Larry's Tax Law

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part I – The Built-In-Gains Tax

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In October 2023, I authored a new White Paper, *A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary.* This year, in a multi-part article, I intend to take our blog subscribers through some of the most significant changes made to Subchapter S over the past 40 years, (i) pointing out some of the not-so-obvious aspects of these developments, (ii) alerting readers to some of the obscure traps that were created by these changes, and (iii) arming readers with various methods that may be helpful in avoiding, minimizing or eliminating the adverse impact of the traps. This first installment is focused on one area of Subchapter S – the Built-In-Gains Tax.

Brief History of Subchapter S

In 1954, President Eisenhower recommended legislation that would minimize the influence federal income tax laws had on the selection of a form of entity by closely held businesses. Congress did not act on the president's recommendation, however, until 1958. Interestingly, the new law was not contained in primary legislation. Rather, the first version of Subchapter S was enacted as a part of the Technical Amendments Act of 1958. The legislation was, at best, an afterthought.

The original legislation contained numerous flaws and traps that often caught the unwary, resulting in unwanted tax consequences. Among these flaws and traps existed: (i) intricate eligibility, election, revocation and termination rules; (ii) complex operational priorities and restrictions on distributions; (iii) a harsh rule whereby net operating losses in excess of a shareholder's stock basis were lost forever without any carry forward; and (iv) a draconian rule whereby excessive passive investment income caused a retroactive termination of the S election (i.e., all of the way back to the effective date of the S election). Due to these significant flaws, tax advisers rarely recommended Subchapter S elections.

Fast forward 24 years when tax advisers saw the enactment of the Subchapter Revision Act of 1982 (the "82 Act"). The 82 Act removed most of these flaws or reduced the negative impact of the existing traps.

Four years later came the Tax Reform Act of 1986 (the "86 Act"). With the enactment of the 86 Act, we saw the repeal of the General Utilities Doctrine, and the inversion of the individual and corporate rate structures. These revisions to the Code, among others, changed the landscape, making Subchapter S the most desired form of business entity of the time.

Unfortunately, the 86 Act and the myriad of tax law changes impacting Subchapter S that followed over the next four decades created several not-so-obvious rules and traps for unwary taxpayers and their advisers. Some of these changes that created potentially treacherous grounds for taxpayers and their advisors are contained in Code Section 1374 – the Built-In-Gains Tax.

The Built-In-Gains Tax

Background

Prior to the 86 Act, the Built-In-Gains Tax (the "BIG tax") generally only applied to the net pre-S corporation appreciation in capital assets, and the recognition period was only three years. As you may recall, the General Utilities Doctrine allowed C corporations to potentially distribute appreciated property to their shareholders without recognition of gain at the corporate level. With its repeal, Congress felt it was necessary to revamp the BIG tax so that C corporation taxpayers could not side-step this change in the law by making an S election, waiting three years to avoid the application of Code Section 1374, and then distribute its assets to the shareholders in a single tax liquidation. With that goal in mind, the 86 Act broadened Code Section 1374 to apply to the net pre-S corporation appreciation in all assets (capital and non-capital assets). Also, it increased the recognition period from three years to ten years.

Fast forward 23 years. In 2009, Congress tinkered with the recognition period, temporarily reducing it to seven years. In 2011, Congress temporarily reduced it to five years. Finally, as part of the PATH Act, in 2015, Congress permanently set the recognition period at five years, where is remains today.

As you likely know, the general rule is that a former C corporation or an S corporation that acquires assets from a C corporation in a carry-over basis transaction (such as a merger) is potentially subject to the BIG tax if it realizes and recognizes gain from the disposition of its BIG assets within the recognition period.

In 1990, without a lot of fanfare, Treasury issued Notice 90-27. In that notice, the government informed taxpayers that it would be issuing regulations to clarify an exception to the rule that the BIG tax is only applicable to gain recognized during the recognition period. On December 8, 1992, it issued those regulations in proposed form. The regulations were finalized two years later, on December 23, 1994.

Treasury Regulation Section 1.1374-4(h)(1) / Extension of the Recognition Period

Treasury Regulation § 1.1374-4(h)(1) is an obscure regulation. It expressly tells us that gain from the disposition of BIG assets that occurs within or before the “recognition period” will be subject to the BIG tax after the “recognition period” expires if the gain is reported on the installment method under the Code § 453(a) following the expiration of the recognition period. In other words, the regulation extends the recognition period in this instance. Accordingly, taxpayers cannot avoid the BIG tax by deferring payments beyond the “recognition period” using an installment note.

EXAMPLE 1: Corporation X, a C corporation, elected S effective January 1, 2019. At that time, Corporation X had two assets, namely, Whiteacre, with a FMV on that date of $8,000,000 and an adjusted basis of $1,000,000, and Machinery with a FMV of $1,300,000 and an adjusted basis of $2,300,000. Accordingly, it had $6,000,000 of Net Unrealized Built-in Gain (total FMV of $9,300,000 less total adjusted basis of $3,300,000 = $6,000,000). If Corporation X sells Whiteacre on January 1, 2023, for $12,000,000 cash, it will realize and recognize a gain of $11,000,000, of which $6,000,000 is subject to the BIG tax (remember, your built-in gain cannot exceed the net unrealized built-in gain, which is normally the net built-in gain existing at the effective date of the S election).

EXAMPLE 2: Let’s change the facts. Corporation X actually sold Whiteacre on January 1, 2023, for $12,000,000 on an installment note calling for monthly interest only payments during 2023 and a balloon payment of all principal on June 1, 2024. At first blush, it appears Corporation X avoided the BIG tax as the recognition of the gain will not occur until after the expiration of the five-year recognition period. Unfortunately for Corporation X, in accordance with Treasury Regulation § 1.1374-4(h)(1), gain from the disposition of BIG assets that occurs within or before the “recognition period” will be subject to the BIG tax after the “recognition period” expires if the gain is reported on the installment method under the Code § 453(a). So, Corporation X will report the built-in gain in 2024 when it recognizes the gain even though the recognition period officially expired six months earlier (on January 1, 2024). There are some things Corporation X could have done to avoid the wrath of Treasury Regulation § 1.1374-4(h)(1), including delaying closing the sale of Whitacre until after January 1, 2024, avoiding the BIG tax entirely.

Taxable Income Limitation

What is known as the “Taxable Income Limitation” could have offered shelter to Corporation X from the BIG tax in the examples above. Often overlooked or forgotten by tax advisors is Code Section 1374(d)(2), which provides:

The net recognized built-in gain for the taxable year cannot exceed the S corporation's taxable income for the taxable year determined as if it were a C corporation.

Accordingly, if the excess of the corporation's recognized built-in gain over the recognized built-in loss for the taxable year exceeds its taxable income, the amount subject to the penalty tax under Code § 1374 is limited to the taxable income of the corporation. The taxable income limitation places a premium on creating deductions in the year in which built-in gain is recognized by an S corporation. If the corporation's taxable income can be reduced to zero, no Built-In-Gains Tax will be imposed. Consequently, accelerating allowable deductions in the years that built-in gain is recognized can eliminate or reduce the impact of the BIG tax. Payments of compensation, as an alternative to distributions, creates deductions and thereby reduces taxable income. However, the success of this strategy depends upon compensation payments being "reasonable" and for actual services rendered.

Prior to 1988, if the taxable income limitation reduced or eliminated the recognition of the BIG tax in a tax year, the BIG tax was eliminated forever – in other words, the tax would not be recognized in future years when the corporation had sufficient income. The Technical and Miscellaneous Revenue Act of 1988, also known as TAMRA 1988, however, changed the terrain. In accordance with Code § 1374(d)(2)(B), if the taxable income limitation applies, then the excess of the corporation's net recognized built-in gain over its taxable income is treated as recognized built-in gain in the succeeding taxable year(s).

PRACTICE ALERT: Unlike the indirect extension of the recognition period caused by using the installment method to report built-in gain, the taxable income limitation does not extend the recognition period. So, if the taxable income of the S corporation, computed as if it was a C corporation, is zero for each tax year during the remainder of the recognition period, the corporation may escape the wrath of the BIG tax altogether.

EXAMPLE 3: Corporation Y, formerly a calendar year C corporation, elects S status on January 1, 2023. Corporation Y has two assets on that date: one with a FMV of $1,000,000 and a basis of $100,000; the other with a FMV of $200,000 and a tax basis of $300,000. Therefore, "net unrealized built-in gain" of Corporation Y is $800,000 ($900,000 of built-in gain less $100,000 of built-in loss).

If Corporation Y sells both assets on January 2, 2023, its net recognized built-in gain would be $800,000. Assume, however, that because of other deductions, Corporation Y's taxable income in 2023 is reduced to zero. In that case, no penalty tax would be imposed in 2023. The $800,000 of built-in gain would be carried over and treated as recognized built-in gain in 2024 or future taxable years within the "recognition period," provided Corporation Y has sufficient

taxable income in such year(s). If, of course, Corporation Y could reduce its taxable income to zero each tax year through the end of 2027, it would totally escape the BIG tax.

In Example 3, if Corporation Y cannot reduce its taxable income to zero using reasonable deductions in each of the years remaining of the recognition period, there may be other ways to avoid incurring the BIG tax, including:

1. Corporation Y could zero out income in 2023 (the year it realized the built-in gain) and on or before March 15, 2024, revoke its S election, effective January 1, 2024. It would totally avoid the BIG tax. The downside is that it could not reelect S status for five years.
2. If Corporation Y recognizes the problem early (that is, on or before the 15th day of the third month of the taxable year), it could retroactively revoke the S election.
3. If the issue is caught after the 15th day of the third month of the taxable year, making sure its taxable income computed year to date is zero or nominal, Corporation Y could cause the termination of its S election by transferring shares to an ineligible shareholder or by creating and issuing a second class of stock. In such cases, there would be a short S and a short C year. The BIG tax would be limited to the taxable income attributable to the short S year. The bottom line is: The income limitation could be your friend. **Don't forget it.**

Reverting back to Examples 1 and 2 above, Corporation X elected S status effective January 1, 2019. If it had sold Whiteacre on January 1, 2023 on an installment note that required the payment of interest only in 2023 and a balloon payment of the principal on January 1, 2024 (a day after the recognition period ended), it could have possibly avoided the BIG tax by (1) electing out of installment reporting, (2) taking the gain into income in 2023, and (3) zeroing out its taxable income by taking ordinary, necessary and reasonable deductions. In that case, the recognition period would not be extended by the use of an installment note. Be careful, the Service will scrutinize the harvesting of deductions to use the income limitation. This is one of the instances where unreasonable compensation in the case of shareholder employees of an S corporation could be problematic.

PRACTICE ALERT: One more word on this topic – You can use C corporation tax attributes to reduce or eliminate the BIG tax. In general, we are talking about the carry-over of C corporation credits and NOLs. Don't forget this precious tool. It is contained in Code Section 1374(b).

Not-So-Obvious Triggers of the BIG Tax

When we think of BIG tax triggers, we think of straight taxable dispositions of BIG assets. There are, however, quite a few not-so-obvious triggers. I want to mention six of them.

Possible Trigger #1 is taxable Code Section 1031 exchanges and taxable Code Section 1033 condemnations, thefts or seizures.

In general, if all of the requirements of Code Section 1031 are satisfied, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment. That sounds well and good. Unfortunately, many impediments to obtaining total tax deferral exist, including: failing to meet any of the many Section 1031 statutory and regulatory requirements; having "boot" involved in an otherwise qualifying exchange; or disposition of the exchange property by either party within two years following a related party exchange. This sets the stage of a potential disaster for a corporation that is subject to the Built-In-Gains Tax under Code Section 1374.

If a corporation (that is otherwise subject to the Built-In-Gains Tax) disposes of a BIG asset within the "recognition period" in a transaction that qualifies for tax deferral, no realized gain will be recognized. The BIG tax will not be triggered. In that scenario, the corporation generally obtains a carryover basis in the replacement property and continues to be subject to the Built-In-Gains Tax throughout the remainder of the "recognition period" (with respect to the replacement property). In other words, the replacement property continues with the same taint that was attached to the relinquished property. If, however, the exchange happens to be taxable, in whole or part, in addition to the regular tax, the corporation may be subject to the Built-In-Gains Tax.

The Tax Cuts and Jobs Act ("TCJA") changed the landscape a bit in this area. As a result of the TCJA, personal property is no longer like kind. Picture this: You have a client that is otherwise subject to Code Section 1374. It plans to dispose of a BIG asset, a warehouse facility, in a Code Section 1031 exchange. That is all well and good. When it acquired the property, however, it had conducted a cost segregation study to isolate items of depreciable personal property. This is a very common occurrence. The gain on the personal property will likely be considered "boot" in the Code Section 1031 exchange. Consequently, the portion of the gain attributable to pre-S status will be subject to the BIG tax.

Also, under Code Section 1033, if property (as a result of its destruction, in whole or in part, theft, seizure, or condemnation) is converted into property similar or related in service or use, no gain will generally be recognized. If, however, the property is converted into money or property not similar or related in service or use, subject to limited exceptions, the gain will be recognized.

Like Code Section 1031, to obtain non-recognition under Code Section 1033, several requirements and formalities, including timing and reporting requirements, must be met. If these requirements are not met, the gain will be recognized. This sets the stage for a potential disaster for a corporation that is subject to the Built-In-Gains Tax under Code Section 1374. If a corporation (that is otherwise subject to the Built-In-Gains Tax) disposes of a BIG asset within the "recognition period" in a transaction that qualifies for tax deferral, including deferral under Code Section 1033, no realized gain will be recognized. The Built-In-Gains Tax will not be triggered. The corporation generally obtains a carryover basis in the replacement property and continues to be subject to the Built-In-Gains Tax throughout the remainder of the "recognition period" with respect to the replacement property. If, however, the conversion is taxable, in whole or part, in addition to the regular tax, the corporation will be potentially subject to the Built-In-Gains Tax.

PRACTICE ALERT: What if a condemnation, theft or seizure, or for that matter, the start of a Section 1031 exchange, occurs during the recognition period, but the replacement period extends beyond the recognition period? Does the corporation escape the application of the Built-In-Gains Tax if it fails to acquire qualifying replacement property in this situation since the date of the realizing event is outside of the recognition period? The short answer is: No. It will not escape the wrath of Code Section 1374. If a taxpayer fails to acquire qualifying replacement property, it must go back and amend the tax return for the year in which the condemnation, theft or seizure occurred and claim the gain. The same conclusion is true in the case of a failed 1031 exchange, but for a slightly different reason. Treasury Regulation Section 1.1031(k)-1(j)(2)(vi), Example 3, tells us that you report the income of a failed 1031 exchange, as long as there was a good faith intent to complete the exchange, on the installment method. Remember, as discussed above, Treasury Regulation Section 1.1374- 4(h)(1) tells us that use of an installment sale will not avoid the application of Code Section 1374 even if the payments extend beyond the recognition period. Unfortunately, these conclusions are not intuitive – hence, they are traps waiting for unwary taxpayers and their tax advisers.

Possible Trigger #2 is cash basis receivables. Cash basis accounts receivable create a Code Section 1374 problem for the unwary. When a C corporation that used the cash receipts and disbursements method of accounting makes an S election, the application of the Built-In-Gains Tax under Code Section 1374 may be simple and clear, but a surprise may be lurking around the corner and raise its ugly head as the C years' accounts receivables are collected during the "recognition period." They are built-in-gain assets. It is important to note that the accounts payable for these corporations that exist at the time the S election becomes effective serve as built-in losses and can reduce the net recognized built-in gain created by the cash basis receivables. While the taxable income limitation may save the day, at least temporarily, as

discussed above, the built-in gains resulting from the receivables, like other built-in gains not recognized because of the taxable income limitation, will be carried over to future years during the "recognition period" and may be recognized during those years.

The cash basis receivables trigger should be obvious, but it is often forgotten. Don't fall into the trap. If you do, you will be looking at the taxable income limitation and/or S election revocation or termination to manage the disaster.

Possible Trigger #3 is Code Section 338(h)(10) and Code Section 336(e) transactions. Code Sections 338(h)(10) and 336(e) potentially offer a purchaser of the stock of a target S corporation the ability to have a stock transaction treated as an asset purchase and sale for income tax purposes. The benefit of an asset sale to a buyer is obvious – the basis of the target corporation's assets, including goodwill, are stepped up to fair market value. In both Code Section 338(h)(10) and a Code Section 336(e) scenarios, a deemed sale of the assets of the target corporation occurs. It is vital that the potential application of the Built-In-Gains Tax is carefully analyzed in the case of any acquisition, especially if a Code Section 338(h)(10) or Code Section 336(e) election is being considered.

If the target corporation is subject to Code Section 1374 at the time of the transaction, both a Code Section 336(e) and a Code Section 338(h)(10) election will trigger the Built-In-Gains Tax. This could be a disaster if it was not anticipated when the transaction was structured and the purchase price was negotiated. Be careful!

Possible Trigger #4 is QSub elections. In general, when a parent S corporation elects to treat its wholly-owned subsidiary as a Qualified Subchapter S Subsidiary ("QSub"), a liquidation of the subsidiary into the S corporation parent is deemed to occur for income tax purposes under Code Section 332. Assuming the requirements of Code Sections 332 and 337 are satisfied, the deemed liquidation will generally be tax-free. Consequently, the basis of the assets should carry over from the QSub to the parent S corporation under Code Section 334(b). Several traps for the unwary, however, may arise from the deemed liquidation. These traps may bring unintended tax consequences. At least two of the traps involve Code Section 1374. These traps come into play when the subsidiary pre-existed the QSub election and has appreciated assets from its C corporation tax years (or appreciated assets it obtained from a C corporation in a tax-free or tax- deferred carryover-basis transaction), or it has cash basis accounts receivable attributable to its C corporation years.

Trap One: The first trap may be triggered when there is a disposition of built-in-gains assets by the parent corporation that were previously held by the subsidiary. If the QSub was previously a C corporation with appreciated assets, obtained appreciated assets from a C corporation (or an S corporation subject to the Built-In-Gains Tax under Code Section 1374) in a tax-free or tax-deferred transaction, and the assets are disposed of within the "recognition period" under

Code Section 1374(d)(7), the S corporation parent is exposed to the Built-In-Gains Tax imposed under Code Section 1374. This is a tax that the S corporation parent may have otherwise been immune from had it not made the QSub election.

Trap Two: The second trap potentially raises its ugly head when the deemed liquidation resulting from QSub election occurs. If the deemed liquidation of the QSub up into the S corporation parent is tax-free and the carry-over basis rules apply, the story is fairly mundane. If, however, the deemed liquidation is not tax-free, for any reason, the story may not end well. For one, in the instance where the deemed liquidation is not tax-free (for example, due to the subsidiary's aggregate debt exceeding the aggregate adjusted basis in its assets) and the QSub has built-in-gains assets, the tax imposed under Code Section 1374 will be triggered. You have to fully analyze the deemed liquidation before the QSub election is made.

The take-away is simple – you cannot ignore the possibility that a QSub election may either trigger the Built-In-Gains Tax or place a corporation that was not previously subject to the tax in harm's way.

Possible Trigger #5 is in-kind distributions. Code Section 1374 cannot be ignored or forgotten if a corporation is desiring to make distributions in kind to its shareholders. The Built-In-Gains Tax may raise its ugly head if caution is not employed.

The law is clear. Under Code Section 1368, a distribution by an S corporation that has no accumulated earnings and profits is taxed under a two-tier approach to the shareholders: First, the distribution is a tax-free reduction of the shareholders' basis in the corporation's stock. Second, any distribution in excess of the shareholders' stock basis is treated as gain from the sale or exchange of the underlying stock.

In the case of an S corporation that has C earnings and profits ("E&P"), unless an election is made to bail out E&P, the distribution gauntlet under Code Section 1368(c) is three tiers. First, to the extent of AAA, there is a tax-free reduction in stock basis. Second, there is a dividend to the extent of C earnings and profits. Third, after both AAA and C earnings and profits are exhausted, any excess results in capital gain.

In both cases, the amount distributed in kind is the fair market value of the property. When appreciated property is distributed from an S corporation to its shareholders, under Code Section 311(b), gain is recognized in the same manner as if the S corporation had sold the property to the shareholders at fair market value. The gain passes through to the shareholders under Code Section 1366 and increases the basis in their stock. No loss is allowed, however, if the distributed property has a fair market value that is less than the corporation's tax basis in the property. The shareholders' basis in the distributed property is its fair market value. So, if a corporation that has net unrealized built-in gain under Code Section 1374 distributes a built-in-

gain asset to its shareholders during the "recognition period," it will trigger the application of Code Section 1374 and the Built-In-Gains Tax, as well as the normal tax consequences of a distribution of property to its shareholders.

Possible Trigger #6 is state law conversions. Most states have adopted entity conversion statutes. These statutes allow entities to easily convert from one business form to another. The procedure, commonly referred to as a "statutory conversion," automatically transfers an entity's assets and liabilities to a new form of entity. Unlike other methods of conversion (such as a merger of corporations), only one business entity is involved – there is no need to separately form a new entity. The most common types of conversions today are likely limited liability companies converting to corporations, and corporations converting to limited liability companies. Unfortunately, the tax consequences of conversions are often forgotten or ignored, especially by non-tax advisers. The process is simple and appears to be harmless. Unfortunately, from a tax perspective, it may be anything but harmless.

The conversion of a limited liability company taxed as a partnership into a corporation, for income tax purposes, is simply the liquidation of the limited liability company and the distribution of its assets and liabilities to the members, followed by the members' contribution of the assets and liabilities to the capital of a newly formed corporation. In that situation, the provisions of Code Sections 731 and 351, and other ancillary Code provisions, including, but not limited to Code Section 357 and 743, may come into play.

The conversion of a corporation into a limited liability company, for income tax purposes, is simply the liquidation of the corporation and the distribution of its assets and liabilities to the shareholders, followed by the shareholders' contribution of the assets and liabilities to the capital of a newly formed limited liability company. In that situation, the provisions of Code Sections 721, 331 and 336, as well as other Code provisions may come into play such as Code Section 1374.

Conversion statutes may be a nifty mechanism to change the form of a currently existing business entity in a fast and simple manner, but the tax consequences of the conversion are often forgotten. The Built-In-Gains Tax under Code Section 1374 is only one of the many tax perils that loom out there in the case of a conversion. The same issue exists in the case of changing an entity's tax status under the Check-the-Box Regulations. You have to consider the tax consequences, including the possible application of the BIG tax.

Putting the Genie Back in the Bottle

If you are faced with any of these six BIG tax triggers, you may find yourself trying to put the genie back in the bottle. As discussed above, there may be ways to manage or eliminate the BIG tax. Several possible methods exist to eliminate or control exposure to the Built-In-Gains

Tax once it is triggered.

The following seven strategies should be carefully reviewed. Some of these strategies are obvious, while others are obscure:

- Revoking the S election before it is effective.
- Adopting a prospective revocation of the S election and the using of the taxable income limitation to control or eliminate the BIG tax exposure.
- Terminating the S election and using the taxable income limitation to control or eliminate the BIG tax exposure. If the S election cannot be revoked during the current taxable year, the termination rules along with the taxable income limitation may be available to limit or eliminate the impact of the Built-In-Gains Tax during the current taxable year. An election may be terminated for failure to qualify as a "small business corporation." The effective date of the termination is the date the corporation ceases to be a "small business corporation." So, for example, the transfer of shares to an ineligible trust or the creation and issuance of a second class of shares would terminate the S election on the date of transfer or issuance of shares. This makes termination a useful tool. You can control the timing.
- Outlasting the "recognition period." A possible strategy may be to limit taxable income for each taxable year during the remaining "recognition period" to limit or eliminate the Built-In-Gains Tax As I said earlier, the success of this strategy depends upon the ordinary, necessary and reasonableness of the expenses that are incurred and that lower or eliminate taxable income during the "recognition period." With the recognition period now only five years, this strategy may not be so far-fetched.
- Using any remaining C years tax attributes. Don't forget about Code Section 1374(b)(2) and (3). These provisions may be an additional tool for controlling or limiting the Built-In-Gains Tax. Code Section 1374(b)(2) expressly permits an S corporation to use any of its net operating loss carryforwards arising from taxable years in which it was a C corporation as a deduction against the net recognized built-in gain. This strategy may incentivize some taxpayers to acquire losses from another corporation. Code Section 382 may prohibit or limit this strategy. Net operating losses are not the only tax attributes from prior C years that may be used to reduce the Built-In-Gains Tax. Some tax credits may be available to help the S corporation and its shareholders. Code Section 1374(b)(3) expressly permits an S corporation to use any of its business credit carryforwards under Code Section 39, and any minimum tax credit carryforwards under Section 53 from the tax imposed by Code Section 55 arising from taxable years in which it was a C corporation as a credit against the Built-In-Gains Tax imposed under Code Section 1374 in the same manner as it would be applied against any tax that would have been imposed

on the corporation under Code Section 11 if it were a C corporation. For this purpose, the Built-In-Gains Tax imposed under Code Section 1374 is treated as if it were imposed under Section 11.

- Keeping good record of all after acquired assets. Often over-looked is the obvious – assets acquired after the effective date of an S election are generally not subject to the Built-In-Gains Tax, unless they were acquired in certain carry-over basis transactions. There is a simple take-away: Maintenance of adequate books and records to reflect when and how assets were acquired post-S election is key. The burden of proof is on the taxpayer.
- Eliminating or reducing the impact of the BIG tax by knowing the amount of appreciation in all assets at the effective date of the S election. Asset appreciation that occurs after the effective date of an S election is generally not subject to the Built-In-Gains Tax under Code Section 1374. The burden to prove that all or part of the gain on the sale of an asset after the effective date of an S election is attributable to post-S election appreciation is on the S corporation taxpayer. Likewise, the burden is on the S corporation taxpayer to prove any recognized built-in loss existed at the effective date of the S election (i.e., did not occur post- S election). Consequently, it is imperative that corporate taxpayers contemplating an S election have each of its assets, including goodwill, properly identified and valued as of the effective date of the S election. The greatest defense to any audit or assertion by the Service that gain occurred post-election or any loss occurred pre-election is a contemporaneous written valuation at the effective date of the S election.

Conclusion

Subchapter S, due to changes made by Congress as well as cases, rulings and regulations, has become complex. There are numerous obscure aspects of Subchapter S and several traps that exist for unwary taxpayers and their tax advisers. I hope this blog post on the Built-In-Gains Tax illuminates some of the obscure aspects of Code Section 1374 and arms taxpayers and their advisers with tools to avoid or reduce the impact of these traps. I will provide guidance on some of the other not-so-obvious aspects of Subchapter S in future blog posts.

Tags: A Journey Through Subchapter S, built-in gains tax, C corporation, S corporation, Subchapter S