Timing of S Election Can Minimize Double Taxes on Gains

Corporations that are considering electing S status have the option of being subject to the old corporate level tax on capital gains or the new built-in gains tax. The key is the timing of the election.

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The Tax Reform Act of 1986 (TRA '86) substantially changed the scope of Section 1374. Although these changes, which impose a corporate level tax on certain gains of S corporations, generally became effective in 1987, certain corporations are still governed by old Section 1374 by virtue of the transition rules in TRA '86.

Under the Technical Corrections and Miscellaneous Revenue of 1988 Act ('88 Act)[1], whether the S election is filed in 1988 or 1989 may determine whether the old or new Section 1374 applies.

While old Section 1374 was generally more favorable than new Section 1374, there are situations in which new Section 1374 will be more favorable.

Old Section 1374

Under prior law, if an S corporation's net capital gain (*i.e.*, the excess of its net long-term capital gain over its net short-term capital loss)[2] was more than 50% of its taxable income, the S corporation was generally subject to capital gains tax on its net capital gain as if it were a C corporation. The capital gain, less the amount of tax payable by the S corporation, then passed through to the shareholders as capital gains.[3]

There were three exceptions to this general rule:

1. The first $25,000 per year of capital gain was exempt from this tax.
2. The tax could not exceed the tax which the corporation would have paid on its entire taxable income if it were a C corporation.
3. The tax did not apply to corporations which were always S corporations or which were S corporations during each of the three immediately preceding years.

New Section 1374

The TRA '86 changed the rules governing the corporate level tax on gains of S corporations under Section 1374. New Section 1374 imposes a tax at the corporate level if an S corporation has a "recognized built-in gain" for any taxable year beginning in the "recognition period." The recognition period is the ten-year period beginning on the first day of the first taxable year for which the corporation is an S corporation. The "recognized built-in gain" is the gain recognized during the recognition period, to the extent it is attributable to unrealized gain as of when the corporation became an S corporation. The tax is imposed at the highest corporate tax rate specified in Section 11(b), which is presently 34%.

For example, if an S corporation has an asset with a basis of $100 which has a fair market value of $200 when it becomes an S corporation, and it sells the asset for $300 during the recognition period, the $100 of built-in gain will be subject to tax at the corporate level.

The changes in Section 1374 made by TRA '86 generally became effective for taxable years beginning after 1986.[4] However, the new rules do not apply to corporations which filed S elections before 1987. These corporations remain subject to the old rules. For this purpose, the effective date of the S election does not matter, so long as the S election was filed before 1987.[5]

In addition, certain small corporations are generally subject to the old rules (and not the new rules) if they become S corporations for taxable years beginning before 1989. For this transition rule to apply, more than 50% of the stock must be held by ten or fewer shareholders (with certain attribution rules) at all times since August 1, 1986, and the value of the corporation cannot exceed $5 million. This transition rule is phased out as the value of the corporation increases from $5 million to $10 million.[6]

The transition rule is not elective.

The transition rule for certain small corporations does not apply to the following items, which are always subject to new Section 1374 if the S election is filed after 1986:

1. Ordinary gains and losses (determined without regard to Section 1239).
2. Short-term capital gains and losses.
3. Gains from the disposition of installment obligations.[7]

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Under TRA '86, the transition rule is only available for corporations whose S elections are effective before January 1, 1989. Thus, without the '88 Act, the only corporations which could still choose whether to come under the old or new version of Section 1374 are small corporations qualifying for the transition rule with fiscal years ending during the period beginning two months and 15 days before the S election is filed and ending on November 30, 1988. If the corporation uses any other fiscal year, or the calendar year, the earliest that the S election can become effective is January 1, 1989, which is too late to qualify for the transition rule. A corporation cannot automatically change its fiscal year so as to make an S election for its first fiscal year following the change.[8] For example, a corporation cannot automatically change to a November 30 fiscal year so as to make an S election for a fiscal year beginning December 1, 1988.

However, under the '88 Act, the transition rule applies (if all other requirements are met) if the S election is filed by December 31, 1988,[9] even if the S election does not become effective until 1989. Thus, corporations otherwise eligible for the transition rule can choose old Section 1374 by filing S elections in 1988, or new Section 1374 by filing S elections after 1988.

This presents a trap for the unwary. Since the transition rule is not elective, corporations qualifying for the transition rule which file S elections in 1988, to become effective in 1989, will come under old Section 1374 if the relevant provision of the TCA '88 passes, even if they intended to come under new Section 1374. Thus, such corporations should wait until after December 31, 1988, to file their S elections, to ensure that they will not inadvertently fall within the transition rule.

Comparison between old and new Sections 1374

The principal differences between old Section 1374 and new Section 1374 are as follows:

1. Old Section 1374 applied only to gains during the first three years that an S election is in effect.

Thus, if a corporation waited until the fourth year that its S election was in effect before recognizing a capital gain, the tax under old Section 1374 did not apply.

2. Old Section 1374 did not apply to the first $25,000 per year of net capital gain. Moreover, the tax did not apply at all unless the net capital gain exceeded 50% of the total taxable income. An S corporation could thus completely avoid the tax under old Section 1374 by using the installment method so that its capital gain recognized during each of its first three years of S status would not exceed the greater of $25,000 or 50% of its taxable income.[10]

An S corporation could avoid old Section 1374 with installment sales.

3. Old Section 1374 did not apply to ordinary gains such as depreciation recapture, gains on the sale of appreciated inventory and the collection of receivables by cash method corporations. However, the Internal Revenue Service takes the position that all of these items are subject to new Section 1374,[11] and the '88 Act makes this result clear.[12] This is a serious problem for professional and other service corporations which have no basis (and hence have built-in gains) in their receivables.

4. Under old Section 1374, the tax was limited to the tax which would have been imposed if the corporation were not an S corporation.[13] Thus, the corporation got the benefit of the graduated corporate tax rates on the first $75,000 of taxable income under Section 11(b).

Under TRA '86, the tax under new Section 1374 is limited to 34% of the corporation's taxable income as if it were not an S corporation.[14] This protects cash method corporations such as professional and other service corporations, which generally do not have significant taxable income in any year, even though they may have substantial receivables containing built-in gain at any given time. However, under the '88 Act, if a corporation files its S election after March 30, 1988, the excess of its reorganized built-in gains over its taxable income is carried over and treated as a recognized built-in gain in the following year. Professional and other service corporations should consider the effect of this carryover provision when making S elections.

5. New Section 1374 only applies to built-in gains (*i.e.*, unrealized appreciation) as of the time the S election first becomes effective. The amount subject to the tax is limited to the lesser of the built-in gain on the asset disposed of or the aggregate built-in gain on all of the corporation's assets.[16] Old Section 1374, by comparison, applied to capital gains regardless of whether they were attributable to appreciation occurring before or after the effective date of the S election.

Thus, corporations which do not have substantial built-in gain may prefer the new Section 1374. Although they will remain exposed to potential corporate level tax for ten years rather than three years, the maximum exposure can be quantified in advance. Such corporations should consider having their assets appraised at the time their S elections become effective.

6. Under new Section 1374, an S corporation can use its net operating loss carryovers (and, under the '88 Act, its capital loss carryovers) and its investment credit and other business credit carryovers from when it was a C corporation to offset its Section 1374 tax.[17] Under old Section 1374,

[1] H.R. 4333, S. 2238 (100th Cong., 2d Sess.) (1988).
[2] Section 1222(11).
[3] Sections 1366(b) and 1366(f)(2).
[4] TRA '86, Section 633(b).
[5] TRA '86, Section 633(b); *Rev. Rul.* 86-141, 1986-2 CB 80.
[6] TRA '86, Section 633(d).
[7] TRA '86, Section 633(d)(2).
[8] Reg. 1.442-1(c)(2)(v); Reg. 1.442-2T(d)(3).
[9] '88 Act, Section 1006(g)(7), amending TRA '86 Section 633(d)(8).
[10] *Ltr. Ruls.* 8704042 and 8649032.
[11] Announcement 86-128, 1986-51 IRB 22.
[12] '88 Act, Section 1006(f)(6)(A), adding new Section 1374(d)(5)(A).
[13] Section 1374(b)(2), prior to amend. by TRA '86.
[14] Sections 11(b) and 1374(b)(1)(B).
[15] '88 Act, Section 1006(f)(5)(A), amending Section 1374(d)(2).
[16] Section 1374(d)(1).

these deductions and credits were not available for this purpose. Thus, corporations having loss and credit carryovers may prefer to come under new Section 1374.

Eligibility requirements

In order to be eligible to make an S election, a corporation must be a "small business corporation" as defined in Section 1361(b). In other words, it may not have more than 35 shareholders, any shareholders other than individuals, estates and certain types of trusts, any nonresident alien shareholder or more than one class of stock. In addition, it may not be a member of an affiliated group, a bank, an insurance company, a Section 936 corporation, a DISC or a former DISC.

All of these requirements must be met on the day the S election is filed, even if the S election does not take effect until a future date.[18] In addition, if a corporation desires to make an S election during the first two months and 15 days of its taxable year retroactive to the beginning of that year, it must have met all of the eligibility requirements at all times between the beginning of the year and the filing of the S election.[19]

Although old Section 1374 is generally preferable to new Section 1374 due to the shorter exposure period (three years rather than ten years), corporations with little or no built-in gain or with loss or credit carryovers may prefer to be governed by new Section 1374. To ensure that new Section 1374 will apply even if TCA 1988 is enacted, such corporations should wait until after December 31, 1988, to file their S elections. ■

[17] Sections 1374(b)(2) and 1374(b)(3); '88 Act, Section 1006(f)(2).
[18] Reg. 1.1372-1(a).
[19] Section 1362(b)(2)(B)(i).