



1999 Income Tax School

S CORPORATIONS

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S CORPORATIONS

The coverage of S corporations in this chapter is limited to the following topics:

- Late and defective elections by S corporations
- The built-in gains tax on certain S corporations
- The Accumulated Adjustments Account (AAA) and Schedules M-1 and M-2 of Form 1120S
- Basis worksheets for shareholder stock and debt

Some materials in this chapter are adapted from the *S Corporation Taxation Guide* by Robert W. Jamison, published each fall by Harcourt Professional Publishing. Copies may be ordered at 1-800-831-7799 or at amazon.com.

A. RELIEF PROVISIONS FOR LATE AND DEFECTIVE S ELECTIONS

Before 1996 the IRS could grant relief for violation of S corporation eligibility rules if the corporation already had a valid S election in effect. However, there was no explicit relief provision governing a corporation that had filed an untimely or improper S corporation election. The IRS has granted such relief frequently, for almost every conceivable violation of the S corporation eligibility rules, such as transfer of shares to an ineligible shareholder. The Small Business Job Protection Act of 1996 expanded inadvertent termination relief to situations where the corporation had never filed a proper S election. The new extensions of that relief are discussed below. That act also added I.R.C. §1361(b)(5), which specifically allows the IRS to accept late elections. Since its enactment, this rule has been one of the busiest ruling areas in all of subchapter S.

The IRS is directed to grant relief for **late** or **inadvertently defective** S elections, in addition to inadvertent termination relief. Congress has directed the IRS to apply the same standards to late or defective elections that it has applied in granting inadvertent termination relief (H.R. Conf. Rep. 104-737, p. 204).

Relief for a late or defective S election is available for any election that should have been filed **after 1982**. Thus any corporation concerned with this problem may request a ruling by filing Form 2553. The request must be prepared in accordance with the detailed instructions and checklist, shown in Rev. Proc. 99-1, and must be accompanied by a user fee, generally \$5,000. In addition, if there is quick corrective action, there may be relatively inexpensive relief available from the service center.

1. LATE S CORPORATION ELECTIONS

A. DEFECTIVE AND LATE S ELECTIONS, IN GENERAL

Defective elections must be **inadvertent** in order for the IRS to grant relief. The sole judge of inadvertence is the national office of the IRS. The only way to apply for such relief is to request a private letter

ruling. A letter ruling request must be accompanied by a user fee, of \$5,000 as of 1999 [Rev. Proc. 99-1, 1999-1 IRB 6, Appendix A(3)(c)]. Thus, it's always better to do it right the first time. However, this provision may drastically limit the damage from failure to make a timely election.

In contrast to the defective election relief rules, the IRS may accept **late** elections if there is **reasonable cause**. Reasonable cause is a less stringent standard than inadvertence. The IRS has the power to delegate dispositions of late elections to its service centers or to rule on such requests in the national office. The major distinction between these two avenues is that a request to a regional office does not need to be a ruling request and does not require the payment of a user fee. As of the middle of 1999, there are two valid revenue procedures that instruct S corporations to apply for late election relief to service centers. Rev. Proc. 98-55 (1998-46 IRB 1) is extremely useful but requires prompt discovery and action. Rev. Proc. 97-48 (1997-43 IRB) applies to more limited circumstances.

B. REV. PROC. 97-48 (1997-43 IRB)

This procedure allows the IRS service center (or district director) to accept elections more than 12 months late if all intended S years are still open at the corporation and shareholder levels. It provides special procedures to obtain relief for certain late S corporation elections. The revenue procedure applies only to the following two situations:

1. A corporation intends to be an S corporation, the corporation and its shareholders reported their income consistent with S corporation status for the taxable year in which the S corporation election should have been made and for every subsequent year, and the corporation did not receive notification from the Service regarding any problem with the S corporation status within 6 months of the date on which Form 1120S for the first year was timely filed.
2. For periods prior to January 1, 1997, a corporation intends to be an S corporation; however, due to a late S corporation election, the corporation was not permitted to be an S corporation for the first taxable year specified in the election (because late S corporation election relief was not available during this period), the corporation and the shareholders treated the corporation as an S corporation for all succeeding years, and all relevant taxable years for both the corporation and all of its shareholders are open.

Procedural Requirements for Automatic Relief under Rev. Proc. 97-48. The corporation must file with the applicable service center (or district director, if under examination) a completed Form 2553, signed by an officer of the corporation authorized to sign and by all persons who were shareholders at any time during the period that the corporation intended to be an S corporation. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97-48." Attached to the Form 2553 must be a dated declaration signed by an officer of the corporation authorized to sign and by all persons who were shareholders at any time during the period that the corporation intended to be an S corporation, attesting (but, in the case of a shareholder, only with respect to that shareholder) that:

1. The corporation and the shareholder reported their income (on all affected returns) consistent with the requirements for automatic relief under section 4.02 of Rev. Proc. 97-48.
2. The corporation and the shareholder agree to amend their tax returns (if the corporation filed Form 1120) for the first year and any other affected returns to reflect S corporation status.
3. "Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

Since the form is filed with the service center or district director, there is no filing fee. The IRS must grant the election if the request is properly filed.

Observation. The relief rules of Rev. Proc. 97-48 are quite narrow in scope. The first of its provisions will disappear completely when the 1996 taxable years are closed. More often, practitioners will rely on Rev. Proc. 98-55, discussed next.

C. REV. PROC. 98-55 (1998-46 IRB 1)

This pronouncement is much more comprehensive than the earlier procedures. It covers all of the following:

- Late S corporation elections
- Late qualified subchapter S subsidiary (QSub) elections
- Late qualified subchapter S trust (QSST) elections
- Late electing small business trust (ESBT) elections

If a corporation qualifies for relief under this provision, the relief is granted by the IRS Service Center and does not require payment of the ruling request fee (Rev. Proc. 98-55 §3.05).

i. Relief for late S corporation election

A corporation is eligible for relief for a late S election if it meets the following requirements:

- The corporation fails to qualify as an S corporation solely because the Form 2553 (Election by a Small Business Corporation) was not filed timely pursuant to I.R.C. §1362(b)(1), and
- The due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation has not passed.

Procedural Requirements for Relief from Late S Corporation Election. According to Rev. Proc. 98-55 §4.01,

- Within 12 months of the original due date for the S corporation election, the corporation must file with the applicable service center a completed Form 2553, signed by an officer of the corporation authorized to sign and by all persons who were shareholders (or deemed to have been shareholders) at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the election is made.
- The Form 2553 must state at the top of the document “FILED PURSUANT TO REV. PROC. 98-55.”
- Attached to the Form 2553 must be a statement explaining the reason for the failure to file a timely S corporation election.

Example 1. On August 18, 1998, Lico, a new corporation, had three shareholders: Marcia, Andy, and Doug. Lico intended to be an S corporation but did not file a timely Form 2553 on or before November 2, 1998. On March 1, 1999, Lico’s tax advisor, Jay, became aware that no such form had been filed. Jay believed that the cause for not filing Form 2553 was reasonable.

In the meantime, there had been some activity with respect to Lico’s shares. The corporation issued new shares to Marianne on January 10, 1999. On February 2, 1999, Marcia sold all of her shares to Glenn.

In order to obtain relief under Rev. Proc. 98-55, the parties must do the following:

1. Jay must prepare a Form 2553 along with a statement as to the cause of the lateness of the election.
2. The corporation must file this form with the service center where the corporation files returns on or before March 15, 1999 (if Lico uses the calendar year). There is no need to file a ruling request with the IRS national office, and no need to pay a user fee.
3. The request must be signed by Marcia, Andy, Doug, Marianne, and Glenn, since all of these persons were shareholders during the period of time that the corporation intended to be an S corporation.

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Upon receipt of a completed application requesting relief under this revenue procedure, the Internal Revenue Service will determine if there was reasonable cause for the failure to file a timely S corporation election and will notify the corporation of the result of the reasonable cause determination.

Observation. Rev. Proc. 98-55 does not define reasonable cause for lateness. It does not provide any examples as to what might or might not be reasonable cause. However, the national office has accepted nearly every cause, including no reason at all. These rulings are numerous; a few are cited below. A tax advisor might want to look up some of these rulings and cite them as demonstrative examples of situations accepted by the national office. A Service Center would probably look with favor upon a well-prepared and documented statement as to the reasonable cause of a late election.

In cases that do not qualify under Rev. Proc. 98-55, the corporation must file a **ruling request** with the national office of the IRS. The **ruling fee** is \$5,000 as of 1999 [Rev. Proc. 99-1, 1999-1 IRB 6, Appendix A (3)(c)]. Following is a sample of the rulings issued granting late elections. In each of these situations, the corporation was required to pay the user fee because it did not qualify under Rev. Proc. 97-48 or Rev. Proc. 98-55.

Cause for Lateness	Private Letter Ruling
Employee filed Form 2553 in filing cabinet.	9752041
Election erroneously filed by corporate officer prior to formal incorporation.	9816004
"In the confusion of company's startup period, the form was filed internally rather than mailed to the appropriate Service Center."	9750026
Shareholder purchased a "corporate kit." Because of personal reasons, A was unable to consult an attorney or accountant.	9746012
Sole shareholder believed that the filing of the articles of incorporation was in itself sufficient for X to become an S corporation.	9815037
Shareholder "attempted to file Form 2553," but IRS never received it.	9736022
Corporate president did not file Form 2553.	9735026
Neither attorney nor accountant advised shareholder of need to file Form 2553.	9735020
Prior shareholder represented that the corporation was an S corporation. Purchasing shareholder had already dissolved corporation when election was accepted under I.R.C. §1362(b)(5).	9734024
Sole shareholder had hired new accounting firm and was engaged in acrimonious divorce.	9734005
Shareholders believed Form SS-4 was sufficient for the S election.	9751009
Shareholders intended to file Form 2553 but were preoccupied with other business matters.	9741024
Accountant advised that Form 2553 and Form 1120S were unnecessary, and all information could be filed on Schedule C.	9743036
"Reasons stated in the ruling request."	9746037
Form 2553 was neglected during transition of accounting services.	9742034
Shareholder expected corporation to be an S corporation but did not file Form 2553.	9739029
Unaware of need for Form 2553.	9652016
Client did not follow attorney's advice to sign and file Form 2553.	9739012
Corporation believed it had filed timely, but IRS had no evidence.	9734031
Reliance on attorney.	9719016
Timely election not filed—no reason stated.	9717016

Observation. There have been over 700 rulings issued by the IRS from 1997 through the middle of 1999 allowing late elections. As the above listing indicates, nearly any cause is reasonable. Perhaps most revealing is that some of the rulings do not state any cause at all for the late election, yet they received relief. Thus it should not be difficult to state a truthful yet fully viable reasonable cause for a late S election, along with the \$5,000 user fee.

ii. Relief for late S corporation election and late QSub election

In years beginning after 1996, an S corporation is allowed to own a qualified Subchapter S subsidiary (QSub) [I.R.C. §1361(b)(3)]. A QSub is a domestic corporation. All of the stock of this subsidiary must be held by the S corporation parent. The S corporation parent must elect to treat the subsidiary as a qualified Subchapter S subsidiary. Under the election, the QSub is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

A parent corporation may qualify for relief under Rev. Proc. 98-55 for a late QSub election. The unextended due date for the parent's first intended S corporation year must not have expired. The corporation files the late Form 2553 and the QSub election simultaneously with the appropriate IRS Service Center(s).

iii. Relief for late S corporation election and late QSST or ESBT election

Only a few trusts qualify as S corporation shareholders. Some of these require special elections. The qualified Subchapter S trust (QSST) requires that the beneficiary file an election to include the income on his or her own return. This election must be filed with the IRS Service Center where the S corporation files its returns, within 2 months and 15 days after the date that the trust acquires shares in an S corporation. A more recent type of trust, the electing small business trust (ESBT), includes a requirement that the fiduciary file an election to treat the trust as an ESBT. Rev. Proc. 98-55 provides the relief for late QSST and ESBT elections.

2. DEFECTIVE S CORPORATION ELECTIONS

The IRS is directed to grant relief for inadvertently defective S elections. Congress has directed the IRS to apply the same standards to defective elections that it has applied in granting inadvertent termination relief [I.R.C. §1362(f)].

To qualify for this relief the IRS must be convinced that the defect was **inadvertent**, which is a stricter standard than reasonable cause. The corporation and its shareholders must have taken corrective action within a reasonable time after discovery of the problem.

In order to qualify for relief for a defective election, the corporation must request a ruling, even if there is prompt action. Rev. Proc. 98-55 does not allow the Service Center to entertain any request for a waiver of a defect in an election. An example of an inadvertently defective election is found in Ltr. Rul. 199909010, in which a corporation had filed a proper Form 2553 in all respects except that it did not have the proper consents. The corporation stated that it had since obtained the proper consents. The IRS accepted the reason and granted the corporation a valid S election from the date originally filed.

A more frequent cause of rulings has been that the corporation did not meet the S corporation eligibility requirements when it filed Form 2553. Rulings issued to date under the amended version of I.R.C. §1362(f) have granted elections under these circumstances. Again, the corporation must state the corrective action taken and pay the user fee.

Eligibility Problem	Corrective Action	Private Letter Ruling(s)
Corporation had two classes of stock when Form 2553 filed.	Modified share rights so that there was one class and filed for relief.	9701015
Filed when ineligible person held stock.	Ineligible person transferred shares to eligible holders.	9741028, 9816011, 9832015, 9839013
Filed when preferred stock outstanding.	Recalled preferred shares.	9745011, 9815026, 9829020
Filed with no valid QSST election on one shareholder.	Filed QSST election.	9815030
When corporation filed Form 2553, stock was held by two trusts. Fiduciaries signed QSST elections and consented to Form 2553.	Obtained beneficiary signatures.	9843027
Filed with no valid ESBT election on one shareholder.	Filed ESBT election.	9808028, 9814017, 9820013
Filed with no valid ESBT election on one shareholder.	Filed late ESBT elections, simultaneously submitting other ruling requests to accept late ESBT elections.	9841028
Trust was ineligible to be ESBT but filed ESBT election, when corporation filed Form 2553.	Trustee relinquished certain powers, and trust became eligible as ESBT.	9832003
Affiliated group status on date Form 2553 filed (pre 1/1/97).	Amended merger to be effective on earliest possible date, or liquidated subsidiary.	9717019, 9741006, 9741008, 9804018, 9830024

3. LATE TRUST ELECTIONS, WHERE S ELECTION IS ALREADY IN EFFECT

As stated above, certain elections must be made in order for some trusts to be eligible shareholders in S corporations. The election time periods have been troublesome for QSSTs and for ESBTs. The discussion above concentrated on situations where the S corporation election and the trust election were both late, but the deadline for the first Form 1120S had not expired. Rev. Proc. 98-55 also provides relief for certain late trust elections when the corporation already has its S election in effect. To qualify, the trust election must be made no more than 24 months after its normal due date. Any election filed within this time may be approved by the Service Center, without the payment of any fee. Trust elections filed after this grace period must be approved by the national office, with the ruling request and fee therefor. The IRS national office has accepted late elections and allowed trusts to be treated as eligible shareholders from the desired date [Ltr. Ruls. 9832038, 9841029, 9842011, 9842022].

4. LATE QSUB ELECTIONS, WHERE S ELECTION IS ALREADY IN EFFECT

Rev. Proc. 98-55 provides expeditious relief when a parent S corporation owned a subsidiary that could have qualified as a QSub but the parent failed to file a timely QSub election. To qualify for this relief at the Service Center level (with no user fee), the due date for the parent corporation's return for the first intended year of QSub treatment must not have expired. Attached to the form must be a statement explaining the reason for the failure to file a QSub election within the time period. The IRS national office has granted late QSub elections in several cases, when the parent corporation has paid the user fee along with the ruling request [Ltr. Ruls. 9748024, 9814009, 9825028, 9826009, 9834010, 9837035, 9838015, 9839012, 9839013, 9840027, 9843029, 9827013, 9827029, 9828025].

B. THE BUILT-IN GAINS TAX

1. INTRODUCTION

The built-in gains tax is a corporate-level tax imposed on certain S corporations. As such, it is a deviation from the general rule that S corporations pay no federal income tax. It applies to only two categories of S corporations:

- S corporations that were formerly C corporations, and for which the current taxable year begins no more than 10 years following the effective date of the S election. Such a corporation is subject to tax on the disposition of any asset that it owned when it became an S corporation.
- S corporations that have acquired assets from C corporations or from former C corporations in tax-free reorganizations or liquidations. Such a corporation is subject to the assets acquired in that transaction for 10 years following that transaction.

When this tax applies, it is probably the most complicated problem that an S corporation may face. The following discussion specifies the basic rules and uses a continuing, integrated example to explain the rules.

This tax was enacted as a companion provision to the 1986 liquidation rules under which gains and losses are recognized on corporate liquidations. Its principal purpose was to prevent C corporations from avoiding the tax on liquidating distributions by becoming S corporations before they liquidated. The Tax Reform Act of 1986 gave the IRS broad interpretive powers, including several grants to issue legislative regulations [I.R.C. §337(d)].

In December 1994, the IRS issued final regulations covering the built-in gains tax (T.D. 8579):

§1.1374-0	Table of contents to §1374 regulations
§1.1374-1	General rules and definitions
§1.1374-2	Net recognized built-in gain
§1.1374-3	Net unrealized built-in gain
§1.1374-4	Recognized built-in gain or loss
§1.1374-5	Loss carryforwards
§1.1374-6	Credits and credit carryforwards
§1.1374-7	Inventory
§1.1374-8	§1374(d)(8) transactions
§1.1374-9	Anti-stuffing rule
§1.1374-10	Effective date and additional rules

The tax applies to built-in gains and losses on dispositions of certain property within the 10-year period. The tax is imposed on the corporation's **net recognized built-in gain**, which may require three separate computations, discussed below. There are allowable offsets for net operating loss carryforwards and net capital loss carryforwards, but not for other carryovers.

The recognized built-in gains tax rate is the highest corporate rate [I.R.C. §1374(b)(1)].

- Under current (1999) law that rate is 35%.
- The tax may be reduced by certain credits.
- The tax paid by the corporation is treated as a reduction of the corporation's income.
- Thus it reduces the amount that otherwise would have passed through to the shareholders.
- Correspondingly, it reduces the amount that would be posted to the corporation's AAA and OAA.

As this chapter demonstrates, the computations can be quite complicated. The IRS provides little guidance on Form 1120S and its instructions. However, Form 1120S does require an S corporation to disclose its recognized built-in gains limitation on Schedule B, with only minimal explanation in the instructions. The built-in gains tax results are shown on Schedule D, with no form or worksheet for

computation. Therefore, S corporations must use unofficial schedules to make the most of the computations necessary for compliance with the built-in gains tax rules.

2. RECOGNITION PERIOD

In general, the recognition period, during which the S corporation is subject to the built-in gains tax, is the first 10 years of existence as an S corporation. The recognition period is 10 years, and not 10 taxable years. Therefore, if a corporation has one or more short years in the recognition period, the recognition period may end in the middle of a tax year.

When an S corporation sells built-in gains property within the recognition period and the sale qualifies for the installment method, the recognition period for that sale continues until the last installment is collected, even if the collection period extends beyond the corporation's normal recognition period [Treas. Reg. §1.1374-10(b)(4)].

3. NET UNREALIZED BUILT-IN GAIN

One of the important calculations at the time of conversion is net unrealized built-in gain.

- This figure must be reported annually on Form 1120S.
- This figure sets one of the limits on the amount of taxable built-in gain that the corporation will report during the recognition period.

It is important to establish this figure at the time the S election takes effect. It is in essence the net gain that the corporation would have recognized if it had liquidated on the first day it became an S corporation.

- In general, the term means the fair market value of all of the corporation's assets, less the adjusted basis [I.R.C. §1374(d)(1)].
- The value also includes any item that would be treated as a built-in gain, even if it is not on the balance sheet [I.R.C. §1374(d)(5)(A) and (C)].
- It is reduced for any amount allowable as a deduction (such as accounts payable of a cash-basis corporation) that would be treated as a built-in loss, even though the item is not reflected on the corporation's balance sheet [I.R.C. §1374(d)(5)(B) and (C)].

Observation. To properly comply with this rule, the corporation must value all assets, including intangible property such as goodwill. The corporation must also value cash-method accounts receivable and other zero-basis property, since all of these can result in taxable built-in gains.

An S corporation's net unrealized built-in gain includes any item that would have been taken into account before conversion if the corporation had used the accrual method of accounting [Treas. Reg. §1.1374-4(b)(1)]. Similarly, a built-in loss includes any item that would have been allowable under the accrual method. "Allowable as a deduction" is determined without regard to I.R.C. §461(h)(2)(C), dealing with torts and other items subject to cash method deduction timing [Treas. Reg. §1.1374-4(b)(2)].

Note. The facts of Example 2 are used throughout the rest of this chapter to illustrate the application of the built-in gains tax to a "typical" corporation that has recently converted from C corporation to S corporation status.

Example 2. Calboco was a C corporation through 1997. Calboco became an S corporation on January 1, 1998. At the end of 1997 Charles owned 60% of Calboco's outstanding shares and Charlene owned the other 40%. These percentages do not change throughout this discussion. Calboco used the cash

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method of accounting. On January 1, 1998, Calboco's balance sheet (at adjusted basis and fair market value) was:

<u>Assets</u>	<u>Adjusted Basis</u>	<u>Market Value</u>
Cash	\$ 60,000	\$ 60,000
Accounts receivable	0	300,000
Securities held for investment	10,000	15,000
Furnishings	40,000	35,000
Building	265,000	285,000
Land	150,000	180,000
Totals	<u>\$ 525,000</u>	<u>\$ 875,000</u>
Liabilities and shareholders' equity		
Accounts payable	\$ 0	\$ 150,000
Payable to shareholders	0	85,000
Equity	525,000	640,000
Totals	<u>\$ 525,000</u>	<u>\$ 875,000</u>

However, the shareholders expect that they could receive \$1,050,000 on a sale of the assets. This amount is \$175,000 more than the fair market value of the assets identified on the corporation's balance sheet. This \$175,000 premium would be classified as goodwill.

Calboco had a net operating loss carryforward of \$16,000 from 1994, which the corporation had not been able to use by the end of 1997.

Thus Calboco's net unrealized built-in gain as of January 1, 1998, is:

Asset value	\$875,000
Less asset basis	(525,000)
Add goodwill	175,000
Less deductible accrued liabilities	<u>(235,000)</u>
Net unrealized built-in gain	\$290,000

This net recognized built-in gain total, as of the beginning of the year, must be reported on Schedule B, line 9. An abbreviated Schedule B follows.

Schedule B Other Information

		Yes	No
1	Check method of accounting: (a) <input type="checkbox"/> Cash (b) <input type="checkbox"/> Accrual (c) <input type="checkbox"/> Other (specify) ▶		
2	Refer to the list on pages 26 through 28 of the instructions and state the corporation's principal:		
9	If the corporation: (a) filed its election to be an S corporation after 1986, (b) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and (c) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see page 16 of the instructions) ▶ \$ <u>290,000</u>		
10	Check this box if the corporation had accumulated earnings and profits at the close of the tax year (see page 16 of the instructions) ▶ <input checked="" type="checkbox"/>		

Note that the net operating loss carryforward does not affect Calboco's net unrealized built-in gain. However, it may be an important factor to consider later in the discussion of this example.

For each year of the recognition period, the important steps for the built-in gains tax are as follows:

1. Determine the net recognized built-in gain (three steps).
2. Reduce by any allowable net operating loss carryforward.
3. Compute the tax.
4. Reduce the tax by any general business or AMT credit carryforward.
5. Apportion the tax to the built-in gains of different character.
6. Apply this apportioned tax as a loss in determining the pass-through to shareholders and the AAA.
7. Determine the effect of this year's activities on the built-in gain carryforward, and any NOL or credit carryforwards.
8. Adjust the net unrealized built-in gain limitation for the next year.

4. NET RECOGNIZED BUILT-IN GAIN

The corporation's net recognized built-in gain is the lesser of:

- The pre-limitation amount
- The taxable income limitation
- The net unrealized built-in gain limitation

A. PRE-LIMITATION AMOUNT

The pre-limitation amount is determined by taking into account only the corporation's recognized built-in gains and recognized built-in losses for any taxable year. In other words, all activities that were not in progress at the date of conversion to S status (the "conversion date") are disregarded for this calculation.

The corporation must use its actual accounting method in determining which gains and losses are recognized [Treas. Reg. §1.1374-2(d)]. Thus an S corporation that uses the cash method of accounting for reporting income to its shareholders may not use the accrual method to determine its recognized built-in gains and losses for the year.

The pre-limitation amount is the computation of the corporation's taxable income under the following rules:

- The corporation follows C corporation rules of offset, limitations, etc.
- The corporation is not allowed any dividends-received deduction.
- The corporation is not allowed to deduct any carryforwards from years in which it was a C corporation (although there is an exception discussed below for NOL carryforwards).
- The only items reported on the return are the corporation's recognized built-in gains and recognized built-in losses.

Accordingly, it is important to understand recognized built-in gains and recognized built-in losses.

i. Recognized built-in gains

The Code establishes a presumption that all recognized gains are built-in gains [I.R.C. §1374(d)(3)]. The S corporation may rebut this presumption by establishing one of two facts:

- The corporation did not own the asset that created the recognized built-in gain on the conversion date, or
- The gain is attributable to postconversion appreciation.

The gain must be recognized according to the corporation's method of accounting. Thus assets disposed of in a nonrecognition transaction, such as a like-kind exchange or tax-free reorganization, are

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not recognized built-in gains. See discussion below, regarding the collateral rules governing these transactions.

The regulations state that an income item is treated as a recognized built-in gain if it would have been reported on the final C corporation tax return by a taxpayer who uses the accrual method of accounting. Thus, there are two criteria that must be met at the conversion date:

1. All events must have occurred that establish the taxpayer's right to receive the item, and
2. The amount must be fixed or reasonably estimated.

Income items arising prior to the S election are treated as built-in gains when recognized for tax purposes [I.R.C. §1374(d)(5)(A)].

- There may be problems in dealing with inventory gains, especially in the first year of the recognition period. The corporation must separate the gain on inventory that had accrued prior to conversion from the gain generated by postconversion activities.
- The corporation must use its normal inventory method (FIFO, LIFO, etc.) to determine the identity of inventories disposed of. Thus, most FIFO taxpayers will dispose of their entire opening inventory in the first year. By contrast, LIFO taxpayers would not dispose of any opening inventory until one or more layers are liquidated [Treas. Reg. §1.1374-7(b)].
- In the only case to date on this issue, the Tax Court valued inventories between replacement and resale (*Reliable Steel Fabricators, Inc.*, T.C. Memo 1995-293).

LIFO inventories are covered specifically by the LIFO recapture tax. In effect, they are exempt from the built-in gains tax, unless the corporation liquidates one or more LIFO layers during the recognition period.

Example 2 (continued). In 1998, Calboco collected \$1,000,000 of accounts receivable, of which \$300,000 were outstanding at the end of 1997. Calboco's recognized built-in gain from this source for 1998 is \$300,000. Calboco also sold the securities for \$16,000. Note that the gain is \$6,000, but the recognized built-in gain from the securities is only \$5,000.

ii. Recognized built-in losses

Recognized built-in losses are treated as deductions and may offset recognized built-in gains in any taxable year.

The presumption is that there are no recognized built-in losses. The corporation may rebut this presumption by establishing that fair market value was less than basis on the first day of the first S year, or that unrealized payables existed at that date. As is the case with net unrealized built-in gains, the burden is on the corporation to keep careful records.

According to the regulations and the preamble to the regulations, there will be no recognized built-in loss for deductions suspended under I.R.C. §465 or §469 while the corporation was a C corporation. The preamble treats these deductions as "carryovers," for which there is a complete disallowance pursuant to I.R.C. §1371 (T.D. 8579, §3.C).

The Tax Court has recently held that the disallowance of prior C corporation carryovers is an inclusive term. Thus, this disallowance applies to losses that had been suspended under I.R.C. §469 while the corporation was a C corporation [*St. Charles Investment Co.*, 110 T.C. No. 6 (1998)]. The regulations under I.R.C. §1374 are entirely consistent with this position.

The regulations state that a deduction is treated as a recognized built-in loss if it would have been reported on the final C corporation tax return by a taxpayer that uses the accrual method of accounting. Thus, there are three criteria that must be met at conversion date [Treas. Reg. §1.1374-4(b)(2)]:

1. All events must have occurred that establish the taxpayer's right to receive the item.
2. The amount must be fixed or reasonably estimated.
3. The corporation must meet the economic performance test.

Example 2 (continued). In 1998, Calboco paid \$798,000 of expenses (other than salaries to shareholders), of which \$150,000 were accounts payable at the end of 1997. Calboco would treat \$150,000 as a 1998 recognized built-in loss.

B. SPECIAL PROBLEMS DEALING WITH DISALLOWED EXPENSES AND DEFERRED COMPENSATION

Any amount that was disallowed by reason of I.R.C. §267(a)(2) before the S election took effect can be treated as a recognized built-in loss only if it is paid within 2½ months of the beginning of the first year of the recognition period [Treas. Reg. §1.1374-4(c)(1)(ii)(A)]. The 2½-month deadline is not applicable to a person who (actually and constructively) owns less than 5% of the corporation's outstanding stock [Treas. Reg. §1.1374-4(c)(1)(ii)(B)].

This rule applies if the corporation uses the cash method and is not denied the deduction by I.R.C. §267(a)(2), per se. The corporation would not have been entitled to deduct these expenses in its final C corporation year if it had used the accrual method of accounting.

Observation. When a C corporation intends to make an S election, it should evaluate any potential disallowed accruals to shareholders. This includes potential accruals by a cash-method corporation to any constructive majority shareholder (or any shareholder if the corporation is a personal service corporation). It should plan to either pay these amounts in its last C corporation year, or make sure to pay them in the first 2 months and 15 days of its first S corporation year, whichever will yield the greatest tax benefit. It might want to borrow the money to ensure that it will be able to pay these amounts in cash.

Example 2 (continued). In 1998, Calboco paid \$150,000 in salaries to its two shareholders, Charles and Charlene, who were not related to each other within the meaning of I.R.C. §267(c). (Charles owned 60% of Calboco's outstanding shares and Charlene owned the other 40%.) Charles received \$90,000, of which \$25,000 was paid between January 1 and March 15, 1998.

Charlene received \$60,000, of which \$15,000 was paid between January 1 and March 15, 1998. \$85,000 would have been accrued at the end of 1997 if the corporation used the accrual method of accounting. \$50,000 was accrued to Charles and \$35,000 was accrued to Charlene.

Note that the corporation uses the cash method of accounting, and so is not subject to I.R.C. §267(a)(2). In measuring the allowable built-in losses, however, it must observe the rules that §267(a)(2) would apply if the corporation used the accrual method.

Under the regulations, the amounts paid to Charles after March 15, 1998, could not be treated as a recognized built-in loss. The accrual to Charles would have been disallowed under §267(a)(2) for 1997 if the corporation had used the accrual method. In general, the accrual to Charlene would not have been disallowed under §267(a)(2), since she was not an actual or constructive owner of more than 50% of Calboco's outstanding stock. The corporation could take the position that \$35,000 of the payments to Charlene were recognized built-in losses, unless it is a personal service corporation. If it is a personal service corporation, payments to both shareholders would be governed by I.R.C. §267(a)(2).

Assume that Calboco treats \$60,000 of the salaries to the two shareholders as a recognized built-in loss for 1998. Calboco's pre-liquidation amount is calculated as follows:

Recognized built-in gain from securities	\$ 5,000
Recognized built-in gain from receivables	300,000
Less recognized built-in losses:	
Expenses	(150,000)
Salaries to shareholders	(60,000)
Pre-liquidation amount	\$ 95,000

The pre-liquidation amount is entered on Schedule D of Form 1120S, (shown later in this chapter). The IRS requires that the S corporation fill out a dummy Form 1120 (page 1 only) to show the calculation of the pre-liquidation amount. For this purpose the only income items are the recognized built-in gains, and the only deductions are the recognized built-in losses of the current year. Following is a copy of Form 1120 showing Calboco's pre-liquidation amount.

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Form 1120 Department of the Treasury Internal Revenue Service	U.S. Corporation Income Tax Return For calendar year 1998 or tax year beginning, 1998, ending, 19 ... ▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.	OMB No. 1545-0123 1998
A Check if a: 1 Consolidated return (attach Form 851) <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (as defined in Temporary Regs. sec. 1.441-4T—see instructions) <input type="checkbox"/>	Use IRS label. Otherwise, print or type. Name Calboco (Dummy, Pre-Limitation) Number, street, and room or suite no. (If a P.O. box, see page 5 of instructions.) City or town, state, and ZIP code	B Employer identification number _____ C Date incorporated _____ D Total assets (see page 5 of instructions) \$ _____
E Check applicable boxes: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Change of address		
Income	1a Gross receipts or sales 300,000 b Less returns and allowances _____ c Bal ▶	1c 300,000 2 0 3 300,000 4 0 5 0 6 0 7 0 8 5,000 9 0 10 0 11 305,000
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (Schedule E, line 4) _____ 13 Salaries and wages (less employment credits) _____ 14 Repairs and maintenance _____ 15 Bad debts _____ 16 Rents _____ 17 Taxes and licenses _____ 18 Interest _____ 19 Charitable contributions (see page 8 of instructions for 10% limitation) _____ 20 Depreciation (attach Form 4562) 20 0 21 Less depreciation claimed on Schedule A and elsewhere on return 21a 0 22 Depletion _____ 23 Advertising _____ 24 Pension, profit-sharing, etc., plans _____ 25 Employee benefit programs _____ 26 Other deductions (attach schedule) _____ 27 Total deductions. Add lines 12 through 26 ▶ 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11 29 Less: a Net operating loss deduction (see page 9 of instructions) 29a _____ b Special deductions (Schedule C, line 20) 29b _____ 29c _____	12 60,000 13 0 14 0 15 0 16 0 17 0 18 0 19 0 20 _____ 21b 0 22 0 23 0 24 0 25 0 26 150,000 27 210,000 28 95,000 29c 0 30 95,000
30 Taxable income. Subtract line 29c from line 28		

C. TAXABLE INCOME LIMITATION

The net recognized built-in gain, upon which the corporation is ultimately taxable, is limited to the corporation's taxable income, taking into account all gains, income, deductions, and losses for the year.

Code §1374(d)(2)(A)(ii) refers back to the passive-income tax rule for the definition of taxable income. According to the regulations, it is important to observe all of the offset rules and deduction limitations that would be applicable if the corporation were a C corporation. For this calculation, however, it is not necessary to determine the year of economic origin of any item. Thus payments to related parties, including deferred compensation, are fully deductible for this calculation. Restated briefly, taxable income is computed as if the corporation were a C corporation, except that it is not allowed the special deduction for dividends received. Nor is it allowed to use any carryover deductions. Later this discussion will address the use of its net operating loss carryforward.

Example 2 (continued). Calboco also made \$2,000 of charitable contributions in 1998. In that same year Calboco received \$3,000 of municipal bond interest. The corporation paid \$4,500 of premiums on key employee life insurance.

Calboco would compute its taxable income limitation by taking into account all income and deductions of 1998.

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Gross ordinary income	\$1,000,000
Capital gain from securities	6,000
Expenses other than salaries	(798,000)
Charitable contributions	(2,000)
Salaries	(150,000)
	\$ 56,000
Taxable income limitation	\$ 56,000

Note that the charitable contribution is allowed in full, because it does not exceed the C corporation limit of 10% of taxable income. Also note that the \$3,000 of municipal bond interest is not included, and the \$4,500 of life insurance premiums is not deducted. These items receive the normal treatment under the tax law.

The pre-limitation amount is also entered on Schedule D of Form 1120S. Again, the IRS instructs the corporation to prepare a dummy Form 1120 (page 1 only) to show the calculation of the taxable income limitation. For this purpose the income items include all of the corporation's gross income. Deductions similarly include all allowable deductions of the current year. Attached is a copy of Form 1120 showing Calboco's taxable income limitation.

Form 1120 Department of the Treasury Internal Revenue Service	U.S. Corporation Income Tax Return For calendar year 1998 or tax year beginning, 1998, ending, 19 ... ▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.	OMB No. 1545-0123 1998
A Check if a: 1 Consolidated return (attach Form 851) <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (as defined in Temporary Regs. sec. 1.441-4T—see instructions) <input type="checkbox"/>	Use IRS label. Otherwise, print or type. Name Calboco (Dummy, Taxable Income Limitation) Number, street, and room or suite no. (If a P.O. box, see page 5 of instructions.) City or town, state, and ZIP code	B Employer identification number : C Date incorporated D Total assets (see page 5 of instructions)
E Check applicable boxes: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Change of address		
Income	1a Gross receipts or sales 1,000,000 b Less returns and allowances 0 c Bal ▶	1c 1,000,000
	2 Cost of goods sold (Schedule A, line 8)	2 0
	3 Gross profit. Subtract line 2 from line 1c	3 1,000,000
	4 Dividends (Schedule C, line 19)	4 0
	5 Interest	5 0
	6 Gross rents	6 0
	7 Gross royalties	7 0
	8 Capital gain net income (attach Schedule D (Form 1120))	8 6,000
	9 Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)	9 0
	10 Other income (see page 6 of instructions—attach schedule)	10 0
	11 Total income. Add lines 3 through 10 ▶	11 1,006,000
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (Schedule E, line 4)	12 150,000
	13 Salaries and wages (less employment credits)	13 0
	14 Repairs and maintenance	14 0
	15 Bad debts	15 0
	16 Rents	16 0
	17 Taxes and licenses	17 0
	18 Interest	18 0
	19 Charitable contributions (see page 8 of instructions for 10% limitation)	19 2,000
	20 Depreciation (attach Form 4562)	20 0
	21 Less depreciation claimed on Schedule A and elsewhere on return	21a 0
	22 Depletion	22 0
	23 Advertising	23 0
	24 Pension, profit-sharing, etc., plans	24 0
	25 Employee benefit programs	25 0
	26 Other deductions (attach schedule)	26 798,000
	27 Total deductions. Add lines 12 through 26 ▶	27 950,000
	28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28 56,000
	29 Less: a Net operating loss deduction (see page 9 of instructions)	29a 0
	b Special deductions (Schedule C, line 20)	29b 0
	29c	29c 0
	30 Taxable income. Subtract line 29c from line 28	30 56,000

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D. ADJUSTED NET UNREALIZED BUILT-IN GAIN LIMITATION

The next limit on net recognized built-in gain is the adjusted net unrealized built-in gain. For the first year of the recognition period, the adjusted net unrealized built-in gain limitation is the corporation's net unrealized built-in gain, as discussed above. For subsequent years, this limitation is reduced by the net recognized built-in gain of each prior year.

Example 2 (continued). Calboco's net unrealized built-in gain limitation for 1998 is \$290,000, which was computed at the introduction of this example. It also appears on line 9 of Schedule B of Form 1120S, shown earlier.

5. TAXABLE BUILT-IN GAIN

After the corporation has computed its pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation, it takes the lowest of these three amounts as its net recognized built-in gain for the year.

Example 2 (continued). Calboco's net recognized built-in gain for 1998 is the least of three amounts:

Pre-limitation amount	\$ 95,000
Taxable income limitation	\$ 56,000
Adjusted net unrealized built-in gain limitation	\$290,000

Thus its net recognized built-in gain is \$56,000.

Observation. Calboco's adjusted net unrealized built-in gain for 1999 is \$234,000 (\$290,000 – \$56,000).

6. USE OF NET OPERATING LOSS CARRYFORWARD

In spite of the general prohibition against the use of carryforwards from C corporation years, an S corporation may use a net operating loss carryforward to offset its net recognized built-in gain [I.R.C. §1374(b)(2)]. When the corporation has finally determined the taxable (net recognized) built-in gain for the year, it utilizes any carryforwards from C years.

Example 2 (continued). As stated in the introduction to the example, Calboco had a net operating loss carryforward of \$16,000 from 1994, which the corporation had not been able to use by the end of 1997. This item has not reappeared in subsequent steps, since it has no effect on the recognized built-in gain, per se, or any of its three components.

At this point, Calboco uses the net operating loss carryforward to reduce its taxable built-in gain.

Net recognized built-in gain	\$56,000
Less NOL carryforward	(16,000)
Taxable built-in gain	\$40,000

The IRS terms the allowable carryforward the **section 1374(b)(2) deduction**.

7. COMPUTATION OF TAX

The corporation computes the tax on this figure at the highest corporate rate (currently 35%).

Example 2 (continued). Calboco's built-in gain tax is

Taxable built-in gain	\$40,000
Tax rate	× 35%
Tax	\$14,000

8. USE OF CREDIT CARRYFORWARDS

There is a limited ability to use credits to offset the tax [I.R.C. §1374(b)(3)]. The corporation offsets the tax with any business credit carryforward and alternative minimum tax credit from a C corporation year. The corporation must observe any limitations that apply to these two credits. It cannot utilize any other credit (except for the fuel credit) from an S year. These credits pass through to the shareholders.

Example 2 (continued). Assume that Calboco has an AMT credit carryforward of \$25,000 from prior C corporation years. Also assume that Calboco's computation of its tentative minimum tax for the current year is \$11,000 (details not given). Calboco's final built-in gain tax liability for 1998 is

Tax (pre-credit)	\$14,000
Less AMT credit (as limited)	(3,000)
Final built-in gains tax	<u>\$11,000</u>

Calboco cannot utilize any other credit (except for the fuel credit) from an S corporation year.

9. COMPLETING FORM 1120S

An S corporation that has built-in gains problems has a much more complicated return than most other S corporations. The tax itself involves the computations described previously. As stated earlier, the forms and instructions are a bit disjointed. This portion of the chapter shows how our hypothetical corporation will complete parts of its Form 1120S and report its annual activity to its shareholders.

A. COMPUTATION OF TAX ON SCHEDULE D

Entering the built-in gains tax on Form 1120S begins with Part IV of Schedule D.

1. This part of the form begins with the pre-limitation amount, entered on line 25. This is the same total as line 28 on the first dummy Form 1120.
2. On line 26 of Schedule D the taxable income limitation is entered from the second dummy Form 1120.
3. Line 27 takes the lower of the two amounts above, or the unrealized built-in gain from line 9, Schedule B.
4. The loss carryforward is shown as the I.R.C. §1374(b)(2) deduction on line 28.
5. Lines 23 and 30 are self-explanatory.
6. Line 31 shows the allowable credit. In this case it is \$3,000.
7. Finally, the corporation's tax liability is shown on line 32.

SCHEDULE D
(Form 1120S)

Capital Gains and Losses and Built-In Gains

OMB No. 1545-0130

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1120S.

▶ See separate instructions.

1998

Part IV		Built-In Gains Tax (See instructions before completing this part.)	
25	Excess of recognized built-in gains over recognized built-in losses (attach computation schedule)	25	95,000
26	Taxable income (attach computation schedule)	26	56,000
27	Net recognized built-in gain. Enter the smallest of line 25, line 26, or line 9 of Schedule B	27	56,000
28	Section 1374(b)(2) deduction	28	16,000
29	Subtract line 28 from line 27. If zero or less, enter -0- here and on line 32	29	40,000
30	Enter 35% of line 29	30	14,000
31	Business credit and minimum tax credit carryforwards under section 1374(b)(3) from C corporation years	31	3,000
32	Tax. Subtract line 31 from line 30 (if zero or less, enter -0-). Enter here and on Form 1120S, page 1, line 22b	32	11,000

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B. EFFECT OF THE BUILT-IN GAINS TAX ON SHAREHOLDER INCOME AND THE ACCUMULATED ADJUSTMENTS ACCOUNT (AAA)

The Code treats the built-in gains tax as a loss, which corresponds to the gain that created the tax [I.R.C. §1366(f)(2), Prop. Reg. §1.1366-4(b)]. The tax is apportioned according to the **recognized built-in gain** (not net recognized built-in gain) of each character. The tax thus reduces items that flow through to the shareholders.

Example 2 (continued). Calboco's recognized built-in gains, by character, absorb the built-in gains tax as follows:

	<u>Amount</u>	<u>Percent</u>	<u>Tax</u>
Ordinary income from receivables	\$300,000	98.36	\$10,820
Capital gain from securities sales	5,000	01.64	180
Total	<u>\$305,000</u>	<u>100.00</u>	<u>\$11,000</u>

If the tax is payable by the corporation in the same year that the gain is recognized, the application of this rule will reduce the gain passing through to the shareholders.

Example 2 (continued). Assuming that Calboco has no separately reported income or loss items other than the capital gain from the securities, only ordinary income and capital gain will pass through to the shareholders.

Also, assume that the amounts calculated above for Calboco's taxable income limitation are the same as the amounts that pass through to the shareholders.

Calboco's Page 1 of Form 1120S and Schedule K would show the following amounts:

<u>Description</u>	<u>Before Tax</u>	<u>Built-in Gains Tax</u>	<u>Net of Tax</u>
Ordinary income*	\$52,000	\$10,820	\$41,180
Charitable contribution	(2,000)	0	(2,000)
Capital gain	6,000	180	5,820
Total	<u>\$56,000</u>	<u>\$11,000</u>	<u>\$45,000</u>

*($\$1,000,000 - \$798,000 - \$150,000$)

Thus \$45,000 would pass through to the shareholders as positive adjustments to basis for the year.

The corporation's AAA would increase by \$45,000, before consideration of any distributions of the year.

C. COMPLETION OF FORM 1120S PAGE 1

To demonstrate all of these computations, we now use the various parts of Form 1120S. Page 1 shows the usual computation of taxable income. Note that all of the deductions other than the shareholders' salaries are shown as part of the "other deductions" on line 19. Recall that this amount is \$798,000. The instructions for Form 1120S are not specific as to the treatment of the built-in gains tax on the form. The portion allocated to ordinary income (\$10,820) is shown as an additional part of the other deductions on line 19, so this line totals \$808,820. Page 1 shows the final ordinary income net of the built-in gains tax.

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Schedule K Shareholders' Shares of Income, Credits, Deductions, etc.		(a) Pro rata share items	(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1 41,180
	2	Net income (loss) from rental real estate activities (attach Form 8825)	2 0
	3a	Gross income from other rental activities	3a
	3b	Expenses from other rental activities (attach schedule)	3b
	3c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c 0
	4	Portfolio income (loss):	
	4a	a Interest income	4a
	4b	b Ordinary dividends	4b
	4c	c Royalty income	4c
	4d	d Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	4d
	4e(2)	e Net long-term capital gain (loss) (attach Schedule D (Form 1120S)); (1) 28% rate gain (loss) ▶ (2) Total for year ▶	4e(2) 5,820
	4f	f Other portfolio income (loss) (attach schedule)	4f
	5	Net section 1231 gain (loss) (other than due to casualty or theft) (attach Form 4797)	5 0
6	Other income (loss) (attach schedule)	6 0	
Deductions	7	Charitable contributions (attach schedule)	7 2,000
	8	Section 179 expense deduction (attach Form 4562)	8 0
	9	Deductions related to portfolio income (loss) (itemize)	9
	10	Other deductions (attach schedule)	10 0
Investment Interest	11a	Interest expense on investment debts	11a
	11b(1)	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1) 0
	11b(2)	(2) Investment expenses included on line 9 above	11b(2) 0
Credits	12a	Credit for alcohol used as a fuel (attach Form 6478)	12a 0
	12b(1)	b Low-income housing credit: (1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1) 0
	12b(2)	(2) Other than on line 12b(1) for property placed in service before 1990	12b(2)
	12b(3)	(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)
	12b(4)	(4) Other than on line 12b(3) for property placed in service after 1989	12b(4)
	12c	c Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)	12c 0
	12d	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d
12e	e Credits related to other rental activities	12e	
13	Other credits	13 0	
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a 0
	14b	b Adjusted gain or loss	14b
	14c	c Depletion (other than oil and gas)	14c
	14d(1)	d (1) Gross income from oil, gas, or geothermal properties	14d(1)
	14d(2)	(2) Deductions allocable to oil, gas, or geothermal properties	14d(2)
14e	e Other adjustments and tax preference items (attach schedule)	14e	
Foreign Taxes	15a	Type of income ▶	15a
	15c	b Name of foreign country or U.S. possession	15c
	15d	c Total gross income from sources outside the United States (attach schedule)	15d
	15e	d Total applicable deductions and losses (attach schedule)	15e
	15f	e Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	15f
	15g	f Reduction in taxes available for credit (attach schedule)	15g
	15g	g Other foreign tax information (attach schedule)	15g
Other	16b	16 Section 59(e)(2) expenditures: a Type ▶ b Amount ▶	16b
	17	17 Tax-exempt interest income	17 3,000
	18	18 Other tax-exempt income	18
	19	19 Nondeductible expenses	19 4,500
	20	20 Total property distributions (including cash) other than dividends reported on line 22 below	20
	21	21 Other items and amounts required to be reported separately to shareholders (attach schedule)	21
	22	22 Total dividend distributions paid from accumulated earnings and profits	22
23	23 Income (loss) . (Required only if Schedule M-1 must be completed.) Combine lines 1 through 6 in column (b). From the result, subtract the sum of lines 7 through 11a, 15e, and 16b	23 45,000	

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Of each of the items shown on Schedule K, 60% will go to Charles on Schedule K-1. Similarly, 40% of each item will go to Charlene. In the interests of brevity, these schedules are not shown. From Schedule K-1, each shareholder will report the information on his or her Form 1040 as follows:

- The line 1 ordinary income is reported on the Schedule E of each shareholder's Form 1040. It is not subject to self-employment tax.
- The capital gain is posted to each shareholder's Schedule D. Note that there is no portion of this gain designated as taxable at the 28% rate.
- The charitable contribution goes to Schedule A, as an itemized deduction. The deductibility of this contribution will depend on each shareholder's election to itemize and each shareholder's AGI limits.
- The tax-exempt interest must be noted on each shareholder's Form 1040 so that it may be taken into account for the tax on social security benefits, if applicable.
- The premiums paid on officers' life insurance are not deductible under any provision. However, they must be allocated to the shareholders for basis considerations.

E. COMPLETION OF SCHEDULES M-1 AND M-2

Schedules M-1 and M-2 are unique to the S corporation. C corporations have similarly titled schedules, and partnerships have a Schedule M-1. Schedule M-1 reconciles book income to certain items on Schedule K, generally, the taxable income and deductible items of the year. This reconciliation seems to serve little purpose, other than being a check on the mechanical aspects of Schedule K.

Example 2 (continued). Calboco's book income for 1998 is

Gross ordinary income	\$1,000,000
Capital gain from securities	6,000
Tax-exempt interest	3,000
Expenses other than salaries	(798,000)
Charitable contributions	(2,000)
Salaries	(150,000)
Premium on insurance	(4,500)
Built-in gains tax	(11,000)
Taxable income limitation	<u>\$ 43,500</u>

Schedule M-2 is a reconciliation of several account balances. The most important of these is the corporation's Accumulated Adjustments Account (AAA). This account serves as the cushion, or maximum amount distributable to shareholders before any distribution is taxable as a dividend. Accordingly, this account is of immediate benefit only to corporations that have accumulated earnings and profits from C corporation years, which are treated as a dividend if distributed to shareholders. Note that Schedule M-2 has no place for accumulated earnings and profits—a fact that limits its usefulness somewhat.

The AAA is adjusted for all items that appear on Schedule K, except for tax-exempt income and related expenses. Thus, in our example it includes the ordinary income, the capital gain, and the charitable contribution. The tax-exempt income and related expense are posted to the Other Adjustments Account (OAA). Schedule M-2 has a final set of columns for "shareholders' undistributed taxable income previously taxed," also known as "previously taxed income," or PTI. This account deals with pre-1983 accumulations of S corporations and is not relevant to this problem.

Calboco's Schedules M-1 and M-2 are shown below. Schedule M-1 begins with the book income, shown above. It then adjusts for the tax-exempt income and the premiums on insurance, for a result of \$45,000, which is the same as the total of taxable items on Schedule K. Note also that this total will be the same as the current year's adjustments to the AAA, shown on Schedule M-2. The adjusting items are posted to the OAA, also on Schedule M-2.

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Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than \$25,000.)					
1	Net income (loss) per books	43,500	5	Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize):	
2	Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):	0	a	Tax-exempt interest \$	3,000
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16b (itemize):		6	Deductions included on Schedule K, lines 1 through 11a, 15e, and 16b, not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$	0
b	Travel and entertainment \$		7	Add lines 5 and 6	3,000
	insurance	4,500	8	Income (loss) (Schedule K, line 23). Line 4 less line 7	45,000
4	Add lines 1 through 3	48,000			

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see page 24 of the instructions)			
	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	0	0
2	Ordinary income from page 1, line 21	41,180	
3	Other additions	5,520	
4	Loss from page 1, line 21	(0)	
5	Other reductions	(2,000)	
6	Combine lines 1 through 5	45,000	0
7	Distributions other than dividend distributions	0	
8	Balance at end of tax year. Subtract line 7 from line 6	45,000	0

The Schedule M-2 items are taken directly from Schedule K. The taxable items are posted to the AAA, whereas the tax-exempt income and related expense are shown in the OAA. These items are also used to calculate the annual adjustments to a shareholder's stock basis.

F. SHAREHOLDER BASIS ADJUSTMENTS

As mentioned above, all of the income and expenses, whether taxable or not, affect a shareholder's basis. The following worksheet is shown for shareholder Charles, who owns 60% of the stock in Cal-boco. It is assumed that Charles's basis was \$100,000 at the beginning of 1998. He will post 60% of each item on the Schedule K to his basis worksheet.

(References in the following worksheet are to sections in the *S Corporation Taxation Guide* by Robert W. Jamison, published each fall by Harcourt Professional Publishing. Copies may be ordered at 1-800-831-7799, or at amazon.com.)

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Worksheet: Stock Basis in Post-1996 Year

Keep a separate worksheet for each block of stock.

If the corporation has terminated a year under I.R.C. §1377(a)(2) or Treas. Reg. §1.1368-1(g), complete a separate worksheet for each portion of the year.)

1. Basis at beginning of year, or at acquisition date of acquired during year	<u>\$100,000</u>
2. Additions to basis (CAUTION: Make sure that any debt basis has been restored to extent of prior reductions.)	
a. Add all taxable items from shareholder's K-1 (to the extent allocated to this block) (\$24,708 ordinary income + \$3,492 capital gain)	<u>28,200</u>
b. Add all tax-exempt income (CAUTION: If including corporate cancellation of debt income, review current IRS position and consider disclosure.) See discussion at 925.22	<u>1,800</u>
c. Add any deemed dividend allocated to this block. (See Chapter 7, at 740.5.)	_____
3. Subtotal (1 + 2a + 2b + 2c)	<u>130,000</u>
4. Reductions of basis	
a. Distributions received by shareholder during year (Do not include any dividend from earnings and profits or deemed dividend.) (Do not reduce basis below zero. If distributions exceed basis, check to see if other block of stock has sufficient basis to absorb excess.)	_____
b. Subtotal (3 – 4a) CAUTION: Determine if prior or current election to reduce for deductible expenses under Treas. Reg. §1.1367-1(f) is in effect. If such election is in effect, skip line 4c and go directly to line 4d.)	<u>130,000</u>
c. Nondeductible expenses, not capitalized (Include any spillovers from other blocks of stock.) (Do not reduce basis below zero.) Check to see if other block of stock has sufficient basis to absorb excess. Check to see if shareholder debt has sufficient basis to absorb excess. (Do not carry forward any excess expense to next year.) (charitable contribution of \$1,200 + insurance premium of \$2,700)	<u>-3,900</u>
d. Deductible expenses and losses (Include any spillovers from other blocks of stock.) (Include any amounts carried forward from last year.) (Do not reduce basis below zero.) Check to see if other block of stock has sufficient basis to absorb excess.) (Check to see if shareholder debt has sufficient basis to absorb excess.) (Carry forward any excess expense to next year.)	_____
e. Subtotal (4b – 4c – 4d) (CAUTION: If prior or current election to reduce for deductible expenses under Treas. Reg. §1.1367-1(f) is not in effect, skip line 4f and go directly to line 4g.)	<u>126,100</u>
f. Nondeductible expenses, not capitalized (Include any spillovers from other blocks of stock.) (Include any amounts carried forward from last year.) (Do not reduce basis below zero.) (Check to see if other block of stock has sufficient basis to absorb excess.) (Check to see if shareholder debt has sufficient basis to absorb excess.) (Carry forward any excess expense to next year.)	_____
g. Subtotal (4e – 4f)	<u>\$126,100</u>
5. Ending basis (4f – 4g)	<u>\$126,000</u>

10. OTHER YEAR-END TASKS TO COMPLY WITH BUILT-IN GAINS RULES

A. RECOGNIZED BUILT-IN GAIN CARRYFORWARD

If the corporation's taxable income limit is the lowest measure of net recognized built-in gain, the reduction in income must be treated as a recognized built-in gain in the next year of the recognition period.

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Example 2 (continued). Calboco must calculate its built-in gain carryforward, since its taxable income limitation was the limiting factor for this year.

Recall from above the three computations of net recognized built-in gain:

Pre-limitation amount	\$ 95,000
Taxable income limitation	\$ 56,000
Net unrealized built-in gain limitation	\$290,000
Smallest, other than taxable income limitation	\$ 95,000
Less taxable income limitation	(56,000)
Recognized built-in gain carryforward	<u>\$ 39,000</u>

Thus Calboco's pre-limitation amount in 2000 will be \$39,000, in addition to any built-in gains actually recognized in that year.

B. ADJUSTMENT TO OTHER CARRYFORWARD

The corporation must continue to observe all carryforward periods for the net operating loss, general business credit, and alternative minimum tax carryforwards. It must also adjust the carryforwards for any amounts used during the current year.

Example 2 (continued). Calboco would eliminate its net operating loss carryforward from C corporation years, since its 1998 net recognized built-in gain absorbed all of this tax attribute.

Calboco would reduce its AMT credit carryforward from \$25,000 (the balance that existed at the end of 1997) by \$2,000 (the amount used in 1998). Thus it would carry \$23,000 forward to the remaining years in its recognition period.

C. ADJUSTMENT TO NET UNREALIZED BUILT-IN GAIN LIMITATION

For any year in which a corporation has a net recognized built-in gain, it reduces the net unrealized built-in gain by the same amount. In this manner, the adjusted net unrealized built-in gain can effectively limit the tax on recognized built-in gains during the 10 years for which the corporation is subject to the tax.

Thus the net unrealized built-in gain limitation is gradually reduced as the corporation reports net recognized built-in gains.

Example 2 (continued). At the end of 1998, Calboco will be able to calculate its net unrealized built-in gain limitation for 1999.

Net unrealized built-in gain limitation, 1998	\$290,000
Less net recognized built-in gains, 1998	(56,000)
Net unrealized built-in gain limitation, 1999	<u>\$234,000</u>

This amount will be shown on line 9 of Schedule B of Calboco's 1999 Form 1120S and will enter into its built-in gains tax computations in 1999.