PacificCPE

S Corportations: Corporate Income Taxes and Credits

Course # 3281A

Taxes

2 Credit Hours

Support@PacificCPE.com | (800) 787-5313

PacificCPE.com

S CORPORTATIONS: CORPORATE INCOME TAXES AND CREDITS

This course covers the tax rates and credits that affect S corporations

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Corporate Income Taxes and Credits

Study the course materials from pages 1 to 46

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recognize the tax rates and credits that affect S corporations

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

TABLE OF CONTENTS

CHAPTER 1: CORPORATE INCOME TAXES AND CREDITS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the tax rates and credits that affect S corporations.

101 CORPORATE TAX LIABILITIES

An S corporation can be liable for income tax (at the *corporate* level) for the following: built-in gains, passive investment income, and LIFO inventory recapture. All three of the income taxes imposed on an S corporation occur only after a C corporation has switched to an S corporation or an S corporation has acquired a C corporation.

102 BUILT-IN GAINS TAX

.01 Background and Net Recognized Built-In Gains

Background. Congress recognized a problem shortly after creating S corporations in 1958—that corporations could use the S status to avoid double taxation, particularly with the capital gains tax. Example 1-1 illustrates the type of abuse that Congress was concerned about in changing the law.

Example 1-1

A C corporation, Jacobi Inc., foreseeing large capital gains in the following year, adopted the S status for that tax year, passing the capital gains and distributing money equal to the capital gains to its shareholders. The next year, Jacobi Inc. terminated its S election and continued to conduct business. By adopting the C-S-C approach, the corporation avoided any capital gains tax at the C level and was able to pass its gains to its shareholders.

To prevent such tax avoidance, Congress in 1966 imposed a tax on built-in gains by adopting Code Sec. 1378. When the Subchapter S Revision Act of 1982 was adopted, Code Sec. 1378 became Code Sec. 1374. Code Sec. 1374 has been modified several times since then with its purpose (as was its predecessor's) being to impose tax hurdles on C corporations converting to S status with appreciated assets.

Net recognized built-in gains. Code Sec. 1374 imposes a corporate level tax ("built-in gains tax") on S corporations which dispose of assets that appreciated in value during the years the S corporation was a C corporation. Any net recognized built-in gain that the S corporation has for a tax year is taxed

at the highest corporate rate, currently 21 percent. The tax applies to built-in gains recognized during a recognition period. For taxable years before 2009 the recognition period was the ten-year period beginning on the date the C corporation converted to S status; then it was changed to seven years for 2009 and 2010 (i.e., the "recognition period"). For tax years beginning in 2011 through 2014, Code Sec. 1374's recognition period was five years and for tax years beginning with 2014, Congress has continued the five-year recognition period. This recognition period applies as well when an S corporation acquires C corporate assets in a carryover basis transaction such as in a merger under Code Sec. 368. The "net recognized built-in gain" is defined as the lesser of (1) the amount that would be the S corporation's taxable income if only recognized built-in gain and loss were taken into account or (2) the corporation's taxable income for the tax year computed with the modification listed in Code Sec. 1375(b)(1)(B).

Example 1-2

Grayson Inc., a calendar-year, cash-basis C corporation, converts to S status on January 1, 20XX. At the time of conversion, it has only one asset, a piece of land with a basis of $100 and a fair market value of $300. Two years after conversion, Grayson Inc. sells the land for $700. Grayson Inc. will pay a tax under Code Sec. 1374 on $200 of the gain ($300 – $100), passing the gain, net of the tax paid, to its shareholders. Assuming a built-in gains rate of 21% at the time of sale, the shareholders will receive their allocation of the net gain after tax, $158 ($200 – (.21 × $200)), plus their allocation of the remainder of the gain, $400 ($700 – $300).

The key to understanding Code Sec. 1374 is "recognized built-in gain." If there is no recognized built-in gain, then there is no tax on disposition of the C corporation assets. Assuming Grayson in Example 1-2 acquired the land on January 1, 2013 and sold the land on January 1, 2018, Grayson Inc. would not be subject to any Code Sec. 1374 taxation because it held the land beyond Code Sec. 1374's built-in gain recognition period of five years. If in Example 1-2, if the land was sold for $100 or less, during Code Sec. 1374's recognition period, there would be no recognized built-in gain. Selling a C corporation asset for its book value at the time of conversion may be unrealistic, however. Fortunately, there are ways to minimize (and in some instances, avoid entirely) the built-in gains tax.

The Code provides rules for determining recognized built-in gain (and recognized built-in loss) and for determining built-in income (and deduction) items. Any gain recognized by an S corporation during the recognition period is presumed to be a recognized built-in gain unless the S corporation shows that it did not hold the asset on the first day of the recognition period or there was no appreciation at the time of the conversion. Similar rules apply to any loss recognized during the recognition period. Gain or loss recognized may come from sales or exchanges. A gain or loss resulting from transactions other than sales or exchanges is also taken into account under the built-in income (and deduction) rules (e.g., distribution of appreciated property to shareholders).

The built-in gains tax is not a subjective tax depending on the taxpayer's motive; rather, it is a mechanical one geared to statutory definitions. Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the first taxable year for which the

corporation was an S corporation shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account.

Under the regulations, an S corporation's items of income or deduction generally are treated as recognized built-in gain or loss if the item would have been taken into account before the recognition period by a taxpayer using the accrual method. The accrual method is used because valuing items of income and deduction on the first day of the recognition period would be unduly burdensome both for S corporations, many of which are small businesses, and the IRS.

The regulations also adopt special rules for determining recognized built-in gain and loss in the case of (1) positive and negative income adjustments under Code Sec. 481(a), (2) cancellation of indebtedness income and bad debt deductions, (3) income and deductions reported under the completed contract method, (4) income from sales or exchanges reported under the installment method, and (5) the distributive share of partnership items of income, gain, loss, and deduction.

Revocation and re-election of S corporate status. When Code Sec. 1374 was amended in the Tax Reform Act of 1986 to prescribe a ten-year measuring period for Code Sec. 1374 instead of a three-year one, Congress provided a transitional rule in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) for C corporations that made an election to be an S corporation before January 1, 1989. In *Colorado Gas Compression, Inc. v. Commissioner*, the Court reviewed a unique situation involving the transition rule. The C corporation elected S status during the transition period in 1988, and then revoked the election on December 1, 1989. Subsequently, the C corporation re-elected S status effective January 1, 1994. The corporation sold assets during the years 1994 through 1996. The Court held that the 1998 election was made during the transition period when Code Sec. 1374's three-year rule applied.

The Service, in response to this decision, promulgated Reg. § 1.1374-8 and Reg. §1.1374-10 to provide that the S corporation's most recent election, not an earlier election which had been revoked or terminated, is to be utilized to determine the measuring period for Code Sec. 1374's rules. Under Reg. § 1.1374-8 and Reg. §1.1374-10, the corporation in *Colorado* would have been held to a ten-year measuring period under Code Sec. 1374, not the three-year one, as the Court decided. It remains to be seen what effect Reg. § 1.1374-8 and Reg. § 1.1374-10 will have on future Court decisions on this point.

.02 Comparison to the Passive Investment Income Tax

It is possible for an S corporation to be subject to both the built-in gains tax and the passive investment income tax. However, the chance of being liable for both taxes is rare since the passive investment income tax cannot be imposed unless the S corporation has C corporation earnings and profits and the S corporation has passive investment income. The built-in gains tax will be imposed whether or not there are C corporation earnings and profits.

.03 Computing the Built-In Gains Tax

To compute the built-in gains tax, Reg. § 1.1374-1(a) prescribes that the tax imposed on the income of an S corporation by Code Sec. 1374(a) for any tax year during the recognition period is computed using the following four steps: