STIMULUS PACKAGE AND THE 10 YEAR 'S' CORPORATION ELECTION

Please read if you have taken the S Corporation election. If you are a C Corporation, there may be an opportunity for you to take the S Corporation election now. If you are thinking about selling, talk to your tax advisor on the benefit to you, if any.

Recognition Period for S Corporation Built-In Gains Tax

Summary:

For a tax year beginning in 2009 or 2010, no tax will be imposed on an S corporation's net recognized built-in gain if the seventh tax year in the 10-year recognition period preceded the tax year.

Background:

A corporate-level tax is imposed on an S corporation's net recognized built-in gains attributable to assets that it held at the time it converted from a C corporation to an S corporation, if the gain is recognized during the statutorily defined recognition period (Code Sec. 1374(a)). The tax on built-in gains also applies if an S corporation sells, during the recognition period, assets that were acquired in a carryover basis transaction (e.g., a tax-free reorganization) in which the S corporation's basis in the assets is determined by reference to the C corporation's basis in the assets.

The term "net recognized built-in gain" means, with respect to any tax year in the recognition period, the lesser of (1) the amount that would be the taxable income of the S corporation if only recognized built-in gains and recognized built-in losses were taken into account or (2) the corporation's taxable income for the tax year (Code Sec. 1374(d)(2)).

For assets held by the S corporation as of the beginning of its first tax year, the recognition period is the 10-year period beginning with the first day of the first tax year for which the corporation was an S corporation (Code Sec. 1374(d)(7)).

For assets acquired from a C corporation in a carryover basis transaction, the recognition period is

the 10-year period beginning on the day the assets were acquired by the S corporation instead of the beginning of the first tax year for which the corporation was an S corporation (Code Sec. 1374(d)(8)).

The recognition period is not limited to 10 years for income resulting from the Code Sec. 593(e) treatment of pre-1988 bad debt reserves of thrift and former thrift institutions that became S corporations. Thus, distributions that trigger Code Sec. 593(e) will be subject to corporate-level recapture even if the distributions occur more than 10 years after the beginning of the recognition period (Code Sec. 1374(d)(7)).

Comment:

The built-in gains tax was enacted to prevent a C corporation from electing S corporation status to avoid a corporate-level tax on gain from unrealized appreciation of C corporation assets or gain from C corporation assets on which depreciation deductions had been taken. To avoid the built-in gains tax, the S corporation must not sell the assets during the recognition period applicable to the assets. The built-in gains tax does not apply if the assets are sold after the recognition period.

NEW LAW EXPLAINED

Ten-year recognition period for built-in gains tax temporarily reduced. --For a tax year beginning in 2009 or 2010, no tax will be imposed on the net recognized built-in gain of an S corporation if the seventh tax year in the 10-year recognition period preceded that tax year. The reduction in the recognition period applies separately with respect to any asset acquired in a carryover basis transaction pursuant to Code Sec. 1374(d)(8) (Code Sec. 1374(d)(7)(B), as amended by the American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5)).

Practical Analysis:

Charles C. Hwang, Partner, and Jennifer A. Ray, Associate, in the Tax Group at Crowell & Moring LLP, note that the Code Sec. 1374(d)(7) recognition period for net recognized built-in gains of S corporations is temporarily reduced. Code Sec. 1374 imposes an entity-level tax on an S corporation's net unrealized built-in gains that arose before the corporation's conversion from a C corporation to an S corporation and that are recognized during the "recognition period." Generally, the recognition period is the 10-year period beginning with the first day of the first year the company was an S corporation. Act Sec. 1251 of the American Recovery and Reinvestment Tax Act of 2009 temporarily reduces the recognition period for built-in gains. New Code Sec. 1374(d)(7) provides that for tax years beginning in 2009 and 2010, no tax is imposed on an S corporation's net recognized built-in gain if the seventh year in the recognition period preceded such tax year. New Code Sec. 1374(d)(7) applies to tax years beginning after December 31, 2008, but (as with Code Sec. 1374(d)(7) before this revision) does not apply to any amount includible in income by reason of distributions to shareholders pursuant to Code Sec. 593(e).

Comment:

Thus, for a tax year beginning in 2009 or 2010, in the case of gain that arose prior to the conversion of a C corporation to an S corporation, no built-in gain tax under Code Sec. 1374 will be imposed on the corporation after the seventh tax year that the S corporation election is in effect. With respect to built-in gain attributable to an asset received by an S corporation from a C corporation in a carryover basis transaction, no tax will be imposed on the corporation under Code Sec. 1374 if the gain is recognized after the date that is seven years following the date on which the asset was acquired. Shareholders will continue to take into account all items of gain and loss under Code Sec. 1366 (Conference Committee Report for American Recovery and Reinvestment Act of 2009).

Practical Analysis:

Kip Dellinger, CPA, Senior Tax Partner at Kallman And Co. LLP in Los Angeles, observes that the opportunity for existing corporations to dispose of assets in some circumstances that are otherwise subject to the built-in gains may be crucial to the survival of some companies; this is particularly true for companies dependent on the transportation industry that provide parts, services to, and repair and maintenance under subcontract to the larger companies in their industry. The built-in gains tax is often thought of as a tax if the company is sold within the 10-year conversion time frame (now seven years in some circumstances), but it actually operates to tax at the corporate level assets held at conversion and disposed of during the requisite time frames. Therefore, it can be triggered by downsizing, acting on survival decisions, or on a decision to dispose of unused assets to raise needed cash. Consequently, the relief provided in this provision should be very valuable and welcome to small family or privately-owned businesses. It may be especially valuable when coupled with the extended net operating loss carryback periods of Act Sec. 1211.

The special recognition rule for 2009 and 2010 does not apply to distributions to shareholders pursuant to Code Sec. 593(e), relating to pre-1988 bad debt reserves of thrift and former thrift institutions that became S corporations (Code Sec. 1374(d)(7)(C), as amended by the 2009 Recovery Act). Such distributions under Code Sec. 593(e) continue to be subject to corporate-level taxation without regard to when the distributions occur.

Practical Analysis:

Michael Schlesinger, a partner in Schlesinger & Sussman of New York, New York and author of *Practical Guide to S Corporations* (4th edition), points out that a reduction in Code Sec. 1374's conversion period to seven years is beneficial. However, the key to minimizing and possibly eliminating Code Sec. 1374's tax bite is planning both before the C corporation converts to S status and during the conversion period. An example of tax planning before conversion would be the sale of appreciated assets by the C corporation so that there is only one level of taxation instead of two as would possibly occur under Code Sec. 1374. Caution must be exercised however in that the sale of appreciated assets will generate earnings and profits exposing the S corporation to tax under Code Sec. 1375 if the S corporation has at least one dollar of these earnings and profits at the time of conversion and has more than 25 percent of its gross receipts arising from passive investment income. Further, there could be loss of S status under Code Sec. 1362(d)(3) if the S corporation has at least 25 percent of gross receipts from passive investment income for three consecutive years and

earnings and profits from a predecessor C corporation.

While there are various ways to avoid the trap generated by Code Secs. 1375 and 1362(d)(3), this requires advance planning. One means is to fail one of the tests under Code Secs. 1375 and 1362(d)(3) such as distribution of the C corporation's earnings and profits prior to or during conversion; however, to avoid a termination under Code Sec. 1362(d)(3), the distribution must occur before the expiration of three consecutive years where the corporation has more than 25 percent of its gross receipts from passive investment income in each of these years. Another is to eliminate any passive investment income for the S corporation by making it "active."

Reg. §1.1362-2(c)(5)(ii)(B)(2) prescribes that in the case of rents (one of the categories of passive investment income), the income will be treated as "active" and lose its passive taint if the rents are "derived in an active trade or business of renting property." The determination of whether there is "an active trade or business" is a fact one and there are a slew of private letter rulings which address this issue. An example where "active income" was found for an S corporation was in LTR 200128025 (Apr. 12, 2001) where the corporation through its full-time and part-time employees, as well as through outside vendors and independent contractors, provided services to various properties including maintenance of common areas and facilities; maintenance and repair of structural portions of the properties, including foundations, exterior walls, and roofs; parking lot and sidewalk repair; making and supervising of tenant improvements.

During Code Sec. 1374's conversion period, various steps can be undertaken to minimize or eliminate Code Sec. 1374's tax. Some key means follow:

(1) Instead of selling appreciated assets, do tax-free exchanges.

(2) If there are C corporate net operating loss carryforwards, Code Sec. 1374 allows these losses to offset Code Sec. 1374's built in gains. Thus, if at the time of conversion, the S corporation did not dispose of appreciated assets, a sale of the appreciated assets before the expiration of the carryforward for the C net operating losses utilizing these losses will reduce Code Sec. 1374's tax.

(3) Engage in leasing or licensing the appreciated assets, mindful that the income generated will be passive investment income and subject to the tax effects of Code Secs. 1375 and 1362(d)(3) if these tax provisions apply, subject to the discussion as outlined above.

(4) Since one measure of Code Sec. 1374's tax is taxable income, minimize its effect by declaring

bonuses to shareholder-employees. However, Code Sec. 1374's tax is geared to C corporate standards, so care must be utilized to prevent a challenge by the IRS for unreasonable compensation.

(5) Contribution of appreciated property to a charity. LTR 200004032 (Oct. 26, 1999) held that when an S corporation contributes appreciated property to a charity, there is no gain or loss recognition under Code Sec. 1374.

(6) Allocation of the purchase price to non-Code Sec. 1374 items. An example of such an allocation occurred in *Martin Ice Cream Co.*, 110 TC 189, Dec. 52,624 (1998) where a sale of an oral distribution agreement was deemed personal to an S corporate shareholder and not a corporate asset subject to Code Sec. 1374.

Practical Analysis:

John A. Sikora, J.D., Partner in the Milwaukee and Delafield offices of Weiss Berzowski Brady LLP, notes that Act Sec. 1251 of the American Recovery and Reinvestment Act of 2009 temporarily reduces the "recognition period" applicable under the S corporation built-in gains tax rules from 10 to seven years. The revision applies only to built-in gains recognized in tax years beginning in 2009 and 2010.

The rules relating to the tax on S corporation built-in gains were revised substantially in 1986. Before revision, a corporate-level tax generally applied for only a three-year period following conversion to S corporation status and then only if the corporation had relatively substantial net capital gain income.

The 1986 change coincided with the repeal of provisions which, under certain circumstances, permitted liquidation of a corporation without incurring a "double-level" tax upon the prior sale of its assets or the distribution of its assets to the shareholders in liquidation, which (double tax) is now generally the case (except for certain complete liquidations of subsidiaries) under Code Secs. 331 and 336. See Code Secs. 336 and 337 as in effect prior to the Tax Reform Act of 1986 (P.L. 99-514).

Following the effective date of the 1986 changes to the corporate liquidation provisions (beneficial transitional rules applied to certain small corporations for 1987 and 1988), corporations generally recognize all gains realized on the sale or distribution of their assets and a shareholder recognizes gain upon liquidation of the corporation if the value of the property distributed to the shareholder exceeds the basis in the stock (i.e., together the corporation and shareholders are potentially subject to a "double-level" tax). The principal reason for extending the built-in gains tax recognition period

to 10 years and making the tax applicable to all gains recognized by an S corporation in 1986 was to prevent corporations contemplating liquidation, perhaps following a sale of the corporation's business, from circumventing the revised liquidation rules by electing S corporation status (and its general "single-level" tax regime) before the applicable transactions. The apparent expectation was that time period was sufficient because few corporations would plan a business sale or complete liquidation more than 10 years in the future (or that even if a corporation did so, waiting 10 years justified imposing essentially only a "single-level" tax).

The 10-year built-in gains tax rule has inhibited sales of appreciated assets by S corporations subject to it. Depending on the nature of the asset, the character of any resulting gain and the tax rates then in effect, the combined effective built-in gains tax and shareholder tax rate on the corporation's disposition of an asset that it held at the time of the conversion to S status could exceed 50 percent. The post-1986 built-in gain tax provisions also often affect the overall structure of asset dispositions; for example, an S corporations that converted from C corporation status is frequently willing to dispose of assets within 10 years only if it can do so in circumstances in which gain will not be recognized (such as, for example, under Code Sec. 1031). The provision has also motivated sellers of S corporation businesses to negotiate for the sale of the corporate stock, rather than the corporation's assets, if a business sale is under consideration during the built-in gains recognition period. Finally, the 1986 changes to the corporate liquidation and built-in gains tax provisions have motivated corporations for which sale of the business is a possibility in the relatively long term (i.e., more than 10 years in the future) to consider making an S election currently.

Act Sec. 1251 of the 2009 Recovery Act revises paragraph (7) of Code Sec. 1374(d) to add a new subparagraph (B) applicable to tax years of the S corporation beginning in 2009 or 2010. No built-in gains tax is imposed on gains recognized in such years if "the 7th tax year in the recognition period preceded" the 2009 or 2010 tax year. In other words, for 2009 and 2010, the recognition period under Code Sec. 1374 for imposition of the built-in gains tax has generally been reduced from 10 years to 7 years. By way of example, if a C corporation elected S status for its tax year beginning on January 1, 2002, it will be entitled to sell appreciated assets it held on that date during 2009 (and 2010) without being subject to tax under Code Sec. 1374. (Note, however, that in the case of assets described in Code Sec. 1374(d)(8), the recognition period runs from the date the assets are acquired by the S corporation rather than from the beginning of its first S corporation year.)

Because the change applies only to tax years beginning in 2009 or 2010, the principle that motivated extension of the built-in gains tax period to 10 years in 1986 will not be adversely affected. A corporation that elected S corporation status more than seven years prior to the 2009 tax year could not have anticipated the change included in the Act and, because the change applies only to gains recognized in 2009 and 2010, no C corporation now planning to sell its business or to liquidate can elect S status and obtain the benefit of the temporary changes made by the 2009 Recovery Act.

➢**Effective date.** The amendment is effective for tax years beginning after December 31, 2008 (Act Sec. 1251(b) of the American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5)).

Law source: Law at ¶5295. Committee Report at ¶10,300.

-- Act Sec. 1251(a) of the American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5), amending Code Sec. 1374(d)(7);

-- Act Sec. 1251(b), providing the effective date.

Reporter references: For further information, consult the following CCH reporters.

-- Standard Federal Tax Reporter, ¶32,203.021

-- Tax Research Consultant, SCORP: 356

-- Practical Tax Explanation, §28,305.15

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