
 - d. A qualified retirement plan may hold S corporation stock and is not subject to the unrelated business taxable income (UBTI) rules.
13. Which of the following statements about stock ownership is not correct?
- a. A single member LLC can be an S corporation shareholder.
 - b. An S corporation can own stock of a C corporation.
 - c. An S corporation can own stock of a qualified subchapter S subsidiary.
 - d. A C corporation can own stock of an S corporation.

14. A S corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. This determination is based on the "governing provisions." Which of the following is not included in the governing provisions?
- a. Articles of incorporation.
 - b. Corporate charter.
 - c. Employment agreement.
 - d. Corporate bylaws.
15. The Tax Court has applied various factors when determining whether S corporation debt is a second class of stock, including all of the following, *except*?
- a. Intent of the parties.
 - b. Right to enforce payment.
 - c. Source of repayment.
 - d. Service business model.
16. A portion of the payments received on a straight debt obligation which bears an unreasonably high interest rate will be treated as interest. How will the other portion be treated?
- a. As a second class of stock.
 - b. As tax-exempt interest.
 - c. As a payment that is not interest.
 - d. As taxable interest.
17. Baldhead Corp., an S corporation, has 2 equal shareholders: Chris lives in a state without an income tax and Susie lives in a state with a 7.75% income tax rate. As a result, it pays a \$25,000 distribution to Chris to cover his federal tax liability related to Baldhead, and it pays a \$30,000 distribution to Suzie to cover her federal and state income taxes related to Baldhead's income. Suzie receives her distribution at the end of the tax year and Chris receives his distribution the following tax year. Their after-tax distribution is equal. Will Baldhead be considered as having 2 classes of stock as a result of this arrangement?
- a. Yes, distribution is disproportionate.
 - b. No, their after-tax distribution is equal.
 - c. No, pass-through income is allocated according to ownership percentage.
 - d. Yes, the distributions differ in timing.

Lesson 2: Filing and Repairing the S Election

INTRODUCTION

Although filing an S election on Form 2553 (Election by a Small Business Corporation) is often viewed as a straightforward task, there are some practical questions associated with S election procedures. Measuring the 15th-day-of-the third-month deadline for election can often be confusing with newly formed entities. Severe consequences can result if the corporation is required to operate as a C corporation because of an ineffective S election. Fortunately, remedies may be available to mitigate the damage from a missed S election deadline.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the deadlines and forms required when filing an S election and determining when the initial tax year begins for the new S corporation.
- Recognize the methods for obtaining relief from a late or invalid S election.
- Determine the requirements for an LLC to elect S status.

FORM 2553 AND FILING THE S ELECTION

Form 2553

A corporation elects to operate as an S corporation by filing Form 2553 (Election by a Small Business Corporation).

S Election Remains in Effect until Terminated

Once made, the S election remains in effect until it is voluntarily or involuntarily terminated. Changes in ownership of S corporation stock have no effect on the S election, so long as all of the stock is owned by individuals or other entities eligible to be S shareholders. (Eligible shareholders are discussed in Lesson 1.)

When S Election Form Is Filed

The deadline for filing the Form 2553 differs depending on whether the corporation is already in existence (i.e., operating as a C corporation) or newly formed.

Existing Corporations

For an existing C corporation electing S status, the election must be filed:

1. during the tax year preceding the first tax year the S election is to be effective, or
2. on or before the 15th day of the third month of the initial S year.

Thus, the S election can be retroactive to the first of the tax year if the election is filed within 2 months and 15 days after the beginning of the tax year. However, the S election is retroactive to the first day of the tax year only if the electing corporation qualifies as a small business corporation on the first day of the tax year and on each day until the election is filed.

When an existing corporation becomes an S corporation, S status begins on the day following the last day of the C corporation's tax year.

Newly Formed Corporations

For a newly formed corporation, the election must be filed on or before the 15th day of the third month following the "activation date" of the corporation. The regulations indicate that the activation date is the earliest date that the

corporation has shareholders, acquires assets, or begins conducting business. Care must be taken to ensure that the S election is not filed before the corporation is in existence (i.e., before the charter or articles are registered with and authorized by the Secretary of State in the state of incorporation.) Both IRS regulations and case law hold that an S election is not valid if the corporation is not in existence at the time the election is filed.

The S corporation's first tax year begins on its activation date. (See Example 2A-1.)

Example 2A-1 Determining the election deadline for a newly formed corporation.

CSM, Inc. is a newly formed corporation for which the three shareholders intend to file an S election. CSM was incorporated on March 9, 2010 (the date the articles of incorporation were accepted and authorized by the Secretary of State for the jurisdiction of incorporation). CSM opened its checking account on March 11; its shareholders had been investigating and preparing for business activity even before the articles were filed on March 9. The shareholders advanced their capital on March 11, but as of late May, the attorney still had not completed the paperwork to issue the shares of stock.

Before measuring the 2-month-and-15-day deadline, CSM must identify its activation date. Usually, the earliest of the three dates (i.e., the date the corporation has shareholders, acquires assets, or begins doing business) will be determined by reference to the legal incorporation process. In a 1972 Revenue Ruling, the IRS looked to the law of the state in which the incorporation had occurred to determine the start of corporate legal existence. In that state, corporate existence began when the articles of incorporation were filed with the secretary of state. The stock subscribers were deemed to be shareholders as of that date, even though the corporate stock had not actually been issued. This interpretation was also applied in a 1969 Tax Court case.

Under its state law, CSM is considered to have shareholders on its incorporation date, March 9, 2010. For purposes of measuring the 2-month-and-15-day deadline, the term "month" is defined as the period starting on the day within the calendar month that is numerically equal to the first day of the tax year and ending on the day before the same numerical day in the next calendar month. Since most newly formed corporations do not begin their first tax year on the first day of a calendar month, the election deadline will not necessarily fall on the 15th of a given month. Thus, to measure the 2-month-and-15-day deadline from an activation date of March 9, the regulations consider April 8 as the end of the first month and May 8 as the second month end; the remaining 15 days would expire on May 23. CSM must file its S election (Form 2553) on or before May 23, 2010.

If the 2-month-and-15-day deadline falls on a Saturday, Sunday, or legal holiday, IRC Sec. 7503 applies to extend the filing period to the next business day.

CSM elects to use a calendar year. Its first tax year begins on its activation date, March 9, and ends on December 31, 2010.

Example 2A-2 Filing the S election when first corporate year is 2½ months or less.

Bellco was incorporated on November 1, 2010, and intends to use a calendar tax year. If the shareholders intend to elect S status for the first short-year return, by when must the election be filed?

The regulations indicate that for a short year of 2½ months or less, the election must be made before the 16th day of the third month after the first day of the tax year. Accordingly, the shareholders and corporation would have until January 15, 2011, to elect S status. The period within which the election must be made is never shorter than 2½ months.

The shareholders have great flexibility in this situation. An S election filed between January 1 and January 15, 2011, could specify an effective date of (1) November 1, 2010 (the corporation would be an S corporation for its first short year and thereafter); (2) January 1, 2011 (the corporation would be a C corporation from November 1 through December 31, 2010, and an S corporation thereafter); or (3) January 1, 2012 (the corporation would be a C corporation for the short year ending December 31, 2010, and the 2011 calendar year, and an S corporation thereafter). The shareholders may wish to retain flexibility on this decision by not electing until early January to determine if the actual November and December 2010 operating results of the corporation are best reported under C or S status.

If the corporation opts for either the second or third alternative, it will be a C corporation for a short time before the S election becomes effective. In that event, the S corporation will be subject to the built-in gains tax, and the effects of that tax must be considered when deciding when S status should begin. Furthermore, the C corporation can generate accumulated earnings and profits (AE&P) that can cause distributions of taxable dividends to the S corporation shareholders.

Example 2A-3 Filing the S election before formal incorporation occurs.

The shareholders of a newly formed corporation mail Form 2553 to the IRS on March 2, 2009. However, they do not file the articles of incorporation with the Secretary of State until March 13 (which under state law in the state of incorporation is the date the corporate existence begins and the corporation has shareholders). In this situation, the S election is invalid because it was filed before the company became a corporation.

The proper beginning of the S corporation's tax year is March 13. The two-month-and-15-day period beginning on that date ends on May 27. The corporation can file a new Form 2553 on or before May 27 showing an effective date of March 13. The new form should be completely filled out and include all of the required shareholder consents. A letter explaining that the first form was prematurely submitted should be attached to the Form 2553. If the error was discovered after May 27, the corporation could request relief from the invalid election, as discussed later in this lesson.

Example 2A-4 Filing the S election before the corporation begins business.

The shareholders of a newly formed corporation file the articles of incorporation with the Secretary of State on March 2, 2010, and mail Form 2553 to the IRS the next day. However, the corporation does not have shareholders until March 13 and does not acquire assets and begin transacting business until March 25, 2010. Although filed after the date of incorporation, the S election is invalid because it was filed before the beginning of the corporation's first tax year. [In some states, the filing of articles of incorporation with the Secretary of State begins the corporate existence, with the stock subscribers deemed to be shareholders as of that date, even though the corporate stock has not actually been issued.]

The proper beginning of the S corporation's tax year is March 13. The two-month-and-15-day period beginning on that date ends on May 27. The corporation can file a new Form 2553 before May 27 showing an effective date of March 13. The new form should be completely filled out and include all of the required shareholder consents. A letter explaining that the first form was prematurely submitted should be attached to the Form 2553. If the error was discovered after May 28, the corporation could request relief from the invalid election, as discussed later in this lesson.

The S Election Is Made on Form 2553

To make the election to become an S corporation, Form 2553 is filed with the IRS. Three separate compliance matters occur with the filing of this form: (1) the election of the corporation to adopt S status (evidenced by the signature of an officer at the bottom of the first page of the form), (2) the consent of all the shareholders of the corporation (evidenced by their signatures in column K), and (3) selection of the S corporation tax year (designated at line F.) If not made on Form 2553, a shareholder consent can be made on a separate statement, which must be signed by the shareholder and include the name, address, taxpayer identification numbers of the corporation and the shareholder, the number of shares owned by the shareholder, the date of stock acquisition, and the date on which the shareholder's tax year ends. Shareholder consent is binding and may not be withdrawn after a valid election is made by the corporation.

Persons Required to Consent to the S Election

All persons who are shareholders on the date the S election is filed must consent to the election. Consents are also required from anyone who held shares at any time from the beginning of the tax year through the day the S election is filed. Shareholders who acquire stock after the S election is filed need not consent.

The following rules apply in determining who is required to consent to the S election:

1. *Spousal and Joint Ownership of S Stock.* Each person having a community interest in the stock (or income therefrom) and each tenant in common, joint tenant, and tenant by the entirety must consent to the election.

Each person with an interest in the stock must separately consent to the election, even though (as in the case of spouses and family members) the individuals are counted as one shareholder for purposes of the 100-shareholder limit.

2. *Minor.* A minor or the minor's legal representative must consent to the election. If no legal representative has been appointed and the minor cannot sign or is otherwise unable to consent, the consent is made by the minor's natural or adoptive parent.
3. *Estate.* The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary duly appointed and having jurisdiction over the administration of the estate. In the case of a bankruptcy estate, the trustee consents to the S election.
4. *Trust.* For a trust [other than an electing small business trust (ESBT)] that is an eligible S corporation shareholder, the persons treated as shareholders for purposes of the 100-shareholder limitation under IRC Sec. 1361(b)(1) must consent to the election. For married shareholders, both husband and wife must consent to the election if they have a community interest in the trust. The trustee of an ESBT consents to the election.
5. *Family Ownership.* As discussed in lesson 1, all family members are treated as one shareholder for purposes of determining the number of shareholders in the corporation. For shareholder consent signatures, however, each person holding an interest in the S corporation's stock must sign the consent.

Example 2A-5 Obtaining proper spousal consents.

Essco, Inc. meets all the requirements necessary to qualify for S status, and the shareholders want the corporation to make the S election for the coming calendar year. The tax practitioner learns that the corporation has 1,000 shares outstanding. Keith and Mary Cousins hold 600 shares as joint tenants with right of survivorship (often abbreviated as JTROS or JTWROS). The remaining 400 shares are in the name of Joan Smith. Joan is married to Samuel Smith and the shares are community property under state law. While spouses are considered as one for S election purposes, this is only for purposes of the 100-shareholder limit. For shareholder consent signatures, each person holding an interest in the stock must sign the consent.

Thus, Keith and Mary Cousins, as well as Joan and Samuel Smith, must consent to the election.

Obtaining Relief from Omitted Consent of Community Property Spouse

Automatic relief is available if the S election Form 2553 does not include the signature of a community property spouse who was a shareholder solely because of the state's community property law.

Beneficial Owner

The registered owner of S corporation stock might not be the beneficial owner (i.e., the person or entity that controls the stock or reaps the benefits of stock ownership). In that event, the beneficial owner, rather than the owner of record, is considered to be the shareholder (i.e., the owner of the S corporation stock). Thus, a beneficial owner of stock must consent to the S election.

Example 2A-6 Beneficial shareholder must consent to election even if no shares are issued.

Scoop, Inc. filed its S election on December 15 to be effective January 1. Earlier in the year, Patricia Knoll verbally agreed to buy 100 shares of Scoop for \$4,875. (There is no written stock subscription agreement.) As of December 15, Patricia has paid \$3,250 toward the \$4,875 stock subscription, and no stock certificates have been issued to her. Must she consent to the S election?

Under similar facts, the 7th Circuit affirmed the Tax Court and ruled that an S election was invalid when the stock subscriber (i.e., Patricia) did not consent. Under the laws of the state of incorporation (Delaware), a person can be a shareholder even though stock certificates are not issued. Furthermore, the state's law provides that a corporation can issue dividends on shares to the extent they are paid for. The nature of the

agreement between Scoop and Patricia was unclear, and the Court found that she could have been a beneficial stockholder on December 15. Since the corporation could not prove she was not a beneficial shareholder, the S election was disallowed.

The Court stated that the result may have been different if the agreement had clearly provided that Patricia would not be a shareholder and would have no rights of stock ownership until the stock was fully paid for. (The laws of some states provide that a person becomes a shareholder when he subscribes to stock. Also, as discussed earlier in this lesson, some states provide that a corporation is deemed to have shareholders on the date it is legally incorporated within the state.)

This case points out the importance of obtaining S election consents from anyone who is a beneficial owner of stock on the date the election is made. To be on the safe side, anyone who *may* have a beneficial interest in the stock should consent in order to protect the S election.

Family Members

Family members are treated as one shareholder for purposes of determining the number of shareholders in the corporation. For shareholder consent signatures, however, each person holding an interest in the S corporation's stock must sign the consent.

Example 2A-7 Obtaining S election consents from a family group.

MM Inc. is a C corporation that is electing S status. The corporation has 108 shareholders. Of these, 99 shareholders are unmarried and unrelated. The remaining 9 shareholders are Molly and her spouse, her 5 children, father, and grandmother. Molly and her family members (including her spouse) are treated as one shareholder for purposes of the 100-shareholder limit. Thus, the corporation is considered to have 100 shareholders for purposes of the maximum-number-of-shareholders test. However, all 108 shareholders must consent to the S election.

The box on line G of the S election Form 2553 should be checked to indicate that, under the family member rules, the corporation is within the allowable number of shareholders, even though more than 100 shareholders are required to consent to the S election.

Shareholders Acquiring Stock after the S Election Is Filed

Shareholders who acquire stock after the election is filed are not required to consent to the S election. However, if the IRS grants an extension of time to submit consents, a consent must be made by all persons who (1) were shareholders at any time during the period beginning on the date the election was filed and ending on the extended date for obtaining the consents, and (2) have not previously consented to the election.

Deadline for Filing Shareholder Consents Can Be Extended

The IRS has authority to waive the effects of an invalid S election or accept an S election filed after the 15-day-of-the-third-month deadline has expired. Likewise, the deadline for obtaining a particular shareholder's consent to the S election can be extended with the approval of the IRS.

Example 2A-8 Extending the time for a shareholder consent.

Minnow Corporation, Inc. was formed eleven years ago, and has operated as a regular C corporation. Early in the year, the shareholders, with the assistance of their tax practitioner, decide to elect S status, to be effective on January 1, 2010. However, when the practitioner meets with the shareholders on February 17 to secure the election, it is learned that a shareholder, William Wilson, is out of the country on foreign business travel and will not return until after the March 15 deadline.

Under Reg. 1.1362-6(b)(3), an extension to obtain a shareholder's consent may be granted if reasonable cause is shown for the request, the interest of the government is not jeopardized by the extension, and a valid consent to the S election is filed within the extended period granted by the IRS. Furthermore, the regulations

state that consents must be filed within the extended period by all persons who have not previously consented to the S election and who were shareholders at any time during the period beginning on the first day of the tax year for which the S election was supposed to be valid, and ending on the extended date for obtaining the consent.

Accordingly, Minnow submits its S election (Form 2553) in a timely manner by March 15 and attaches to the Form 2553 a request for extension. In column K of Form 2553, in lieu of Wilson's signature, a notation is entered indicating that an extension request is attached. When he returns within the extended period, a new Form 2553 is submitted containing the signatures of consent of all persons who had not previously consented to the election and who were shareholders at any time from January 1 through the extended date for obtaining such consents, with a copy of the IRS letter approving the extension. Here, only Wilson's signature of consent is needed.

Relief from an invalid S election can also be requested when shareholder consents were inadvertently omitted when the original Form 2553 was filed.

Filing the S Election by Mail, Private Delivery Service, or Fax

Mail. As with other IRS filings, a U.S. Postal Service postmark on a mailed election is evidence that the election was filed on that date. If the election is sent by certified or registered mail, the date stamped by the post office on the sender's receipt is considered to be the date of filing. Furthermore, the date-stamped sender's receipt will be proof that the election was actually delivered to the IRS if the IRS later claims that the election was not received.

If the IRS receives the Form 2553, it will accept a U.S. Postal Service postmark as the date the form was delivered to the IRS. However, if the election is not mailed as certified or registered and the IRS claims it did not receive the Form 2553 on time, the S election may be declared invalid even though the client or practitioner can provide evidence showing that the election was timely mailed. S elections submitted by mail should *always* be sent by certified or registered mail with a return receipt requested.

Sending the election by certified or registered mail is also important if a private postage meter stamp is used. If an election mailed with a timely private meter stamp is not received by the due date, timely filing is assumed if the election is received within the time that an envelope bearing a post office postmark and mailed from the same location ordinarily would have been received by the IRS. If the election is received outside the normal delivery time, the taxpayer must prove that the untimely filing was because of a delay in transmitting the mail. The taxpayer must also prove the cause of the delay. In applying this rule, one judge noted: "Given the vagaries of the postal system, a taxpayer seldom will be able to prove why his letter was delayed".

Private Delivery Service. An approved private delivery service may also be used for IRS filings. The date the delivery service actually picks up or otherwise receives the document will be considered the postmark date. The receipt showing the date and time of pickup will be proof the election was filed in a timely manner, if the IRS receives the form. Under IRS Notice 2004-83, the following private delivery services and the specific types of services are approved by the IRS:

<u>Name</u>	<u>Types of Services</u>
1. DHL Express (DHL)	DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Service.
2. Federal Express (FedEx)	FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2 Day, FedEx International Priority, and FedEx International First
3. United Parcel Service (UPS)	UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express

The IRS has issued proposed regulations stating that sending a form or payment by private delivery service is the same as sending it by regular mail, not certified or registered mail. In other words, the date shown on the delivery

service's receipt will be considered the date of filing provided the IRS receives the form. However, if the IRS claims it did not receive the form, the receipt from the delivery service is not prima facie evidence that the form was delivered. The assumption that the form was actually delivered will be provided only by using certified or registered mail (or hand-delivering it to the IRS). The proposed regulations apply to all documents mailed after September 21, 2004.

It is difficult to understand why the IRS came to this conclusion. It seems contrary to the intent of IRC Sec. 7502(f)(3), which authorizes the IRS to extend the prima facie evidence of delivery rule to private delivery services. Even the instructions to the Form 2553 (Rev. December 2007) state that, when the IRS questions whether the Form 2553 was filed, a receipt from a designated private delivery service is acceptable proof of filing.

Fax. The instructions to the S election Form 2553 state that the form can be faxed to the appropriate IRS Service Center and provides fax numbers. If the form is faxed, the practitioner retains the original Form 2553 in the files. The instructions also make it clear, however, that faxing the form does not provide proof of filing. Therefore, unless the practitioner takes the Form 2553 directly to an IRS office and receives a date-stamped copy, the authors recommend that the form be sent by U.S. mail (either certified or registered mail, with a return receipt) to provide proof that the form was timely filed.

Where Form 2553 Is Filed

If the Form 2553 is mailed, sent by delivery service, or faxed, it is filed with the IRS Service Center in Cincinnati, OH, or Ogden, UT, depending on where the corporation's principal business, office, or agency is located. Alternatively, the election may be hand delivered to the IRS.

Filing the S Election by Delivering It to an IRS Taxpayer Assistance Center

The Form 2553 can be delivered to an IRS Taxpayer Assistance Center. If this is done, the practitioner should carry the original form and a copy to the IRS office. The IRS will date-stamp the copy, which should be retained by the practitioner as proof of the form's delivery.

Practitioners Should Follow Up with IRS, If Necessary

The instructions to Form 2553 state that the IRS generally acknowledges acceptance of the election within 60 days. Practitioners should mark their calendars to follow up with the IRS if acknowledgment is not timely received.

Consequences If Form 2553 Is Not Properly Filed

Under many circumstances, a corporation that files its S election late or improperly can apply for a waiver of a late or invalid S election. If the IRS grants the waiver, the corporation may be treated as an S corporation from the date it originally intended to elect S status.

Failure to timely or properly file the S election could have severe consequences to the shareholders. The corporation may neglect to apply for a waiver (see the preceding paragraph) or, less commonly, the IRS may not approve the waiver. Even without the benefit of a waiver, the corporation can normally qualify for S status for the following year, but even a one-year postponement could be detrimental. For example, a new entity denied S status for its first year may find an initial operating loss trapped within a regular corporate return. Or, a one-year C corporation that converts to S status exposes itself to the Section 1374 built-in gains tax on any appreciated assets as of the date of conversion. Furthermore, if the entity was a C corporation intending to convert to S status, it may have made distributions to its shareholders under the assumption it was an S corporation, and those distributions may become taxable as dividends. For new entities that miss the S election deadline, an initial short-period Form 1120 (U.S. Corporation Income Tax Return), with capitalization of organization and start-up costs, may be a solution.

S Election May Be Revoked before It Becomes Effective

An S election can be revoked before it becomes effective by filing a revocation (1) before the date the S election is to become effective or (2) before the 16th day of the third month of the tax year. If the election is so revoked, and the C corporation is using a fiscal year, its fiscal year does not change. Furthermore, the corporation is not subject to

the five-year waiting period before it can re-elect S status. The revocation must be accompanied by the consent of shareholders who, at the time of the revocation, hold more than 50% of the issued and outstanding shares of the corporation's stock, including nonvoting stock.

Example 2A-9 Revoking the S election before it becomes effective.

LCL Corp. is a calendar-year C corporation. On November 5, 2009, LCL files a Form 2553 electing S status as of January 1, 2010. Dina, the sole shareholder, consents to the election. On December 15, Dina finds out that the C corporation's carryover losses cannot be used if the corporation elects S status.

On the following January 31, the corporation (with Dina's consent) terminates its S election by mailing a revocation with a retroactive effective date of January 1, 2010. Since the revocation was filed before the 16th day of the third month of what would have been the S corporation's first tax year, the S election never became effective. Furthermore, the five-year waiting period to re-elect S status does not apply to LCL because the original S election was terminated as of the first day on which it would have taken effect.

If LCL had been using a fiscal year and had elected to change to a calendar year in connection with its S election, it would retain its fiscal year after the revocation because the S election was terminated on the day it was to become effective.

IRS Guidance for Filing Form 2553

An IRS article discusses the requirements for filing the S election Form 2553 when a C corporation elects S status. The article also provides guidance relating to how and when to file Form 2553 when the taxpayer is seeking relief because the S election has not been timely filed. The article can be found on the IRS website www.irs.gov by entering "filing requirements for filing status change" in the search box. (Relief from a late or invalid S election is discussed later in this lesson.)

DECIDING WHEN THE INITIAL TAX YEAR BEGINS

Beginning of First Year Tax Year for Newly Formed Corporation Electing S Status

A newly formed corporation's first S year begins on the date the S election is effective (i.e., the earliest date on which the corporation has shareholders, acquires assets, or begins doing business.)

Beginning of First Tax Year for C Corporation Electing S Status

When an existing corporation becomes an S corporation, S status begins on the day following the last day of the C corporation's tax year.

Example 2B-1 Beginning of first S year for existing corporation.

ABC, Inc., a C corporation using a tax year ending September 30 decides to become an S corporation and change to a calendar year. The S year is effective on the day following the last day of the C corporation's normal tax year. Thus, the S election would be effective on October 1, 2009, if the S election is filed any time from October 1, 2008 (i.e., the beginning of the C corporation's tax year), through December 15, 2009 (i.e., the 15th day of the third month of the new tax year). The final C corporation return will be for the 12-month period ending September 30, 2009. The S corporation's first tax return will cover October 1 through December 31, 2009. The second S corporation return will be for the following calendar year.

The first S year of a C corporation electing S status begins the first day following the calendar or fiscal tax year of the electing C corporation. To illustrate, if a C corporation using, for example, a June 30, 2009, fiscal year elects S status, the first S year normally will begin July 1. If, in connection with filing its S election, the corporation elects to use a calendar year, its first S year will begin July 1 and end December 31, 2009. However, some strategies will cause a C corporation to have a short tax year before the S election becomes effective. Such a strategy for a newly formed corporation is illustrated later in this lesson. Also, an existing C corporation can change its tax year before electing S status, as covered in the following discussion.

52-53 Week Year. For purposes of the S election, a 52-53 week tax year ending on a day other than the last day of the month is treated as ending on the last day of the month. Thus, a 52-53 week year ending, for example, on January 3 is considered to end on December 31.

Changing the C Corporation's Year before Electing S Status

A C corporation can automatically change its tax year to a calendar year (or other permitted year) even if it is electing S status effective for the tax year immediately following the C corporation's short period.

Example 2B-2 Changing fiscal year-end before electing S status.

XYZ Inc., a C corporation, uses a fiscal year that ends on June 30, 2010. If all the requirements are met, XYZ can automatically change to a calendar year ending December 31. The corporation will file a short year C corporation return for the period July 1 through December 31, 2010. If the corporation elects S status on January 1, the S corporation's first return will cover the 2011 calendar year.

Selecting the Initial Tax Year

The decision to file an S election requires consideration of the tax year to be used by the S corporation. At the time Form 2553 is filed, the corporation must designate its selected accounting period. In general, an S corporation must use a calendar year or make the Section 444 fiscal year election. As a result, a company that is incorporating and electing to be an S corporation from its inception has four choices relating to its tax year. The new S corporation can:

1. use a calendar year;
2. make the Section 444 election and use an acceptable fiscal year;
3. apply for a fiscal year that will be approved automatically (i.e., a year that is deemed to have a business purpose either because of conformity with its natural business year or because it coincides with the tax year of a majority of the corporation's shareholders); or
4. apply for a fiscal year for which there is a business purpose (based on facts and circumstances) that must be approved by the IRS.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Rosewell Supply is a calendar year corporation. All shareholders are eligible S corporation shareholders as of January 1, 20X1 and Rosewell Supply qualifies as a small business corporation for the entire year. Rosewell Supply files an election to operate as an S corporation on March 1, 20X1 and receives notification of acceptance by the IRS on June 30, 20X1. When will the S election be effective?
- a. January 1, 20X1.
 - b. March 1, 20X1.
 - c. June 30, 20X1.
 - d. January 1, 20X2.
18. Wilson Enterprises is a newly formed corporation for which the five shareholder intend to file an S election. The important dates for Wilson Enterprises are:

Business plan developed by shareholders—January 1, 2010
Incorporated the company—February 1, 2010
Shareholders contribute assets to company—February 28, 2010
Company issues stock to the shareholders—March 15, 2010

What is Wilson Enterprises' activation date?

- a. January 1, 2010.
 - b. February 1, 2010.
 - c. February 28, 2010.
 - d. March 15, 2010.
19. Ron, Susan, and George are shareholders in the Sunscape Co. an existing calendar year C corporation. On February 28, Sunscape elects to operate as an S corporation retroactive to the beginning of the current tax year. On January 31, Susan sold her interest to Kim. On March 15, George sold his interest to David. Which of the following shareholders is not required to consent to the S election?
- a. Ron.
 - b. Susan.
 - c. Kim.
 - d. David.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Rosewell Supply is a calendar year corporation. All shareholders are eligible S corporation shareholders as of January 1, 20X1 and Rosewell Supply qualifies as a small business corporation for the entire year. Rosewell Supply files an election to operate as an S corporation on March 1, 20X1 and receives notification of acceptance by the IRS on June 30, 20X1. When will the S election be effective? **(Page 51)**

- a. **January 1, 20X1. [This answer is correct. The S election can be retroactive to the first of the tax year if the election is filed within 2 months and 15 days after the beginning of the tax year. Since Rosewell Supply filed before March 15, 20X1, they can elect S status for 20X1.]**
- b. March 1, 20X1. [This answer is incorrect. For an existing corporation, the effective date for an S election is not the date the election is filed. An existing corporation may either be an S corporation for the entire tax year of the election or the tax year after the election, depending on the date the election is filed.]
- c. June 30, 20X1. [This answer is incorrect. The IRS will send the corporation notification of either the acceptance or denial of the S election. This notification must be attached to the initial tax return of the S corporation. However, the notification date is not the effective date of the election for an existing corporation.]
- d. January 1, 20X2. [This answer is incorrect. For an existing C corporation to elect S status, an election must be filed on or before the 15th day of the third month of the initial S year. Since Rosewell Supply did meet the requirements, they are allowed a retroactive election which would be before the next calendar year.]

18. Wilson Enterprises is a newly formed corporation for which the five shareholder intend to file an S election. The important dates for Wilson Enterprises are:

Business plan developed by shareholders—January 1, 2010
 Incorporated the company—February 1, 2010
 Shareholders contribute assets to company—February 28, 2010
 Company issues stock to the shareholders—March 15, 2010

What is Wilson Enterprises' activation date? **(Page 51)**

- a. January 1, 2010. [This answer is incorrect. Although this is the date that shareholders decide to form Wilson Enterprises, it is not the company's activation date. The IRS recognizes an event of a company as the activation date, and the shareholders deciding to start the corporation is not it.]
- b. **February 1, 2010. [This answer is correct. The activation date is the earliest of three dates: The date the corporation has shareholders, acquires assets, or begins doing business. Since the first of these dates was the date the company incorporated, this would be the date the company would be considered activated.]**
- c. February 28, 2010. [This answer is incorrect. The shareholders contributing assets is one of dates that would be recognized as an activation date, but this is not the date that would be used by Wilson Enterprises, since it is not the earliest date that an activation date could be recognized.]
- d. March 15, 2010. [This answer is incorrect. Although this is the 2-month-and-15-day deadline, this is not the activation date of Wilson Enterprises. The 2-month-15-day deadline is the date that the S election must be filed by following the activation date.]

19. Ron, Susan, and George are shareholders in the Sunscape Co. an existing calendar year C corporation. On February 28, Sunscape elects to operate as an S corporation retroactive to the beginning of the current tax year. On January 31, Susan sold her interest to Kim. On March 15, George sold his interest to David. Which of the following shareholders is not required to consent to the S election? **(Page 51)**
- a. Ron. [This answer is incorrect. All persons who are shareholders on the date the S election is filed must consent to the election.]
 - b. Susan. [This answer is incorrect. Although Susan sold her interest prior to the date the S election is filed, she must still consent to the election. The election is retroactive to the beginning of the tax year and she is required to recognize her prorata share of pass through items.]
 - c. Kim. [This answer is incorrect. Consents are required from anyone who held shares at any time from the beginning of the tax year through the day the S election is filed when the election is effective retroactively to the beginning of the tax year.]
 - d. David. **[This answer is correct. David purchased his interest after the S election is filed; therefore, his consent is not required.]**

REPAIRING A LATE OR INVALID S ELECTION

Waiver of Invalid S Election

The S election is not valid unless the corporation is eligible for S status (i.e., is a “small business corporation” as defined in lesson 1). Furthermore, Form 2553 (Election by a Small Business Corporation) must be properly completed, signed by a corporate officer, accompanied by all shareholder consents, and filed by the appropriate deadline. If one or more of these requirements are not met, however, the IRS has authority to waive an invalid election and allow the S election to become effective.

When an S corporation election is ineffective because the corporation failed to qualify as a small business corporation, or obtain shareholder consents, the corporation will be treated as an S corporation during the period specified by the IRS if all the following conditions are met:

1. The IRS determines that the circumstances resulting in the ineffective election were inadvertent.
2. Within a reasonable period after discovering the circumstances causing the invalidity, steps are taken to qualify the corporation as a small business corporation, or to obtain the requisite shareholder consents [including elections for qualified Subchapter S trusts (QSST) or electing small business trusts (ESBT)].
3. During the period that the S election was ineffective, the corporation and each shareholder agree to adjustments required by the IRS pertaining to that period.

Methods of Obtaining Relief from a Late or Invalid S Election

The IRS has provided the following ways to obtain relief from invalid elections:

1. *Failure to Obtain Shareholder Consents.* If the election is invalid because shareholder consents were omitted, Reg. 1.1362-6(b)(3)(iii) provides that the S corporation can request an extension of time in which to furnish the consents. No user fee is required.
2. *Relief for Late Election under Rev. Proc. 2007-62.* If the election is late, relief is provided under Rev. Proc. 2007-62, which allows the S corporation to file a late Form 2553 along with the corporation's first S corporation income tax return. Under Rev. Proc. 2007-62, a corporation can obtain relief from filing a late S election if a request for relief is filed no later than six months after the original due date of the Form 1120S (excluding extensions) for the year the election was first intended. The S corporation must show reasonable cause why the election was not filed in a timely manner. No user fee is required.
3. *Relief for Late Election under Rev. Proc. 2003-43.* If the election is late, relief is provided under Rev. Proc. 2003-43, which allows the S corporation to file Form 2553 even though the due date has passed. Under Rev. Proc. 2003-43, a corporation can obtain relief for failing to file an S election if a request for relief is filed within 18 (or in certain cases, 24) months of the original due date of the S election. The S corporation must show reasonable cause why the election was not filed in a timely manner. No user fee is required. Rev. Proc. 2003-43 also provides relief for late ESBT and QSST elections and QSub elections.
4. *Relief for Late Election under Rev. Proc. 97-48.* Late S elections are also provided relief under Rev. Proc. 97-48. The corporation must have filed S corporation tax returns (Form 1120S) and the shareholders must have reported their income consistent with S status for the tax year in which the S election should have been made and for all later years. No user fee is required.
5. *Requesting a Letter Ruling to Waive the Effect of an Invalid Election.* The S corporation can request relief from an invalid election by obtaining a letter ruling. A user fee applies.
6. *Failure to File ESBT or QSST Election.* If an ESBT trustee or QSST beneficiary fails to make the ESBT or QSST election, S status can terminate. Rev. Proc. 2003-43 provides relief from S corporation termination when an ESBT or QSST election is inadvertently not filed. No user fee is required. The relief provisions described in items 1-4 of this list also apply to ESBT and QSST elections.

Failure to Obtain Shareholder Consents

If an invalid election is caused by a failure to obtain the necessary shareholder consents, the IRS has issued special rules that allow relief to be obtained through the Service Center with which the corporation files its income tax return.

Example 2C-1 Supplying an omitted shareholder consent signature.

Newco filed a timely Form 2553 to be taxed as an S corporation for its initial year ending December 31. However, in preparing the initial Form 1120S, the corporation's tax practitioner notes that none of the spouses of the shareholders signed the Form 2553 consent, even though all of the shareholders reside in a community property state. How may the S election be preserved in view of the omitted shareholder consents?

To comply with corrective procedures in Reg. 1.1362-6(b)(3), Newco must satisfy the IRS that it had reasonable cause for not including the signatures and submit the omitted signatures of the spouses, as well as new consents by the shareholders, within any extended period which may be granted by the IRS.

Relief for Late Election under Rev. Proc. 2007-62

Rev. Proc. 2007-62 allows eligible small business corporations to request relief from a late S corporation election by filing Form 2553 with the S corporation's first income tax return. The procedure is in lieu of the letter ruling process ordinarily used to obtain relief for late elections. Accordingly, no user fee is required.

Eligibility for Relief. Rev. Proc. 2007-62 can be used to correct a late filed S election if all the following requirements are met:

1. The corporation fails to qualify for its intended status as an S corporation on the first day that status was desired solely because of the failure to timely file an S election with the appropriate Service Center.
2. The request for relief from the late election is filed no later than six months after the original due date of the Form 1120S (excluding extensions) for the year the election was first intended (i.e., its first Form 1120S).
3. The corporation has not yet filed its first Form 1120S.
4. The corporation has reasonable cause for its failure to make a timely election.
5. All taxpayers whose tax liability or tax returns would be affected by the election (including all shareholders of the S corporation) have reported consistently with the S corporation election on all affected returns for the year the election was intended and for any subsequent years. (This means that proper Schedules K-1 have been issued to the shareholders and they have reported the pass-through items on their tax returns.)

Form 2553 Is Filed with Form 1120S. Under Rev. Proc. 2007-62, the taxpayer attaches a completed Form 2553 to its first Form 1120S. Page 1 of the Form 2553 includes a space for entering an explanation giving reasonable cause for the late election. Line G on page 1 of Form 1120S includes a "Yes" box to check if the corporation is filing its first income tax return.

Deadline for Filing the Tax Return. The Forms 1120S and 2553 must be filed no later than six months after the original due date of the S corporation's first return (excluding extensions).

Example 2C-2 Filing Forms 1120S and 2553 under Rev. Proc. 2007-62 for relief from late election.

Matrix Corp., a newly formed corporation, begins business on January 1, 2010. On March 1, 2011, the corporation's sole owner, Matt, advises his tax practitioner that the corporation has been formed and will be operated as an S corporation beginning on the date it started business. The practitioner finds that Matt was not aware of the S election requirements and no Form 2553 has been filed.

Matrix's Form 1120S is filed on March 8, 2011. A completed S election, Form 2553, is attached to the return. The reasons for not timely filing the election are written in the space provided on page 1 of the Form 2553.

Matrix qualifies for relief under Rev. Proc. 2007-62 because it has not yet filed its first Form 1120S, and Form 2553 will be filed with the first Form 1120S no later than six months after the return's original due date (excluding extensions). Matrix is not subject to a user fee for requesting relief under Rev. Proc. 2007-62. If the IRS determines Matrix had reasonable cause for its failure to timely file Form 2553, Matrix's S election will be effective on January 1, 2010, as planned.

Relief for Late Election under Rev. Proc. 2003-43

Rev. Proc. 2003-43 allows eligible small business corporations to request relief from a late S corporation election. Rev. Proc. 2003-43 is in lieu of the letter ruling process ordinarily used to obtain relief for late elections. Accordingly, no user fee is required.

Eligibility for Relief. Rev. Proc. 2003-43 relief for a late S election is available if all of the following requirements are met:

1. The corporation fails to qualify for its intended status as an S corporation on the first day that status was desired solely because of the failure to timely file an S election with the appropriate Service Center.
2. Less than 24 months have passed since the original due date of the S election.
3. The corporation has reasonable cause for its failure to make a timely election.
4. All taxpayers whose tax liability or tax returns would be affected by the election (including all shareholders of the S corporation) have reported consistently with the S corporation election on all affected returns for the year the election was intended and for any subsequent years. (This basically means that proper Schedules K-1 have been issued to the shareholders and they have reported the pass-through items on their tax returns as if a valid S election was in effect.)

The deadline for filing for late S election relief depends on whether the corporation has filed its Form 1120S.

Deadline When Corporation Has Not Filed a Tax Return. If the corporation has not filed a Form 1120S, a Form 2553 must be filed under Rev. Proc. 2003-43 by the earlier of (1) 18 months after the original due date for the S corporation election, or (2) six months after the due date of the Form 1120S (excluding extensions) for the first year the election was intended.

Deadline When Corporation Has Filed a Tax Return. If the corporation has filed a Form 1120S for the first year in which the election was intended, the application for relief is filed under Rev. Proc. 2003-43 within 24 months of the original due date for the S corporation election. To qualify for this relief, the Form 1120S must have been filed within six months of the due date of the Form 1120S (excluding extensions).

All taxpayers whose tax liability or tax returns would be affected by the election (including all shareholders of the S corporation) must have reported consistently with the S corporation election on all affected returns for the year the election was intended, and for any following years.

Procedural Requirements for Relief under Rev. Proc. 2003-43. The application for relief under Rev. Proc. 2003-43 for a late S election is made by filing a properly completed Form 2553 with the Service Center where the original S election would have been filed.

The words "FILED PURSUANT TO REV. PROC. 2003-43" should be written or typed at the top of the Form 2553, and the completed form must be signed by an authorized corporate officer.

Documentation Required for Rev. Proc. 2003-43 Relief. Information provided on the Form 2553 or on statements attached to the Form 2553 must include the following:

1. A statement giving reasonable cause for the failure to file a timely election. (Note that this should be a separate statement. There is a space on page 1 of Form 2553 for providing a reason for a late S election, but that space is only to be used if the S election is being filed with Form 1120S, which would be the case only if the corporation was seeking relief under Rev. Proc. 2007-62.)

2. The signature of anyone who was a shareholder at any time during the period beginning on the first day of the tax year for which the election is to be effective and ending on the day the election is made.
3. Statements from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed election was filed that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and for all subsequent years. (Effectively, the shareholders are affirming that proper Schedules K-1 have been issued to the shareholders and they have reported the pass-through items on their tax returns.)
4. A dated declaration signed by an authorized corporate officer stating: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

IRS Notification. The IRS will examine the application for relief to determine whether the requirements for granting additional time to file the S election have been satisfied and will notify the corporation of its decision. Corporations that are ineligible for relief under Rev. Proc. 2003-43 or that are denied relief can still ask for a letter ruling granting relief from the late S election.

Example 2C-3 Filing Form 2553 under Rev. Proc. 2003-43 for relief from late election.

In February 2009, DIF Corp. completes an S election (Form 2553) that is to become effective on January 1, 2010. The Form 2553 is inadvertently placed in a file and is not mailed. On March 15, 2011, DIF timely mails an S corporation tax return (Form 1120S) to the IRS. The pass-through items shown on each shareholder's Schedule K-1 are properly reported on the shareholder's Form 1040. On September 10, 2011, DIF receives notification from the IRS that the Form 1120S could not be accepted because they had no record of receiving DIF's Form 2553. DIF immediately engages a tax practitioner.

DIF qualifies for relief under Rev. Proc. 2003-43 because (1) DIF filed Form 1120S for the first tax year the corporation intended to be an S corporation and (2) the Form 2553 is going to be filed within 24 months of the original due date of the S election.

If DIF had not filed a Form 1120S, relief under Rev. Proc. 2003-43 would be available only if the Form 2553 was filed within 18 months of the S election's original due date, as discussed earlier in this lesson. Also, if no Form 1120S had been filed, the S corporation could qualify for relief under Rev. Proc. 2007-62, so long as the first tax return is filed no later than six months after the original due date (excluding extensions) of the Form 1120S for the year the election was first intended.

DIF's Form 2553 should have "FILED PURSUANT TO REV. PROC. 2003-43" typed at the top of page 1 of Form 2553, and a statement explaining the reason for the failure to timely file the corporation's election should be attached. In addition, all persons who were shareholders (or deemed to have been shareholders) at any time during the period that began on the first day for the tax year for which the election is to be effective and ends on the day the election is made must sign in the shareholder consent area of the form. Further, an attachment to the Form 2553 should contain statements from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed election was filed that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and for all subsequent years. The attachment should also include a dated declaration signed by an authorized corporate officer stating: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete." DIF is not subject to a user fee for requesting relief under Rev. Proc. 2003-43.

If the IRS determines DIF had reasonable cause for its failure to timely file Form 2553, DIF's S election will be effective on January 1, 2010, as planned.

See Example 2C-7 for discussion of obtaining relief for a late election under Rev. Proc. 2003-43 when a Form 1120S has not been filed. Corporations that are ineligible for relief under Rev. Proc. 2003-43 or that are denied relief can still ask for a letter ruling granting relief from the late S election.

Relief for Late Election under Rev. Proc. 97-48

The IRS has also issued Rev. Proc. 97-48, which provides *automatic* relief for late S corporation elections without the need to pay a user fee. Rev. Proc. 97-48 applies if all of the following conditions are met:

1. the corporation fails to qualify as an S corporation solely because Form 2553 was not timely filed;
2. the corporation and all of its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent tax year, if any;
3. at least six months have elapsed since the corporation filed its tax return for the first year the corporation intended to be an S corporation; and
4. neither the corporation nor any of its shareholders has received notice from the IRS regarding its S corporation status within six months of when it timely filed Form 1120S for the first year.

Example 2C-4 Relief for late S election under Rev. Proc. 97-48.

In February 2010, GHI Corp. completes an S election, Form 2553. The election is to become effective on January 1, 2010. The Form 2553 is inadvertently placed in a file and is not mailed. GHI was unaware that the election was not filed and timely filed a request to extend the filing date of the tax return (Form 1120S). On September 15, 2011, GHI timely mailed Form 1120S. The pass-through items shown on each shareholder's Schedule K-1 were properly reported on the shareholder's Form 1040. On April 1, 2012 (6½ months after the Form 1120S was filed), the corporation receives notification from the IRS that they have no record of receiving GHI's Form 2553. GHI qualifies under Rev. Proc. 97-48 for automatic relief from a late election because (1) the Form 2553 was not filed, (2) GHI and its shareholders reported their income consistent with S status, (3) six months or more have elapsed since GHI timely filed its first Form 1120S, and (4) notice from the IRS regarding S status was not received within six months of when the first Form 1120S was timely filed. Thus, under Rev. Proc. 97-48, GHI's S election will be effective on January 1, 2010, as originally planned.

See Example 2C-3 for relief from a late S election under Rev. Proc. 2003-43. Also see Example 2C-5 for the S corporation's choices if it files a Form 1120S and notice is received from the IRS within six months after the Form 1120S was filed.

To obtain automatic relief, the corporation must file a completed Form 2553 with "FILED PURSUANT TO REV. PROC. 97-48" typed or printed across the top of the form. The form, as well as an attached statement containing the information required by the revenue procedure, must be signed by an authorized corporate officer and all persons who were shareholders at any time during the period in which the corporation intended to be an S corporation.

Corporations that are ineligible for relief under Rev. Proc. 97-48 or that are denied relief can still ask for a letter ruling granting relief from the late S election.

Requesting a Letter Ruling to Waive the Effect of an Invalid Election

As discussed earlier in this key issue, the IRS can waive the effect of an invalid election. The waiver can apply to invalid elections caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents. Furthermore, the IRS may treat a late S election as timely if there was reasonable cause for the delay in filing. The IRS may even exercise this authority if the taxpayer did not actually file an election.

Example 2C-5 Requesting a letter ruling to obtain relief for an invalid S election.

In February, 2010, ABC Corp. completed an S election, Form 2553. The election was to become effective on January 1, 2010. Due to confusion among ABC, the practitioner, and the attorney, the Form 2553 was inadvertently placed in a file and was not mailed. ABC was unaware that the election was not filed and timely filed a request to extend the filing date of the tax return (Form 1120S). On September 15, 2011, ABC timely mailed Form 1120S. The pass-through items shown on each shareholder's Schedule K-1 were properly reported on the shareholder's Form 1040. On March 14, 2012, the corporation received notification from the

IRS that it had no record of receiving ABC's Form 2553. ABC's tax practitioner is informed about the notice on March 21. ABC does not qualify for relief under Rev. Proc. 97-48 because the IRS notice was received within six months of the date the first Form 1120S was filed.

In some situations, relief would still be available under Rev. Proc. 2003-43, but that is not true in ABC's case. If a Form 1120S has been filed, the deadline for filing a Form 2553 under Rev. Proc. 2003-43 expires 24 months after the original due date for the S corporation election. ABC's Form 2553 was originally due on March 15, 2010, so, to qualify for relief under Rev. Proc. 2003-43, a new Form 2553 would have to be filed no later than March 15, 2012.

ABC can, however, request a letter ruling to determine whether the IRS will waive the invalid election. A user fee applies, as discussed later in this lesson.

There seems to be a good chance that the IRS will allow the S election to become effective on January 1, 2010. The IRS has ruled that the corporation had reasonable cause for not filing its election on time and allowed the S election to become effective on the date requested. For example, invalid election relief was granted when the taxpayer relied on other parties to file the Form 2553, when the corporation was ineligible for S status on the date the election was to become effective, when employees inadvertently failed to mail the Form 2553, and even when no reason was given for the late filing except that the corporation intended to elect S status.

User Fee

According to IRS Ann. 97-4, the rules under Reg. 1.1362-4(c)–(f) relating to waiver of inadvertent termination of the S election also apply to relief from invalid elections. Under those regulations, a request for waiver of an inadvertent S termination requires payment of a user fee. The user fee is (1) \$625 if the S corporation's gross income is less than \$250,000; (2) \$2,000 if gross income is \$250,000 or more, but less than \$1 million; or (3) \$14,000 if gross income is \$1 million or more.

Minor Errors Do Not Invalidate the S Election

An S election may be valid even though there are minor errors on Form 2553. The IRS has ruled that an incorrect disclosure of the number of shares owned by two shareholders on a Form 2553 did not invalidate an S election. Similarly, a timely filed S election that incorrectly disclosed the corporation's selected tax year did not preclude IRS approval.

When a practitioner encounters a newly formed corporation after the 2-month-and-15-day deadline for submission of an S election has passed, a possible remedy (other than seeking relief through the IRS) may be filing an initial short-period C corporation return to start a new tax year for which a timely S election can be filed.

Example 2C-6 Closing the C year to file a timely S election.

Bill and Ted formed Excellent Adventures, Inc., (EA) and began business operations on January 2, 2010. They anticipate initial losses, and are generally aware that the filing of an S election will allow a pass-through loss that can be deducted on their personal income tax returns. However, they did not visit with their tax practitioner until March 26, 2010, 10 days beyond the deadline for the filing of the Form 2553. How might the practitioner salvage this situation by use of a short-period C return?

As discussed in the following paragraph, the corporation can establish a C corporation tax year ending January 31, so its first tax year will begin on January 2 and end January 31, 2010. If it then elects S status and uses a calendar year, the S corporation's first tax year will begin on February 1 and end December 31, 2010. The short years are allowable because both the C corporation and the S corporation are in existence only part of their respective first tax years.

A new C corporation is not restricted in its choice of a fiscal year. Thus, by filing an initial short-period C corporation tax return for the period January 2–31, EA can establish a new fiscal year beginning February 1, for which a timely S election can now be made. If there is insufficient time to compile the data for the preparation

of the one-month initial short-period return, a timely extension request filed by April 15 would serve to fix the January 31 fiscal year-end. The S election in this situation would also be due by April 15, 2010 and would establish the end of the corporation's first S tax year as December 31, 2010.

In this manner, the practitioner will have limited the initial losses trapped in the C return to only a one-month period. To minimize the trapped losses, the practitioner should scrutinize the first month's transactions to identify any Section 195 start-up costs or any Section 248 corporate organizational costs that can be deducted and/or amortized.

Example 2C-7 Obtaining relief for a late election under Rev. Proc. 2003-43 when Form 1120S has not been filed.

Assume the same facts as in Example 2C-6. Rather than having EA file a short period C corporation return, the practitioner will normally suggest that the corporation apply for relief from filing a late election under Rev. Proc. 2003-43. If such relief is granted, EA will become an S corporation on January 2, 2010, the date the corporation was formed and began business operations. As discussed in Example 2C-3, EA is required to show that the late filing was inadvertent and must meet the other requirements of Rev. Proc. 2003-43. When the corporation has not filed a Form 1120S, the late election on Form 2553 must be filed by the earlier of (1) six months after the due date of the corporation's tax return (excluding extensions) for the first tax year the corporation intended to be an S corporation, or (2) 18 months from the original due date of the S election. Thus, EA will file its Form 2553 as early as possible, but no later than September 15, 2011, six months after the due date of the corporation's Form 1120S for the tax year beginning January 2 and ending December 31, 2010. No user fee is required.

Under Rev. Proc. 2003-43, EA will be an S corporation from inception. Thus, it will not be subject to the problems outlined in the warning in Example 2C-6. (Even though Rev. Proc. 2003-43 is not automatic and requires that an acceptable reason be given for the late filing, the IRS has seemingly been generous in waiving invalid elections, as discussed in Example 2C-5 .) If the IRS does not grant relief, EA will have to file a new Form 2553 by April 15, 2010 (two months and 15 days after February 1, the beginning of the tax year), if the S election is to be effective retroactively to February 1. If a new Form 2553 is not filed by April 15, 2010, EA will be required to operate in C status until the end of its first tax year, January 31, 2011.

IRS Guidance for Filing Form 2553

An IRS article discusses the requirements for filing the S election Form 2553 when a C corporation elects S status. The article also provides guidance relating to how and when to file Form 2553 when the taxpayer is seeking relief because the S election has not been timely filed. The article can be found on the IRS website www.irs.gov by entering "filing requirements for filing status change" in the search box.

Admitting a New Shareholder to S Corporation

Shareholders who acquire stock after the election is filed are not required to consent to the S election. The corporation's S status is not affected, assuming the shareholder is eligible to hold S stock. However, S status would terminate if the shareholder later transfers stock to an ineligible shareholder.

Stock Basis

The new shareholder's beginning stock basis is the initial cost of the shares. This basis may be determined in full or in part by reference to property transferred by the shareholder to the corporation under IRC Sec. 351.

Pass-through of S Corporation Items

Under the normal pass-through rules, the new shareholder will be allocated his or her allocable share of the S corporation's pass-through items of income, loss, deduction, and credit under the normal per-share, per-day rules. The new shareholder is allocated pass-through items for each day during the year he or she held the corporation's stock. For the year of the stock acquisition, the new shareholder is allocated pass-through items beginning on the

day he or she acquired the stock through the end of the corporation's normal tax year, assuming the shareholder held the stock continuously throughout that period.

Electing to Apply the Specific Accounting Rules. The new shareholder's stock acquisition may result in the complete disposition of an existing shareholder's stock (e.g., the new shareholder acquired all of another shareholder's stock). In that event, the corporation can elect to apply specific accounting rules for purposes of allocating pass-through items to shareholders, including the new one.

The new shareholder's stock acquisition may result in a "qualifying disposition" of stock, allowing the corporation to elect to apply specific accounting rules for purposes of allocating pass-through items to shareholders, including the new one. A qualifying disposition of stock results when (1) a shareholder disposes of 20% or more of the corporation's issued stock in one or more transactions within any 30-day period during the corporation's tax year, or (2) stock equal to or greater than 25% of the previously outstanding stock is issued to one or more new shareholders within any 30-day period during the corporation's tax year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. The IRS provides several different methods to obtain relief from a late or invalid S election. Which of the following methods described below requires a user fee?
- a. Extension for omitted shareholder consents.
 - b. Relief under Rev. Proc. 2003-43 due to late election by the company.
 - c. Request a letter ruling from the IRS to obtain relief from an invalid election.
 - d. Relief under Rev. Proc. 2007-62 for late election using Form 2553.
21. Rev. Proc. 2007-62 and Rev. Proc. 2003-43 provide relief from a late or invalid S election. What is main difference between the two revenue procedures?
- a. How to file for relief.
 - b. Reason corporation fails to qualify for its intended status.
 - c. Whether shareholders have reported pass-through income consistent with a valid S election.
 - d. Reasonable cause provision.
22. Betty and Rhonda are equal shareholders in Myrtle Star Resort, Inc., a calendar year S corporation. Due to a disagreement between the shareholders, Betty sells her entire interest to Robert on June 30. Which of the following items is correct when an S corporation admits a new shareholder?
- a. Robert will assume Betty's stock basis in Myrtle Star Resort.
 - b. Consent is required from Betty and Robert to elect the specific accounting rules for this transaction.
 - c. Robert must file Form 2553 to reflect consent for the S election previously filed by Myrtle Star Resort.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. The IRS provides several different methods to obtain relief from a late or invalid S election. Which of the following methods described below requires a user fee? **(Page 64)**
- a. Extension for omitted shareholder consents. [This answer is incorrect. If the election is invalid because shareholder consents were omitted, Reg. 1.1362-6(b)(3)(iii) provides that the S corporation can request an extension of time in which to furnish the consents. No user fee is required.]
 - b. Relief under Rev. Proc. 2003-43 due to late election by the company. [This answer is incorrect. If the election is late, relief is provided under Rev. Proc. 2003-43 which allows the S corporation to file Form 2553 even though the due date has passed. The S corporation must show reasonable cause why the election was not filed in a timely manner. No user fee is required.]
 - c. **Request a letter ruling from the IRS to obtain relief from an invalid election. [This answer is correct. The S corporation can request relief from an invalid election by obtaining a letter ruling if other methods for obtaining relief are not available to the S corporation. A user fee applies.]**
 - d. Relief under Rev. Proc. 2007-62 for late election using Form 2553. [This answer is incorrect. If the election is late, relief is provided under Rev. Proc. 2007-62 which allows the S corporation to file a late Form 2553 along with the corporation's first S corporation income tax return. The S corporation must show reasonable cause why the election was not filed in a timely manner. No user fee is required.]
21. Rev. Proc. 2007-62 and Rev. Proc. 2003-43 provide relief from a late or invalid S election. What is main difference between the two revenue procedures? **(Page 64)**
- a. **How to file for relief. [This answer is correct. To qualify for relief under Rev. Proc. 2007-62, the corporation may not have filed its first Form 1120S. The procedure for relief requires the corporation attach a completed Form 2553 to its first Form 1120S. Relief under Rev. Proc. 2003-43 may be obtained even if the initial Form 1120S has been filed. The taxpayer files Form 2553 along with required documentation within the time frame required depending upon whether or not the initial Form 1120S has been filed.]**
 - b. Reason corporation fails to qualify for its intended status. [This answer is incorrect. Both revenue procedures provide relief for when a corporation fails to qualify for its intended status as an S corporation on the first day that status was desired solely because of the failure to timely file an S election with the appropriate Service Center.]
 - c. Whether shareholders have reported pass-through income consistent with a valid S election. [This answer is incorrect. To qualify for relief under either revenue procedure, all taxpayers whose tax liability or tax returns would be affected by the election (including all shareholders of the S corporation) must have reported consistently with the S corporation election on all affected returns for the year the election was intended and for any subsequent years.]
 - d. Reasonable cause provision. [This answer is incorrect. Both revenue procedures require a corporation have reasonable cause for its failure to make a timely election. Reasonable cause includes reliance on the corporation's CPA or attorney to file the election form.]

22. Betty and Rhonda are equal shareholders in Myrtle Star Resort, Inc., a calendar year S corporation. Due to a disagreement between the shareholders, Betty sells her entire interest to Robert on June 30. Which of the following items is correct when an S corporation admits a new shareholder? **(Page 70)**
- a. Robert will assume Betty's stock basis in Myrtle Star Resort. [This answer is incorrect. The new shareholder's beginning stock basis is the initial cost of the shares. This basis may be determined in full or in part by reference to property transferred by the shareholder to the corporation under IRC Sec. 351.]
 - b. Consent is required from Betty and Robert to elect the specific accounting rules for this transaction. [This answer is correct. Since Betty disposed of her entire interest in the S corporation, the corporation can elect to apply specific accounting rules for purposes of allocating pass-through items to shareholders, including Robert. Rhonda need not elect.]**
 - c. Robert must file Form 2553 to reflect consent for the S election previously filed by Myrtle Star Resort. [This answer is incorrect. Shareholders who acquire stock after the election is filed are not required to consent to the S election. Once the stock is acquired, the normal S corporation rules apply to the new shareholder.]

ELIGIBLE LLC CAN ELECT S STATUS

Classifying LLC as a Corporation Can Be Section 351 Transfer

An entity [such as a limited liability company (LLC)] can elect under the check-the-box rules to be classified as a corporation. If the election is made, the entity is deemed to transfer all of its assets and liabilities to the corporation in exchange for the corporation's stock. The entity is then deemed to distribute the corporation's stock to its owners in complete liquidation. The deemed transfer to the corporation is tax-free, assuming IRC Sec. 351(a) applies and the LLC's liabilities do not exceed the basis of its assets.

Eligible LLC Electing Treatment as a Corporation Can Elect S Status

An LLC or other entity that has filed a check-the-box election to be taxed as a corporation is eligible for S status. But to do so, the entity's members must be eligible to hold S corporation stock.

Filing the Election to Be Treated as a Corporation. The entity normally files the election to be taxed as a corporation on Form 8832 (Entity Classification Election) in accordance with Reg. 301.7701-3(c). However, if an LLC that is eligible to elect S status timely files an S election (Form 2553), the entity is considered to have made the election to be taxed as a corporation. This means that the Form 8832 does not have to be filed if the entity timely and properly elects S status.

Election Can Be Prospective or Retroactive. Under Reg. 301.7701-3(c), the effective date of the classification election specified on Form 8832 cannot be more than 75 days prior to the date on which the election is filed and can not be more than twelve months after the date on which the election is filed. This means that the classification change can be retroactive for up to 75 days before the Form 8832 is filed. Under the S corporation rules, however, a newly formed corporation must file the S election on or before the *15th day of the third month* following the *activation date* of the corporation, which is the earliest date that the corporation has shareholders, acquires assets, or begins conducting business. If the entity plans to make the election to be treated as a corporation and become an S corporation on the same date, only Form 2553 is filed, and it should conform to the S corporation rules. The Form 2553 be filed by the *earlier* of 75 days or two months and 15 days after the date the S election is to become effective. In this way, the Form 2553 will be filed within both the Form 8832 and Form 2553 filing limits.

Election to Be Treated as a Corporation Remains Effective until Another Entity Classification Is Made. An entity that makes the deemed election to be taxed as a corporation by filing the S election, Form 2553, will be classified as a corporation on the date the S election is effective, and will continue to be treated as a corporation until it makes another entity classification. If an entity elects to change its classification, it cannot change its classification again during the 60 months after the effective date of the election without IRS permission. Before a change in classification takes place, the practitioner must consider the tax effects of the change. For example, the reclassification of a corporation to a partnership under the check-the-box regulations is a complete liquidation of the corporation.

Filing Form 2553 When an LLC Elects S Status

Effective Date of S Election If LLC Is Currently Treated as a Corporation. If the S election is being made by an LLC that is currently treated as a corporation under the check-the-box provisions, the rules relating to C corporations apply. The Form 2553 (Election by a Small Business Corporation) must be filed (1) during the tax year preceding the first tax year the S election is to be effective, or (2) on or before the 15th day of the third month of the initial S year. S status begins on the day following the last day of the LLC's tax year, so the effective date of the S election will generally be January 1.

Effective Date of S Election If LLC Is Simultaneously Making Election to Be Treated as a Corporation. An LLC that is making the election to be treated as a corporation and become an S corporation on the same date is not required to have the S election become effective at the first of the tax year. Rather, the election can be retroactive or prospective within the time limits surrounding the date the Form 2553 is filed, which is generally (1) no more than 75 days prior to the date on which the election is filed and (2) no more than 12 months after the date on which the election is filed. (See "Election Can Be Prospective or Retroactive" earlier in this lesson.) The LLC makes the election to be classified as a corporation on Form 2553; no Form 8832 is required.

To recap, an LLC that is making the election to be treated as a corporation and become an S corporation on the same date can generally have the S election become effective retroactively up to 75 days before the Form 2553 is filed. Alternatively, the election can become effective on a specified date within 12 months after the Form 2553 is filed. (Allowing an LLC to make a mid-year S election makes sense because a newly electing S corporation can begin its first S year at any allowable date.

Date of Incorporation and Number of Shares. Completing Form 2553 can be challenging because no actual incorporation takes place and no shares are issued. The instructions to the Form 2553 offer some guidance on how to fill out the Form 2553 under these circumstances. However, the Form 2553 does not divulge how an LLC shows the effective date or state of incorporation. It would seem logical to show the effective date of the Form 8832 (if one is filed) as the "date incorporated" on Form 2553. If Form 8832 has been filed, the authors recommend that a copy of the Form 8832 be attached to the Form 2553, along with an explanatory statement that the entity has made the check-the-box election and is now making the S election. If Form 8832 is not filed, the effective date of the S election could be entered. The state of incorporation is evidently the state where the entity was formed. The instructions say that the number-of-shares and date acquired sections of Form 2553 should show each individual's percentage of ownership and the date (or dates) acquired. If Form 8832 is not filed, the authors recommend that a statement be attached to the Form 2553 stating that the entity is making an election to be classified as an association taxable as a corporation under Reg. 301.7701-3(c)(1)(v)(C).

Relief Provisions When Form 2553 or Form 8832 Are Not Timely Filed

In Rev. Procs. 2004-48 and 2007-62, the IRS provides two simplified methods for requesting relief when an entity that intended to be classified as an association taxable as a corporation on the date the S election became effective failed to timely file Form 2553 (and Form 8832, if required). Relief under these procedures allows an entity that fits the requirements to be an S corporation from the date it originally intended to elect S status, even though the form(s) were not timely filed. Reasonable cause must be given for the failure to timely submit the Form 2553 or both forms.

Rev. Proc. 2004-48 calls for the late Form 2553 to be mailed or otherwise delivered to the appropriate IRS service center. In contrast, Rev. Proc. 2007-62 provides that the Form 2553 is to be filed together with the corporation's first S return, Form 1120S. Also, when relief is requested under Rev. Proc. 2004-48, a separate statement explaining the reason for late filing accompanies the Form 2553. On the other hand, when relief is requested under Rev. Proc. 2007-62, the reason for late filing is submitted directly on Form 2553.

Relief under Rev. Proc. 2004-48. Relief under this revenue procedure is available when Form 2553 (and Form 8832, if that form should have been filed) is late. Rev. Proc. 2004-48 allows the entity to elect S status by filing a properly completed Form 2553 no later than six months after the due date of the tax return, excluding extensions, for the first year the entity intended to be an S corporation. If this revenue procedure is followed, Form 8832 is not required to be filed; only Form 2553 is submitted, along with any required statements.

Relief under Rev. Proc. 2007-62. Relief under this revenue procedure is available when Form 2553 (and Form 8832, if that form should have been filed) is late. Rev. Proc. 2007-62 allows the entity to elect S status by filing Form 2553 with its first Form 1120S. The forms must be filed no later than six months after the due date of the tax return, excluding extensions, for the *first* year the entity intended to be an S corporation. If this revenue procedure is followed, Form 8832 is not required to be filed; only Form 2553 is attached to the Form 1120S.

Electing S Status by LLC Treated as Partnership

When an LLC treated as a partnership files Form 8832 or Form 2553 and elects to be taxed as a corporation, the transaction is treated as a liquidation of the partnership and formation of a corporation. This can cause tax issues such as those encountered when a partnership incorporates.

LLC Converting to S Status Must Conform to S Corporation Rules

Once the LLC has elected S status, the entity is operating as an S corporation and, therefore, must conform to the S corporation rules. Furthermore, once the S election is effective, the LLC members will be treated as shareholders. Member/shareholders who provide services to the corporation are employees of the corporation, and their compensation is subject to payroll taxes.

To meet the S corporation eligibility requirements, the operating agreement and any other pre-S election documents based on the LLC's treatment as a partnership must be amended or replaced. If, for example, the LLC's operating agreement allows special allocations of income or loss to be passed through to members, the LLC is not eligible to be treated as an S corporation because it would be considered to have more than one class of stock. [As discussed in lesson 1, an S corporation has one class of stock only if all outstanding shares (which in the case of an LLC would be membership interests) confer identical rights to distribution and liquidation proceeds. Differences in voting rights are ignored.] Allocations based on anything other than percentage of ownership breach the one-class-of-stock rule and are not allowable in an S corporation.

The operating agreement of an LLC operating as a partnership may specify that certain members are general partners and other members are limited partners. The IRS has ruled that the general and limited partnership interests that confer identical rights to distribution and liquidation proceeds satisfy the one-class-of-stock requirement. However, the IRS will no longer issue advance rulings on whether state-law limited partnerships that check the box to be taxed as corporations have more than one class of stock. This revenue procedure and its predecessors cause uncertainty as to whether such interests conform to the one-class-of-stock rules.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. A limited liability company (LLC) is simultaneously making an election to be treated as a corporation and electing S status. Which form is the LLC required to file?
- a. Form 8832.
 - b. Form 2553.
 - c. Form 1120S.
 - d. Form 851.
24. Under Rev. Proc. 2004-48 and 2007-62, the IRS provides relief for when an LLC intending to be classified as a corporation and electing S status fails to timely file the election form(s). What is the primary difference between the revenue procedures?
- a. The time period the entity intended to file for S status.
 - b. Deadline for filing Form 2553 or Form 8832.
 - c. How the information is submitted to the IRS.
25. Yellow Springs, LLC operates as a partnership and desires to check-the box and be treated as a corporation and elect S status. Its operating agreement specifies one member acts as a service general partner and the other three members are limited partners, each with identical distribution rights and liquidation proceeds. In addition, the LLC operating agreement allows for special allocation of depreciation to the limited partners up to the amount of their capital contribution. Which of the following reasons would prevent Yellow Springs, LLC from making a valid S election?
- a. Payment to a member for services is considered a distribution.
 - b. Due to the special allocation of depreciation.
 - c. General and limited partnership interests constitute second class of stock.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. A limited liability company (LLC) is simultaneously making an election to be treated as a corporation and electing S status. Which form is the LLC required to file? **(Page 76)**
- a. Form 8832. [This answer is incorrect. An entity normally files the election to be taxed as a corporation on Form 8832, Entity Classification Election. However, a different form may be used if the entity simultaneously elects taxation as a corporation and S status.]
 - b. **Form 2553. [This answer is correct. If an LLC that is eligible to elect S status timely files an S election (Form 2553), the entity is considered to have made the election to be taxed as a corporation. This means that the Form 8832 does not have to be filed if the entity timely and properly elects S status.]**
 - c. Form 1120S. [This answer is incorrect. Form 1120S, U.S. Income Tax Return for an S Corporation, is filed to report income, gains, losses, deductions, and credits of an entity for any tax year covered by an election to be an S corporation.]
 - d. Form 851. [This answer is incorrect. Form 851, Affiliations Schedule, is filed by a parent corporation to identify each member of an affiliated group, and attached to the parent's federal income tax return.]
24. Under Rev. Proc. 2004-48 and 2007-62, the IRS provides relief for when an LLC intending to be classified as a corporation and electing S status fails to timely file the election form(s). What is the primary difference between the revenue procedures? **(Page 76)**
- a. The time period the entity intended to file for S status. [This answer is incorrect. Both Rev. Proc 2004-48 and 2007-62 requires the entity to request the relief no later than six months after the due date of the tax return, including extensions, for the first year the entity intended to be an S corporation.]
 - b. Deadline for filing Form 2553 or Form 8832. [This answer is incorrect. The forms must be filed no later than six months after the due date of the tax return, excluding extensions, for the first year the entity intended to be an S corporation.]
 - c. **How the information is submitted to the IRS. [This answer is correct. The primary difference between Rev. Procs. 2004-48 and 2007-62 is how the information is submitted to the IRS. Rev. Proc. 2004-48 calls for the late Form 2553 to be mailed or otherwise delivered to the appropriate IRS service center. In contrast, Rev. Proc. 2007-62 provides that the Form 2553 is to be filed together with the corporation's first S return, Form 1120S.]**
25. Yellow Springs, LLC operates as a partnership and desires to check-the box and be treated as a corporation and elect S status. Its operating agreement specifies one member acts as a service general partner and the other three members are limited partners, each with identical distribution rights and liquidation proceeds. In addition, the LLC operating agreement allows for special allocation of depreciation to the limited partners up to the amount of their capital contribution. Which of the following reasons would prevent Yellow Springs, LLC from making a valid S election? **(Page 76)**
- a. Payment to a member for services is considered a distribution. [This answer is incorrect. Member/shareholders who provide services to the corporation are employees of the corporation, and their compensation is subject to payroll taxes.]
 - b. **Due to the special allocation of depreciation. [This answer is correct. To meet the S corporation eligibility requirements, the operating agreement and any other pre-S election documents based on the LLC's treatment as a partnership must be amended or replaced. If, for example, the LLC's operating agreement allows special allocations of income or loss to be passed through to members, the LLC is not eligible to be treated as an S corporation because it would be considered to have more than one class of stock.]**

- c. General and limited partnership interests constitute second class of stock. [This answer is incorrect. The operating agreement of an LLC operating as a partnership might specify that certain members are general partners and other members are limited partners. The IRS has ruled that the general and limited partnership interests that confer identical rights to distribution and liquidation proceeds satisfy the one-class-of-stock requirement.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (T2STG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

18. A corporation elects to be treated as an S corporation by filing which form?
- a. Form 1120.
 - b. Form 1120S.
 - c. Form 2553.
 - d. Form 8832.
19. Which of the following compliance matters is normally included on Form 2553, but can be made on a separate statement, as long as additional information is included from each shareholder?
- a. The consent from each shareholder.
 - b. The election by the corporation to adopt S status.
 - c. The selection of the S corporation tax year.
 - d. Do not select this answer choice.
20. Eagle Eye Co. has one owner for purposes of the 100-shareholder limit, Andrew Simmons. The following individuals own shares in Eagle Eye: Andrew, his seven children, and his 16 grandchildren held in custodial accounts. His wife, Sarah, does not own shares in the company but she does have a community property interest in the stock. Eagle Eye would like to operate as an S corporation. How many shareholders must consent to the election?
- a. 25.
 - b. 24.
 - c. 8.
 - d. 1.
21. Blue Blood Enterprises filed a Form 2553 on March 1 after forming on January 1 to be taxed as an S corporation for its initial year ending December 31. Blue Blood is made up of five shareholders. The company was set up in a community property state. Three of the shareholders are currently married and two are not. When submitting the Form 2553, all five shareholders signed the consent form. What was done incorrectly in the filing of Form 2553?
- a. The corporation fails to qualify as an S corporation due to omitted shareholder consents.
 - b. Blue Blood Enterprises did not file their S election on a timely basis in the initial year.
 - c. Blue Blood Enterprises did not request a letter ruling to make the S election for their company.
 - d. The company has too many shareholders to qualify for S election.

22. A corporation may request relief for a late S election under various methods. Which method is automatic and does not require a user fee?
- a. Rev. Proc. 2007-62.
 - b. Rev. Proc. 2003-43.
 - c. Rev. Proc. 97-48.
 - d. IRS letter ruling.
23. The default classification for an LLC is partnership; however, an LLC can check-the-box to be treated as a corporation. Which of the following statements is incorrect if an LLC elects to be treated as a corporation?
- a. The LLC is deemed to transfer its assets and liabilities to the corporation in exchange for stock.
 - b. The LLC distributes the corporation's stock to the members of the LLC in complete liquidation.
 - c. The members of the LLC own shares in the corporation and membership interests in the LLC.
 - d. The deemed transfer to the corporation is tax-free if Sec. 351(a) applies and the LLC's liabilities do not exceed the basis of its assets.
24. Nightsky, LLC files Form 8832 to classify the LLC as a corporation. The effective date of the classification election specified on Form 8832 is not allowed to be how many more days prior to the date on which the election is filed?
- a. 30 days.
 - b. 60 days.
 - c. 75 days.
 - d. 120 days.
25. Palm Cove, LLC elects to be treated as a corporation and subsequently elects S status. After three years of operating as an S corporation, Palm Cove decides to revoke its S election. How long must Palm Cove wait to reelect S status without IRS permission?
- a. Palm Cove may reelect S status in the year following the revocation of the S election.
 - b. Palm Cove is required to wait 60 months after revocation of the S election.
 - c. Palm Cove is required to wait 120 months after revocation of the S election.
 - d. Palm Cove is prohibited from making another S election.

Lesson 3: Termination of S Status

INTRODUCTION

A corporation's S status can be terminated in a number of ways, both voluntarily and involuntarily, by corporate-level events and shareholder-level events. When the S election is terminated, a number of tax return reporting issues arise, as discussed in this lesson.

The controlling provisions of the tax law dealing with termination of S status are found in IRC Sec. 1362(d)–(g), as amplified by Regs. 1.1362-2 through -6.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the process for a voluntary revocation of an S election and how to waive an inadvertent termination of an S election.
- Identify the advantages and tax consequences of the S termination year and post-termination transition period.
- Identify the process for reelecting S status after termination and exceptions to the five-year reelection rule.
- Determine the estimated tax requirements for the corporation following a termination of an S election.

REVOKING THE S ELECTION VOLUNTARILY

Termination by Revocation

An S corporation can revoke (terminate) its S election with the consent of shareholders owning more than half of its stock. After the S election is revoked, the corporation becomes a “regular” or “Subchapter C” corporation. Generally, it cannot reelect S status for at least five years following the revocation, although the IRS may approve an earlier reelection in certain circumstances. Such approval may be given, for example, if the corporation has new shareholders or if the corporation never enjoyed the benefits of S status.

Revocation Is Made in Statement Form

The revocation is made by the corporation in the form of a statement filed with the IRS Service Center where the corporation initially filed its S election. Under Reg. 1.1362-6(a)(3), the statement should be signed by a person authorized to sign Form 1120S (i.e., a corporate officer) and must provide:

1. that the corporation is revoking its election under IRC Sec. 1362(a) to be taxed as an S corporation;
2. the number of shares of stock, including nonvoting stock, outstanding when the revocation is made; and
3. the effective date of the revocation, if it is to be a prospective revocation (discussed later in this lesson).

Statement of Shareholder Consent to Revocation

A separate statement of shareholder consent should be attached to the statement of revocation, signed by each shareholder who consents to the revocation. This statement will provide evidence that shareholders owning more than 50% of the outstanding stock consented to the revocation. All S shareholders, voting and nonvoting, must be considered in the 50% determination.

Family Members. Family members are treated as one shareholder for purposes of the 100-shareholder limit. For all other purposes, including consents, each person holding an interest in the S corporation's stock is considered a shareholder. Thus, shareholders owning more than 50% of the corporation's outstanding stock must consent to the revocation, without regard to how those shareholders are counted for purposes of the 100-shareholder limit.

Effective Date of Revocation

A revocation may specify a prospective effective date. This can be any date on or after the day on which the revocation is made, but must be stated in terms of a specific day, month, and year, and not in terms of a specific event.

A revocation filed on or before the 15th day of the third month of the tax year may specify that termination of the S election will be retroactive to the beginning of the tax year. If no effective date is specified, the revocation will be effective:

1. on the first day of the tax year if the revocation statement is filed on or before the 15th day of the third month of the tax year; or
2. on the first day of the following year if the revocation is filed after the 15th day of the third month.

The filing date is generally the date the revocation is mailed or hand-delivered to the IRS. If the revocation is mailed, the filing date is determined by the date of the U.S. postmark. Thus, it should be sent by either certified or registered mail, with a return receipt to provide proof that the form was timely filed.

Thus, the corporation and shareholders have a great deal of flexibility as to the timing of the revocation. An S corporation that specifies a prospective date for revocation that is other than the first day of the tax year will create an "S termination year."

Example 3A-1 Prospective revocation of S status.

Essco, Inc., a calendar-year S corporation, decides to revoke its S election effective August 1. To do so, it must file its revocation statement with consents attached on or before August 1, indicating that the revocation is intended to be effective on that date.

Example 3A-2 Revocation that does not specify a prospective effective date.

Beecorp, a calendar-year S corporation, files a revocation (that does not specify an effective date) on March 10, 2010. The revocation is effective as of January 1, 2010.

Assume, instead, that Beecorp's revocation (which still does not specify an effective date) is misplaced and not mailed until March 20, 2010. The revocation will be effective as of January 1, 2011.

S Election May Be Revoked before It Becomes Effective

An S election can be revoked before it becomes effective. If the election is so revoked, and the C corporation is using a fiscal year, its fiscal year does not change. Furthermore, the corporation is not subject to the five-year waiting period before it can reelect S status. The revocation must be accompanied by the consent of shareholders who, at the time of the revocation, hold more than 50% of the issued and outstanding shares of the corporation's stock, including nonvoting stock.

Example 3A-3 Revoking selection before it becomes effective.

Seecorp, a regular C corporation that uses a June 30 fiscal year, elected S status for its tax year beginning July 1, 2010, by filing a properly completed Form 2553 (Election by a Small Business Corporation), on July 15, 2010. On Form 2553, Seecorp stated that it will change its tax year to a calendar year. On September 15, 2010, Seecorp properly revoked its S election effective July 1. Seecorp's revocation of S status is retroactively effective to July 1, 2010 since it filed the revocation on or before the 15th day of the third month of the tax year.

Since Seecorp revoked its election to be an S corporation effective on the first day for which its election to be an S corporation was effective, the statement on the Form 2553 regarding the change in Seecorp's tax year will have no effect. Seecorp will not become an S corporation and as a C corporation will retain its June 30 fiscal year-end.

Checkbox on Form 1120S Is Used to Report Revocation of S Election

If the S election is terminated or revoked during the year, the box at line H(5) ("S election termination or revocation") on page 1 of Form 1120S and the "Final K-1" box on Schedule K-1 should be checked to notify the IRS that this will be the final S corporation return. Furthermore, if the S election involuntarily terminated, a statement should be attached to the tax return. The "Final return" box at line H(1) on page 1 of Form 1120S is checked only if the corporation liquidated during the year and no longer exists.

Filing the Revocation When an LLC Revokes S Status

An LLC can elect to be treated as an S corporation. It is unclear how such an LLC completes the revocation because no actual incorporation has taken place and no shares have been issued. Since there is no guidance on how an LLC revokes the S election, the revocation should be acceptable if it is completed in a clear and reasonable manner. Instead of showing the number of shares of stock, the percentage of ownership of the entity held by each individual could be shown. Evidently, LLC members owning more than 50% of the LLC must consent to the revocation. Finally, the revocation should be signed by an LLC member authorized to sign the Form 1120S.

Bankruptcy Trustee May Have Power to Avoid S Revocation

A bankruptcy trustee may be able to "avoid" a revocation filed shortly before a bankruptcy petition is filed. The 9th Circuit has held that a corporation's pre-bankruptcy revocation of its S election was a "transfer" that was avoidable by the bankruptcy trustee. The 9th Circuit bankruptcy panel concluded that the corporation's pre-bankruptcy "right" to make or revoke an S election was "property" or "an interest of the debtor in property" under the Bankruptcy Code. Furthermore, a prepetition revocation of S status was a "transfer" that could be avoided by the trustee under Bankruptcy Code Sec. 548(a). Once a revocation is avoided it is treated as if it had never been made, and the trustee is free to act as he sees fit.

Example 3A-4 Bankruptcy trustee nullifies recent S revocation.

Barnes Corp. is a calendar year S corporation 100% owned by Nola. The losses that Barnes has experienced over the last several years have passed through to Nola. She has deducted these pass-through losses to the extent of her stock basis. During the current year, she realizes the corporation will continue to incur losses and will not be able to pay its debts as they come due. She decides to have the corporation file a bankruptcy petition, but she realizes the bankruptcy trustee will liquidate the corporation and the gains realized on the sales of the corporation's assets will flow through to her if the corporation maintains its S status. To prevent this, she files a revocation of the corporation's S election two weeks before it files for bankruptcy. Under these circumstances, the bankruptcy trustee may be able to avoid the revocation of S status and have the corporation continue to be treated as an S corporation. Nola would be liable for the tax resulting from the pass-through gains on the liquidation of the corporation.

Rescission of a Revocation

An S corporation can rescind a revocation of its S election at any time before the revocation becomes effective. A rescission can be made only with the consent of each person who consented to the revocation and each person who became a shareholder after the revocation was filed.

The procedures for rescinding a revocation of an S election are similar to those described for the revocation itself. A statement that the corporation rescinds the revocation made under IRC Sec. 1362(d)(1) is to be filed with the Service Center where the revocation was filed. The notice of rescission should be in the form of a written statement that sets forth the name, address, and identification number of the corporation, as well as a statement that the corporation rescinds its revocation made under IRC Sec. 1362(d)(1). The notice of rescission should be signed on behalf of the S corporation by an officer authorized to sign the corporate return. The rescission must also be accompanied by the signed consent of each shareholder who consented to the revocation and each person who became a shareholder after the revocation was filed (including those who acquired a community property interest or other interest in the shares).

Example 3A-5 Prospective rescission of S revocation.

Deecorp files a revocation of its S election on November 5, 2010, that specifies an effective date of January 1, 2011. The revocation can be rescinded if the appropriate statement and shareholder consent are filed before the January 1 effective date.

Example 3A-6 Retroactive rescission of S revocation.

Messco, Inc., is a calendar-year S corporation. On February 1, 2010, the corporation revoked the S election retroactively to January 1 because its shareholders determined that C corporation status was more beneficial in the circumstances. However, due to unforeseen economic developments, the shareholders changed their minds and decided that S status was, after all, in their best interests. Can a revocation filed by the 15th day of the third month following the beginning of the S year be rescinded if the rescission is also filed within the 2½-month period?

Although this issue is not specifically addressed in the regulations, they provide that the revocation may be rescinded by a corporation at any time before the revocation becomes effective. In Messco's case, the revocation is effective on January 1, 2010. Therefore, a literal interpretation is that the revocation cannot be rescinded because the rescission could not be filed before the effective date of the revocation.

INADVERTENTLY TERMINATING THE S ELECTION BECAUSE OF FAILURE TO QUALIFY AS AN S CORPORATION

Events That Terminate S Status

If an S corporation fails to maintain its status as a "small business corporation" under IRC Sec. 1361(b), its S election automatically terminates on the date the disqualifying event occurs. The disqualifying events that can terminate S status include any one of the following:

1. Having more than 100 shareholders.
2. Having an ineligible shareholder (e.g., a corporation, partnership, ineligible trust, or nonresident alien).
3. Having more than one class of stock.
4. Becoming an ineligible corporation such as an insurance company, or DISC.
5. Transferring place of incorporation to a foreign country (thus no longer qualifying as a domestic corporation).

Unintended termination of the S election can occur because of circumstances that are more obscure than a shareholder selling stock to an ineligible shareholder. For example, termination can occur if:

1. an S shareholder transfers stock in a form of joint ownership, resulting in more than 100 shareholders because each joint owner, other than a family member, is a separate shareholder;
2. the successor beneficiary of a qualified Subchapter S trust (QSST) affirmatively refuses to consent to the original QSST election, which means the QSST is no longer an eligible shareholder;
3. S corporation stock is pledged as collateral for a personal loan and, upon default, the stock is acquired by an ineligible shareholder pursuant to a foreclosure sale; or
4. an S corporation that has accumulated earnings and profits (AE&P) receives more than 25% of its gross receipts from passive investment sources in three consecutive years.

Termination Due to Second Class of Stock

An S corporation is not permitted to have more than one class of stock. Under Reg. 1.1361-1(l), a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and

liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. Differences in voting rights are disregarded (i.e., an S corporation can issue both voting and nonvoting stock).

A corporation that has elected S status and subsequently is treated as having more than one class of stock loses its S corporation status. In such a case, the corporation's S election terminates on the date the corporation is treated as having more than one class of stock.

Example 3B-1 Involuntary terminations of the S election when the corporation becomes ineligible for S status.

Esscorp elected S status on January 1, 2009. On April 1, 2010, Esscorp unknowingly issued a second class of stock. However, this fact did not become known until after the 2010 S corporation income tax return, Form 1120S, had been filed. The S election terminated on March 31, 2010, and Esscorp became a C corporation on April 1, the day the second class of stock was issued. Unless Esscorp applies for and receives relief from the inadvertent termination (discussed later in this lesson), it will be required to amend the Form 1120S and file a Form 1120 to reflect the short S and C years for 2010.

Variation: Assume now that it is determined that Esscorp had two classes of stock on January 1, 2009. The S election would never become effective because Esscorp was not eligible for S status. Unless Esscorp applies for and receives relief from the invalid election, Form 1120 would have to be filed to replace any S corporation returns. Once the corporation becomes eligible for S status, however, it can elect to become an S corporation at the end of any C corporation year. The company has never been an S corporation and therefore is not subject to the five-year waiting period to reelect S status.

Inadvertent termination relief pursuant to IRC Sec. 1362(f) will be available in appropriate cases, as discussed later in this lesson. In general, a corporation that qualifies under IRC Sec. 1362(f) will have its S status restored retroactive to the date the S election was terminated.

Effective Date of Termination

Except for the special rule applying to excess passive investment income, a termination is effective as of the day on which the disqualifying event occurs (i.e., the last day of the S year is the day before the event occurs). Also, voluntary revocations frequently specify a prospective non-year-end termination date. Such terminations result in two short tax years for reporting and allocation purposes, with the S corporation short period ending on the day before the disqualifying event, and the regular C corporation short period beginning on the date of the disqualifying event and ending on the last day of the tax year.

Disqualifying Event May Be Voluntary or Involuntary

The occurrence of a disqualifying event may be voluntary or involuntary. For example, if in mid-year minority shareholders determine that S status should be terminated immediately, they could cause a disqualifying event to occur (e.g., by transferring stock to an ineligible shareholder). Frequently, however, a disqualifying event will occur inadvertently, causing termination of S status as of the date the event occurred (or on the first day of the first S tax year if the corporation fails to meet the definition of a small business corporation on that day).

Notification to IRS of S Termination

When the S election terminates involuntarily, the corporation must attach to its tax return for the tax year in which the termination occurs a statement including notification that a termination has occurred and the termination date. The box at H(5) ("S election termination or revocation") on page 1 of Form 1120S and the "Final K-1" box on Schedule K-1 should be checked to notify the IRS that this will be the final S corporation return.

Example 3B-2 Notification to IRS of S termination.

Jim Bridges owned 25% of the outstanding stock of AVC Corp., an S corporation. On July 20, 2010, Jim contributed his AVC stock to a trust that was not an eligible S shareholder. However, the transfer did not become known to the corporate officers until February 2011.

Upon discovery of the ineligible shareholder, AVC should attach to its 2010 tax return a statement that includes notification that a termination has occurred and the termination date.

Waiver of Inadvertent Termination

Terminating Event Must Be Inadvertent. When the disqualifying event occurs inadvertently, and the corporation and its shareholders desire to retain S status, the IRS has the authority to waive the termination requirements. (This waiver rule does not apply to terminations caused by voluntary revocation.)

Requirements for Continuing S Status. A corporation will be treated as continuing to be an S corporation following a disqualifying event if it:

1. previously made a valid S election and that election terminated;
2. establishes to the satisfaction of the IRS that the disqualifying event was inadvertent;
3. takes appropriate steps to correct the situation within a reasonable period after discovery of the disqualifying event; and
4. agrees (along with its shareholders) to any adjustments required by the IRS pertaining to the period that the corporation was in violation of the S corporation eligibility rules.

Before a waiver can become effective, the corporation must be brought back into compliance with all of the S corporation eligibility requirements. This may require transferring shares among shareholders to ensure that all shareholders are eligible to own S stock or eliminating a deemed second class of stock.

Requesting Relief for an Inadvertent Termination. The next step is to request relief or waiver of the terminating event from the IRS under the inadvertent termination rule. The corporation has the burden of establishing that under the relevant facts and circumstances the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, tends to establish that the termination was inadvertent.

This request for a letter ruling should be sent to the IRS National Office seeking relief under IRC Sec. 1362(f) for an inadvertent termination. The request should include the following:

1. the date of the corporation's S election,
2. the date and detailed explanation of the terminating event,
3. the facts supporting that the termination was unintentional,
4. when and how the terminating event was discovered,
5. a summary of the steps taken by the corporation to return to eligibility for S status, and
6. the fact that the corporation and shareholders agree to make any adjustments required by the IRS as a condition of obtaining relief under the inadvertent termination rule.

User Fee. A user fee must accompany the request for a letter ruling when the corporation is requesting that the IRS waive the effects of an inadvertent termination of the S election.

IRS May Grant Retroactive Relief from Termination. The adjustments referred to in item 6 theoretically will be consistent with treatment of the corporation as an S corporation during a period specified by the IRS. A waiver may be granted retroactive for all years for which the terminating event was effective, in which case the corporation will be treated as if its election has not terminated. Conversely, a waiver may be granted retroactive only for the period in which the corporation again became eligible for Subchapter S treatment, in which case it will be treated as a C corporation during the period for which it was not eligible for Subchapter S treatment.

All persons who were shareholders during the period specified by the IRS, as well as the corporation, must consent to the adjustments. The consents are to be in the form of statements attached to the corporation's tax return for the period in which the adjustments are to be made. The corporation's consent statement should include the name, address, and ID number of the corporation and each shareholder. The shareholders' consent statement is to include the following information:

1. each shareholder's name, address, and social security number;
2. the corporation's name, address, and identification number;
3. the number of shares of stock owned during the period; and
4. the dates during the period on which the shares were owned.

Both the shareholder and corporate consent statements should describe the IRS requirements and the period for which a waiver of the terminating event is requested. Each shareholder must sign the shareholders' consent and an officer of the corporation must sign the corporation's consent.

Pass-through When IRS Waives Termination of the S Election

As stated earlier in this lesson, the corporation and its shareholders must agree to any adjustments required by the IRS relating to the period that the corporation was not eligible for S status. If the termination took place because stock was transferred to an ineligible shareholder, that shareholder should also consent to the adjustments. In some rulings where inadvertent termination relief was granted, the IRS has required the ineligible shareholder to be treated as a shareholder during the period that S stock was held. Those rulings state that corporate items of income, loss, deduction, and credit are passed through to the shareholders (including the ineligible shareholder) under the normal pass-through rules. In other rulings, the IRS has stated that corporate items will not pass through to the ineligible shareholder.

Example 3B-3 Waiver of inadvertent termination of S status.

Xcorp is an S corporation that is 50% owned by a revocable grantor trust (the Trust). The grantor of the Trust died on July 13, 2008, but his Xcorp stock remained in the Trust pending eventual transfer to his children. In August 2010 the Trust changed accounting firms, and the new tax practitioner discovered that Xcorp's S election terminated as of July 12, 2010, because the Trust was a permitted shareholder for only a two-year period.

To preserve the corporation's S election, the tax practitioner recommends that the disqualifying event be immediately rectified, which means that the stock must be removed from the Trust. Accordingly, the tax practitioner, with appropriate involvement of legal counsel, arranges for the Xcorp stock to be distributed immediately to the individual beneficiaries of the Trust. In this way, the stock will be held by individuals, who are eligible to be S shareholders.

The corporation applies for a letter ruling requesting relief from the IRS of the terminating event under the inadvertent termination rule, as discussed earlier in this lesson. Since the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, and because the event took place without the knowledge of the corporation, there appears to be cause to establish that the termination was inadvertent.

Examples of Inadvertent Termination Waivers

A growing number of private letter rulings indicate circumstances in which potential terminating events may be waived by the IRS, as the following examples illustrate.

Example 3B-4 Transfer of stock to an IRA.

In 2008, a shareholder of Ponder, Inc., an S corporation, directed his IRA to purchase shares of the corporation's stock. In 2010, Ponder's new tax practitioner advises the corporation that its S election terminated when

the shares were transferred to the IRA, an ineligible shareholder. Ponder immediately redeemed the stock it had sold to the IRA.

In similar situations, the IRS has ruled that the termination was inadvertent, allowing S status to continue throughout the period the IRA held the stock because the corporation submitted the proper notification to the IRS, took appropriate steps to correct the problem, and intended no tax avoidance and none occurred.

In Ltr. Ruls. 9551004 and 200047028, the IRS stated that the corporation's pass-through items of income, loss, deduction, and credit must be allocated only to the eligible shareholders. However, in Ltr. Rul. 199929029, the IRS ruled that, if the S corporation passed through a loss, the loss had to be allocated to all shareholders, including the ineligible IRA. If, however, the S corporation passed through net income, the income would be allocated only to eligible shareholders.

A rollover distribution of S stock held by an ESOP to a participant's IRA will not terminate the corporation's S election under very limited circumstances. Also, an IRA can be a shareholder of an S corporation bank under certain circumstances.

Example 3B-5 Transfer of stock to corporation, partnership, or other ineligible shareholder.

On March 1, a shareholder of ABC, Inc., an S corporation, transferred his shares to another corporation. This transfer constituted a terminating event, resulting in loss of S status because corporations are ineligible to own S stock. When preparing the corporate tax return, ABC's tax practitioner discovered the terminating event and instructed the shareholder to rescind the exchange. Immediately thereafter, ABC requested relief under IRC Sec. 1362(f).

The IRS has ruled in similar situations that the terminating event was inadvertent, and that the corporation could continue to operate as an S corporation during the period that the stock was held by the ineligible shareholder. In these letter rulings, the IRS stated that the S corporation's pass-through items of income, loss, deduction, and credit must be allocated only to the eligible shareholders. To accomplish this result, the corporation and shareholders may be required to file amended returns for the years in which the ineligible shareholder held the corporation's stock.

In Ltr. Ruls. 200007024 and 200223003, stock was inadvertently transferred to an ineligible shareholder. When the eligible shareholders realized that the S election had terminated, they acquired the stock from the ineligible shareholder. The IRS stated that the corporate items of income, loss, deduction, and credit must be passed through to all shareholders, including the ineligible shareholder.

Example 3B-6 Ineligible trust owning S stock.

Shermco, Inc., an S corporation, issued shares to a trust that did not qualify as an eligible S shareholder. The tax practitioner learned of this disqualifying event and instructed the corporation to redeem all shares held by the trust.

In situations where a trust that was an ineligible S shareholder acquired S stock, the IRS ruled that the termination was inadvertent and permitted the corporation to continue to operate as an S corporation. Not all circumstances require the ineligible trust to dispose of its shares. Assume that the trust in this example had two current income beneficiaries, so it did not qualify as a qualified Subchapter S trust (QSST). Upon discovering that the S election terminated because the stock was held by an ineligible trust, the trust is split into two trusts, each with one beneficiary, and each qualifying as a QSST. Shermco applies for a letter ruling requesting the IRS to waive the termination. Under similar circumstances, the IRS allowed the corporation to remain in S status during the period that the trust was ineligible. The IRS required the beneficiaries of the trust to elect QSST status within 60 days after the letter ruling was issued.

In Ltr. Rul. 200306029, the IRS ruled that pass-through from the S corporation must be allocated only to the eligible shareholders. In Ltr. Ruls. 9623008 and 200216008, the IRS stated that the S corporation's pass-through items must be allocated to all shareholders, including the ineligible trusts.

Example 3B-7 S corporation with C corporation E&P and passive investment income exceeding 25% of gross receipts for three years.

Mayfield, Inc. is a calendar-year real estate holding company that acts as a landlord for its commercial real estate holdings. All tenants are under net leases and Mayfield does not provide significant services or incur substantial costs in the rental business. Mayfield operated as a C corporation from its inception until January 1, 2006, the effective date of its S election. On that date, Mayfield had C corporation accumulated earnings and profits (AE&P) of \$50,000. During 2006, 2007, and 2008, Mayfield's rental income exceeded 25% of its gross receipts. The corporation's former tax preparer did not know the significance of AE&P on the status of an S corporation or that the AE&P could be distributed to the shareholders. In addition, the practitioner failed to have Mayfield pay tax on its net excess passive investment income for 2006–2008, and did not realize that the income would cause the S election to terminate.

In 2011, Mayfield engaged a new tax practitioner to prepare its 2010 return. The new practitioner discovered that the corporation's S status terminated on January 1, 2009. In assessing the situation, the new practitioner learned that neither Mayfield nor its shareholders were aware that the corporation's S status had terminated or that tax was due on its excess net passive investment income. The practitioner also learned that the corporation and its shareholders intended for the corporation to maintain its S status and had continued to treat the corporation as an S corporation after the terminating event.

The IRS has ruled in similar situations that the termination of the corporation's S status was inadvertent. The IRS waived the termination and treated the corporation as continuing its S status. As a condition of the waiver, the IRS required a payment. Presumably the payment was the corporation's liability for the tax on excess net passive income and may have included tax on such income for more than three years. The IRS has also conditioned the waiver on the distribution (or deemed distribution) of the accumulated C corporation earnings and profits.

In another ruling, the IRS granted relief from inadvertent termination because of excess net passive income even though the relief was not requested until several years after the inadvertent termination occurred, and several of the earlier years apparently were closed under the statute of limitations. Also, although not directly stated in the letter ruling, the IRS evidently did not require the S corporation to distribute all of its AE&P to shareholders. Rather, the letter ruling states only that the S corporation took corrective actions to eliminate excessive passive investment income in the future.

Relief from Missed QSST or ESBT Election

If a QSST beneficiary or ESBT trustee fails to make the QSST or ESBT election, S status can terminate. Under Rev. Proc. 2003-43, the IRS provides a waiver from S corporation termination when a QSST or ESBT election is inadvertently not filed. No user fee is required. An S corporation that is ineligible for relief under Rev. Proc. 2003-43 or that is denied relief under that revenue procedure can still ask for a letter ruling granting relief from the inadvertent termination.

Relief from Corporation Dissolution under State Law

The IRS has ruled that the administrative dissolution of an S corporation under state law (because its registration to do business in the state had expired) did not terminate the S election. Furthermore, the corporation's subsequent reincorporation was treated as an F reorganization within the meaning of IRC Sec. 368(a)(1)(F).

Although in several prior rulings the IRS has held that the administrative dissolution of an S corporation did not terminate its S election where, under state law, the corporation was retroactively reinstated, this appears to be the first ruling holding that the S election did not terminate even though the corporation was not retroactively reinstated under state law.

AVOIDING INVOLUNTARILY TERMINATING THE S ELECTION BECAUSE OF EXCESS PASSIVE INVESTMENT INCOME

Passive Investment Income Test

S corporation status will terminate automatically under IRC Sec. 1362(d)(3) if for three consecutive years the corporation has both:

1. accumulated earnings and profits (AE&P) on the last day of the tax year, and
2. passive investment income (including tax-exempt investment income) in excess of 25% of gross receipts.

The termination is effective on the first day of the fourth year.

AE&P

For purposes of the S corporation termination rule, the corporation's AE&P is its earnings and profits (E&P) determined under IRC Sec. 312 for any year during which it was not an S corporation. C corporation AE&P can also exist if an S corporation acquires any other corporation with C corporation AE&P [Reg. 1.1362-2(c)(3)]. (An S corporation does not generate E&P)

Passive Investment Income

Passive investment income for purposes of the three-year termination rule is defined as gross receipts derived from royalties, rents, dividends, interest, and annuities. Passive investment income does not include receipts derived in the ordinary course of a trade or business. For example, income from the active trade or business of renting property, such as income from hotel operations and from vehicle leasing, is not considered passive investment income.

Passive investment income for purposes of terminating the S election has the same definition as passive investment income for purposes of calculating the tax on excess net passive income.

Gross Receipts

Passive investment income must exceed 25% of the corporation's gross receipts before termination of S status is triggered. The term *gross receipts* for purposes of the three-year termination rule has the same definition as gross receipts for calculating the tax on excess net passive income.

Example 3C-1 Determining if passive investment income exceeds 25% of gross receipts.

Essco, Inc., an S corporation with AE&P, had gross income from business operations of \$75,000, of which \$18,000 was received from royalty payments with respect to a patent. In addition, Essco received \$3,500 gross rental receipts, and \$500 in tax-exempt interest income.

The corporation's total gross receipts are calculated as follows:

Gross receipts from operations	\$ 75,000
Gross rental receipts	3,500
Tax-exempt interest income	<u>500</u>
Total gross receipts	<u>\$ 79,000</u>

Passive investment income is determined as follows:

Gross patent royalty receipts	\$ 18,000
Gross rental receipts	3,500
Tax-exempt interest income	<u>500</u>
Total passive investment income gross receipts	<u>\$ 22,000</u>

Essco's passive investment income is 27.85% ($\$22,000 \div \$79,000$ of its gross receipts). This percentage exceeds 25% and consequently begins the running of the three-year period for purposes of terminating the S election under IRC Sec. 1362(d)(3). If the passive income percentage was more than 25% in the second and third years of S status and if Essco continued to have AE&P, the S election would terminate on the first day of the fourth tax year.

Termination of the S Election Can Be Avoided by Distributing AE&P

After all AE&P has been distributed, the S corporation will no longer be subject to the three-year termination rule. Thus, the S election will not terminate if the corporation distributes its AE&P before it has received passive investment income in excess of 25% of gross receipts for three consecutive years. To facilitate distribution of the AE&P, a special election is available that allows S corporations to make distributions from AE&P instead of the accumulated adjustments account (AAA). Another election (to make a deemed dividend) may be helpful if the corporation lacks sufficient assets to make a distribution.

Requesting Waiver of Termination because of Excess Net Passive Income

If the S election terminates because the corporation has AE&P and excess net passive income for three consecutive tax years, the corporation can request that the involuntary termination be waived.

PASSING-THROUGH INCOME AND LOSSES IN THE S TERMINATION YEAR

S Termination Year

The termination of an S election at any time other than the first day of the corporation's tax year results in the creation of an "S termination year." An S termination year must be separated into two short tax years, referred to as an "S short year" and a "C short year." The part of the S termination year ending on the day before the effective date of the termination is an S short year. The remainder of the year, beginning on the date the terminating event occurs, is a C short year.

Allocation of Pass-through Items

If the S election terminates at any time other than the first day of the corporation's tax year, items of income, loss, deduction, and credit must be allocated between the short S and C tax years. The general rule for S termination years requires a prorata allocation based on the number of days in each short tax year. Under this general prorata allocation rule, the amount of each item of separately stated income, deduction, and credit, as well as all of the nonseparately computed net income (or loss), is computed for the entire tax year. Each separately stated item of income, deduction, and credit, and the nonseparately stated net income is then allocated on a prorata basis to each short year using the ratios of the days in each short year to the days in both short tax years combined.

The corporation can elect (with consent of its shareholders) to assign the items of income, loss, and deduction, and credit as if the books were closed as of the day before the S termination. This specific accounting method, however, is required (rather than elective) if 50% or more of the stock is sold or exchanged in the termination year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. How many shareholders are required to sign the separate statement of revocation to give consent?
- a. All shareholders.
 - b. All shareholders owning voting stock.
 - c. Only one family from each family, since they are treated as one shareholder.
 - d. 50% of the shareholders owning outstanding stock.
27. Benji, Inc., a calendar year S corporation, mails a revocation statement to the IRS postmarked on March 13, 20X1. The IRS received the statement on March 20, 20X1. The statement does not specify a revocation date. What date will the revocation be effective?
- a. January 1, 20X1.
 - b. March 13, 20X1.
 - c. March 20, 20X1.
 - d. January 1, 20X2.
28. An S corporation can rescind a voluntary revocation of its S election under certain circumstances. Which of the following statements correctly describes a component of the rescission process?
- a. The rescission may be filed on Form 2553.
 - b. A revocation may be rescinded at any time before the revocation becomes effective.
 - c. Rescission requires consent of more than 50% of the shareholders.
29. In which of the following situations would an S election terminate?
- a. A shareholder pledges his S corporation stock as collateral for a margin loan.
 - b. An S corporation has 100 unrelated shareholders and one shareholder transfers stock to his spouse as joint tenants with rights of survivorship.
 - c. An S corporation has accumulated earnings and profits and fails the passive investment income test for two consecutive years.
 - d. A shareholder transfers 2% of his stock to his wholly owned professional corporation.
30. The IRS has the power to waive an inadvertent S termination. Which of the following terminating events would the IRS not grant a waiver of inadvertent termination?
- a. Deemed second class of stock.
 - b. Transfer of stock to nonresident alien without knowledge of corporation.
 - c. Termination caused by voluntary revocation.
 - d. Exceeding 100 shareholder limit.

31. Orchid, Inc. is a calendar year S corporation. Orchid has accumulated earnings and profits (AE&P) of \$90,000; gross receipts from operations of \$240,000 of which \$25,000 is rental income associated with its lawn equipment leasing business; dividend income of \$15,000, interest income of \$40,000, and taxable income of \$120,000. What should the corporation's passive investment income gross receipts total?
- a. \$55,000.
 - b. \$80,000.
 - c. \$175,000.
 - d. \$295,000.
32. Landco, Inc. is a calendar-year real estate development corporation with accumulated earnings and profits (AE&P) of \$125,000. The company sells all of its assets and invests the proceeds in marketable securities. The corporation elects S status subsequent to the asset sale. Which of the following actions may the corporation take to avoid a termination of the S election due to excess passive investment income?
- a. Invest the sale proceeds in tax-exempt securities.
 - b. Distribute the AE&P before the end of three years as an S corporation.
 - c. Annually distribute the S corporation's passive investment income.
 - d. Pay a corporate level tax on the excess passive investment income generated.
33. Telecom International, a calendar year S corporation, is owned 60% by Luke and 40% by Lora. Luke sells his stock on September 30 to Aidan. In addition, the remaining shareholders voluntarily revoke the S election effective December 31 of the same year. The corporation recognized taxable income of \$150,000 in the first three quarters and a loss of \$50,000 in the fourth quarter. How much income/(loss) is reportable by Luke for the current year?
- a. (\$30,000).
 - b. \$40,000.
 - c. \$45,000.
 - d. \$90,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

26. How many shareholders are required to sign the separate statement of revocation to give consent? **(Page 85)**
- All shareholders. [This answer is incorrect. For a corporation to elect S status, all shareholders must consent to the election. However, a different criterion applies for the revocation of an S election.]
 - All shareholders owning voting stock. [This answer is incorrect. All S shareholders, voting and nonvoting, must be considered.]
 - Only one family from each family, since they are treated as one shareholder. [This answer is incorrect. Family members are treated as one shareholder for purposes of the 100-shareholder limit. For all other purposes, including consents, each person holding an interest in the S corporation's stock is considered a shareholder. For determining consent, how shareholders are counted for purposes of the 100-shareholder limit does not signify.]
 - 50% of the shareholders owning outstanding stock. [This answer is correct. An S corporation can revoke (terminate) its S election with the consent of shareholders owning more than half of its stock. After the S election is revoked, the corporation becomes a "regular" or "Subchapter C" corporation.]**
27. Benji, Inc., a calendar year S corporation, mails a revocation statement to the IRS postmarked on March 13, 20X1. The IRS received the statement on March 20, 20X1. The statement does not specify a revocation date. What date will the revocation be effective? **(Page 85)**
- January 1, 20X1. [This answer is correct. If no effective date is specified, the revocation will be effective: 1) on the first day of the tax year if the revocation statement is filed on or before the 15th day of the third month of the tax year; or 2) on the first day of the following year if the revocation is filed after the 15th day of the third month. Benji's revocation statement was postmarked and filed on March 13, 20X1 which is before the 15th day of the third month.]**
 - March 13, 20X1. [This answer is incorrect. A revocation may specify a prospective effective date. This can be any date on or after the day on which the revocation is made, but must be stated in terms of a specific day, month, and year, and not in terms of a specific event. However, Benji did not specify a date for which the election is effective and must follow the default rules.]
 - March 20, 20X1 [This answer is incorrect. This date represents the date the election is received by the IRS and is not the effective date of the revocation. Benji may specify a prospective effective date for the revocation; however, it failed to do so. Also, the filing date is generally the date the revocation is mailed or hand-delivered to the IRS.]
 - January 1, 20X2 [This answer is incorrect. A revocation statement postmarked after the 15th day of the third month of the tax year and which did not specify a prospective revocation date would be effective as of the first day of the following tax year.]
28. An S corporation can rescind a voluntary revocation of its S election under certain circumstances. Which of the following statements correctly describes a component of the rescission process? **(Page 85)**
- The rescission may be filed on Form 2553. [This answer is incorrect. A statement that the corporation rescinds the revocation made under IRC Sec. 1362(d)(1) is to be filed with the Service Center where the revocation was filed. The notice of rescission should be in the form of a written statement that sets forth the name, address, and identification number of the corporation, as well as a statement that the corporation rescinds its revocation made under IRC Sec. 1362(d)(1). Form 2553 is used to elect S status.]
 - A revocation may be rescinded at any time before the revocation becomes effective. [This answer is correct. According to Reg. 1.1362-6(b), an S corporation can rescind a revocation of its S election**

at any time before the revocation becomes effective. The notice of rescission should be signed on behalf of the S corporation by an officer authorized to sign the corporate return.]

- c. Rescission requires consent of more than 50% of the shareholders. [This answer is incorrect. A rescission can be made only with the consent of each person who consented to the revocation and each person who became a shareholder after the revocation was filed as stated in Reg. 1.1362-6(b).]

29. In which of the following situations would an S election terminate? **(Page 88)**

- a. A shareholder pledges his S corporation stock as collateral for a margin loan. [This answer is incorrect. The mere pledging of the stock does not cause the S election to terminate. Termination can occur if S corporation stock is pledged as collateral for a personal loan and, upon default, the stock is acquired by an ineligible shareholder pursuant to a foreclosure sale.]
- b. An S corporation has 100 unrelated shareholders and one shareholder transfers stock to his spouse as joint tenants with rights of survivorship. [This answer is incorrect. A husband and wife are considered one shareholder for the 100-shareholder limit regardless of how the stock is owned.]
- c. An S corporation has accumulated earnings and profits and fails the passive investment income test for two consecutive years. [This answer is incorrect. Termination can occur if an S corporation that has accumulated earnings and profits (AE&P) receives more than 25% of its gross receipts from passive investment sources in three consecutive years.]
- d. **A shareholder transfers 2% of his stock to his wholly owned professional corporation. [This answer is correct. If an S corporation fails to maintain its status as a "small business corporation" under IRC Sec. 1361(b), its S election automatically terminates on the date the disqualifying event occurs. A disqualifying event that can terminate S status include having an ineligible shareholder (e.g., a corporation, partnership, ineligible trust, or nonresident alien), including a wholly owned corporation.]**

30. The IRS has the power to waive an inadvertent S termination. Which of the following terminating events would the IRS not grant a waiver of inadvertent termination? **(Page 88)**

- a. Deemed second class of stock. [This answer is incorrect. If an S corporation inadvertently held a second class of stock, such as shareholder debt reclassified as equity, then the IRS may waive the inadvertent termination. Before a waiver can become effective, the corporation must be brought back into compliance with all of the S corporation eligibility requirements. This may require eliminating a deemed second class of stock.]
- b. Transfer of stock to nonresident alien without knowledge of corporation. [This answer is incorrect. Transfer of stock to a nonresident alien without the knowledge of the corporation would constitute an inadvertent termination of the S election. The individual transferring the stock would need to rectify the situation before the IRS would waive the inadvertent termination (e.g. buy back the shares).]
- c. **Termination caused by voluntary revocation. [This answer is correct. This waiver rule does not apply to terminations caused by voluntary revocation. A voluntary revocation requires consent of more than 50% of the shareholders and would not be considered an inadvertent termination.]**
- d. Exceeding 100 shareholder limit. [This answer is incorrect. Inadvertent termination can occur if an S shareholder transfers stock in a form of joint ownership, resulting in more than 100 shareholders because each joint owner, other than a family member, is a separate shareholder. The IRS may waive such an inadvertent termination as long as the waiver procedures are followed and the corporation is brought back into compliance as a small business corporation.]

31. Orchid, Inc. is a calendar year S corporation. Orchid has accumulated earnings and profits (AE&P) of \$90,000; gross receipts from operations of \$240,000 of which \$25,000 is rental income associated with its lawn equipment leasing business; dividend income of \$15,000, interest income of \$40,000, and taxable income of \$120,000. The corporation's passive investment income gross receipts total? **(Page 94)**
- a. **\$55,000.** [This answer is correct. Passive investment income for purposes of the three-year termination rule is defined as gross receipts derived from royalties, rents, dividends, interest, and annuities. Passive investment income does not include receipts derived in the ordinary course of a trade or business or from the business of renting property.]
 - b. \$80,000. [This answer is incorrect. Income from the active trade or business of renting property, such as income from hotel operations and from equipment leasing, is not considered passive investment income.]
 - c. \$175,000. [This answer is incorrect. Taxable income is not considered passive investment income. Passive investment income gross receipts are calculated at gross as opposed to net of expenses.]
 - d. \$295,000. [This answer is incorrect. Gross receipts from operations are ordinary business income and do not constitute passive investment income. Passive investment income is generated from passive activities or investments.]
32. Landco, Inc. is a calendar-year real estate development corporation with accumulated earnings and profits (AE&P) of \$125,000. The company sells all of its assets and invests the proceeds in marketable securities. The corporation elects S status subsequent to the asset sale. Which of the following actions may the corporation take to avoid a termination of the S election due to excess passive investment income? **(Page 94)**
- a. Invest the sale proceeds in tax-exempt securities. [This answer is incorrect. Tax-exempt investment income is considered passive investment income.]
 - b. **Distribute the AE&P before the end of three years as an S corporation.** [This answer is correct. After all AE&P has been distributed, the S corporation will no longer be subject to the three-year termination rule. Thus, the S election will not terminate if the corporation distributes its AE&P before it has received passive investment income in excess of 25% of gross receipts for three consecutive years.]
 - c. Annually distribute the S corporation's passive investment income. [This answer is incorrect. Annual distributions to the shareholders consisting of the S corporation's passive investment income will reduce the corporation's accumulated adjustments account (AAA). The distribution is treated as a return of previously taxed income to the shareholder and does not alleviate a potential termination of an S election due to excess passive investment income.]
 - d. Pay a corporate level tax on the excess passive investment income generated. [This answer is incorrect. If an S corporation with AE&P has excessive passive investment income, it will be subject to an excise tax. However, this tax will not avoid a potential termination of the S election.]
33. Telecom International, a calendar year S corporation, is owned 60% by Luke and 40% by Lora. Luke sells his stock on September 30 to Aidan. In addition, the remaining shareholders voluntarily revoke the S election effective December 31 of the same year. The corporation recognized taxable income of \$150,000 in the first three quarters and a loss of \$50,000 in the fourth quarter. How much income/(loss) is reportable by Luke for the current year? **(Page 95)**
- a. (\$30,000). [This answer is incorrect. This amount represents the pass-through loss allocated to Aidan for the period of his ownership.]
 - b. \$40,000. [This answer is incorrect. This amount represents the pass-through income to Lora since she is a 40% shareholder the entire calendar year.]

- c. \$45,000. [This answer is incorrect. This amount represents the allocable income to Luke under the prorata allocation method. However, this method cannot be used when 50% or more of the S corporation stock is sold or exchanged in the termination year.]
- d. **\$90,000. [This answer is correct. The specific accounting method is required (rather than elective) if 50% or more of the stock is sold or exchanged in the termination year. Luke's allocation is 60% of the taxable income recognized through September 30 which equals \$90,000 (60% x \$150,000).]**

FILING SHORT-YEAR RETURNS FOR S TERMINATION YEAR

Filing Requirements

In addition to the corporate election statement and shareholder consent statement to be attached to the short C return if the corporation elects to use the specific accounting method, certain other unique reporting issues arise in an S termination year.

Pass-Through in Short S Year

A non-year-end termination of S status divides the tax year into two separate periods for allocation purposes. The S short period begins on the first day of the tax year and ends on the day before the terminating event occurs. The C short period begins on the day the terminating event occurs, and ends on the last day of the tax year. Items of corporate income, loss, deduction, etc., are allocated to the S and C short periods on a daily prorata basis using the prorata method or the specific accounting method. Items allocated to the S short period pass through to the shareholders and are reported by them in the year in which the corporation's tax year normally ends. (Stated another way, termination of S status does not accelerate the shareholder's reporting of pass-through items.) Items allocated to the C short period are reported by the C corporation.

Due Date for S and C Short-year Returns

If an S corporation terminates its S election during its tax year, the question arises as to when Form 1120S for the S short year must be filed. IRC Sec. 1362(e)(6)(B) provides that the due date for filing the return for the S short tax year is the same as the due date for filing Form 1120 for the C short year (including extensions).

Example 3E-1 Due date for S short-year return.

Esscorp, an S corporation, has historically used a September 30 year-end for tax purposes. On October 1, 2010, Esscorp filed a revocation of its S status to be effective January 1, 2011. It will therefore have to file Form 1120S for the short tax year ending December 31, 2010.

The final Form 1120S for the S short year ending December 31, 2010, and the Form 1120 for the C short year ending September 30, 2011 are due December 15, 2011. Esscorp's shareholders include the pass-through items from the S short year ending December 31, 2010 in their 2011 personal returns.

Obtaining an Extension to File Both Short-period Returns

The corporation can obtain a six-month extension to file both short-period returns resulting from a mid-year termination of S status. According to Reg. 1.1362-3(c)(5), the return for the S short year is due by the same date the return for the C short year is due, including extensions. Thus, filing Form 7004 (Application for Automatic Extension of Time to File Corporate Income Tax Return) extends the due date for both the final S return and the initial C return.

Example 3E-2 Extending both short-period returns.

Assume the same facts as in Example 3E-1. Esscorp can extend the due date for filing both the final Form 1120S and the initial Form 112 to June 15, 2012, by filing Form 7004. In the authors' opinion, to obtain the extension, Esscorp would:

1. enter "12" (the code for the C corporation tax return, Form 1120) on line 1b,
2. show the beginning and ending dates of its C short year in line 5a of Form 7004,
3. check the "Initial return" box on line 5b of Form 7004 to indicate an initial C return, and
4. write "S termination year" in a blank space on line 5b of Form 7004.

Annualizing C Short-year Income

To eliminate the benefit from full use of the lower corporate tax rate tiers in the initial Form 1120, a corporation terminating its S election (such as Esscorp in Example 3E-2) must compute tax under the annualized method for the C short period.

Counting Years for Carryover Purposes

For carryover purposes, the S short year is not counted, even though two tax reporting years are created. Thus, for purposes of the statute of limitations, as well as the carryover of net operating losses, capital losses, and unused credits, the S termination year counts as only one year even though two returns are filed.

Example 3E-3 Carryover items when S election terminates.

Newco, Inc., a calendar-year corporation, incorporated in 2006 and incurred a \$20,000 net operating loss and a \$5,000 capital loss that year when the company reported as a C corporation on Form 1120. Newco elects S status the following year. The corporation revoked its S election effective July 1, 2010, creating two short tax years in that calendar year. (No capital gains were recognized during the C short year.)

If each short tax year in the S termination year counted as a separate year for carryover purposes, the five-year carryover period for capital losses would have expired by December 31, 2010. Fortunately, the S and C short years count as one year, so 2011 is the fifth year of the carryover period and the C corporation can use the capital loss to the extent of capital gains in that year.

Checkbox on Form 1120S to Report S Election Termination or Revocation

If the S election is terminated or revoked during the year, the box at line H(5) on page 1 of Form 1120S and the "Final K-1" box on Schedule K-1 should be checked to notify the IRS that this will be the final S corporation return. Furthermore, if the S election involuntarily terminated, a statement should be attached to the tax return. The "Final return" line on page 1 at H(1) is checked only if the corporation liquidated during the year and no longer exists.

Balance Sheet Presentation on Form 1120S in Year S Election Terminates

Schedule L on Form 1120S is comprised of the S corporation's balance sheets at the beginning and end of the tax year.

Accounting for AAA and AE&P following Termination of S Status

Shareholder basis, and the corporation's accumulated adjustments account (AAA) and accumulated earnings and profits (AE&P), are accounted for in the following manner following the termination of the corporation's S election:

1. Each shareholder's stock basis carries over and becomes the shareholder's basis in C corporation stock.
2. Each shareholder's debt basis carries over and becomes the shareholder's basis in debt owed by the C corporation.
3. The corporation's AAA can be distributed tax-free (to the extent of stock basis) during the post-termination transition period. However, any AAA remaining after the end of the post-termination transition period loses its identity as such, and so loses its tax-free attribute. The remaining AAA carries over to become part of the C corporation's retained earnings.
4. The corporation's AE&P carries over and becomes part of the C corporation's AE&P.

THE ADVANTAGES OF THE POST-TERMINATION TRANSITION PERIOD

Purpose of Post-termination Transition Period

Following termination of S status, a special grace period, the post-termination transition period (PTTP), is provided for these important purposes.

1. Distributions of money to shareholders are nontaxable to the extent of the accumulated adjustments account (AAA). (Such nontaxable distributions, however, are limited to the shareholder's stock basis.)
2. Shareholders may increase basis in their stock, to allow the deduction of pass-through S corporation losses not previously deducted because of the lack of shareholder basis.
3. Losses of an S corporation suspended under the at-risk rules of IRC Sec. 465 are carried forward to the S corporation's PTTP. The losses can be deducted at the end of the PTTP to the extent stock basis and at-risk basis are increased by (e.g., capital contributions) during the PTTP.

Methods of Increasing Stock Basis during the PTTP. A shareholder may increase stock basis during the PTTP by making capital contributions to the corporation or purchasing stock in the corporation. Also, stock basis is increased if the shareholder is allocated additional pass-through income due to an IRS audit.

Definition of Post-termination Transition Period

The post-termination transition period is:

1. the period beginning on the day after the last day of the corporation's last S corporate year and ending on the later of:
 - a. one year after such last day, or
 - b. the due date, including extensions, of that year's tax return;
2. the 120-day period after a determination that the S election had been terminated for a previous year; or
3. the 120-day period beginning on the date of any determination under an IRS audit occurring after the termination of the S election, if an S corporation item of income, loss, or deduction is adjusted.

Items 2 and 3 on the preceding list provide a grace period for an S corporation that discovers the occurrence of a retroactive termination of S status, or when S corporation items of income or loss are changed by an IRS audit. For purposes of beginning the 120-day period, a determination of loss of S status includes a court decision that has become final, a closing agreement with the IRS, or an agreement between the IRS and the corporation that it failed to qualify as an S corporation. While the date that a court decision becomes "final" has not been clarified by the IRS, it presumably is the date after which the decision can no longer be modified or appealed.

Distributions of AAA during the Post-termination Transition Period

For a C corporation, distributions to shareholders are first treated as dividends, to the extent of either current or accumulated earnings and profits of the corporation. However, the PTTP exists to provide relief to the shareholders of a corporation that has terminated its S status. During the PTTP, any distribution of money by the corporation to its shareholders is first applied to reduce the basis of the shareholder's stock to the extent the distribution does not exceed the AAA.

Example 3F-1 Distributions during the post-termination transition period.

Bowser Bags, Inc., an S corporation, terminates its S election on December 31, 2009, and becomes a C corporation on the following day. The corporation has balances of \$21,000 in AAA, \$7,000 in PTI, and

\$12,000 in AE&P at December 31, 2009. Bob, the sole shareholder, has stock basis of \$30,000 at the date the S election terminates.

Nontaxable cash distributions up to the amount of the AAA ending balance (\$21,000) can be made to Bob during the post-termination transition period, in this case the one-year period following revocation of the S election. (This is true even though the corporation is now in C status and distributions would normally be distributions of AE&P.) The distributions reduce the corporation's AAA balance and reduce Bob's stock basis.

Example 3F-2 PTI and the post-termination transition period.

Assume the same facts as in Example 3F-1, except that the corporation distributes \$28,000 to Bob during the post-termination transition period. The distribution is nontaxable to the extent of AAA, \$21,000. However, the PTI disappears when the S election terminates and cannot be distributed before AE&P. Therefore, \$7,000 of the distribution is a distribution of AE&P and is a taxable dividend.

Example 3F-3 Post-termination transition period following an IRS audit.

Kelli is the sole shareholder in Jetcorp, an S corporation. The corporation voluntarily revokes its S election on December 31, 2008 when the AAA balance is \$25,000 and Kelli's stock basis is \$32,000. Kelli withdraws \$25,000 in cash from the corporation on March 15, 2009. Since the withdrawal is made during the PTTP, it is a distribution of AAA and reduces the AAA to zero and her stock basis to \$7,000. On February 1, 2010, the IRS begins an audit of Jetcorp's 2008 return. The auditor finds that the S corporation's depreciation deduction was overstated by \$5,000. On March 18, 2010, Kelli signs a closing agreement showing an assessment of additional tax on her 2008 Form 1040 because of the error on Jetcorp's return. Kelli's stock basis and the accumulated adjustments account will increase by the additional income, \$5,000, and Kelli can withdraw the AAA in cash tax-free if the withdrawal is made by July 15, 2010 (i.e., the end of the 120-day PTTP that begins on March 18).

The PTTP represents a last chance opportunity to bail previously taxed cash and basis out of the corporation in a tax-free manner. A distribution sufficient to eliminate the previously taxed AAA should be considered, either in the final S year or during the PTTP. Note that the post-termination transition period allows access only to AAA; if a distribution during the PTTP exceeds AAA, it first is considered from current C corporation earnings and profits before being allowed as a return of stock basis.

Distributions of AAA during the PTTP should be reported on Form 5452 (Corporate Report of Nondividend Distributions), according to the instructions to the form.

Election to Distribute AE&P before AAA

Any distribution of money by the corporation to its shareholders during the PTTP is first applied to reduce the basis of the shareholder's stock to the extent the distribution does not exceed the AAA. Thus, the PTTP allows an S corporation to distribute AAA in cash after the S election terminates. However, in certain situations it may be beneficial for the corporation to distribute AE&P prior to AAA, and an election is available for the corporation to do so.

Using the Post-termination Transition Period to Deduct Losses

Losses Limited by Stock and Debt Basis. The carryover of unused S corporation losses (resulting from stock and debt basis limitations) that occurs at the shareholder level is indefinite, provided the S corporation continues to maintain its eligibility. However, upon termination of S status, these shareholder suspended loss carryovers expire. IRC Sec. 1377(b) provides a special relief provision that allows these losses to be deducted by the shareholder at the end of the PTTP.

Any losses that have not been used when the S election terminates are treated (under this special provision) as if they were incurred on the last day of the PTTP. Accordingly, if an S shareholder increases stock basis during the PTTP, suspended losses will be deductible to the extent of the additional basis.

Example 3F-4 Losses allowed after S termination.

Frank Andrews is the sole shareholder of Dellcom, Inc., a calendar-year S corporation. On February 14, 2010, he transfers a portion of his stock to a partnership (an ineligible shareholder), causing termination of S status. As of the beginning of the year, Frank had \$3,000 of adjusted basis in his S corporation stock. However, his pass-through loss for the final short-period S corporation return from January 1 through February 13, 2010 is \$10,000, resulting in a \$7,000 excess loss due to insufficient basis. Under the post-termination transition period rule, Frank has until March 15, 2011 (the due date of the final S corporation tax return) to contribute additional capital, which will generate stock basis that will allow Frank to utilize the \$7,000 suspended loss. If the corporate tax return is extended, Frank will have until the extended due date to inject the capital.

The loss is treated as incurred on the last day of the PTTP. Evidently, the loss cannot be deducted before the end of the PTTP, so Frank could not claim the \$7,000 loss in 2010, even if he increased his stock basis by such amount on or before December 31, 2010.

Example 3F-5 Debt basis not available after S termination.

Assume the same facts as in Example 3F-4, except that Frank is reluctant to inject \$7,000 of additional paid-in capital to increase his stock basis, since this does not increase his percentage ownership in the corporation. Frank fears that much of the economic benefit of any additional paid-in capital on his part would fall to the partnership, which now owns the majority of the stock. Frank would prefer to loan \$7,000 of additional funds to the corporation during the PTTP to claim his suspended loss. However, IRC Sec. 1366(d)(3)(B) limits the use of losses and deductions during the PTTP to the adjusted basis of the shareholder's stock. Additional basis generated via a loan to the corporation does not qualify for this privilege.

While losses cannot be deducted against debt basis during the PTTP, loans made to the corporation before the S election terminates can be used to make full use of S corporation pass-through losses. For example, if Frank had anticipated the transfer of stock to the partnership, he could have calculated the expected disallowed loss and loaned that amount to Dellcom on or before February 13. Such a transaction would give Frank sufficient debt basis to deduct his share of the loss for the final S year in full without sacrificing capital to the partnership.

Increasing Stock Basis during the PTTP. When evaluating the merits of contributing capital into the corporation during the PTTP to deduct losses limited by the stock or at-risk basis rules, the shareholder must consider the economic merits. For example, the loss allowed by a contribution of \$10,000 recovers only \$3,500 of tax savings at a 35% rate. If the corporation fails, the shareholder has lost \$6,500. The likelihood of recovering the funds should be explored before making the capital contribution.

However, reduced basis debt (i.e., debt with an adjusted basis that is less than its face amount) will give rise to corporate-level income if contributed after the S election terminates. Income recognition can be avoided if the debt is contributed before S status is terminated.

Losses Limited by At-risk Basis

Losses of an S corporation suspended under the at-risk rules of IRC Sec. 465 are carried forward to the S corporation's PTTP. The losses can be deducted at the end of the PTTP to the extent stock basis and at-risk basis are increased (e.g., by capital contributions) during the post-termination transition period [IRC Sec. 1366(d)(3)].

Example 3F-6 Carryover of at-risk loss to the post-termination transition period.

Andy owns 30% of the stock in a calendar-year S corporation. Andy has a \$9,000 suspended at-risk loss carryforward. Shareholders owning more than 50% of the corporation's stock file a revocation of the corporation's S election, effective January 1, 2010, and the one-year PTTP begins on that date. The corporation makes no distributions during 2010. If Andy contributes at least \$9,000 to capital during 2010, he can deduct the \$9,000 at-risk loss carried into that year. Andy must increase stock basis; an increase in debt basis during the PTTP will not increase his amount at-risk.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Diane is the sole shareholder of Beach Villa, Inc., a September 30 year-end S corporation. On December 31, 2010, she transfers all of her stock to the Barefoot Beach Partnership in exchange for a general partnership interest. The S election terminates. In which year would Diane will recognize the pass-through items for the S short year on her personal returns?
- a. 2010.
 - b. 2011.
35. After an S corporation ceases to qualify as a small business corporation, a post-termination transition period (PTTP) follows. The PTTP is important because it allows the shareholder and/or corporation the following actions during the grace period, except?
- a. Increase shareholder basis in their stock.
 - b. Distribute the accumulated adjustments account tax-free to shareholders.
 - c. Increase a shareholder's at-risk basis.
 - d. Pass-through of corporate losses.
36. Mugsy, Inc. is a calendar year S corporation. It voluntarily revokes its S election effective December 31, 20X1. What is the latest date that the post-termination transition period (PTTP) ends for Mugsy?
- a. September 15, 20X2.
 - b. December 31, 20X2.
 - c. The 120-day period after a determination that the S election terminated for a previous year.
 - d. The 120-day period after the IRS concurs with the termination of S status.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. Diane is the sole shareholder of Beach Villa, Inc., a September 30 year-end S corporation. On December 31, 2010, she transfers all of her stock to the Barefoot Beach Partnership in exchange for a general partnership interest. The S election terminates. In which year would Diane will recognize the pass-through items for the S short year on her personal returns? **(Page 103)**
2010. [This answer is incorrect. The S corporation will file its final Form 1120S for the short tax year ending December 31, 2010. However, Diane will recognize the pass-through income/(loss) in a different period.]
 - 2011. [This answer is correct. Items allocated to the S short period pass through to the shareholders and are reported by them in the year in which the corporation's tax year normally ends as indicated in Reg. 1.1362-3(c)(6). (Stated another way, termination of S status does not accelerate the shareholder's reporting of pass-through items.) The S corporation's normal year-end would be June 30, 2011; therefore, Diane will recognize the pass-through items on her 2011 personal return.]**
35. After an S corporation ceases to qualify as a small business corporation, a post-termination transition period (PTTP) follows. The PTTP is important because it allows the shareholder and/or corporation the following actions during the grace period, except? **(Page 105)**
- Increase shareholder basis in their stock. [This answer is incorrect. During the PTTP, shareholders may increase basis in their stock, to allow the deduction of pass-through S corporation losses not previously deducted because of the lack of shareholder basis as stated in RC Sec. 1366(d)(3).]
 - Distribute the accumulated adjustments account tax-free to shareholders. [This answer is incorrect. The accumulated adjustments account (AAA) is an S corporation account. Distributions of money to shareholders are nontaxable to the extent of AAA according to IRC Sec. 1371(e)(1). (Such nontaxable distributions, however, are limited to the shareholder's stock basis.) During the PTTP, the corporation may distribute money from AAA. Once the PTTP expires, AAA is folded into corporate retained earnings and distributions are considered dividends to the shareholder.]
 - Increase a shareholder's at-risk basis. [This answer is incorrect. Losses of an S corporation suspended under the at-risk rules of IRC Sec. 465 are carried forward to the S corporation's PTTP. The losses can be deducted at the end of the PTTP to the extent stock basis and at-risk basis are increased by (e.g., capital contributions) during the PTTP as detailed in IRC Sec. 1366(d)(3)(D).]
 - Pass-through of corporate losses. [This answer is correct. Once the S election terminates, the entity is a C corporation. Losses recognized as a C corporation cannot pass-through to the shareholders, even losses incurred during the PTTP. The PTTP allows a shareholder to increase their stock basis and/or at-risk basis to deduct previously disallowed losses or to allow a shareholder to distribute AAA tax-free to the extent of stock basis.]**
36. Mugsy, Inc. is a calendar year S corporation. It voluntarily revokes its S election effective December 31, 20X1. What is the latest date that the post-termination transition period (PTTP) ends for Mugsy? **(Page 105)**
- September 15, 20X2. [This answer is incorrect. The due date for the final S corporation return, including extensions, is September 15, 20X2. Under certain circumstances, the PTTP ends on this date; however, Mugsy, Inc. is allowed a longer grace period.]
 - December 31, 20X2. [This answer is correct. For Mugsy, Inc. the post-termination transition period is the period beginning on the day after the last day of the corporation's last S corporate year and ending on the later of: a) one year after such last day, or b) the due date, including extensions. December 15, 20X2 is the later of the two dates.]**

- c. The 120-day period after a determination that the S election terminated for a previous year. [This answer is incorrect. The PTP may extend to the 120-day period after a determination that the S election had been terminated for a previous year. This provides a grace period for an S corporation that discovers the occurrence of a retroactive termination of S status. However, Mugsy, Inc. did not terminate in a previous year.]
- d. The 120-day period after the IRS concurs with the termination of S status. [This answer is incorrect. The IRS does not review all S corporation terminations. If audited, the PTP may extend to the 120-day period beginning on the date of any determination under an IRS audit occurring after the termination of the S election, if an S corporation item of income, loss, or deduction is adjusted.]

THE PROCESS OF REELECTING S STATUS AFTER TERMINATION

Five-year Reelection Rule

Generally, a corporation must wait five years after termination of its S election before it can reelect S status (i.e., the corporation cannot make a new S election before its fifth tax year that begins after the first taxable year for which the termination was effective). This rule applies whether the termination was voluntary or involuntary, and it applies to any successor corporation.

Example 3G-1 Applying the five-year reelection rule.

Newpro, Inc., a calendar year S corporation, revoked its S election effective January 1, 2010. Once the S election is terminated, the corporation cannot make a new S election before its fifth tax year that begins after the first tax year for which the termination was effective. (The year ended December 31, 2010, is the first tax year in which the termination was effective.) Therefore, the earliest that Newpro can reelect S status without IRS permission is January 1, 2015, i.e., the fifth tax year beginning after the first tax year for which the termination was effective.

Assume now that Newpro revoked its S election effective May 1, 2010. Here, the period between May 1 and December 31, 2010 is treated as the first tax year in which the termination was effective. Therefore, Newpro can reelect S status on January 1, 2015, i.e., the fifth tax year beginning after the first tax year for which the termination was effective. If Newpro wanted to reelect S status before that date, it could request the IRS to waive the five-year period, as discussed later in this lesson.

Five-year Waiting Period Applies to QSub Terminations

A five-year waiting period is similarly imposed on a corporation after its qualified Subchapter S subsidiary (QSub) election terminates. The former QSub corporation generally must wait five years before it is eligible to make an S election or have another QSub election made for it.

Exceptions to the Five-year Rule

The IRS has the authority to waive the five-year rule in certain situations. Under Reg. 1.1362-5, the IRS may consent to an early reelection in one of two situations:

1. *New Majority Ownership.* More than 50% of the stock in the corporation is owned by persons who did not own the stock at the time of the termination.
2. *Inadvertent Termination.* The event that caused the termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation, and it was not part of a plan by the corporation or the shareholders to terminate the election. If the corporation loses its S status because it inadvertently ceased to qualify as an S corporation or inadvertently violated the restriction on passive investment income, the IRS may allow it to retain S status upon establishing that the termination was unintentional, and the corporation and its shareholders have taken steps to correct the event within a reasonable period of time. The IRS, for example, waived the five-year rule when a depressed economy caused a company to have excess passive investment income.

An S corporation requests the IRS to waive the five-year rule by applying for a letter ruling. A user fee must accompany the ruling request.

Example 3G-2 Requesting IRS permission to reelect S status before five-year period expires.

Rocker, Inc., a calendar-year S corporation, revokes its S election on April 1, 2010. Each of Rocker's five shareholders owns 100 shares of stock. In 2011, three shareholders sell all of their stock to an unrelated shareholder. Can Rocker reelect S status after the new stockholders acquire their shares? The IRS would probably grant permission to reelect S status before expiration of the five-year period because more than 50%

of the stock in the corporation is owned by persons who did not own the stock at the time the S election terminated. Rocker would file a request for a letter ruling and remit the applicable user fee discussed earlier.

Other Exceptions. There are two other possible exceptions to the five-year waiting period that could allow a corporation to immediately reelect S status:

1. *Never an S Corporation because of Ineligibility.* The five-year waiting period does not apply if the termination occurred because the corporation failed the eligibility tests on the first day for which its S election was to become effective.
2. *Election Revoked before Becoming Effective.* The purpose of IRC Sec. 1362(g) is to prevent corporations from electing in and out of S status whenever the change is beneficial. Therefore, the IRS has ruled that an S corporation that validly elects S status, but never receives the benefit of S status because the election is revoked or terminated (by filing a revocation of the election by the 15th day of the third month of the corporation's fiscal year for which the election was to be effective), can make a new election prior to the expiration of the five-year waiting period.

Because the five-year waiting period does not apply under the preceding two circumstances, the S corporation is not required to file for a letter ruling or pay a user fee.

Five-year Reelection Rule Applies to a Successor Corporation

The rule prohibiting an S corporation from reelecting S status for five years also applies to a "successor corporation" of the S corporation. A successor for these purposes is defined as any corporation:

1. 50% or more of the stock of which is owned, directly or indirectly, by the same persons who, on the date of the termination, owned 50% or more of the stock of the prior corporation; and
2. that acquires a substantial portion of the assets of the prior corporation.

Example 3G-3 Reapplying for S corporation status by a successor corporation (five-year rule).

Newpro, Inc., a calendar-year S corporation, revokes its S election on May 1, 2010. (These are the same facts as in Example 3G-1.) Each of Newpro's four shareholders owns 100 shares of stock. In 2011, three of the four Newpro shareholders formed a new corporation, AMB, Inc. Thereafter, they merged Newpro into AMB and redeemed all of the stock owned by the fourth Newpro shareholder. The three shareholders of AMB want to once again elect S status.

As noted in Example 3G-1, Newpro is prohibited from reelecting S status until the tax year beginning on January 1, 2015. The five-year rule also applies to AMB if it is the "successor corporation" of Newpro. Since the AMB shareholders owned 75% of the Newpro stock at the time the S termination was effective, AMB is a successor to Newpro and cannot elect S status without IRS permission for five years. It is unlikely that the IRS would grant permission to reelect S status before that period ends because more than 50% of AMB's stock is owned by persons who owned Newpro's stock at the time the S election terminated. (If AMB were owned by persons unrelated to the Newpro shareholders, AMB would not be a successor corporation and could immediately elect S status without IRS permission.)

Carryover Losses after Termination of S Status

It is unclear what happens to a shareholder's carryover losses when the S election terminates and S status is reelected.

Example 3G-4 Carryover losses when S status is terminated and reelected.

Geecorp is an S corporation that terminates S status. At that time, Gary, its sole shareholder, has \$15,000 of suspended losses he cannot use because of lack of basis. He does not increase basis and deduct the losses during the post-termination transition period (PTTP). No S corporation attributes carry over into the C corpora-

tion years, so he is unable to deduct the \$15,000 loss after the expiration of the PTP. Five years later, the corporation reelects S status. Can Gary deduct the unused S corporation losses if he has sufficient basis in Geecorp after S status is reelected?

The answer to this question is unknown. Reg. 1.1366-2(a)(2) calls for the “indefinite” carryover of disallowed losses and deductions, but does not provide that the loss will survive a termination of the S election.

The next to last sentence of Reg. 1.1366-2(b)(2) states that any carryover losses and deductions in excess of a shareholder's adjusted stock basis as of the end of the PTP are “permanently disallowed.” However, some practitioners argue that this sentence in the regulation relates to the previous sentence that discusses when adjusted basis is computed for a shareholder who disposed of all his S stock during the year. More guidance from the IRS is needed in this area.

Carryover of S Corporation Attributes after Termination

It is unclear what happens to S corporation attributes (such as the AAA and shareholders' carryover losses) when the S election terminates and S status is reelected.

Example 3G-5 Carryover of S corporation attributes when S status is reelected.

Geecorp is an S corporation that terminates S status. At that time it has a \$20,000 negative balance in its AAA and Gary, its sole shareholder, has \$15,000 of suspended losses he cannot use because of lack of basis. He does not increase basis and deduct the losses during the post-termination transition period (PTTP). No S corporation attributes carry over into the C corporation years, so he is unable to deduct the \$15,000 loss after the expiration of the PTP. Five years later, the corporation reelects S status.

Does the AAA balance begin at zero, even though it had a negative balance when the S election terminated?

The answer to this question appears to be yes. The AAA balance begins at zero on the first day of the first year in which the corporation is an S corporation. The Code provides that AAA is adjusted for pass-through items and distributions during the “S period.” The S period is the “most recent, continuous period during which the corporation has been an S corporation”. Because adjustments are made to the AAA only during the *most recent* continuous period of operating as an S corporation, it appears that the AAA would begin at zero when S status is reelected. This would evidently be true regardless of whether the AAA balance was negative or positive when the election terminated.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. Generally, a corporation must wait five years after its S election terminates before it can reelect S status. Which of the following is an exception to the five-year rule?
- a. Less than 50% change in ownership of the corporation.
 - b. Voluntary revocation.
 - c. The company never became an S corporation due to ineligibility.
38. Which of the following would be an exception to the five-year reelection rule for reelecting S corporation status?
- a. Stock transfer to ineligible shareholder.
 - b. Qualified subchapter S subsidiary election terminates.
 - c. S election revoked before becoming effective.
 - d. Successor corporation of the S corporation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. Generally, a corporation must wait five years after its S election terminates before it can reelect S status. Which of the following is an exception to the five-year rule? **(Page 112)**
- a. Less than 50% change in ownership of the corporation. [This answer is incorrect. The IRS may consent to an early reelection if more than 50% of the stock in the corporation is owned by persons who did not own the stock at the time of the termination according to Reg. 1-1.362-5.]
 - b. Voluntary revocation. [This answer is incorrect. The IRS may consent to an early reelection if the event that caused the termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation, and it was not part of a plan by the corporation or the shareholders to terminate the election. A voluntary revocation is within the control of the shareholders and would not be allowed under Reg. 1.1362-5.]
 - c. **The company never became an S corporation due to ineligibility. [This answer is correct. As stated in Reg. 1.1362-5(c), the five-year waiting period does not apply if the termination occurred because the corporation failed the eligibility tests on the first day for which its S election was to become effective.]**
38. Which of the following would be an exception to the five-year reelection rule for reelecting S corporation status? **(Page 112)**
- a. Stock transfer to ineligible shareholder. [This answer is incorrect. Transfers of stock to an ineligible shareholder will terminate the S election. The five-year rule applies whether the S election termination was voluntary or involuntary.]
 - b. Qualified subchapter S subsidiary election terminates. [This answer is incorrect. A qualified subchapter S subsidiary (QSub) is a wholly owned subsidiary of the S corporation. The S corporation must elect to treat the corporation as a QSub. A five-year waiting period is similarly imposed on a corporation after its qualified Subchapter S subsidiary (QSub) election terminates. The former QSub corporation generally must wait five years before it is eligible to make an S election or have another QSub election made for it.]
 - c. **S election revoked before becoming effective. [This answer is correct. The purpose of IRC Sec. 1362(g) is to prevent corporations from electing in and out of S status whenever the change is beneficial. Therefore, the IRS has ruled that an S corporation that validly elects S status, but never receives the benefit of S status because the election is revoked or terminated (by filing a revocation of the election by the 15th day of the third month of the corporation's fiscal year for which the election was to be effective), can make a new election prior to the expiration of the five-year waiting period.]**
 - d. Successor corporation of the S corporation. [This answer is incorrect. The rule prohibiting an S corporation from reelecting S status for five years also applies to a "successor corporation" of the S corporation. A successor for these purposes is defined as any corporation 50% or more of the stock of which is owned, directly or indirectly, by the same persons who, on the date of the termination, owned 50% or more of the stock of the prior corporation; and that acquires a substantial portion of the assets of the prior corporation.]

THE TAX REQUIREMENTS OF ESTIMATED TAX FOLLOWING A TERMINATION

Estimated Tax Payment Requirements

After terminating S status, a corporation will immediately need to consider its responsibility to file quarterly estimates of corporate income taxes. Because the final S corporation return normally will not involve the payment of any corporate tax, the first C corporation return following termination of S status generally often will not have a "prior year tax" exception (discussed later) on which to base quarterly estimates. Accordingly, the estimated tax payments for the first C corporation return will normally be based on actual income earned in the first C tax year. However, see Example 3H-1 for circumstances when estimate payments may be based on the corporation's last year in S status.

Corporations subject to income tax must make payments of estimated tax during the taxable year unless their actual tax for the year is less than \$500. (However, as discussed later in this lesson, Reg. 1.6655-5 provides that no estimated tax payments are required if the corporation has a short tax year of less than four months.) Failure to make payments of estimated tax results in an underpayment penalty assessed at the underpayment rate, which is a floating interest rate determined by the IRS under IRC Sec. 6621.

The underpayment penalty for insufficient estimated tax payments applies if the amounts actually remitted do not reach 100% of the tax shown on the return as filed for the corporate tax year (or, if no return is filed, 100% of the tax liability). However, there are exceptions that will negate this underpayment penalty, even though a corporation may not have actually paid in amounts that reach 100% of the tax shown on the return for the current year. The underpayment penalty will not apply if the actual estimated tax payments exceed one of the following amounts:

1. *100% of the Prior Year's Tax.* The amount of tax shown on the return of the corporation for the preceding tax year, if a return showing a liability was filed by the corporation for the preceding year, and the preceding year was a taxable year of 12 months.
2. *100% of the Current Year's Annualized Tax.* An amount equal to 100% of the tax for the current year computed by placing the actual taxable income earned during the period before each quarterly estimated tax payment date on an annualized basis.
3. *100% of the Adjusted Seasonal Tax.* An amount equal to 100% of the tax determined by annualizing current year-to-date income using a percentage derived from the ratio of the prior three years' quarterly income to total income.

Basing C Corporation Estimated Tax on 100% of Prior Year's Tax

Basing the estimated tax payments on 100% of the prior year's tax (exception 1 in the preceding list) is not available for large corporations, defined as those having taxable income of \$1 million or more for any of the three tax years preceding the tax year for which the estimated tax payments are made. However, a large corporation can generally base the first required installment for any year on the prior year's tax.

Under IRC Sec. 6655(d)(1), a C corporation (other than a large corporation, as defined in the preceding paragraph) should be able to look back to the final S return to determine its estimated tax payments, provided the S return showed a tax liability and the S return covered a period of 12 months.

Example 3H-1 Computing corporate estimated tax for the year following S corporation termination when termination occurs at year-end.

Exxco Corp., a calendar-year corporation, elected S status several years ago. The Exxco shareholders file a revocation of S corporation status, effective for the corporate year beginning January 1.

As a C corporation, Exxco will need to make quarterly corporate estimated tax payments by the 15th day of the 4th, 6th, 9th, and 12th months of the C corporation's tax year. Exxco anticipates taxable income of about

\$400,000. On its final S corporation return, Exxco reported S corporation taxable income of \$50,000, but did not report a tax liability, so exceptions 2 and 3 to the underpayment penalty (shown in the preceding list) do not apply. How should Exxco compute its estimated tax payments when its prior-year return was an S corporation return?

In its first C corporation year following its final S return, Exxco must make quarterly estimated tax payments. Because there was no tax liability for the S corporation's final year, the commonly used exception based on the prior year's tax is not available. Exxco will need to monitor its actual taxable income throughout its first C return year and calculate its estimated tax payments accordingly.

C Corporation Can Base Its Estimate Payments on the Prior S Year's Tax under Certain Circumstances

A C corporation can evidently base its estimated tax payments on its prior S year if it is otherwise eligible for the prior year's tax exception (because its taxable income is less than \$1 million). Such a corporation should be able to look back to the final S return to determine its estimated tax payments, provided the S return showed a tax liability (e.g., the built-in gains tax), and the S return covered a period of 12 months. This exception may result in substantially lower estimated tax payments during the corporation's first year as a C corporation. However, if a midyear termination occurred, this exception would not be available due to the requirement that the prior year must be a full 12-month tax year.

Example 3H-2 Basing C corporation estimated tax payments on the prior year's tax when the S election terminates.

ABC Corporation plans to revoke its S status effective on the first day of the following tax year and anticipates a \$25,000 tax liability with its first Form 1120. ABC recognizes a nominal \$100 built-in gain on the sale of a fully-depreciated typewriter. ABC reports the \$100 gain on its final Form 1120S and pays a \$35 tax. Because there was a tax liability in the preceding tax year and that year covered a full 12-month period, ABC is evidently qualified to use 100% of the last S year's tax when making estimated tax payments for the first C year. Thus, the C corporation can make estimated tax payments of \$35 and effectively defer the payment of \$24,965 of tax until the due date of its first Form 1120.

Example 3H-3 Prior year's tax exception cannot be used in the C tax year following a midyear S termination.

Felco is a calendar year S corporation that terminated its S election by loss of eligibility rather than by a voluntary revocation. The loss of eligibility occurred midyear on July 1, 2010, so Felco must file a short-period S return for January 1 through June 30 and a short-period C return for July 1 through December 31. In filing the two short-period returns, Felco elects not to use the prorata method of allocating income, but rather, closes its books on June 30 and thereby determines that its short-period S return for the first half of the year will report \$20,000 of taxable income, and the short-period C return for the second half of the year will report \$50,000 of taxable income. What responsibility does Felco have for estimated tax payments for the second half of the year when filing as a regular corporation?

Felco cannot base its estimated tax payments on 100% of the prior year's tax (exception 1 in the preceding list) for two reasons. First, Felco's final Form 1120S does not show a tax liability and a tax liability is required for the exception to apply. Second, Felco's final S year does not cover a full 12-month period as required under the first exception. Thus, even if Felco had reported a tax on its final Form 1120S (most likely due to the built-in gains tax or the tax on excess passive investment income), the 100% of the prior year's tax exception is not available.

Estimated Tax Payments When the Prior Year's Tax Exception Does Not Apply

When a midyear S termination occurs, the corporation can allocate its income to the S and C short years on a prorata basis or it can elect to use specific accounting based on a closing of its books. Clear authority for computing estimated tax payments following a midyear S termination apparently does not exist. The general rule for S termination years requires a prorata allocation based on the number of days in each short tax year under IRC Sec. 1362(e)(2). An estimated tax problem arises when a corporation uses the prorata method because the corporation cannot properly make the prorata allocation until its S termination year ends.

One reasonable approach to overcome this problem is to calculate the corporation's actual income from the beginning of the S corporation year and to prorate this amount based on the number of days in each short year under IRC Sec. 1362(e)(2). The amount allocated to the C short year would be used when computing estimated tax payments under the current year's annualized tax or adjusted seasonal tax exceptions of IRC Sec. 6655(e).

If the shareholders have agreed to use the specific accounting method, the C corporation's actual transactions can be used to determine its estimated payments.

Example 3H-4 Estimated tax payments when the corporation elects to allocate income based on specific accounting.

Assume the same facts as in Example 3H-3. An appropriate response for Felco is the use of the annualization calculation to compute its estimated corporate tax payments for the last two quarters of the calendar year. Under this approach, Felco would use its actual income for the first three months of its C corporation return (July through September) for its first installment and its actual income for the period July through December for the second required installment, with the amount of the installment based on 100% of the tax computed by placing taxable income on an annualized basis.

No Estimated Tax Payments Required for Short Tax Year Less Than Four Months

No payment of estimated tax is required if the short tax year is less than four full calendar months.

Example 3H-5 Calculating estimated taxes when short C year is less than four months.

Assume the same facts as in Example 3H-3, except that the shareholders file a revocation of S corporation status to be effective October 1, 2010. As a result, Felco must file a short-period S return for the period January 1 through September 30 and a short-period C return for the period October 1 through December 31.

In this example, the C short tax year is less than four months long. The regulations excuse the corporation from its obligation to compute and pay estimated taxes for the last three months of the year. The corporation is, however, obligated to compute and pay estimated taxes beginning on January 1 of the following tax year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. When a corporation's S status terminates, the resulting C corporation may need to pay quarterly estimated taxes in order to avoid an underpayment penalty. Which of the following methods is not a safe harbor from the underpayment penalty?
- a. 100% of the prior year's tax.
 - b. 100% of the average prior five-year's tax.
 - c. 100% of the current year's annualized tax.
 - d. 100% of the adjusted seasonal tax.
40. Which of following corporations is required to file quarterly estimates of corporate income tax?
- a. Bell, Inc., a calendar year S corporation, terminates its S election effective October 31 and projects a corporate tax liability of \$5,000.
 - b. Chase Co., a calendar year S corporation, terminates its S election effective January 15 and projects a corporate tax liability of \$250.
 - c. Elly Enterprises, a September 30 year-end S corporation, terminates its S election on May 15 and projects a corporate tax liability of \$1,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

39. When a corporation's S status terminates, the resulting C corporation may need to pay quarterly estimated taxes in order to avoid an underpayment penalty. Which of the following methods is not a safe harbor from the underpayment penalty? **(Page 117)**
- a. 100% of the prior year's tax. [This answer is incorrect. The underpayment penalty will not apply if the actual estimated tax payments exceed the amount of tax shown on the return of the corporation for the preceding tax year, if a return showing a liability was filed by the corporation for the preceding year, and the preceding year was a taxable year of 12 months.]
 - b. **100% of the average prior five-year's tax. [This answer is correct. A corporation cannot avoid the underpayment penalty by paying estimated taxes equal to 100% of the average prior five-year's tax. To qualify under the safe harbor rules, a corporation's actual estimated tax payments must equal the current year's tax liability (either annualized or adjusted seasonal) or the prior's years tax liability. An average of tax years is not allowed.]**
 - c. 100% of the current year's annualized tax. [This answer is incorrect. The underpayment penalty will not apply if an amount equal to 100% of the tax for the current year computed by placing the actual taxable income earned during the period before each quarterly estimated tax payment date on an annualized basis.]
 - d. 100% of the adjusted seasonal tax. [This answer is incorrect. The underpayment penalty will not apply if an amount equal to 100% of the tax determined by annualizing current year-to-date income using a percentage derived from the ratio of the prior three years' quarterly income to total income.]
40. Which of following corporations is required to file quarterly estimates of corporate income tax? **(Page 117)**
- a. Bell, Inc., a calendar year S corporation, terminates its S election effective October 31 and projects a corporate tax liability of \$5,000. [This answer is incorrect. Reg. 1.6655-5 provides that no estimated tax payments are required if the corporation has a short tax year of less than four months.]
 - b. Chase Co., a calendar year S corporation, terminates its S election effective January 15 and projects a corporate tax liability of \$250. [This answer is incorrect. Corporations subject to income tax must make payments of estimated tax during the taxable year unless their actual tax for the year is less than \$500.]
 - c. **Elly Enterprises, a September 30 year-end S corporation, terminates its S election on May 15 and projects a corporate tax liability of \$1,000. [This answer is correct. Elly Enterprises must file quarterly estimated tax payments because the corporate tax year exceeds four months and the projected income tax liability exceeds \$500. It will pay two installments during its C short year due on June 15 and September 15.]**

EXAMINATION FOR CPE CREDIT**Lesson 3 (T2STG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

26. An S corporation voluntarily revokes its S election. How must the corporation notify the IRS of the termination?
- a. Check box H(5) on page 1 of Form 1120S and the "Final K-1" box on Schedule K-1.
 - b. A statement should be attached to final S corporation tax return.
 - c. A letter should be sent to the IRS service center with which the corporation files its income tax return.
 - d. Attach the final K-1 to the shareholder's individual income tax return.
27. Carolina Accents, Inc., a September 30 fiscal year-end corporation, files Form 2553 on October 28 to elect S status and change to a calendar year-end. On November 30, the corporation files a statement with the IRS revoking the S election. Which of the following statements is true?
- a. Carolina Accents, Inc. will change to a calendar year-end.
 - b. The corporation will not be able to reelect S status for 5-years from the revocation date.
 - c. All shareholders who consented to the S election must consent to the revocation.
 - d. Carolina Accents Inc.'s revocation is retroactively effective to September 30.
28. Which of the following events will cause an S election to automatically terminate?
- a. A father transferring stock to his son as tenants in common.
 - b. The sale of a portion of the company to a partnership.
 - c. Issuing nonvoting shares to family members.
 - d. Reorganizing from a North Carolina corporation to a Delaware corporation.
29. When a corporation's S election terminates, the IRS will allow the corporation to continue as an S corporation if certain conditions are met. Which of the following items is not one of the conditions?
- a. The corporation previously made a valid S election which terminated.
 - b. The termination was inadvertent and this is established with the IRS.
 - c. The corporation takes steps to correct the situation which caused the disqualifying event.
 - d. The corporation agrees to adjustments required by the IRS, but does not establish compliance with its shareholders.
30. Which of the following is not included in the letter ruling request when a corporation applies for relief from the IRS for an inadvertent termination of an S election?
- a. Date and detailed explanation of the terminating event.
 - b. When and how the terminating event was discovered.
 - c. Consents of all shareholders during the termination period.
 - d. A user fee from the corporation.

31. An S election will terminate if the S corporation has accumulated earnings and profits on the last day of the tax year and passive investment income in excess of 25% of gross receipts for how many years?
- a. Three consecutive years.
 - b. Three out of five years.
 - c. Five consecutive years.
 - d. Five out of ten years.
32. Which of the following types of income is considered passive investment income for the purpose of the three-year termination rule?
- a. Rental income for an equipment leasing company.
 - b. Dividends from marketable securities.
 - c. Gross receipts from operations.
 - d. Interest on notes from sales of inventory.
33. Hoover, Inc. is a calendar year S corporation. It fails to qualify as a small business corporation on April 30 and its S election terminates. The S short year ends on what date?
- a. March 15.
 - b. April 29.
 - c. April 30.
 - d. December 31.
34. A calendar year S corporation terminates on November 15. Under the general rule, how will income and loss be reported for the S short year?
- a. The C corporation on its initial tax return.
 - b. The shareholders as if the books were closed as of the day before the S termination.
 - c. Prorata allocation to the shareholders based on the number of days in the short tax year.
 - d. Equally divided between the shareholders and the initial C corporation.
35. Sunnyside Co. is a calendar year S corporation. Sandra is the sole shareholder and voluntarily revokes its S election effective on December 31. The corporation has balances of \$45,000 in AAA, \$4,000 in PTI, and \$30,000 in AE&P. Sandra has a stock basis of \$50,000 at the date the S election terminates. During the post-termination transition period (PTTP), the corporation distributes \$50,000 to Sandra. How much of the distribution is tax-free?
- a. \$30,000.
 - b. \$45,000.
 - c. \$49,000.
 - d. \$50,000.

36. Jordan is the sole shareholder of Lakeview Co., a calendar year S corporation. On August 5, Jordan transfers 100 shares to Jordan Enterprises, a wholly owned C corporation, and the S election terminates. Jordan had \$5,000 adjusted basis in his S corporation stock prior to the termination. The loss allocable to the S short year is \$10,000. In anticipation of the transfer and during the PTP, which of the following items would not give Jordan basis to deduct the loss?
- a. Loan to the C corporation.
 - b. Loan to the S corporation prior to termination.
 - c. Capital contributed to the C corporation.
 - d. Capital contributed to the S corporation prior to termination.
37. A calendar year S corporation involuntarily terminates on March 15, 20X1. The corporation does not request a letter ruling to waive the reelection restrictions. What is the earliest date the S corporation may reelect S status?
- a. March 15, 20X5.
 - b. January 1, 20X6.
 - c. March 15, 20X6.
 - d. January 1, 20X7.
38. Stormy, Inc. terminates its S election effective June 30. Five years later it reelects S status. What balance will Stormy Inc.'s AAA have on the first day of the first year the corporation reelects S status?
- a. Equal to retained earnings on the last day of the last year as a C corporation.
 - b. Reinstated to AAA balance at S termination adjusted for corporate dividends paid.
 - c. Reinstated to AAA balance at S termination.
 - d. Balance starts over at zero at the reelection.
39. Greenleaf Alliance, a calendar year S corporation, voluntarily revokes its S election on December 31. On its final S corporation return, it reports \$300 built-in gain tax and \$200 excess passive investment income tax. Greenleaf anticipates going public in its first corporate tax year and generating taxable income of \$500,000 and a tax liability of \$160,000 (\$40,000 per quarter). What is the least amount of annual estimated tax Greenleaf may pay in order to avoid an underpayment penalty?
- a. \$500.
 - b. \$40,000.
 - c. \$144,000.
 - d. \$160,000.

40. Tina is the sole shareholder of Domino, Inc., a calendar year S corporation. On February 28, she transfers 500 shares of stock to a real estate investment partnership. On its final S corporation return, Domino pays \$1,250 built-in gain tax. Under the general rule, the C short year is allocated \$950,000 taxable income which results in a tax liability of \$300,000 (\$75,000 per quarter). For the closing of the books method, the C short year is allocated taxable income of \$400,000 which results in a tax liability of \$140,000 (\$35,000 per quarter). What is the least amount of annual estimated tax Domino may pay in order to avoid an underpayment penalty if Tina, as the sole shareholder, agrees to use the specific accounting method?
- a. \$1,250.
 - b. \$35,000.
 - c. \$140,000.
 - d. \$300,000.

GLOSSARY

Accumulated Earnings and Profits (AE&P): A company's net profits after deducting distributions to the stockholders. This is calculated as of the beginning of the year.

Accounting Adjustments Account (AAA): An account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under title 26 and the phrase '(but not below)' shall be disregarded in 1367(b)(2)(A)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

Basis: The amount assigned to an asset from which gain or loss is determined for income tax purposes. For assets acquired by purchase, basis is cost. Special rules govern the basis of property received by virtue of another's death, by gift, or in an exchange; the basis of stock received on a transfer of property to a controlled corporation; the basis of the property transferred to the corporation; and the basis of property received upon the liquidation of a corporation.

Beneficial owner: The person or entity that controls the stock or reaps the benefits of stock ownership.

Calendar year: A period of 365 (or 366) days, now commonly divided into 12 calendar months and reckoned as beginning January 1 and ending December 31.

Charitable remainder trust: A "split-interest" trust in which one party receives an income interest for a term of years (which could be measured by reference to someone's life), and a qualified charitable organization receives the remainder interest. If properly structured as an annuity trust or a unitrust, a charitable contribution deduction is allowed at the time that the trust is funded. The contribution deduction is based on the present value of the remainder interest to be transferred to the charity.

Corporation: A form of business that is a legal entity separate and apart from its owners. In the United States, corporations may be formed under state law, can sue and be sued, can own property and be taxed, and are responsible for their own debts and torts and the torts of their officers, agents, or employees during the course and within the scope of their corporate duties. Owners (shareholders) are subject to limited liability only (i.e., to the extent of their investment). The shareholders annually elect a board of directors to set policy for the corporation. The board appoints officers to carry out the day-to-day management of the corporation. Except for electing directors, the shareholders have no authority to manage the business.

Distribution: Money a taxpayer withdraws from a retirement plan such as an individual retirement account or an employer-maintained pension plan.

Election: An affirmative choice subject to a particular tax law provision. Elections often require the filing of a specific statement or form.

Employee Stock Ownership Plan (ESOP): A stock bonus plan that is qualified, or a stock bonus and a money purchase plan, both of which are qualified under IRC Section 401(a) and that are designed to invest primarily in qualifying employer securities. In addition, the participant is entitled to demand that benefits be distributed in the form of employer securities. If the stock is not readily tradable on an established market, the participant has a right to require that the employer repurchase the securities under a fair valuation formula.

Estate: A taxable, organizational entity used to wind up the affairs and distribute the property of a deceased person. It comes into existence only upon a person's death and holds title to the property of the deceased and exists for a limited time. An estate succeeds to the title of all property of the deceased and is liable for debts. It must pay federal estate tax, applicable state inheritance tax, federal income tax, and any other tax that becomes due on the real and personal property of the estate.

Estimated tax: The amount of tax a taxpayer expects to owe for the year after subtracting expected amounts withheld and the amount of any expected credits. For taxpayers who have earnings not subject to withholding, the IRS requires deposits of the estimated tax four times a year.

Fiscal year: An accounting year ending on the last day of any month except December.

PTTP: Post-termination transition period.

Revenue procedure: An official statement of procedures that affect either the rights or duties of taxpayers under the IRC and related statutes, treaties, and regulations. A Revenue Procedure is issued only by the National Office of the IRS and is published in the Internal Revenue Bulletin.

S corporation: A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in Subchapter S of the Internal Revenue Code (IRC).

Shareholder: An individual or entity that owns shares of capital stock.

Short tax year: A calendar or fiscal year that is less than 12 months. This may occur in three circumstances. The first instance would be in the first year of operations if the corporation desires to elect a fiscal year ending on a date other than the date (the day before) on which it was incorporated or desires to elect a calendar year and it was not incorporated on January 1.

Tenant in common: A term applying to real property when there is more than one owner. Tenants in common have co-ownership in an undivided interest in the real property. In the event of death of one of the owners, the ownership passes to his estate.

Testamentary: Describes a trust, bequest, or gift created by will that takes effect when the creator dies.

Trust: A fiduciary relationship in which one person holds legal title to property subject to an equitable obligation to safeguard or use the property for the benefit of another. A trust represents a separation of legal and equitable title and may be of two types—inter vivos or testamentary. A trust may have different characteristics, such as accumulation, charitable, Clifford, complex, constructive, irrevocable, living, private, or revocable.

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COMPANION TO PPC'S 1120S DESKBOOK**COURSE 2****Corporate Taxes (T2STG102)****OVERVIEW**

COURSE DESCRIPTION:	This interactive self-study course discusses the built-in gains tax and the tax on excess net passive income. S corporations have many nuances when it comes to taxation of their activities. The flow-through of these types of transactions is also discussed in this course. The last lesson covers other tax payments S corporations may have and how those taxes are remitted to the Treasury Department.
PUBLICATION/REVISION DATE:	December 2010
RECOMMENDED FOR:	Users of <i>PPC's 1120S Deskbook</i>
PREREQUISITE/ADVANCE PREPARATION:	Experience with the preparation of Form 1120S
CPE CREDIT:	8 QAS Hours, 8 Registry Hours 8 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours. Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by December 31, 2011
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:**Lesson 1—Built-in Gains Tax**

Completion of this lesson will enable you to:

- Identify corporations subject to the built-in gains tax and summarize the built-in gains rules, compute built-in gains and utilize the current recognition limit and taxable income limit to calculate and report the built-in gains tax.
- Describe the built-in gain rules for valuing goodwill, intangibles and inventory.
- Apply the built-in gains rules to installment sales, property distributions, and qualified Subchapter S subsidiaries and compute the net unrealized built-in gain and discuss methods to reduce the built-in gains tax.

Lesson 2—Tax on Excess Net Passive Income

Completion of this lesson will enable you to:

- Identify corporations subject to the excess net passive income tax.
- Compute the tax on excess net passive income.

Lesson 3—Other Tax Payments

Completion of this lesson will enable you to:

- Identify the estimated tax requirements at the S corporation level.
- Calculate LIFO recapture and LIFO recapture tax.
- Identify required payments for fiscal year elections, recapturing business credits, and remitting S corporation taxes.

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Lesson 1: Built-in Gains Tax

INTRODUCTION

In general, an S corporation is not taxed; instead its income, deductions, gains, losses, and tax credits pass through to the shareholders. However, if an S corporation was once a C corporation (or, in some cases, acquires “transferred basis” property from a C corporation or from another S corporation that is subject to the built-in gains tax rules), there are three situations in which an S corporation itself will be currently taxed. One of these taxes is discussed in this lesson—the built-in gains tax. The other two taxes that can be currently imposed on S corporations are the tax on excess net passive income (see Lesson 2) and the recapture of business tax credits.

There are three other situations that may cause an S corporation to pay tax, but these taxes are not corporate income taxes resulting from the S corporation’s operations. The situations are:

1. An S Corporation pays tax assessed to the predecessor C corporation. For example, a calendar year C corporation elects to become an S corporation effective January 1. Any tax due on the C corporation return for the year just ended is paid by the S corporation.
2. An S corporation makes required payments to elect or retain a fiscal year under IRC Sec. 444.
3. An S corporation makes the installment payments of tax caused by LIFO inventory recapture when it converted from C corporation to S status.

The built-in gains tax is suspended in 2009 and 2010 for an S corporation if the *seventh tax year* of the corporation’s 10-year recognition period ended before the beginning of either of those tax years. Furthermore, suspension of the built-in gains tax continues during 2011 if the *fifth year* of the corporation’s 10-year recognition period ended before the beginning of the 2011 tax year.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify corporations subject to the built-in gains tax and summarize the built-in gains rules, compute built-in gains and utilize the current recognition limit and taxable income limit to calculate and report the built-in gains tax.
- Describe the built-in gain rules for valuing goodwill, intangibles and inventory.
- Apply the built-in gains rules to installment sales, property distributions, and qualified Subchapter S subsidiaries and compute the net unrealized built-in gain and discuss methods to reduce the built-in gains tax.

Identify Corporations Subject to the Built-in Gains Tax and Summarize Built-in Gains Rules

Background and Summary of Built-in Gains Rules

Generally, a liquidation is treated as a sale of corporate assets at fair market value, and gain or loss is recognized at the corporate level. C corporation liquidation gain is effectively taxed twice—once at the corporate level and again at the shareholder level when distributed in exchange for stock surrendered. This makes S corporation status more attractive because gain recognized upon liquidation generally will be taxed only once (at the shareholder level) due to the increase in stock basis that results from pass-through treatment. To discourage C corporations from electing S status to avoid double taxation upon liquidation, certain S corporations are subject to a tax on “built-in gains.”

The built-in gains tax generally applies to C corporations that make an S corporation election, and can be assessed during the ten-year period beginning with the first day of the first tax year for which the S election is effective. The built-in gains tax is imposed at the highest corporate rate (presently 35%), and is triggered by the disposition of an asset that was on hand at the time the S election became effective, if on that date the asset had a FMV in excess of

its basis. The term “disposition,” however, is broadly defined for built-in gains purposes, and includes certain routine transactions such as the collection of cash-method zero-basis accounts receivable. An asset not on hand when the S election became effective, such as equipment acquired after the corporation elected S status, ordinarily would not be subject to the tax. However, certain property may be subject to the tax if it is acquired from another corporation in a transferred (substituted) basis transaction. The built-in gains tax is subject to certain limitations, discussed later in this lesson.

The following paragraphs provide an overview of the built-in gains tax rules and include cross references to where these topics are discussed in this lesson.

Corporations Subject to the Built-in Gains Rules. The built-in gains tax applies to C corporations that make S elections. (See discussion later in this lesson.) Normally, an S corporation that has never been a C corporation is not subject to the tax. However, the tax can also apply to S corporations that acquire transferred basis property from a C corporation or an S corporation subject to the built-in gains tax.

Tax Rate. Taxable built-in gains (calculated as discussed later in this lesson) are taxed at the highest corporate rate, presently 35%.

Recognition Period. Built-in gains are generally recognized during the 10-year (i.e., 120-month) recognition period beginning with the first day of the first tax year the S election is effective. However, for transferred basis property received from a C corporation, or another S corporation subject to the built-in gains tax, the recognition period is measured from the date the property is received. Furthermore, built-in gain can be recognized after the recognition period has expired when certain installment payments are received after that time and the installment sale originated either before or during the 10-year recognition period. (See further discussion later in this lesson.)

Built-in Gains Arise from Property Dispositions. Built-in gains are triggered by the “disposition” of assets that were on-hand at the time the S election became effective. Transactions such as the collection of cash-method zero-basis accounts receivable or the sale of inventory in the ordinary course of business are considered dispositions for built-in gains purposes. Also, distributions of assets to shareholders are dispositions subject to the built-in gains tax rules. In the case of transferred basis property received from a C corporation or another S corporation subject to the built-in gains tax, the asset subject to the tax may have been acquired after the date the S election became effective.

Net Unrealized Built-in Gain. The corporation's total built-in gain is normally limited to the net unrealized built-in gain (i.e., the excess of the aggregate FMV over the aggregate adjusted basis of all assets on hand as of the date the S election was effective, reduced by any previously recognized built-in gains). However, in the case of transferred basis property received from a C corporation or another S corporation subject to the built-in gains tax, the asset subject to the tax may have been acquired after the date the S election became effective.

Built-in Losses. Certain built-in losses can offset built-in gains.

Net Recognized Built-in Gain and Limit on Built-in Gain. Net recognized built-in gain is the amount of gain subject to the tax. This amount is limited to the smallest of (1) the *overall limit*, i.e., net unrealized built-in gain (see Example 1B-1); (2) the *current recognition limit*, i.e., the amount that would be taxable income if only recognized built-in gains and recognized built-in losses were taken into account (see Example 1C-1); or (3) the *taxable income limit*, i.e., the corporation's taxable income for the year, computed as if it were a C corporation.

Carryover of Built-in Gain. If net recognized built-in gain is limited by the corporation's net income (item 3 in the preceding paragraph), the gain in excess of the taxable income limit carries over to the subsequent year.

Carryovers from C Period. Net operating losses, capital losses, minimum tax credits, and business tax credits that are carried over from C corporation tax years are used to reduce the built-in gains tax.

Deductibility of Built-in Gains Tax. The built-in gains tax is deductible from the S corporation's income and passes through to the shareholders as a loss.

S Corporations Not Subject to the Built-in Gains Tax

As discussed in this lesson, an S corporation is not subject to the built-in gains tax rules if any of the four following situations apply:

1. It was never a C corporation, and it has not received transferred basis property from a C corporation or an S corporation subject to the built-in gains tax rules.
2. It had no net unrealized built-in gain (i.e., the aggregate basis of its assets exceeded their cumulative FMV) on the date the S election became effective, and it has not received transferred basis property from a C corporation or another S corporation subject to the built-in gains tax.
3. It has previously recognized built-in gains equal to the net unrealized built-in gain on the date the S election became effective, and it has not received transferred basis property from a C corporation or another S corporation subject to the built-in gains tax.
4. The 10-year recognition period beginning with the date the S election was effective has expired, and (a) the corporation has not received transferred basis property from a C corporation or an S corporation subject to the built-in gains tax, and (b) there are no outstanding payments from installment sales that originated before or during the 10-year period beginning with the date the S election became effective.

Corporations Affected by the Built-in Gains Tax

The built-in gains tax applies to C corporations that make S corporation elections after 1986. The tax generally does not apply to a corporation that has always been an S corporation. However, the built-in gains tax will apply to a corporation that has always been an S corporation to the extent it has acquired transferred basis property from a C corporation or from another S corporation that is subject to the built-in gains tax rules. (See Example 1B-9.)

Example 1A-1 Corporations electing S status.

Elderco, Inc. is a former C corporation that uses a fiscal year ending September 30 and filed its S election on October 10, 2010. The election was effective with its short tax year that began October 1 and ended December 31, 2010. Elderco is subject to the built-in gains tax of IRC Sec. 1374. The corporation's recognition period expires on September 30, 2020 (i.e., 10 years after the S election became effective).

Transferred Basis Property

Corporations that have always been S corporations generally are not subject to the built-in gains tax. However, they will become subject to the built-in gains tax if they acquire transferred (substituted) basis property from a C corporation, such as in a merger or from another S corporation that is subject to the built-in gains tax rules. [Property has a transferred basis if its basis in the hands of the acquiring entity is determined, in whole or in part, by reference to the asset's (or any other asset's) basis in the hands of the transferor entity.] The 10-year recognition period for such assets received by an S corporation from a C corporation is measured from the date of acquisition by the S corporation, rather than from the date S status is elected. If an S corporation acquires transferred basis property from another S corporation that was subject to the built-in gains tax, the recognition period is the remainder of the original 10-year period during which the transferor S corporation was subject to the built-in gains tax with respect to that property.

Built-in Gains Rules Do Not Apply When a Corporation is in C Status

The built-in gains tax applies to S corporations and is no longer applicable after S status is revoked or terminated. The resulting C corporation's income, however, is subject to tax at the corporate level under the regular corporation rules and is taxed again at the shareholder level when distributed to shareholders.

Built-in Gains Tax Suspended During 2009, 2010, and 2011 for Certain S Corporations

The built-in gains tax is suspended in 2009 and 2010 for an S corporation if the *seventh tax year* of the corporation's 10-year recognition period ended before the beginning of either of those tax years. Furthermore, suspension of the

built-in gains tax continues during 2011 if the *fifth year* of the corporation's 10-year recognition period ended before the beginning of the 2011 tax year.

Recognize Built-in Gains

Built-in Gains Are Triggered by Asset Dispositions

If the corporation is subject to the built-in gains tax, the tax is triggered by the disposition of assets that were on hand at the time the S election became effective. The term "disposition" is broadly defined for purposes of the built-in gains tax. The built-in gains tax can be triggered by routine transactions such as the collection of cash-method, zero-basis accounts receivable or the sale of inventory in the ordinary course of business. Furthermore, the distribution of appreciated assets to a shareholder is a disposition subject to the built-in gains tax (discussed later in this lesson).

Built-in Gain Applies to Assets on Hand When S Status is Elected

An asset is subject to the tax if it was on hand at the date S status was effective *and* on such date had a fair market value (FMV) in excess of its basis. An asset not on hand when the S election became effective (such as assets subsequently contributed to the corporation) are generally not subject to the tax. (However, certain property may be subject to the tax if it was acquired from another corporation under the transferred basis property rules or exchanged basis property rules discussed later in this lesson.) The built-in gain on each asset is limited to the amount by which the asset's FMV exceeded its adjusted basis on the date the S election became effective. The built-in gains tax applies to both capital and ordinary gains that arise from the sale or exchange of assets subject to the tax.

10-year Recognition Period

For a built-in gain to be subject to the built-in gains tax, it generally must be realized during the 10-year recognition period. (The recognition period is discussed later in this lesson.)

Determining Built-in Gain or Loss upon Disposition of an Asset

When an asset subject to the built-in gains tax is disposed of at a gain, the built-in gain is limited to the lesser of:

1. the gain actually recognized, or
2. the amount by which the fair market value of the asset exceeded its adjusted basis on the date the S election became effective.

If an asset subject to the built-in gains tax is disposed of at a loss, the loss is limited to the lesser of:

1. the loss actually recognized, or
2. the amount by which the adjusted basis of the asset exceeded its fair market value on the date the S election became effective.

Net Recognized Built-in Gain

The amount of gain subject to the built-in gains tax in any tax year is referred to as net recognized built-in gain.

Limitations on Taxation of Built-in Gains

The amount of built-in gain subject to tax in any year (i.e., the net recognized built-in gain) is limited under IRC Sec. 1374(d)(2) to the *smallest* of:

1. the *overall limit*, which is the net unrealized built-in gain (i.e., generally, the overall, or aggregate, built-in gain at the date the S election is effective) less amounts previously recognized during the 10-year recognition period (see Example 1B-1);

2. the *current recognition limit*, which is the amount that would be the corporation's taxable income for the tax year if only recognized built-in gains and recognized built-in losses were taken into account (see Examples 1B-6 and 1C-1); or
3. the *taxable income limit*, which is the corporation's taxable income for the year, computed as if it were a C corporation.

Substantiating Value

The presumption is that any gain on disposition of assets is built-in unless the corporation can establish otherwise. This can be done by proving that the asset that caused the gain was not on hand on the date the S election was first effective, or that the asset appreciated in value after the election date.

Importance of Appraisals. The assets of a newly elected (or electing) S corporation should be appraised to establish the values at the date the election becomes effective. Of course, factors such as relatively low asset values or the types of corporate assets involved may reduce the need to rely on a formal appraisal. (Even then, unexpected increases in the value of the business or its assets may cause the appearance that built-in gains were present when the S election became effective.) If no formal appraisal is made, the practitioner should advise the corporation to retain other documentation to support asset values.

Goodwill and Other Intangibles. Appraisals of intangible assets, such as goodwill, should not be overlooked when determining the value of corporate assets on the day the S election becomes effective. Goodwill and other intangibles may be easy to miss if they have a zero basis and do not appear on the balance sheet. It is also important to include only corporate goodwill in the corporation's assets. The value of goodwill and certain intangibles may be excluded when they are owned by the shareholders and not by the corporation.

Net Unrealized Built-in Gain (The Overall Limit)

The maximum built-in gain upon which a corporation is potentially subject to tax is the "net unrealized built-in gain." This maximum amount of gain subject to tax equals the excess of the aggregate FMV over the aggregate adjusted basis of all assets on hand as of the date the S election was *effective*.

Built-in losses are netted against built-in gains when calculating net unrealized built-in gain. Cash-basis liabilities (such as trade accounts payable and accrued compensation) that give rise to deductible S corporation expenses when paid are also built-in losses for purposes of determining net unrealized built-in gain. (See additional discussion of built-in losses later in this lesson). Also, net unrealized built-in gain is increased or decreased by the corporation's Section 481(a) adjustments (required by changes in accounting method) on the first day of the recognition period.

The computation of net unrealized built-in gain does not include any recognized built-in loss that would not be allowed under IRC Secs. 382 (limitation on net operating loss carryforwards), 383 (limitation on certain credit and capital loss carryforwards), or 384 (limitation on use of preacquisition losses).

Example 1B-1 Determination of net unrealized built-in gain.

Acme, a cash-basis C corporation, makes an S election that is effective January 1 of the current year. As of the beginning of the first day it operates as an S corporation, Acme has assets with a FMV of \$112,500, and accounts payable of \$12,500 that will be deductible when paid. Acme's net unrealized built-in gain is \$45,000 determined as follows:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>	<u>Built-in Gain (Loss)</u>
Cash	\$ 10,000	\$ 10,000	\$ —
Accounts receivable	50,000	—	50,000
Fixed assets	22,500	30,000	(7,500)
Intangibles	<u>30,000</u>	<u>15,000</u>	<u>15,000</u>

	Fair Market Value	Adjusted Basis	Built-in Gain (Loss)
Totals	112,500	55,000	57,500
Accounts payable	<u>(12,500)</u>	<u>—</u>	<u>(12,500)</u>
Totals	<u>\$ 100,000</u>	<u>\$ 55,000</u>	
Net unrealized built-in gain			<u>\$ 45,000</u>

During its first year operating as an S corporation, Acme collects the \$50,000 of accounts receivable and pays the \$12,500 of accounts payable. No other assets were disposed of during the year and, at year-end, the corporation's taxable income (computed as if the corporation were a C corporation) was \$40,000. The corporation realized a \$50,000 built-in gain from the collection of accounts receivable and a \$12,500 built-in loss from payment of the accounts payable, for a net built-in gain of \$37,500.

The net recognized built-in gain for the year is \$37,500, the lowest of:

The recognized built-in gain (net of built-in losses)	<u>\$ 37,500</u>
Taxable income, computed as if the corporation were a C corporation	<u>\$ 40,000</u>
The net unrealized built-in gain	<u>\$ 45,000</u>

The 2010 built-in gains tax is \$13,125 (\$37,500 x 35%). The tax passes through to shareholders as a loss.

The corporation's net unrealized built-in gain at the end of the year is \$7,500 (\$45,000 – \$37,500). This represents the most built-in gain that the corporation will be required to recognize in future years unless it acquires transferred basis property, as described in the following paragraph.

Transferred Basis Assets. A corporation's total built-in gain is generally limited to the net unrealized built-in gain. However, transferred basis assets received from a C corporation or an S corporation subject to the built-in gains tax, after the S election becomes effective can also generate built-in gain. This potential gain will not have been included in the calculation of net unrealized built-in gain as of the date the S election became effective. (Transferred basis property is discussed later in this lesson.)

Net Unrealized Built-in Loss

The built-in gains rules do not apply to the corporation unless there is net unrealized built-in gain. In other words, if the calculation results in a net unrealized built-in *loss*, the corporation is not subject to the built-in gain rules (unless it acquires transferred basis property, as discussed later in this lesson).

Example 1B-2 Net unrealized built-in loss.

Jaycorp, a cash basis C corporation, elects S corporation status and has the following assets on hand on the first day it is treated as an S corporation:

	FMV	Adjusted Basis	Built-in Gain (Loss)
Cash	\$ 15,000	\$ 15,000	\$ —
Accounts receivable	60,000	—	60,000
Machinery and equipment	<u>30,000</u>	<u>95,000</u>	<u>(65,000)</u>
Totals	<u>\$ 105,000</u>	<u>\$ 110,000</u>	<u>\$ (5,000)</u>

Jaycorp is not subject to the built-in gains tax because the aggregate basis of all the assets exceeds the total FMV; the net unrealized built-in gain is zero.

Recognition Period

An S corporation generally is subject to the built-in gains tax during its “recognition period.” The recognition period is defined as the 10-year period beginning with the first day of the first tax year for which the corporation is an S corporation. There is no statutory reference to “taxable periods”; accordingly, the recognition period lasts a full 10 years (i.e., 120 months), beginning with the date the S election becomes effective. A short tax year, such as when a fiscal-year S corporation changes to a calendar tax year, does not affect or reduce the recognition period.

Example 1B-3 10-year recognition period.

Renco, Inc. elected S status as of November 1, 2010. Three years after electing S status, Renco changes to a calendar year. The recognition period begins on the first day of Renco's first S corporation tax year (i.e., November 1, 2010) and ends 10 years later on October 31, 2020. The recognition period will end on the same date even if there are more than 10 taxable periods during the 120-month recognition period. Renco changed its tax year to a calendar year, resulting in more than 10 taxable periods within the recognition period because of the short tax year ending December 31; however, the recognition period is not altered by the short tax year and will still end on October 31, 2020.

Taxable Income Limitation When Recognition Period Ends during Tax Year. The taxable income limitation restricts the amount of built-in gain subject to tax in any year to the corporation's taxable income computed as if it were a C corporation. If the 10-year recognition period ends during, rather than at the close of, the tax year, the taxable income limit is determined for the year as if the corporation's books were closed at the end of the recognition period.

Reelecting S Status Starts New Recognition Period. The built-in gains tax applies to the corporation's most recent S election. Thus, a new 10-year recognition period begins when a C corporation (that was previously an S corporation) reelects S status.

Example 1B-4 New 10-year recognition period begins when corporation reelects S status.

ABC, Inc., a C corporation, elects to become an S corporation effective November 1, 2000. The corporation revokes its S election four years later, then reelects S status on November 1, 2010.

ABC is subject to the built-in gains tax while it is an S corporation. Since the built-in gains tax applies to the corporation's most recent S election, a new 10-year recognition period begins on November 1, 2010, and continues through October 31, 2020. The corporation's net unrealized built-in gain (discussed earlier) is determined on November 1, 2010.

Cash-basis Receivables

An asset disposition that is subject to the built-in gains tax is defined very broadly. The built-in gains tax applies to any income recognition event involving “appreciated” assets owned on the date of conversion to S status. (An appreciated asset for this purpose is any asset that has a fair market value in excess of its adjusted basis as of the beginning of the corporation's first S tax year.)

Generally, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period by a taxpayer using an accrual method. Under this rule, zero-basis or low-basis assets (cash-basis receivables, inventories, installment notes, etc.) are subject to the built-in gains tax when income is recognized due to their collection, sale, or other disposition.

For purposes of net unrealized built-in gain upon conversion to S status, an asset gives rise to unrealized built-in gain only to the extent its FMV exceeds its adjusted basis. Items of income and deduction such as receivables, work-in-process, and contract rights cannot have a FMV for determining net unrealized built-in gains that is less than their face amount, unless they are disposed of in a transaction treated as a sale or exchange.

Example 1B-5 Income from cash-basis receivables.

Esco, Inc. is a cash-basis, calendar-year corporation. Esco made an S election that was effective on January 1, 2010. On the first day of its first S corporation tax year, Esco had receivables with face value of \$100,000 and a fair market value (FMV) of \$85,000. The corporation had a zero basis in the receivables. During 2010, Esco collected all of the receivables outstanding on January 1. Because of other appreciated assets, Esco's overall net unrealized built-in gain exceeds \$200,000.

Collection of the accounts receivable gives rise to recognized built-in gains because the receivables would have been included in gross income before the beginning of the recognition period had Esco used an accrual method of accounting. In this case, the built-in gain recognized equals \$100,000. The built-in gains tax (assessed at the highest corporate rate) equals 35% of \$100,000, or \$35,000. However, if Esco had disposed of the accounts receivable at FMV (\$85,000) in a transaction treated as a sale or exchange, it would have recognized built-in gain of \$85,000. See later discussion of the taxable income limitation that can defer or eliminate the actual built-in gains tax liability.

Inventory

Inventory on hand at the effective date of the S corporation election must be considered in the built-in gain calculation. According to the regulations, the value of an S corporation's inventory on the first day of the recognition period generally is determined by reference to a hypothetical sale of the entire business of the S corporation to a buyer that expects to continue operating the business. The buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts. The regulations expect that the value so determined will generally be less than the inventory's anticipated retail price but greater than its replacement cost. See later paragraphs for a discussion of inventory valuation for built-in gain purposes.

LIFO Inventory. Disposition of LIFO inventory is subject to the built-in gains tax. However, sales of LIFO inventory do not result in built-in gain until the corporation invades a LIFO layer that existed prior to the beginning of its first S corporation tax year. This layer, however, is increased to the equivalent of FIFO cost because of the recapture discussed in the following paragraph.

A C corporation using the LIFO method must recapture (i.e., recognize as income) the excess of its FIFO inventory cost over LIFO cost as of the end of the tax year preceding its first S corporation tax year. The increase in tax that results from this income inclusion is paid in four equal, annual installments, beginning with the last C corporation return. The corporation's basis in its inventory is adjusted by the LIFO recapture amount that is included in income. The result is that the corporation's basis in its LIFO inventory is adjusted (i.e., increased) so that it equals the FIFO cost, thus eliminating double taxation when the inventory is sold. (See lesson three.) LIFO recapture does not terminate the LIFO method, and the S corporation can continue using that method.

Built-in Losses

S corporations are allowed to offset built-in gains with built-in losses. Losses are built-in if an asset's basis exceeded its FMV at the S election's effective date. A built-in loss generated by the disposition of an asset is limited to the lesser of (1) the actual loss or (2) the amount by which the adjusted basis of the asset exceeded its FMV at the date the S election became effective. Built-in losses also occur when an amount is allowable as a deduction during the 10-year recognition period, if the expense is attributable to the C period (e.g., accounts payable or bonuses payable at the date an S election is effective).

Liabilities incurred during the C corporation period are treated as built-in losses only if they are deductible by the S corporation. For example, a liability associated with a capitalized cost (such as one arising from the purchase of an asset) does not create a built-in loss. Similarly, an expense accrued by an accrual-basis C corporation will not generate a built-in loss because the deduction was claimed on a C corporation return (Form 1120) prior to conversion to S status.

Built-in Losses Reduce Net Unrealized Built-in Gain.

Built-in losses offset built-in gain in the year the loss is recognized. Built-in losses are also beneficial because they reduce net unrealized built-in gain; that is, the overall limit on the amount of built-in gain that can be taxed. (See Examples 1B-6, 1B-7, and 1B-8.)

Example 1B-6 Effect of built-in losses

Building on the facts contained in the preceding example, assume that on January 1 Esco has accounts payable of \$35,000 and also owns, among other items, Asset B with a FMV of \$30,000 and a basis of \$105,000. During 2010, Esco pays the accounts payable and sells Asset B.

The built-in losses eliminate the built-in gain associated with the collection of Esco's receivables, determined as follows:

Collection of receivables	\$ 100,000
Payment of accounts payable	(35,000)
Sale of Asset B	<u>(75,000)</u>
Net recognized built-in gain (loss)	<u>\$ (10,000)</u>

Under the current recognition limit, the net recognized built-in gain is limited to the amount that would be the corporation's taxable income for the tax year if only recognized built-in gains and losses were taken into account. In this example, netting the built-in gains and losses results in a loss of \$10,000. Thus, offsetting built-in gains and losses successfully avoids the built-in gains tax for the year.

Built-in losses do not offset recognized built-in gains unless they are recognized in the same year. There are no provisions for carrying recognized built-in losses to prior or subsequent years if they exceed recognized built-in gains for a given year. In addition, no built-in loss will be recognized if the built-in loss asset is sold to someone who is (directly or indirectly) a shareholder in the S corporation. If the sale is to a shareholder or other related party, no offset against recognized built-in gain will be allowed.

Example 1B-7 Built-in losses and related-party sales.

Seecorp elected S status in 2010. At the time of conversion, Seecorp owned one asset with a built-in gain of \$50,000 and one asset with a built-in loss of \$45,000. During the year, Seecorp sold the built-in gain asset to an unrelated party for a \$52,500 gain. Seecorp also sold the built-in loss asset at its FMV at the date of conversion to S status to another corporation owned by the same shareholder group.

The full \$50,000 built-in gain is subject to the built-in gains tax. The built-in loss is disallowed under IRC Sec. 267. However, under the overall net unrealized built-in gain limitation, the amount of net recognized built-in gain taken into account for purposes of the built-in gains tax cannot exceed \$5,000 (i.e., the FMV of assets at the beginning of the first S year over the aggregate adjusted bases of the assets).

Accrued Bonuses to Shareholder-employees

If the C corporation declares a bonus or accrues other expenses to a shareholder-employee, the bonus or expense will be a built-in loss (for purposes of the built-in gain rules) under certain circumstances if paid after the S election becomes effective. IRC Sec. 267(a)(2) generally requires an S corporation to defer the deduction of certain expenses until a related person includes the item in gross income. The regulations provide that an amount properly deducted under IRC Sec 267(a)(2) is a recognized built-in loss to the extent (1) all events have occurred that establish the fact of the liability, and the exact amount of the liability can be determined, as of the beginning of the recognition period, and (2) the amount is paid in the first 2½ months of the recognition period, or is paid to an individual who owned, directly or indirectly, less than 5% of the corporation's stock.

Example 1B-8 Effect of accrued bonuses on built-in gain and net unrealized built-in gain.

Elton is the sole shareholder in Elco, a cash-basis C corporation that makes an S election effective January 1, 2010. The corporation earns net income of \$55,000 per year. As of the beginning of the first day it

operates as an S corporation, Elco has \$12,500 of accounts payable that will be deductible when paid and the following assets on hand:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>	<u>Built-in Gain (Loss)</u>
Cash	\$ 10,000	\$ 10,000	\$ —
Accounts receivable	50,000	—	50,000
Fixed Assets	22,500	30,000	(7,500)
Goodwill	30,000	15,000	15,000
Totals	<u>112,500</u>	<u>55,000</u>	<u>57,500</u>
Accounts payable	<u>(12,500)</u>	<u>—</u>	<u>(12,500)</u>
Totals	<u>\$ 100,000</u>	<u>\$ 55,000</u>	
Net unrealized built-in gain			<u>\$ 45,000</u>

In 2010, Elco collects the accounts receivable and pays the accounts payable, but does not dispose of any assets. In this case, Elco would show a recognized built-in gain during the year of \$37,500 (\$50,000 – \$12,500).

Assume that on December 31, 2009 (i.e., before the S election becomes effective), Elco accrues a \$45,000 bonus to Elton. (Assume Elton's compensation, including the bonus, is reasonable.) The bonus represents a built-in loss and reduces net unrealized built-in gain to zero. Under this approach, the overall limit (see "Limitations on Taxation of Built-in Gains" earlier in this lesson) will be zero and the corporation will never be subject to the built-in gains tax rules (unless it acquires transferred basis property).

Accrual-basis S Corporation Reduces Net Unrealized Built-in Gain by Accrued Bonus. In the previous example, Elco uses the cash basis. An accrual method C corporation electing S status can also reduce net unrealized built-in gain by accrued bonuses. Payment to a shareholder is not deductible until the shareholder includes the payment in income. However, a built-in loss results when an accrual basis C corporation accrues a bonus to a cash basis shareholder and pays the bonus within 2½ months after the S election becomes effective.

Contribution of Built-in Loss Assets

If an S corporation owns built-in loss assets (i.e., assets with adjusted bases in excess of their FMV) at the date the S election becomes effective, the built-in losses reduce built-in gains for purposes of determining net unrealized built-in gain. (See Example 1B-2.) To discourage shareholders from manipulating the built-in gains tax by contributing built-in loss assets to the corporation, special treatment applies to any asset acquired before or during the recognition period with a principal purpose of avoiding the built-in gains tax. The regulation provides that the asset and any loss, deduction, credit, and carryover attributable to the asset are disregarded when determining the S corporation's net recognized built-in gain and the amount of any net operating loss or credit carryforwards allowed to reduce or offset the S corporation's built-in gains tax.

Separate Recognition Periods for Transferred Basis Assets

The application of the built-in gains tax can be extended beyond the general 10-year recognition period if an S corporation acquires assets that have a transferred (substituted) basis. In effect, an S corporation can have more than one recognition period if it acquires transferred basis assets from a C corporation or from another S corporation that is subject to the built-in gains tax. If an S corporation acquires transferred basis property from another S corporation that was subject to the built-in gains tax, the recognition period is the remainder of the original 10-year period during which the transferor S corporation was subject to the built-in gains tax with respect to that property.

Example 1B-9 Acquisition of transferred basis property from a C corporation.

Circle, Inc. began its first S tax year twelve years ago and has continued to operate as an S corporation through the present. In a tax-free merger on September 1, 2010 (in which Circle was the surviving entity), Circle acquired all of the assets and liabilities of Square, Inc., a C corporation.

Under the general rules, Circle is not subject to the built-in gains tax because more than 10 years has elapsed since the S election became effective. Circle is, however, subject to the built-in gains tax with respect to the transferred basis assets acquired from the C corporation in the merger. The acquisition of a transferred basis asset is treated as a conversion to S corporation status with respect to such asset. The net unrealized built-in gain related to the transferred basis asset is measured when the property is received (September 1, 2010), and the 10-year recognition period begins on that date. Circle's other assets do not become subject to the built-in gains tax.

Example 1B-10 Acquisition of transferred basis property from an S corporation.

Assume the same facts as in the previous example, except that the transferor corporation (Square, Inc.) was a C corporation that became an S corporation on January 1, 2008. The transferred basis property was subject to the built-in gains tax in the hands of Square, and continues to be subject to the tax while held by Circle. The property's recognition period in the hands of Circle begins on September 1, 2010 (the date of transfer), but the 10-year period is reduced by the 32 months that Square was subject to the built-in gains tax. Thus, the last day of the recognition period for those assets is December 31, 2017, which is 10 years from the date Square became subject to the built-in gains tax and 88 months from the date the assets were acquired by Circle.

The IRS has ruled that transferred basis property acquired from an S corporation that is not subject to the built-in gains tax does not cause the transferee S corporation to become subject to the tax. If, for example, Square had never been a C corporation (and had not acquired the property in a transfer from a corporation that was subject to the built-in gains tax), the transfer of the property would not cause Circle to become subject to the built-in gains tax.

Effect of a Merger on the Built-in Gains Tax. If an S corporation acquires an unrelated C corporation's assets in a tax-free transaction, it appears that IRC Sec. 384 may impose a five-year waiting period before the acquiring company's NOLs and business credit carryovers can be used to offset the recognized built-in gain on disposition of the acquired corporation's assets.

Separate Computation for Transferred Basis Assets

Per Reg. 1.1374-8, a separate built-in gains tax computation is made with respect to transferred basis assets. That is, a separate computation is made for transferred basis assets acquired in each "Section 1374(d)(8) transaction" (such as the tax-free merger of a C corporation into an S corporation) and for assets owned by the S corporation on the first day of the 10-year recognition period. For purposes of the separate built-in gains tax computations, an S corporation's taxable income limitation for any tax year is allocated among the computations based on the ratio of "separate" net recognized built-in gains to the sum of all net recognized built-in gain. Loss carryforwards acquired in a transferred basis transaction can offset only the net recognized built-in gain attributable to assets acquired in the same transaction. Loss carryforwards related to assets owned on the first day of the 10-year recognition period can offset only the net recognized built-in gain attributable to assets owned on the first day of the recognition period.

Another way of viewing the recognition period is to think of it as applying to specific assets. An S election (or asset acquisition by an S corporation in a transferred basis transaction) starts the 10-year recognition period running for each asset. Once begun, the recognition period for each asset terminates not later than the end of 10 years of uninterrupted S corporation ownership, regardless of how many times the asset changes ownership in transferred basis transactions. Of course, if the S corporation acquires an asset in a taxable transaction (where basis is not determined by reference to the asset's basis in the hands of the transferor), the acquired asset is not subject to the built-in gains tax.

Example 1B-11 Separate recognition periods for transferred basis property.

Zippy, Inc. is a newly organized corporation that elected S status effective March 1, 2009, the beginning of its first tax year. On September 1, Zippy acquires Asset A in a merger with a C corporation. On January 1, 2010, Zippy acquires Asset B in a merger with an S corporation that owned Asset B on July 1, 2008, the date its conversion from C status was effective.

As discussed earlier in this lesson, Zippy is not initially subject to the built-in gains tax because it has always been an S corporation. However, as a result of the mergers, Zippy is now subject to the built-in gains tax with respect to Assets A and B. The 10-year recognition period for Asset A begins on the date of the merger with the C corporation (September 1, 2009) and ends on August 31, 2019. The amount of net unrealized built-in gain (discussed earlier) associated with Asset A is determined as of the date Zippy acquired the asset.

The recognition period for Asset B begins on the date the asset is transferred (January 1, 2010) and ends on June 30, 2018, which is the same date it would have expired if the transferor S corporation had retained the asset. The recognition period for Asset B is reduced by the portion of the 10-year recognition period that had expired before the transfer to Zippy. Evidently, the amount of net unrealized built-in gain associated with Asset B is determined at the date the transferor S corporation elected S status (July 1, 2008) rather than the date that Zippy acquired Asset B (January 1, 2010).

Exchanged Basis Property

The built-in gains tax also applies to exchanged basis property (for example, property received in a like-kind exchange under IRC Sec. 1031 or involuntary conversion under IRC Sec. 1033). Any unrecognized built-in gain carries over from the exchanged asset to the property received in the exchange if the basis of the new asset is determined, at least in part, by reference to the basis of the exchanged asset. In other words, any unrecognized built-in gain inherent in an asset on hand when the S election became effective transfers over to a new asset received in a nontaxable exchange. The 10-year recognition period continues to be measured from the date the S election became effective (not the date of the exchange).

Example 1B-12 Acquisition of exchanged basis property.

Zeecorp, a C corporation, elected S status on January 1, 2010. On that date, it held land that had a tax basis of \$100,000 and a fair market value of \$150,000. Zeecorp's unrealized net built-in gain at the date the S election became effective was \$60,000, and no built-in gains have yet been recognized by the corporation. Zeecorp's annual income from business operations is approximately \$95,000. On January 1, 2015, Zeecorp exchanges the land for like-kind property under IRC Sec. 1031. For built-in gains purposes, the new property takes the place of the property transferred and carries a \$50,000 built-in gain potential through the end of the original recognition period, December 31, 2019. No built-in gain is recognized on the exchange and the corporation's net unrealized built-in gain remains at \$60,000.

Example 1B-13 Recognizing built-in gain on boot received in a tax-deferred exchange.

Assume the same facts as in the previous example, except that Zeecorp received like-kind property and cash of \$45,000 in the exchange. Under IRC Sec. 1374(d)(3), gain is recognized during the recognition period on the disposition of any asset, limited to the net unrealized built-in gain related to that specific asset. Furthermore, recognized built-in gains are subject to the overall limit, current recognition limit, and taxable income limit discussed earlier in this lesson. Thus, Zeecorp recognizes \$45,000 of built-in gain in the year the exchange takes place. The property's \$50,000 (\$150,000 – \$100,000) of net unrealized built-in gain at the date the S election became effective is reduced by the \$45,000 of recognized built-in gain on the exchange. If Zeecorp disposes of the property at a gain on or before December 31, 2019, the end of the original recognition period, the corporation will recognize up to \$5,000 (\$50,000 – \$45,000) of built-in gain on the transaction.

Variation: Assume now that Zeecorp received \$57,000, rather than \$45,000, of cash in the exchange. Here, the recognized gain on the transaction is limited to the original \$50,000 of net unrealized built-in gain. Therefore, the corporation recognizes \$50,000 of built-in gain. Zeecorp passes through to shareholders the \$57,000 of gain on the exchange, reduced by the built-in gains tax.

Section 481(a) Adjustments

Any Section 481(a) adjustment (relating to changes in accounting method) taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the recognition period.

Example 1B-14 Positive Section 481(a) adjustments are built-in gains.

Bellco, a calendar-year C corporation, changes a method of accounting. The change results in a Section 481(a) adjustment of \$80,000 that will be included in Bellco's income at the rate of \$20,000 per year for four years beginning in 2009. On January 1, 2010, Bellco elects S status and reports \$20,000 of Section 481(a) adjustment income in years 2010, 2011, and 2012. The adjustment amounts taken into income after the S election is effective are recognized built-in gains. If the corporation has no other built-in gains or losses, it will pay built-in gains tax of \$7,000 ($\$20,000 \times 35\%$) in 2010, 2011, and 2012.

Example 1B-15 Negative Section 481(a) adjustment is built-in loss.

Jellco, a C corporation, has been improperly capitalizing repair costs and recovering them through depreciation deductions. On January 1, 2007, Jellco elects S status. On that date, repair costs of \$27,500 had been capitalized and not depreciated. In 2010, Jellco properly changes its accounting method to deduct repair costs as they are incurred. At that time, \$21,000 of repair costs had been capitalized and not depreciated. The basis of the related assets is reduced by \$21,000 to remove the erroneous repair costs, and Jellco has a negative Section 481(a) adjustment of \$21,000. The adjustment will be taken as a deduction in 2010. The negative Section 481(a) adjustment is a recognized built-in loss because all of the \$21,000 undepreciated repair costs were attributable to the period before the S election became effective.

Banks. A bank that changes from the reserve method of accounting for bad debts for its first taxable year as an S corporation can elect to take the entire income adjustment into account in its final C corporation year. If the election is made, it allows the S corporation to (1) avoid any built-in gains tax on the Section 481(a) adjustment and (2) avoid having to pass through to shareholders any taxable income from the adjustment.

Completed Contract Method

Income taken into account under the completed contract method may be recognized built-in gain, if performance on the contract started before the beginning of the recognition period. The built-in gain is limited to the income recognized during the recognition period that would have been included in gross income before the beginning of the recognition period under the percentage of completion method. Thus, contractors using the completed contract method must review contracts existing at the date the S election becomes effective and determine the profit that has accrued on those contracts under the percentage of completion method. Income recognized from those contracts after the S election becomes effective is built-in gain to the extent of the profit accrued at the S election date.

Installment Sales

Special rules apply to installment sales made before or during 10-year recognition period that begin when the S election becomes effective. The built-in gains tax applies regardless of whether an installment payment is received (and, thus, income is recognized) during or after the end of the recognition period.

Discharge of Indebtedness Income and Bad Debt Deductions

Discharge of indebtedness income that is taxable under IRC Sec. 61(a)(12) may be recognized built-in gain. However, it is built-in gain only if the income arises from a debt owed by the S corporation at the beginning of the recognition period *and* the income is recognized during the first year of the recognition period. Also, a bad debt deduction under IRC Sec. 166 is recognized built-in loss if it arises from a debt owed to the S corporation at the beginning of the recognition period and the deduction is taken during the first year of the recognition period.

Partnership Interests

Reg. 1.1374-4(i) generally applies look-through principles to an S corporation's interest in a partnership. An S corporation should treat its distributive share of partnership items as recognized built-in gain or loss to the extent such amounts would have been treated as built-in gain or loss had the items originated in and been taken into account directly by the S corporation. Application of the look-through rules generally is limited to the corporation's built-in gain (or loss) in its partnership interest. Also, the look-through rules do not apply if the S corporation's

partnership interest (1) is less than 10% of the partnership's profits and capital at all times during the tax year and all prior tax years in the recognition period, and (2) has a value less than \$100,000 at the beginning of the recognition period.

Built-in Gains Tax Suspended During 2009, 2010, and 2011 for Certain S Corporations

The built-in gains tax is suspended in 2009 and 2010 for an S corporation if the *seventh tax* year of the corporation's 10-year recognition period ended before the beginning of either of those tax years. Furthermore, suspension of the built-in gains tax continues during 2011 if the *fifth year* of the corporation's 10-year recognition period ended before the beginning of the 2011 tax year.

Applying Current Recognition Limit, Taxable Income Limit, and Net Unrealized Built-in Gain (Overall Limit) to Built-in Gains

Current Recognition Limit

Under the current recognition limit, the net recognized built-in gain is limited to the amount that would be the corporation's taxable income for the tax year if only recognized built-in gains and losses were taken into account. (See Examples 1B-1, 1B-6 and 1C-1.)

Net Unrealized Built-in Gain (the Overall Limit)

Under the overall limit, the net recognized built-in gain is limited to the net unrealized built-in gain, which is the excess of the aggregate FMV over the aggregate adjusted basis of all assets on hand as of the date the S election was effective. (See Examples 1B-1 and 1C-1.)

Taxable Income Limit

The amount of built-in gain subject to tax in any year is limited to the corporation's taxable income computed as if it were a C corporation. For purposes of computing this "as if" taxable income, no deductions are allowed for net operating loss carryovers, dividends received, or premiums on certain repurchased debt.

The taxable income limitation does not affect the reporting of income or loss for any purpose other than the computation of the built-in gains tax. Income from the disposition of corporate assets (including built-in gains assets) is reported in the tax year in which the gain is realized. The taxable income limitation can defer or eliminate the built-in gains tax, but the taxable income limitation cannot defer or eliminate reporting the gains for normal tax reporting and pass-through purposes.

Example 1C-1 Net recognized built-in gain in excess of taxable income.

Stitchco filed an S election on January 1, 2010, and is subject to the built-in gains tax. Stitchco's net unrealized built-in gain is \$20,000. Stitchco sold an asset during 2010 that resulted in a Section 1231 gain of \$12,000, all of which is subject to the built-in gains tax. No other assets were disposed of during the year. The corporation shows taxable income for the year (calculated as if the corporation were a C corporation) of \$2,000.

In general, the built-in gains tax is computed based on Stitchco's recognized built-in gain for the tax year. However, the amount of gain subject to tax in any year is limited to the lowest of:

The recognized built-in gain (net of built-in losses)	<u>\$ 12,000</u>
Taxable income, computed as if the corporation were a C corporation	<u>\$ 2,000</u>
The net unrealized built-in gain	<u>\$ 20,000</u>

Stitchco's net recognized built-in gain for the current year is limited to \$2,000. The 2010 built-in gains tax is \$700 (\$2,000 x 35%). The tax passes through to shareholders as a loss.

The corporation's net unrealized built-in gain at the end of the year is \$18,000 (\$20,000 – \$2,000). This represents the most built-in gain that the corporation will be required to recognize in future years unless it acquires transferred basis property.

Stitchco has built-in gain of \$10,000 (\$12,000 – \$2,000) that was not recognized in the current year because of the taxable income limitation. See Example 1C-2 for an illustration of the carryover rule.

Carryover Rule

Realized built-in gains that are not taxed because of the income limitation will carry forward during the remainder of the 10-year recognition period. The net recognized built-in gain that is carried forward because of this taxable income limitation is treated as a recognized built-in gain in the succeeding tax year. To the extent the corporation has taxable income in subsequent years during the recognition period, these realized built-in gains that were carried forward are taxed in such years (after being netted with other built-in gains and losses recognized during the year).

Example 1C-2 Carryover of excess realized built-in gain.

Assume the same facts and limitations as discussed in the previous example. Also, assume Stitchco has net taxable income in 2011 of \$6,000 from its manufacturing operation.

The 2010 realized built-in gain that was not taxed because of the taxable income limitation is carried over to 2011 and treated as a \$10,000 recognized built-in gain in that year. No other built-in gains or losses are recognized during the year. Stitchco is liable for the built-in gains tax for 2011 based on \$6,000 of net recognized built-in gain. The remaining \$4,000 of realized built-in gain from 2010 is carried over to 2012 and treated as a recognized built-in gain in that year.

Note that Stitchco reports all of the \$12,000 Section 1231 gain on its Schedules K and K-1 in 2008, the year the gain is recognized. No portion of the \$10,000 built-in gain carried over to 2011 is reported as income again. In effect, it is the built-in gains tax that carries forward, rather than the gain itself.

Any built-in gain that has not been taxed because of the taxable income limitation expires at the end of the recognition period. In Stitchco's case, this means that the remaining \$4,000 of built-in gains tax carryover will completely escape the built-in gains tax only if the corporation has no net income (calculated as if it were a C corporation) through December 31, 2019.

Taxable Income Limitation in Year the Recognition Period Expires

The taxable income limitation is affected by the end of the recognition period. In the year the recognition period expires, the taxpayer calculates the taxable income limitation based on the period up to the date of expiration, rather than on the income shown on the Form 1120S for the entire year.

Built-in Gains Tax Gains Tax Suspended During 2009, 2010, and 2011 for Certain S Corporations

The built-in gains tax is suspended in 2009 and 2010 for an S corporation if the *seventh tax year* of the corporation's 10-year recognition period ended before the beginning of either of those tax years. Furthermore, suspension of the built-in gains tax continues during 2011 if the *fifth year* of the corporation's 10-year recognition period ended before the beginning of the 2011 tax year.

Calculate and Report the Built-in Gains Tax

Tax Rate

Built-in gains (after applying the limitations) are taxed at the highest corporate tax rate in effect for the year, presently 35%.

Computing the Built-in Gains Tax

Only gains recognized during the 10-year recognition period are taxed under IRC Sec. 1374. Gains recognized after the recognition period are not taxed, other than certain installment gains under a special rule. In addition, asset

appreciation that occurs after the corporation's S election becomes effective is not subject to the built-in gains tax. Finally, net recognized built-in gain (i.e., the amount of built-in gain subject to tax) cannot exceed the smallest of (1) the overall limit (i.e., net unrealized built-in gain); (2) the current recognition limit (i.e., the amount that would be taxable income if only recognized built-in gains and recognized built-in losses were taken into account; or (3) the taxable income limit (i.e., the corporation's taxable income for the year, computed as if it were a C corporation).

Example 1D-1 Recognizing built-in gains.

Rainier Corp. is a C corporation that reports on the cash basis and uses a calendar year. The corporation elects S corporation status effective January 1, 2010. On that date, the corporate assets are as follows:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>	<u>Built-in Gain (Loss)</u>
Cash	\$ 35,000	\$ 35,000	\$ —
Accounts receivable	55,000	—	55,000
Other assets	<u>97,500</u>	<u>97,500</u>	<u>—</u>
Totals	<u>\$ 187,500</u>	<u>\$ 132,500</u>	
Net unrealized built-in gain			<u>\$ 55,000</u>

The corporation has no accounts payable. (See Example 1D-2.) The taxable income for the first S year will be approximately \$60,000. (Taxable income would be the same if it were computed under the C corporation rules.) What will Rainier Corp.'s built-in gains tax liability be if it elects S corporation status?

A cash basis corporation with accounts receivable faces the built-in gains tax when the accounts receivable are collected, normally during the year the election is first effective. Collection of an account receivable by a cash basis taxpayer is a disposition of an asset and can result in built-in gain recognition. In this case, \$55,000 from such collections is subject to built-in gains tax. The tax (assessed at the highest corporate rate) is 35% of \$55,000, or \$19,250. The taxable income of \$60,000 is passed through to Ray, the sole shareholder, and the corporate tax passes through to him as a loss, resulting in a pass-through to Ray of \$40,750 (\$60,000 – \$19,250) in net income.

Example 1D-2 Applying built-in losses against built-in gains.

Assume the same facts as in the previous example, except that the corporation also has \$30,000 of accounts payable on the date the S election becomes effective. All of the payables will be deducted by the S corporation when paid in 2010, so the \$30,000 of payables represents a built-in loss. This built-in loss reduces the net unrealized built-in gain at the date the S election is effective. Thus, \$25,000 (\$55,000 – \$30,000) is the maximum cumulative amount of built-in gains that Rainier Corp. will be required to recognize. Since the accounts receivable are received and the accounts payable are paid in 2010, the built-in gain recognized in that year is \$25,000 (\$55,000 – \$30,000). Rainier Corp. is no longer subject to the built-in gains tax because the entire amount of net unrealized built-in gain has been recognized.

Example 1D-3 Computing the built-in gains tax—comprehensive example.

Servico, Inc., a C corporation, elected S status on January 1, 2009. (Servico had no unused losses or credits on the date the S election became effective.) The corporation's net unrealized built-in gain (i.e., the fair market value of the corporation's assets over their adjusted bases) at that date was \$32,000, calculated as follows:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>	<u>Built-in Gain (Loss)</u>
Cash	\$ 50,000	\$ 50,000	\$ —
Asset A	32,000	20,000	12,000
Asset B	40,000	25,000	15,000
Asset C	18,000	10,000	8,000

	Fair Market Value	Adjusted Basis	Built-in Gain (Loss)
Asset D	4,000	9,000	(5,000)
Asset E	11,000	15,000	(4,000)
Asset F	<u>8,000</u>	<u>2,000</u>	<u>6,000</u>
Totals	<u>\$ 163,000</u>	<u>\$ 131,000</u>	
Net unrealized built-in gain			<u>\$ 32,000</u>

During 2009, Servico recognized built-in gain of \$6,000 from the sale of Asset F. However, at year-end, the corporation passed through an operating loss to shareholders, so the \$6,000 built-in gain carried over to the following year. For 2010, Servico's taxable income, computed as if it were a C corporation, is \$20,000. During the year, Servico disposed of the rest of the assets that were owned as of the first day of its first tax year as an S corporation. The following is a summary of the asset dispositions and net recognized built-in gain calculation:

	Built-in Gain (Loss)	Actual Gain (Loss)	Recognized Built-in Gain (Loss)
Asset A	\$ 12,000	\$ 14,000	\$ 12,000
Asset B	15,000	13,000	13,000
Asset C	8,000	(1,000)	—
Asset D	(5,000)	(7,000)	(5,000)
Asset E	(4,000)	(3,000)	(3,000)
Current year net recognized built-in gain			<u>17,000</u>
Carryover net recognized built-in gain (on Asset F)			<u>6,000</u>
Net recognized built-in gain			<u>\$ 23,000</u>

The built-in gain (loss) from disposition of an asset equals the difference between the asset's FMV and adjusted basis at the date the S election became effective. The actual gain (loss) equals the difference between the asset's sales price and adjusted basis as of the date of disposition (as reported for normal tax return reporting purposes). The recognized built-in gain or loss is the lesser of the built-in gain (loss) or the actual gain (loss). However, a recognized built-in gain cannot be reduced below zero by an actual loss.

Servico's 2010 built-in gains tax is computed on \$20,000—the lesser of net recognized built-in gains or taxable income. At the highest corporate tax rate, Servico's built-in gains tax is \$7,000 (\$20,000 × 35%).

Also, see the following paragraphs (and Example 1D-4) for discussion of how net operating loss, capital loss, minimum tax credit, and business credit carryovers from C corporation tax years are used to reduce the built-in gains tax. (A discussion of the special fuels credit, a refundable credit that can be used to offset the built-in gains tax is provided later in this lesson.)

Tentative Built-in Gains Tax

The tentative built-in gains tax is the tax *before* application of allowable loss and credit carryovers from C corporation years (see the following discussion).

C Corporation Carryovers Reduce Built-in Gains Tax

Net operating losses, capital losses, minimum tax credits, and business tax credits that are carried over from C corporation tax years are used to reduce the built-in gains tax. These carryforwards will offset the built-in gains tax regardless of when the corporation's S election was effective. Net operating loss and capital loss carryovers are deductions against the corporation's net recognized built-in gain; however, capital losses are allowed only to the

extent the net built-in gain is net capital gain (i.e., capital loss carryovers cannot offset net built-in gain that is ordinary income). Minimum tax credit and business tax credit carryovers are credits against the built-in gains tax. The C corporation loss and credit carryovers are used to determine the built-in gains tax only; they do not reduce the income passed through to shareholders.

Net operating loss, capital loss, minimum tax credit, and business credit carryovers are entered on the appropriate lines of Schedule D (Form 1120S). Form 3800 (General Business Credit) should be completed when a business credit carryover is claimed. Form 8827 (Credit for Prior Year Minimum Tax—Corporations) should be completed when a minimum tax credit carryover is claimed.

Example 1D-4 Using C corporation carryovers to reduce the built-in gains tax.

Assume that Servico (the S corporation from the previous example) was formerly a C corporation, and at the time of its conversion to S status it had an NOL carryover of \$8,500, a capital loss carryover of \$1,000, and a minimum tax credit carryover of \$500. Further assume that more than \$1,000 of the net recognized built-in gain is capital gain. The built-in gains tax using these additional facts is computed as follows:

Net recognized built-in gain limited to taxable income	\$ 20,000
Less:	
Net operating loss deduction	(8,500)
Capital loss deduction	<u>(1,000)</u>
Adjusted net recognized built-in gain	10,500
Highest corporate tax rate	× 35%
Tentative built-in gains tax	\$ <u>3,675</u>
Less:	
Minimum tax credit	<u>(500)</u>
Net built-in gains tax	<u><u>\$ 3,175</u></u>

Note that the special fuels credit (discussed at the end of this lesson), if any, is claimed on page 1 of Form 1120S as a payment. The special fuels credit is not a part of the Schedule D (Form 1120S) computations.

The general business credit and minimum tax credit carryovers are allowed only to the extent they could be used under the C corporation rules.

Limitation on S Corporation's Use of C Corporation General Business Credit

The general business credit is generally limited to the taxpayer's tax plus AMT, less the larger of (1) tentative minimum tax or (2) 25% of the amount by which the regular tax exceeds \$25,000.

Even though an S corporation is not subject to the alternative minimum tax (AMT), a "tentative minimum tax" limits the amount of C corporation credits that can be used to offset the built-in gains tax. (In other words, when applying the general business credit limitation, an S corporation has to "pretend" it is a C corporation for AMT purposes.) However, many S corporations are not affected by this tentative minimum tax limitation because the AMT does not apply to "small" corporations. A small corporation is defined as one having three-year average annual gross receipts not exceeding \$5 million for its first tax year beginning after 1996, and not having three-year average annual gross receipts exceeding \$7.5 million for any later year.

The tentative minimum tax rule can limit the amount of built-in gains tax that can be offset by business credits. However, certain business credits can offset both regular tax and AMT and are therefore not limited by the tentative minimum tax calculation.

Example 1D-5 Applying the business credit carryover.

Mast, Inc., a C corporation with annual gross receipts of \$750,000, elects S status on January 1 of the current year. The corporation had \$95,000 of unused general business credit at the date the S election became effective. During the year, it sells an asset and recognizes an ordinary gain of \$100,000, which is subject to the

built-in gains tax. At the end of the year, the corporation passes through \$125,000 of nonseparately stated income as well as the separately stated \$100,000 gain on the sale of the asset.

The built-in gains tax before credits is \$35,000 ($\$100,000 \times 35\%$). How much of the \$95,000 general business credit carryover can be applied against the built-in gains tax?

The AMT would not apply if Mast were a C corporation because its gross receipts average only \$750,000. Thus, the general business credit limitation applies to 25% of the tax liability in excess of \$25,000, which in Mast's case is \$2,500 [$25\% \times \$10,000 (\$35,000 - \$25,000)$].

The general business credit carryover cannot offset \$2,500 of the tax. Mast can apply \$32,500 ($\$35,000 - \$2,500$) of the general business credit carryover against the built-in gains tax, resulting in a built-in gains tax liability of \$2,500.

The unused general business credit carryover to the following year is \$62,500 ($\$95,000 - \$32,500$).

Limitation on S Corporation's Use of C Corporation Minimum Tax Credit

A limitation similar to the business credit carryover applies to the minimum tax credit carryover.

Example 1D-6 Applying the minimum tax credit carryover.

Assume the same facts as in the previous example, (i.e., Mast, Inc. has built-in gains tax before credits of \$35,000) except that Mast, Inc. has minimum tax credit carryover (instead of general business credit carryover) of \$95,000.

The same limitations apply, so Mast can use \$32,500 ($\$35,000 - \$2,500$) of the minimum tax credit carryover against the built-in gains tax, resulting in a built-in gains tax liability of \$2,500. The minimum tax credit carryover to the following year is \$62,500 ($\$95,000 - \$32,500$).

Special Fuels Credit

The special fuels credit is the only current-year tax credit that an S corporation can generate to offset the built-in gains tax. (Remember, C corporation minimum tax credit and business tax credit carryovers are not *current-year* tax credits.) The special fuels credit is computed on Form 4136 (Credit for Federal Tax Paid on Fuels) and claimed as a tax payment on page 1 of Form 1120S.

Estimated Tax Payments

Built-in gains tax is subject to the estimated tax payment requirements. These requirements are discussed in lesson 3.

Built-in Gains Tax Suspended During 2009, 2010, and 2011 for Certain S Corporations

The built-in gains tax is suspended in 2009 and 2010 for an S corporation if the *seventh tax year* of the corporation's 10-year recognition period ended before the beginning of either of those tax years. Furthermore, suspension of the built-in gains tax continues during 2011 if the *fifth year* of the corporation's 10-year recognition period ended before the beginning of the 2011 tax year.

Passing the Deduction for Built-in Gains Tax through to Shareholders

Deducting Built-in Gains Tax from S Corporation Income

The built-in gains tax is deductible from the S corporation's income. This is accomplished by treating the built-in gains tax as a loss sustained by the S corporation during the tax year. The character of such loss is determined by allocating the loss proportionately among the built-in gains that give rise to the built-in gains tax. The built-in gains

tax is calculated on Form 1120S, Schedule D. According to the instructions to that form, the built-in gains tax attributable to ordinary gain is deducted on Form 1120S, page 1, line 12 (Taxes and licenses). The built-in gains tax attributable to short-term capital gain is reported as a short-term capital loss on Form 1120S, Schedule D, line 5. The built-in gains tax attributable to long-term capital gain is reported as a long-term capital loss on Form 1120S, Schedule D, line 12.

The instructions also state that the corporation must attach a statement to Schedule D showing the total net recognized built-in gain and listing separately any ordinary gain or loss and capital gain or loss.

Example 1E-1 Passing through built-in gains and deducting built-in gains tax.

Bluecorp is a cash basis corporation that elected S status effective January 1 of the current year. During the calendar year, Bluecorp collects accounts receivable that give rise to the built-in gains tax. The built-in gain is \$100,000 and the corporation's total nonseparately stated income, before considering the built-in gains tax, is \$210,000. The tax on the gain is \$35,000 (35% of \$100,000). Mel, the sole shareholder, materially participates in Bluecorp's operations. How is the shareholder affected by the corporation's built-in gain?

Here, the income from the accounts receivable is part of the corporation's nonseparately stated income; that is, its ordinary income from trade or business activities. Consequently, the \$35,000 is deducted on Form 1120S, page 1, line 12. The nonseparately stated income amount shown on page 1 of the Form 1120S and carried to line 1 of Schedule K is \$175,000, computed as follows:

Nonseparately stated income before considering the built-in gains tax	\$ 210,000
Built-in gains tax arising from collection of accounts receivable	<u>(35,000)</u>
Amount shown on Schedule K, line 1	<u>\$ 175,000</u>

Mel reports the \$175,000 of ordinary income on Schedule E of his Form 1040. In this case, the built-in gains tax is a deduction from the income that caused the tax because both the income and the tax were recognized in the same year, but that is not always true, as discussed in the Example 1E-3.

Example 1E-2 Allocating built-in gains tax among pass-through items.

Esco is a former C corporation that filed its S election three years ago. During 2010, Esco disposed of several assets that generated built-in gains and built-in losses, resulting in built-in gains tax of \$10,500. The following is a summary of Esco's built-in gains tax calculation and allocation among the items giving rise to the tax:

	<u>Built-in Gains Tax Calculation</u>	<u>Relative Share of Tax</u>	<u>Allocation of Built-in Gains Tax</u>
Built-in gain (loss) items resulting in:			
Ordinary income	\$ 2,500	8.33%	\$ 875
Long-term capital gain	20,000	66.67%	7,000
Short-term capital gain	<u>7,500</u>	<u>25.00%</u>	<u>2,625</u>
Net recognized built-in gain	30,000		
Highest corporate tax rate	<u>× 35%</u>		
Built-in gains tax	<u>\$ 10,500</u>	<u>100.00%</u>	<u>\$ 10,500</u>

For purposes of completing Schedules K and K-1, assume there are no items to report on Esco's S corporation return other than the ones listed above. Accordingly, Form 1120S and Schedules K and K-1 will have the following items entered:

Ordinary income from business activities:	
Ordinary income, before considering built-in gains tax	\$ 2,500
Allocable share of built-in gains tax (reported on Form 1120S, page 1, line 12)	<u>(875)</u>
Amount reported on Schedules K and K-1 (line 1)	<u>\$ 1,625</u>

Net long-term capital gain:	
Long-term capital gain	\$ 20,000
Allocable share of built-in gains tax (reported on Schedule D, line 12)	<u>(7,000)</u>
Amount reported on Schedules K and K-1 (line 8a)	<u>\$ 13,000</u>
Net short-term capital gain:	
Gain	\$ 7,500
Allocable share of built-in gains tax (reported on Schedule D, line 5)	<u>(2,625)</u>
Amount reported on Schedules K and K-1 (line 7)	<u>\$ 4,875</u>

Matching Problems When Tax Is Limited by Taxable Income

The pass-through of built-in gains and the resulting built-in gains tax can cause a “mismatch” when taxable income is less than the net recognized built-in gain (i.e., the amount of gain subject to tax). If the carryover rule discussed earlier applies, the built-in gains tax related to the carried over built-in gain can pass through when there are no items with the same character against which the tax can be netted before entry on Schedules K and K-1. This occurs because the carried over built-in gain is recognized for built-in gains tax purposes and enters into the built-in gains tax computation in a tax year subsequent to the tax year in which the gain is reported for normal tax purposes. Therefore, the deduction for the built-in gains tax could pass through in a year subsequent to the year in which the related income item is reported. The tax benefit associated with the deduction could be deferred to even later years if the tax passes through and is subject to additional limitations such as the capital loss or passive activity loss limitations.

Example 1E-3 Taxable income limitation and the carryover rule.

Assume the same facts as in the previous example, except that Esco also has \$25,000 of ordinary deductions that are not items of built-in loss.

Esco's taxable income, computed as if it were a C corporation, is \$5,000 (\$30,000 – \$25,000). Because of the taxable income limitation of IRC Sec. 1374(d)(2)(A)(ii), Esco's net recognized built-in gain for its 2010 tax year will be \$5,000 and the built-in gains tax will be \$1,750 (35% of \$5,000). The following is a summary of Esco's built-in gains tax calculation and allocation among the items giving rise to the tax:

	<u>Built-in Gains Tax Calculation</u>	<u>Relative Share of Tax</u>	<u>Allocation of Built-in Gains Tax</u>
Built-in gain (loss) items resulting in:			
Ordinary income	\$ 2,500	8.33%	\$ 146
Long-term capital gain	20,000	66.67%	1,167
Short-term capital gain	<u>7,500</u>	<u>25.00%</u>	<u>437</u>
Net built-in gain	<u>\$ 30,000</u>		
Net recognized built-in gain (limited to “taxable income”)	\$ 5,000		
Highest corporate tax rate	<u>× 35%</u>		
Built-in gains tax	<u>\$ 1,750</u>	<u>100.00%</u>	<u>\$ 1,750</u>

The net built-in gain of \$25,000 (i.e., the excess of \$30,000 net built-in gain over taxable income of \$5,000) will be treated as a recognized built-in gain in the subsequent tax year because of the carryover rule of IRC Sec. 1374(d)(2)(B). The carryover net recognized built-in gain will generate a built-in gains tax to the extent Esco has “taxable” income in a subsequent year during the recognition period.

Under Reg. 1.1374-2(c), the character of the net recognized built-in gain carried over is retained on a prorata basis. That is, in the subsequent tax year \$2,083 (8.33%) of the \$25,000 built-in gain is characterized as

ordinary income, \$16,667 (66.67%) is characterized as long-term capital gain, and \$6,250 (25%) is characterized as short-term capital gain.

This opens the door to possible "mismatching." The built-in gains tax could pass through during a tax year in which the deduction allowed for the tax exceeds the income of like character against which the tax is netted. In Esco's situation, assume that in 2011 there are no additional dispositions of built-in gain or built-in loss assets. Also, assume that year's income equals \$80,000 and is all ordinary trade or business income. The calculation and characterization of the built-in gains tax arising during the year are as follows:

	<u>Built-in Gains Tax Calculation</u>	<u>Relative Share of Tax</u>	<u>Allocation of Built-in Gains Tax</u>
Built-in gain (loss) items resulting in:			
Ordinary income	\$ 2,083	8.33 %	\$ 729
Long-term capital gain	16,667	66.67 %	5,833
Short-term capital gain	6,250	25.00 %	2,188
Net recognized built-in gain	<u>25,000</u>		
Highest corporate tax rate	<u>× 35 %</u>		
Built-in gains tax	<u><u>\$ 8,750</u></u>	<u>100.00 %</u>	<u><u>\$ 8,750</u></u>

For purposes of completing Schedules K and K-1, the only items to report on Esco's return for 2011 are the \$80,000 ordinary trade or business income and the deduction allowed for the built-in gains tax. Remember, for regular tax purposes, the income generated by the prior year's asset dispositions was not deferred by the taxable income limitation; such gains were reported for regular tax purposes on Schedules K and K-1 in the prior year. Accordingly, Schedules K and K-1 for 2011 will show only the following items:

Ordinary income from business activities:	
Ordinary income, before considering built-in gains tax	\$ 80,000
Allocable share of built-in gains tax (8.33% × \$8,750)	<u>(729)</u>
Amount reported on Schedules K and K-1	<u><u>\$ 79,271</u></u>
Net long-term capital gain (loss):	
Allocable share of built-in gains tax (66.67% × \$8,750)	<u><u>\$ (5,833)</u></u>
Net short-term capital gain (loss) under Section 1231:	
Allocable share of built-in gains tax (25% × \$8,750)	<u><u>\$ (2,188)</u></u>

Now assume that Jack is the sole shareholder in Esco. If Jack has no capital gains on his personal return, he will be limited to a \$3,000 (\$1,500, if he is married and files a separate return) capital loss deduction in 2011 under IRC Sec. 1211. Under IRC Sec. 1212(b), the remainder of the capital loss carries forward until used, and the capital loss deduction may be limited each year, depending on the other capital gains and losses shown on the shareholder's specific returns.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What is the built-in gains tax rate?
 - a. 5% or 15%.
 - b. 35%.
 - c. Depends on the income level.
2. The built-in gains tax is assessed to which of the following?
 - a. The built-in gains tax applies to an S corporation during the year of conversion from a C corporation to an S corporation.
 - b. The built-in gains tax applies to an S corporation during a year in which there is a disposition of an asset owned during the C corporation years.
 - c. The built-in gains tax applies to the shareholders of an S corporation during the year of conversion from a C corporation to an S corporation.
 - d. The built-in gains tax applies to the shareholders of an S corporation during a year in which there is a disposition of an asset owned during the C corporation years.
3. Which of the following regarding the built-in gains tax is correct?
 - a. Built-in losses may offset built-in gains.
 - b. Net operating losses do not carryover from a C corporation to an S corporation.
 - c. Capital losses carried over from a C corporation year do not reduce the built-in gains.
 - d. The built-in gains tax passes through to shareholders as a tax credit.
4. Identify which of the following corporations would be subject to the built-in gains tax.
 - a. A corporation that has always been an S corporation.
 - b. C corporations with unrealized built-in gains that make an election to be treated as an S corporation after 1986.
 - c. S corporations without net unrealized built-in gain at the election date.

Use the following for questions 5, 6, and 7:

Aloha, Inc. a C corporation electing S status effective January 1, 2009, has the following assets and liabilities on the date the S election is made.

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>
Cash	\$ 200,000	\$ 200,000
Accounts receivable	100,000	-0-
Equipment	160,000	180,000
Land	2,500,000	1,900,000

5. Considering the above assets, which could be subject to the built-in gains tax if disposed by Aloha in a taxable transaction?
 - a. Accounts receivable and land.
 - b. Equipment and land.
 - c. Accounts receivable, equipment and land.
 - d. Cash, accounts receivable, equipment and land.
6. Determine Aloha's net unrealized built-in gain.
 - a. \$580,000.
 - b. \$600,000.
 - c. \$680,000.
 - d. \$700,000.
7. During 2010, Aloha collects the accounts receivable and the equipment is sold for \$160,000. Determine the net recognized built-in gain or loss for the year.
 - a. \$(20,000).
 - b. \$80,000.
 - c. \$100,000.
 - d. \$0.

Use the following information for questions 8 through 9 and 13 through 16:

Coffeehouse, Inc. was a C corporation that elected S status effective January 1, 2008. The company is 100% owned by Sally and has the following assets and liabilities on the date the S election was made:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>
Cash	\$ 200,000	\$ 200,000
Accounts receivable	105,000	-0-
Equipment	120,000	130,000
Land	1,500,000	800,000
Accounts Payable	110,000	-0-

In 2009, Coffeehouse sells the Land for \$2 million, collects all of the accounts receivable and pays the accounts payable. The taxable income for 2009 is \$590,000.

8. What is the net unrealized built-in gain on January 1, 2008?
 - a. \$685,000.
 - b. \$700,000.
 - c. \$795,000.
 - d. \$805,000.
9. What is the net recognized built-in gain in 2009?
 - a. \$685,000.
 - b. \$695,000.
 - c. \$805,000.
 - d. \$1,195,000.
10. Which of the following regarding built-in gains and losses is correct?
 - a. If a C corporation accrues deductible bonuses to a shareholder-employee, the bonus is treated as a built-in loss if unpaid at the time of election to S status.
 - b. The built-in gains rules apply to a corporation that has an overall net unrealized built-in loss at the time of converting from a C corporation to an S corporation.
 - c. Shareholders are subject to the built-in gains tax during the 10 year recognition period beginning with the first day the corporation is treated as an S corporation.
 - d. The amount of built-in gains subject to tax is limited to the smaller of taxable ordinary income or recognized built-in gain.

11. Copy Services, Inc. is an S corporation that filed its S election on January 1, 2009, but was originally organized as a C corporation on October 1, 2005. Mail Services, Inc. is an S corporation that used to be a C corporation prior to January 1, 2007. In a tax-free merger on November 1, 2010, Copy Services acquires all of the assets and liabilities of Mail Services, Inc. When will Copy Services no longer be subject to the built-in gains tax?
- a. September 30, 2014.
 - b. December 31, 2016.
 - c. December 31, 2018.
 - d. October 31, 2019.
12. An S corporation has a recognized built-in gain of \$107,000, net unrealized built-in gain of \$140,000, and taxable income of \$85,000. The company has an \$8,000 NOL carryforward from a C corporation year, and a \$9,000 capital loss carryforward from a C corporation year. The built-in gains tax liability is:
- a. \$23,800.
 - b. \$29,750.
 - c. \$31,500.
 - d. \$37,450.
13. Refer back to the Coffeehouse information to answer questions 13 through 16. What is the built-in gains tax liability for 2009?
- a. \$206,500.
 - b. \$243,250.
 - c. \$418,250.
 - d. \$420,000.
14. How much gain will pass through to Sally on her Schedule K-1 from the sale of the Land?
- a. \$700,000.
 - b. \$992,014.
 - c. \$993,500.
 - d. \$1,200,000.
15. How much is the built-in gain carryover to 2010?
- a. \$0.
 - b. \$95,000.
 - c. \$105,000.
 - d. \$(10,000).

16. Assume all of the same information above for 2009. In the year 2010, the S corporation reports taxable income of \$300,000 and the equipment is sold in 2010 for \$140,000. What is the built-in gains tax?
- a. \$0.
 - b. \$3,500.
 - c. \$7,000.
 - d. \$33,250.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What is the built-in gains tax rate? **(Page 133)**

- a. 5% or 15%. [This answer is incorrect. The built-in gains tax rate is not the same as the capital gains tax rates per IRS Code.]
- b. 35%. [This answer is correct. Per IRS Code, the highest corporate tax rate applies to the built-in gains tax. Currently, the highest corporate tax rate is 35%.]**
- c. Depends on the income level. [This answer is incorrect. The built-in gains tax is not a graduated tax rate. The highest corporate tax rate is the applicable tax rate for any built-in gains tax per IRS Code.]

2. The built-in gains tax is assessed to which of the following? **(Page 133)**

- a. The built-in gains tax applies to an S corporation during the year of conversion from a C corporation to an S corporation. [This answer is incorrect. The built-in gains tax does not apply during the year a C corporation converts to an S corporation according to IRS Code.]
- b. The built-in gains tax applies to an S corporation during a year in which there is a disposition of an asset owned during the C corporation years. [This answer is correct. Per IRS code, an S corporation is subject to the built-in gains tax on a disposition of an asset owned when the corporation was a C corporation before converting to an S corporation.]**
- c. The built-in gains tax applies to the shareholders of an S corporation during the year of conversion from a C corporation to an S corporation. [This answer is incorrect. The built-in gains tax does not apply to the shareholders when a C corporation converts to an S corporation per the IRS Code.]
- d. The built-in gains tax applies to the shareholders of an S corporation during a year in which there is a disposition of an asset owned during the C corporation years. [This answer is incorrect. The built-in gains tax does not apply to the S corporation shareholders. The S corporation is subject to the built-in gains tax.]

3. Which of the following regarding the built-in gains tax is correct? **(Page 133)**

- a. Built-in losses may offset built-in gains. [This answer is correct. Certain built-in losses may reduce built-in gains. A corporation is not subject to built-in gain rules if the built-in losses exceed the built-in gains.]**
- b. Net operating losses do not carryover from a C corporation to an S corporation. [This answer is incorrect. Net operating losses will carryover from a C corporation to an S corporation upon conversion and may offset future built-in gains.]
- c. Capital losses carried over from a C corporation year do not reduce the built-in gains. [This answer is incorrect. Capital losses carried over from a C corporation year to an S corporation year can offset future built-in gains as indicated in IRS Code.]
- d. The built-in gains tax passes through to shareholders as a tax credit. [This answer is incorrect. The built-in gains tax is deductible from the S corporation's income and passes through to shareholders as a loss, not a tax credit.]

4. Identify which of the following corporations would be subject to the built-in gains tax. **(Page 133)**

- a. A corporation that has always been an S corporation. [This answer is incorrect. The built-in gains tax is applicable to corporations that were previously C corporations but the tax does not apply to a corporation that has always been an S corporation unless it received property subject to the built-in gains tax rules from a C corporation or S corporation.]
- b. **C corporations with unrealized built-in gains that make an election to be treated as an S corporation after 1986. [This answer is correct. The built-in gains tax applies to corporations electing S status after 1986 that also have accumulated earnings and profits per IRS Code.]**
- c. S corporation without net unrealized built-in gain at the election date. [This answer is incorrect. An S corporation is not subject to built-in gains tax if it had no net unrealized built-in gain on the date the S election became effective unless it received transferred basis property subject to the built-in gains tax per IRS Code.]

Use the following information for questions 5, 6 and 7:

Aloha, Inc. a C corporation electing S status effective January 1, 2009, has the following assets and liabilities on the date the S election is made.

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>
Cash	\$ 200,000	\$ 200,000
Accounts receivable	100,000	-0-
Equipment	160,000	180,000
Land	2,500,000	1,900,000

5. Considering the above assets, which could be subject to the built-in gains tax if disposed by Aloha in a taxable transaction? **(Page 136)**
- a. **Accounts receivable and land. [This answer is correct. In this example, only accounts receivable and land could be subject to the built-in gains tax, because they are the only assets with a built-in gain at the time of S election. A sale of the equipment would result in a built-in loss, which would reduce any built-in gain but not cause a built-in gain tax liability.]**
 - b. Equipment and land. [This answer is incorrect. Land could be subject to the built-in gains tax but in this example, there are other assets that could also be subject to the built-in gains tax based on IRS Code. In addition, built-in loss property would only reduce built-in gains tax.]
 - c. Accounts receivable, equipment and land. [This answer is incorrect. All of the assets, excluding cash, should be included in computing the built-in gain. However, built-in loss property would only reduce any built-in gains tax.]
 - d. Cash, accounts receivable, equipment and land. [This answer is incorrect. Since cash has no difference between adjusted basis and fair market value, cash is not subject to the built-in gains tax.]

6. Determine Aloha's net unrealized built-in gain. **(Page 136)**

- a. \$580,000. [This answer is incorrect. This answer choice does not properly consider all assets when computing the net unrealized built-in gain. Accounts receivable should be included.]
- b. \$600,000. [This answer is incorrect. The net unrealized built-in gain is computed for all applicable assets, not just land. Accounts receivable and equipment should be included.]
- c. \$680,000. [This answer is correct. The net unrealized built-in gain equals the difference between adjusted basis and fair market value of all assets at the time of conversion from a C corporation to an S corporation.]**
- d. \$700,000. [This answer is incorrect. The net unrealized built-in gain is computed by netting all built-in gains and losses at the time of conversion from a C corporation to an S corporation. This answer choice does not include the built-in loss on equipment.]

7. During 2010, Aloha collects the accounts receivable and the equipment is sold for \$160,000. Determine the recognized built-in gain (net of built-in losses) for the year. **(Page 136)**

- a. \$(20,000). [This answer is incorrect. Accounts receivable are subject to the built-in gains tax. The built-in gain from the accounts receivable should be netted with the built-in loss for the year.]
- b. \$80,000. [This answer is correct. The built-in gain from the accounts receivable of \$100,000 is recognized when the accounts receivable are collected and the built-in loss from the equipment of \$(20,000) is recognized and netted with the gain when sold.]**
- c. \$100,000. [This answer is incorrect. This answer choice does not properly consider all assets with a disposition during 2010. There is a built-in loss to be netted with the gain.]
- d. \$0. [This answer is incorrect. There is a built-in gain to be recognized during the year because of the disposition of built-in gain property.]

Use the following information for questions 8 through 9 and 13 through 16:

Coffeehouse, Inc. was a C corporation that elected S status effective January 1, 2008. The company is 100% owned by Sally and has the following assets and liabilities on the date the S election was made:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>
Cash	\$ 200,000	\$ 200,000
Accounts receivable	105,000	-0-
Equipment	120,000	130,000
Land	1,500,000	800,000
Accounts Payable	(110,000)	-0-

In 2009, Coffeehouse sells the Land for \$2 million, collects all of the accounts receivable and pays the accounts payable. The taxable income for 2009 is \$590,000.

8. What is the net unrealized built-in gain on January 1, 2008? **(Page 136)**

- a. **\$685,000. [This answer is correct. The net unrealized built-in gain is the excess of the aggregate FMV over the aggregate adjusted basis of all assets on hand on the date the S corporation election is effective.]**
- b. \$700,000. [This answer is incorrect. The land is not the only asset to include in computing the net unrealized built-in gain. Accounts receivable, equipment, and accounts payable must be factored in.]
- c. \$795,000. [This answer is incorrect. Accounts payable must be treated as a built-in loss and netted with unrealized built-in gains.]
- d. \$805,000. [This answer is incorrect. All assets and liabilities, including those with a built-in loss, should be included in the computation of the net unrealized built-in gain at the time of S election.]

9. What is the net recognized built-in gain in 2009? **(Page 136)**

- a. **\$685,000. [This answer is correct. The net recognized built-in gain in 2009 equals the gains and losses built-in at the time of S election and will not include the appreciation in assets after the S election is effective. The current recognition limit equals \$695,000 (land of \$700,000 plus accounts receivable of \$105,000 minus accounts payable of \$110,000), but it is limited to the net unrealized built-in gain (the overall limit) of \$685,000.]**
- b. \$695,000. [This answer is incorrect. The current recognition limit for the year equals \$695,000 but is limited to the net unrealized built-in gain (the overall limit).]
- c. \$805,000. [This answer is incorrect. The payment of the liabilities in the year 2009 is treated as a recognized built-in loss and netted with the built-in gains.]
- d. \$1,195,000. [This answer is incorrect. The net recognized built-in gain includes, for assets sold during the current year, only the gains or losses built-in at the time of S election and will not include appreciation thereafter.]

10. Which of the following regarding built-in gains and losses is correct? **(Page 136)**

- a. **If a C corporation accrues deductible bonuses to a shareholder-employee, the bonus is treated as a built-in loss if unpaid at the time of election to S status. [This answer is correct. Bonuses accrued to a shareholder-employee that satisfy the rules to be deductible are treated as a built-in loss at the time of S election as stated in IRS Sec. 267(a)(2).]**
- b. The built-in gains rules apply to a corporation that has an overall net unrealized built-in loss at the time of converting from a C corporation to an S corporation. [This answer is incorrect. If there is a net unrealized built-in loss at the time of S election, then the built-in gains rules do not apply.]
- c. Shareholders are subject to the built-in gains tax during the 10 year recognition period beginning with the first day the corporation is treated as an S corporation. [This answer is incorrect. S corporations, not shareholders, are subject to the built-in gains tax during the 10 year period following election of S corporation status.]
- d. The amount of built-in gains subject to tax is limited to the smaller of taxable ordinary income or recognized built-in gain. [This answer is incorrect. Built-in gain subject to tax is limited to the smaller of the overall limit (unrealized built-in gain less previous gains recognized) or the current recognition limit (net recognized built-in gains and losses) or the taxable income computed as if the corporation were a C corporation.]

11. Copy Services, Inc. is an S corporation that filed its S election on January 1, 2009, but was originally organized as a C corporation on October 1, 2005. Mail Services, Inc. is an S corporation that used to be a C corporation prior to January 1, 2007. In a tax-free merger on November 1, 2010, Copy Services acquires all of the assets and liabilities of Mail Services, Inc. When will Copy Services no longer be subject to the built-in gains tax? **(Page 136)**
- a. September 30, 2014. [This answer is incorrect. The date a corporation becomes a C corporation is irrelevant to the determination of the recognition period for built-in gains tax purposes.]
 - b. December 31, 2016. [This answer is incorrect. The recognition period for the assets acquired in the merger expires on December 31, 2016, but there is second recognition period for assets held by Copy Services as a C corporation.]
 - c. **December 31, 2018. [This answer is correct. The 10-year recognition period begins on the first day of the S election. There is a second recognition period set when the merger transpires. The recognition period for built-in gains tax on assets acquired from Mail Services will expire on December 31, 2016, but the company is still subject to the built-in gains tax for its own original C corporation assets.]**
 - d. October 31, 2019. [This answer is incorrect. The remaining recognition period for the assets acquired in the merger carries over to the acquiring company.]
12. An S corporation has a recognized built-in gain of \$107,000, net unrealized built-in gain of \$140,000, and taxable income of \$85,000. The company has an \$8,000 NOL carryforward from a C corporation year, and a \$9,000 capital loss carryforward from a C corporation year. The built-in gains tax liability is: **(Page 146)**
- a. \$23,800. [This answer is incorrect. Net recognized built-in gain may be reduced by the NOL carryforward and the capital loss carryforward. The taxable income is not reduced by either when computing the taxable income limitation.]
 - b. **\$29,750. [This answer is correct. The built-in gains tax is limited to the taxable income of \$85,000 multiplied by the highest corporate tax rate of 35%.]**
 - c. \$31,500. [This answer is incorrect. The net recognized built-in gain should be reduced by the NOL and capital loss carryovers, but there is a limit on the amount considered for the built-in gain tax calculation.]
 - d. \$37,450. [This answer is incorrect. The net recognized built-in gain may be reduced by the NOL carryforward and the capital loss carryforward from the C corporation years.]
13. Refer back to the Coffeehouse information to answer questions 13 through 16. What is the built-in gains tax liability for 2009? **(Page 151)**
- a. **\$206,500. [This answer is correct. The built-in gains tax liability for the year is equal to the net recognized built-in gain limited to taxable income of \$590,000 multiplied by 35%.]**
 - b. \$243,250. [This answer is incorrect. This answer choice does not properly apply all the elements of the tax calculation. The amount of tax is limited by one element in the scenario presented.]
 - c. \$418,250. [This answer is incorrect. The net recognized built-in gain includes, for assets sold during the current year, only the gains or losses built-in at the time of S election and will not include appreciation thereafter. Then, any net recognized built-in gain is subject to the highest corporate tax rate.]
 - d. \$420,000. [This answer is incorrect. The built-in gains tax applies to assets sold and liabilities paid during the year. In addition, the built-in gains tax does not apply to appreciation during the S corporation years. The land is not the only asset sold or disposed.]

14. How much gain will pass through to Sally on her Schedule K-1 from the sale of the Land? **(Page 151)**
- a. \$700,000. [This answer is incorrect. The entire gain of \$1,200,000 should be passed through to Sally regardless of how much the built-in gain is. However, the reported gain must be reduced by some amount.]
 - b. \$992,014. [This answer is correct. The total gain reported to Sally of \$1,200,000 is reduced by the built-in gains tax attributable to the land ($\$700,000/\$695,000 \times \$206,500$).]**
 - c. \$993,500. [This answer is incorrect. This answer choice represents the entire gain reduced by an incorrect amount of built-in gains tax.]
 - d. \$1,200,000. [This answer is incorrect. This answer choice represents the total amount of gain. The built-in gain tax applicable to the land must be accounted for before Schedule K-1 reporting.]
15. How much is the built-in gain carryover to 2010? **(Page 151)**
- a. \$0. [This answer is incorrect. There is a built-in gain carryover from 2010 due to the taxable income limitation.]
 - b. \$95,000. [This answer is correct. The net recognized built-in gain is limited to \$685,000 first due to the overall limit. Then, the taxable income limit applies causing the built-in gains tax to be limited to $\$590,000 \times 35\%$. The built-in gain carryover to 2010 is the difference between \$685,000 and \$590,000.]**
 - c. \$105,000. [This answer is incorrect. This answer choice does not properly reflect the built-in gain carryover. The net recognized built-in gain is \$685,000 is limited to the net unrealized built-in gain upon election of S status and to taxable income for the current year.]
 - d. \$(10,000). [This answer is incorrect. The built-in loss on the equipment does not equal the carryover.]
16. Assume all of the same information above for 2009. In the year 2010, the S corporation reports taxable income of \$300,000 and the equipment is sold in 2010 for \$140,000. What is the built-in gains tax? **(Page 151)**
- a. \$0. [This answer is incorrect. Since there was a built-in gain carryover for the year, the built-in gains tax is not limited to zero.]
 - b. \$3,500. [This answer is incorrect. The built-in gains tax does not include tax on asset appreciation from the time of the S election.]
 - c. \$7,000. [This answer is incorrect. The net recognized built-in gain is not the sale price of the equipment compared to the fair market value at the date of S election.]
 - d. \$33,250. [This answer is correct. All of the built-in gain carryover from 2009 is carried over to 2010 and recognized because there is enough taxable income during 2010, i.e. the taxable income limit does not apply for 2010. The sale of the equipment does not cause additional built-in gain or loss to be recognized because all of the net built-in gain was recognized in 2009.]**

How to Value Goodwill and Intangibles

Appraisals of Goodwill and Intangibles Should Be Completed

As pointed out earlier, appraisals should be completed to provide necessary substantiation of asset valuation. When such an appraisal is done, practitioners should be on the lookout for goodwill and other intangibles that are easy to miss because they have no basis and do not appear on the balance sheet. An S corporation that sells assets constituting a trade or business may be subject to the built-in gains tax from goodwill, including goodwill that was not purchased but was generated by the corporation itself when it was in C status. Unless an accurate appraisal is done as of the date the S election becomes effective, the valuation of goodwill can be somewhat subjective creating the possibility that, upon IRS examination, the goodwill will be valued higher than the taxpayer expected. The higher value would increase the value of the assets on hand at the date S status was achieved, which then increases the potential built-in gain under the overall limit.

Goodwill or Intangibles Owned by Shareholders Do Not Generate Built-in Gain

Two Tax Court decisions highlight a possible means of eliminating the value of certain goodwill. This strategy works only when the goodwill or other valuable intangibles are owned by the shareholders and not by the corporation.

In *Martin Ice Cream Co.*, the corporation was in the business of distributing ice cream to supermarkets, grocery stores, and food-service accounts. Arnold, who owned 51% of the corporation, had an oral agreement with an ice cream company that the corporation would act as a distributor of its ice cream. Arnold also had longstanding relationships with the owners and managers of supermarket chains. Arnold did not have an employment contract with the corporation nor did he sign a covenant not to compete. The Tax Court held that the valuable intangible assets embodied in Arnold's oral distribution agreement with the ice cream company and his relationships with the supermarket chains were not owned by the corporation. Rather, Arnold was the sole owner of these intangibles and simply made them available to the corporation by working for it. Thus, the value of the corporation's goodwill was zero.

In *Norwalk*, the IRS argued that a professional accountancy corporation owned approximately \$580,000 of intangibles when it liquidated. However, the Tax Court concluded that the goodwill associated with the practice was not a component of the corporation's value but rather was a personal asset of the shareholders. Further, the corporation's client list was held to have no value in the hands of the liquidating corporation, because no noncompete agreement with the corporation was effective against the shareholders. Without such a noncompete agreement, the shareholders were free to take the corporation's clients and serve them individually, rendering the client list valueless to the liquidating corporation. (As a practical matter, it was the personal abilities and characteristics of the individual accountants that mattered to clients, not the existence of the corporation.) The court noted the importance of the lack of a noncompetition agreement between the shareholder-employees and the corporation by stating "there is no salable goodwill where, as here, the business of a corporation is dependent upon its key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation."

These cases illustrate that intangible assets at the corporate level may be valued at zero in a professional practice where the controlling shareholders have no noncompete agreements, employment contracts, or similar arrangements with the corporation. Because built-in gain is limited to the excess of an asset's fair market value at the date the S election becomes effective over its adjusted basis at that date, intangibles and other corporate assets with no value at the date the S election becomes effective will not be subject to the built-in gains tax.

Watch For Goodwill and Intangibles

The practitioner should be on guard for goodwill and other intangibles that are easy to miss because they may have no basis and may not appear on the balance sheet. An S corporation that sells assets constituting a trade or business may be subject to the built-in gains tax from goodwill, including goodwill that was generated by the corporation itself when it was a C corporation. It is extremely important to have a qualified appraisal to determine the value of the corporation's assets, including goodwill and other intangibles (whether purchased or generated by the corporation), at the date the S election becomes effective.

Premium Received for Partnership Interest was not Subject to Built-in Gains Tax

The maximum built-in gain an S corporation must recognize on the disposition of an asset is the net unrealized built-in gain related to that asset, i.e., the excess of the asset's FMV over its adjusted basis on the day that the S election becomes effective.

In *Ringgold Telephone Company* (RTT), the taxpayer sold a 25% partnership interest that it valued on the S election date (January 1) at approximately \$2.6 million, the amount determined by its CPA's February valuation report. Assuming that the corporation's basis in the partnership interest was zero, RTT would have net unrealized built-in gain of 2.6 million related to the partnership interest.

The partnership interest was sold on November 27 of that year for approximately \$5.3 million. RTT reported gain of \$5.3 million on the sale. The recognized built-in gain, however, was limited to the net unrealized built-in gain, \$2.6 million, and RGG paid built-in gains tax on that amount.

The IRS contended that the value on the date the S election was effective was the November sales price, \$5.3 million. This adjustment would raise the net unrealized built-in gain, and the resulting recognized built-in gain, to \$5.3 million.

The Tax Court ruled that the value on the date the S election became effective was about \$3.7 million. This amount was based on an equal weighting of a business enterprise analysis (\$2.7 million), a distribution yield analysis (\$3.2 million), and the sale price (\$5.2 million). The Tax Court reduced the IRS's proposed value to reflect the likelihood that the buyer viewed the partnership interest as a strategic acquisition and was willing to pay a premium above fair market value to avoid an exercise of first refusal rights by the other partners. Under the Court's calculation, the net unrealized built and the recognized built-in gain were \$3.2 million each.

The court also held that RTT was not liable for the substantial underpayment penalty under IRC Sec. 6662(a) because the corporation acted with reasonable cause and in good faith in relying on the CPA's advice on valuing the partnership interest.

How to Value Date-of-conversion Inventory for Built-in Gains Tax Purposes

Built-in Gains Rules Apply to Inventory

If an S corporation was once a C corporation (or, in some cases, acquires "transferred basis" property from a C corporation or from another S corporation that is subject to the built-in gains tax rules), the S corporation is subject to the built-in gains tax. Furthermore, Reg. 1.1374-7(a) clearly indicates that the built-in gains tax applies to inventories. Since the built-in gain on each asset is limited to the amount by which the asset's FMV exceeded its adjusted basis on the date the S election became effective, *valuing* inventory at the date of conversion to S status becomes a crucial part of reducing the impact of the built-in gains tax.

Method of Valuing Inventory Items

The value of an S corporation's inventory on the day its S election becomes effective is determined by reference to a hypothetical sale of the entire business of the S corporation to a buyer that expects to continue operating the business. The buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts. According to the preamble to the regulations, the value so determined will generally be less than the inventory's anticipated retail price but greater than its replacement cost. Reg. 1.1374-7 generally applies to corporations that filed S elections on or after December 27, 1994.

Example 1G-1 Valuing inventory for purposes of the built-in gains tax.

Bandbox, a clothing store, is an accrual-basis S corporation that converted from C status effective January 1 of the current year. On that date the corporation had the following assets:

	<u>FMV</u>	<u>Adjusted Basis</u>	<u>Built-in Gain</u>
Cash	\$ 25,000	\$ 25,000	\$ —
Inventory	90,000	90,000	—
Fixed assets	60,000	75,000	(15,000)
Other assets	250,000	170,000	80,000
Totals	<u>\$ 425,000</u>	<u>\$ 360,000</u>	<u>\$ 65,000</u>

On the date the S election became effective, January 1, Brad, the sole shareholder of Bandbox stock, had Bandbox's inventory appraised to determine its value if there was a sale of the entire business. The inventory's FMV was found to be \$90,000, the same as its cost. The inventory is fast moving and generally neither appreciates nor depreciates before it is sold. Thus, sale of Bandbox's inventory will not result in built-in gains tax.

Example 1G-2 Slower moving inventory may result in built-in gain (or loss).

Glitter City, a jewelry store that operates as a C corporation, bought some diamonds for \$100,000. Subsequently, on January 1, 2007, the date that Glitter City elects S status, the diamonds are appraised and found to have a FMV of \$150,000. Other inventory items have not appreciated and their FMV equals their adjusted basis on the date the S election is effective. The aggregate FMV of all Glitter City's assets exceeds their aggregate bases by \$175,000. The corporation's net income is more than \$50,000 each year. Thus, sale of the diamonds during the 10-year recognition period will result in built-in gains of \$50,000.

These examples illustrate that an S corporation that purchases inventory and turns it over relatively quickly will generally not experience significant built-in gains from the sale of inventory. Slow-moving inventory, on the other hand, may appreciate or depreciate between the time the inventory is bought and the date the S election becomes effective, causing the inventory to be subject to built-in gain or loss when sold. Some inventory items, however, carry a FMV that is much higher than cost due to the nature of the item. Examples of these could include items that are rare, unusual, or artistic, such as gems or paintings. Inventory with a FMV in excess of cost can result in significant built-in gains tax regardless of the inventory turnover rate.

Factors to Consider when Valuing Inventory. Measuring the appreciation (if any) in inventory on the date the S election becomes effective is inherently difficult. The FMV of inventory is what a willing buyer would pay a willing seller as part of a purchase of all of the S corporation's assets, assuming the buyer expects to continue to operate the S corporation's business. The Preamble to TD 8579 (the final Section 1374 regulations issued in 1994) further clarifies that the FMV of inventory generally is expected to be between the replacement cost and the anticipated retail price. In addition, the buyer and seller are assumed to have knowledge of all relevant facts including the replacement cost; the expected retail selling price; and any buyer and seller costs to obtain, prepare, carry, and dispose of the inventory before and after the sale of the business.

Rev. Proc. 2003-51 contains guidelines for determining the FMV of bulk sale inventory. This procedure applies to inventory items acquired (1) in a lump sum purchase of business assets or (2) when the acquiring corporation makes a Section 338 election. Per the IRS, valuation is an inherently factual determination and therefore rigid formulas should *not* be used. Thus, the procedure contains three methods to be used only as guidelines. In the situations set forth in the revenue procedure, the quantity of inventory to be valued generally would be different from the quantity usually purchased. The FMV of the goods in process and finished goods on hand is to be determined in light of what a willing purchaser would pay and a willing seller would accept for the inventory at the various stages of completion, when the buyer is not under any compulsion to buy and the seller is not under any compulsion to sell, and both buyer and seller having reasonable knowledge of relevant facts. In making the inventory valuation determination, a fair division between the buyer and seller of the profit on the inventory must be made, taking into account that the quantity of inventory purchased may be greater than the quantity of inventory usually purchased. The three methods set forth in the revenue procedure are as follows:

- *Replacement Cost Method.* This method generally provides a good indication of FMV if inventory is readily replaceable in a wholesale or retail business. However, it is not recommended for use in establishing the FMV of the work in process or finished goods of a manufacturing concern. In valuing a bulk inventory of

raw materials or goods purchased for resale under this method, the determination of the replacement cost of the individual items should be only a base or starting point. This base amount must then be adjusted for generally relevant factors (e.g., a fair return on the seller's expenditures in accumulating and preparing the inventory for distribution).

- *Comparative Sales Method.* This method utilizes the actual or expected selling prices of finished goods to customers in the ordinary course of business as the base amount that must be adjusted for factors that are generally relevant in determining the inventory's FMV. The inventory to be valued may represent a larger quantity than the normal trading volume. The expected selling price is a valid starting point only if the inventory is expected to be used to fill customers' orders in the ordinary course of business; if it is used as a basis for valuing finished goods inventory, the base amount must be adjusted for relevant factors (e.g., expenses expected to be incurred on the disposition, a profit commensurate with the investment in the asset and the degree of risk, and the time required to dispose of the inventory).
- *Income Method.* This method recognizes that finished goods must generally be valued in a profit-motivated business. As the inventory amount may be large in relation to normal trading volume, the inventory's highest and best use will be to provide for a continuity of the going business's marketing operation. Also, the finished goods inventory will usually provide the only source of revenue of an acquired business during the period it is being used to fill customers' orders; the acquired company's historical financial data can be used to determine the amount that could be attributed to finished goods in order to pay all costs of disposition and provide a return on the investment during the disposition period.

The FMV of work in process should be based on the same factors used to determine the FMV of finished goods reduced by the expected costs of completion, including a reasonable profit allowance for the completion and selling effort of the acquiring corporation.

Work in Progress

An S corporation has an incentive to minimize the value of its inventory, and thereby minimize the built-in gain and related exposure to the built-in gains tax. Conversely, the IRS has an incentive to maximize built-in gain on inventory items to protect federal tax revenues. Among other things, these opposing motives are certain to influence the valuation of inventory items that are unfinished on the date the S election becomes effective. The amount of pre-conversion activity versus post-conversion activity should be a significant factor influencing the value of work-in-process.

In *Reliable Steel Fabricators, Inc.*, the Tax Court considered how to value a steel fabricator's work-in-progress inventory. The Court began by quoting the language now incorporated in Reg. 1.1374-7(a) and approving its use as an appropriate way of determining the FMV of work-in-progress inventory. The Court noted that there are no previous cases dealing with FMV for built-in gains tax purposes, but stated that the FMV standard (what a willing buyer would pay a willing seller for the work-in-progress inventory) has been applied in similar contexts. The Court examined three cases in such similar contexts and concluded that the FMV of work-in-progress would fall between its cost and retail value. The Court also concluded that a discount from full retail price is appropriate for work-in-progress inventory. Accordingly, the method the IRS used in *Reliable Steel* for calculating the built-in gain on the work-in-progress inventory may be recast as follows:

- Sales price
- Discount based on the FMV standard (what a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue the corporation's business)
- Estimated total completed cost
- = Estimated total profit
- × Percentage of completion (cost incurred on the unfinished inventory before the day the S election became effective divided by estimated total completed cost)
- = Built-in gain

A cash basis C corporation that renders personal services (such as a CPA firm) must consider work in progress when it elects S status. The value of the work in progress in excess of its basis is subject to the built-in gains tax rules, and is included in net unrealized built-in gain at the date the S election becomes effective, so a lower valuation is better. However, determining FMV is not an exact science and can be especially difficult when valuing an intangible such as work in progress, as illustrated in the preceding discussion. It appears that applying a reasonable formula would go a long way toward establishing that work in progress had been properly valued.

When Does a Disposition of Inventory Owned on the Date of Conversion Occur?

Built-in gain recognition and the related tax are triggered only by dispositions of assets that are owned on the date of the S election (i.e., owned as of the first day of the first S corporation tax year). To determine whether disposition of an inventory item has occurred, the S corporation generally must use the same inventory method (FIFO, LIFO, etc.) that it uses for tax purposes. For example, an S corporation using the LIFO inventory method is not subject to the built-in gains tax on sales of inventory unless the corporation invades a LIFO layer that existed prior to the beginning of its first S corporation tax year.

Are Natural Resources Exempt from the Built-in Gains Tax?

The following discussion relates to built-in gains from the disposition of natural resources.

Standing Timber. The IRS has issued Rev. Rul. 2001-50 exempting standing timber from the built-in gains tax. Under the ruling, built-in gain is *not* recognized when an S corporation holds timber property on the date it converts from C status to S status (or acquires transferred basis timber property from a C corporation or S corporation subject to the built-in gains tax) and, during the 10-year recognition period, the corporation:

1. cuts the timber and sells the resulting wood products,
2. recognizes gain or loss on cutting the timber under a Section 631(a) election, or
3. recognizes gain or loss on the disposal of timber under a Section 631(b) contract.

IRC Sec. 631(a) provides an election under which the cutting of timber by a taxpayer who owns, or has a contract right to cut, timber is treated as a sale or exchange of the timber in the year the timber is cut, provided the timber or the contract right to cut the timber is held for more than one year, regardless of whether the timber or timber products are sold during the year. Under IRC Sec. 631(b), the owner may contract to dispose of certain timber while retaining an economic interest in the property. The gain or loss on the disposition of timber may be treated as if the property had been sold, resulting in capital gain or loss on the transaction. IRC Sec. 631(c) provides similar treatment for certain coal or domestic iron ore dispositions.

As stated earlier, the IRS has ruled that the income derived by the S corporation from the cutting of timber and sale of logs produced from the cut timber during the 10-year built-in gain recognition period does not constitute recognized built-in gain. However, if any timber is cut before the corporation's S election becomes effective and the logs produced from the cut timber are held as inventory on the day the S election becomes effective, any income derived by the S corporation on the sale of such logs during the 10-year recognition period will constitute recognized built-in gain.

Oil and Gas. The built-in gains tax regulations provide that the sale of oil produced from an oil and gas working interest held on the effective date of the corporation's S election is not subject to the built-in gains tax. However, the sale of the oil and gas property during the recognition period is subject to the built-in gains tax.

Coal or Domestic Iron Ore Property. Under Rev. Rul. 2001-50, no built-in gain results when an S corporation holds coal or domestic iron ore property on the date it converts from C status to S status (or acquires transferred basis coal or domestic iron ore property from a C corporation or S corporation subject to the built-in gains tax) and, during the 10-year recognition period, recognizes gain or loss on the disposal of the coal or iron ore under a Section 631(c) contract.

Summary. The ruling on timber and coal or domestic iron ore and the regulations on oil and gas are consistent in holding that income from the production of a natural resource property held on the first day of the corporation's first year as an S corporation is not subject to the built-in gains tax. However, income from the sale of severed or extracted natural resources held on the effective date of the corporation's S election is subject to the built-in gains tax.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Which of the following statements regarding inventory is correct?
 - a. Slower moving inventory may result in a built-in gain.
 - b. Determining the FMV of work in process is dissimilar to determining the FMV of finished goods.
 - c. Work in progress is not subject to the built-in gains tax.
18. For a C corporation electing S status, which of the following would cause a built-in gains tax?
 - a. Corporate intangible assets in a professional practice that may have no value.
 - b. The corporation invades a LIFO layer that existed prior to S corporation conversion.
 - c. Corporation with an overall net unrealized built-in loss sells an asset at a gain.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Which of the following statements regarding inventory is correct? **(Page 167)**

- a. **Slower moving inventory may result in a built-in gain. [This answer is correct. Slow-moving inventory may appreciate or depreciate between the time the inventory is bought and the date the S election becomes effective, causing the inventory to be subject to a built-in gain or loss when the inventory is sold.]**
- b. Determining the FMV of work in process is dissimilar to determining the FMV of finished goods. [This answer is incorrect. The FMV of work in process should be based on the same factors used to determine the FMV of finished goods reduced by the expected costs of completion, including a reasonable profit allowance for the completion and selling effort of the acquiring corporation.]
- c. Work in progress is not subject to the built-in gains tax. [This answer is incorrect. Work in progress is subject to the built-in gains tax if it is in excess of its basis as stated in IRS regulations.]

18. For a C corporation electing S status, which of the following would cause a built-in gains tax? **(Page 167)**

- a. Corporate intangible assets in a professional practice that may have no value. [This answer is incorrect. Corporate intangible assets in a professional practice without any value will not be subject to a built-in gains tax because built-in gain is limited to the excess of an asset's fair market value at the date the selection becomes effective over its adjusted basis at that date.]
- b. **The corporation invades a LIFO layer that existed prior to S corporation conversion. [This answer is correct. Built-in gain recognition and the related tax are triggered by dispositions of assets that are owned on the date of the S election. An S corporation using the LIFO inventory method is subject to the built-in gains tax on sales of inventory if the corporation invades a LIFO layer that existed prior to the beginning of its first S corporation tax year.]**
- c. Corporation with an overall net unrealized built-in loss sells an asset at a gain. [This answer is incorrect. The corporation would not be subject to the built-in gains tax because there is a net unrealized built-in loss at the time of S election.]

How to Apply Built-in Gains Rules to Installment Sales

Installment Note Executed during C Corporation Period

Collection of an installment note receivable during the 10-year recognition period results in built-in gain if the note was executed during the C corporation period.

Example 1H-1 Installment note executed during C corporation period.

Four years ago, Splash, Inc., closed an installment sale and realized a \$200,000 gain, which it reports on the installment method. On January 1, 2010, the date Splash elects S status, \$100,000 of the gain is unreported. Splash's net unrealized built-in gain is \$310,000 (including the \$100,000 deferred installment gain). Splash collects the remaining note payments in 2010 and 2011 and recognizes \$50,000 of gain on the installment sale in each year. Splash's taxable income each year was \$75,000, and no other built-in gains or losses were recognized. The \$50,000 installment gain recognized each year is subject to the built-in gains tax.

Installment Sale Benefits Are Restricted for Built-in Gains Purposes

Regulations restrict the tax benefits of installment sales as they relate to the built-in gains tax. The regulations ensure that installment sales cannot be used as a means of avoiding the built-in gains tax of IRC Sec. 1374.

The installment method is not allowed for calculating the built-in gains tax for dispositions either *before or during* the 10-year recognition period that begins on the first day of the first tax year that the corporation is an S corporation. Effectively, the 10-year time limit is extended for an installment sale originating before or during the 10-year recognition period. When installment sale income is recognized under normal installment sale reporting rules, it is taxed to the corporation under the built-in gain rules to the extent it would have been taxed in prior years had the seller elected out of installment reporting. Under this rule, the amount of installment sale built-in gain deemed taxed in any prior year will not exceed the corporation's taxable income for that year (computed as if it were a C corporation).

Under these rules, the amount of gain from the installment sale subject to the built-in gains tax may differ from the installment sale gain passed through to shareholders for normal tax purposes. For normal tax reporting purposes, installment sales by S corporations are reported without regard to the built-in gains tax rules. The deemed "election out" of installment reporting under Reg. 1.1374-4(h) does not apply to the determination of the amount of gain recognized for regular tax purposes at the S corporation level and passed through to shareholders. The deemed election out is solely for purposes of determining the amount and timing of the built-in gains tax.

No Built-in Gain Recognition until Payments Are Received

These installment sale rules do not require recognition of built-in gain arising from an installment sale until the gain is recognized under the normal installment sale reporting rules. (That is, no installment sale built-in gain is recognized until installment payments are actually received during the year.) Effectively, the rules extend the 10-year time limit for an installment sale originating before or during the 10-year recognition period. Furthermore, the taxable income limitation for each year an installment payment is received must be recalculated to include the installment sale gain that would have been taxed in prior years had the seller elected out of installment reporting.

Effective Date and Examples

The built-in gain installment sale regulations are effective for installment sales occurring *after* March 25, 1990, unless a binding contract was in effect on or before that date.

Example 1H-2 Installment gain recognized outside the 10-year recognition period.

In Year 1 of the recognition period, S Corp realizes a \$100,000 built-in gain on the installment sale of an asset. S Corp receives no down payment, and in Year 11 it receives the entire amount due under the installment note in one deferred payment. Under the normal installment sales reporting rules, S Corp reports the entire \$100,000 gain in Year 11 for normal tax reporting purposes.

Assume that S Corp has an operating loss of \$60,000 in Year 1 and breaks even for all other years within the 10-year recognition period. For built-in gain purposes, S Corp is deemed to have elected out of installment reporting. If S Corp had elected out of installment reporting, the entire \$100,000 gain would have been recognized in Year 1. After considering the taxable income limitation of \$40,000 (\$60,000 operating loss plus \$100,000 installment gain deemed recognized), \$40,000 of the \$100,000 gain would have been subject to the built-in gains tax in Year 1. S Corp does not actually report or pay built-in gains tax on this hypothetical amount in Year 1 (because it received no installment payments in Year 1). Instead, \$40,000 of the \$100,000 gain actually recognized in Year 11 is subject to the built-in gains tax in Year 11, according to IRS Notice 90-27 and Reg. 1.1374-4(h). Thus, the built-in gains tax is not due until the gain is actually recognized on the installment method. The tax is due for Year 11 even though the gain is recognized outside the 10-year recognition period. If S Corp had recognized positive taxable income for any year in Years 2 through 10, the built-in gains tax would apply on up to \$60,000 (the amount of "untaxed" built-in gain carried over from Year 1 to subsequent years) of additional gain. This is true even if S Corp. has no taxable income in Year 11.

Example 1H-3 Installment gain recognized within the 10-year recognition period.

In Year 1 of the recognition period, Y Corp realizes a \$100,000 built-in gain on the installment sale of an asset. The corporation does not elect out of installment sale reporting. Ignoring the installment gain, Y Corp has no income or loss for the year, and it breaks even for all other years within the recognition period. Y Corp receives full payment in Year 6 and the gain on the sale is reported in that year. If Y Corp *had* elected out of installment reporting, the gain would have been recognized in Year 1 and, taking into account the application of the taxable income limitation, the full \$100,000 gain would have been subject to the built-in gains tax in Year 1. Therefore, the full \$100,000 of gain is subject to the built-in gains tax in Year 6, even if there is no taxable income in Year 6.

Example 1H-4 Installment sale before S election.

On April 1, 2004, Z Corp realizes a \$250,000 gain, which it reports on the installment method. On January 1, 2010, \$100,000 of the gain is unreported. Z Corp becomes an S corporation on that date and determines that its net unrealized built-in gain (including the \$100,000 deferred installment gain) is \$325,000. Z Corp has no income or loss for its first year in S status and breaks even for all other years within the recognition period. No other built-in gains or losses are recognized. The 10-year recognition period expires on December 31, 2019, and the corporation receives full payment on the note in 2020.

When an asset is sold on the installment basis, the entire amount of income not recognized before the recognition period is treated as having been reported in the first year of the recognition period for purposes of computing the built-in gains tax. Under this provision, Z Corp treats the \$100,000 of unreported gain as if the installment sale occurred in 2010. If the sale had taken place in that year, and if Z Corp had elected out of the installment method, the corporation's net income for the year would have been \$100,000. Thus, the \$100,000 installment gain is subject to the built-in gains tax when the note is collected in 2020, even though the recognition period has expired. Also, the built-in gains tax would apply in 2020 even if there was no taxable income in that year because the taxable income limitation must be recalculated to include the installment sale gain that would have been taxed in prior years had the seller elected out of installment reporting.

Installment Sales Subject to the Special Installment Sale Rules

The built-in gain installment sale rules apply to asset dispositions before and during the 10-year recognition period that begins with the date the S election becomes effective. However, assets acquired after the S election becomes effective are generally not subject to the built-in gains tax. An exception to this rule provides that transferred basis property received from a C corporation or an S corporation subject to the built-in gains tax rules can be subject to the tax, even if the property is received after the S election is in effect.

Therefore, the built-in gain installment sale rules apply to the following:

- *Installment notes executed before the S election became effective (i.e., during the C corporation period).* The deferred installment gain at the date the S election became effective is subject to the built-in gains tax.
- *Installment notes executed after the S election became effective, and before the end of the 10-year recognition period, if the asset sold was on hand at the S election effective date.* The gain on the sale is

subject to the built-in gains tax, limited to the excess of the asset's fair market value over its basis at the date the S election became effective.

- *Installment notes executed before the end of the 10-year recognition period if the asset sold is transferred basis property received from a C corporation or an S corporation subject to the built-in gains tax rules.* This lesson discusses how the amount subject to the built-in gains tax is determined and how the 10-year recognition period is measured for transferred basis property.

Built-in Gains Tax Suspended During 2009, 2010, and 2011 for Certain S Corporations

The built-in gains tax is suspended in 2009 and 2010 for an S corporation if the *seventh tax year* of the corporation's 10-year recognition period ended before the beginning of either of those tax years. Furthermore, suspension of the built-in gains tax continues during 2011 if the *fifth year* of the corporation's 10-year recognition period ended before the beginning of the 2011 tax year. Although no IRS guidance has been released at the date this book went to press, it appears that eligible S corporations will not report recognized built-in gains from installment sales during the 2009, 2010, and 2011 suspension periods.

Property Distributed to Shareholders

Property Distributions May Result in Built-in Gains Tax

Gain Recognition—Regular Tax. When an S corporation distributes appreciated property [i.e., property that has a fair market value (FMV) in excess of its adjusted basis] to a shareholder, gain is recognized by the corporation as if it had sold the property to the shareholder at its FMV. The gain passes through to shareholders in accordance with the normal pass-through rules of IRC Sec. 1366. No loss is allowed if the distributed property has a FMV less than the corporation's adjusted basis in such property. [An exception to the loss disallowance rule applies to complete liquidations.]

Gain Recognition—Built-in Gains Tax. In addition to gain recognition, a distribution of property can result in built-in gains tax at the S corporation level. If the FMV of the distributed property exceeded its tax basis at the time of conversion to S status, subsequent distribution of the property is subject to tax if the Section 1374 built-in gains tax rules apply.

Example 11-1 Built-in gains tax caused by property distribution.

Carco, Inc. converted from C to S status effective January 1, 2009. At the time of conversion, Carco owned a fully depreciated automobile worth \$7,500 and had a net unrealized (i.e., overall) built-in gain of \$50,000. In November 2010, Carco distributed the automobile to Jerry, its sole shareholder, when the car was worth \$6,000. How much of the gain is included in Carco's taxable income and thus passed through to Jerry? How much of the gain, if any, is subject to the built-in gains tax at the S corporation level? How much is Carco's "net unrealized built-in gain" reduced by the distribution?

As noted earlier, a distribution of appreciated property by a corporation is treated as a deemed sale of the property to the shareholder for its FMV as of the date of distribution. In this example, the car was worth \$6,000 and had a zero basis at the date of distribution. Therefore, the deemed sale results in \$6,000 of ordinary income (depreciation recapture) to the S corporation, to be reported initially on Form 4797 (Sales of Business Property) and passed through to Jerry on Schedule K-1.

The gain of \$6,000 (not the \$7,500 of gain built in at the date of conversion to S status) is subject to the built-in gains tax. The tax is computed on Schedule D of Form 1120S and passes through as a loss to the shareholder, taking on the same character as the built-in gain that gave rise to the tax. Furthermore, since gains subject to the built-in gains tax are limited to the excess of FMV over basis at the time of conversion to S status less previously recognized built-in gains, the (overall) net unrealized built-in gains will be reduced by \$6,000.

Built-in Gains Apply to Property Distributed in Liquidation. Built-in gains are triggered by the disposition of assets that were on hand at the time the S election became effective. Therefore, an S corporation that is subject to the

built-in gains tax will incur tax at the corporate level if it recognizes gain on the sale or distribution of appreciated assets in liquidation. The gain passes through and is also subject to regular tax at the individual shareholder level.

How to Apply the Built-in Gains Rules to Qualified Subchapter S Subsidiaries

Qualified Subchapter S Subsidiary

A qualified Subchapter S subsidiary (QSub) is a subsidiary corporation that is 100% owned by an S corporation that has made a QSub election for the subsidiary. (An S corporation, for example, can own 100% of the stock of two subsidiaries and make a QSub election for either, neither, or both of them.) A QSub is technically neither a C corporation nor an S corporation. Instead, a QSub is not treated as a separate corporation for federal tax purposes (although it is still treated as a separate corporation for other purposes).

If the subsidiary was a C corporation or an S corporation subject to the built-in gains tax before the QSub election, its assets are subject to the built-in gains tax. Built-in gain is generally not recognized when the QSub election is made, but the subsequent disposition of assets can result in the recognition of built-in gains.

Avoiding Potential Duplicate Built-in Gains Tax Liability for Parent S Corporations

Regulations eliminate a potential tax trap for parent S corporations subject to the built-in gains tax. The regulations prevent gain or loss from being counted twice for purposes of the built-in gains tax. The duplication could occur when a C corporation converted to S status and owned stock in a subsidiary corporation that was later liquidated.

Accrued Bonuses Can Reduce Net Unrealized Built-in Gain

Bonuses

If a C corporation declares or accrues reasonable bonuses to shareholder/employees and pays them after the S election becomes effective, the bonus is a built-in loss that reduces the net unrealized built-in gain, and also offsets built-in gain in the year the bonus is paid.

In general, an S corporation must defer the deduction of certain expenses until a related person includes the item in gross income. The regulations provide that an amount properly deducted under this rule is recognized as a built-in loss if the bonus is paid:

1. within the first 2¹/₂ months of the recognition period, or
2. to an employee who owns less than 5% of the corporation's stock.

Under IRC Sec. 267(e)(1), any S corporation shareholder is a related person. However, Reg. 1.1374-4(c)(1) removes an employee who owns less than 5% of the corporation's stock from the definition of a related person for built-in loss purposes.

Payments governed by IRC Sec. 404(a)(5). A payment is governed by IRC Sec. 404(a)(5) [rather than IRC Sec. 267(a)(2)] if it is paid under a plan deferring the receipt of compensation. A plan is considered to be deferring the receipt of compensation if the employee receives the compensation more than a brief period of time after the end of the corporation's tax year. A payment made more than 2¹/₂ months after the end of the corporation's tax year is presumed to be paid more than a brief period of time after the end of the corporation's tax year, and is therefore presumed to be made under a deferred payment plan.

A bonus or other deferred compensation governed by IRC Sec. 404(a)(5) qualifies as a built-in loss if it is paid to an employee who owns less than 5% of the corporation's stock.

Recap. To summarize, a bonus paid to a shareholder generally qualifies as a built-in loss if it is:

1. paid within the first 2½ months of the recognition period, without regard to the amount of stock the shareholder owns; or
2. paid at any time after the beginning of the recognition period to an employee who owns less than 5% of the corporation's stock.

Bonuses or deferred compensation accruals that qualify as built-in losses under either of the two items in the preceding recap are also beneficial because they reduce net unrealized built-in gain; that is, the overall limit on the amount of built-in gain that can be taxed.

Charitable Contributions of Appreciated Property Are Not Subject to Built-in Gains Tax

The built-in gains tax applies when an asset that was on hand at the date the S election became effective is disposed of, but only if the transaction results in recognized income or gain. A charitable contribution of appreciated property does not result in recognized gain. Therefore, charitable contributions of property that appreciated before the S election became effective are not subject to the built-in gains tax.

Reporting Built-in Gains during the 2009 and 2010 Built-in Gains Tax Suspension Period

As part of the stimulus package, the American Recovery and Reinvestment Act of 2009 (the 2009 Recovery Act) suspends imposition of the built-in gains tax for tax years beginning in 2009 and 2010 for qualifying S corporations. The rule basically says that built-in gains tax will not be imposed during 2009 and 2010 for an S corporation if the seventh tax year of the corporation's 10-year recognition period ended before either of those tax years.

Built-in Gains Suspension When Recognition Period Began in 2002

Under the 2009 Recovery Act, an S corporation whose 10-year recognition period began in 2002 will not be subject to built-in gains tax for tax years beginning in 2009 or 2010.

Example 1M-1 Suspending built-in gains tax in 2009 and 2010 for S corporation with recognition period beginning in 2002.

Gem, Inc., a calendar year C corporation, elected S status on April 1, 2002. Gem's 10-year recognition period ends on March 31, 2012. However, the seventh tax year of Gem's 10-year recognition period ended on December 31, 2008 (i.e., before the beginning of the 2009 tax year), so Gem's net recognized built-in gain during 2009 and 2010 will not be subject to the built-in gains tax.

Counting Years for Purposes of the 10-year Recognition Period Rules and the Suspension Period Rules. The application of the built-in gains suspension rules requires the practitioner to have a clear distinction between the 10-year recognition period rules and the suspension qualification rules. The 10-year (120-month) built-in gains recognition period begins on the date the corporation's S election becomes effective. However, the built-in gains tax suspension rules apply to tax years beginning in 2009 or 2010 if the seventh tax year in the recognition period preceded 2009 or 2010. Thus, the built-in gains tax suspension rules are evidently keyed to the corporation's tax year rather than to any specific 12-month period within the normal 10-year (120-month) recognition period. Example 1M-1 illustrates the application of these rules. In that example, the corporation's 10-year recognition period began on April 1, 2002, the date of its S election. Accordingly, the seventh full year of the corporation's built-in gains recognition period would end March 31, 2009. However, because the built-in gains tax suspension rules of IRC Sec. 1379(d)(7)(B) are keyed to the corporation's *taxable year*, the corporation qualifies for the suspension of the built-in gains tax because its seventh tax year in the recognition period (i.e., the calendar year ending December 31, 2008) ends before 2009.

Built-in Gains Suspension When Recognition Period Began in 2003

An S corporation whose 10-year recognition period began in 2003 will be exempt from the built-in gains tax for the tax year beginning in 2010 only.

Example 1M-2 Suspending built-in gains tax in 2010 for S corporation with recognition period beginning in 2003.

Assume the same facts as in Example 1M-1, except that Gem, Inc. elected S status on April 1, 2003. The seventh tax year of Gem's 10-year recognition period ends on December 31, 2009 (i.e., before the beginning of the 2010 tax year). Thus, Gem's net recognized built-in gain during 2010 will not be subject to the built-in gains tax.

Built-in Gains Suspension When Recognition Period Expires in 2009 or 2010

An S corporation whose 10-year recognition period expires during the 2009–2010 suspension period will not be subject to built-in gains tax after the tax year beginning in 2008.

Example 1M-3 Built-in gains tax does not apply after 2008 for an S corporation whose recognition period expires during 2009 or 2010.

Klip Inc. elected S status on January 1, 2001. The seventh year of Klip's 10-year recognition period ends on December 31, 2007 (i.e., before the beginning of the 2009 tax year). Klip's 10-year recognition period expires on December 31, 2010. So Klip is exempt from the built-in gains tax under the temporary suspension rule during 2009 and 2010 and the tax no longer applies after 2010, so Klip will not be subject to the built-in gains tax rules after December 31, 2008.

Even if an S corporation's recognized built-in gains are otherwise exempt from built-in gains tax during the 2009–2010 built-in gains tax suspension period, it can be subject to the built-in gains tax during that period if the corporation received transferred (substituted) basis property from a C corporation or an S corporation subject to the built-in gains tax rules.

Treatment of Transferred Basis Property during the 2009–2010 Built-in Gains Tax Suspension Period

A separate 10-year recognition period applies to transferred basis property received from a C corporation or an S corporation subject to the built-in gains tax rules. The 10-year recognition period for such assets received by an S corporation from a C corporation is measured from the date of acquisition by the S corporation rather than from the date S status is elected. If an S corporation acquires transferred basis property from another S corporation that was subject to the built-in gains tax, the recognition period is the remainder of the original 10-year period during which the transferor S corporation was subject to the built-in gains tax with respect to that property.

Property has a transferred basis if its basis in the hands of the transferee is determined, in whole or in part, by reference to the asset's (or another asset's) basis in the hands of the transferor.

Gain on the disposition of transferred basis property acquired from a C corporation is exempt from the built-in gains tax during tax years beginning in 2009 and 2010 if the property is acquired by the S corporation at least seven years before those tax years.

Example 1M-4 Applying the 2009–2010 built-in gains tax suspension period to transferred basis property.

Assume the same facts as in Example 1M-1. Also assume that on February 1, 2005, Gem acquired appreciated land from a C corporation as part of a reorganization. Gem now has two 10-year recognition periods. The first begins on April 1, 2002, and applies to property on hand when the S election became effective. The second begins on February 1, 2005, and applies to the land received in the reorganization.

Gem faces the built-in gains tax if it disposes of the land on or before January 31, 2015 (i.e., within 10 years from the date it acquired the land). If Gem disposes of the land during 2009 or 2010, the S corporation is subject to built-in gains tax on the disposition of that asset because the seventh year of the recognition period has not ended before those tax years.

Calculating Net Recognized Built-in Gain and Net Unrealized Built-in Gain

Net Unrealized Built-in Gain Is Reduced during the 2009–2010 Built-in Gains Tax Suspension Period. The maximum built-in gain an S corporation must recognize is the “net unrealized built-in gain” (the excess of the aggregate FMV over the aggregate adjusted basis of all assets on hand as of the first day the S election is effective).

The Code states that “In the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year”. This seems to mean that, for S corporations that are exempt from the built-in gains tax during 2009 and 2010, the net recognized built-in gain is calculated but no built-in gains tax applies. Therefore, the net unrealized built-in gain (i.e., the overall limit) is evidently reduced by built-in gain recognized but not taxed, which likewise reduces the maximum amount of built-in gain that is subject to tax after 2010.

Net Recognized Built-in Gain. Net recognized built-in gain is the amount of built-in gain that is subject to tax after applying the applicable limitations. The wording of IRC Sec. 1374(d)(7)(B) (quoted in the preceding paragraph) sounds like the net recognized built-in gain is calculated in the regular manner, except that no tax applies to built-in gains recognized by qualifying S corporations during the 2009–2010 built-in gains tax suspension period.

Example 1M-5 Calculating net recognized built-in gain and net unrealized built-in gain during the 2009–2010 built-in gains tax suspension period.

Gem, Inc., a calendar year C corporation, elected S status on April 1, 2002. The seventh tax year of Gem's 10-year recognition period ended on March 31, 2008 (i.e., before the beginning of the 2009 tax year). Thus, Gem's net recognized built-in gain during 2009 and 2010 will not be subject to the built-in gains tax. (These are the same facts as in Example 1M-1.) On April 1, 2002, Gem had the following assets:

	<u>FMV</u>	<u>Adjusted Basis</u>	<u>Built-in Gain (Loss)</u>
Cash	\$ 15,000	\$ 15,000	\$ —
Asset A	100,000	40,000	60,000
Asset B	46,000	30,000	16,000
Totals	<u>\$ 161,000</u>	<u>\$ 85,000</u>	<u>\$ 76,000</u>

Gem did not dispose of any assets until June 30, 2010, when it sold Asset A for \$100,000 and recognized \$60,000 of ordinary income. No other assets were disposed of during the year. At year-end, the Gem's taxable income (computed as if it were a C corporation) was \$65,000. Because Gem is a qualifying corporation within the 2009–2010 built-in gains tax suspension period, there is no built-in gains tax attributable to the gain recognized from the sale of Asset A. Therefore, “0” is entered on line 14 of Schedule D (Form 1120S), and Gem owes no built-in gains tax for the year. The Gem's recognized built-in gain for the year is the lowest of:

The recognized built-in gain	\$ 60,000
Taxable income, computed as if the corporation were a C corporation	\$65,000
The net unrealized built-in gain	\$76,000

The instructions to Schedule D (Form 1120S) add that the exclusion on line 14 does not apply when:

- figuring the carryover of net recognized built-in gain in excess of the taxable income limitation;
- determining the net unrealized built-in gain limitation reported on line 6 of Schedule B (Form 1120S) in any subsequent year;
- attributing the deemed loss arising from the built-in gains tax to ordinary gain, short-term capital gain, or long-term capital gain under Reg. 1.1366-4(b);
- calculating the Section 1374(b)(2) deduction for C corporation loss carryovers (line 17) in any subsequent year; or

- allocating the taxable income limitation (line 15) between separate groups of assets, as required by Reg. 1.1374-8(d).

For all of these purposes, the practitioner should treat the net recognized built-in gain excluded from line 14 (\$60,000 in the preceding example) as if the full amount had been entered on line 14.

Example 1M-6 Calculating net unrealized built-in gains at the end of the 2009-2010 suspension period.

Assume the same facts as in Example 1M-5. As already noted, the prior year's \$60,000 exclusion on line 14 does not apply when figuring the net unrealized built-in gain limitation reported on line 6 of Schedule B (Form 1120S) in any subsequent year. Therefore, Gem's net unrealized built-in gain at December 31, 2010, is \$16,000 (\$76,000 net unrealized built-in gain less \$60,000 built-in gain recognized in 2010).

Carryover of Built-in Gains

Any built-in gain not recognized because of the taxable income limitation carries over during the 10-year recognition period. According to the instructions to Schedule D (Form 1120S), the exclusion on line 14 for any net recognized built-in gain during the suspension period does not apply when figuring the carryover of net recognized built-in gain in excess of the taxable income limitation. This appears to mean that the taxable income limit is applied to built-in gains recognized during the suspension period and built-in gains in excess of the taxable income limit carry over to the following year, even though that recognized built-in gain arose during the suspension period. More IRS guidance is needed to clarify this issue.

2011 Built-in Gains Suspension Period

Qualification for 2011 Built-in Gain Suspension Period

No tax is imposed on an S corporation's recognized built-in gain during the tax year beginning in 2011 if the *fifth* year in the recognition period (measured in calendar years) precedes the tax year beginning in 2011.

Example 1N-1 Suspending built-in gains tax in 2011.

Pix, Inc., a calendar year C corporation, elects S status on April 1, 2005. The fifth year of Pix's 10-year recognition period ends on March 31, 2010. Because the fifth year of the corporation's recognition period ends before the beginning of the 2011 tax year, Pix's net recognized built-in gain during 2011 is not subject to the built-in gains tax.

Gain on the disposition of transferred basis property is exempt from the built-in gains tax during tax years beginning in 2011 if the property is acquired by the S corporation at least five years before the beginning of that tax year.

Comparison with 2009-2010 Suspension Period

Following changes by the 2009 Recovery Act, built-in gains tax is not imposed during 2009 and 2010 for an S corporation if the seventh tax year of the corporation's 10-year recognition period ends before either of those tax years.

This differs from the way in which the years preceding the suspension period are counted for purposes of the 2011 suspension period. The years preceding the 2009-2010 suspension period are measured in tax years, while the years preceding the 2011 suspension period are measured in calendar years.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following is correct regarding the application of the built-in gains rules to installment sales?
- a. Installment sales are not subject to the built-in gains rules.
 - b. The 10-year recognition period may be extended for installment sales.
 - c. The election out of installment reporting [Reg. 1.1374-4(h)] applies for regular tax purposes.
20. J&J Contractors, Inc. elected S status effective January 1, 2010. The company sold an asset on the installment basis on October 30, 2009 and the installment sale resulted in a realized installment gain of \$30,000. The fair market value at the time of sale was \$50,000 and the adjusted basis of property sold was \$20,000. At the time of S election, none of the proceeds from the sale had been paid and the company had an outstanding installment receivable equal to \$50,000, from the year 2009, when the corporation was a C corporation. On December 31, 2011, the company received a \$10,000 payment on the installment. How much gain will the company recognize in 2011 and how much built-in gains tax will the company incur in 2011?
- a. Gain recognized = \$10,000; built-in gains tax = \$3,500.
 - b. Gain recognized = \$6,000; built-in gains tax = \$2,100.
 - c. Gain recognized = \$10,000; built-in gains tax = \$0.
 - d. Gain recognized = \$6,000; built-in gains tax = \$0.
21. Georgia's Tile and Marble, a calendar year corporation, elected S status effective January 1, 2011. At the time of electing S status, the corporation had equipment valued at \$100,000 with an adjusted basis of \$80,000 and accounts receivable with a value of \$30,000. At the end of 2011, the S corporation distributes the equipment to Lola, the S corporation's sole shareholder, when the equipment has a value of \$110,000. What is the effect to the S corporation?
- a. The S corporation will not recognize any built-in gain.
 - b. The S corporation will recognize a built-in gain of \$20,000.
 - c. The S corporation will recognize a built-in gain of \$30,000.
 - d. The S corporation will recognize a built-in gain of \$50,000.
22. Which of the following statements is correct?
- a. A C corporation may generate a built-in loss if bonuses to shareholder/employees are accrued but unpaid prior to the date the S election becomes effective.
 - b. Property distributed in liquidation is not subject to built-in gains.
 - c. Built-in gains tax applies to charitable contributions of appreciated property.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Which of the following is correct regarding the application of the built-in gains rules to installment sales? **(Page 173)**

- a. Installment sales are not subject to the built-in gains rules. [This answer is incorrect. Regulations restrict the tax benefits of installment sales as they relate to the built-in gains tax. The regulations ensure that installment sales cannot be used as a means of avoiding the built-in gains tax of IRC Sec. 1374.]
- b. The 10-year recognition period may be extended for installment sales. [This answer is correct. The 10-year time limit is extended for an installment sale originating before or during the 10-year recognition period. When installment sale income is recognized under normal installment sale reporting rules, it is taxed to the corporation under the built-in gain rules to the extent it would have been taxed in prior years had the seller elected out of installment reporting.]**
- c. The election out of installment reporting [Reg. 1.1374-4(h)] applies for regular tax purposes. [This answer is incorrect. The deemed "election out" of installment reporting under Reg. 1.1374-4(h) does not apply to the determination of the amount of gain recognized for regular tax purposes at the S corporation level and passed through to shareholders. The deemed election out is solely for purposes of determining the amount and timing of the built-in gains tax.]

20. J&J Contractors, Inc. elected S status effective January 1, 2010. The company sold an asset on the installment basis on October 30, 2009 and the installment sale resulted in a realized installment gain of \$30,000. The fair market value at the time of sale was \$50,000 and the adjusted basis of property sold was \$20,000. At the time of S election, none of the proceeds from the sale had been paid and the company had an outstanding installment receivable equal to \$50,000, from the year 2009, when the corporation was a C corporation. On December 31, 2011, the company received a \$10,000 payment on the installment. How much gain will the company recognize in 2011 and how much built-in gains tax will the company incur in 2011? **(Page 173)**

- a. Gain recognized = \$10,000; built-in gains tax = \$3,500. [This answer is incorrect. The gain recognized on the installment basis is not equal to the amount of proceeds received during the year.]
- b. Gain recognized = \$6,000; built-in gains tax = \$2,100. [This answer is correct. The company will recognize \$6,000 of the \$30,000 gain when \$10,000 of the installment is received, using a gross profit rate of 60% (\$30,000/\$50,000). The built-in gains tax applies to the recognized gain equal to \$2,100 or \$6,000 × 35%.]**
- c. Gain recognized = \$10,000; built-in gains tax = \$0. [This answer is incorrect. Built-in gains tax will apply to assets sold on an installment basis during a C corporation year if proceeds from the sale are received during an S corporation year. In addition, the gain recognized on the installment basis is not equal to the amount of proceeds received during the year.]
- d. Gain recognized = \$6,000; built-in gains tax = \$0. [This answer is incorrect. There is a built-in gains tax when gain is recognized under the installment sale reporting rules.]

21. Georgia's Tile and Marble, a calendar year corporation, elected S status effective January 1, 2011. At the time of electing S status, the corporation had equipment valued at \$100,000 with an adjusted basis of \$80,000 and accounts receivable with a value of \$30,000. At the end of 2011, the S corporation distributes the equipment to Lola, the S corporation's sole shareholder, when the equipment has a value of \$110,000. What is the effect to the S corporation? **(Page 175)**

- a. The S corporation will not recognize any built-in gain. [This answer is incorrect. A distribution of appreciated property is taxable to the S corporation. It is treated as a deemed sale of the property to the shareholder.]
- b. The S corporation will recognize a built-in gain of \$20,000. [This answer is correct. Appreciated property distributions of property held during a C corporation year will result in recognized gain.]**

The built-in gain is \$20,000, which is the difference between the value and the adjusted basis of the equipment on the date of S election.]

- c. The S corporation will recognize a built-in gain of \$30,000. [This answer is incorrect. Built-in gain is recognized only on assets sold or disposed during the year where there was appreciation during the C corporation years.]
- d. The S corporation will recognize a built-in gain of \$50,000. [This answer is incorrect. The net unrealized built-in gain at the time of S election is \$50,000. It is not all recognized in 2011.]

22. Which of the following statements is correct? **(Page 176)**

- a. **A C corporation may generate a built-in loss if bonuses to shareholder/employees are accrued but unpaid prior to the date the S election becomes effective. [This answer is correct. Bonuses accrued but not paid to shareholder/employees are treated as built-in losses at the time of S election.]**
- b. Property distributed in liquidation is not subject to built-in gains. [This answer is incorrect. Built-in gains apply to property distributed in liquidation. Built-in gains are triggered by the disposition of assets that were on hand at the time the S election became effective per IRC Sec. 1374(d)(3). Therefore, an S corporation that is subject to the built-in gains tax will incur tax at the corporate level if it recognizes gain on the sale or distribution of appreciated assets in liquidation.]
- c. Built-in gains tax applies to charitable contributions of appreciated property. [This answer is incorrect. The built-in gains tax applies when an asset that was on hand at the date the S election became effective is disposed of, but only if the transaction results in recognized income or gain. A charitable contribution of appreciated property does not result in recognized gain. Therefore, charitable contributions of property that appreciated before the S election became effective are not subject to the built-in gains tax.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (T2STG102)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. The built-in gains tax rate:
 - a. Equals the applicable capital gains tax rates.
 - b. Equals the shareholder's marginal tax rate.
 - c. Equals the highest corporate tax rate.
 - d. Varies depending upon the S corporation's taxable income.
2. Built-in gains tax is triggered by all of the following **except**:
 - a. Asset acquired after S status election.
 - b. Disposition of S corporation assets.
 - c. Collection of zero-basis account receivable.
 - d. Do not select this answer choice.
3. The built-in gains tax applies to which of the following assets?
 - a. Assets owned during a C corporation year and sold within ten years of S election.
 - b. Assets owned during an S corporation year and sold within ten years of S termination.
 - c. Assets disposed at a gain but not loss.
 - d. Assets disposed at a loss but not gain.
4. Cardinal Corporation organizes as a C corporation on February 1, 2010. Effective January 1, 2011, Cardinal elects to be treated as an S corporation. When does the corporation's built-in gain recognition period expire?
 - a. February 1, 2020.
 - b. December 31, 2020.
 - c. January 1, 2021.
 - d. December 31, 2021.
5. Which of the following is a means to avoid or reduce the built-in gains tax?
 - a. Increase taxable income of the S corporation.
 - b. Recognize built-in gain after corporate carryovers expire.
 - c. Decrease capital losses before the S election.
 - d. Reduce unrealized built-in gain before the S election.

6. When an S corporation merges with another S corporation which has built-in gains from its time as a C corporation, which of the following is correct?
- Built-in gains carryover with the merger and the recognition period begins on the day of the merger.
 - Built-in gains carryover with the merger and the remaining recognition period carries over.
 - Built-in gains carryover with the merger and the recognition period begins on the day of the acquiring corporation's S election.
 - Built-in gains do not carryover with the merger.
7. Which of the following is correct regarding the built-in gains tax?
- Built-in gains not recognized due to the taxable income limitation are carried over for three years.
 - Built-in gains not recognized due to the taxable income limitation are carried over during the remainder of the recognition period.
 - Built-in gains not recognized due to the taxable income limitation do not carryover if not recognized in the year of disposition.
 - Built-in losses not recognized due to the overall limitation will carryover to subsequent years if not recognized in the year of disposition.

Use the following information for questions 8 through 10:

Spruce, Inc. was organized as a C corporation many years ago and is electing S status effective January 1, 2010. As of January 1, 2010, the date the S election is effective, Spruce had the following assets and liabilities:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>
Cash	\$ 100,000	\$ 100,000
Accounts receivable	200,000	-0-
Inventory*	110,000	130,000
Equipment	600,000	300,000

*FIFO method

8. Considering the above assets, which of the assets could be subject to the built-in gains tax if disposed by Spruce in a taxable transaction?
- Accounts receivable and cash.
 - Equipment only.
 - Cash, accounts receivable, and equipment.
 - Accounts receivable, inventory, and equipment.

9. How much is Spruce's net unrealized built-in gain?
- \$300,000.
 - \$380,000.
 - \$480,000.
 - \$500,000.
10. During 2010, Spruce collects the accounts receivable and sells the inventory for \$120,000. Taxable income for the year is \$500,000. Determine the net recognized built-in gain or loss for the year.
- \$200,000.
 - \$190,000.
 - \$180,000.
 - (\$10,000).

Use the following information for questions 11 through 13 and 15 through 16:

Treehouse, Inc. was a C corporation that elected S status effective January 1, 2009. The company is 100% owned by Julia and has the following assets and liabilities on the date the S election was made:

	<u>Fair Market Value</u>	<u>Adjusted Basis</u>
Cash	\$ 100,000	\$ 100,000
Accounts receivable	15,000	-0-
Equipment	2,000	12,000
Land	130,000	70,000
Accounts Payable	40,000	-0-

In 2010, Treehouse sells the Land for \$200,000, collects the account receivable and pays the accounts payable. The taxable income for 2010 is \$30,000.

11. What is the net unrealized built-in gain on January 1, 2009?
- \$25,000.
 - \$35,000.
 - \$65,000.
 - \$75,000.
12. How much is the corporation's net unrealized built-in gain at the end of 2010?
- \$0.
 - \$5,000.
 - \$25,000.
 - \$30,000.

13. Assume all of the same information for 2010. In the year 2011, the S corporation reports taxable income of \$300,000 and the equipment is sold in 2011 for \$2,500. What is the built-in gains tax liability for the sale of the equipment?
- a. \$0.
 - b. \$175.
 - c. \$500.
 - d. \$875.
14. An S corporation has a net recognized built-in gain of \$48,000 and taxable income of \$104,000 during the current year. The company has a \$3,000 NOL carryover from a C corporation year. Compute the built-in gains tax liability for the current year.
- a. \$15,750.
 - b. \$16,800.
 - c. \$35,350.
 - d. \$36,400.
15. Refer back to the Treehouse information to answer questions 15 and 16. What is the built-in gains tax liability for 2010?
- a. \$8,750.
 - b. \$10,500.
 - c. \$12,250.
 - d. \$21,000.
16. How much ordinary income or loss attributable to the collection of the account receivable and payment of the account payable will pass through to Julia on her Schedule K-1?
- a. \$11,250.
 - b. \$15,000.
 - c. (\$18,750).
 - d. (\$25,000).
17. For a C corporation electing S status, which of the following would most likely cause a built-in gains tax to be imposed on the S corporation?
- a. Sale of timber cut from the corporation's property.
 - b. Sale of oil from an oil and gas working interest.
 - c. Sale of self-generated goodwill.
 - d. Do not select this answer choice.

18. Which of the following statements regarding inventory is most correct?
- a. The IRS offers guidelines, not rigid formulas, for determining the FMV of bulk sale inventory.
 - b. Companies are required to use FIFO inventory to value inventory at the date of S election.
 - c. The IRS strives to minimize built-in gain in order to protect federal tax revenues.
 - d. Work in progress inventory is not subject to the built-in gains tax.
19. Triton, Inc. elected S status effective January 1, 2010. The company sold land on the installment basis on February 12, 2009 and the installment sale resulted in a realized installment gain of \$40,000. The fair market value at the time of sale was \$80,000 and the adjusted basis of property sold was \$40,000. At the time of S election, none of the proceeds from the sale had yet been received by the company and payments on the receivable were scheduled to begin in 2010. The company then received a \$20,000 payment on the installment note at the end of 2010. How much gain will the company pass through to its shareholders on Schedule K of Form 1120S in 2010 and how much built-in gains tax will the company incur in 2010?
- a. Gain reported on Schedule K = \$20,000; built-in gains tax = \$7,000.
 - b. Gain reported on Schedule K = \$6,500; built-in gains tax = \$3,500.
 - c. Gain reported on Schedule K = \$13,000; built-in gains tax = \$0.
 - d. Gain reported on Schedule K = \$10,000; built-in gains tax = \$3,500.
20. Tyler's Pool Services, Inc., a calendar year corporation, elected S status effective January 1, 2010. At the time of electing S status, the corporation had machinery valued at \$70,000 with an adjusted basis of \$40,000 and accounts receivable with a value of \$20,000. At the end of 2010, the S corporation distributes the machinery to Tyler, the S corporation's sole shareholder, when the machinery had a value of \$60,000. Assume the basis is still \$40,000. What is the effect to the S corporation?
- a. The S corporation will not recognize any built-in gain.
 - b. The S corporation will recognize a built-in gain of \$20,000.
 - c. The S corporation will recognize a built-in gain of \$30,000.
 - d. The S corporation will recognize a built-in gain of \$50,000.
21. When considering bonuses accrued during a C corporation year but not paid until 2½ months after conversion to an S corporation, which of the following statements is correct?
- a. The accrued bonus paid during the S corporation year will increase the S corporation's taxable income.
 - b. An accrued but unpaid bonus is treated as a built-in gain increasing the net unrealized built-in gain.
 - c. An accrued but unpaid bonus at the S election offsets the built-in gain in the year the bonus is paid.
 - d. The accrued bonus will not affect the computation of net unrealized built-in gain or net recognized built-in gain.

22. An S corporation whose 10-year recognition period began in 2002 will be exempt from built-in gains tax for the tax year beginning in:
- a. 2003.
 - b. 2006.
 - c. 2008.
 - d. 2010.
23. Safeco, Inc. elected S status on January 1, 2000. Their 10-year recognition period ends on December 31, 2009. What is the last year that Safeco would be subject to built-in gains tax?
- a. 2007.
 - b. 2008.
 - c. 2009.
 - d. Do not select this answer choice.

Lesson 2: Tax on Excess Net Passive Income

INTRODUCTION

In general, an S corporation is not taxed; instead, its income, deductions, gains, losses, and tax credits are passed through and taxed at the shareholder level. However, if an S corporation was once a C corporation (or, in some cases, acquires “transferred basis” property from a C corporation), there are three situations in which the S corporation itself will be currently taxed. The tax on excess net passive income is discussed in this lesson. The built-in gains tax was discussed in the previous lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify corporations subject to the excess net passive income tax.
- Compute the tax on excess net passive income.

Corporations Subject to the Excess Net Passive Income Tax

The purpose of the corporate-level tax on excess net passive income is to discourage a C corporation with accumulated earnings and profits (AE&P) from becoming (or functioning as) a holding company in order to obtain favorable tax treatment under Subchapter S. Since an S corporation is not subject to the personal holding company tax, an S election avoids the personal holding company tax on income earned during an S corporation tax year.

Requirements

The tax on excess net passive income is imposed if *all* of the following conditions are met:

1. the S corporation has AE&P,
2. the S corporation has “net passive income,”
3. the S corporation’s passive investment income exceeds 25% of its gross receipts for the tax year, and
4. the S corporation has taxable income (computed as if the corporation were a C corporation).

Tax Rate

The tax is assessed at the highest corporate tax rate imposed by IRC Sec. 11(b) (currently 35%).

Passive Investment Income Can Cause Termination of S Status

Even if there is no tax liability (e.g., because *net* passive income is less than zero or because of the taxable income limitation), the corporation’s S election will terminate under IRC Sec. 1362(d)(3) if the corporation has AE&P and its *gross* passive investment income exceeds 25% of gross receipts in each of three consecutive tax years. The corporation can, however, request an IRS waiver of termination.

Accumulated Earnings and Profits

Generally, passive investment income is subject to a corporate-level tax when an S corporation has accumulated earnings and profits (AE&P) at the end of the tax year and the amount of passive investment income is more than 25% of the S corporation’s gross receipts. Only an S corporation (that was previously a C corporation) with undistributed AE&P is subject to the tax. However, an S corporation can acquire AE&P and become subject to the tax if it enters into a tax-free reorganization, such as a merger, with a corporation that has AE&P.

Note that “passive income” for purposes of IRC Sec. 1375 has nothing to do with the passive activity loss limitation rules of IRC Sec. 469. However, it is similar to portfolio income as defined in Temp. Reg. 1.469-2T.

Example 2A-1 C corporation AE&P required.

Esco, Inc. was organized and immediately elected S corporation status. An S corporation does not generate AE&P and cannot have AE&P unless it was previously a C corporation (or acquired another corporation). Thus, Esco is not subject to the tax on excess net passive income because it has no AE&P.

Assume now that Esco incorporated three years ago and operated as a C corporation until electing S status on January 1 of the current year, when it had an AE&P balance of \$10,000. Esco is subject to the tax on excess net passive income because it has AE&P. If the AE&P balance is distributed to shareholders, Esco will no longer be subject to the excess net passive income tax. (See the following discussion.)

Election to Bypass AAA. A corporation that does not have AE&P is not subject to the tax on excess net passive income and does not face termination of its S election if its passive investment income exceeds 25% of its gross receipts in each of three consecutive tax years. Accordingly, it may be desirable for a corporation with AE&P to make a taxable (i.e., dividend) distribution of AE&P to eliminate its exposure to the tax and potential termination of S status. If there is uncertainty about the balance of the corporation's accumulated adjustments account (AAA), or if assets suitable for distribution are insufficient to exhaust AAA and AE&P, the corporation can make an election under IRC Sec. 1368(e)(3) to bypass AAA (i.e., distribute AE&P before AAA). If the corporation lacks suitable distributable assets, it can still make the election to bypass AAA by distributing notes payable to its shareholders, or by electing to issue a deemed dividend under Reg. 1.1363-1(f)(3).

Passive Investment Income

The tax does not apply unless passive investment income exceeds 25% of the corporation's gross receipts for the tax year. *Passive investment income*, as defined in the regulations, generally includes gross receipts from royalties, rents, dividends, interest, and annuities. Gross receipts from other sources (such as gains from sales of real property held for investment) are not passive investment income, even if such amounts are received in the course of holding passive investments.

Stock and Securities. Gain from the disposition of stock and securities is *not* considered to be passive investment income. Such gain *is*, however, included in the calculation of gross receipts.

Exceptions. The main exception to the definition of passive investment income pertains to gross receipts (including rent, royalties, interest, and income from certain lending or financing activities) derived in the ordinary course of a trade or business, as covered in the following discussion.

Income Derived in the Course of a Trade or Business Is Not Passive

Income that is *not* passive investment income because it is derived in the ordinary course of a trade or business includes:

1. Rental income from the use of real or personal property, if the taxpayer is in the active trade or business of renting property. (See "Active Rental Trade or Business" later in this lesson.)
2. Interest income on obligations acquired from the sale of inventory items in the ordinary course of business (e.g., accounts receivable).
3. Gross receipts (including interest) from the trade or business of lending or financing; dealing in property; purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages.
4. Interest earned by a bank (as defined in IRC Sec. 581), bank holding company, or financial holding company. (See "S Corporation Banks" later in this lesson.)
5. Certain dividends paid to a bank (as defined in IRC Sec. 581), bank holding company, or financial holding company. (See "S Corporation Banks" later in this lesson.)
6. Certain mineral, oil, or gas royalties. (Generally, royalties that are not personal holding company income under IRC Sec. 543.)

7. Certain software or copyright royalties.

Active Rental Trade or Business

Income from an active rental trade or business is not passive investment income. A corporation can conduct an active rental trade or business only if it performs *significant services* or incurs *substantial costs* (other than depreciation) in the rental business.

The facts and circumstances in each case are used to determine whether significant services are performed or substantial costs are incurred in the rental business. These facts and circumstances include (but are not limited to) the number of persons employed to provide the services and the types and amounts of costs and expenses incurred, other than depreciation. However, a net lease generally will not be considered a rental trade or business.

Other than the net lease provision, the regulations do not provide any guidance on what “significant services” or “substantial costs” are. However, in a series of letter rulings, the IRS has consistently ruled that income from rental real estate is not passive investment income where the taxpayer performs various services relating to the rentals and tenants. These rulings, associated with the definition of “rent,” include the following:

1. *Rental of Commercial Real Estate.* Income from the rental of commercial real estate was not passive investment income when the taxpayer approved, supervised, and paid for services, including building alterations, maintenance and repair services, utilities, janitorial work, trash collection, grounds maintenance, painting, and general upkeep. The taxpayer also selected the tenants, negotiated leases, collected rents, and paid bills and payroll. The services were performed either directly or through an agent.

The IRS also ruled that an S corporation's pass-through income from a partnership is not passive investment income when the S corporation holds 50% of a partnership that owns a rental building (Ltr. Rul. 9721024). [The partnership (either directly or through an agent) performs all operational and managerial functions associated with the building. The S corporation is a tenant of the building and its employees review the partnership's billings, collections, and expenses; review tenant leases and renewals; inspect the building; and provide other services relating to the rental. None of the building's tenants are subject to a net lease.] In Ltr. Ruls. 9536007 and 9536008, the IRS ruled that rental income is not passive income, even though the lessee-tenant bears the cost of maintenance, repairs, taxes, and insurance. The lessor invests as a limited partner in most of the tenant's operations. Among other duties, the lessor handles all aspects of tenant billings and collections, monitors each tenant's compliance with lease terms, collects rent directly from delinquent tenants, hires and supervises local bill collectors or legal counsel to recover delinquent rent payments, has managers who personally inspect most of the properties at least quarterly to monitor the management and physical condition of the properties, is directly involved in remodeling the properties, and collects evidence that the tenant operators timely pay property taxes, carry adequate insurance, and properly maintain and repair the facilities.

2. *Rental of a Significant Number of Real Estate Properties.* A corporation owned substantial real estate properties consisting of a hotel, office buildings, a large regional shopping mall, retail “strip centers” and other retail stores, apartment and other multi-family residential buildings. The corporation managed the real estate property with its own employees, and the rental income was found not to be passive investment income.
3. *Rental of Apartment Buildings.* Corporations did not receive passive activity income from apartment rentals because significant services were provided.
4. *Operation of Mobile Home Park.* A corporation that was engaged in owning and operating a mobile home park, where the corporation provided paved roadways and maintained general street lighting along with sewer lines, water lines, and electric lines, was found to provide “significant services” in the active trade or business of operating the mobile home park, and the rental income was deemed not to be passive investment income.
5. *Leasing of Equipment.* A corporation that was a third-party lessor of equipment, where the corporation purchased the equipment from manufacturers and distributors and simultaneously entered into equipment leases with end users, was deemed not to be passive investment income.

6. *Leasing Vehicles to Fleet Customers.* A corporation engaged in the business of leasing vehicles to fleet customers for extended terms, where the corporation provided account representatives responsible for dealing with the customers, was deemed to provide "significant services," and the income was not passive investment income.
7. *Leasing of Farmland.* Income paid to an S corporation for the lease of agricultural real property was found not to be passive income where the S corporation performed certain services and paid real estate taxes, insurance, and certain other costs relating to the land. These leases are so-called "crop-share rental arrangements." See Example 2A-4.

Example 2A-2 Determining whether rental income from real property is passive investment income.

Southco was organized seven years ago and initially operated as a C corporation. The company had AE&P of \$320,000 when it elected S corporation status. For its first S corporation year, Southco's gross receipts from business operations are \$300,000. The corporation also receives \$60,000 of rental income from leasing office space on a net lease arrangement. (All of the leases expire at the end of the current year.) The rental income is passive investment income, but Southco is not subject to the tax on excess net passive income because its passive investment income is 16.67% (\$60,000/\$360,000) of the corporation's gross receipts for the year. (The tax does not apply unless the passive income exceeds 25% of gross receipts.)

Assume now that the following year, the business operations are discontinued and generate no gross receipts. Assume also that the office building had an adjusted basis of \$125,000 and a fair market value of \$290,000 when the S election became effective. If the corporation sells the office building or distributes it to shareholders, the transaction will be subject to the built-in gains tax provisions of IRC Sec. 1374. Under the built-in gains tax rules, Southco can recognize up to \$165,000 (\$290,000 – \$125,000) of built-in gains when the building is disposed of, resulting in tax at the corporate level. If Southco retains the building and continues to rent it, the corporation will be subject to the tax on excess net passive income because all of its gross receipts will be passive investment income from net leases. Furthermore, the S election will terminate under IRC Sec. 1362(d)(3) if the corporation has AE&P and its gross passive investment income exceeds 25% of gross receipts in each of three consecutive tax years. The S election will terminate even if there is no tax liability (e.g., because net passive income is less than zero or because of the taxable income limitation).

Southco enters into new lease agreements providing that the corporation (or, on occasion, third-party contractors) will provide various services relating to the rentals, including structural repairs to the building, plumbing and electrical repairs, repair and maintenance of the parking lot, landscaping, lawn maintenance, and exterior painting. Interior maintenance, plus additional interior repairs, will be handled on a case-by-case basis. In addition, Southco will perform the usual leasing and administrative functions involved in managing real estate. The resulting rental income will evidently not be passive because the IRS has ruled that leasing commercial space under similar circumstances qualified as a rental trade or business (Ltr. Rul. 200217012).

Recognizing When Rent is Not Passive Investment Income. It is a fairly common occurrence for the active business of an S corporation to cease, leaving passive investment income as the primary income source. However, given the favorable IRS opinions relating to rental income, leases can be arranged in a manner that assures the S corporation will meet either the significant services or substantial cost tests, thereby removing the rental income from the passive investment income rules. When one or both of the tests are met, the corporation will have no passive investment income and will no longer face the threat that the S election will terminate after three years. This may make it possible for the property to remain within the S corporation without the necessity of a liquidation or distribution of the property to the shareholders. Practitioners need to understand the availability of this strategy if they encounter an S corporation where the business is sold or terminated and real estate remains trapped within the S corporation.

Example 2A-3 Rent derived in the active conduct of a trade or business.

Marquee Signs, Inc. is an S corporation that engages in the sale and rental of portable signs. The corporation purchases portable signs, advertises their availability, receives telephone calls for their rental, and delivers the signs to the lessee's locations. Under the facts and circumstances of this example, the sign rentals probably

qualify for the exception to the definition of passive investment income for rent derived in the active conduct of a trade or business because Marquee Signs provides significant services and incurs substantial costs.

Example 2A-4 Rent received from the rental of agricultural real property.

Harvest, Inc. is an S corporation that converted from C status and has undistributed AE&P. It rents farmland to an unrelated partnership for cash, and is not involved in the management or operation of the farming activities. The partnership provides all labor, machinery, and supplies, and has the sole right to make decisions regarding all aspects of the farming operations. The rent received by Harvest is passive investment income because the S corporation does not provide significant services and does not participate in the farming activities. Harvest reports the cash rent income on Form 8825 (Rental Real Estate Income and Expenses of a Partnership or an S Corporation.)

Variation 1: The income would not be passive investment income if Harvest provided significant services or incurred substantial costs. Assume that Harvest leases farmland to a C corporation (Seecorp) and in return receives a percentage of the proceeds from crop sales and state support programs. Seecorp consults with Harvest concerning many aspects of the farm operations. Harvest pays real property taxes, assessments, and water district taxes. Processing charges related to Harvest's portion of the crop and certain other charges are paid from Harvest's crop share. (This is a typical "crop-share rental arrangement.") Under similar facts, the IRS ruled that the rent received by an S corporation from renting its agricultural real property is income from an active trade or business and not passive investment income for purposes of the S corporation excess net passive income test. A typical share-crop arrangement is reported on Form 4835 (Farm Rental Income and Expenses) and attached to the Form 1120S of an S corporation that receives proceeds from crop and livestock sales.

Variation 2: In another letter ruling an S corporation was found to be engaged in the business of leasing a farm and the rent income was not passive investment income. Under the facts of that ruling, the corporation was responsible for paying all of the real estate taxes and insurance. Also, the corporation maintained equipment located on the farm. In addition, the lease agreement stipulated that the corporation would operate and maintain a waste and run-off water system located on the farm in order to meet the environmental standards required by the state (Ltr. Rul. 200002031).

Self-produced and Self-developed Property. An exception from the passive investment income rules applies to rental income derived from leasing self-produced personal property and self-developed real property. Under the regulations, passive investment income does not arise from renting property that is developed, manufactured, or produced by the taxpayer if the taxpayer develops or produces similar property during the tax year.

Example 2A-5 Rent from leasing self-produced property.

Hansen Construction, Inc. is an S corporation that constructs office buildings and leases space in completed buildings. The rental income from leasing the property is not considered passive investment income under the significant services exception as long as Hansen continues to construct buildings of the same type.

Hotels and Motels. Passive investment income does not include income derived in the ordinary course of a trade or business. Therefore, income from operating a hotel or motel is not passive investment income.

Significant Services. Since the determination of when services are significant is often subjective, the IRS and the courts have been relatively active in providing guidance and have been fairly generous in ruling that many rental activities do not generate passive investment income. For example, the IRS has ruled that significant services were performed in connection with, and consequently no passive income was received from, the rental of: (1) autos and trucks; (2) aircraft for charter; (3) glassware, silverware, and tables; (4) controlled environmental grain storage; (5) television sets to hospitals; and (6) tennis and handball facilities.

Interest Income

Interest (including tax-exempt interest) is generally passive investment income. Also included are amounts treated as interest under IRC Secs. 483 (interest on certain deferred payments), 1272 (original issue discount), 1274 (certain debt instruments issued for property), and 7872 (loans with below-market interest rates).

The following types of interest, however, are *not* passive investment income:

1. Interest on obligations received in the ordinary course of business on the sale of inventory or the performance of services.
2. Amounts directly derived from the ordinary course of the trade or business of lending or financing; dealing in property; purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages.

Thus, passive investment income does not include interest on accounts receivable. Also, passive investment income does not include interest received by, for example, a bank in the normal course of its business. Furthermore, interest received by an S corporation (a registered securities broker-dealer) from loans made to customers to allow them to buy stock on margin was not passive investment income.

Interest-bearing Installment Payments. Interest received on the installment sale of inventory (e.g., a house built for resale) is not passive investment income, while passive investment income would include interest received on the installment sale of an asset used in the operation of the business (e.g., a warehouse).

Tax-exempt Interest Income

The definition of passive investment income for purposes of the tax on excess net passive income includes interest income, but makes no distinction between taxable and tax-exempt interest. Although tax-exempt interest is excluded from gross income for purposes of computing taxable income, it is included in passive investment income for purposes of the tax on excess net passive income. Tax-exempt income can also contribute to loss of the S election. If the corporation has AE&P and its gross passive investment income (including tax-exempt income) exceeds 25% of gross receipts for three consecutive years, the corporation's S election will terminate.

Dividends Received from a Subsidiary Corporation

The term *passive investment income* does not include dividends received from an 80% or more owned C corporation subsidiary to the extent the dividends are attributable to an active trade or business. As long as the subsidiary is engaged in an active trade or business, the parent does not include dividends from the subsidiary as passive investment income.

An S corporation may use any reasonable method to determine the amount of dividends that are not treated as passive investment income. The safe harbor method discussed in the following paragraph can be used for this purpose. If less than 10% of a C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income (determined as if the C corporation were an S corporation), all the C corporation's earnings and profits produced during that tax year are considered active earnings and profits.

The C corporation's earnings and profits for a year can be treated as active earnings and profits in the same proportion as its gross receipts derived from activities that would not produce passive investment income (determined as if the C corporation were an S corporation) bear to the corporation's total gross receipts for the year. Dividends from current earnings and profits are attributable to active earnings and profits in the same proportion as current active earnings and profits bear to total current earnings and profits of the C corporation. Dividends distributed by a C corporation out of accumulated earnings and profits for a taxable year are attributable to active earnings and profits in the same proportion as accumulated active earnings and profits for that taxable year bear to total accumulated earnings and profits for that taxable year immediately prior to the distribution.

Example 2A-6 Dividends received from a subsidiary corporation.

Essco is an S corporation that owns 85% of the stock of Jazz. On December 31 of the current year, Jazz's earnings and profits for the year are \$100,000, and Jazz declares a dividend of that amount. During the year, Jazz has total gross receipts of \$1,000,000. Of this amount, \$200,000 would be passive investment income if Jazz were an S corporation. Thus, \$17,000 ($\$85,000 \times \$200,000 \div \$1,000,000$) of the \$85,000 dividend to Essco is treated as passive investment income.

Assume that Jazz also owns 90% of the stock of Z-Rocks. Jazz and Z-Rocks do not join in the filing of a consolidated return. During the year, Z-Rocks has gross receipts of \$1,500,000. Of this amount, \$1,200,000 would produce passive investment income. On December 31, Z-Rocks declares a dividend of \$1,000,000 (\$900,000 to Jazz) from current earnings and profits. Thus, \$720,000 ($\$900,000 \times \$1,200,000 \div \$1,500,000$) of the dividend is considered gross receipts from an activity that would produce passive investment income. The \$900,000 dividend to Jazz gives Jazz \$1,900,000 ($\$1,000,000 + \$900,000$) in gross receipts, \$920,000 ($\$200,000 + \$720,000$) of which is attributable to passive investment income-producing activities. Under these facts, \$41,160 ($\$85,000 \times \$920,000 \div \$1,900,000$) of Jazz's distribution to Essco is passive investment income to Essco.

A C corporation may treat all earnings and profits accumulated prior to the date an S corporation held stock meeting the 80% control requirement of IRC Sec. 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three tax years ending prior to date the S corporation acquired 80% of the C corporation bear to the total earnings and profits for those three tax years.

S Corporation Banks

Passive investment income does not include: (1) interest income earned by a bank, bank holding company, or financial holding company; or (2) dividends on assets that must be held by a bank, bank holding company, or financial holding company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank, or participation certificates issued by a Federal Intermediate Credit Bank.

Under Notice 97-5 the IRS will treat income earned by an S corporation bank on the following assets as received in the conduct of a banking business, and not as passive investment income: (1) all loans and real estate mortgage investment conduit (REMIC) regular interests owned by the bank; (2) assets required to be held to conduct a banking business, such as Federal Reserve Bank stock; (3) assets pledged to a third party to secure deposits or business for the bank; and (4) investment assets that are held by the bank to satisfy reasonable liquidity needs.

Computing the Tax on Excess Net Passive Income

The tax on excess net passive investment income is based on the following four elements: (1) gross receipts, (2) passive investment income, (3) net passive income, and (4) taxable income. It is assessed at the highest corporate tax rate imposed by IRC Sec. 11(b) (currently 35%).

Gross Receipts

The term "gross receipts" is *not* synonymous with "gross income." Gross receipts means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Accordingly, returns and allowances, cost of goods sold, and deductions are not allowed as reductions in determining gross receipts. The corporation's distributive share of partnership gross receipts is also included.

Tax-Exempt and Imputed Interest Income. In addition to usual items, Reg 1.1362-2(c)(5) provides that gross receipts include tax-exempt interest and imputed interest income. (Imputed interest at the corporate level can arise when the corporation loans funds to a shareholder at a below market interest rate, and interest income is imputed, even if the shareholder does not actually pay the interest.)

Although tax-exempt interest income is excluded from the computation of taxable income, it is considered to be passive investment income and is included in gross receipts for purposes of the tax on excess net passive income. The effect of tax-exempt income when calculating excess net passive income is discussed in examples later in this lesson. Also, if the corporation has AE&P and its gross passive investment income exceeds 25% of gross receipts in each of three consecutive tax years, the corporation's S election will terminate.

Proceeds from Sale of Capital Assets. Generally, proceeds from the sale of capital assets are included in gross receipts only to the extent the corporation has "capital gain net income" (i.e., the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges).

Sales of Stock or Securities. Gross receipts include gains from sales or exchanges of stock or securities. That is, the gross receipts from the sale of any stock is the excess, if any, of the amount realized over the stock's adjusted basis.

Losses on sales or exchanges of stock or securities do not offset gains on the sale of other stock or securities. The term "stock or securities" includes shares or certificates of stock; stock rights or warrants; an interest in any corporation, limited partnership, or profit-sharing agreement; certificates of interest in any oil, gas, or mineral property; collateral or voting trust certificates; bonds; debentures; and notes. Gain on the disposition of a general partnership interest is treated as gain from the sale or exchange of stock or securities only to the extent the corporation would have had gain if the partnership had sold its stock or securities. However, if this approach is burdensome, the corporation can choose to treat a general partnership interest as a security.

Depreciable Assets and Trade or Business Property. Depreciable assets and real property used in a trade or business are not capital assets. Thus, proceeds from the sale of those assets are fully included in gross receipts, even though all or part of any gain therefrom may be treated as a capital gain.

Nontaxable Exchanges. Gross receipts generally do not include amounts received in nontaxable exchanges; however, gain recognized because of the receipt of "boot" is included. Also excluded from gross receipts are loans received, loans repaid, capital contributions, and amounts received in connection with issuance of the corporation's own stock. Gross receipts do not include certain payments received in liquidation of a corporation that IRC Sec. 331 treats as payments in exchange for stock owned by the S corporation.

Long-term Contracts and Installment Sales. Gross receipts from a long-term contract reported on the percentage-of-completion method equal the portion of the entire contract that has been completed during the tax year. Gross receipts from a sale reported on the installment method include the principal payments actually received during a given tax year.

Example 2B-1 Gross receipts resulting from sale of assets.

Alpha, Inc., an S corporation using the accrual method of accounting, sells the following assets:

	<u>Sales Price</u>	<u>Basis</u>	<u>Gain (Loss)</u>
Depreciable equipment	\$ 10,000	\$ 8,000	\$ 2,000
Capital asset (other than stock or securities)	7,000	4,000	3,000
Capital asset (other than stock or securities)	12,000	13,000	(1,000)
Securities	15,000	10,000	5,000
Securities	2,000	10,000	(8,000)

The full sales price of the depreciable equipment (\$10,000) is included in gross receipts, even if it were sold at a loss. With respect to the capital assets, gross receipts include the capital gain net income of \$2,000 (i.e., the excess of the \$3,000 gain over the \$1,000 loss). The sale of securities is included in gross receipts to the extent of the gain (\$5,000). The loss from sale of securities is not netted against gains; accordingly, gross receipts do not include the sales price or any loss related to stocks or securities sold at a loss.

Alpha's gross receipts as a result of the above transactions are \$17,000 (\$10,000 + \$2,000 + \$5,000).

Passive Investment Income

"Passive investment income" generally includes gross receipts derived from royalties, rents, dividends, interest, and annuities. The main exception to the definition of passive investment income provides that gross receipts (including rent, royalties, interest, and income from certain lending or financing activities) derived in the ordinary course of a trade or business are not passive investment income.

Stock and Securities. Gain from the disposition of stock and securities is *not* considered to be passive investment income. Such gain *is*, however, included in the calculation of gross receipts.

Net Passive Income

The tax is imposed on excess net passive income. Accordingly, the corporation must first have positive net passive income before there can be any "excess." Net passive income equals passive investment income, minus allowable

deductions that are directly connected with the production of such income. An item is directly connected with the production of income when it has a "proximate and primary relationship to the income". Expenses, depreciation, and similar items are deducted in determining net passive income if they are attributable solely to the production of passive investment income.

Example 2B-2 Net passive income.

Beta, Inc., an S corporation, has tax-exempt interest income of \$2,000, passive rental income of \$5,000, dividend income of \$3,000, and expenses of \$7,500 that are directly related to the production of the rental income. Thus, Beta's net passive income equals \$2,500 (\$2,000 + \$5,000 + \$3,000 - \$7,500).

Excess Net Passive Income

Excess net passive income is basically calculated in two steps. First, the passive investment income in excess of 25% of gross receipts for the tax year is divided by the corporation's passive investment income. Second, the net passive income is multiplied by the resulting percentage to arrive at excess net passive income. Thus, if passive investment income for the year does not exceed 25% of gross receipts, there cannot be any excess net passive income. (See Example 2B-3.)

Example 2B-3 Excess net passive income.

Acme, Inc., an S corporation with AE&P, has the following income and expense items for the current tax year:

Trade or business income	\$ 1,700
Rental income	2,500
Taxable interest income	1,000
Tax-exempt interest income	700
Trade or business expenses	(500)
Rental expenses	(1,300)

Gross receipts equal \$5,900 (\$1,700 + \$2,500 + \$1,000 + \$700). Passive investment income equals \$4,200 (\$2,500 + \$1,000 + \$700). Net passive income equals \$2,900 (\$4,200 passive investment income - \$1,300 passive income expense). Acme's net income (computed as if it were a C corporation) is \$3,400.

Excess net passive income is computed as follows:

$$\frac{\text{Passive income} - 25\% \text{ of gross receipts}}{\text{Passive income}} \times \text{Net passive income}$$

$$\frac{\$4,200 - (25\% \times \$5,900)}{\$4,200} \times \$2,900 = \$1,882$$

Thus, Acme's excess net passive income for the current year is \$1,882, and its tax on that income is \$659 (\$1,882 × 35%). The tax is reported on page 1 of Form 1120S.

Acme's passive investment income is 71% of gross receipts (\$4,200 ÷ \$5,900). Acme's S corporation status will terminate if the corporation has both AE&P and passive investment income in excess of 25% of gross receipts for three consecutive years.

Taxable Income Limitation

For purposes of calculating the tax, excess net passive income cannot exceed the corporation's taxable income. No tax is imposed if the corporation's taxable income for the year is zero or a loss. Generally, the S corporation's taxable income is computed as if it were a C corporation.

Example 2B-4 Taxable income limitation.

Assume the same facts as in Example 2B-3, except that Acme has business expenses of \$2,500. Acme's taxable income for the year is \$1,400 (\$1,700 + \$2,500 + \$1,000 - \$2,500 - \$1,300). (The tax-exempt

income is excluded from taxable income.) Under IRC Sec. 1375(b)(1)(B), excess net passive income is limited to the amount of Acme's taxable income, computed as if Acme were a C corporation. Accordingly, Acme's excess net passive income for the current year is limited to \$1,400.

In computing the taxable income limitation, net operating loss carryovers from C corporation tax years and special deductions (e.g., dividends received deduction) other than the amortization of organizational expenses are not allowed.

Tax Rate and Tax Credits

The tax is assessed at the highest corporate tax rate imposed by IRC Sec. 11(b) (currently 35%). The pass-through of the net passive income is reduced by the amount of the tax imposed. Other than the refundable credit for certain uses of gasoline and special fuels, there are no tax credits allowable against the tax on excess net passive income.

Tax-exempt Interest Income

The definition of passive investment income includes interest income, but makes no distinction between taxable and tax-exempt interest. Although tax-exempt interest is excluded from gross income for purposes of computing taxable income, it is included in passive investment income for purposes of the tax on excess net passive income. Deemed interest that is reported under the unstated interest rules, the original issue discount (OID) rules, and the below-market interest rules is also passive investment income.

Example 2B-5 Effect of tax-exempt income.

Essco, Inc., an S corporation, sells a significant line of business and temporarily invests the proceeds in tax-exempt municipal bonds. Essco formerly was a C corporation and has AE&P from its prior C years. Essco reports on a calendar year, and during the year recognized income as follows:

Gross income from operations	\$ 60,000
Operating expenses	(20,000)
Tax-exempt interest income	50,000

Although the tax-exempt interest is excluded from the computation of taxable income, it is considered to be passive investment income and is included in gross receipts for purposes of the tax on excess net passive income. The tax applies in this situation. Therefore, although the tax-exempt interest itself is not taxed when passed through to the shareholders, it causes Essco to be subject to the tax on excess net passive income. In this case, Essco's gross receipts equal \$110,000 (\$60,000 + \$50,000). Passive investment income and net passive income are \$50,000. Essco's net income (computed as if it were a C corporation) is \$40,000. Excess net passive income is computed as follows:

$$\frac{\text{Passive income} - 25\% \text{ of gross receipts}}{\text{Passive income}} \times \text{Net passive income}$$

$$\frac{\$50,000 - (25\% \times \$110,000)}{\$50,000} \times \$50,000 = \$22,500$$

Thus, Essco's excess net passive income for the current year is \$22,500. The tax on this income is \$7,875 (\$22,500 × 35%).

In general, tax-exempt bonds cause unwanted tax problems for S corporations with AE&P. In addition to the corporate-level tax on excess net passive income, AE&P must be distributed before tax-exempt income can be distributed free from shareholder-level tax. Furthermore, if the corporation has AE&P and its gross passive investment income (including tax-exempt income) exceeds 25% of gross receipts for each of three consecutive tax years, the corporation's S election will terminate.

How Tax Is Reported

The tax on excess net passive income is shown on Form 1120S, page one, line 22a. The statement is attached to Form 1120S to support the tax calculation.

Estimated Tax Payments

An S corporation is subject to the estimated tax payment rules with respect to the tax on excess net passive income. See the following lesson for a detailed discussion of estimated tax payment requirements for S corporations.

Passing Excess Net Passive Income Tax through to Shareholders

Each item of passive investment income passed through to the shareholders is reduced by a prorata portion of the tax on excess passive income. The reduction allocable to an item of passive investment income equals the tax multiplied by the ratio of the amount of such item to the total net passive investment income for the tax year. The passive investment income pass-through items are reduced by the tax imposed on those items. Thus, they are reduced in the year the income is recognized, regardless of when the tax is paid. Note that the items of *income* are reduced; the tax does not pass through as a separate deduction.

Example 2C-1 Prorata reduction of passive investment income items.

Acme incurs a tax of \$659 on excess net passive income. As indicated below, the tax must be allocated among items of passive investment income:

		<u>Share of Tax</u>	
		<u>%</u>	<u>Amount</u>
Net rental income (\$2,500 – \$1,300)	\$ 1,200	41.4%	\$ 273
Taxable interest income	1,000	34.5%	227
Tax-exempt interest income	<u>700</u>	<u>24.1%</u>	<u>159</u>
Passive investment income and total tax	<u>\$ 2,900</u>	<u>100.0%</u>	<u>\$ 659</u>

Passive investment income is not separately disclosed as a line item on Form 1120S. It is not included on page 1 because income and deduction items on that page represent ordinary income from trade or business activities. Furthermore, passive investment income is not identified as such on Schedules K and K-1. In general, the items of income considered to be passive investment income are separately reported on Schedules K and K-1.

Coordinate the Tax on Passive Investment Income with the Built-in Gains Tax

If a gain would otherwise be subject to both the tax on passive investment income under IRC Sec. 1375 and the built-in gains tax under IRC Sec. 1374, it will not be subject to taxation under both provisions. The amount treated as passive investment income for the Section 1375 tax does not include any recognized built-in gain or loss (taxable under the built-in gains tax rules of IRC Sec. 1374) for any year during the recognition period.

Note: The potential for dual taxation exists, for example, to the extent cash-basis income items (such as interest or rents accrued at the date the S election became effective) are both passive investment income and built-in gains.

Example 2D-1 Computing the built-in gains tax and the tax on passive investment.

Dynaco is an S corporation with C corporation AE&P. During the current year, the company has gross receipts of \$200,000, including interest income of \$105,000 from investments. Dynaco has no expenses directly connected with the production of the interest income. Under IRC Sec. 1374, \$60,000 of the interest accrued

prior to the date the S election was effective and is subject to the built-in gains tax. This recognized built-in gain is not taken into account in determining Dynaco's passive investment income.

Dynaco's passive investment income is \$45,000 (\$105,000 – \$60,000), which is 22.5% of the \$200,000 gross income. Because the passive investment income does not exceed 25% of gross income, Dynaco has no excess net passive income. Thus, Dynaco is not subject to the tax on excess net passive income for the year. Furthermore, the year is counted as a year in which the S corporation does not have excess net passive income for purposes of the rule requiring the S election to terminate when the S corporation has AE&P and excess net passive income for three consecutive tax years.

Waive the Tax on Excess Net Passive Income

In certain cases, the tax on excess passive income may be waived by the IRS. To secure the waiver, the S corporation must establish that (1) it initially determined in good faith that it had no AE&P, and (2) upon redetermination that it did have AE&P and such AE&P was distributed within a reasonable period of time. (This could happen, for example, when a prior year's C corporation taxable income is adjusted during an audit.) All AE&P must be distributed before the date the waiver is to be effective.

A request for a waiver of the tax imposed by IRC Sec. 1375 must be made in writing to the District Director (or successor). The request should contain the following information:

1. A description of how and when the S corporation made its initial good faith determination that it had no AE&P.
2. A description of how and when the S corporation determined that it in fact had AE&P.
3. A description (including dates) of any steps taken to distribute the AE&P.
4. If the AE&P has not yet been distributed, a timetable for distribution and an explanation of why such timetable is reasonable.

A user fee must accompany the ruling request.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. The tax on excess net passive income applies to which of the following entities?
- An S corporation.
 - A C corporation.
 - An individual shareholder.
24. Vet Services, Inc. is a calendar year S corporation reporting \$135,000 in gross receipts, \$18,000 in ordinary income, and passive investment interest income of \$1,000 for the current year. If all items of income and loss flow through to the 100% shareholder for the year, then:
- The passive investment income can offset passive activity losses from other sources.
 - The shareholder will have to pay \$350 in excess net passive investment income tax.
 - The S corporation's S election will terminate.
 - The excess net passive investment income tax does not apply.
25. For purposes of computing excess net passive investment income, passive investment income includes which of the following?
- Income from an active rental trade or business.
 - Dividends received from an 80% owned subsidiary.
 - Tax-exempt interest income.
 - Income from leasing farmland.

Use the following information for questions 26 through 29:

Spices, Inc., an S corporation, entirely owned by one shareholder was organized originally as a C corporation in the year 2006 and elected to be treated as an S corporation effective January 1, 2009. Spices, Inc. has undistributed AE&P from a C corporation year. For the current year the S corporation reports the following items of income and deductions:

Gross operating receipts	\$400,000
Operating expenses	\$250,000
Interest Income	\$280,000
Deductions attributable to interest income	\$14,000

26. What is the company's net passive income?
- a. \$150,000.
 - b. \$266,000.
 - c. \$280,000.
 - d. \$416,000.
27. What is the company's excess net passive income?
- a. \$104,500.
 - b. \$107,825.
 - c. \$171,000.
 - d. \$266,000.
28. How much is the company's excess net passive income tax?
- a. \$0.
 - b. \$36,575.
 - c. \$93,100.
 - d. \$98,000.
29. How much interest income will the S corporation report to its shareholder on his Schedule K-1?
- a. \$161,500.
 - b. \$243,425.
 - c. \$266,000.
 - d. \$280,000.
30. How is the excess net passive income tax passed through to shareholders?
- a. The excess net passive income tax is passed through to shareholders as a tax credit.
 - b. The excess net passive income tax is passed through to the shareholders as a reduction to the passive income.
 - c. The excess net passive income tax is not passed through to the shareholders.
31. The IRS may waive the tax on excess net passive income if:
- a. The S corporation incorrectly computed AE&P.
 - b. The IRS does not waive the tax on excess net passive income.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. The tax on excess net passive income applies to which of the following entities? **(Page 191)**
- a. **An S corporation. [This answer is correct. S corporations are the only entity type subject to the excess net passive income tax according to IRS Code.]**
 - b. A C corporation. [This answer is incorrect. C corporations are not subject to the tax on excess net passive income per IRS Code.]
 - c. An individual shareholder. [This answer is incorrect. According to IRS rules, the individual shareholder is not subject to the excess net passive income tax.]
24. Vet Services, Inc. is a calendar year S corporation reporting \$135,000 in gross receipts, \$18,000 in ordinary income, and passive investment interest income of \$1,000 for the current year. If all items of income and loss flow through to the 100% shareholder for the year, then: **(Page 191)**
- a. The passive investment income can offset passive activity losses from other sources. [This answer is incorrect. Passive investment income is not the same as passive income under the Section 469 rules.]
 - b. The shareholder will have to pay \$350 in excess net passive investment income tax. [This answer is incorrect. The S corporation, not the shareholders, pays the tax on excess net passive investment income.]
 - c. The S corporation's S election will terminate. [This answer is incorrect. If the S corporation has gross passive investment income that exceeds 25% of gross receipts for three consecutive years, then the S election will terminate.]
 - d. **The excess net passive investment income tax does not apply. [This answer is correct. The tax does not apply unless passive investment income exceeds 25% of the corporation's gross receipts for the year.]**
25. For purposes of computing excess net passive investment income, passive investment income includes which of the following? **(Page 191)**
- a. Income from an active rental trade or business. [This answer is incorrect. Income from an active trade or business is not treated as passive investment income if the corporation performs significant services or incurs substantial costs.]
 - b. Dividends received from an 80% owned subsidiary. [This answer is incorrect. Dividends received from an 80% or more owned subsidiary are not treated as passive investment income to the extent the dividends are attributable to an active trade or business.]
 - c. **Tax-exempt interest income. [This answer is correct. Tax-exempt interest and taxable interest are included in the definition of passive investment income according to IRS regulations.]**
 - d. Income from leasing farmland. [This answer is incorrect. Income paid for the lease of agricultural real property is not treated as passive investment income if the S corporation provided certain services and paid real estate taxes.]

Use the following information for questions 26 through 29:

Spices, Inc., an S corporation, entirely owned by one shareholder was organized originally as a C corporation in the year 2006 and elected to be treated as an S corporation effective January 1, 2009. Spices, Inc. has undistributed AE&P from a C corporation year. For the current year the S corporation reports the following items of income and deductions:

Gross operating receipts	\$400,000
Operating expenses	\$250,000
Interest Income	\$280,000
Deductions attributable to interest income	\$14,000

26. What is the company's net passive income? **(Page 197)**

- \$150,000. [This answer is incorrect. Net passive income will not include operating receipts or operating expenses.]
- \$266,000. [This answer is correct. Net passive income equals interest income net of deductions attributable to interest income (\$280,000 – \$14,000).]**
- \$280,000. [This answer is incorrect. Net passive income does not include just interest income.]
- \$416,000. [This answer is incorrect. Not all of the above items are included in computing net passive income.]

27. What is the company's excess net passive income? **(Page 197)**

- \$104,500. [This answer is correct. Excess net passive income is computed as follows: $[\$280,000 - (\$680,000 \times 25\%)] / \$280,000 \times \$266,000$.]**
- \$107,825. [This answer is incorrect. This amount does not properly reflect the computation of excess net passive income. Total gross receipts does not include the reduction for deductions attributable to interest income.]
- \$171,000. [This answer is incorrect. Excess net passive income is computing by subtracting 25% of the total gross receipts from passive investment income. Total gross receipts includes interest income.]
- \$266,000. [This answer is incorrect. Net passive income equals \$266,000, which is used in the calculation of excess net passive income.]

28. How much is the company's excess net passive income tax? **(Page 197)**

- \$0. [This answer is incorrect. Since the company has excess net passive income in excess of 25% of the company's total gross receipts and there is no taxable income limitation, there will be an excess net passive income tax.]
- \$36,575. [This answer is correct. The excess net passive income tax is 35% of the company's excess net passive income or $35\% \times \$104,500$.]**
- \$93,100. [This answer is incorrect. The excess net passive income tax is 35% but it is not applied to net passive income.]
- \$98,000. [This answer is incorrect. The excess net passive income tax rate is 35% but is not applied directly to interest income.]

29. How much interest income will the S corporation report to its shareholder on his Schedule K-1? **(Page 201)**
- a. \$161,500. [This answer is incorrect. This amount does not properly reflect the computation of interest income passed through to the shareholder.]
 - b. \$243,425. [This answer is correct. The Schedule K-1 will report interest income of \$280,000 reduced by the excess net passive income tax paid by the S corporation of \$36,575.]**
 - c. \$266,000. [This answer is incorrect. Interest income reported to the shareholder is not reduced by the deductions attributable to interest income. Those deductions would be reported as portfolio deductions.]
 - d. \$280,000. [This answer is incorrect. The interest income must be reduced if the excess net passive income tax applies to the S corporation.]
30. How is the excess net passive income tax passed through to shareholders? **(Page 201)**
- a. The excess net passive income tax is passed through to shareholders as a tax credit. [This answer is incorrect. The excess net passive income tax is not passed through to the shareholders as a tax credit. The items of income are reduced, but the tax does not pass through as a separate deduction.]
 - b. The excess net passive income tax is passed through to the shareholders as a reduction to the passive income. [This answer is correct. According to IRS regulations, the excess net passive income tax reduces the amount of passive investment income allocated to the shareholder by a prorata portion.]**
 - c. The excess net passive income tax is not passed through to the shareholders. [This answer is incorrect. The excess net passive income tax is passed through to the shareholders per IRS Code.]
31. The IRS may waive the tax on excess net passive income if: **(Page 202)**
- a. The S corporation incorrectly computed AE&P. [This answer is correct. If an S corporation can establish that it initially determined in good faith that there was no AE&P and later redetermined there was AE&P, the IRS may waive the tax on excess net passive income if all AE&P is distributed before the date the waiver is effective.]**
 - b. The IRS does not waive the tax on excess net passive income. [This answer is incorrect. The IRS may waive the tax in certain situations. The waiver must be requested in writing and contain specific information.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (T2STG102)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

24. Which of the following regarding the excess net passive income tax is correct?
- a. Excess net passive investment income excludes tax-exempt interest income.
 - b. An S corporation can terminate its S election if its excess net passive investment income exceeds 25% of gross receipts for three consecutive years.
 - c. An S corporation must have accumulated earnings and profits to be subject to the tax on excess net passive income tax.
 - d. Passive investment income generally includes gains from the sale of real property.
25. Identify which of the following types of income would be treated as passive income under the passive investment income rules:
- a. Interest received by a company in the business of lending money.
 - b. Interest received on an accounts receivable.
 - c. Dividends received from an 80% owned subsidiary.
 - d. Gross receipts from royalties.
26. Income from a rental trade or business will be treated as passive investment income in which of the following situations?
- a. Income from the rental of commercial real estate where the taxpayer approves, supervises, and pays for services and general upkeep of the commercial property.
 - b. Income from rental of apartment buildings where significant services were provided including maintenance and repairs, utilities, janitorial services, and trash collection.
 - c. Rental income received by a corporation which rented a significant number of real estate properties and engaged a management company to assist in operations.
 - d. Rental income received for the lease of agricultural real property where the S corporation performed services and paid real estate taxes under a crop-share rental arrangement.

Use the following information for questions 27 through 30:

Tornado, Inc., an S corporation, elected to be treated as an S corporation effective January 1, 2009. Tornado, Inc. is entirely owned by one shareholder. The company was organized originally as a C corporation in the year 2007 and has undistributed AE&P from a C corporation year of \$100,000. For the current year, the S corporation reports the following items of income and deductions:

Gross operating receipts	\$320,000
Operating expenses	\$275,000
Interest Income	\$130,000
Tax-exempt interest income	\$30,000
Deductions attributable to taxable interest income	\$20,000

27. What is the company's net passive income?
 - a. \$110,000.
 - b. \$130,000.
 - c. \$140,000.
 - d. \$160,000.
28. What is the company's excess net passive income?
 - a. \$14,807.
 - b. \$35,000.
 - c. \$42,308.
 - d. \$67,692.
29. How much is the company's excess net passive income tax?
 - a. \$2,962.
 - b. \$5,183.
 - c. \$12,250.
 - d. \$15,750.
30. How much taxable interest income will the S corporation report to its sole shareholder on his Schedule K-1?
 - a. \$120,047.
 - b. \$110,000.
 - c. \$130,000.
 - d. \$147,750.

31. Tinakon, Inc. is an S corporation that was previously a C corporation and has gross receipts during the current year of \$120,000. Tinakon has AEP of \$52,000 and taxable income of \$20,000. There is passive investment income of \$80,000, with \$20,000 of expenses directly related to the production of passive investment income. What is Tinakon's excess net passive income tax for the year?
- a. \$7,000.
 - b. \$7,875.
 - c. \$10,500.
 - d. \$28,000.
32. Able, Inc., a calendar year S corporation, sold land during the current year resulting in a recognized built-in gain of \$100,000. Able has no expenses connected with the production of investment income. The company has gross receipts of \$120,000 and taxable income of \$105,000. Compute the built-in gains tax liability and the excess net passive income tax for the S corporation for the year of sale.
- a. Net passive investment income tax = \$15,750; built-in gains tax = \$0.
 - b. Net passive investment income tax = \$35,000; built-in gains tax = \$35,000.
 - c. Net passive investment income tax = \$15,750; built-in gains tax = \$35,000.
 - d. Net passive investment income tax = \$0; built-in gains tax = \$35,000.

Lesson 3: Other Tax Payments

INTRODUCTION

Payment of tax owed by an S corporation often involves more than merely reporting the amount of the tax on page 1 of Form 1120S and remitting a check to a qualified depository for federal taxes. (The instructions to Form 1120S state that the check is not remitted directly to the IRS.) The most common corporate-level taxes (the built-in gains tax and the tax on excess net passive income) must be paid in quarterly installments over the course of the tax year in which liability for the tax arises. In addition, corporations that used the LIFO inventory method before electing S status are allowed to pay the LIFO recapture tax over a four-year period to mitigate the effects of including the entire amount in income on the final C corporation tax return. Also, to offset the income tax deferral provided by adopting a fiscal tax year, S corporations must make "required payments" each year that a Section 444 fiscal year election is in effect. Finally, if a C corporation claims a general business credit and then elects S status, the corporation, rather than the shareholders, is responsible for any subsequent recapture of the credit.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the estimated tax requirements at the S corporation level.
- Calculate LIFO recapture and LIFO recapture tax.
- Identify required payments for fiscal year elections, recapturing business credits, and remitting S corporation taxes.

Estimated Tax Payments at the S Corporation Level

Estimated Tax Payments

An S corporation is required to make estimated tax payments under IRC Sec. 6655 if (1) the corporation is subject to one or more of the taxes that can be assessed at the corporate level and (2) the total of the taxes for the year is \$500 or more. The taxes that can be assessed at the S corporation level are:

1. The tax on built-in gains imposed by IRC Sec. 1374.
2. The tax on excess net passive income imposed by IRC Sec. 1375.
3. Recapture of business credits under IRC Sec. 1371(d)(2) that were originally claimed by a C corporation before it converted to S status.

There are three other situations where an S corporation pays tax, but the tax is not subject to estimated tax payments. The situations are:

1. The S corporation pays tax that was assessed to the predecessor C corporation. When a C corporation elects S status, for example, any tax due on the final C return is paid by the S corporation.
2. The S corporation makes the installment payments of tax caused by LIFO inventory recapture when it elected S status or when it acquired LIFO inventory from a C corporation in a tax-free transaction.
3. The S corporation makes required payments to elect or retain a fiscal year.

Required Annual Payment

An S corporation makes payments of estimated taxes based on the amount of the "required annual payment." An S corporation's required annual payment under IRC Sec. 6655(g)(4) is the lesser of:

1. 100% of the tax shown on the return for the current tax year, or

2. the sum of the following:

- a. 100% of the tax that would be owed for the current tax year if the only taxes taken into account for that year were the taxes on built-in gains and recapture of business credit; and
- b. 100% of the tax on excess net passive income that was shown on the S corporation's return for the preceding tax year.

The rule prohibiting "large corporations" with taxable income of \$1 million or more from basing payments on the prior year's tax does not apply to S corporations.

Estimated Tax Payments Based on the Previous Year's Excess Net Passive Income Tax

The estimated payments for the tax on excess net passive income can be based on 100% of the amount of that tax shown on the prior year's return, even if there was no tax liability in that prior year.

Built-in Gain and Business Credit Recapture Cannot Be Based on Last Year's Tax

The previous year's tax cannot be used as a basis for estimating the built-in gains tax and business credit recapture. In other words, an S corporation cannot use "safe" estimates based on the prior year's tax for any tax other than the tax on excess net passive income. For this reason it is very important to review the tax situation regarding built-in gains and business credit recapture at each estimated tax payment due date.

Four Equal Installment Payments

S corporations, like C corporations, are generally required to pay the estimated tax in four equal installments. Each required installment is 25% of the required annual payment. (However, S corporations may be eligible to use the annualized income or adjusted seasonal methods, which may not result in four equal payments.)

Due Dates for Payment of Estimated Tax

For a calendar-year S corporation, estimated tax installments are due by April 15, June 15, September 15, and December 15. For a fiscal-year S corporation, installments are due by the fifteenth day of the fourth, sixth, ninth, and twelfth months of the fiscal year.

Example 3A-1 When estimated tax payments are required.

Colt, Inc., a calendar-year C corporation, elected S status on January 1, 2010. During January it sells a business asset that results in built-in gains of \$14,286 and built-in gains tax of \$5,000 ($\$14,286 \times 35\%$).

Colt, Inc. must make estimated payments of at least \$5,000 to avoid the penalty for underpayment of estimated tax. Estimated tax payments of \$1,250 ($1/4$ of \$5,000) are due on April 15, June 15, September 15, and December 15.

Example 3A-2 Computing the amount of the estimated tax payment.

Assume the same facts as in Example 3A-1. Also assume that Colt, Inc. sells a business asset in January 2011 that results in built-in gains tax of \$3,060. The corporation also receives passive investment income during the year and incurs a \$4,000 tax on its excess net passive income.

Estimated tax payments due to the built-in gains tax cannot be avoided by reference to the prior year's tax. However, since the corporation did not incur the tax on excess net passive income in 2010, Colt, Inc., is not required to make estimated tax payments in 2011 relating to the tax on excess net passive income. (See item 2 in the preceding list following the caption "Required Annual Payment.") Therefore, Colt's required annual estimated tax payment is computed as follows:

100% of current year's built-in gains tax	\$ 3,060
100% of last year's passive income tax	<u>—</u>
Required annual estimated tax payment	<u><u>\$ 3,060</u></u>

Estimated tax payments of \$765 ($\frac{1}{4}$ of \$3,060) are due on April 15, June 15, September 15, and December 15, 2011.

In this example and the previous example, the asset causing the built-in gain is sold in January. The remaining examples in this lesson illustrate how estimated tax payments are calculated when income (such as built-in gain) is recognized later in the year.

Four Variable Installment Payments

While estimated tax generally is payable in four equal installments, the corporation may be able to lower the amount of one or more installments by using the adjusted seasonal method or the annualized income method under IRC Sec. 6655(e). If the required quarterly installment determined under one of these methods is less than 25% of the required annual payment under the general rule the corporation can pay the lesser amount for that quarter.

Adjusted Seasonal Method

Under the adjusted seasonal method, the underpayment penalty does not apply if the estimated payments are equal to 100% of the tax determined by annualizing current year-to-date income using a percentage derived from the ratio of the prior three years' quarterly income to total income. This method is restricted to corporations that recognize income on a seasonal basis (e.g., a toy store or ski resort).

Using the Annualized Income Method for Calculating Estimated Tax Payments

Under the annualized income method, the corporation is allowed to "catch up" in the installment period that the income is recognized. This method is especially useful, for example, if at the beginning of the tax year the corporation did not anticipate the recognition of built-in gains tax from the sale of an asset or the collection of cash-basis accounts receivable later in the tax year.

The estimated tax installment for the installment period the income is recognized equals the amount of tax, multiplied by the required percentage from the following table:

<u>For income recognized in the:</u>	<u>The required percentage is:</u>
First installment period	25 %
Second installment period	50 %
Third installment period	75 %
Fourth installment period	100 %

S corporations are required to base their estimated tax payments for built-in gains tax and business credit recapture on 100% of the tax shown on their return for the current year (without reference to the preceding year's tax), regardless of whether the tax is determined on an actual or annualized basis.

Monthly Periods. Corporations using the annualization method are required to compute their annualized income using a standard set of monthly periods unless they elect to use one of two optional sets of monthly periods. The standard and optional periods are as follows:

	<u>Standard</u>	<u>Option 1</u>	<u>Option 2</u>
First installment	1st 3 mos.	1st 2 mos.	1st 3 mos.
Second installment	1st 3 mos.	1st 4 mos.	1st 5 mos.
Third installment	1st 6 mos.	1st 7 mos.	1st 8 mos.
Fourth installment	1st 9 mos.	1st 10 mos.	1st 11 mos.

An election to use one of the optional periods is applicable only for the year in which it is made and must be made on or before the due date for the first installment. The election is made by filing Form 8842 (Election to use Different Annualization Periods for Corporate Estimated Tax).

Applying the Annualized Income Method. Generally, the annualized income installments of estimated tax are computed by determining the income through the end of the monthly period (listed earlier), then completing the following steps:

1. The income is annualized by multiplying the taxable income for the period by 12 and dividing by the number of months in the period (e.g., three for the first and second installments when the standard period is used).
2. Calculate the tax on the annualized income.
3. Multiply the amount from Step 2 by the applicable percentage 25% for the first required installment, 50% for the second, 75% for the third, and 100% for the fourth.
4. Subtract from the amount determined in Step 3 the total of any previously required installments for the tax year. The remainder is the annualized income installment.

Annualization May Not be Required for Nonrecurring Transactions. The annualization process may overstate the corporation's income, especially if a transaction occurs only once during the year. Regulations allow corporations to use a reasonably accurate estimate of annualized taxable income under certain circumstances. For example, items that are incurred once or infrequently during the tax year need not be annualized to avoid distorting the estimate of annualized taxable income. On the other hand, the regulations require the corporation to allocate certain deductions (such as real property taxes and employee bonus compensation) in a reasonably accurate manner.

Example 3A-3 Using the annualized income method to lower the amount of one or more installments.

Assume the same facts as Example 3A-1, except that the asset is sold in June 2010, rather than January. Colt, Inc., did not have net recognized built-in gain for purposes of making estimated tax payments until June (the third installment under the standard period), so it can use the annualized income method and make estimated payments in the following amounts during the year:

April 15	\$ —
June 15	—
September 15 ($75\% \times \$5,000$)	3,750
December 15 ($100\% \times \$5,000 - \$3,750$)	<u>1,250</u>
Total payments required	<u>\$ 5,000</u>

The corporation can use the annualized income method to compute estimated tax installments if that method results in lower estimated payments than the general rule requiring four equal payments. In Colt's case, the standard periods are through the months of March, June, and September. The income is annualized, and the tax is computed. For the first installment, the income through March 31 is annualized, and the installment payment is 25% of the tax. For the second installment, the income through March 31 is also used, and the installment payment is 50% of the tax minus the installment payment made in April. (Note that in this example the April 15 and June 15 installments are zero using the annualized income method.)

For the third installment, income from January 1 through June 30 is normally annualized, and the installment payment is 75% of the tax minus the previous installment payments. However, as discussed earlier, the regulations provide that items that are incurred once or infrequently during the tax year do not have to be annualized. In this example, the \$14,286 of built-in gain is the only taxable income that Colt expects to receive during the year. Thus, Colt is not required to annualize the built-in gain, and the third estimated tax installment is based on the \$5,000 of actual built-in gains tax ($\$14,286 \times 35\%$). The installment amount is \$5,000 multiplied by 75%, or \$3,750. Because there were no previous installment payments, the estimated tax payment due by September 15 is \$3,750.

For the fourth installment, income from January 1 through September 30 is generally annualized, and the installment payment is 100% of the tax minus the previous installment payments. However, because Colt had

no taxable income in the fourth installment period and the income in the third period was not annualized, the installment payment is \$1,250, which is 100% of the \$5,000 built-in gains tax, reduced by previous payments of \$3,750. If all four payments are made in the correct amounts by their respective due dates, the corporation will not be subject to a penalty for underpayment of estimated tax. Any additional tax is paid when the tax return is filed.

Example 3A-4 Electing to use an optional set of monthly periods to lower the amount of one or more installments.

Assume the same facts as in Example 3A-1, except that the asset is sold on March 2, 2010. Before April 15, the due date of the first installment, the corporation files Form 8842 and elects to make estimate payments using the monthly periods in Option 1. Since the first installment under Option 1 is based on income during the first two months of the tax year, Colt is not required to make that installment. The second installment is based on the income for the first four months of the tax year, and the installment payment is 50% of the tax. The corporation makes estimated payments in the following amounts during the year:

April 15	\$ —
June 15 (50% x \$5,000)	2,500
September 15 (75% x \$5,000 – \$2,500)	1,250
December 15 (100% x \$5,000 – \$3,750)	<u>1,250</u>
Total payments required	<u>\$ 5,000</u>

By making the election to use an optional set of monthly periods, the corporation has deferred its first estimated tax payment for two months.

Tax Deposits and Reporting

Estimated tax payments (other than those filed electronically) are made by using Form 8109 (Federal Tax Deposit Coupon) to deposit the amount due into a federal depository.

The total amount of estimated tax paid during the tax year is reported in the "Tax and Payments" section of page 1 of Form 1120S. Form 2220 is used to determine if the corporation is liable for the underpayment of estimated tax penalty, and to compute the amount of the penalty. If the penalty is owed, Form 2220 should be completed and attached to Form 1120S, the box on the "Estimated tax penalty" line at the bottom of page 1 of Form 1120S should be checked, and the amount of the penalty should be entered on that line.

Exceptions to the Penalty

There is no reasonable cause exception to the penalty for underpayment of estimated tax. However, no penalty is imposed if the tax shown on the return for the tax year (or, if no return is filed, the tax) is less than \$500. Furthermore, no penalty is imposed on the debtor or trustee in bankruptcy under Title 11 of the U.S. Code, to the extent the bankruptcy case precludes such payment.

Quick Refunds

Under certain circumstances, a C corporation can apply for a quick refund of overpaid estimated tax under IRC Sec. 6425 by filing Form 4466 (Corporation Application for Quick Refund of Overpayment of Estimated Tax). The IRS will act on the request within 45 days of the date the form is filed. Unfortunately, this procedure does not apply to taxes imposed on S corporation. However, the instructions to Form 4466 state that the form can be filed by S corporations who have made protective estimated tax payments in their first taxable year (i.e., protective payments of C corporation income taxes in case the S election is improperly made).

How to Calculate LIFO Recapture

LIFO Inventory on Date S Election Becomes Effective

A C corporation using the LIFO method of valuing inventories must recapture (i.e., recognize as income) the excess of its FIFO inventory cost over LIFO cost as of the end of the tax year preceding its first S corporation tax year. This LIFO recapture must also take place when an S corporation succeeds to a C corporation's LIFO inventory in a tax-free transaction. This amount (referred to as the "LIFO recapture amount") is included in income on the tax return for the last C corporation year. As discussed later in this lesson, the increase in tax generated by including the income is paid in four annual installments, beginning with the final C return.

C corporations using the FIFO method are not affected by this LIFO recapture provision. Also, S corporations that make a LIFO election are not affected by this provision.

The LIFO recapture amount is generally included in income on the last C corporation tax return. The increase in tax that results from this income inclusion is paid in four equal, annual installments, beginning with the last C corporation return. The C corporation pays the first installment with its last C corporation return, and the S corporation pays the succeeding installments.

LIFO Recapture When an S Corporation Acquires Inventory from a C Corporation

The LIFO recapture provisions were intended to prevent built-in gain avoidance that could arise when an S corporation succeeds to a C corporation's LIFO inventory in a tax-free transaction. Accordingly, LIFO recapture does *not* occur when a sole proprietorship transfers its operating assets (including LIFO inventories) to a corporation in a Section 351 transaction, the corporation makes a timely election in its first year to use the LIFO method, and the corporation elects S status for the first year of its existence.

Look-through Provisions May Apply When a C Corporation Owns Partnership Interests. Under the regulations, a C corporation that holds an interest in a partnership owning LIFO inventory must include the look-through LIFO recapture amount in its gross income when it elects S status or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The look-through LIFO recapture amount must be determined, in general, on the day before the effective date of the S corporation election or the date of the transfer. The corporation then increases its basis in the partnership interest by the recapture amount. The regulations also allow the partnership to adjust the basis of its inventory (or look-through partnership interests held by that partnership) to account for the LIFO recapture.

Inventory Adjustment

The corporation's basis in its inventory is adjusted by the LIFO recapture amount that is included in income. The result is that the corporation's basis in its LIFO inventory is adjusted (i.e., increased) so that it equals the FIFO cost, thus eliminating double taxation when the inventory is sold. The adjustment does not affect the corporation's LIFO election. Unless the corporation obtains permission from the IRS to switch from the LIFO method, it is required to continue using the LIFO method in its S corporation tax returns. The appropriate method for adjusting the inventory's basis is to collapse the LIFO layers and add the LIFO recapture amount to the LIFO carrying value of the inventory as of the end of the last tax year as a C corporation.

LIFO Recapture Amount

The LIFO recapture amount is defined as the amount, if any, by which the inventory amount computed using the FIFO method exceeds the inventory amount computed using the LIFO method. When computing the inventory amount using the FIFO method, the corporation must use the retail method if that method is used for LIFO purposes; otherwise, the corporation must use the lower-of-cost-or-market method.

LIFO Recapture Tax

To determine the incremental tax resulting from the LIFO recapture, the corporation follows these three steps:

1. Complete the tax computation schedule (Schedule J of the Form 1120) based on taxable income that includes the LIFO recapture amount.
2. On a separate worksheet (using the Schedule J format), calculate what the corporation's tax (after credits) would be if the LIFO recapture amount were excluded from taxable income. (In determining its tax without the recapture amount, the corporation may also have to recalculate some items such as alternative minimum tax, general business credits, and the foreign tax credit.)
3. Compare the tax liability that results when the LIFO recapture amount is included in taxable income with the liability that results when the recapture is excluded from income; the difference is the additional tax attributable to the LIFO recapture amount.

The additional tax is paid in four installments. The first installment is due with the electing corporation's return for its last C corporation tax year. It must be paid on or before the due date (excluding extensions) of the last C corporation return. The C corporation's LIFO recapture amount is included on the "Other income" line of Form 1120.

The C corporation's Form 1120, Schedule J (Tax Computation) (lines 1 through 10), is used to calculate the corporation's tax, including all the additional tax due to the LIFO recapture amount. The deferred LIFO tax ($\frac{3}{4}$ of the additional tax) is subtracted at line 10 of Schedule J to arrive at the total tax due. The C corporation should write, "Section 1363(d) deferral" and the amount on the dotted line to the left of the total tax on line 10. The instructions add that a computation of the amount to be deferred should be attached to the return.

Example 3B-1 Reporting the LIFO recapture tax on the final C corporation return.

Fairfield, Inc., a calendar-year C corporation, elects S status. On its final C corporation return (Form 1120), it reports taxable income of \$90,000, including a LIFO recapture amount of \$10,000. Fairfield does not claim any credits on its final C return. The amount of income tax computed on Form 1120, Schedule J is \$18,850. On a separate copy of Schedule J (not filed with Form 1120), the company's income tax is recomputed by excluding the \$10,000 LIFO recapture amount. The amount of tax owed on \$80,000 is \$15,450, so the tax due to LIFO recapture equals \$3,400 (\$18,850 – \$15,450).

The \$2,550 amount to be deferred ($\frac{3}{4}$ of \$3,400) is subtracted to arrive at the total tax owed by the C corporation. The words "Section 1363(d) deferral" and the amount of \$2,550 (in brackets) are entered on the dotted line to the left of the "Total tax" line of Schedule J. The end result is that Fairfield will pay income tax of \$16,300 (\$18,850 – \$2,550) on its final Form 1120.

The remaining three installments of tax due to recapture of the LIFO reserve are paid with the corporation's Form 1120S for the three succeeding tax years, and are due on or before the due dates (excluding extensions) of the returns. No interest is charged on the installments unless they are made after the due dates. The installments are included in the total amount of tax owed by the S corporation reported on the "Tax and Payments" section of Form 1120S. Specifically, on the dotted line to the left of the line for total taxes (line 22c), the practitioner should enter the words "LIFO tax" and the amount of the installment.

Example 3B-2 Reporting installments of the LIFO recapture tax on subsequent-year S corporation returns.

Assume the same facts as in the previous example. Fairfield's initial S corporation return will include an \$850 installment of tax due to LIFO recapture ($\frac{1}{4}$ of \$3,400). The installment is included in the total amount of tax owed by the S corporation reported on line 22c of Form 1120S. The words "LIFO tax" and the amount of the installment are entered on the dotted line to the left of the total. Fairfield will repeat this procedure in its tax returns for the following two years.

Transfers of LIFO Inventory

Reg. 1.1363-2 provides an exception to the general rule requiring a C corporation to include the LIFO recapture amount in income on its return for its last C tax year. If a C corporation transfers LIFO inventory to an S corporation in a tax-free transaction during a tax year before its final tax year, the C corporation includes the LIFO recapture amount in income on its return for the year of transfer instead of on its return for its last tax year. Furthermore, a C corporation also must recapture its LIFO reserve if it merges into an S corporation and the S corporation is the surviving entity. In these situations, the transferor C corporation pays the first installment of the LIFO recapture tax with its return for the year of transfer. The transferee S corporation then pays the three remaining installments on or before the due dates of its returns for the three succeeding tax years.

Failure to Make Timely LIFO Recapture Installment Payments

The IRS has ruled that the following consequences can result when a corporation fails to make timely LIFO recapture installment payments.

1. A 20% accuracy-related penalty under IRC Sec. 6662 may apply if the corporation does not include the required LIFO recapture amount in the C corporation's gross income for its last C tax year.
2. A failure-to-pay penalty under IRC Sec. 6651 may apply if the corporation does not make a LIFO recapture installment by its due date.
3. Late LIFO recapture installment payments are subject to interest under IRC Sec. 6601 on the unpaid amount from the due date of the payment until it is paid.

Also, Notice 2003-4 clarifies that the due dates of subsequent LIFO recapture installment payments remain the same, even if the corporation has failed to pay, or has been late in paying, its required installments.

LIFO Recapture Does Not Terminate LIFO Method

LIFO recapture requires the recognition of income equal to the excess of the inventory's FIFO value over its LIFO value at the end of the C corporation's year. It does not cause the LIFO method to terminate; i.e., the S corporation continues using LIFO.

Reporting Inventory on Tax Return Balance Sheets and Financial Statements

The LIFO recapture amount is included in income in the last C corporation tax return, or in the C return for the year of a nonrecognition transfer. It is unclear how the C corporation reports its ending inventory in Schedules J (Cost of Goods Sold) and L (Balance Sheet) of its return. Generally, in Schedule J, all C corporations should report their ending inventory using the LIFO basis before any adjustment for recapturing the LIFO reserve. In Schedule L, a C corporation that maintains its books and records on a financial (rather than tax) basis should report its inventory according to its financial books and records. Thus, the corporation should make no adjustment to the amount it reports as its ending inventory on Schedule L. If, however, a corporation maintains only tax-basis books and records, the corporation should report in Schedule L the amount of its ending inventory after adjustment for the LIFO recapture amount and attach a statement to its return explaining the difference between the ending inventory amounts reported in Schedules J and L.

The beginning inventory amount on the S corporation's Schedule L will agree with the ending inventory amount on the C corporation's Schedule L. However, the beginning inventory on the S corporation's Schedule J should include the LIFO recapture amount. Since the Schedule J beginning inventory will differ from the C corporation's Schedule J ending inventory, a statement explaining the difference should be attached to the return.

Generally, a corporation that uses the LIFO inventory method for tax purposes must use the same inventory procedures for financial reporting and credit purposes. However, a corporation that makes the LIFO recapture adjustment is not required to make the adjustment for financial reporting purposes. The corporation does not violate the LIFO conformity requirements by making the LIFO recapture adjustment to the basis of its inventory for tax purposes but not for financial reporting purposes.

How to Make Required Payments for Fiscal Year Elections

Most S corporations cannot establish a business purpose for the use of a fiscal tax year, and therefore must either use a calendar year or make the Section 444 election. IRC Sec. 444 allows an S corporation to elect to use a fiscal year that meets certain criteria. In addition, IRC Sec. 7519 states that the entity must make required payments if a Section 444 fiscal year is elected. The required payments are intended to approximate the amount of tax that would be paid by the shareholders if the corporation changed to a calendar year, and so offset the income tax deferral provided by the fiscal year.

How to Recapture Business Credits

Business credit recapture is the responsibility of the party that claims the credit. Therefore, if a C corporation claims the credit, the succeeding S corporation is responsible for the recapture. If the company is an S corporation when the credit originates, the credit passes through to the shareholders and the shareholders must report the recapture.

How to Remit S Corporation Taxes

Federal Tax Deposit Coupons

If estimated tax payments are being made, or Form 1120S shows a tax payable, the amount due is remitted with Form 8109 (Federal Tax Deposit Coupon) to a federal depository. The tax due should not be sent directly to the IRS. According to the 2006 instructions to Form 1120S (page 4), the corporation's employer identification number, the tax period, and "Form 1120S" should be written on the check. Also, the "1120" box on Form 8109 should be darkened.

Enrollment in Electronic Federal Tax Payment System

Individuals and businesses (including S corporations) can choose to submit tax payments electronically using the Electronic Federal Tax Payment System (EFTPS). Enrollment in EFTPS can be accomplished online at www.eftps.gov or by calling the IRS at (800) 555-4477 or (800) 945-8400.

Mandatory Electronic Tax Payment Requirements

Certain S corporations are required to make *all* tax deposits electronically using EFTPS. If the organization falls within the mandatory electronic payment requirements, the IRS should automatically send a letter notifying the corporation of the requirements and explaining how to register for EFTPS.

Tax deposits must be made by electronic funds transfer (EFT) if the corporation has aggregate annual tax deposits of more than \$200,000 for a calendar year after 1997. Aggregate tax deposits include corporate income taxes, estimated taxes, FICA taxes (both employer and employee portions), and federal withholding taxes during the year. A corporation that has previously had \$200,000 or less of annual tax deposits is given a one-year grace period before it must begin using EFT.

Example 3E-1 First year that electronic deposits are required.

Rotor, Inc. incorporated and elected S status on January 1, 2008. For that year, it made tax deposits of \$45,000. For 2009, it made tax deposits of \$210,000. It has a one-year grace period from the year it exceeded the \$200,000 threshold and must make tax deposits by EFT beginning January 1, 2011.

Once the \$200,000 threshold is reached, electronic deposits must continue, even if actual deposits subsequently drop below the threshold level.

Regulations Require Payment by Electronic Funds Transfer

Proposed regulations would eliminate the rules for using paper-based federal tax deposit coupons because the paper coupon system will no longer be maintained by the Treasury Department after December 31, 2010. Corporate tax payments including estimated taxes, income taxes, excise, payroll, and withholding taxes would be made by electronic funds transfer.

The proposed regulations do not change existing rules for determining a taxpayer's status as a monthly or semiweekly depositor, or for determining whether a taxpayer can remit taxes with a return.

The proposed regulations are scheduled to become effective for remittances made after the date that final regulations are published, but no earlier than January 1, 2011.

Penalty for Failure to Deposit Electronically

An S corporation required to participate in the EFTPS will be subject to the failure to deposit penalty under IRC Sec 6 if its tax deposits are not filed electronically by the respective due date of those deposits (unless it can show the failure was based on reasonable cause). Once the electronic funds transfer (EFT) deposit rules apply, any payments made by means other than EFT are generally subject to the late deposit penalty, even if those payments are timely made. If electronic filing is required, the penalties can be applied solely because electronic filing was not used even if the taxes are timely paid in full into an authorized government depository and there is no underpayment or late payment of the taxes.

How to Avoid the Estimated Tax Underpayment Penalty for S Corporation Shareholders

IRC Sec. 6654 imposes a penalty for underpayment of an individual's estimated tax, which presents special problems and challenges to S corporation shareholders who must account for S corporation pass-through income or loss when determining the amount of their estimate payments.

The underpayment penalty can be avoided if any of the following situations apply.

1. *Small Balance Due after FIT Withholding.* The tax after a reduction for federal income tax withheld, is less than \$1,000.
2. *No Prior-year Tax Liability.* The taxpayer (a) had no tax liability for the prior tax year, (b) was a U.S. citizen or resident for that entire year, and (c) the prior tax year was a full 12 months. There is no requirement that a prior year's return was filed, provided these conditions are met.
3. *Payment of 90% of Current Year's Tax.* The taxpayer paid (through withholding and/or timely estimates) at least 90% of the current year's tax.
4. *Payment of Prior Year's Tax.* The taxpayer paid (through withholding and/or timely estimates) at least 100% of the prior year's tax liability. If the shareholder's adjusted gross income for the prior year is more than \$150,000 (\$75,000 if married filing a separate return), the taxpayer must make payments of at least 110% of the prior year's tax liability to avoid the penalty. The prior-year's-tax rule applies only if a return was filed for the previous year and that year was a 12 full months.
5. *Annualization Method.* The taxpayer paid (through withholding and/or timely estimates) at least 90% of the current year's tax based on annualization of actual year-to-date income for each quarter of the year.

For calendar-year taxpayers, estimated tax payments are due "quarterly" by April 15, June 15, September 15, and January 15 for the periods ending March 31, May 31, August 31, and December 31, respectively.

Federal income tax withholding can be treated as if it was withheld evenly throughout the year. Alternatively, the amounts actually withheld at a specific date can be used if the individual can establish such amounts.

S Corporation Shareholders

S corporation income or loss is passed through to shareholders on a daily basis. For estimated tax purposes, an S corporation shareholder generally must make estimated tax payments as if the S corporation's pass-through items were received evenly throughout the tax year. However, the annualization method (discussed later in this lesson) allows the S shareholder to base estimated tax payments on the S corporation's actual income at the end of each quarter.

Example 3F-1 Making estimated payments based on S corporation income.

Steve owns all the shares of Limeco, a calendar-year S corporation. On December 1, Limeco sells an investment asset and recognizes a long-term capital gain of \$700,000 on the sale. For the year ended December 31, Limeco passes through to Steve ordinary income of \$100,000 and the \$700,000 capital gain. Limeco's income, other than the capital gain, and Steve's income and withholding are spread evenly throughout the year. Steve's income tax liability for the year is \$185,000, as follows:

Tax on S corporation income	\$ 33,000
Tax on capital gain from S corporation	105,000
Tax on other income (not from S corporation)	<u>47,000</u>
Total tax	<u>\$ 185,000</u>

Steve had \$20,000 withheld from wages during the year. His tax for the preceding year was \$260,000. He believes his income this year will be less than it was in the preceding year, so he chooses not to avoid the underestimation penalty by making estimated tax payments of 110% of the preceding year's tax.

Steve will not be subject to the underestimation penalty if he pays a total of \$166,500 (90% of the \$185,000 current year's tax) through withholding and/or timely-made estimate payments during the year. Thus, Steve could avoid the penalty by making estimated tax payments totaling \$146,500 (\$166,500 – \$20,000) for the year in quarterly payments of \$36,625 (\$146,500 ÷ 4) by each payment's due date.

Assume that Steve made estimated tax payments of \$6,750 for each of the first three quarters to cover the \$47,000 of tax that arose from income other than from the S corporation. He arrived at the \$6,750 by subtracting the \$20,000 withholding from the \$47,000 tax, then dividing the remaining \$27,000 by four quarters. He made three timely payments of \$6,750 and a final installment of \$126,250 by the due date of the fourth estimated tax installment. Is he subject to the underestimation penalty?

Yes, he has not met the requirements for the first three payments, even though he has paid in the required amount of tax (\$166,500) for the year. His payments were:

Withholding	\$ 20,000
Estimated tax payments (3 × \$6,750)	20,250
Final estimated tax payment	<u>126,250</u>
Total payments	<u>\$ 166,500</u>

Steve is subject to the underestimation penalty for the first three quarters because an S corporation shareholder must normally treat the income from the S corporation as if it was received evenly throughout the year.

Annualization Method

The annualization method (item 5 in the preceding list) is available for taxpayers whose income is not received evenly throughout the year, and can be beneficial when a larger portion of the income is recognized after the first quarter. To meet the requirements of the annualization method, the S shareholder pays through withholding and/or timely estimates an amount equal to 90% of the current year's tax computed by annualizing actual year-to-date income for each quarter of the year.

If the annualization method is used, the shareholder must be able to determine his or her share of the S corporation's pass-through amounts at the end of each quarter. This information may be difficult for the shareholder to get, or even difficult for the corporation to determine in time for the shareholder to make timely quarterly estimate payments. Nevertheless, when a large portion of the shareholder's income is received later in the year, the annualization method can result in the least amount of required estimated tax payments.

The annualization method is calculated on a cumulative basis, that is, the required estimated payment is determined from the beginning of the year to the end of a specific quarter, and any prior quarters' payments are subtracted from that amount.

Taxpayers can use the annualization method for one installment, then switch to one of the other methods in the next quarter, if it results in a lower payment. However, they must recapture (i.e., pay back) any savings from the prior periods the annualization method was used. Thus, any reduction in an estimated tax payment resulting from the use of the annualization method must be added to the next estimated payment (if any) not based on annualization.

Example 3F-2 Making estimated payments based on the annualization method.

Assume the same facts as in the previous example. What are the minimum estimated payments Steve can make to avoid the underestimation penalty?

Steve makes the least possible estimated tax payments by using the annualization method. He must get the information regarding Limeco's income amounts at the end of each quarter. To determine each estimated tax payment, his income through the end of each quarterly period is annualized and the potential tax determined. His estimate payment must be at least 90% of that tax multiplied by 25%, 50%, 75%, or 100% depending on the quarter. The resulting amount is then reduced by any prior estimated tax payments and withholding.

For the first quarter, Steve's annualized income tax is \$80,000 (\$33,000 on S corporation income plus \$47,000 on other income) because the capital gain has not yet been recognized. The estimated tax payment due on April 15 is \$13,000, calculated like this:

Annualized income tax	<u>\$ 80,000</u>
90% of annualized income tax	<u>\$ 72,000</u>
First quarter required payment (25% of \$72,000)	\$ 18,000
Withholding (25% of \$20,000)	<u>(5,000)</u>
Required payment due	<u>\$ 13,000</u>

For the second and third quarters, Steve's annualized income tax is again \$80,000. The estimated tax payments due on June 15 and September 15 are again \$13,000, calculated as follows:

	<u>Second Quarter</u>	<u>Third Quarter</u>
Annualized income tax	<u>\$ 80,000</u>	<u>\$ 80,000</u>
90% of annualized income tax	<u>\$ 72,000</u>	<u>\$ 72,000</u>
Total required payment (50% and 75% of \$72,000)	\$ 36,000	\$ 54,000
Withholding (50% and 75% of \$20,000)	<u>(10,000)</u>	<u>(15,000)</u>
Balance	26,000	39,000
Previous estimated payments made	<u>(13,000)</u>	<u>(26,000)</u>
Required payment due	<u>\$ 13,000</u>	<u>\$ 13,000</u>

The annualized method does not apply to the fourth quarter. Steve's required estimated tax payment for that quarter is 90% of his tax less prior payments. Thus, the estimated tax installment due on January 15 of the following year is \$107,500, as shown in the following table:

Income tax for the year	<u>\$ 185,000</u>
90% of income tax	\$ 166,500
Withholding	(20,000)
Previous estimated payments made	<u>(39,000)</u>
Required payment due	<u>\$ 107,500</u>

Steve has met the requirement to timely pay estimated taxes of \$166,500 by making the following payments:

First quarter	\$ 13,000
Second quarter	13,000
Third quarter	13,000
Fourth quarter	107,500
Withholding	<u>20,000</u>
Total payments and withholding	<u>\$ 166,500</u>

As illustrated in this example, the annualization method can reduce the required estimated tax payments for an S shareholder if a significant portion of the shareholder's income is received later in the year. However, the shareholder must be able to determine the S corporation's earnings each quarter.

Original Return Establishes Estimated Tax Requirements

The underpayment penalty does not apply to corrections of tax made by amended returns filed after the "original return." The taxpayer's original return is used to determine the estimated tax requirements for that year. For this purpose, the taxpayer's original return is the last return, including an amended return, filed on or before the due date (including extensions) of the return for the tax year (Rev. Rul. 83-36). An amended return filed after the due date is not taken into account. The tax reported on the original return establishes the amount of estimated taxes that must be paid, and this amount is not recalculated, even if the original return was fraudulent.

Penalty for Failure to Pay

IRC Sec. 6651 imposes a civil penalty if a taxpayer does not timely pay tax that is due. This failure to pay (FTP) penalty has two components—the failure to pay tax shown as due on a return on the date prescribed for payment and the failure to pay tax within 21 calendar days (10 business days if the amount demanded is \$100,000 or more) of the date of notice and demand for the tax. The first component can apply to the late payment of tax shown as due on the return, while the latter can apply to deficiencies resulting from an examination of the return or a mathematical error on the return. As with the failure to file penalty, the FTP penalty does not apply if the failure was due to reasonable cause and not willful neglect.

The regulations state that reasonable cause for failure to pay exists to the extent the taxpayer can satisfactorily show ordinary business care and prudence where exercised in providing for the payment of the tax liability, but the taxpayer was nevertheless either unable to pay the tax or would have suffered undue hardship if the tax was paid on the due date. In determining whether reasonable cause exists, consideration is given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could reasonably have expected, at the time he made the expenditures, to receive before the tax payment due date.

Examples of reasonable cause include: (1) death or serious illness of the taxpayer, a relative, or someone effecting the taxpayer's business; (2) the unavoidable absence of the taxpayer or another person; (3) the destruction of the taxpayer's place of business or records (i.e., casualty loss, theft, accidental loss); and (4) civil disturbances impairing the taxpayer's ability to pay.

To claim the reasonable cause exception, the taxpayer must make an affirmative showing of all facts alleged to constitute reasonable cause in a written statement, signed under penalties of perjury, that is filed with the IRS office where the return is filed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. Calendar year S corporations are required to:
- a. Pay their first quarterly estimated tax payment by March 15th.
 - b. Use the annualized income method for purposes of computing estimated tax.
 - c. Compute estimated tax payments based on 100% of the prior year built-in gains tax.
 - d. Compute estimated tax based on 100% of the prior year excess net passive income tax.
33. An S corporation's required estimated tax payment should equal the lesser of:
- a. 100% of the current year tax or 100% of the previous year tax on excess net passive income plus 100% of current year tax on built-in gains and recapture of business credit.
 - b. 100% of the previous year tax or 90% of the current year tax as shown on the return.
 - c. 100% of the previous year tax or 100% of the previous year excess net passive income tax.
 - d. 100% of the current year tax or 100% of the previous year built-in gains tax, recapture of business credit, and tax on excess net passive income.
34. Unilink, Inc. is a calendar year S corporation that elected S status effective January 1, 2007, after it had operated as a C corporation for a number of years. During February of the current year, Unilink sells some business assets resulting in a built-in gains tax liability of \$4,000. Last year the company incurred a built-in gain tax liability of \$2,000. For the current year, what is the required first quarter estimated tax payment and due date for the company?
- a. \$500 estimated tax payment due March 15th.
 - b. \$1,000 estimated tax payment due March 15th.
 - c. \$500 estimated tax payment due April 15th.
 - d. \$1,000 estimated tax payment due April 15th.
35. Mason, Inc. was a C corporation that converted to an S corporation in 2010. Mason used the LIFO inventory method in 2009 and had LIFO inventory of \$310,000 (FIFO value of \$440,000). What is the corporations' 2009 LIFO recapture tax liability due with the final C corporation return, assuming the corporation is subject to a 35% tax rate?
- a. \$0.
 - b. \$11,375.
 - c. \$45,500.
 - d. \$130,000.

36. Assume the same information as the previous question. Mason used the LIFO inventory method in 2009 and had LIFO inventory of \$310,000 (FIFO value of \$440,000). What is the S corporation's 2010 LIFO recapture tax liability?
- a. \$0.
 - b. \$11,375.
 - c. \$34,125.
 - d. \$45,500.
37. Which of the following statements regarding LIFO recapture would be most correct?
- a. LIFO recapture will cause the LIFO method to terminate.
 - b. The LIFO recapture tax is included only on the S corporation's tax return.
 - c. The LIFO recapture amount is included in income on the last C corporation tax return.
 - d. The corporation's basis in inventory is reduced by the LIFO recapture amount included in income.
38. Under which of the following situations would an estimated tax underpayment penalty be imposed on an S corporation?
- a. The S corporation neglected to make required estimated tax payments but had no prior-year tax liability.
 - b. The S corporation did not remit the entire current year tax, but paid in 90% of the current year's tax.
 - c. The S corporation annualized its income for the year and paid in 90% of the current year tax.
 - d. The S corporation paid in 90% of the prior year's tax.
39. When determining required quarterly estimated tax payments, S corporation shareholders must:
- a. Include the S corporation built-in gains tax when considering their individual estimated tax requirements.
 - b. Include the S corporation excess net passive income tax when considering their individual estimated tax requirements.
 - c. Make estimated tax payments as if the S corporation's pass through items were received evenly throughout the year.
 - d. Use the annualization method to determine the amount of estimated tax payments required for items of income or loss passing through from the S corporation.
40. Which of the following statements is accurate regarding the shareholder's use of the annualization method to avoid the underpayment penalty?
- a. This method is available for taxpayers who receive income evenly throughout the year.
 - b. This method is available in certain instances when a large portion of the shareholder's income is received in the first quarter of the year.
 - c. This method is available for taxpayers who are only able to determine their share of the S corporation's pass-through amounts at mid-year and yearend.
 - d. This method is calculated on a cumulative basis.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. Calendar-year S corporations are required to: **(Page 211)**

- a. Pay their first quarterly estimated tax payment by March 15th. [This answer is incorrect. Calendar-year S corporations must remit their first quarterly estimated tax payment by April 15th.]
- b. Use the annualized income method for purposes of computing estimated tax. [This answer is incorrect. S corporations may use the adjusted seasonal method or the annualized income method to lower their installment amounts, but generally are not required to use those methods.]
- c. Compute estimated tax payments based on 100% of the prior year built-in gains tax. [This answer is incorrect. An S corporation may not use the previous year's tax as a "safe" estimate.]
- d. **Compute estimated tax based on 100% of the prior year excess net passive income tax. [This answer is correct. Only for the tax on excess net passive income may an S corporation compute estimated tax using the previous year's tax.]**

33. An S corporation's required estimated tax payment should equal the lesser of: **(Page 211)**

- a. **100% of the current year tax or 100% of the previous year tax on excess net passive income. [This answer is correct. An S corporation must remit the lesser of 100% of the current year tax or 100% of the previous year tax on excess net passive income tax plus 100% of current year tax on built-in gains and recapture of business credit per IRC Sec. 6655(g)(4).]**
- b. 100% of the previous year tax or 90% of the current year tax as shown on the return. [This answer is incorrect. 90% of the current year tax is not the requirement for estimated tax payments per the IRS rules for S corporations.]
- c. 100% of the previous year tax or 100% of the previous year excess net passive income tax. [This answer is incorrect. This answer does not properly reflect the requirements for estimated tax payments as dictated by the IRS for S corporations tax payments.]
- d. 100% of the current year tax or 100% of the previous year built-in gains tax, recapture of business credit, and tax on excess net passive income. [This answer is incorrect. According to the IRS, the previous year built-in gains tax and business credit recapture cannot be used as a basis for estimating the current year estimated tax.]

34. Unilink, Inc. is a calendar year S corporation that elected S status effective January 1, 2007, after it had operated as a C corporation for a number of years. During February of the current year, Unilink sells some business assets resulting in a built-in gains tax liability of \$4,000. Last year the company incurred a built-in gain tax liability of \$2,000. For the current year, what is the required first quarter estimated tax payment and due date for the company? **(Page 211)**

- a. \$500 estimated tax payment due March 15th. [This answer is incorrect. The previous year's built-in gains tax liability may not be used as the estimated tax base.]
- b. \$1,000 estimated tax payment due March 15th. [This answer is incorrect. The due date for the first quarter estimated tax is not March 15th.]
- c. \$500 estimated tax payment due April 15th. [This answer is incorrect. The prior year built-in gains tax may not be used to estimate the current year built-in gains tax.]
- d. **\$1,000 estimated tax payment due April 15th. [This answer is correct. Per the Internal Revenue code, the current year built-in gain tax must be used in computing the estimated tax payment, the first quarter of which is due on April 15th since Unilink, Inc. is a calendar year S corporation.]**

35. Mason, Inc. was a C corporation that converted to an S corporation in 2010. Mason used the LIFO inventory method in 2009 and had LIFO inventory of \$310,000 (FIFO value of \$440,000). What is the corporations' 2009 LIFO recapture tax liability due with the final C corporation return, assuming the corporation is subject to a 35% tax rate? **(Page 216)**
- a. \$0. [This answer is incorrect. The C corporation will have a LIFO recapture tax on its final C corporation return year.]
 - b. \$11,375. [This answer is correct. The LIFO recapture amount is \$130,000 or \$440,000-\$310,000. The LIFO recapture tax is 35% of \$130,000 but only the first of four installments is due on the corporation's final C corporation tax return.]**
 - c. \$45,500. [This answer is incorrect. Not all of the LIFO recapture tax is due with the corporation's final year C corporation tax return.]
 - d. \$130,000. [This answer is incorrect. This is the amount of the LIFO recapture, but does not reflect the tax liability for Mason, Inc.]
36. Assume the same information as the previous question. Mason used the LIFO inventory method in 2009 and had LIFO inventory of \$310,000 (FIFO value of \$440,000). What is the S corporation's 2010 LIFO recapture tax liability? **(Page 216)**
- a. \$0. [This answer is incorrect. The S corporation will incur LIFO recapture tax in this situation.]
 - b. \$11,375. [This answer is correct. The second of four installments of LIFO recapture tax is due the first year the company operates as an S corporation since the installments are due for the three succeeding tax years.]**
 - c. \$34,125. [This answer is incorrect. Not all of the remaining LIFO recapture tax is due the first year the S election is in place.]
 - d. \$45,500. [This answer is incorrect. Not all of the LIFO recapture tax is reported by the S corporation in the first year the S election is effective.]
37. Which of the following statements regarding LIFO recapture would be most correct? **(Page 216)**
- a. LIFO recapture will cause the LIFO method to terminate. [This answer is incorrect. LIFO recapture will not cause the LIFO method to terminate.]
 - b. The LIFO recapture tax is included only on the S corporation's tax return. [This answer is incorrect. LIFO recapture tax could be reported on either the final C corporation tax return or on the S corporation's tax return.]
 - c. The LIFO recapture amount is included in income on the last C corporation tax return. [This answer is correct. While only $\frac{1}{4}$ of the LIFO recapture tax is paid by the C corporation, the entire LIFO recapture amount is included in income on the last C corporation tax year.]**
 - d. The corporation's basis in inventory is reduced by the LIFO recapture amount included in income. [This answer is incorrect. The corporation's basis in inventory is increased by the amount of LIFO recapture income included in income.]

38. Under which of the following situations would an estimated tax underpayment penalty be imposed on an S corporation? **(Page 220)**
- a. The S corporation neglected to make required estimated tax payments but had no prior-year tax liability. [This answer is incorrect. The underpayment penalty may be avoided if the S corporation had no prior-year tax liability.]
 - b. The S corporation did not remit the entire current year tax, but paid in 90% of the current year's tax. [This answer is incorrect. If an S corporation pays in 90% of the current year's tax, there would be no estimated tax underpayment penalty imposed.]
 - c. The S corporation annualized its income for the year and paid in 90% of the current year tax. [This answer is incorrect. If an S corporation annualizes its income for the year and pays in at least 90% of the prior year's tax, the underpayment penalty may be avoided.]
 - d. The S corporation paid in 90% of the prior year's tax. [This answer is correct. In this choice, only 90% of the prior year's tax was paid. All of the prior year's tax must be paid in to avoid the underpayment penalty under IRC Sec. 6654.]**
39. When determining required quarterly estimated tax payments, S corporation shareholders must: **(Page 220)**
- a. Include the S corporation built-in gains tax when considering their individual estimated tax requirements. [This answer is incorrect. Shareholders are not responsible for remitting the built-in gains tax, and, as such, are not required to include the built-in gains tax in their estimated tax payments.]
 - b. Include the S corporation excess net passive income tax when considering their individual estimated tax requirements. [This answer is incorrect. Since shareholders do not pay the excess net passive income tax, it will not affect the amount of estimated tax required.]
 - c. Make estimated tax payments as if the S corporation's pass through items were received evenly throughout the year. [This answer is correct. S corporation shareholders are required to make estimated tax payments as if the corporation's pass through items of income and loss were received evenly throughout the year.]**
 - d. Use the annualization method to determine the amount of estimated tax payments required for items of income or loss passing through from the S corporation. [This answer is incorrect. The shareholders may choose to use the annualization method but are not required to do so per the IRS.]
40. Which of the following statements is accurate regarding the shareholder's use of the annualization method to avoid the underpayment penalty? **(Page 220)**
- a. This method is available for taxpayers who receive income evenly throughout the year. [This answer is incorrect. The annualization method is available for taxpayers who do *not* receive income evenly throughout the year.]
 - b. This method is available in certain instances when a large portion of the shareholder's income is received in the first quarter of the year. [This answer is incorrect. The annualization method is available in cases when a large portion of the shareholder's income is received in the first quarter of the year; however, when this occurs, the annualization method can result in higher upfront estimated tax payments.]
 - c. This method is available for taxpayers who are only able to determine their share of the S corporation's pass-through amounts at mid-year and yearend. [This answer is incorrect. The shareholder must be able to determine his or her share of the S corporation's pass-through amounts at the end of each quarter, not just at mid-year and yearend.]

- d. This method is calculated on a cumulative basis. [This answer is correct. The annualization method is calculated on a cumulative basis whereby the required estimated payment is determined from the beginning of the year to the end of a specific quarter, and any prior quarters' payments are subtracted from that amount. This method is beneficial when a larger portion of the income is recognized after the first quarter.]

EXAMINATION FOR CPE CREDIT**Lesson 3 (T2STG102)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

33. An S corporation incurred the following taxes during the year:

I	Built-in gains tax
II	Excess net passive income tax
III	LIFO recapture tax
IV	Required payments to elect a fiscal year

For which of the above would an S corporation be required to remit estimated tax payments?

- a. I and II.
 - b. I, II and III.
 - c. IV only.
 - d. I, II, III and IV.
34. Fiscal year S corporations with annual tax deposits:
- a. Should make their first quarterly payment by the 15th day of the fourth month.
 - b. Are required to compute estimated tax payments based on 100% of the current year tax.
 - c. Must use the annualized method of computing estimated tax payments.
 - d. Are required to remit their estimated tax payments electronically.
35. Briton, Inc. is a calendar year S corporation that elected S status effective January 1, 2007, after it had operated as a C corporation for a number of years. During the current year, Briton owns some passive assets resulting in an excess net passive income tax liability of \$6,000. Last year the company incurred an excess net passive income tax liability of \$2,400. For the current year, what is the company's required first quarter estimated tax payment and due date?
- a. \$600 estimated tax payment due March 15th.
 - b. \$1,500 estimated tax payment due March 15th.
 - c. \$600 estimated tax payment due April 15th.
 - d. \$1,500 estimated tax payment due April 15th.

36. LIFO recapture tax applies to which of the following entities?
- a. A C corporation using the FIFO method.
 - b. An S corporation electing the LIFO method.
 - c. A shareholder in a C corporation converting to an S corporation.
 - d. A C corporation incurring LIFO recapture while converting to an S corporation.
37. Herron, Inc. was a C corporation that converted to an S corporation in 2010. Herron used the LIFO inventory method in 2009 and had LIFO inventory of \$100,000 (FIFO value of \$160,000). What is the corporation's 2009 LIFO recapture tax liability, assuming the corporation is subject to a 35% tax rate?
- a. \$0.
 - b. \$5,250.
 - c. \$21,000.
 - d. \$35,000.
38. As previously stated, Herron, Inc. was a C corporation that converted to an S corporation in 2010. Herron used the LIFO inventory method in 2009 and had LIFO inventory of \$100,000 (FIFO value of \$160,000). What is the S corporation's total LIFO recapture tax liability for the remaining years the tax is applicable?
- a. \$0.
 - b. \$5,250.
 - c. \$15,750.
 - d. \$21,000.
39. Identify which of the following is most correct for an S corporation remitting tax payments.
- a. Federal tax payments must be remitted with the tax return using Form 8109.
 - b. Federal tax payments must be submitted electronically using the Electronic Federal Tax Payment System.
 - c. A failure to deposit electronically when required could result in a penalty.
 - d. Section 444 payments should be remitted on the due date of the return.
40. When computing a required estimated tax payment, an S corporation shareholder:
- a. Is required to annualize income from the S corporation to compute the required estimated tax payment.
 - b. Will generally include all items flowing through from the S corporation as if earned evenly during the year.
 - c. Should include all S corporation payments of built-in gains tax and/or excess net passive income tax as withholding payments.
 - d. Will generally treat all S corporation estimated tax payments as withholding payments.

GLOSSARY

Accrued bonuses: A C corporation, electing S status can declare a bonus or accrue other expenses to a shareholder-employee. The bonus or expense will be a built-in loss (for purposes of the built-in gain rules) under certain circumstances if paid after the S election becomes effective.

Accumulated Adjustments Account (AAA): The AAA is the first tier used to determine the tax treatment of distributions when the corporation has AE&P. The AAA is used to track the undistributed net income that has been subject to tax at the shareholder level. The AAA balance generally can be distributed to the shareholder without causing additional shareholder-level tax.

Accumulated Earnings and Profits (AE&P): An S corporation only has AE&P if it was previously a C corporation or acquires another corporation that has AE&P.

Active rental trade or business: Income from an active rental trade or business is not passive investment income. A corporation can conduct an active rental trade or business only if it performs significant services or incurs substantial costs (other than depreciation) in the rental business.

Built-in gain carryover: Tax credit carryovers from a C corporation year cannot be used to reduce any S corporation tax liability other than the built-in gains tax. The credit carryovers that can offset a built-in gains tax liability are the business credit carryovers arising under IRC Sec. 39 and the minimum tax credit arising under IRC Sec. 53.

Built-in gain tax: The built-in gains tax generally applies to C corporations that make an S corporation election, and can be assessed during the ten-year period beginning with the first day of the first tax year for which the S election is effective. The built-in gains tax is imposed at the highest corporate rate (presently 35%), and is triggered by the disposition of an asset that was on hand at the time the S election became effective, if on that date the asset had a FMV in excess of its basis.

Built-in gain: Built-in gains are triggered by the "disposition" of assets that were on-hand at the time the S election became effective. Transactions such as the collection of cash-method zero-basis accounts receivable or the sale of inventory in the ordinary course of business are considered dispositions for built-in gains purposes. Also, distributions of assets to shareholders are dispositions subject to the built-in gains tax rules.

Built-in loss: Losses are built-in if an asset's basis exceeded its FMV at the S election's effective date. A built-in loss generated by the disposition of an asset is limited to the lesser of (1) the actual loss or (2) the amount by which the adjusted basis of the asset exceeded its FMV at the date the S election became effective.

Electronic deposit: A corporation that has previously had \$200,000 or less of annual tax deposits is given a one-year grace period before it must begin using EFT.

Electronic tax payment: Individuals and businesses (including S corporations) can choose to submit tax payments electronically using the Electronic Federal Tax Payment System (EFTPS). Certain S corporations are required to make all tax deposits electronically using EFTPS.

Estimated tax payment: An S corporation is required to make estimated tax payments under IRC Sec. 6655 if (1) the corporation is subject to one or more of the taxes that can be assessed at the corporate level and (2) the total of the taxes for the year is \$500 or more. The taxes that can be assessed at the S corporation level are: 1. The tax on built-in gains imposed by IRC Sec. 1374. 2. The tax on excess net passive income imposed by IRC Sec. 1375. 3. Recapture of business credits under IRC Sec. 1371(d)(2) that were originally claimed by a C corporation before it converted to S status.

Excess net passive investment income: "Excess net passive income" is defined in terms of a percentage of net passive income for the tax year. The percentage is calculated by dividing the passive investment income in excess of 25% of the gross receipts for the year by the total passive investment income. Multiplying this percentage by net passive income results in excess net passive income. Thus, if passive investment income for the year does not exceed 25% of gross receipts, there cannot be any excess net passive income.

Excess net passive investment income tax: The tax on excess net passive investment income is based on the following four elements: (1) gross receipts, (2) passive investment income, (3) net passive income, and (4) taxable income. It is assessed at the highest corporate tax rate imposed by IRC Sec. 11(b) (currently 35%).

Fair market value: An asset is subject to the tax if it was on hand at the date S status was effective and on such date had a fair market value (FMV) in excess of its basis.

FIFO inventory: An S corporation using the FIFO inventory method will almost certainly recognize the entire built-in gain associated with its inventory items in its first S corporation tax return. The FIFO method treats sales of inventory items as first out of inventory on hand as of the date of conversion to S status; post-conversion inventory acquisitions are not treated as disposed of until date-of-conversion inventory has been exhausted.

Goodwill: Appraisals of intangible assets, such as goodwill, should not be overlooked when determining the value of corporate assets on the day the S election becomes effective.

LIFO inventory: Disposition of LIFO inventory is subject to the built-in gains tax. However, sales of LIFO inventory do not result in built-in gain until the corporation invades a LIFO layer that existed prior to the beginning of its first S corporation tax year. This layer, however, is increased to the equivalent of FIFO cost because of the LIFO recapture

LIFO recapture: A C corporation using the LIFO method must recapture (i.e., recognize as income) the excess of its FIFO inventory cost over LIFO cost as of the end of the tax year preceding its first S corporation tax year. The increase in tax that results from this income inclusion is paid in four equal, annual installments, beginning with the last C corporation return.

LIFO recapture tax: To determine the incremental tax resulting from the LIFO recapture, the corporation follows these three steps: 1. Complete the tax computation schedule (Schedule J of the Form 1120) based on taxable income that includes the LIFO recapture amount. 2. On a separate worksheet (using the Schedule J format), calculate what the corporation's tax (after credits) would be if the LIFO recapture amount were excluded from taxable income. (In determining its tax without the recapture amount, the corporation may also have to recalculate some items such as alternative minimum tax, general business credits, and the foreign tax credit.) 3. Compare the tax liability that results when the LIFO recapture amount is included in taxable income with the liability that results when the recapture is excluded from income; the difference is the additional tax attributable to the LIFO recapture amount.

Net passive investment income tax: The tax on excess net passive investment income is based on the following four elements: (1) gross receipts, (2) passive investment income, (3) net passive income, and (4) taxable income. It is assessed at the highest corporate tax rate imposed by IRC Sec. 11(b) (currently 35%).

Net recognized built-in gain: Net recognized built-in gain is the amount of gain subject to the tax. This amount is limited to the smallest of (1) the overall limit, i.e., net unrealized built-in gain; (2) the current recognition limit, i.e., the amount that would be taxable income if only recognized built-in gains and recognized built-in losses were taken into account; or (3) the taxable income limit, i.e., the corporation's taxable income for the year, computed as if it were a C corporation.

Net unrealized built-in gain: The corporation's total built-in gain is normally limited to the net unrealized built-in gain (i.e., the excess of the aggregate FMV over the aggregate adjusted basis of all assets on hand as of the date the S election was effective, reduced by any previously recognized built-in gains).

Passive activity: Any rental activity, or a trade or business in which the taxpayer does not materially participate.

Passive activity loss: For purposes of the Section 469 passive activity loss rules, income or loss from a rental activity conducted by the S corporation generally is passive, regardless of whether the shareholder materially participates and regardless of whether the rented property is real or personal property.

Passive investment income: Interest is generally passive investment income. More specifically, passive investment income includes tax-exempt interest income. Also included are amounts treated as interest under IRC Secs. 483 (interest on certain deferred payments), 1272 (original issue discount), 1274 (certain debt instruments issued for property), and 7872 (loans with below-market interest rates).

Penalty for failure to deposit electronically: If a taxpayer is required to deposit electronically and deposits taxes using a coupon, the failure to deposit penalty under IRC Sec. 6656 can be assessed.

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You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS**. Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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CPE Examination Questions (Lesson 1)	185
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EXAMINATION FOR CPE CREDIT ANSWER SHEET**Companion to PPC's 1120S Deskbook—Course 2—Corporate Taxes (T2STG102)****CTEC Course No. 3039-CE-0260****Price \$79**

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add \$24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙.

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. ○	○	○	○	11. ○	○	○	○	21. ○	○	○	○	31. ○	○	○	○
2. ○	○	○	○	12. ○	○	○	○	22. ○	○	○	○	32. ○	○	○	○
3. ○	○	○	○	13. ○	○	○	○	23. ○	○	○	○	33. ○	○	○	○
4. ○	○	○	○	14. ○	○	○	○	24. ○	○	○	○	34. ○	○	○	○
5. ○	○	○	○	15. ○	○	○	○	25. ○	○	○	○	35. ○	○	○	○
6. ○	○	○	○	16. ○	○	○	○	26. ○	○	○	○	36. ○	○	○	○
7. ○	○	○	○	17. ○	○	○	○	27. ○	○	○	○	37. ○	○	○	○
8. ○	○	○	○	18. ○	○	○	○	28. ○	○	○	○	38. ○	○	○	○
9. ○	○	○	○	19. ○	○	○	○	29. ○	○	○	○	39. ○	○	○	○
10. ○	○	○	○	20. ○	○	○	○	30. ○	○	○	○	40. ○	○	○	○

You may complete the exam online by logging onto our online grading system at **cl.thomsonreuters.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1120S Deskbook—Course 2—Corporate Taxes Course Acronym: T2STG102

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☐.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
2. How would you rate the examination related to the course material?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
3. Does the examination consist of clear and unambiguous questions and statements?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
4. Were the stated learning objectives met?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
5. Were the course materials accurate and useful?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
7. Was the time allotted to the learning activity appropriate?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
8. If applicable, was the technological equipment appropriate?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
10. If applicable, how well did the audio/visuals contribute to the program?	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

Additional Comments:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____