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010000 LOCATING ITEMS ON S CORPORATION AND SHAREHOLDER RETURNS

S Corp 010100	Diagram of Federal 1120S
S Corp 010200	Diagram of California Form 100S
S Corp 010300	Diagram of California 540
S Corp 010400	Glossary of Terms
S Corp 010500	California Form 100S
S Corp 010600	Federal Form 1120S: U.S. Income Tax Return for an S Corporation
S Corp 010700	California Form 540: California Resident Income Tax Return

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010100 DIAGRAM OF FEDERAL 1120S

Diagram of Federal 1120S

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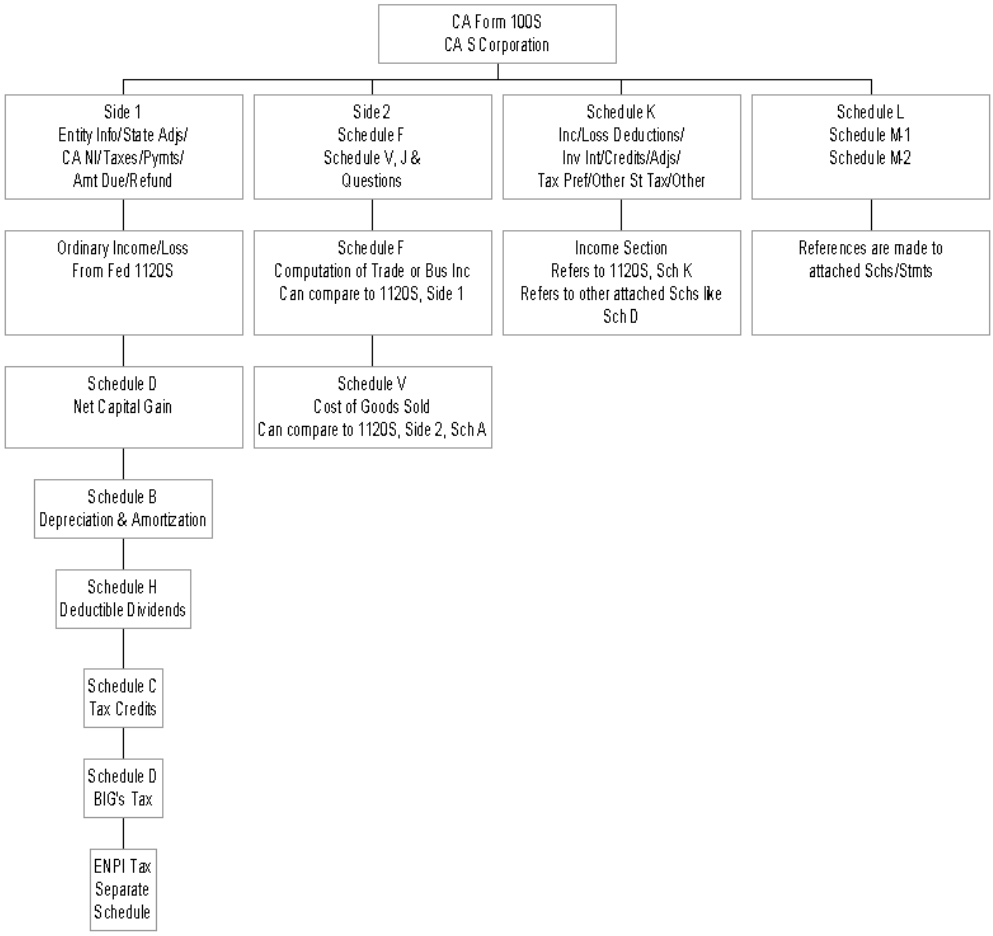
010200 DIAGRAM OF CALIFORNIA 100S

Diagram of California 100S



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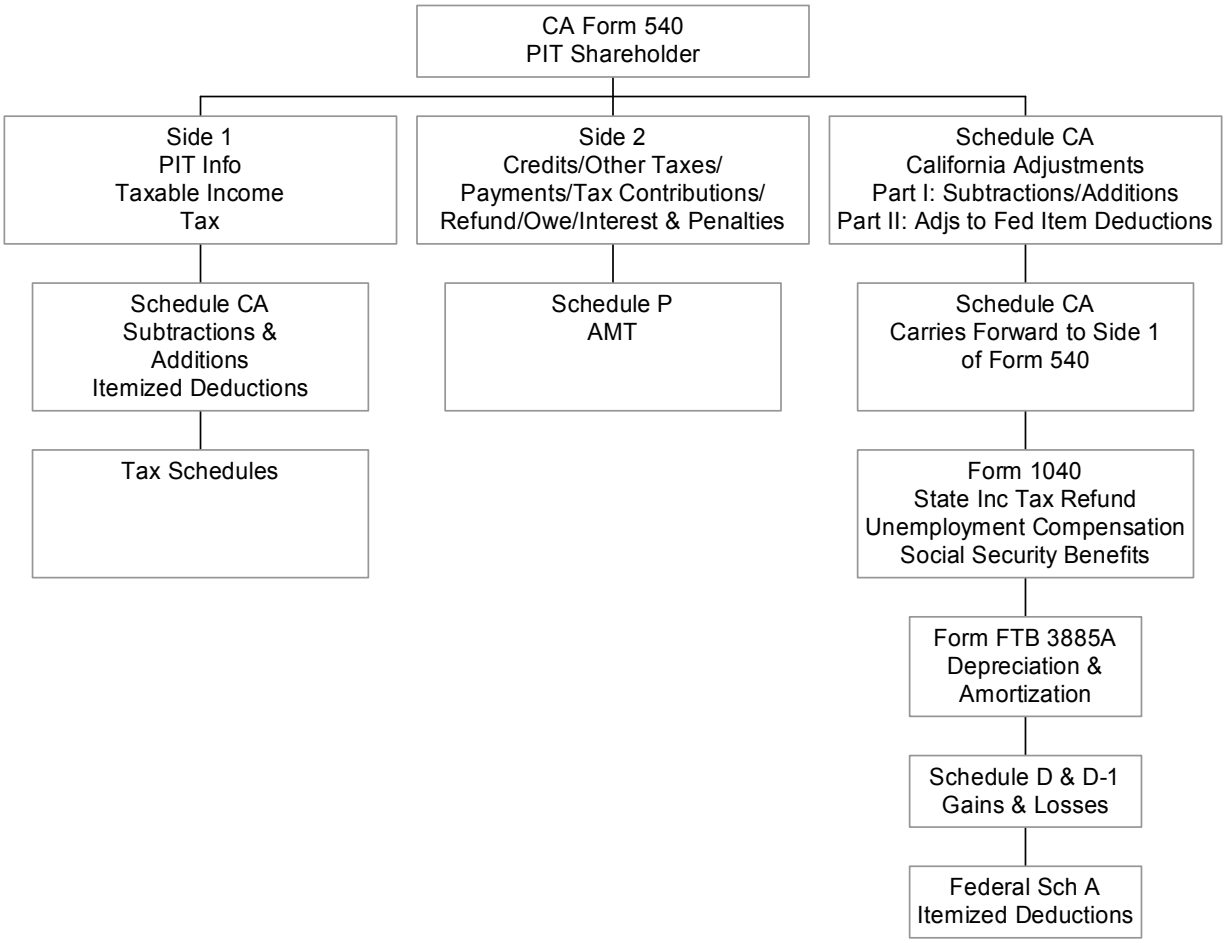
010300 DIAGRAM OF CALIFORNIA 540

Diagram of California 540



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010400 GLOSSARY OF TERMS

The following list includes typical S corporation terms:

TERM	MEANING
AAA	Accumulated Adjustments Account
BIG or BIG's	Built-in Gains
BIL or BIL's	Built-in Losses
COD	Cancellation of Debt
CODI	Cancellation of Debt Income
C/G	Capital Gain
C/L	Capital Loss
CGS or COGS	Cost of Goods Sold
E&P	Earnings & Profits
ENPI	Excessive Net Passive Income
FEIN	Federal Employer Identification Number
FIFO	First-In, First-Out
C Corporation or C Corp.	General C Corporation
GM	Gross Margin
GP	Gross Profit
LIFO	Last-In, First-Out
MIC	Manufacturers' Investment Credit
NI	Net Income
NOL	Net Operating Loss
NPI	Net Passive Income
OAA	Other Adjustments Account
PTI	Pass Through Income
PTTP	Post Termination Transition Period
R&D Credit	Research and Development Credit
S/H or SHD	Shareholder
SS# or SSN	Social Security Number
SA or S/A	State Adjustments
S Corporation or S Corp.	Subchapter S Corporation

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010500 CALIFORNIA 100S

When scoping California Form 100S, Federal 1120S, and California Form 540, consider the materiality of audit issues. Also, consider the shareholders' tax consequences of the adjustments made at the corporate level.

When scoping the California Form 100S, consider the following issues:

S Corp 010501	Form 100S: Questions - Side 1
S Corp 010502	Form 100S: Side 1
S Corp 010503	Form 100S: Schedule F Computation of Trade or Business Income
S Corp 010504	Form 100S: Schedule V Cost of Goods Sold
S Corp 010505	Form 100S: Schedule J Add-On Taxes or Recapture of Tax Credits
S Corp 010506	Form 100S: Questions Side 2
S Corp 010507	Form 100S: Schedule K
S Corp 010508	Form 100S: Schedule L Balance Sheet
S Corp 010509	Form 100S: Schedule M-1
S Corp 010510	Form 100S: Schedule M-2
S Corp 010511	California Schedule K-1 (100S)

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010501 Form 100S: Questions - Side 1

Form Item	
"Questions" on Form 100S page 1	**Example** Question A – A check in any of these boxes indicates that this is the corporation's final return. Did the corporation merge or reorganize with another entity? If yes, look for the merger/reorganization information attached to the return. Question B - If the "yes" box was checked, find out why. Question C – To find out the S corporation's business activity, look up the business activity code in California Package X, 100S instructions for Question C.

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010502 Form 100S: Side 1

Form Item	
Line 1 - Ordinary Income	Trace the amount to Form 100S, Schedule F, line 22 as well as to the federal Form 1120S, Line 21
Line 2 - Foreign or domestic tax	This tax add-back amount may be traced back to Form 100S, Sch. F, Line 12. Form 100S, Sch. F, line 12 often includes other tax items. Look for a statement detailing the tax reported on Form 100S, line 12 in the return.
Line 4 - Net Capital Gain	
Line 6 - Portfolio Income	If this is a material amount and the corporation reports C corporation earnings and profits, the excess net passive income issue may exist. The ENPI tax is reported on Form 100S, line 29. Various types of portfolio income are reported on Form 100S, Sch. K, lines 4a-4f.
Line 7 - Other Additions	If amounts are material, find out what they are.
Line 9 - Dividends	Refer to Sch. H for details of the dividends reported.
Line 11 - Contributions	The contributions deduction is limited. Refer to Form 100S Instructions.
Line 13 - Other Deductions	Look for a statement detailing the items of deductions.
Line 17 - R&TC Section 23802(e) deduction	The amount of ENPI or BIG is deducted here to compute net income for 1.5% tax purposes.
Line 23~26 - Tax Credits	See Sch. C and California forms filed for respective credits.
Line 28 - Tax from Sch. D	The BIG tax, if any, should be reported here.
Line 29 - Excessive Net Passive Income Tax	The ENPI tax, if any, should be reported here.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

010503 Form 100S: Schedule F Computation of Trade or Business Income

Form Item	
Line 1a – Gross Receipts	
Line 2 - Cost of Goods Sold	This line sources from Form 100S, Schedule V Cost of Goods Sold, line 8.
Line 4 – Net Gain	This amount sources from Form 100S, Schedule D, Section B, Part II, line 10.
Line 5 - Other Income	Look for a statement explaining the income. Be aware that ENPI or BIG issues may be present.
Line 12 - Taxes	Look for a statement explaining the types of taxes. Certain taxes deducted here must be added back on Form 100S, Side1, line 2.
Line 20 - Other Deductions	Look for a statement explaining the deductions. Are they reasonable?
Line 22 - Ordinary Inc/Loss	This amount should be carried over to Form 100S, Side 1, line 1.

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010504 Form 100S: Schedule V Cost of Goods Sold

Form Item	The amount on Form 100S, Schedule V, line 8 should be carried overt to Form 100S, Schedule F, line 2.

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010505 Form 100S: Schedule J Add-On Taxes or Recapture of Tax Credits

Form Item	This Schedule reports additional taxes & recapture of certain items.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

010506 Form 100S: Questions Side 2

Form Item	
Question F	This date (along with the date reported on Question K) may be useful in scoping for issues arising from the corporation's S election. Examples are BIG, ENPI, and other issues relating to the S corporation's maintaining C-Corp E&P.
Question G	This information indicates changes in the ownership of the S corporation. Compare this figure with the number of schedule K-1's filed with the return.
Question H	See Question F explanation above.
Question I	If the "yes" box is checked, consider obtaining a copy of the Revenue Agent's Report if not provided with the return.
Question J and K	This date may be important for BIG and ENPI purposes. Caution these dates may not be reliable. Look for California Form 3560 in the Corp folder for accuracy.
Question O	If "no" is checked, consider finding what wasn't filed.
Special Note:	Tax preparers sometimes place disclaimers on the returns.

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010507 Form 100S: Schedule K

Form Item	The items presented on this Schedule are items that are to be allocated among the shareholder(s).
Column b - Amount from Federal Sch K	The items reported in this column should be the items reported on the federal Form 1120S, Sch. K.
Column c - California Adjustment	California adjustments can be traced to other attached schedules.
Line 1 - Ordinary Income/Loss	This amount can be found on federal Form 1120S, Sch. K, line 1; California Form 100S, Sch. F, line 22; and California Form 100S, Side 1, line 1.
Line 4d - Net Short-Term Capital Gain/Loss Line 4e, Net Long-Term Capital Gain/Loss	Refer to California Form 100S, Sch. D and California Schedule D-1 for details.
Line 4f - Other Portfolio Income	Refer to detailed attachments/statements. If the S Corporation has C Corporation earnings & profits and reports a large portfolio income, there may be an ENPI issue. The ENPI tax should be reported on Form 100S, Side 1, line 29.
Line 5 - IRC Section 1231 Net Gain/Loss	Look for potential BIG or BIL issues. The amount of IRC Section 1231 gain/loss traces back to California Form 100S, Sch. D, Section B, Part II, line 5 and to California Schedule D-1, Part I, line 9.
Line 6 - Other Income	Look for a schedule/statement detailing other income.
Line 7 - Charitable Contributions	The amount of charitable contributions deductions for an S corporation is limited to 10% of California Net Income without regard to charitable contributions and special deductions. If an appreciated property was contributed, there may be an AMT issue at the shareholder level.
Line 10 - Other Deductions	Review the schedule/statement detailing the deductions. If deductions are material, consider requesting explanations during the examination.
Line 13 - Other Credits	Scope appropriate California forms used to compute credits.
Line 14a ~ 14f - Adjustments & Tax Preference Items	Include these items in computing shareholder AMT. For more detail, refer to the federal 1120S

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	instructions for Sch. K.
Line 15 - Other State Taxes	Sometimes corporations attach copies of the other states' tax returns to the California Form 100S.
Line 16 - IRC Section 59(e) Election Expenditure	If the amount is material, verify the application of IRC section 59.
Line 17~18 - Tax Exempt Interest Income & Other Tax Exempt Income	See S Corp 090000 (Shareholder Basis) and S Corp 080000 (Distribution/AAA) of this manual.
Line 19 - Nondeductible Expenses	The amount reported on this reduces shareholder basis.
Line 20 - Total Property Distributions	This amount should equal the aggregate amount of distributions reported on line 21 of Sch. K-1's of Form 100S and the amount reported on line 7(a) of Sch. M-2 of Form 100S. If there is a discrepancy, consider requesting detailed explanation.
Line 21 - Other Items	Review the attached schedule/statement.
Line 22 - Total Dividend Distributions	If an amount is reported, scope the shareholder's federal personal income tax return, Form 1040, Sch. B, for the dividend income.

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010508 Form 100S: Schedule L Balance Sheet

Form Item	
The balance sheet items help to identify transactions incurred during the year.	
Line 2 - Receivables	Find out the corporation's primary business to understand the types of receivables included in the account.
Line 3 - Inventories	Find out the corporation's primary business to understand what costs were capitalized in the account.
Line 5 - Other Current Assets	Review schedules/statements attached.
Line 6 - Loans to Shareholders	Are these bona-fide loans or disguised distributions? Did the corporation report any interest earned on loans made to shareholders?
Line 8 - Other Investments	Look for statements explaining other investments.
Line 9 - Buildings & Other Assets	Look for schedules/statements (such as a depreciation schedule) explaining tangible depreciable assets. Note any increase or decrease in the account. Taxable transactions may be associated with the changes in the account.
Line 10 - Depletable Assets	Look for schedules/statements explaining depletable assets. Do these assets lead to any depletion expenses? Oil wells?
Line 12 - Intangible Assets	Look for schedules/statements explaining intangible assets.
Line 13 - Other Assets	Look for schedules/statements explaining other assets.
Line 18 - Loans from Shareholders	Look for schedules/statements for details. If any portion of loans were repaid, there may be a taxable loan repayment issue at the shareholder level. See S Corp 090000 for details.
Line 19 - Mortgages/Notes/Bonds ≥ 1 yr	Sometimes loans from shareholders are reported here.
Line 20 - Other Liabilities	Sometimes loans from shareholders are reported here.
Line 21 - Capital Stock	This item is generally reported consistently from year to year. If there are any changes between taxable years, there may be changes in the

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	ownership of the corporation.
Line 22 - Paid-In Capital Surplus	This amount represents the amount of additional capital contributions from shareholders. The amount of loans from shareholders may be reclassified to PICS here.

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010509 Form 100S: Schedule M-1

Sch. M-1 reconciles the corporation's book income to its taxable income. Analyze the reconciliation to ensure proper reporting of Sch. M-1 items. A statement explaining each Sch. M-1 item may help you identifying tax issues.

Form Item	
Line 1 - Net Income Per Books	This number is the corporation's book income.
Line 8 - Income/Loss	This number is the corporation's taxable income and is carried forward to Form 100S, Side 1, line 15.

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010510 Form 100S: Schedule M-2

Sch. M-2 reports the changes in the corporation's retained earnings during the year.

Column (a), Line 1a - Balance at the beginning of the year	The initial AAA balance is zero. The corporation reports the running balance of the account every year, carrying the previous year's ending balance over to the current year.
Column (a), Line 2a - Ordinary Income	This amount is the income reported on Form 100S, Side 1, line 1.
Column (a), Line 3a - Other Additions	This amount includes all income/gains including California positive adjustments, except for ordinary income reported on line 2a above.
Column (a), Line 4a - Loss from Side 1, line 1	This amount is the loss reported on Form 100S, Side 1, line 1.
Column (a), Line 5a - Other Reductions	This amount includes all loss/deduction items including California negative adjustments, except for ordinary loss reported on line 2a above.
Column (a), Line 7 - Distributions Other than Dividend Distributions	This amount is the amount of distributions from the S Corp's earnings (after tax). This amount must not create a negative AAA balance. Therefore, the amount entered here may be a plug-in figure and may not be the actual amount of distributions. Compare this amount with the amount reported on California Form 100S, Sch. K, line 20.
Column (b), Lines 1, 3, 5~8	Only S corporations that have Accumulated E&P at year-end maintain this column. The account is used for tax-exempt income (& related expenses) of the S corporation.
“Box” - Regarding C Corporation E&P	This box should be checked if the S corporation retains C-Corp E&P. Consider verifying the amount reported here.

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010511 California Schedule K-1 (100S)

This schedule is used to present each shareholder's pro rata share of flow-through gains/losses from the S corporation.

Schedule Item	
Shareholder's Identifying Number	Usually the shareholder's social security number.
California Corporation Number	S corporation's California corporation number (7 digits).
A: Shareholder's percentage of stock ownership	Percentage of the shareholder's interest in the S corporation at the end of year.
C: Check boxes if applicable: Final K-1; Amended K-1	(1) The final K-1 means the final K-1 for a terminating S corporation or the final K-1 for the departing shareholder (the shareholder has sold or redeemed his/her interest). (2) If this is an amended K-1, consider verifying what items were amended and whether the shareholder filed an amended return.
E: Nonresident shareholders	If the "yes" box is checked, review column (e) and the shareholder's Form 540NR filed with the FTB. Did the shareholder report his/her share of California source income in California?
The Columns: (a) Pro Rata Share Items, (b) Amount from Federal Sch. K-1, (c) CA adjustment, (d) CA amount, (e) CA source amounts and credits	Sch. K-1 should reflect all items reported on Sch. K, allocated by the ownership percentage.
Lines 17~18 - Tax Exempt Interest Income & Other Tax Exempt Income	This amount increases shareholder basis.
Line 19 - Nondeductible Expenses	This amount reduces shareholder basis.
Line 20 - Total Dividend Distributions paid from Accumulated E&P	The California Sch. K-1, line 20 reports "total dividend distribution paid from accumulated earnings and profits." The shareholder must report the dividend income in his federal Form 1040, Sch. B.
Line 21 - Property Distributions (including cash) other than dividend distributions.	The aggregate of Sch. K-1, line 21 must equal the amount reported on Sch. K, line 20.
Line 22 - Loan Repayments	If an amount is reported here, estimate the shareholder

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	stock and debt basis for a possible taxable loan repayment issue.
Line 23 - Supplemental Information	This area is often used to disclose additional information.

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010600 FEDERAL FORM 1120S: U.S. INCOME TAX RETURN FOR AN S CORPORATION

S Corp 010601 Federal Form 1120S: Side 1 and Side 2
S Corp 010602 Federal Form 1120S: Schedule K-Shareholder's Shares Of Income, Credits, Deductions, Etc.
S Corp 010603 Federal Form 1120S: Schedules L, M-1, & M-2
S Corp 010604 Federal Form 1120S: Schedule K-1

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010601 Federal Form 1120S: Side 1 and Side 2

Note: Federal Form 1120S, Side 1 is similar to California Form 100S, Sch. F (Computation of Trade or Business Income). Because of the California's 1.5% entity-level tax, the front page of California Form 100S, Side 1 contains separately stated items reported on Sch. K, but federal Form 1120S does not.

Form Item	
A: Date of election as an S Corporation	This date should be the date reported on California Form 100S, Side 2, Question L (Effective date of federal S election).
B: Business Code	The code is similar to the code reported on California Form 100S, Side 1, Question C (Principal Business Activity Code).
C: Employer Identification Number	This is the FEIN. California Form 100S, Side 1 also contains the FEIN.
D: Date Incorporated	This date should be the date reported on California Form 100S, Side 2, Question F (Date Incorporated)
E: Total Assets	This amount can be reconciled with the federal & California Sch. L.
F: Check Applicable Boxes	If any of these boxes are checked, consider examining any issues associated with the box checked.
Line 1-21	These items should be consistent with items reported in California Form 100S, Sch. F.
Schedule A-Cost of Goods Sold	This schedule should be consistent with California Form 100S, Sch. V.
Schedule B-Other Information	Compare the information with the information reported on California Form 100S, Questions E ~ Q for consistency.

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010602 Federal Form 1120S: Schedule K-Shareholder's Shares Of Income, Credits, Deductions, Etc.

Federal Form 1120S, Sch. K(b) should be consistent with California Form 100S, Sch. K(b).

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010603 Federal Form 1120S: Schedules L, M-1, & M-2

These schedules are similar to California Schedules L, M-1 & M-2.

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010604 Federal Form 1120S: Schedule K-1

This schedule is similar to California Sch. K-1. Federal Sch. K-1, column (b) is comparable with California Sch. K-1, column (b). To find out what adjustments were made for California purposes, see California Sch. K-1, column (c).

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010700 CALIFORNIA 540: CALIFORNIA RESIDENT INCOME TAX RETURN

Each flow-through item in federal Sch. K-1, column (b) or in California Sch. K-1, column (b) should be reported using the appropriate federal Form 1040 schedule. Then, each flow-through item should be adjusted by the amount of California positive/negative adjustment reported in California Sch. K-1, column (c), to convert the federal figure to the California figure. This adjustment is made in California Schedule CA(540).

TRACING SCH K-1 TO 1040		**Federal Sch. K-1, column (b) California Sch. K-1, column (b)**
Form 1040, Sch. E	Part I - Income from Rentals & Royalties Part II - Income or Loss From Partnerships & S Corporations	Sch. K-1, lines 1 ~ 3 flow through to the shareholder's Sch. E. Part I reports the shareholder's pro rata share of the S corporation's rental activity income/loss and royalties. Part II reports the shareholder's pro rata share of the S corporation's ordinary income/loss.
Form 1040, Sch. B	Part I-Interest Income & Part II-Dividend Income	Generally, Sch. K-1, lines 4a and 4b flow through to this schedule.
Form 1040, Line 21 - Other Income		Sch. K-1, line 4f – other portfolio income/loss, and line 6, other income, may be reported here. Also, if taxable loan repayments from "Loans from Shareholders" exist (California Sch. K-1, line 22), the taxable amount may be reported on federal Form 1040 as other income.
Form 1040 and Sch. D		Sch. K-1, lines 4d and 4e (capital gains) flow through to this schedule. Sch. K-1, line 5 may be reported in Sch. D, also.
Form 1040, Sch. A		Sch. K-1, line 7a (charitable contributions) flows through to Sch. A, Gifts to Charity. Sch. K-1, line 11, investment interest flows through to Sch. A, line 13.
Federal Form 6251		From Sch K-1, lines 14a-14e.

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– AMT		

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020000 EXAMINING S CORPORATION AND SHAREHOLDER RETURNS

S Corp 020100 Purpose
S Corp 020200 S Corporation Return Assigned
S Corp 020300 Examining the Return

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020100 PURPOSE

The purpose of this subsection is to provide auditors with key points for examining S Corporation returns (California Form 100S) and shareholder returns (California Form 540). California Form 100S, corresponding forms such as the federal Form 1120S, California Form 540, and other documents are used.

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020200 S CORPORATION RETURN ASSIGNED

Follow these steps to start the S corporation return examination.

1. Gather:
   a. The S corporation's corporate folder.
   b. The shareholders' personal income tax returns.
   c. The corporation's corporate transcript to understand the corporation's filing history.
      I. Are there any amended returns?
      II. When did the corporation elect federal S status?
      III. When did the corporation elect California S status?
2. Scope the return and clarify tax issues.

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020300 EXAMINING THE RETURN

Note that the sample returns used in this manual are for taxable year 2001.

S Corp 020301	Form 100S: California S Corporation Franchise or Income Tax Return
S Corp 020302	Federal Individual Income Tax Return: Form 1040
S Corp 020303	California Resident Income Tax Return: Form 540
S Corp 020304	California Fiduciary Income Tax Return: Form 541

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020301 Form 100S: California S Corporation Franchise or Income Tax Return

a. Form 100S: Side 1

Entity Information	
For Income Year Beginning	If the corporation uses a fiscal year, check the S corporation's qualifications for fiscal year treatment.
California Corporation Number	Each corporation qualified to do business in California receives a CCN from the California SOS. This number is used for California purposes only. Use this number to obtain additional information/documents in-house.
Federal Employer Identification Number	This number is a federal number, also referred to as the FEIN number. Use this number to obtain corporate information from the IRS using FTB 6227 (Request for Federal Tax Information).
Corporation Name	Be aware that the corporation's name may change, but the corporation's CCN does not change.
A.	If any of the boxes is checked, the reasons for filing the final return should be explained. For example, a merger agreement, a stock sale agreement, or the federal Form 8023 may be attached to the return.
B.	If the "yes" box is checked, additional information should be attached to the return, such as a reorganization agreement or a Sch. K-1 indicating the shareholder's stock ownership percentage change.
C.	Use this code to gain a preliminary understanding of the S corporation's business. See Form 100S Instruction for the business code listing.

S Corp State NI & Tax Reporting

Line 1	This amount should be the amount reported on the federal Form 1120S, line 21 as well as the amount reported on California Form 100S, Sch. F, line 22.
Line 2	Make sure that the corporation added back the correct amount of tax for California Franchise or Income Tax purposes. See California Form 100S, Sch. F, line 12 for reference. Be aware that California Sch. F, line 12 often

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	includes other taxes.
Line 4	Refer to Sch. D, Sections A and B for acquisition dates. Look for potential Built-In Gains/Loss (BIG & BIL) issues.
Line 6	If the corporation retains C corporation Earnings & Profits, look for a potential ENPI issue. See S Corp 070000 for details.
Line 7 - Other Additions	Line 7 may be used to report the passive activity income. Line 7 and line 13 may be used to reconcile the federal/California differences for some items.
Line 11	There is a 10% California net income limitation for the amount of contribution deduction allowed at the corporate level. Be aware of a potential AMT issue at the shareholder level if the corporation contributed appreciated property.
Line 13	See line 7.
Line 18, Line 19, and Line 20	An S corporation cannot use NOL's that were generated during the C years.
Line 22 - Tax	Make sure that the corporation used the correct tax rate. A financial S corporation must use the 2.5% tax rate in accordance with R&TC Section 23802(b)(2).
Lines 23~26 Tax Credits	Verify the corporation's qualification to take the credit. Verify qualification of the costs included in the credit computation.
Line 28 - Tax from Sch. D	BIG tax computed in Sch. D is reported here. Did the corporation compute the amount of Net Realized BIG correctly? See S Corp 050000 for details.
Line 25 - ENPI Tax	Verify computational accuracy. If the corporation had ENPI more than three consecutive years, its S election is in jeopardy of being revoked.

b. Form 100S: Side 2

Schedule F - Computation of Trade/Business Income	
Line 1	If the amount of gross receipts is greater than $50,000,000, the corporation is a "large S." Make sure your Program Manager is aware of this.
Line 2	How did the COGS affect the gross profit? Is the gross profit margin reasonable, consistent each year, and

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	comparable with the industry average? If not, why? Also, consider examining Sch. V to verify that the items included in the inventory account were properly capitalized and deducted as COGS.
Line 4	What is the net gain? Is the gain subject to the BIG tax? If the amount was the result of the section 1245 recapture, verify the recapture computation.
Line 5	Check the schedule(s) attached to the return to find out what created other income. Is it subject to the BIG tax?
Line 7	Compare the amount of compensation with the amount of tax-free distributions and/or the amount of loans to shareholders. There may be a reclassification issue.
Line 9	Should the cost be capitalized?
Line 10	Is this a valid bad debt? Refer to IRC section 166.
Line 12	The amount of income tax paid for foreign, domestic, or California purposes must be added back to the net income. See California Form 100S, Side 1, line 2.
Line 15	What kind of depletion took place? Federal law is different from California law, especially in the case of intangible drilling.
Line 20	Verify the items of Other Deductions. Are they deductible?

Schedule V - Cost of Goods Sold	**The issues in this schedule depend on the business/industry.**
Line 2 - Purchases	Examine the purchase account with the A/P account. Did the corporation purchase goods for sale? Examine purchase orders and invoices.
Line 3 - Cost of Labor	Did the corporation properly identify the amount of direct labor costs allocable to inventory?
Line 4 - Other IRC Section 263A Costs	Proceed carefully because materiality may prevail.
Line 6 – Total	If this amount is overstated, the cost of goods sold is overstated, and gross profit is understated.
Line 7 – EOY Inventory	If this amount is understated, the cost of goods sold is overstated, and gross profit is understated.
NOTE:	If any of the questions on Sch. V are answered “yes,” there is a potential BIG issue for LIFO recapture.

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Schedule J - Add-On Taxes or Recapture of Tax Credits	
Line 1 - LIFO Recapture Due to S Election	Verify the amount of LIFO recapture for accuracy.
Line 2 - Look-Back Method Interest	Verify the interest computation for accuracy.
Line 3 - Interest on Tax Attributable to Installment	Verify the amount for accuracy.
Line 5 - Credit Recapture	Was the credit generated during the C-Corp years?
Questions (cont. from Side 1)	
E.	The “yes” box should be checked if the S corporation has one or more qualified subchapter S subsidiaries. Verify Sch. Qs attached.
F.	This date helps to identify a potential BIG's issue.
G.	This information, when compared to the number of K-1s prepared, helps to identify stock transactions among the corporation and the shareholders.
H.	Compare the date with the dates reported on Form 100s, Side 2, Questions F, J, and K. Are the dates reasonable?
I.	If “yes” was checked, find out the issues examined by the IRS and the result of the audit.
J.	This date, when used with the date reported on Question K, helps to identify a potential BIG issue. This date may not be reliable. For the correct date, request a copy of the date stamped federal Form 2553 and/or a copy of the letter sent by the IRS certifying that the corporation is a federal S corporation. BMF MFTRA (e) transcript from the IRS also is usuful.
K.	See questions F, H, and J.
L.	Be aware that a collection on the accounts receivable of a cash basis taxpayer may trigger a BIG tax issue. Find out when the receivable was booked. If it was booked during the C-Corp year, the income recognized during the S-Corp year is subject to the BIG tax. There is no BIG tax issue for an accrual method taxpayer, since the corporation recognized the income when the receivable was booked.
O.	If “no” is checked, find out what isn’t filed with the FTB.

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P.	If "yes" is checked, the corporation is an apportioning S corporation. **Note:** If the S corporation is doing business within and outside the state, there is potential for a *Valentino et al. v. Franchise Tax Board* (CtApp March 23, 2001) 105 Cal.Rptr. 2d 304, issue. The court held that income passed through to a nonresident shareholder of an out-of-state S corporation's California business activities is subject to California personal income tax. The income of an S corporation shareholder receives the same treatment as that of a partner in a partnership. The shareholder's pro rata share of income is passed through to him/her and treated as though it were realized by the shareholder directly from the same source as derived by the S corporation. (*Valentino et al. v. Franchise Tax Board* (CtApp March 23, 2001) 105 Cal.Rptr. 2d 304.

c. Master Files Codes: Transaction

Transaction codes (TC) consist of three digits. They are used to identify a transaction being processed and to maintain a history of actions posted to a taxpayer's account on the Master File. Every transaction processed must contain a Transaction Code to maintain Accounting Controls of debits and credits, to cause the computer to post the transaction on the Master File, to permit compilation of reports, and to identify the transaction when a transcript is extracted from the Master File.

For a detailed definition of transaction codes, please see the IRS website.

d. Form 100S: Schedule K

Schedule K - S Corporation Shareholder's Share of Income, Deductions, Credits, etc.	
Line 1 - Ordinary Inc/Loss	This amount should match Side 1, line 1 of Form 100S.
Line 4a-4f - Portfolio Income	If the corporation retains C corporation earnings and profits at year-end, there is a potential ENPI tax issue. Compute the amount of excess net passive income. See S Corp 070000 for details.

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Line 5 - Net gain/loss IRC Section 1231	Verify the corporation's California S election date. Did the corporation sell assets and recognized the gain accumulated during C-Corp years? See S Corp 050000 for BIG's tax issue.
Line 6 - Other Income/Loss	Determine the nature of other income/loss. Consider BIG, BIL and ENPI issues.
Line 7 - Contributions	There is a potential AMT preference issue at the shareholder level, if the corporation contributed appreciated property.
Line 8-11 - Expenses	Examine the accuracy of expenses reported.
Line 12 & 13 - Credits	A 100% of credit (generated by the corporation) passes through to shareholders, prorated according to stock ownership percentage. The amount of credit allowed at the shareholder's level may be limited. See applicable California tax law for details.
Line 14a~14e - Adjustments & Tax Preferences	If the amount is material, consider examining the adjustments and tax preference items for potential audit adjustments due to federal and state law differences.
Line 15 - Other State Taxes	In examining the accuracy of the amount reported, consider the pass-through tax effects for other state tax credits.
Line 16a & 16b – IRC Section 59(e) expenditures	Refer to IRC section 59(e)(2) and R&TC section 23459. There are federal and state law differences for circulation expenses and oil and gas intangible drilling/development costs.
Line 20 - Property Distributions (other than dividends)	Compare this amount with the aggregate amount reported on line 21 of Sch. K-1s of Form 100S. Be aware that the amount reported on line 7 of Sch. M-2 of Form 100S may be a plug-in figure if the amount of distributions is in excess of AAA balance. Are any parts of the distributions dividend distributions or taxable capital gains to the shareholders?

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e. Form 100S: Schedule L, Schedule M-1, and Schedule M-2

Sch. L - Balance Sheet	**Make sure any increase/decrease on balance sheet accounts is reflected on the tax return.**
Line 2 - Trade Notes & Accounts Receivable	Using the Corporate Folder, examine the history of the receivables account. Be aware of a potential BIG issue for a cash basis taxpayer. See Form 100S, Side 2, Question L.
Line 5 - Other Current Assets	If there is a large increase or decrease in this area, examine the attached schedule/statement. Pay special attention to the disposition of assets. Did the corporation realize and recognize gain or loss? Did the corporation report the recognized net gain? Did the corporation defer the gain? Are there BIG, BIL, or ENPI issues?
Line 6 - Loans to Shareholders	Examine the history of "loans to shareholders." Are the loans bona-fide loans? Is the shareholder paying interest to the corporation? What is the interest rate? Is it "at" or below the AFR? When is the loan payable? Should it be re-characterized as a distribution?
Line 7 - Mortgage and Real Estate Loans and Line 8 - Other Investments	"Loans to shareholders" may be reported here as "related party loans" or "advances." If the corporation owns interests in partnerships, verify that the corporation reported its share of flow-through income/loss from each partnership.
Line 9 - Buildings & Other Fixed Assets, Line 10 - Deplorable Assets, Line 12 - Land, and Line 13 - Other Assets	Review the attached schedule/statement for changes in the account balance. Are the changes reflected on the return? Did the corporation sell or distribute assets? How? Consider potential BIG, BIL, and section 1245 recapture issue. Did the corporation defer gain under IRC Section 453?
Line 18 - Loans from Shareholder	Are the loans bona-fide debts from shareholders? A mere shareholder guarantee on corporate debt does not provide debt basis to the shareholder. The shareholder must make payments as a guarantor. Is

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	the interest rate "at" or below the AFR? If below, is there an imputed interest issue? If the shareholder took flow-through losses on the debt basis and later received loan repayments from the corporation, there may be a taxable loan repayment issue at the shareholder level.

Schedule L	
Line 21 - Capital Stock Line 22 - Paid-In or Capital Surplus	Total the figures reported on line 18(b), line 21(b), line 22(b), and Sch. M-2 line 1(a) to estimate the aggregate amount of shareholder basis at BOY. Does each shareholder have enough basis to take the net flow-through losses in the current year? Does each shareholders have enough basis to receive tax-free distributions from the corporation?

Schedule M-1	
Line 1 - Net Income per Books	Compare this amount with the corporation's net income for financial purposes. If the numbers don't match, find out why. Does the discrepancy result in the understatement of taxable income on line 6?
Line 2 & Line 5	Be aware of BIG items such as LIFO recapture. If the amount of debt cancelled was reported, examine whether the corporation meets the requirements for excluding the income and whether the shareholders increased their stock basis by the amount of excluded COD income. (See the Supreme Court decision of *Gitlitz v. Commissioner* (Jan. 2001) and the subsequent law change as of Jan. 2002.)
Line 8	Compare this amount with the amount reported on line 15 of Form 100S. If the discrepancy is material, find out why.

Schedule M-2	
Line 1 - Balance at Beginning of Year	If this is the corporation's first year as an S corporation, the balance should be zero. Otherwise, make sure that the corporation has been carrying over ending balances consistently. Be aware that if the corporation's previous year returns have been examined and adjusted, this amount may not be

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	accurate.
Line 3 - Other Additions	This amount can be traced to Side 1 of Form 100S, as well as to any referenced schedules/statements.
Line 5 - Other Deductions	This amount can be traced to Side 1 of Form 100S, as well as to any referenced schedules/statements.
Line 7 - Distributions Other Than Dividend Distributions	This amount may be a plug-in figure if the amount of distributions is in excess of AAA balance. Otherwise, this amount should equal the amount reported on line 20 of Sch. K, Form 100S and the aggregate amount reported on line 21 of Sch. K-1s of Form 100S. Should any part of distributions be considered dividend distributions or taxable capital gains to the shareholders? Did the corporation distribute AAA before passing through the net loss to shareholders?
C Corp. E&P	If the last box of Sch. M-2 is checked, the amount entered to the right of the box should equal the C corporation E&P balance. Be sure to check the amount if you have an issue such as termination per IRC section 1362(d)(3) of the S corporation, excess passive income for three consecutive years, or the imposition of ENPI tax per IRC section 1375.

f. Form 100S: Schedule D

California Sch. D - S Corporation Capital Gains & Losses and Built-In Gains - Section A, Parts I, II, & IV	
Part I - Short-Term C/G's & C/L's	This part reports short-term C/G's & C/L's. These items are subject to BIG tax, which is computed on Sch. D, Part IV. These amounts are carried over to line 4d of Sch. K of Form 100S, for pass-through purposes.
Part II - Long-Term C/G's & C/L's with Consideration for BIG's Tax on the Items	This part reports long-term C/G's & C/L's. These items are subject to BIG tax, which is computed on Sch. D, Part IV. These amounts are carried over to line 4e of Sch. K

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	of Form 100S, for pass-through purposes.
Part IV - Tax on Built-In Gains	Built-in gains tax is computed in this area and reported on line 28 of Form 100S. In addition to examining the accuracy of the BIG computation, review line 17 of Form 100S to ensure that the corporation deducted the correct amount of BIG deduction for 1.5% purposes. Also, ensure that the amount of BIG tax was treated as a flow-through loss to the shareholders. For the corporation, the amount of BIG tax is not a deductible item. See S Corp 050000 for details.

California Sch. D - S Corporation Capital Gains and Losses and Built-In Gains - Section B, Parts I & II	
Part I - Short-Term C/G's & C/L's	This part reports short-term C/G's & C/L's subject to the S corporation rate 1.5%. Any C/L carryovers are applied here.
Part II - Long-Term C/G's & C/L's	This part is to report long-term C/G's & C/L's subject to the S corporation rate 1.5%.
	The net effect of these parts is carried forward to line 4 of Form 100S. If losses exceed gains, the net loss must be carried forward to the next year.

g. California Schedule K-1

California Sch. K-1	This schedule reports each shareholder's allocable portion of each flow-through item from the corporation. If flow-through items are not allocated according to the shareholder's stock

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	ownership percentage, the disproportional allocation may create a second class of stock and jeopardize the corporation's S status. Review Sch. K-1 with the shareholder's return (California Form 540 or individual or group Form 540NR) to ensure that the shareholder reported all flow-through items.
Shareholder's Identifying Number	Usually, this is the shareholder's SSN. Use this number to order shareholder returns. Keep in mind that the number reported here may not be accurate.
Shareholder's name, address & zip code	This section may suggest that shareholders are related: a husband and his wife or parents and children.
A. Shareholder's Percentage of Stock Ownership for Income Year End	If there is a change in the ownership percentage during the year, consider examining the stock transaction issues. A change on line 21 of Sch. L of Form 100S, line 22 of Sch. L of Form 100S, or in AAA account indicates that the shareholder redeemed stock or purchased additional stock from the corporation. If no changes are reported on Sch. L or AAA, the shareholder may have sold his/her stock to other shareholders (or a third party) or purchased stock from other shareholders.
C. Check Box - Final/Amended	If the "final" box is checked, consider examining the disposition (redemption or sale) of stock by the shareholder. The "final" could mean that the corporation terminated its S status at the end of year. If the "amended" box is checked, consider examining the shareholder's amended return to ensure that the shareholder correctly reflected the revisions on his/her California From 540X.
Column (b) - Amount from federal Sch. K-1	The figures entered in this column should be the figures reported on the federal Sch. K-1(b). If not, find out why. The shareholder reported the figures in this column on his/her federal Form 1040, using appropriate forms and schedules, according to the character/type of income/loss. For example, the amount on line 1, Column (b) of Sch. K-1, should be reported on the

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	shareholder's federal Form 1040, Sch. E., Part II. If the amount of flow-through ordinary loss is in excess of shareholder basis, the amount reported on federal Form 1040, Sch. E, Part II should be limited. See S Corp 090000 for details.
Column (c) - California Adjustment	These amounts represent the federal/California tax law differences. Determine whether these adjustments are accurate and properly reflected on the shareholder's California Schedule CA(540).
Column (d) - California Amount	Determine whether the figures in this column are the correct California flow-through amounts.
Line 7 - Charitable Contributions	If the corporation contributed appreciated property, the shareholder may have an AMT preference issue.
Line 20 - Property Distributions Other than Dividends	If the shareholder received distributions in excess of his/her stock basis, the amount received in excess of stock basis should be taxable income to the shareholder. See S Corp 080000 for details.
Line 23	Look for additional information.

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020302 Federal Individual Income Tax Return: Form 1040

Tracing Flow-Through Ordinary Income on California Form 100S, Sch. K-1, column (b), line 1 to federal Form 1040, line 17 - Rental Real Estate, Royalties, Partnerships, S Corporations, Trust, etc.	Flow-through ordinary income/loss from trade or business on California Form 100S, Sch. K-1, column (b), line 1 should be reported on federal Form 1040, Sch. E, Part II, then on federal Form 1040, line 17. The amount of flow-through loss (both separately and non-separately items) deductible on the federal Form 1040 or California Form 540 is limited. See S Corp 090000 for details. Also, consider examining federal Form 6198 (At-Risk) for the at-risk limitation. See S Corp 100000 for details. There may be issues with regard to the character of flow-through ordinary income or loss. For example, passive loss deduction is limited where non-passive loss deduction is not. Are there any incentives for the shareholder to characterize flow-through items as passive or non-passive?
Tracing Flow-Through Portfolio Interest and Dividends on California Form 100S, Sch. K-1, column (b), line 4(a) and line 4(b) to the federal Form 1040, line 8a and line 9.	Flow-through portfolio interest income and dividends on California Form 100S, Sch. K-1, column (b), line 4(a) and line 4(b) should be reported on federal Form 1040, Schedule B, then on federal Form 1040, line 8a and line 9.
Tracing Flow-Through Net Short-Term and Long-Term Capital Gain/Loss on California Form 100S, Sch. K-1, column (b), line 4(d) and line 4(e) to the federal Form 1040, line 13.	Flow-through net capital gain/loss on California Form 100S, Sch. K-1, column (b), line 4(d) and line 4(e) should be reported on federal Form 1040, Sch. D, then on federal Form 1040, line 13. If the corporation paid BIG tax, the amount of BIG tax is treated as a loss to the shareholder. Therefore, the capital gain (that triggered the BIG) should be reduced by the shareholder's allocable portion of the BIG tax. See S Corp 050000 for details.

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020303 California Resident Income Tax Return: Form 540

All flow-through items reported on federal Form 1120S, Sch. K-1(b) or California Form 100S, Sch. K-1(b) are reported on federal Form 1040 first. Review federal Form 1040. Then, review the California Form 540 information.	Verify the information using federal Form 1120S, Sch. K-1(b) or California Form 100S, Sch. K-1(b).
California Form 540, Line 13 - Federal AGI	This amount came from the shareholder's federal Form 1040, line 33 (Federal AGI), which includes all flow-through items reported in federal Form 1120S, Sch. K-1, column (b) or California Form 100S, Sch. K-1, column (b). .
California Form 540, line 14 - California Adjustments – Subtraction	This amount includes negative adjustments reported in column (c) of California Form 100S, Sch. K-1.
California Form 540, line 16 – California Adjustments – Additions	This amount includes positive adjustments reported in column (c) of California Form 100S, Sch. K-1.

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020304 California Fiduciary Income Tax Return: Form 541

Taxpayer Information	Verify the information for accuracy.
Note: If Form 541 is stamped with a statement that this trust is a grantor trust…	Request the grantor's tax return.
	Compare the S Corp Sch. K-1 with Form 541, Sch. K-1 and with the amount reported on the individual's (grantor's) federal Form 1040, Sch. E.

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030000 AUDIT TECHNIQUES AND PROCEDURES

S Corp 030100 Ordering the Corporate Folder
S Corp 030200 Ordering the Shareholders' Returns
S Corp 030300 Procedure for Mixed File
S Corp 030400 Imposition of Accuracy Related Penalty at Both Corporate and Shareholder Levels
S Corp 030500 Composite Return (Nonresident Group Return)
S Corp 030600 Exhibit

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030100 ORDERING THE CORPORATE FOLDER

It is important to order the corporation folder for the S corporation immediately upon case assignment. The corporate folder may contain all returns filed with the Franchise Tax Board, prior audit reports, election forms, and notes from actions taken on prior and current years. (See GTAM 4400 for ordering procedures.)

The methods of ordering corporation folders are: (1) the PASS system, (2) the BETS system, (3) other procedures designated for your office/unit. (GTAM 4400.)

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030200 ORDERING THE SHAREHOLDERS' RETURNS

It is also important to order all shareholders' returns that correspond with the S corporation tax year(s) under examination. The methods for ordering the shareholders' returns include (1) the PASS system, (2) the TI system, (3) FTB Form 6180 - Request and In-Lieu Form, (4) those designated for your office/unit (GTAM 4400).

Use the TI system to obtain each shareholder's filing history -- filed returns, most current address, return information, etc.

It is advisable to order all shareholders' returns available, not only those that correspond with the S corporation tax year(s) under examination. The audit determination may have to be revised dependent on prior and/or subsequent year reporting.

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030300 PROCEDURE FOR MIXED FILE

A mixed file occurs when an auditor issues various notices (Notice of Proposed Assessments (NPA), Notice of Proposed Overpayments (NPO), Over Assessments (OA), and claims) in one case (consisted of one or more case unit). The most common situation is the assessment of built-in gains (BIG) tax in which the auditor issues an NPA to the S corporation and an NPO to the shareholder of the S corporation.

Generally, the shareholder's overpayment does not offset the corporate assessment unless specifically requested in writing by the shareholder (GTAM 13300). In addition, an NPO may only be issued to the shareholder whose statute of limitations (SOL) is still open. In accordance with Revenue and Taxation Code (R&TC) section 19306, for tax years effective January 1, 2000, the SOL for overpayment is the later of:

- The period ending four years from the date the return was filed (if filed within the extension of time prescribed by R&TC section 18567 or R&TC section 18604, whichever is applicable);
- Four years from the last day prescribed for filing the return (determined without regard to any extension of time for filing the return); or
- One year from the date of overpayment, unless before the expiration of that period the taxpayer files a claim, or unless before the expiration of that period the FTB allows a credit, makes a refund, or mails a notice of proposed overpayment on a preprinted form prescribed by the FTB.

If you are extending the corporation’s SOL, you should also obtain a waiver from each shareholder or inform him/her to file a protective claim. General waiver is preferable in the event new issues arise either at the S corporation or shareholder level.

At the option of the shareholder, he/she may file a claim for refund rather than receiving an NPO. A claim for refund filed under these circumstances will be treated as a protective claim and held until the corporate assessment is finalized. However, this approach is not recommended. Due to the large volume of claims processed by the Department, such claim may be erroneously refunded before the corporate assessment gets finalized. If the assessment is subsequently withdrawn, the department must pursue the erroneous refund within the SOL. In addition, the shareholder may file an appeal with the BOE if the Department does not act on the claim within six months.

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Procedures:

Process a mixed file as follows:

1.	The audit package containing the S corporation audit file and the related shareholder audit file should be noted as a “Mixed File." (GTAM 13300, GTAM 13400)
2.	The corporate NPA should be prepared by completing FTB Form 6830 BCT or using the BETS system. (Use the manner directed by your supervisor.) (GTAM 13240.2)
3.	The shareholder NPO is prepared by completing the blue FTB Form 6846. At the top of this form, write "NPO" or "Notice of Proposed Overpayment" **in red**. (GTAM 13245)
4.	The NPO paragraph should be entered as follows: "This is a proposed overpayment based on an adjustment made to the return of (Name of the corporation). This proposed overpayment would be finalized when the corporate issue is finalized."
5.	Notify the shareholder that he/she will be receiving an NPO. Also, notify the corporate representative that the shareholder will be receiving an NPO and that the NPO will become final when the corporate assessment is finalized. **Warning:** Be careful dealing with the corporation and the shareholder. Unless a representative is authorized by the Power of Attorney to represent both the corporation and the shareholder, discussing or disclosing the tax effects of examination of the shareholder to the representative of the corporation is prohibited. If the shareholder is an officer of the corporation, disclosing the corporate matter to the individual (in his capacity as an officer of the corporation) is allowed. See GTAM 3300 and GTAM 3322 for details.
6.	Complete PASS Notice window. (GTAM 13250)
7.	Assemble the physical case. (GTAM 13260) Create an FTB 6430 (Audit Report) within the corporation case unit. Mark the "Remarks" and provide the name and the SSN of the shareholder in the "Related returns on which reports are submitted concurrently" section. Use the form as a cover sheet for the corporation's physical file. Create an FTB 6430 (Audit Report) within the shareholder case unit. Mark the "Remarks" and provide the name and the CCN of the S corporation the "Related returns on which reports are submitted concurrently" section. Use the form as a cover sheet for the shareholder's physical file.
8.	Verify addresses, SOL, case information, etc. (GTAM 13270)
9.	Transfer case/case unit to the next level. (GTAM 13280)
10	See GTAM 13700 – GTAM 13760 for routing instructions for the physical

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.	and electronic files.
11.	The proposed overpayment is retained within the GTA Technical Support unit, until the corporate NPA becomes final or the Protest Unit requests the file upon receiving the corporation's protest.
12.	The shareholder's overpayment cannot be used to offset the corporation's assessment, unless the shareholder requests it in writing (GTAM 13300). If the shareholder requests the offset in written, note the offset in the "Remarks" section of Form 6430 (Audit Report). Any questions regarding the mixed file procedure should be referred to the supervisor.

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030400 IMPOSITION OF ACCURACY RELATED PENALTY AT BOTH CORPORATE AND SHAREHOLDER LEVELS

The penalty assessed at the corporate level may be passed through to the shareholders.

S Corp 030401 Accuracy Related Penalty

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030401 Accuracy Related Penalty

Audit adjustments made at the S corporation level may result in an additional tax and penalties at the shareholder level. If the shareholder has an underpayment because of the revised (per audit) pass-through items from the S corporation, the actions of the corporation and the shareholder must be considered when applying exceptions to the accuracy related penalty under R&TC section 19164. The assessment of the accuracy related penalty at the S corporation and the shareholder levels depends on the facts and legal authority present in the case. Treas. Reg. section 1.6664(c) and (d) is the relevant federal authority to which California conforms pursuant to R&TC section 19164. *Estate of Alton Bean, Deceased, Gary A. Bean, Administrator, and Mable Bean v. Commissioner. Gary A. Bean and Cynthia Bean v. Commissioner* (2000) T.C. Memo. 2000-355, states in part:

"Accuracy-related penalties may be avoided if taxpayers show that the errors were caused, in some significant part, by detrimental reliance on the advice of qualified tax professionals and that their reliance was reasonable and in good faith. See *sec. 6664(c)*; *United States v. Boyle* [*85-1 USTC ¶13,602*], 469 U.S. 241, 250 (1985); *Stanford v. Commissioner* [*98-2 USTC ¶50,696*], 152 F.3d 450, 460-461 (5th Cir. 1998), affg. in part and vacating on this issue [*Dec. 52,012*] 108 T.C. 344 (1997)."

"J. Brent Haymond and Janis S. Haymond v. Commissioner (1997) T.C. Memo. 1997-289, 73 TCM 3179, states in pertinent part:"

"The accuracy-related penalty will not be imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. *Sec. 6664(c)*. The determination of whether a taxpayer acted with reasonable cause and in good faith depends upon the facts and circumstances. Treas. Regulation Section 1.6664-4(b)(1). The most important factor is the extent of the taxpayer's effort to determine the taxpayer's proper tax liability. *Id."*

"Generally, the taxpayer cannot avoid the duty of filing accurate returns by placing responsibility on a tax return preparer. *Metra Chem Corp. v. Commissioner* [*Dec. 43,787*], 88 T.C. 654, 662 (1987). Reliance on the advice of a professional does not necessarily demonstrate reasonable cause and good faith. *See Treas. Regulation Section 1.6664-4(b)(1)*. Where the taxpayer claims reliance on an accountant who prepared the return, the taxpayer must establish that the correct information was provided to the accountant and that the item

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incorrectly claimed or reported in the return was the result of the accountant's error. *Ma-Tran Corp. v. Commissioner* [*Dec. 35,134*], 70 T.C. 158, 173 (1978); *Enoch v. Commissioner* [*Dec. 31,301*], 57 T.C. 781, 803 (1972)."

Treas. Reg. section 1.6664(d) states:

"(d) *Pass-through items.* The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity."

Depending on the facts and circumstances, examples of " reasonable cause" with respect to the substantial understatement may include:

- The corporate level adjustments occurred because of an error on the part of the representative.
- The shareholder does not materially participate (i.e.- not actively involved) in the trade or business and would, therefore, have no direct knowledge of the corporate transaction(s) resulting in the adjustments per audit.

In the event the accuracy related penalty is proposed, discuss the assessment of the penalty and the three exceptions with the shareholder and the representative of the corporation. The exceptions include (1) Substantial Authority, (2) Adequate Disclosure, and (3) Reasonable Cause. The reasons for the assessment of the penalty (including a detailed analysis of the taxpayer's failure to meet each of the three exceptions to the assessment of the penalty) must be documented in a separate Audit Issue Section of the audit file.

For more information on the accuracy related penalty and pass-through entities, including the three exceptions, refer to GTAM 20531. For further assistance with regard to the penalty, consult your supervisor or contact the GTA Technical Resource Section.

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030500 COMPOSITE RETURN (NONRESIDENT GROUP RETURN)

California provides certain nonresident shareholders of an S corporation with a convenient method of filing their Personal Income Tax (PIT) returns. Nonresident shareholders of an S corporation may elect to file a nonresident group individual return, pursuant to R&TC section 18535(c).

Nonresident shareholders can elect to file a nonresident group return if their only California sourced income (losses) are from the S corporation. A nonresident individual can be included in more than one group nonresident return. FTB Publication 1067 explains how a nonresident group return is prepared and filed (refer to S Corp 030600).

Nonresident shareholders who file a nonresident group return are taxed at the highest individual tax rate and are not permitted deductions or exemptions, except in limited situations.

There are several ways to determine whether a nonresident group return was filed:

- The TI system *
- PASS.
- Central office "Business Entity" Section – BES maintains a list of S corporations whose shareholders elected to file nonresident group returns. Call BES for assistance.

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

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030600 EXHIBIT

Exhibit 030000-1 Franchise Tax Board Publication 1067

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040000 S CORPORATION ELECTIONS & TERMINATIONS

S Corp 040100	Requirements to be a Federal S Corporation (IRC §1361)
S Corp 040200	Requirements to be a California S Corporation (R&TC §23800)
S Corp 040300	Making a Federal S Election (IRC §1362)
S Corp 040400	Making a California S Election (R&TC §23801)
S Corp 040500	Federal Terminations (IRC §1362(d))
S Corp 040600	California Terminations (R&TC §23801(f), (b)(3))
S Corp 040700	Special Considerations for Termination of California S Election With Subchapter C Earnings and Profits and Passive Investment Income in Excess of 25% of Gross Receipts for 3 Consecutive Years
S Corp 040800	Election After Termination (IRC §1362(g))
S Corp 040900	Exhibits

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040100 REQUIREMENTS TO BE A FEDERAL S CORPORATION

Effective January 1, 1997, a corporation electing S corporation status must meet the federal requirements as a "small business corporation" as follows:

- a domestic corporation that is not an ineligible corporation. An ineligible corporation means any corporation which is:
  - a financial institution to which IRC section 585 applies,
  - an insurance company subject to tax under subchapter L,
  - a corporation to which IRC section 936 applies, or
  - a DISC or former DISC.
- has no more than 75 shareholders (a husband and his wife and their estates are treated as one shareholder (IRC §1361(c)(1))).
- a shareholder must be
  an individual, certain trust and estate (IRC §1361(c)(2), (3), and (e) for limitations on estates/trusts), a qualified Subchapter S trust (QSST) (IRC §1361(d), or a certain exempt organization (qualified retirement plan trusts and charitable organizations – see IRC §1361(c)(6) for limitations on tax exempt organizations).
- cannot have a nonresident alien as a shareholder
- has only one class of stock.

Before January 1, 1997:
- an S corporation could not be a member of an affiliated group (IRC §1504 defined, owns more than 80% of another corporation's stock),
- an S corporation could not have more than 35 shareholders, and
- a tax exempt organization could not be an S corporation shareholder.

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040200 REQUIREMENTS TO BE A CALIFORNIA S CORPORATION (R&TC §23800)

S Corp 040201 Requirements for California S Corporations
S Corp 040202 Additional Requirements for Corporations with Nonresident Shareholders

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040201 Requirements for California S Corporations

The corporation must have a valid federal S election in order to make a valid California S election (R&TC §23801(a)(1)).

For the most part, California is in conformity with federal provisions regarding the qualifications of an S corporation. Under R&TC section 23800.5, California modifies IRC section 1361(b)(2)(A), which states that a financial institution that is allowed a bad debt deduction under IRC section 585 is an ineligible corporation. For California purposes, certain entities -- savings and loan associations, banks, and financial corporations which use the reserve method of accounting for bad debts as described in R&TC section 24348 -- are ineligible to elect S corporation status. However, the S corporation status can be elected if the entity changes its accounting method from the bad debt reserve method to the specific write-off method. The corporation is required to recapture its bad debt reserve and pay built-in gains tax thereon. See FTB Notice 1998-3 and *Rev. Proc. 99-49*, I.R.B. 1999-52, 725, for more information.

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040202 Additional Requirements for Corporations with Nonresident Shareholders

If a corporation has one or more shareholders who are nonresidents of the State of California or are trusts with nonresident fiduciaries, each of the following is required per FTB Form 3830 - S Corporation's List of Shareholders and Consents (R&TC §23801(b)):

- Each nonresident shareholder or fiduciary shall file with the return a statement of consent by that shareholder or fiduciary to be subject to the jurisdiction of the State of California to tax the shareholder's pro rata share of the income attributable to California sources (R&TC §23801(b)(1)).
- An "S corporation" shall include in its return for each income year a list of shareholders in the form and in the manner prescribed by the Franchise Tax Board (FTB) (R&TC §23801(b)(2)).

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040300 MAKING A FEDERAL S ELECTION (IRC §1362)

Once the corporation meets the criteria for being an S corporation, it must file a valid S election with the IRS per Form 2553 (Exhibit 040000-2). A valid election requires the following.

1. **All shareholders must consent to the election (§1362(a)(2))**. All persons who are shareholders in the corporation on the day on which the election is made must consent to such election. “Shareholders” also include persons having a community property interest in the corporation’s stock -- as well as tenants in common, joint tenants, and tenants by the entirety -- on the date of election.

   The election would be invalid if consents were not obtained from all shareholders and their respective spouses. The courts strictly adhere to this requirement and oftentimes rule in favor of the IRS. Keep in mind, however, that there are instances in which the stock is not clearly distinguishable as either separate or community property. In a completed case example, the shareholders required their spouses to consent to the election as a precautionary measure and attached a statement specifying that the execution of the spouse's consent was not intended to create any implication as to the existence or nonexistence of an interest of the spouse in the stock. In another completed case example, the shareholder’s spouse did not consent to the election; however, the election was determined to be valid based on litigation pursuant to divorce, which classified the stock as separate property at the time of the S election.
2. **The election must be made during the preceding taxable year or within 2 ½ months of the taxable year (IRC §1362(b)(1)).** For example, if the corporation wants to become an S corporation beginning in its taxable year ending 12/31/97 (meaning effective 1/1/97), Federal Form 2553 must be postmarked anytime during the period covering 1/1/96 to 3/15/97.

Upon receipt of Federal Form 2553, the IRS verifies that (1) all required signatures are contained on the election, (2) the election is made within the required time frame for that taxable year, and (3) the corporation meets the requirements of a small business corporation as provided in IRC section 1361(b).

The S corporation's federal S election can be verified by requesting:

- a “BMF Transcript with MFTRA (E)” and Federal Form 2553 from the IRS, using FTB Form 6227,

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- the IRS acceptance letter from the corporation, and/or
- a copy of Federal Form 2553 from the corporation.

In conjunction with making its federal S election, the corporation is generally required to use the calendar year period - a taxable year ending December 31 - (IRC §1378(b)(1)). An exception is allowed if the corporation establishes a business purpose for using any other accounting period, but not for the sole purpose of deferral of income to its shareholders (IRC §1378(b)(2), IRC §444).

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040400 MAKING A CALIFORNIA S ELECTION (R&TC §23801)

Per R&TC section 23800, California recognizes S corporation treatment for any income year beginning on or after January 1, 1987. Prior to this date, federal S corporations were treated as C corporations for California purposes.

Audit Issues: Due to California's nonrecognition of S corporations prior to 1/1/87, federal and California election dates may differ. This gap creates permanent federal/California differences in shareholder basis accounts, the Accumulated Adjustments Account, application of the capital gains vs. built-in gains rules, etc.

S Corp 040401	Requirement for Corporations Making a California S Election
S Corp 040402	Making a California S Election for Income Years Beginning in 1987
S Corp 040403	Making a California S Election for Income Years Beginning in 1988 or 1989
S Corp 040404	Making a California S Election for Income Years Beginning on or after January 1, 1990
S Corp 040405	Rolling Over Untimely Elections

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040401 Making a California S Election

The corporation must be a federal S corporation in order to make a valid California S election (R&TC §23801(a)(1)).

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040402 Making a California S Election for Income Years Beginning in 1987

Corporations Required to File California Returns

If the corporation has a valid federal S election for the income year beginning in 1987 or prior, it is deemed to be a California S corporation unless it elects on its return to continue to be treated as a California C corporation (R&TC §23801(a)(2)(A)). (The corporation had until 10/15/88 (extended due date) to elect to continue to be treated as a California C corporation.)

Example A

ABC, Inc., incorporated in 1955, makes a valid federal S election in 1982. ABC reports on a calendar year-end.
On 10/15/88, ABC files California Form 100 for IYE 12/87 and checks the box that it is a California S corporation (Form 100S was not available in this year). ABC is deemed to be a California S corporation. No formal election is required.

Example B

ABC, Inc., incorporated in 1955, makes a valid federal S election in 1982. ABC reports on a calendar year-end.
On 10/15/88, ABC files California Form 100 for IYE 12/87 as a California C corporation. ABC is treated as a California C corporation even though no formal election form is required to be filed.

Corporations Not Required to File California Returns

The corporation that is not required to file returns under the jurisdiction of the laws of California but is a federal S corporation may elect to be treated as a California C corporation (R&TC §23801(a)(2)(B)). The purpose of this subdivision was to give a federal S corporation, with one or more California resident shareholders, the opportunity to treat the corporation as a C corporation for California purposes. Without such election, the California resident shareholders would be subject to California taxation on their pro rata shares of flow-through income/loss from the federal S corporation.

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If the corporation files California Form 100, FTB would treat the filing as the corporation's election out of federal S status for California purposes.

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040403 Making a California S Election for Income Years Beginning in 1988 or 1989

Federal S / California C in Preceding Year

If the corporation has a valid federal S election and was treated a California C corporation for the preceding year, the corporation is required to file its California S election with the FTB within 2 ½ months of the current income year on either Federal Form 2553 or FTB Form 3560 -- whichever was available for the year in question (R&TC §23801(a)(3)(A)) to become a California S corporation effective the current income year.

Federal C /California C in Preceding Year or First Income Year of the Corporation

If the corporation makes a valid federal S election for the current taxable year, the corporation is deemed to be a California S corporation unless it elects on its return to continue to be treated as a California C corporation (R&TC §23801(a)(3)(B)). For taxable years 1988 and 1989, the corporation has until the filing of the return to elect to continue to be treated as a California C corporation.

Corporations Not Required to File a California Return

The corporation that is not required to file under the jurisdiction of the laws of California but elected federal S status in the income year, may elect to be treated as a C corporation (R&TC §23801(a)(3)(C)). The purpose of this subdivision was to give a federal S corporation, with one or more California resident shareholders, the opportunity to treat the corporation as a C corporation for California purposes. Without such election, the California resident shareholders would be subject to California taxation on their pro rata shares of flow-through income/loss from the federal S corporation.

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040404 Making a California S Election for Income Years Beginning on or after January 1, 1990

Federal C / California C in Preceding Year or First Income Year of the Corporation

If the corporation makes its federal S election effective for income year beginning on or after 1/1/90, the corporation is deemed to be a California S corporation unless it files an election to be treated as a California C corporation (R&TC §23801(a)(4)(A)).

The California C election can be made only by a corporation that is incorporated in California or qualified to do business in California. The election form (FTB Form 3560) must be postmarked as filed with the FTB within 2 ½ months of the income year (R&TC §23801(a)(4)(A)(ii)).

Federal S / California C in Preceding Year

If the corporation had a valid federal S election and was a California C corporation for the preceding year, the corporation is required to file its California S election (FTB Form 3560) with the FTB within 2 ½ months of its taxable year (R&TC §23801(a)(4)(B)).

Failure to file this form within the 2 ½ month time frame means that the corporation cannot become a California S corporation in the current income year. However, the election could be applied to the next income year. For example, a corporation must file its California S election applicable for IYE 12/91, after 12/31/89 and on or before 3/15/91. An election made after 3/15/91 is valid for IYE 12/92.

If the corporation wants to remain as a California C corporation, it does not have to file a California election. The corporation may continue filing as a California C corporation.

If the corporation terminated its California S election in prior year, it must wait five years before the corporation becomes eligible to make another S election (IRC §1362(g)).

Federal S Corporation Becomes “Qualified to do Business in California”

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If the corporation (1) has a valid federal S election, (2) is not doing business in California, (3) is not filing California returns, and (4) becomes qualified to do business in California, the corporation is deemed to have made its California S election for the income year during which the corporation becomes qualified to do business in California, unless a valid California C election is made (R&TC §23801(a)(4)(C)).

The California C election shall be made on FTB Form 3560 no later than the dates provided below:

- For income years beginning in 1990 - 2 ½ months after being qualified to do business in California.
- For income years beginning on or after 1/1/91 - the last date allowed for filing a federal S election under IRC section 1362(a) for that income year.

Note: For income years beginning on or after 1/1/91, the corporation must file a California C election within 2 ½ months of its income year, not within 2 ½ months after it becomes qualified to do business in California. Also, note that unless the corporation is qualified to business in California, the corporation cannot make an election for California tax purposes.

Example A

ABC, Inc., incorporated in 1977, made a valid federal S election in 1982. It reports on a calendar year-end.
ABC was not incorporated, did not file returns, nor did business in California until August 28, 1998. ABC is deemed to be a California S corporation for income year ending 12/98 unless a California C election is made by 3/15/98 (R&TC §23801(a)(4)(C)(ii)(II)).
ABC would be required to make its California C election (no later than 3/15/98) prior to the date in which it began doing business in California (8/28/98).

Federal S, Corporation Not "Qualified to do Business in California"

A corporation that is not qualified to do business in California, but is treated as an S corporation for federal purposes is treated as an S corporation for California purposes and its shareholders are treated as shareholders of an S corporation (R&TC §23801(a)(4)(D)).

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For income years beginning before 1/1/90, a C election made by a federal S corporation that is not qualified to do business in California shall be revoked.

Example B

ABC, Inc., incorporated in 1982, made a valid federal S election in 1986. It reports on a calendar year-end.
ABC was not incorporated, did not file returns, nor did business in California, however, had one California resident shareholder.
In IYE 12/87, ABC elected to be treated as a C corporation for California purposes per R&TC Section 23801(a)(2)(B).
In IYE 12/90, ABC's C corporation election made in IYE 12/87 was revoked. Its California resident shareholder will be treated as a shareholder in an S corporation for California purposes beginning in IYE 12/90.

Definition: "Qualified to do business in California" or "qualifying to do business in California" means incorporating or obtaining a certificate of qualification pursuant to the Corporations Code (R&TC §23801(a)(4)(E)).

If the corporation obtained a certificate of qualification pursuant to the Corporations Code or incorporated in California for the purpose of electing to be treated as a California C corporation and (1) conducts no business in California with (2) at least one California resident shareholder. Tax practitioners were made aware of the department's pursuance of such scenarios as follows:

The department is currently pursuing certain reporting trends involving safe haven corporations. One type of safe haven involves the formation of a corporation in Nevada that elects federal S status. The corporation obtains a certificate of qualification from the Secretary of State and elects to be treated as a California C corporation. The shareholder, a California resident, transfers intangible portfolio assets in exchange for stock in the corporation. The corporation then sells the intangible portfolio assets at a substantial gain and reports the gain on its Federal Form 1120S. For California purposes, the corporation files a California Form 100 and apportions/allocates 100% of the gain to Nevada thereby only being subject to the minimum franchise tax. Oftentimes no distributions are made and the sales proceeds are reinvested. If the commercial domicile of the corporation is in Nevada, then the gain escapes California taxation at both the corporate and shareholder levels.

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040405 Rolling Over Untimely Elections

It is imperative to distinguish a situation in which a corporation is required to file a formal election from another situation in which a corporation is deemed to be a California C or S corporation. If a formal election is required, the following rules apply to the election submitted after the filing date.

A California S election that is not made within the specified time frame (within 2 ½ months of the tax year) is treated as an election made for the following taxable year (IRC §1362(b)(3)).

However, California law does not provide the same treatment for an untimely C election. R&TC section 23801(a)(4)(F)(ii) states that an untimely C election is considered "null and void and is not to be applied to either the current or any subsequent taxable year."

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040500 FEDERAL TERMINATIONS (IRC §1362(D))

Federal rules specify three situations in which an S election can be terminated:

1. Revocation (IRC §1362(d)(1)),
2. Corporation ceases to be small business corporation (IRC §1362(d)(2)),
3. Corporation's passive investment income exceeds 25% of gross receipts for 3 consecutive taxable years and the corporation has subchapter C earnings and profits (IRC §1362(d)(3)).

Termination by revocation is irrevocable. However, the corporation can request the S election not be terminated if it falls under either of situations #2 or #3 and establishes that the terminating event was inadvertent (IRC §1362(f)).

S Corp 040501	Revocation (IRC §1362(d)(1))
S Corp 040502	Corporations Ceasing to be Small Business Corporations (IRC §1362(d)(2))
S Corp 040503	Passive Investment Income Exceeds 25% of Gross Receipts for 3 Consecutive Taxable Years and the Corporation has Subchapter C Earnings and Profits (IRC §1362(d)(3))
S Corp 040504	Inadvertent Terminations (IRC §1362(f))

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040501 Revocation (IRC §1362(d)(1))

A revocation is effective when more than 50% of the shares consent to the revocation. It is effective for that income year if made within 2 ½ months of the taxable year. If made after the 2 ½ months, it is effective for the beginning of the following taxable year. Federal revocations are made on Federal Form 2553.

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040502 Corporations Ceasing to be Small Business Corporations (IRC §1362(d)(2))

A federal S election ceases to be effective on and after the date it fails to qualify under the federal requirements to be a small business corporation as specified in IRC section 1361(b)(Section 1).

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040503 Passive Investment Income Exceeds 25% of Gross Receipts for 3 Consecutive Taxable Years and the Corporation has Subchapter C Earnings and Profits (IRC §1362(d)(3))

A federal S election ceases to be effective on the first day following the third consecutive taxable year in which the corporation (1) has subchapter C earnings and profits at the close of each of 3 consecutive taxable years and (2) has gross receipts for each of such taxable years more than 25% of which are passive investment income.

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040504 Inadvertent Terminations (IRC §1362(f))

An S corporation that meets the following terminating events will be treated as continuing to be an S corporation during the period specified by the Secretary:

1. an election is terminated because of (a) failure to meet the requirements as a small business corporation or (b) where passive investment income exceeds 25% of gross receipts for 3 consecutive taxable years and has subchapter C earnings and profits,
2. the Secretary determines that the termination was inadvertent,
3. the corporation takes steps within a reasonable period of time after discovery of the terminating event to reinstate itself as a small business corporation, <u>and</u>
4. each shareholder agrees to make such adjustments.

Examples of terminating events in which corporations have requested to be reinstated are as follows.

- The corporation was a family owned business with the mother and father owning 90% and their son owning 10%. The son announced his engagement to a nonresident alien. Upon hearing of the engagement, the CPA contacted the IRS to request that this event not terminate the corporation's S election. The IRS granted the request.
- Minor errors or changes made on Federal Form 2553 (changing facts contained on the form that are not relevant to the corporation's qualifications to make an election, or to the validity of the shareholders' consents, would not invalidate the S election).
- The corporation, unaware of its subchapter C earnings and profits upon S election, reported passive investment income in excess of 25% of its gross receipts for 3 consecutive years. In spite of the fact that this was a terminating event for the corporation, it requested to retain its S status by immediately distributing all subchapter C earnings and profits. The IRS granted the corporation's request.

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040600 CALIFORNIA TERMINATIONS (R&TC §23801(F), (B)(3))

S Corp 040601 Termination of Federal S Election Simultaneously Terminates California S Election
S Corp 040602 Terminating Events Specific to California S Elections
S Corp 040603 R&TC Section 23801(b)(3) Revocations -When Should It be Used?

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040601 Termination of Federal S Election Simultaneously Terminates California S Election

Termination of a federal S election, which is not an inadvertent termination, simultaneously terminates the California S election (R&TC §23801(f)(1)).

If the federal termination was by revocation (more than 50% of the shares consented to the revocation), the corporation is required to notify the FTB by filing FTB Form 3560 within the time frame for reporting its federal revocation (R&TC §23801(f)(2)). Failure to notify the Board, however, has no impact on whether the corporation retains its California S election -- it is automatically terminated with or without such notification.

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040602 Terminating Events Specific to California S Elections

- A corporation that is qualified to do business in California and has a valid federal S election may revoke its California S election (more than 50% of the shares consent) without revoking its federal election (R&TC §23801(f)(3)). Written notification must be made to the FTB on Form 3560 within 2 ½ months of the income year.

- A timely election to be treated as a C corporation under R&TC section 23801 is treated as a revocation for California purposes (R&TC §23801(a)(4)(F)(i)).

- If a corporation has one or more shareholders who are nonresidents of the State of California or is a trust with a nonresident fiduciary, each of the following shall be required per FTB Form 3830 - S Corporation's List of Shareholders and Consents (R&TC §23801(b)):
  - Each nonresident shareholder or fiduciary shall file with the return a statement of consent by that shareholder or fiduciary to be subject to the jurisdiction of the State of California to tax the shareholder's pro rata share of the income attributable to California sources (R&TC §23801(b)(1)).
  - An "S corporation" shall include in its return for each income year a list of shareholders in the form and in the manner prescribed by the FTB (R&TC §23801(b)(2)), which is FTB Form 3830.

  Failure to include either of the above two items with the corporation's tax return shall be grounds for retroactive revocation of the California S election <u>by the FTB</u> (R&TC §23801(b)(3)).

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040603 R&TC Section 23801(b)(3) Revocations -When Should It be Used?

R&TC section 23801(b) is a tool for the FTB to improve nonresident taxpayer compliance. In the event the Board discovers that a nonresident shareholder failed to comply with California law (i.e. - failed to report their pro rata share of income attributable to California sources per Form 540NR), this code section could be used to revoke the S election. However, if the FTB can achieve nonresident shareholder compliance through other means, it may be unnecessary to enforce R&TC section 23801(b)(3).

Due to the complexity of the revocation issue, auditors should consider all facts and circumstances and consult with their supervisors before exercising this section to revoke the corporation's S status.

In addition, only the FTB is given the authority to retroactively revoke California S status when the requirements under R&TC section 23801(b)(1) and (2) are not met (refer to preceding section for the requirements). In the event these requirements are not met, the corporation cannot cite this code section as authority on their behalf if the corporation is otherwise deemed to be an S corporation for California purposes.

Example A

ABC, Inc. made a valid federal S election on 1/1/98, however, did not make the necessary election to continue to file as a California C corporation. ABC had been doing business in California since 1983 and had one nonresident shareholder. It continued filing California C corporation returns.
Upon examination by the FTB, it was determined that ABC was deemed to be a California S corporation beginning on 1/1/98 per R&TC section 23801(a)(4)(A): An election under Section 1362(a) of the Internal Revenue Code, that is first effective for an income year beginning on or after January 1, 1990, … *shall be deemed to have been made for purposes of this part on the same date as the date of the federal election, unless the corporation files a California election under clause (ii) to be treated as a "C corporation" for purposes of this part.*
The auditor recomputed tax liabilities at the corporate and shareholder levels using applicable California S corporation laws.
The corporation agreed that because it failed to make the proper election to continue to be treated as a California C corporation, according to statute, it should have been deemed to be a California S corporation beginning in IYE

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12/98. The corporation, however, went one step further in its analysis. According to R&TC section 23801(b)(1), the corporation could not be a California S corporation due to the lack of consent by its nonresident shareholder to be taxed under the jurisdiction of the State of California on his pro rata share of the S corporation income attributable to California sources and, therefore, should continue to be treated as a California C corporation in IYE 12/98.

R&TC section 23801(b)(3) prevents the corporation from making this argument after a return position has been taken. Only the FTB has the authority at this point to retroactively revoke the deemed California S corporation election based on the nonresident shareholder's lack of consent.

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040700 SPECIAL CONSIDERATION FOR TERMINATION OF CALIFORNIA S ELECTION WITH SUBCHAPTER C EARNINGS AND PROFITS AND PASSIVE INVESTMENT INCOME IN EXCESS OF 25% OF GROSS RECEIPTS FOR 3 CONSECUTIVE YEARS

S Corp 040701 Termination of S Election vs. Assessing the ENPI Tax
S Corp 040702 Applying the Federal/California Code Sections
S Corp 040703 Which Election Date Should be Used - Federal or California?
S Corp 040704 California Subchapter C Earnings and Profits

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040701 Termination of S Election vs. Assessing the ENPI Tax

The events for assessing the excess net passive investment income (ENPI) tax are very similar to the events for terminating the S election. Do not confuse the two events and their respective code sections.

ENPI Tax:

IRC section 1375	Tax imposed when passive investment income of a corporation having subchapter C earnings and profits exceeds 25% of gross receipts.
IRC section 1375(b)(3)	The terms "subchapter C earnings and profits," "gross receipts," and "passive investment income" shall have the same meanings as used in IRC section 1362(d)(3)(B)-(D), respectively. IRC section 1362 makes reference to definitions contained in IRC section 1375 which terminates the S election.
R&TC section 23811	Tax on passive investment income.

Termination of S Election:

IRC section 1362(d)(3)	Termination where passive investment income exceeds 25% of gross receipts for 3 consecutive taxable years and corporation has subchapter C earnings and profits.
R&TC section 23800(a)	For any income year beginning on or after 1/1/87, IRC section 1361- IRC section 1379, relating to the tax treatment of "S corporation" and their shareholders, shall apply, except as otherwise provided. Exceptions relating to California S terminations include R&TC section 23811(d) and (e).
R&TC section 23811(d)	The term "subchapter C earnings and profits" as used in IRC section 1362(d)(3) and IRC section 1375 shall mean the subchapter C earnings and profits of the corporation attributable to California sources determined under this part, modified as provided in subdivision (e).
R&TC section 23811(e)	Distribution of a consent dividend to the

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shareholders is not to exceed the difference between the amount of federal and California subchapter C earnings and profits.

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040702 Applying the Federal/California Code Sections

IRC section 1362(d)(3) provides that if an S corporation has subchapter C earnings and profits at the close of each of 3 consecutive years, and more than 25% of gross receipts for each of the three taxable years are passive investment income, starting from the first date of the fourth year, the corporation's S election will be terminated.

California conformed to IRC section 1362 per R&TC section 23800(a). Therefore, the FTB can terminate the corporation's California S election if the corporation meets the above criteria, as modified using California amounts.

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040703 Which Election Date Should be Used - Federal or California?

An interesting issue was raised concerning a corporation that made a valid federal S election upon incorporation, but was treated as a California C corporation prior to income year 1987. It made a valid California S election for income year 1987. Should the federal or California S election date be used for purposes of applying the termination rules of IRC section 1362(d)(3)?

- If the corporation is allowed to "look-back" to the federal S election date, there would be no subchapter C earnings and profits because it has always been an S corporation for federal purposes.
- If the California S election date is used, the corporation may be subject to termination if it meets the requirements in IRC section 1362(d)(3), as amended for California amounts.

The source of this debate is the wording in R&TC section 23801(a)(2)(C) and (a)(3)(D) [California S elections for income years beginning in 1987 or 1988]:

A corporation that is deemed to have elected to be treated as an "S corporation" [has a valid federal S election in 1987 or prior] shall, <u>for purposes of applying the provisions of Section 1375 of the Internal Revenue Code, relating to tax imposed on passive investment income</u>, be deemed to have made the election to be treated as an "S corporation" on the same date as the date of its federal election under Section 1362(a) of the Internal Revenue Code.

Upon reading the above code section, California allows the "look-back" rule only for application of the ENPI tax, not for termination purposes. Arguments have been made that this section implies the "look-back" rule for terminations as well. The department is taking the position that the California S election date is controlling.

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040704 California Subchapter C Earnings and Profits

To determine whether the corporation has subchapter C earnings and profits, it must compute its subchapter C earnings and profits attributable to California sources as determined under the Bank & Corporation Tax Law, modified for consent dividends (R&TC §23811(d) and (e)).

R&TC section 23811(e) - Consent Dividends:

(1) In the case of a corporation which elects to be treated as an “S corporation” for purposes of this part for its first income year beginning in 1987, or for its first income year for which it has in effect a valid federal S election, there shall be allowed as a deduction in determining that corporation’s subchapter C earnings and profits at the close of any income year the amount of any consent dividend paid after the close of such income year.

(2) In the event there is a determination that a corporation has subchapter C earnings and profits at the close of any income year, that corporation shall be entitled to distribute a consent dividend to its shareholders. The amount of the consent dividend shall not exceed the difference between the California C earnings and profits on the date of determination and the federal C earnings and profits at the same date. A consent dividend must be paid within 90 days of the date of determination. The date of determination means the effective date of a closing agreement defined under R&TC section 19441, the date an assessment of tax imposed by this section becomes final, or the date of execution by the corporation of an agreement with the FTB relating to liability for the tax imposed (excess net passive income tax) by this section.

Example A

ABC, Inc. incorporated in 1977, makes a valid federal S election in 1986.
ABC makes a valid California S election beginning on 1/1/90. On this date, ABC has California subchapter C earnings and profits of $1,000,000 and federal subchapter C earnings and profits of $50,000. Assuming there are no future adjustments to either California or federal subchapter C earnings and profits, ABC is entitled to make a California consent dividend of up to $950,000 ($1,000,000 - $50,000); a federal consent dividend of up to $50,000.
On 3/31/91, ABC makes a consent dividend of $400,000. Its California subchapter C earnings and profits on this date is $600,000 ($1,000,000 - $400,000). Its remaining allowable California consent dividend is $550,000

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($950,000 - $400,000).
On 12/31/92, ABC distributes $600,000: $550,000 is treated as a consent dividend for California purposes per R&TC §23811(e)(1) and $50,000 is treated as a consent dividend for federal (and California) purposes per IRC §1368(e)(3).

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040800 ELECTION AFTER TERMINATION (IRC §1362(G))

IRC section 1362(g) provides that if an S corporation terminates its S status by

- revocation,
- ceasing to be a small business corporation, or
- reporting three years of consecutive excess net passive income,

the corporation must wait five years before making another S election, unless the Secretary consents to such election. California conforms to this code section.

R&TC section 23801(a)(4)(F)(i) adds to the federal provisions by stating that a timely election to be treated as a C corporation shall be treated as a revocation and that IRC section 1362(g), relating to election after termination, shall apply. The election to be treated as a California C corporation is treated as a revocation of S status for California purposes, and the corporation must wait five years from the first C year before it can elect California S status again. Note: the corporation can elect S status within the required five years with the FTB's approval.

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040900 EXHIBITS

Exhibit 040000-1	Franchise Tax Board Form 3830 – S Corporation's List of Shareholders and Consents
Exhibit 040000-2	Federal Tax Form 2553
Exhibit 040000-3	Franchise Tax Board Form 3560
Exhibit 040000-4	Franchise Tax Board Form 6227 - "BMF Transcript with MFTRA (E)" request from the IRS

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050000 BUILT-IN GAINS TAX

S Corp 050100 Purpose of the Built-In Gains Tax
S Corp 050200 Taxation of C Corporation Gains v. S Corporation Built-In Gains Tax
S Corp 050300 Examining The Built-in Gains Tax Issue
S Corp 050400 Corporations Subject to the Built-In Gains Tax
S Corp 050500 Verification of the S Election Date
S Corp 050600 Recognition Period
S Corp 050700 Items of Built-in Gain (Loss)
S Corp 050800 Pre-Limitation Amount
S Corp 050900 Taxable Income Limitation
S Corp 051000 “Net Unrealized Built-in Gain”
S Corp 051100 Net Recognized Built-in Gain
S Corp 051200 IRC Section 1374(d)(8) Asset Acquisitions
S Corp 051300 Special Rules for Installment Reporting
S Corp 051400 Special Rules for Partnership Interests
S Corp 051500 Qualified Corporations
S Corp 051600 Built-in Gains Tax is a Loss Sustained by the Corporation
S Corp 051700 Exhibit

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050100 PURPOSE OF THE BUILT-IN GAINS TAX

The General Utilities rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the General Utilities rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax. Thus the effect of the rule is to grant a permanent exemption from the corporate income tax.

Congress repealed the General Utilities Doctrine. As a result, gain or loss is generally recognized by a corporation on the distribution of its assets. Thus, the principle of double taxation was extended to all distributions and sales of appreciated property by C corporations. However, Congress was concerned that closely held C corporations would circumvent the corporate level tax on liquidating distributions by converting the corporations to S status then liquidate after three years to avoid pre-1986 capital gains tax. To prevent circumvention of the corporate level tax, section 632 of the 1986 Tax Reform Act revised IRC section 1374 to impose a corporate level tax on the built-in gains recognized by former C corporations during the first 10 years of S election. To preserve equality, IRC section 1374 provided offset for built-in gains with any built-in losses or net operating losses attributable to C corporation years.

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050200 TAXATION OF C CORPORATION GAINS V. S CORPORATION BUILT-IN GAINS TAX

A common misconception is that imposition of the built-in gains tax under IRC section 1374 imposes more tax on an S corporation and its shareholders than if it had retained its C status. Congress' intent was to preserve equality between C corporations and those electing S status upon asset disposition:

- The C corporation generates a gain on the sale of an asset, pays the maximum corporate level tax, and distributes the proceeds, less tax paid at the corporate level, to its shareholder(s).

- The S corporation generates a gain on the sale of an asset, pays the maximum corporate level tax on the portion attributable to prior C corporation years, and passes through the gain, less tax paid at the corporate level, to its shareholder(s).

A significant disadvantage of the built-in gains tax is that the gain becomes immediately taxable at both the S corporation and shareholder levels, whereas a C corporation can control the timing of distributions.

Example A

Total Tax Paid by C Corporation and Shareholder(s)

1.	Gain on asset sale	$100,000	
2.	Corporate tax @ 9.3% (beginning before 1/1/97)	9,300	$9,300
3.	Distribution to shareholders	90,700	
4.	Shareholder tax @ 11%	9,977	9,977
5.	Total tax paid		$19,277

Total Tax Paid by S Corporation and Shareholder(s)

1.	Gain on asset sale	$100,000	
2.	Built-in gain tax @ 9.3% (beginning before 1/1/97)	9,300	9,300
3.	Separately stated items per Schedule K-1: Gain on asset sale	100,00	

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	Built-in gains tax	-9,300	
	Subtotal	90,700	
4.	Shareholder tax @ 11%	9,977	9,977
5.	Total tax paid		$19,277

This example demonstrates that imposition of the built-in gains tax does not subject an S corporation and its shareholders to more tax than one that had remained a C corporation. The C corporation, however, could have deferred declaration of the $90,700 distribution until future years.

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050300 EXAMINING THE BUILT-IN GAINS TAX ISSUE

When examining a built-in gains tax issue, the auditor should perform the steps provided below.

1. Determine if the corporation is subject to the built-in gains tax.
   S Corp 050400 - Corporations Subject to the Built-In Gains Tax
   S Corp 050500 - Verification of the S Election Date
   S Corp 051500 - Qualified Corporations
2. Determine if the tax year under examination is within the corporation's recognition period. In one situation, the ten-year recognition period begins when a C corporation elects to convert to an S corporation (IRC §1374(d)(7)). In another situation, the ten-year recognition period begins when an S corporation which is subject to the built-in gains tax acquires property with a carryover basis that was determined by reference to the basis in a C corporation, but only for purposes of determining the gain from such newly acquired asset. (IRC §1374(d)(8))
   S Corp 050600 - Recognition Period
3. Identify items of recognized built-in gain (loss).
   S Corp 050700 - Items of Built-in Gain (Loss)
   S Corp 051300 - Special Rules for Installment Reporting
   S Corp 051400 - Special Rules for Partnership Interests
4. Compute the "pre-limitation amount" (sum of recognized built-in gains, recognized built-in losses, recognized built-in gain carryovers, and IRC §1374 attributes).
   S Corp 050800 - Pre-Limitation Amount
5. Determine if the taxable income limitation applies.
   S Corp 050900 - Taxable Income Limitation
6. Compute the "net unrealized built-in gain".
   S Corp 051000 - Net Unrealized Built-in Gain
7. Compute the "net recognized built-in gain".
   S Corp 051100 - Net Recognized Built-in Gain
8. Determine the built-in gain tax deduction allowed at the shareholder level.
   S Corp 051600 - Built-in Gains Tax is a Loss Sustained by the Corporation

S Corp 050301 Glossary of Terms

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050301 Glossary of Terms

The auditor should become familiar with commonly used terms when examining the built-in gain issue. The following terms are used frequently in reference material.

Recognized Built-in Gain	Any gain on asset disposition or item of income recognized (during the recognition period) that can be attributed to periods before the 1st taxable year for which the corporation was an S corporation or whose basis is determined by reference to a C corporation's basis. (For a detailed definition, see IRC §1374(d)(3).)
Recognized Built-in Loss	Any loss on asset disposition or item of deduction recognized (during the recognition period) that can be attributed to periods before the 1st taxable year for which the corporation was an S corporation or whose basis is determined by reference to a C corporation's basis.
Recognition Period	The period of time in which built-in gains tax can be assessed, generally 120 months beginning on the first day the corporation is an S corporation. A separate recognition period applies to an asset that is acquired by an S corporation from a C corporation, if the S corporation receives a carryover basis (in the asset) that is determined by reference to the C corporation transferor's basis in the same asset immediately before the transfer.
Net Recognized Built-in Gain	The maximum amount subject to the built-in gains tax during the tax year computed by using the lesser of the: (1) pre-limitation amount; (2) taxable income limitation; or (3) net unrealized built-in gain limitation. (Treas. Reg. §1.1374-2(a))
Pre-Limitation Amount	The S corporation's taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, recognized built-in gain carryover, and IRC section 1374 attributes.
IRC section 1374 Attributes	IRC section 1374 attributes are carryovers from C corporation years allowed to reduce recognized

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	built-in gains and the built-in gains tax. For federal purposes, IRC section 1374 attributes include (1) net operating and capital loss carryovers from C corporation years and (2) general business and AMT credit carryovers from C corporation years. IRC section 1374 attributes are carryovers from C corporation years allowed to reduce recognized built-in gains and the built-in gains tax. For federal purposes, IRC section 1374 attributes include (1) net operating and capital loss carryovers from C corporation years and (2) general business and AMT credit carryovers from C corporation years. <u>For California purposes, IRC section 1374 attributes include net operating and capital loss carryovers from C corporation years. R&TC section 23809(c) does not allow credit carryovers to reduce built-in gains tax</u>. In an **unpublished** decision in the *Appeal of Don McComas Enterprises, Inc.*, Cal. St. Bd. Of Equal., April 19, 2001, the State Board of Equalization confirmed that deduction against built-in gains for net operating losses for losses an S corporation accumulated while it was a C corporation, is limited by R&TC section 24416 to 50 percent of those losses.
Taxable Income Limitation	The S corporation's taxable income determined by using all rules applying to C corporations, disregarding net operating loss carryovers and certain deductible dividends.
Net Unrealized Built-in Gain	The amount of gain the corporation would have realized if it remained a C corporation and disposed of all its assets at fair market value on the first day of the recognition period; increased by any recognized built-in loss that would not be allowed as a deduction under IRC section 382, IRC section 383, or IRC section 384, and any IRC section 481 adjustments; and reduced by: (1) any liabilities that would have been included in the amount realized, if payment of the liability would have given rise to a deduction; (2) the corporation's adjusted basis in the assets

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immediately before the constructive sale; and (3) the corporation's IRC section 481 adjustments.

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050400 CORPORATIONS SUBJECT TO THE BUILT-IN GAINS TAX

S Corp 050401 General Rule
S Corp 050402 Summary of Election Dates

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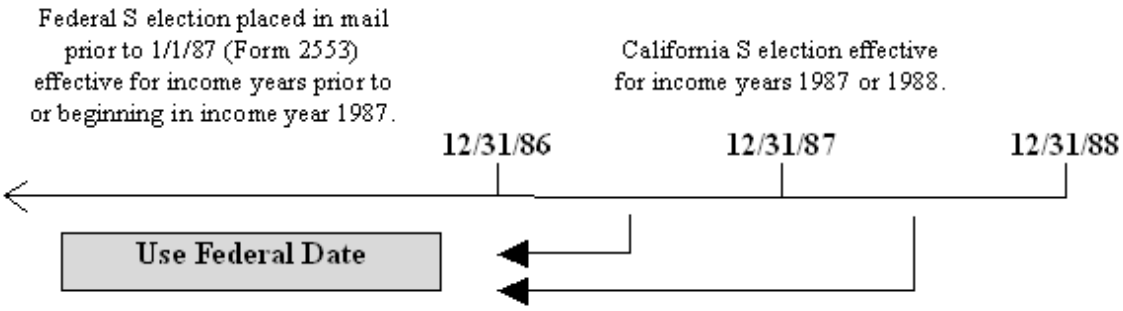
050401 General Rule

The built-in gains tax is applicable to C corporations that make S elections on or after January 1, 1987. However, there are exceptions.

a. Exception #1 - Look Back to Federal Election Date R&TC Section 23801(a)(2)(C) and (a)(3)(D)

If
1) the federal S election was prior to January 1, 1987 effective for income years prior to or beginning in income year 1987 (i.e. - Federal Form 2553 must be postmarked as mailed to the IRS on or before 12/31/86) and
2) a California S election was effective for income years 1987 or 1988,

the corporation "looks back" to the federal S election date and is subject to the old IRC section 1374 capital gains tax. In most instances, the statute for assessing this tax has expired.



b. Exception #2 - Qualified Corporations Public Law 99-514, Section 633, and Public Law 100-647, Section 1006

If
1) both the federal and California S elections were made on or after 1/1/87 effective for income years beginning in 1987 or 1988 and
2) the corporation was a "qualified corporation",

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the S corporation could be subject to both the old IRC section 1374 capital gains tax and the new IRC section 1374 built-in gains tax. Refer to Section 15 for a discussion of qualified corporations.

c. Exception #3 - Acquiring Built-in Gain Assets

Even if the corporation is otherwise not subject to the built-in gains tax, it may become subject to the tax on the assets it acquires through (1) a tax-free merger with a C corporation or former C corporation, and/or (2) an exchange/conversion whereby the basis was determined by reference to unrecognized built-in gain (i.e. - like/kind exchanges, involuntary conversions).

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050402 Summary of Election Dates

Effective Date of CA Election	Subject to Capital Gains Tax or Built-in Gains Tax
1987 & 1988	1. If the federal S election was placed in the mail on or before 12/31/86, use the federal S election date. The corporation is subject to the capital gains tax. The corporation may become subject to the built-in gains tax on the assets acquired through merger with C corporations or prior C corporations, like/kind exchanges, or involuntary conversions. 2. If the federal S election was placed in the mail after 12/31/86, the corporation is subject to the built-in gains tax unless determined to be a “qualified corporation”.
1989 & after	The corporation is subject to the built-in gains tax regardless of when the federal S election was made.

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050500 VERIFICATION OF THE S ELECTION DATE

S Corp 050501 Overview
S Corp 050502 Information Requests

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050501 Overview

If a California S election is made during tax years 1987 or 1988, it may be necessary for the auditor to establish the date in which the corporation actually placed its federal S election in the mail if the federal election was made on or before December 31, 1986. If the election was placed in the mail on or before this date, the corporation is subject to the old IRC section 1374 capital gains tax. If the election was placed in the mail after this date, the corporation is subject to the new IRC section 1374 built-in gains tax (with the exception of certain qualified corporations).

Keep in mind that documents necessary to verify the S election refer to transactions occurring in 1986 and 1987. Although the burden of proof falls on the taxpayer, the auditor needs to remain flexible and open minded on alternative forms of documentation the taxpayer may present to verify the date. Following are examples of alternative forms and are not intended to be all-inclusive. The auditor should also give the taxpayer a reasonable amount of time to present such information.

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050502 Information Requests

If the federal S election date controls and is close to December 31, 1986, it is suggested to obtain the following information.

1. Certified mail receipt (the corporation mailed a document to the IRS on that date).
2. Canceled check for payment of postage (the corporation paid postage for a document placed in the mail on that date).
3. “BMF Transcript with MFTRA (E)” request from the IRS on FTB Form 6227 (the date the IRS processed the S election, not the date in which the IRS received it. It generally takes 4-8 weeks for the IRS to post the election once received).
4. Board minutes (the board discussed making the S election).
5. Federal Form 2553 via facsimile with transmittal verification (the corporation faxed the S election).
6. IRS acceptance letter (generated at approximately the same time as the processing date).
7. Date stamped Federal Form 2553 requested from the IRS (the date in which the IRS received the S election).
8. Copy of Federal Form 2553 from the corporation (the date in which the election was signed. It can be compared with the copy obtained from the IRS).

There is no bright-line test once the above information is obtained. The auditor must analyze the information for reasonableness and consistency on a case-by-case basis.

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050600 RECOGNITION PERIOD

S Corp 050601 General Recognition Period
S Corp 050602 Recognition Period - C Corporation Assets Acquired
S Corp 050603 Recognition Period - Like-Kind Exchanges and Involuntary Conversions

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050601 General Recognition Period

The recognition period is the 10-year (120 month) period beginning on the first day the corporation is an S corporation. A short tax year, such as when a fiscal year S corporation changes to a calendar tax year, does not affect or reduce the recognition period. For example, if the first day of the recognition period is July 14, 1996, the last day of the recognition period is July 13, 2006.

In the event that the corporation terminates its S election (voluntarily or involuntarily) and later becomes an S corporation again, the recognition period from the first S election does not carryover. The recognition period begins on the first day of the first taxable year of the corporation's second S election.

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050602 Recognition Period - C Corporation Assets Acquired

If an S corporation acquires an asset in which the corporation's basis in such asset is determined (in whole or part) by reference to the basis of such asset in the hands of a C corporation (IRC §1374(d)(8)), the 10-year recognition period begins on the date of asset acquisition.

Example A

Tax-free Merger with C corporation
ABC incorporates on 1/1/96 and immediately elects S status.
On 1/1/98, a C corporation merges into ABC, an S corporation.
The first day of the recognition period is 1/1/98. The last day of the recognition period is 12/31/07.

Example B

Tax-free Merger with S Corporation that is Subject to Built-in Gains Tax
ABC incorporates on 1/1/96 and immediately elects S status. XYZ (an S corporation) is subject to the built-in gains tax with its recognition period starting on 1/1/92.
On 1/1/98, ABC acquires XYZ, pursuant to a tax-free merger.
ABC's recognition period in regards to the assets acquired from XYZ begins on 1/1/92 and ends on 12/31/01.
Assume the same facts as above, except for XYZ's recognition period starting on 1/1/97. ABC's recognition period in regards to the assets acquired from XYZ begins on 1/1/97 and ends on 12/31/06.

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050603 Recognition Period - Like-Kind Exchanges and Involuntary Conversions

Unrecognized built-in gain attributable to an asset given up in a like-kind exchange or involuntary conversion attaches to the new asset if the basis of the new asset is determined, in whole or part, by reference to the basis of the exchanged asset. The 10-year recognition period continues to be measured from the date of the S election, not from the date of exchange.

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050700 ITEMS OF BUILT-IN GAIN (LOSS)

In general, a built-in gain (loss) is triggered by the disposition of an asset that was on hand at the time the S election became effective, if the adjusted basis and the fair market value of the asset differed at the time the S election became effective. Following are examples of asset dispositions triggering a built-in gain (loss).

1. Disposition of land, buildings, and depreciable assets.
2. Disposition of assets acquired from a C corporation or former C corporation through merger after becoming an S corporation.
3. Collection of accounts receivable, less expenses incurred to collect such receivables, by a cash-basis taxpayer.
4. Disposition of assets acquired through exchange/conversion.
5. Distribution of appreciated assets to a shareholder.
6. Collection of an installment sale entered into prior to the date of conversion.
7. Collection of an installment sale entered into after the date of conversion where the asset was held at the date of conversion.
8. Sale of inventory (i.e. - LIFO recapture).
9. Sale of goodwill (but not covenant-not-to-compete).
10. S corporation's pro rata share of gain (loss) from partnership asset dispositions.
11. Sale of partnership interests.
12. IRC section 481(a) adjustments.
13. Income received under the completed contract method.
14. Liabilities incurred during the C corporation period deductible by the S corporation (i.e. - payment of accounts payable and accrued bonuses by a cash basis taxpayer).
15. Payments made pursuant to a legal settlement.
16. Receipt of income pursuant to a legal settlement.
17. Recovery of bad debts.
18. Income from discharge of indebtedness.

S Corp 050701 Definition of "Recognized Built-in Gain" - IRC
S Corp 050702 Definition of "Recognized Built-in Loss" - IRC
S Corp 050703 Items of Built-in Gain (Loss) – Final Regulation Section 1.1374
S Corp 050704 Valuations

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050701 Definition of "Recognized Built-in Gain" - IRC

IRC section 1374(d) defines "recognized built-in gain" as any gain recognized during the recognition period on the disposition of any asset except to the extent that the S corporation establishes that

(3)(A) such asset was not held by the S corporation as of the beginning of the 1st taxable year for which it was an S corporation, or

(3)(B) such gain exceeds the excess (if any) of - (i) the fair market value of such asset as of the beginning of such 1st taxable year, over (ii) the adjusted basis of the asset as of such time.

(5)(A) Income items: any item of income which is properly taken into account during the recognition period but which is attributable to periods before the 1st taxable year for which the corporation was an S corporation.

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050702 Definition of "Recognized Built-in Loss" - IRC

IRC section 1374(d) defines "recognized built-in loss" as any loss recognized during the recognition period on the disposition of any asset to the extent that the S corporation establishes that

(4)(A) such asset was held by the S corporation as of the beginning of the 1st taxable year referred to in paragraph (3), and

(4)(B) such loss does not exceed the excess of - (i) the adjusted basis of such asset as of the beginning of such 1st taxable year, over (ii) the fair market value of such asset as of such time.

(5)(B) Deduction items: any amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the 1st taxable year referred to in subparagraph (A).

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050703 Items of Built-in Gain (Loss) - Final Regulations Section 1.1374

Proposed regulations under IRC section 1374, published in the Federal Register on December 8, 1992, provided special rules for certain items of built-in gain (loss) including an S corporation's IRC section 481 adjustments, income reported under the completed contract method, income reported under the installment method, and distributive share partnership items.

On December 27, 1994, after consideration of public comments regarding the proposed regulations, the Internal Revenue Service issued final regulations under IRC section 1374 relating to the tax imposed on an S corporation's net recognized built-in gain.

Final regulations are applicable to taxable years ending on or after December 27, 1994, but only in cases where the return for the taxable year is filed pursuant to an S election or an IRC section 1374(d)(8) transaction occurring on or after December 27, 1994.

The final regulations should be applied to taxable years ending prior to December 27, 1994, unless legislation has taken a contrary position. (See *Argo Sales Company, Inc. v. CIR* (1995) 105 T.C. 86, in which the Tax Court held that, even though 26 C.F.R. part 1.1374-4(d) was not in effect for the years at issue, the taxpayer's IRC section 481(a) adjustments were items of income attributable to periods before the first year for which the corporation was an S corporation and were properly treated as recognized built-in gain. *See also Rondy, Inc. v. Comr.,* T.C. Memo 1995-372. *See* Reg. Section 1.1374-4(d)(1). *See also* H.R. Rep. No. 795, 100th Cong., 2d Sess. 63 (1988). Although IRC Section 481 adjustments are not specifically referenced under the section 1374 tax discussion in the House Report, they are referenced in the same report (p. 46) where the section 382 built-in gain rules are explained. See also S. Rep. No. 445, 100th Cong., 2d Sess. 48 (1988), for a reference to Section 481 adjustments as built-in gain under Section 382.)

The remainder of this section discusses the rules presented in the final regulations.

a. Sales and Exchanges (Treas. Reg. §1.1374-4(a))

A transaction resulting in a gain or loss recognized during the recognition period

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must qualify as a sale or exchange for federal income tax purposes.

b. Accrual Method Rule (Treas. Reg. §§1.1374-4(b)(1) and (2))

Treas. Reg. section 1.1374-4(b)(1) provides that "any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer."

To be treated as "recognized built-in loss", the item of deduction would have to be an allowable deduction against gross income before the beginning of the recognition period to an accrual method taxpayer. The following items are not considered items of deduction for built-in loss purposes: IRC section 461(h)(2)(C) and Treas. Reg. section 1.461-4(g) - liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities.

Example A

Accounts Receivable, Cash Basis S Corporation

ABC, Inc., a cash basis taxpayer, elected S status on 1/1/96.
On this date, it had accounts receivable for services rendered as follows:

Book value	$200,000
Fair market value	$150,000
Adjusted basis	$0

Accounts Receivable Collected During 1996

During 1996, it collected all of the $200,000. ABC would report a recognized built-in gain of $200,000 because it would have been included in gross income before the beginning of the recognition period if ABC had been an accrual basis taxpayer.

Accounts Receivable Sold or Exchanged During 1996

If ABC had disposed of the accounts receivable in 1996 in a transaction treated as a sale or exchange for federal income tax purposes, it would have recognized built-in gain of $150,000 ($150,000 - 0) on the

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disposition.

Example B

Contingent Liability, Cash Basis S Corporation - Lawsuit
ABC, Inc., a cash basis taxpayer, elected S status on 1/1/96.
In 1995, a lawsuit was filed against ABC claiming damages for $10,000,000. The lawsuit was settled in 1996.
ABC paid damage awards of $5,000,000 that it deducted on its 1996 return. The $5,000,000 payment is not a recognized built-in loss because it would not have been deductible before the beginning of the recognition period if ABC had been an accrual basis taxpayer.

Example C

Deferred Payment Liabilities, Cash Basis S Corporation - Lawsuit
ABC, Inc., a cash basis taxpayer, elected S status on 1/1/96.
In 1995, ABC lost a lawsuit and became obligated to pay $10,000,000.
ABC paid the damage awards in 1996, which was deducted on its 1996 return (not allowed as a deduction until payment is made). The $10,000,000 payment is recognized built-in loss because it would have been deductible before the beginning of the recognition period if ABC had been an accrual basis taxpayer.

Example D

Deferred Prepayment Income, Accrual Basis S Corporation - Services Rendered
ABC, Inc., an accrual basis taxpayer, elected S status on 1/1/96.
In 1995, ABC received $50,000 for services to be rendered in 1996.
This would not be considered a recognized built-in gain when ABC recognizes the $50,000 into income in 1996 because it would not have been included in gross income using the method that ABC actually used before the beginning of the recognition period.

Example E

Change in Method, Accrual Basis S Corporation
ABC, Inc., an accrual basis taxpayer, elected S status on 1/1/96.
In 1995, ABC received $5,000 for services to be rendered in 1996 and properly included the $5,000 into income in 1995.
In 1996, ABC, Inc. elected an accounting method change to include the

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$5,000 into gross income in 1996, which resulted in an ($5,000) IRC section 481(a) change in accounting method adjustment.
The $5,000 included into gross income in 1996 is recognized built-in gain because it would have been included in gross income using the method actually used before the beginning of the recognition period.
In addition, the IRC section 481(a) change in accounting method adjustment of ($5,000) is recognized built-in loss because it relates to an item attributable to periods before the beginning of the recognition period.
The net recognized built-in gain is $0.

c. Deductions for Payments to Related Parties (Treas. Reg. §1.1374-4(c)(1))

Any amount properly deducted in the recognition period under IRC section 267(a)(2), relating to payments to related parties, is recognized built-in loss to the extent:

1. All events have occurred that established the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period, and
2. The amount is paid (a) in the first 2½ months of the recognition period or (b) to a related party owning, under the attribution rules of IRC section 267, less than 5%, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

d. Deductions for Payments for Deferred Compensation (Treas. Reg. §1.1374-4(c)(2))

Any amount properly deducted in the recognition period under IRC section 404(a), relating to payments for deferred compensation, is recognized built-in loss to the extent:

1. All events have occurred that established the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period, and
2. The amount is not paid to a related party to which IRC section 267(a)(2) applies.

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e. IRC Section 481(a) Adjustments (Treas. Reg. §1.1374-4(d))

IRC section 481(a) adjustments taken into account in the recognition period are recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period. IRC section 481(a) adjustments regard changes in accounting methods to prevent omissions or duplications of income or deductions.

Example A

ABC, Inc. elects to become a federal and California S corporation effective 1/1/91.
ABC had reported its accounts receivable under the installment sale method beginning in 1985. For income years beginning on or after 1/1/90, California repealed the installment sale method of accounting.
Accounts receivable not reported into income under the installment sale method as of 1/1/90 was $20,000,000. ABC reported the $20,000,000 into income pursuant to IRC section 481(a) -- $10,000,000 in IYE 12/90, $10,000,000 in IYE 12/91.
The IRC section 481(a) adjustment of $10,000,000 included into income in IYE 12/91 would be considered an item of built-in gain because it related to an item attributable to periods before the beginning of the recognition period.

Example B

Omitted Item Attributable to Prerecognition Period
ABC, Inc. elects to become an S corporation effective 1/1/96.
ABC improperly capitalizes repair costs and recovers the costs through depreciation of the related assets.
In 1999, ABC properly changes to deducting repair costs as they are incurred.
Under IRC section 481(a), the basis of the related assets are reduced by an amount equal to the excess of the repair costs incurred before the year of change over the repair costs recovered through depreciation before the year of change. The resulting IRC section 481(a) adjustment is negative.
The IRC section 481(a) adjustment relating to the repair costs incurred before the recognition period is recognized built-in loss because those repair costs are items attributable to periods before the beginning of the recognition period.

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f. Discharge of Indebtedness and Bad Debts (Treas. Reg. §1.1374-4(f))

Any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under IRC section 61(a)(12) or as a bad debt deduction under IRC section 166 is recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.

g. Completion of Contract (Treas. Reg. §1.1374-4(g))

Any item of income properly taken into account during the recognition period under the completed contract method (Treas. Reg. §1.451-3(d)) where the corporation began performance of the contract before the beginning of the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period under the percentage of completion method (Treas. Reg. §1.451-3(c)). Any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method.

h. Installment Method (Treas. Reg. §1.1374-4(h))

In general, if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under IRC section 453, that income is an item of built-in gain. The final regulations have provided special treatment for income received on the installment method. Please refer to **S Corp 051300 - Special Rules for Installment Reporting**.

i. Partnership Interests (Treas. Reg. §1.1374-4(i))

In general, an S corporation owing an interest in a partnership must treat its distributive share of the partnership's items as recognized built-in gain or loss to the extent the S corporation's distributive share would have been treated as recognized built-in gains or loss if the items originated in, and were taken into account directly by the S corporation (the "look-through rule"). The final

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regulations have provided special rules for determining the items of built-in gains (losses) in regards to partnerships. Please refer to **S Corp 051400 - Special Rules for Partnership Interests**.

j. Valuing and Disposing of Inventory (Treas. Reg. §1.1374-7)

The value of an S corporation's inventory on the first day of the recognition period generally is determined by reference to a sale of the entire business of the S corporation to a buyer that expects to continue to operate that business. The buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts such as:

1. The replacement cost of the inventory,
2. The expected retail selling price of the inventory,
3. The seller's incentive to demand a price for the inventory that would compensate for and provide a fair return for expenditures the seller incurred to obtain, prepare, carry, and dispose of the inventory before the sale of the business, and
4. The buyer's incentive to pay a price for the inventory that would compensate for and provide a fair return for similar expenditures the buyer expects to incur after the sale of the business.

The inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period is inventory it held on the first day of that period. Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method as described in IRC §472).

However, if a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under IRC section 1374, it must use its former method to identify its dispositions of inventory. In *Reliable Steel Fabricators, Inc. v. Comr.* (1995) T.C. Memo 1995-293, the Tax Court held that, for purposes of determining the taxpayer's recognized built-in gain, work-in-process is valued at a discount from retail. In determining what a willing buyer would pay a willing seller for its work-in-process, the fair market value was lower than full retail price but higher than cost since a willing buyer would not forgo all profit inherent in the inventory and a willing seller

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would not forgo all profit inherent in the work-in-process.

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050704 Valuations

Per IRC section 1374(d)(3), the "recognized built-in gain amount" is the gain recognized during the 10-year recognition period except to the extent the corporation establishes that the gain occurred after the effective date of the S-election. As a result, valuations are frequently provided by corporations to support fair market values as of the effective date for the S-election. Thus, an understanding of various valuation methods can be critical to resolving BIG cases.

The most widely used methods are listed below in their general order of acceptability.

- Analysis of the Actual Sale
- Analysis of Comparable Companies
- Discounted Cash-flow Method
- Excess Earning Method

A description of each of these methods along with examples follows.

Caution: Examples are provided to illustrate possible uses of each of the above methods. The examples are not intended as definitive guidelines for how to employ each method.

COMPREHENSIVE EXAMPLE

Except for the Excess Earnings method, the valuation methods mentioned above are generally used to derive a FMV for a company's equity. For BIG purposes, the question is usually the FMV of the company's assets. The following is an example showing how the FMV of a company's assets might be computed once a value for the company's equity has been derived.

KEY CONCEPT:

The FMV of a company's assets = The FMV of its liabilities + The FMV of its equity

If we have determined that the FMV of a company's equity is $5 million and a review of its balance sheet reveals liabilities totaling $2 million, the FMV of the company's assets is $7 million. An example will be used to illustrate how the

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FMV of the individual asset groups can be estimated. Generally, current assets have FMVs that are similar to their book values and non-current assets frequently have FMVs that are substantially different from book values.

EXAMPLE A

Don Company is in the business of manufacturing and selling widgets. The company operated as a C-corporation for ten years prior to electing S-status. The company's assets are sold in a complete liquidation three years after the S-election date. Based upon an analysis of the company, the FMV of its equity on the date its S-election became effective is estimated at $6 million. In addition, the company had $2 million of liabilities at the time (the book value of liabilities is assumed to be FMV). Thus, the FMV of Don's total assets are estimated to have been $8 million (6 + 2). Finally, the company's assets were reported on its books as follows:

Cash	$500,000
A/R	$1,000,000
N/R from shareholder	$300,000
Inventory (at cost)	$1,000,000
Equipment (net book)	$1,500,000

Assume that it cost the company $1 to make a widget and that it sells the widget for $2. In addition, assume that an analysis of the actual asset reveals that the equipment was sold for approximately book value.

In the absence of other information, it may be reasonable to estimate the value of the various assets as follows.

Cash	The FMV of cash would be the same as book.
A/R	Accounts receivable would usually have a fair market value that is less than book value due to uncollectible accounts, the costs of collection and the time value of money. Without detailed knowledge concerning the quality of the accounts a 10% discount from book value would probably be reasonable.
N/R	The FMV of the loan to the shareholder would depend on the terms of the loan, the quality of any security and current market rates for similar loans. If the loan has a below market interest (as we will assume and as is quite common), a discount from book value would be warranted. Thus, a 20% discount from book will be applied to estimate FMV.
Inventory	There are special rules that apply when valuing inventory for BIG purposes. Per Treas. Reg. section 1.1374-7, "the fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay a willing seller for the inventory in a

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	purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business". In addition, the preamble to Treasury Decision 8579 states, "the value of inventory will usually be less than its anticipated retail price but more than its replacement cost". In this example, the markup between cost and retail is 100%. Thus, absent additional information, it may reasonable to estimate the FMV of inventory at cost plus 50%.
Equipment	An analysis of the subsequent actual sale revealed that the equipment sold for approximately book value. An actual sale that is reasonably proximate to the valuation date is usually a good indicator of FMV. Thus, it is probably reasonable to estimate the FMV of the equipment on the date the S-election became effective to be the same as book value.
Goodwill	The FMV of goodwill is equal to the value of total assets minus the values previously allocated to other assets.

Based upon the above, the estimated FMV of the company's assets on the valuation date is as follows.

Cash	$500K
A/R	$900K
N/R	$250K
Inventory	$1,500K
Equipment	$1,500K
Goodwill	$3,350K

Note: The total FMV of the company's assets is $8 million.

CAUTION: This approach may or may not be reasonable depending on the volatility of the values of the various asset classes and materiality. The example is presented as a possible approach that may be reasonable under certain circumstances and to illustrate an approach.

a. Actual Sales Method

Analysis of the Actual Sale – This approach is based on the thought that the best indicator of the value of a business is an actual sale of the business, particularly when the sale is proximate in time to the valuation date. (See *Jung Est. v. Comm.*, (1993) 58 TCM 1127, *Morris v. Comm.*, (1978) 70 TC 959; *Narver v. Comm.*, 75 TC 53.) Using this approach, an analysis of the actual sale is made and the data gained from this analysis is then applied to the facts that existed on the valuation date to determine a FMV.

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If the actual sale is only a few months after the valuation date and no material events occurred in the interim, it may be reasonable to use the actual sales price as the estimate of FMV on the valuation date. If the actual sale date is somewhat removed from the valuation date, adjustments can be made to the derived value to account for material events that occurred between the valuation date and the sale date to derive a FMV.

Example A

A company elects S status on 7/1 and, then, it is sold on 8/1 to an unrelated party. If there was no material event between 7/1 and 8/1, the actual sales price is the best indicator of the company's value on 7/1.

Example B

J corporation elects S status on 1/1/00 and the business is sold on 1/1/01. An analysis of the terms of the actual sale may be a sound method for estimating the value of the corporation on the S-election date.
Pertinent facts are as follows.
The corporation sold all of its assets for $20 million in cash.
The corporation's sales in FYE 12/00 were $10 million and its ordinary income from operations for the year was $1 million. In FYE 12/99, its sales were $8 million and its ordinary income from operations was $1 million.
J corporation was 100% owned by an individual who also worked for the corporation. The corporation paid this individual a salary of $1 million in FYE 12/00 and a salary of $700K in FYE 12/99.
In the years preceding the S-election, its sales had steadily grown at a 25% annual rate.
(Note: Because the sole shareholder also draws a salary from the corporation and because the amount paid to the shareholder is discretionary, an adjustment is made to the ordinary income amount to reflect the disallowance of the salary paid to the shareholder. This adjustment is made only to derive a valuation multiple. As a result, the corporation's adjusted ordinary income from operations is $2 million)
Based on the above facts, the corporation sold for two times its prior year's sales ($20 million/$10 million) and 10 times its adjusted ordinary income from operations ($20 million/ $2 million). If these multiples are applied to the figures for FYE 12/99, the following unadjusted value is derived.
Value based on sales multiple – Based on a sales multiple of two, the corporation

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would have a value of $16 million (2 x $8 million) on 1/1/00.
Value based on adjusted ordinary income multiple – The corporation's adjusted ordinary income for FYE 12/99 is $1.7 million ($1,000,000 + $700,000). Based on the derived multiple of ten, a value of $17 million is obtained.
If these two values are averaged, an unadjusted value of $16.5 million is obtained. However, it may be advisable to adjust this value for events that occurred between the valuation date and the sale date such as a strong stock market, a substantial change in prevailing interest rate, a change in the company's growth prospects, etc. In this example, the company's sales continued to grow at a 25% rate so no adjustment is needed for a change in its growth. However, it may be advisable to make adjustments for events in the economy as a whole. For example, if valuation multiples in the economy are up significantly as evidenced by the stock market indexes being up significantly in the period between the valuation date and the sale, it may be reasonable to make an adjustment for this occurrence.

In the above example, if the Standard & Poor's 500 index increased significantly in 2000. It may be reasonable to adjust the $16.5 million value to account for an expansion in valuation multiples.

Example C

Gold Bug Mining is in the gold production business. The company has operated for many years as a "C" corporation and then it elects "S" status. Ten months after electing "S" status, the company is sold for $50 million. In determining the FMV of the company as of the S-election date, you notice that gold stocks appreciated dramatically (P/E ratios for many stocks in the industry doubled) between the S-election date and the actual sale date. Thus, you should probably account for this change in your valuation.

b. The Comparable Sales Approach

Overview – With the comparable sales approach, the value of the subject company is derived from the valuations of similar companies in the same or similar line of business. Support for this approach can be found in both Revenue Rulings 59-60 and 80-233 along with numerous court cases. (See *Newhouse Est. v. Comm.*, (1990) 94 T.C. 193 or *Lauder Est. v. Comm.*, (1994) 68 T.C.M. 985.) In the comparable sales approach, an analysis of publicly traded companies is made to determine valuation multiples that can then be applied to a

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non-publicly traded stock. Per Rev. Rul. 59-60, stock listed on an exchange is to be considered first and over-the-counter stock second for comparison purposes.

Example A

XYZ Computer incorporated in 1987 and it elected S status on 4/1/91. On 1/1/96, the corporation was sold to a third party for $40 million. XYZ's primary product throughout its existence was high-end personal computers. XYZ's sales in FYE 3/91 were $8 million and its net income for FYE 3/91 was $500K.
Based on the comparable sales method, the value of XYZ on 4/1/91 was estimated as follows.
A list of companies in the same or similar line of business is obtained and an analysis of the selected companies is undertaken to derive valuation multiples and financial data.
The valuation multiples of the reference companies are analyzed in light of their financial performances and trends.
Valuation multiples derived from the analysis of the comparable companies are applied to the subject company to derive an estimate of its FMV on the valuation date.
Presented below is selected data for XYZ and the reference companies.

Data on XYZ and Reference Companies

1) **XYZ Computer –** In the spring of 1991, XYZ's main business was the designing, assembling and marketing of high-end portable computers for business.
Sales Growth: FYE 3/89 = 75%, FYE 3/90 = 82%, FYE 3/91 = 148%
Gross Margin: FYE 3/89 = 38%, FYE 3/90 = 32%, FYE 3/91 = 36%
Net Income/Sales: FYE 3/89 = <7.7%>, FYE 3/90 = <5.2%>, FYE 3/91 = 5.7%

2) **ABC Computer**– ABC develops, manufactures and markets personal computer systems for a wide array of markets. For FYE 9/91, the company had sales of $6.3 billion.
a) Sales Growth: FYE 9/89 = 30%, FYE 9/90 = 5%, FYE 9/91 = 14%
b) Gross Margins: FYE 9/89 = 49%, FYE 9/90 = 53%, FYE 9/91 = 47%
c) Net Income/Sales: FYE 8/89 = 8.6%, FYE 9/90 = 8.5%, FYE 9/91 = 4.9%
d) Closing Price on 4/1/91 = $68.50
e) EPS for FYE 9/90 = $3.77
f) P/E ratio based on FYE 9/90 EPS = 18 ($68.50 / $3.77)
g) Sales/Share in FYE 9/90 (based on avg. # of shares in FYE 9/90) = $44.18 ($5,558,435 / 125,813)(000's omitted)
h) Price/Sales based on sales in FYE 9/90 = 1.6 ($68.50 / $44.18)

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Analysis: ABC's sales growth in the period around 4/1/91 is substantially below that of XYZ's. However, its gross margin is somewhat better and its Net Income/Sales ratio about the same as XYZ's. Based on these factors, XYZ's valuation multiples would probably be higher than ABC's due to the upward trend in its sales growth rate and its much higher growth rate.

3) **DEF Computer**– DEF designs, manufactures and direct markets personal computers and computer accessories. For FYE 2/3/91, the company had sales of $546 million.
Sales Growth: FYE 1/89 = 62%, FYE 1/90 = 51%, FYE 1/91 = 41%
Gross Margins: FYE 1/89 = 31%, FYE 1/90 = 28%, FYE 1/91 = 33%
Net Income/Sales: FYE 1/89 = 5.6%, FYE 1/90 = 1.3%, FYE 1/91 = 5.0%
Closing Price on 4/1/91 = $28.625
EPS for FYE 2/3/91 = $.91
P/E based on EPS for FYE 2/3/91 = 31 ($28.625 / $.91)
Sales/Share in FYE 2/3/91 = $18.17 ($546,235 / 30,063)
Price/Sales based on sales in FYE 2/3/91 = 1.6 ($28.625 / $18.17)
Analysis: DEF's sales growth is significantly below XYZ's for the period nearest 4/1/91 (41% vs. 148%) and its sales growth rate has been in decline each of the above years. However, both its gross margin and Net Income/Sales ratios are comparable to XYZ's. Thus, XYZ's valuation multiples would probably be higher than DEF's due to a better trend in its sales growth and the much higher growth rate.

4) **GHI Computer**– GHI designs, manufactures and markets personal computers and related products. In 1991, it was the third largest maker of personal computers. For FYE 12/90, CPQ had total sales of almost $3.6 billion.
Sales Growth: FYE 12/88 = 69%, FYE 12/89 = 39%, FYE 12/90 = 25%
Gross Margins: FYE 12/88 = 40%, FYE 12/89 = 40%, FYE 12/90 = 42%
Net Income/Sales: FYE 12/88 = 12.4%, FYE 12/89 = 11.6%, FYE 12/90 = 12.6%
Closing price on 4/1/91 = $61.625
EPS for FYE 12/90 = $5.14
P/E based on EPS for FYE 12/90 = 12 ($61.625 / $5.14)
Sales/Share for FYE 12/90 = $41.80 ($3,598,800 / 86,090) (000's omitted)
Price/Sales based on sales in FYE 12/90 = 1.5 ($61.625 / $41.80)
Analysis: GHI's sales growth in the fiscal year ending closest to 4/1/91 was well below that of XYZ's (25% vs. 148%). In addition, the trend for sales growth was decidedly downward. However, its Net Income/Sales ratio is well above XYZ's and its gross margins are similar to XYZ's. Based on these factors, it would be reasonable for XYZ to have higher valuation multiples than GHI because it has a better trend in sales growth and a higher sales growth rate.

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5) **JKL Inc.** – JKL designs, manufactures and markets array processors, which are small, special purpose computers. For FYE 8/90, JKL had sales of $11.3 million.
Sales Growth: FYE 8/88 = 2%, FYE 8/89 = 26%, FYE 8/90 = <6%>
Gross Margins: FYE 8/88 = 66%, FYE 8/89 = 63%, FYE 8/90 = 65%
Net Income/Sales: FYE 8/88 = 2.7%, FYE 8/89 = 7.2%, FYE 8/90 = 7.4%
Closing price on 4/1/91 = $6.375
EPS for FYE 8/90 = $.31
P/E based on EPS for FYE 8/90 = 21 ($6.375 / $.31)
Sales/Share in FYE 8/90 = $4.13 ($11,298,000 / 2,733,000)
Price/Sales based on sales in FYE 8/90 = 1.5 ($6.375 / $4.13)
Analysis: JKL's sales growth in the period ending closest to 4/1/91 was a negative 6% vs. a positive 148% for XYZ. However, JKL's gross margin and Net Income/Sales were better than XYZ's. Based on these factors, XYZ's valuation multiples could reasonably be expected to be higher than JKL's due to its better trend in sales growth and its much higher sales growth rate.

Summary
Price/Earnings Multiple – The P/E multiples for the reference companies range from 12 to 31. The average is 20.5 and the median is 19.5.
Price/Sales Multiple – The range for this multiple is 1.5 to 1.6 with 1.55 as both the average and the median value.
Sales Growth – The sales growth rates for the reference companies range from a negative 6% for JKL to a positive 41% for DEF. The average and the median value for the reference companies is 15%.
Based upon our analysis of the above reference companies, it appears that a P/E multiple of 24 and a Price/Sales multiple of 2 seem reasonable for XYZ on 4/1/91. These multiples are above most of the reference companies. The premium is attributed to the fact the XYZ's sales growth rate is vastly higher than any of the reference companies and it has been able to achieve its growth while maintaining stable gross margins.
Applying these multiples to XYZ's FYE 3/91 net income and the company's FYE 3/91 sales, the following values are derived.
P/E value = $500,000 x 24 = $12,000,000
Price / Sales value = $8,000,000 x 2 = $16,000,000
Averaging the two values, a value of $14,000,000 is obtained.

TIPS:
Lists of publicly traded companies in the same or similar industry can readily be found at numerous sites on the internet (i.e. Yahoo/Finance).
Data sources for the reference companies include ValueLine (at the public library) and Moody's along with various other sites or publications. Great care

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must be used in the analysis to make sure that the data is all adjusted for stock splits or stock dividends. ValueLine's data is all split adjusted and on a per share basis.

c. Discounts and Premiums

When the value of a privately held company is derived from the values of publicly held companies, several adjustments to the derived value may be warranted. Two frequently cited adjustments are a premium for control and a discount for lack of marketability. A brief discussion of each is follows.

1) Control Premium

In the comparable sales method, the prices used are from sales of minority interests in publicly traded stocks. Thus, the prices do not reflect the value of the right to control a corporation since such right is usually not inherent in such a trade. The right to control a corporation has significant value. Therefore, a premium to the unadjusted value that was derived from an analysis of publicly traded companies is usually needed.

In "Valuing a Business" by Pratt, Reilly and Schweihs, several studies on control premiums are cited. Most of the studies tend to support premiums in the 25 – 40% range. Thus, an appraisal citing a premium significantly outside this range should be closely reviewed.

Factors affecting the size of the control premium include:

- The rights of minority shareholders
- The perceived quality of the company's management
- The perceived efficiency of current operations

Obviously, these are highly subjective criteria. Thus, detailed analysis is very difficult.

2) Discount for Lack of Marketability

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When the value of a privately held company is derived from the values of publicly-traded companies, a discount to the derived value is typically warranted to reflect the fact that shares in the non-publicly traded companies are not readily marketable. This discount is necessary because, everything else being equal, investors prefer liquid investments. Several widely cited studies concerning this issue have supported discounts in the 30 – 40% range.

In *Bernard Mandelbaum, et al. v. Comm.*, TC Memo 1995-255, the court discusses several of these studies and, then, goes on to state the following:

"Ascertaining the appropriate discount for limited marketability is a factual determination. Critical to this determination is an appreciation of the fundamental elements of value that are used by an investor in making his or her investment decision. A nonexclusive list of these factors includes: (1) The value of the subject corporation's privately traded securities vis-à-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock); (2) an analysis of the subject corporation's financial statements; (3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends; (4) the nature of the corporation, its history, its position in the industry, and its economic outlook; (5) the corporation's management; (6) the degree of control transferred with the block of stock to be valued; (7) any restriction on the transferability of the corporation's stock; (8) the period of time for which an investor must hold the subject stock to realize a sufficient profit; (9) the corporation's redemption policy; and (10) the cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting, and underwriting fees. See *Estate of Gilford v. Commissioner,(1987), 88 T.C. 38, 60; Northern Trust Co. v. Commissioner, (1986), 87 T.C. 349, 383-389*; see also Rev. Rul. 77-287, 1977-2 C.B. 319 (valuation of restricted securities)."

If you are working this issue, it is strongly suggested that you review the court's discussion of these factors. Additional information on this issue can be found in the book "Valuing a Business" by Pratt, Reilly and Schweihs and Rev. Rul. 77-287.

d. The Discounted Cash-Flow Method (DCF)

Overview – The DCF method is typically used when no actual sale is available and no comparable companies can be found. With the discounted cash-flow method, the value of a company is the discounted value of its expected future

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cash flows. This method requires an estimation of the future cash flows associated with company and then the application of an appropriate discount rate given the risks associated with the cash flows and the level of interest rates in the economy. Great care must be taken when projecting the cash flows and even greater care must be exercised in selecting an appropriate discount rate. The discount rate selected can substantially affect the computed value. Cases supporting the use of this method include *Northern Trust Co. v. Comm.*, (1986) 87 TC 349 and *Est. of Cartwright v. Comm.*, TC Memo 1996-286.

Example: What is the present value of ten annual payments of $100K that starts one year from today assuming discount rates of 18% and 24%?

The answer is obtained by multiplying the annual payment amount by the present value interest factor for an annuity (PVIFA) for the stated rate and number of periods. Present value tables can be found in most finance and accounting books. At an 18% discount rate, the value is $449,410 ($100K x 4.4941). At 24%, the value declines to $368,190 ($100K x 3.6819).
The company's cash flows can be reasonably estimated based upon an analysis of financial statements for the years preceding the valuation date. In addition, an analysis of prior years financial statements will probably aid in predicting the expected growth in cash flows.

Example A

Based on a review of the company's financial statements for several years preceding the valuation date, the following assumptions are made in order to project future cash flows.

Sales in the year following the valuation date are projected to be $5 million and sales are expected to grow 20%/year.
Cash flow is expected to be 6% of sales during the forecast period.
The company is assumed to be sold at the end of the fifth year following the valuation date for 10 times cash flow. This assumption is based on the cash flow multiples in the industry at the valuation date.
A discount rate of 20% compounded annually is deemed appropriate.
COMPUTATION

Year	Cash-Flow Amt		P.V. Factor		Present Value
1	$300,000	x	.8333	=	$249,990
2	$330,000	x	.6944	=	$229,152
3	$363,000	x	.5787	=	$210,068

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4	$399,300	x	.4823	=	$192,582
5	$439,230	x	.4019	=	$176,527
			TOTAL		**$1,058,319**

Terminal Value (TV) = 10 x $439,230 = $4,392,300
P.V. of TV = $4,392,300 x .4019 = $1,765,265
Total Present Value = $1,058,319 + $1,765,265 = $2,823,584
Thus, based on the assumptions specified, the company's value is estimated to be $2,823,584 as of the valuation date

1.) Variables in the DCF Method

The DCF method requires that various assumptions be made. Among the most important assumptions are:

- The projected annual cash flows
- The expected terminal value
- The appropriate discount rate

A brief discussion of each of these factors is provided below.

The projected annual cash flows – The DCF method requires that projections be made concerning a company's future cash flows. There are various definitions of cash flow available; however, most are some variation of the following:

Cash Flow = Net Income after taxes + Depreciation – Capital Expenditures

In the absence of information to the contrary, it may be reasonable to predict the future cash flows based on an analysis of the company's cash flows for several years preceding the valuation date. Support for this approach can be found in Rev. Rul. 59-60, Sec. 4.02(d).

The Expected Terminal Value – In the DCF method, an expected future value of the company is frequently predicted so that there is an ending to the projected future cash flows. This terminal value is what the company is expected to sell for at some future date. It may be appropriate to project the expected terminal value based upon valuation multiples for the industry at the valuation date or the average valuation date at several points in time.

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The discount rate – The discount rate is the expected rate of return an investor would require to invest in the company. The discount rate applied to the expected future cash-flows is an extremely important variable. The value derived from this method is greatly altered from relatively minor changes in the discount rate. For example, if a 16% discount rate were used in the above example, the derived value would increase from $2,823,584 to $3,257,284. Conversely, if the discount rate were increased to 24%, the derived value would decrease to $2,463,915.

The appropriate discount rate can be derived in numerous ways. However, most approaches are usually some variation of the following.

Discount Rate = The risk-free interest rate on the valuation date + An equity risk premium + A risk premium for the specific company.

The risk-free rate is frequently the interest rate on treasury bills or treasury notes. The rate chosen should be based on the prevailing rates on the valuation date. Historical data on treasury securities can be found at many Internet sites including Yahoo/Finance or "www.federalreserve.gov".

The equity risk premium is the additional return required to invest in equities instead of the risk-free investment. Frequently, this premium is based on long-term studies of the returns from different securities markets. A premium in the 5-8% range is very common. Many studies are based on data from Ibbotson Associates. The premium used is usually based on comparing the long-term returns from a stock index (i.e. the S&P 500) to the returns from treasury securities. In other words, most of these studies conclude that the rate of return from stocks has usually been
5-8% greater per year than the return from treasury securities.

The risk premium for the specific company can vary widely. The factors cited for the figure selected may include:

- The size of the company.
- The financial strength of the company.
- The degree of leverage used by the company.
- The products produced by the company.
- The company's number of customers.

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The company specific risk premium is frequently in the 6-12% range. A premium greater than 12% may require close scrutiny.

Example B

If the interest rate on 6 month treasury bills is 6%, the discount rate applicable to a well-established small grocery chain that has little debt in its capital structure, a long history of stable sales growth and is situated in a moderate-sized town with a diverse economic base may be computed as follows.

The risk-free rate	6%
The equity risk premium	7%
The company specific risk premium	6%
Discount Rate	19%

In this example, the rationale for selecting a relatively modest company specific risk premium could include the facts that – 1) The company is well-established 2) It has little debt 3) It has a long history of stable growth 4) The town has a diverse economic base 5) Groceries are necessities. All of these factors could indicate a below average specific risk premium is appropriate.

e. Excess Earnings Method

The Excess Earnings method is also known as the formula method. It is not a recommended method but a summary of the method is presented because it is frequently used in appraisal reports provided by taxpayers. Per Rev. Rul. 68-609, the method "should not be used if there is better evidence available from which the value of intangibles can be determined…Accordingly, the formula approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefore available."

Rev. Rul. 68-609 describes the Excess Earnings method as follows:

A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the

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business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say, 15 to 20 percent, is the value of the intangible assets of the business determined under the “formula” approach.

The percentage of return on the average annual value of the tangible assets used should be the percentage prevailing in the industry involved at the date of valuation, or (when the industry percentage is not available) a percentage of 8 to 10 percent may be used.

The 8 percent rate of return and the 15 percent rate of capitalization are applied to tangibles and intangibles, respectively, of businesses with a small risk factor and stable and regular earnings; the 10 percent rate of return and 20 percent rate of capitalization are applied to businesses in which the hazards of business are relatively high.

The above rates are used as examples and are not appropriate in all cases. In applying the “formula” approach, the average earnings period and the capitalization rates are dependent upon the facts pertinent thereto in each case.

The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business. See *Lloyd B. Sanderson Estate v. Commissioner,*(1930), 42 F. 2d 160. Further, only the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable, are used for determining earnings on the tangible assets. Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.

Example A

Based on a review of Joe Corporation's financial statements for the five years preceding the valuation date, the company is expected to have a net income of $2 million dollars a year for the foreseeable future. Furthermore, the value of its net tangible assets on the valuation date is $10 million. In addition, a fair rate of return on the tangible assets is estimated to be 10% and the capitalization rate for excess earnings is 15%. Thus, the value of the company's goodwill is estimated as follows.

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Expected net income	2,000,000
Less: Returns attributable to net tangible assets (10% x $10,000,000)	1,000,000
Expected Excess Earnings	1,000,000
Capitalized Excess Earnings (i.e. goodwill)($1,000,000/15%)	6,666,667
Thus, the total value of the company's tangible and intangible assets is $16,667,667 ($10,000,000 + $6,667,667)	

Additional information concerning this method can be found in "Valuing a Business" by Pratt, Reilly and Schweihs.

Caution: Valuations are far from an exact science. Thus, great care must be exercised with any valuation method.

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050800 PRE-LIMITATION AMOUNT

S Corp 050801 Definition of “Pre-Limitation Amount”
S Corp 050802 Computing “Pre-Limitation Amount” when Recognition Period Ends During the S Corporation’s Taxable Year

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050801 Definition of "Pre-Limitation Amount"

An S corporation's "pre-limitation amount" is its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover.

Example A

ABC, Inc., an accrual basis taxpayer, was incorporated on 12/1/77.

On 1/1/90, ABC made a federal and California S election.

After examination of the ABC's books and records for IYE 12/90, the auditor identifies items of built-in gain (loss). The auditor computes ABC's "pre-limitation amount" -- taxable income computed by using all rules applying to C corporation and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (net operating and capital loss carryovers from C corporation years):

		Recognized Built-in Gain	Recognized Built-in Loss	Pre-Limitation Amount
1.	Installment sale income	$2,500,000		
2.	Bad debt recovery	150,000		
3.	Sale of machinery	100,000		
4.	Recognized built-in gain carryover	0		$2,750,000
5.	Sale of building		-575,000	-575,000
6.	Total			$175,000

Because this was ABC's first year as an S corporation, it had no "recognized built-in gain carryover".
ABC reported a net operating loss of ($350,000) in IYE 12/89.
ABC's pre-limitation amount is $175,000.

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050802 Computing "Pre-Limitation Amount" when Recognition Period Ends During the S Corporation's Taxable Year

If the recognition period for certain assets ends during an S corporation's taxable year (for example, because the corporation was on a fiscal year as a C corporation and changed to a calendar year as an S corporation or because an S corporation acquired assets in a IRC section 1374(d)(8) transaction during a taxable year, the S corporation must determine its pre-limitation amount for the year as if the corporation's books were closed at the end of the recognition period.

Example A

ABC, Inc., a C corporation, reported on a fiscal year ending October 31.
ABC made a federal and California S election effective beginning 11/1/89.
It filed a calendar year end return on 12/31/89.
ABC's recognition period is the 120-month period covering 11/1/89 - 10/31/99.
In IYE 12/99, ABC reported the following gains on asset dispositions for assets held on 11/1/89 (the date of conversion to an S corporation):

1.	Land (sold on 9/3/99)	$1,000,000
2.	Building (sold on 9/3/99)	5,000,000
3.	Building (sold on 11/30/99)	10,000,000

In computing ABC's "pre-limitation amount", only asset sales occurring from 1/1/99 - 10/31/99 are included (last 10 months of recognition period). The building sold on 11/30/99 for a $10,000,000 gain would fall outside the recognition period and would not be included in the "pre-limitation amount".

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050900 TAXABLE INCOME LIMITATION

The taxable income limitation refers to an S corporation's taxable income determined by using all rules applying to C corporations (IRC §63(a)), as modified by IRC section 1375(b)(1)(B).

IRC section 1375(b)(1)(B) disregards the following deductions in computing the taxable income limitation:

- IRC section 172 - Net operating loss deduction (R&TC §24416)
- IRC section 241 - Allowance of special deductions (R&TC §24401)
- IRC section 243 - Dividends received by corporations (R&TC §24402)
- IRC section 244 - Dividends received on certain preferred stock (R&TC §24402)
- IRC section 245 - Dividends received from certain foreign corporations (R&TC §24402)
- IRC section 246 - Rules applying to deductions for dividends received (R&TC §24402)
- IRC section 246A - Dividends received deduction reduced where portfolio stock is debt financed
- IRC section 247 - Dividends paid on certain preferred stock of public utilities (R&TC §24402)
- IRC section 249 - Limitation on deduction of bond premium on repurchase (R&TC §24439)

Final regulations require the S corporation to use the accounting methods it actually uses as an S corporation to make this taxable income determination.

Example A

As Reported per Return:

1.	Ordinary income (loss) from trade or business activities from federal 1120S, line 21.	$50,000
2.	Foreign or domestic tax based on income or profits and California franchise or income tax	15,000
3.	Interest on government obligations	1,000
4.	Net capital gain from Schedule D (100S), Section B	850,000
5.	Depreciation and amortization	-25,000

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	adjustments		
6.	Portfolio income		10,000
7.	Contributions		-1,000
8.	Net income (loss) after state adjustments		$900,000
9.	Net income (loss) for state purposes		$900,000
10.	R&TC Section 23802(e) deduction	850,000	
11.	Net operating loss carryover deduction	50,000	900,000
12.	Net income for tax purposes		$0

Total net operating loss carryover = $700,000.

The taxable income limitation for California purposes is net income (loss) after state adjustments, $900,000. The net operating loss carryover of $700,000 is not part of the taxable income limitation computation.

Note: In this example there were no IRC section 241-249 deductions required to be added back to net income (loss) after state adjustments for purposes of computing the taxable income limitation.

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051000 "NET UNREALIZED BUILT-IN GAIN"

S Corp 051001 Definition of "Net Unrealized Built-in Gain"
S Corp 051002 Computing "Net Unrealized Built-in Gain"
S Corp 051003 "Net Unrealized Built-in Gain" Unknown

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051001 Definition of "Net Unrealized Built-in Gain"

"Net unrealized built-in gain" is the upper limit of "net recognized built-in gain" subject to the built-in gains tax during the recognition period. (IRC §1374(c)(2)(A))

It is the excess of the fair market value of the assets of the S corporation as of the beginning of its 1st taxable year in which an election is made over the aggregate adjusted bases of such assets at such time. (IRC §1374(d)(1)) It also includes items of income and deduction treated as recognized built-in gains or losses during the recognition period. (IRC §1374(d)(5)(C))

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051002 Computing "Net Unrealized Built-in Gain"

The maximum "net recognized built-in gain" subject to the built-in gains tax during the recognition period is the total of the following, as determined on the date the S election was effective.

1. The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by
2. Any liability of the corporation that would be included in the amount realized on the sale referred to in (1), but only if the corporation would be allowed a deduction on payment of the liability; decreased by
3. The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in (1); increased or decreased by
4. The corporation's IRC section 481 adjustments that would be taken into account on the sale referred to in (1); and increased by
5. Any recognized built-in loss that would not be allowed as a deduction under IRC section 382, IRC section 383, or IRC section 384 on the sale referred to in paragraph (1).

Example A

ABC, Inc. is a calendar year C corporation using the cash method. It elects to become an S corporation on January 1, 1996 and, on this day, has assets and liabilities as follows:

Assets	FMV on 1/1/96	Adjusted Basis	Built-in Gain (Loss)
Cash	$10,000	$10,000	$0
Accounts receivable	50,000	0	$50,000
Building	100,000	30,000	70,000
Machine #1	17,000	15,000	2,000
Machine #2	8,000	10,000	-2,000
Furniture & fixtures	1,000	2,000	-1,000
Leasehold improvements	70,000	35,000	35,000
Goodwill	150,000	0	150,000
Total Assets	396,000	92,000	304,000

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Liabilities			
Mortgage	-100,000		
Rent payable *	-10,000	0	-10,000
Supplies payable *	-5,000	0	-5,000
Wages payable *	-15,000	0	-15,000
Total liabilities	-130,000		-30,000

*Deductible when paid.

ABC, Inc. also had IRC section 481(a) income of $300,000 to be reported after conversion.
ABC, Inc.'s net unrealized built-in gain at the date of conversion is:

1.	Amount realized if assets sold at fair market value and liabilities assumed	$396,000
2.	Less: Liability if corporation allowed a deduction on payment	-30,000
3.	Less: Aggregate adjusted basis of assets	-92,000
4.	Plus: IRC section 481(a) income	300,000
5.	Plus: Recognized built-in loss not deductible under IRC section 382, IRC section 383, and IRC section 384	0
	Net unrealized built-in gain	$574,000

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051003 "Net Unrealized Built-in Gain" Unknown

The IRS and Treasury believe that using a valuation approach for determining "net unrealized built-in gain" is not unduly burdensome because IRC section 1374(d)(1) defines net unrecognized built-in gain using an aggregate method. They also believe that many S corporations will not need to know their "net unrealized built-in gain" because they will not approach their "net unrealized built-in gain" limitation during the recognition period.

Keep in mind, however, that the S corporation is responsible for asset valuations at the date of conversion. Without such computation, the corporation may be subject to built-in gains tax on "recognized built-in gains" in excess of its "net unrealized built-in gain".

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051100 NET RECOGNIZED BUILT-IN GAIN

S Corp 051101 In General
S Corp 051102 Allocation Rule
S Corp 051103 Recognized Built-in Gain Carryover

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051101 In General

Net recognized built-in gain is the maximum amount subject to the built-in gains tax during the tax year. This amount is computed after determining the pre-limitation amount, taxable income limitation, and net unrealized built-in gain. Per Treas. Reg. section 1.1374-2(a), an S corporation's net recognized built-in gain for any taxable year is the least of:

1. **Pre-limitation amount** - its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover;

2. **Taxable income limitation** - its taxable income determined by using all rules applying to C corporations as modified by IRC section 1375(b)(1)(B); and

3. **Net unrealized built-in gain limitation** - the amount by which its net unrealized built-in gain exceeds its net recognized built-in gains for all prior taxable year.

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051102 Allocation Rule

If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount. (Treas. Reg. §1.1374-2(b))

Example A

Computation of net recognized built-in gain - **least of**:

1.	Pre-limitation amount [sum of recognized (1) built-in gain, (2) built-in loss, and (3) built-in gain carryover:		
	Sale of building	$500,000	
	Sale of land	-200,000	
	Sale of goodwill	1,000,000	
	Total pre-limitation amount		$1,300,000
2.	Taxable income limitation		**$500,000**
3.	Net unrealized built-in gain		$5,000,000

The S corporation's net recognized built-in gain is $500,000.
Because the pre-limitation amount of $1,300,000 exceeds the net recognized built-in gain of $500,000, the net recognized built-in gain is prorated as follows:

Pre-limitation Item	Pre-limitation Amount	Ratio	Taxable Income Limitation	Pro rata Recognized	Pro rata Carried Over
Sale of building	$500,000	.38		$190,000	$310,000
Sale of land	-200,000	-.15		-75,000	-125,000
Sale of goodwill	1,000,000	.77		385,000	615,000
Total	$1,300,000	1.000	$500,000	$500,000	$800,000

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051103 Recognized Built-in Gain Carryover

IRC section 1374(d)(2)(B) requires net built-in gains in excess of the taxable income limitation to be carried forward if the S election was made on or after March 31, 1988. The intent of this subparagraph was to prevent S corporations from moving items of built-in gain into net operating loss years.

Example A

Computation of net recognized built-in gain - least of:

1.	Pre-limitation amount [sum of recognized (1) built-in gain, (2) built-in loss, (3) built-in gain carryover, and (4) IRC §1374 attributes]:		
	Sale of machinery	$500,000	
	Installment sale income	100,000	
	Sale of land	1,000,000	
	Total pre-limitation amount		$1,600,000
2.	Taxable income limitation		**$1,000,000**
3.	Net unrealized built-in gain		$5,000,000

The S corporation's net recognized built-in gain is $1,000,000.
Because the pre-limitation amount of $1,600,000 exceeds the net recognized built-in gain of $1,000,000, the net recognized built-in gain is prorated as follows:

Pre-limitation Item	**Pre-limitation Amount**	**Taxable Income Ratio**	**Pro rata Limitation**	**Pro rata Recognized**	**Pro rata Carried Over**
Sale of machinery	$500,000	.31		$310,000	$190,000
Installment sale income	100,000	.06		60,000	40,000
Sale of land	1,000,000	.63		630,000	370,000
Total	$1,600,000	1.00	$1,000,000	$1,000,000	$600,000

Succeeding Taxable Year:
The pre-limitation amount would include the sum of (1) recognized built-in gain, (2) recognized built-in loss, and (3) built-in gain carryover as follows - (a) sale of machinery, $190,000; (b) installment sale income, $40,000; and (c) sale of land, $370,000.

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Example B

This example is contained in Treas. Reg. section 1.1374-2(e)
ABC, Inc. converted from a C to an S corporation on 1/1/96.

On 1/1/96, ABC reported a net unrealized built-in gain of $50,000; a net operating loss carryover of $0; and a capital loss carryover of $0.

During 1996, its first S year, it generated $20,000 in realized built-in gains from an IRC section 481(a) cash to accrual adjustment of $15,000, classified as ordinary income, and an asset sale resulting in a $5,000 capital gain.

On 12/31/96, ABC reported taxable income determined by using C corporation rules of $9,600.

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

Pre-limitation amount (net unrealized built-in gain)	20,000
Taxable income limitation (computed as if a C corporation)	9,600
Net unrealized built-in gain limitation (at date of conversion)	50,000

Because ABC's pre-limitation amount of $20,000 exceeded its net recognized built-in gain of $9,600, ordinary income of $15,000 and capital gain of $5,000 must be allocated as follows:
Recognized built-in gain/ordinary income: (15,000 / 20,000) x 9,600 = $7,200
Recognized built-in gain/capital gain: (5,000 / 20,000) x 9,600 = $2,400

ABC has recognized built-in gain carryover to 1997 of:
Ordinary income: $15,000 - $7,200 = $7,800
Capital gain: $5,000 - $2,400 = $2,600

Treas. Reg. section 1.1374-2(c) also provides that if an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its taxable income limitation is a recognized built-in gain carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose.

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051200 IRC SECTION 1374(D)(8) ASSET ACQUISITIONS

S Corp 051201 S Corporations that Become Subject to the Built-in Gains Tax Pursuant to IRC Section 1374(d)(8) Asset Acquisitions
S Corp 051202 Separate Determinations of Tax and Taxable Income Limitations

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051201 S Corporations that Become Subject to the Built-in Gains Tax Pursuant to IRC Section 1374(d)(8) Asset Acquisitions

A corporation that has always been an S corporation or that was deemed to have filed its California S election before January 1, 1987 is usually not subject to the built-in gains tax. It becomes subject to the tax only in regards to assets acquired in a transaction in which the S corporation's bases in the assets are determined (in whole or in part) by reference to a C corporation's bases in the assets. (IRC §1374(d)(8)) Be aware that the Anti-Stuffing Rule may be applicable to certain situations. (Treas. Reg. §1.1374-9)

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051202 Separate Determinations of Tax and Taxable Income Limitations

Final Reg. section 1.1374-8(b) requires that the built-in gains tax be separately determined with respect to:

1. Assets that the S corporation acquired in a IRC section 1374(d)(8) transaction,
2. Assets that the S corporation acquired in another IRC section 1374(d)(8) transaction,
3. Assets that was held when the corporation became an S corporation.

The above requirements necessitate identification and separate treatment of items of built-in gain (loss) and application of net operating loss and capital loss carryovers from C corporation years. In other words, an S corporation's net operating and capital loss carryovers when it becomes an S corporation may only be used to reduce the built-in gains generated on dispositions of assets that the S corporation held at that time. Similarly, an S corporation's net operating and capital loss carryovers acquired in an IRC section 1374(d)(8) transaction may only be used to reduce the built-in gains generated on dispositions of assets that S corporation acquired in the same transaction.

If the aggregate "net recognized built-in gain" from all sources exceeds the net income limitation for the year, each "net recognized built-in gain" determination is allocated based on the ratio of each of those determinations to the sum of all of those determinations.

ABC, Inc. made a federal S election on 1/1/86 and filed as a California S corporation in IYE 12/87, therefore, was not subject to the built-in gains tax rules for federal or California purposes.
ABC generated a $40,000 net operating loss in IYE 12/85, of which $20,000 could be carried over and recognized during 1987, 1988, or 1989.
On 1/1/89, XYZ (an unrelated C corporation) merges into ABC pursuant to an IRC section 368(a)(1)(A) transaction.
XYZ's assets acquired by ABC are subject to the built-in gains rules and have a "net unrealized built-in gain" of $150,000. XYZ had no net operating or capital loss carryovers at the time of merger.
During 1989, ABC sold assets acquired from XYZ resulting in a recognized built-in gain of $50,000. ABC's "net recognized built-in gain" was computed as the least of:

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1.	Pre-limitation amount (recognized built-in gain)	$50,000
2.		100,000
3.	Net unrealized built-in gain	150,000

ABC's "net recognized built-in gain" is $50,000. Its net operating loss carryover from 1985 cannot be used to offset this gain because this was a separate IRC section 1374(d)(8) transaction.

Example B

ABC, Inc., a C corporation, makes a valid federal and California S election effective on 1/1/96 and is, therefore, subject to the built-in gains tax rules for federal or California purposes.
ABC reported the following on 1/1/96:

1.	Net unrealized built-in gain	$5,000
2.	Net operating loss carryover	0

On 1/1/97, XYZ (an unrelated C corporation) merges into ABC pursuant to an IRC section 368(a)(1)(A) transaction.
XYZ reported the following on 1/1/97:

1.	Net unrealized built-in gain	$80,000
2.	Net operating loss carryover	0

During 1997, ABC sold built-in gain assets totaling $30,000 (pre-limitation amount): $15,000 regarding assets held by ABC prior to conversion and $15,000 regarding assets acquired from XYZ.
ABC reported taxable income of $10,000 for IYE 12/97.

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"Net recognized built-in gain" for IYE 12/97 is computed in stages as follows.

		ABC's Assets	XYZ's Assets	Total
	Lesser of the Parts:			
1.	Pre-limitation amount	$15,000	$15,000	
2.	Net unrealized built-in gain	5,000	80,000	
	Lessor of the Totals:			
3.	Lesser of (1) or (2) above	5,000	15,000	20,000
4.	Taxable income			10,000

In this example, built-in gain tax would be assessed on $10,000. Because the taxable income limitation applied and there were separate determinations, "net recognized built-in gain" must be allocated as follows:

ABC's Assets	$2,500	[$10,000 x (5,000 / 20,000)]
XYZ's Assets	$7,500	[$10,000 x (15,000 / 20,000)]

The $10,000 of taxable gain excluded from tax as a result of the corporation's taxable income limitation will be treated as a carryover in the computation of the corporation's pre-limitation amount for the succeeding year.

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051300 SPECIAL RULES FOR INSTALLMENT REPORTING

S Corp 051301 Installment Sales Entered into Prior to March 26, 1990
S Corp 051302 Installment Sales Entered Into On or After March 26, 1990 and Before December 27, 1994
S Corp 051303 Installment Sales Entered Into On or After December 27, 1994

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051301 Installment Sales Entered into Prior to March 26, 1990

Income received during the recognition period for installment sales entered into **prior to March 26, 1990** follow the normal built-in gains rules.

Example A

ABC, Inc., a C corporation, entered into an installment sale for $5,000,000 on 10/1/88. It received $500,000 each year on October 1 beginning in 1989.
ABC made a federal and California S election effective on 1/1/90.
On 1/1/90, ABC had uncollected installment sales proceeds of $4,500,000 [$5,000,000 - 500,000].
ABC would include the $500,000 recognized built-in gain from the installment sale in its “pre-limitation amount” each year during the period covering IYE 12/90 - 12/98.
ABC’s net recognized built-in gain for each year would be the least of its (a) pre-limitation amount, (b) taxable income limitation, or (c) net unrealized built-in gain. The corporation would be required to carryover amounts in excess of the taxable income limitation until the end of its recognition period, 12/31/99. Unused carryover amounts are lost as of 12/31/99.

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051302 Installment Sales Entered Into On or After March 26, 1990 and Before December 27, 1994

Installment sales entered into **on or after March 26, 1990 and before December 27, 1994** follow the rules provided in Treas. Reg. section 1.1374-10(b)(4). If a binding contract was in effect before March 26, 1990, however, the sale follows the rules for installment sales entered into before March 26, 1990.

Treas. Reg. section 1.1374-10(b)(4) states that if a taxpayer sells an asset either prior to or during the recognition period and recognizes income either during or after the recognition period from the sale under the installment method, the income will, when recognized, be taxed under IRC section 1374 to the extent it would have been so taxed in prior taxable years if the selling corporation had made the election under IRC section 453(d) not to report the income under the installment method. For purposes of determining the extent to which the income would have been subject to tax if the IRC section 453(d) election had not been made, the taxable income limitation of IRC section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of IRC section 1374(d)(2)(B) will be taken into account.

Example A

ABC, Inc., a C corporation, made a federal and California S election effective on 1/1/92.
On 6/15/92, ABC sold land and a building resulting in a gain of $3,000,000. ABC did not elect out of installment sale reporting.
ABC received installment proceeds of $1,000,000 in each year during 1994-1996.
ABC reported net income after state adjustments of -$1,000,000, $600,000, $400,000, $200,000, and $500,000 in IYE 12/92 - 12/96, respectively.
If ABC had elected out of installment reporting, the gain would have been recognized in IYE 12/92 and, taking into account the application of the taxable income limitation, $2,000,000 of the gain would have been subject to the built-in gains tax in IYE 12/92; $600,000 in IYE 12/93 (see below).
Treas. Reg. section 1.1374-10(b)(4) provides that $1,000,000 of the gain recognized in IYE 12/94 is subject to the built-in gains tax, even though there is a taxable income limitation of $400,000 computed under the normal built-in gain rules; $1,000,000 is subject to the built-in gains tax in IYE 12/95; and $600,000 in IYE 12/96. Recognition of the remainder $400,000 built-in gain carryover will be limited to the taxable income limitation beginning in IYE 12/97 until the end of the recognition period.

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	12/92	12/93	12/94	12/95	12/96
Net income after state adjustments [Installment method]	-$1,000,000	$600,000	$400,000	$200,000	$500,000
Adjustments for IRC section 453(d) election out:					
Add: Gain on sale of land and building	3,000,000		-1,000,000	1,000,000	1,000,000
Subtract: Installment proceeds					
Net income after state adjustments [IRC section 453(d) election out]	2,000,000	600,000	-600,000	-800,000	-500,00

Per IRC section 453(d):

IYE	Taxable Income Limitation	Sale of Land & Building [BIG]	Net Recognized BIG Carryover [Prior Year]	Pre-Limitation Amount	Net Recognized Built-in Gain	Net Recognized BIG Carryover [Current Year]
12/92	2,000,000	3,000,000	0	3,000,000	2,000,000	1,000,000
12/93	600,000		1,000,000	1,000,000	600,000	400,000
12/94	-600,000		400,000	400,000	0	400,000*
					$2,600,000*	

*Total recognized built-in gain based on taxable income limitation as if elected out of installment reporting
*Remaining built-in gain carryover

Example B

In year 1 of the recognition period under IRC section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 11. Because the corporation does not make an election under IRC section 453(d), all $100,000 of the gain from the sale is reported under the installment method in year 11. If the corporation had made an election under IRC section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income

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limitation of IRC section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of IRC section 1374(d)(2)(B) would have resulted in $40,000 of the gain being subject to tax during the recognition period under IRC section 1374. Therefore, $40,000 of the gain recognized in year 11 is subject to tax under IRC section 1374.

Example C

In year 1 of the recognition period under IRC section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 6. Because the corporation does not make an election under IRC section 453(d), all $100,000 of the gain from the sale is reported under the installment method in year 6. If the corporation had made an election under IRC section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income limitation of IRC section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of IRC section 1374(d)(2)(B) would have resulted in all of the gain being subjected to tax under IRC section 1374 in years 1 through 5. Therefore, notwithstanding that the taxable income limitation of IRC section 1374(d)(2)(A)(ii) might otherwise limit the taxation of the gain recognized in year 6, the entire $100,000 of gain will be subject to tax under IRC section 1374 when it is recognized in year 6.

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051303 Installment Sales Entered Into On or After December 27, 1994

a. General Rule

Per Treas. Reg. section 1.1374-4(h)(1), if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under IRC section 453, that income is an item of built-in gain. If the asset is sold during the recognition period, it must have been held on the first day of the S corporation's recognition period or acquired from a C corporation or prior C corporation through merger.

b. Limitation on Amount Subject to Tax

The taxable income limitation is the amount by which the S corporation's net recognized built-in gain would have increased from the year of the sale to the earlier of the year the income is reported under the installment method or the last year of the recognition period, assuming all income from the sale had been reported in the year of the sale and all provisions of IRC section 1374 applied. If the corporation sells the asset before the recognition period, the income from the sale that is not reported before the recognition period is treated as having been reported in the first year of the recognition period.

c. Rollover Rule

The excess of the built-in gain reported under the installment method over the amount subject to tax under the taxable income limitation is treated as if it were reported in the succeeding taxable year(s), but only for succeeding taxable year(s) in the recognition period. The amount reported in the succeeding taxable year(s) under the preceding sentence is reduced to the extent that the amount not subject to tax under the limitation was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

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Example A:

ABC, Inc. makes an S election effective 1/1/96.
On 1/1/96, ABC sells real property with a basis of $0 and a fair market value of $100,000 in exchange for a $100,000 note. ABC reports the sale using the installment sale method under section 453.
In year 2001, ABC receives $100,000 in payment of the note and reports the gain into income. ABC reports net income after state adjustments of $0 in this year.
If ABC had reported the $100,000 gain in 1996, its net recognized built-in gain from 1996 to 2001 would have been $75,000 greater than otherwise. Per Treas. Reg. §1.1374-4(h), ABC has $75,000 net recognized built-in gain subject to the built-in gains tax. ABC also must treat the $25,000 excess of the amount reported, $100,000, over the amount subject to tax, $75,000, as income reported under the installment method in the succeeding taxable year(s) in the recognition period, except to the extent ABC establishes that the $25,000 was not subject to tax under IRC section 1374 in the year 2001 because ABC had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

d. Use of Losses and Section 1374 Attributes

If an S corporation reports income under the installment method for a taxable year after the recognition period and the income is subject to IRC section 1374 tax, then the S corporation's IRC section 1374 attributes may be used to the extent their use is allowed under all applicable provisions of the IRC in determining the IRC section 1374 tax. However, the S corporation's loss recognized for a taxable year after the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period may not be used in determining the IRC section 1374 tax.

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051400 SPECIAL RULES FOR PARTNERSHIP INTERESTS

S Corp 051401 Taxable Years Ending Before December 27, 1994
S Corp 051402 Taxable Years Ending On or After December 27, 1994

In general, an S corporation owning an interest in a partnership must treat its distributive share of the partnership's items as recognized built-in gain or loss to the extent the S corporation's distributive share would have been treated as recognized built-in gains or loss if the items originated in, and were taken into account directly by, the S corporation (the "look-through rule").

The "look-through rule" applies to the extent the S corporation had built-in gain or built-in loss in its partnership interest at the beginning of the recognition period.

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051401 Taxable Years Ending Before December 27, 1994

Treas. Reg. section 1.1374-10(b)(1) provides that if a corporation transfers an asset to a partnership in a transaction to which IRC section 721(a) applies and the transfer is made in contemplation of an S election or during the recognition period, IRC section 1374 applies on a disposition of the asset by the partnership as if the S corporation had disposed of the asset itself.

The effective date of the above paragraph is for income years beginning on or after 1987 (the effective date of IRC section 1374), unless the recognition period with respect to the contributed asset is pursuant to an S election or an IRC section 1374(d)(8) transaction occurring on or after December 27, 1994.

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051402 Taxable Years Ending On or After December 27, 1994

a. In General

Per Treas. Reg. section 1.1374-4(i)(1), if an S corporation owns a partnership interest at the beginning of the recognition period or transfers property to a partnership in a transaction to which IRC section 1374(d)(6) applies during the recognition period, the S corporation determines the effect on net recognized built-in gain from its distributive share of partnership items as follows:

Step 1: Apply the rules of IRC section 1374(d) to the S corporation's distribute share of partnership items of income, gain, loss, or deduction included in income or allowed as a deduction under the rules of subchapter K to determine the extent to which it would have been treated as recognized built-in gain or loss if the partnership items had originated in and been taken into account directly by the S corporation (partnership 1374 items);

Step 2: Determine the S corporation's net recognized built-in gain without partnership 1374 items;

Step 3: Determine the S corporation's net recognized built-in gain with partnership 1374 items; and

Step 4: If the amount computed under Step 3 exceeds the amount computed under Step 2, the excess is the S corporation's partnership RBIG, and the S corporation's net recognized built-in gain is the sum of the amount computed under Step2 plus the partnership RBIG. (Treas. Reg. §1.1374-4(i)(1)(iv)) If the amount computed under Step 2 exceeds the amount computed under Step 3, the excess is the S corporation's partnership RBIL, and the S corporation's net recognized built-in gain is the remainder of the amount computed under Step 2 after subtracting the partnership RBIL.

b. Limitations

An S corporation's partnership RBIG for any taxable year may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG for prior taxable year. However, this limitation does not apply if the S corporation

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formed the partnership or transferred property to the partnership for the principal purpose of avoiding the tax imposed under IRC section 1374.
An S corporation's partnership RBIL for any taxable year may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL for prior taxable years.

c. Disposition of Partnership Interest

If an S corporation disposes of its partnership interest, the amount that is treated as recognized built-in gain may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG during the recognition period. Similarly, the amount that is treated as recognized built-in loss may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL during the recognition period.

d. RBIG and RBIL Limitations

An S corporation's RBIG or RBIL limitation upon the sale of its partnership interest is the total of the following:

1. The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold its partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at fair market value to an unrelated party; decreased by
2. The corporation's adjusted basis in the partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at the time of sale; and increase or decreased by
3. The corporation's allocable share of the partnership's IRC section 481(a) adjustments at the time sale.

If the above results in a positive amount, the S corporation has a RBIG limitation equal to that amount and a RBIL limitation of $0.

If the above results in a negative amount, the S corporation has a RBIL limitation equal to that amount and a RGIB limitation of $0.

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e. Small Interest Exception

The "small interest" exception explains that the partnership interest rules under Treas. Reg. section 1.1374-4(i)(1) do not apply to an S corporation if it can satisfy the small interest exception with respect to its partnership interest. The "small interest" exception to the "look-through rules" generally applies for a taxable year if (1) the S corporation's interest in the partnership represents less than 10% of the partnership's profits and capital at all times during the taxable year and prior taxable years in the recognition period, and (2) has a value less than $100,000 as of the beginning of the recognition period.

However, if the S corporation contributes an asset to the partnership in the recognition period and the S corporation held the asset as of the beginning of the recognition period, the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is determined as if the asset was contributed to the partnership before the beginning of the recognition period (using the fair market value of the asset as of the beginning of the recognition period).

f. Examples Provided in the Regulations

Example A

ABC, Inc. makes a valid federal and California S election on 1/1/96.
ABC owns 50% of partnership, PS, on the election date. On 1/1/96, PS owns a parcel of land (Parcel #1) with a basis of $25,000; FMV, $45,000.
During 1996, PS buys another parcel of land (Parcel #2) for $50,000.
In 1999, PS sells (1) Parcel #1 for $55,000 and recognizes a $30,000 gain, and (2) Parcel #2 for $42,000 and recognizes a loss of -$8,000.
If ABC could not provide documentation to support appreciation of Parcel #1 during C vs. S corporation years, ABC's distributive share on the sale of Parcel #1 of $15,000 ($30,000 x 50%) would be recognized built-in gain.
Parcel #2 was purchased after the date of conversion and is not an item of built-in gain (loss).

Example B

ABC, Inc. makes a valid federal and California S election on 1/1/96. It owned land with a basis of $100,000; FMV of $200,000 on this date.

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On 1/1/98, ABC contributes the land to partnership, PS, in exchange for 50% partnership interest.
On 1/1/00, PS sells the land for $300,000 and recognizes a $200,000 gain.
ABC is allocated $100,000 of the gain under IRC section 704(c) and $50,000 - its percent share of the remainder.
Because ABC knew the value of the property to be $200,000 at the date of conversion, therefore, $100,000 ($200,000 FMV - $100,000 basis at conversion) would be subject to the built-in gains tax as a partnership IRC section 1374 item.

Example C

ABC, Inc. makes a valid federal and California S election on 1/1/96.
ABC owns 50% of partnership, PS, on the election date. PS owns land with a basis of $50,000; FMV, $200,000. ABC's RBIG limitation in regards to PS is $100,000; RBIL limitation, $0.
In 1996, PS sells the land for $200,000 and recognizes a $150,000 gain, of which $75,000 is ABC's share and is treated as a partnership built-in gain item by ABC.
ABC's "net recognized built-in gain" without partnership items is $35,000 in 1996; $110,000 with partnership items ($35,000 + $75,000).
ABC has a partnership RBIG of $75,000 for the year. Because ABC's RBIG limitation is $100,000, ABC is not limited by ABC's partnership RBIG of $75,000. ABC's net recognized built-in gain is $110,000.
If ABC's RBIG limitation in regards to PS were $50,000, ABC would have net recognized built-in gain of $85,000 ($35,000 + $50,000).

Example D

ABC, Inc. makes a valid federal and California S election on 1/1/96.
ABC owns 50% of partnership, PS, on the election date. PS owns land with a basis of $225,000; FMV, $125,000. ABC's RBIG limitation in regards to PS is $0; RBIL limitation, $60,000.
In 1996, PS sells the land for $125,000 and recognizes a -$100,000 loss, of which -$50,000 is ABC's share and is treated as a partnership built-in loss item by ABC.
ABC's "net recognized built-in gain" without partnership items is $75,000 in 1996; $25,000 with partnership items ($75,000 - $50,000).
ABC has a partnership RBIL of $50,000 for the year. Because ABC's RBIL limitation is $60,000, ABC is not limited by ABC's partnership RBIL of $60,000. ABC's net recognized built-in gain is $25,000.
If ABC's RBIL limitation in regards to PS was $40,000, ABC would have net recognized built-in gain of $35,000 ($75,000 - $40,000).

Example E

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

ABC, Inc. makes a valid federal and California S election on 1/1/96.
ABC owns 50% of partnership, PS, on the election date. ABC's RBIG limitation in regards to PS is $0; RBIL limitation, $25,000.
In 1996, ABC and PS report the following built-in gain (loss) items:

ABC	
Recognized built-in ordinary income	$40,000
Recognized built-in capital loss	-90,000
PS	
Ordinary income	$25,000
Capital gain	75,000

ABC's "net recognized built-in gain" without partnership items is $40,000 in 1996; $65,000 with partnership items ($40,000 + $25,000).
ABC has a partnership RBIG of $25,000 for the year. Because ABC's RBIG limitation is $0, ABC's partnership RBIG of $25,000 is limited to $0. ABC's net recognized built-in gain for the year is $40,000.

Example F

ABC, Inc. makes a valid federal and California S election on 1/1/96.
ABC owns 50% of partnership, PS, on the election date. ABC's RBIG limitation in regards to PS is $60,000; RBIL limitation, $0.
In 1996, ABC and PS report the following built-in gain (loss) items:

ABC	
Recognized built-in ordinary income	$40,000
Recognized built-in capital gain	75,000
PS	
Ordinary income	$25,000
Capital loss	-90,000

ABC's "net recognized built-in gain" without partnership items is $115,000 in 1996 ($40,000 + $75,000); $65,000 with partnership items ($40,000 + $25,000).
ABC has a partnership RBIL of $50,000 for the year. Because ABC's RBIL limitation is $0, ABC's partnership RBIL of $50,000 is limited to $0. ABC's net recognized built-in gain for the year is $115,000.

Example G

ABC, Inc. makes a valid federal and California S election on 1/1/96.
ABC owns 50% of partnership, PS, on the election date. ABC's RBIG limitation in regards to PS is $200,000; RBIL limitation, $0. PS owns land with a basis of $20,000; FMV, $140,000.

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In 1996, PS sells the land for $140,000 and recognizes a $120,000 gain, of which $60,000 is ABC's share and is treated as a partnership built-in gain item by ABC.
ABC's "net recognized built-in gain" without partnership items is $95,000 in 1996; $155,000 with partnership items.
ABC has a partnership RBIG of $60,000 for the year.
In 1999, ABC sells its entire interest in PS for $350,000 and recognizes a $250,000 gain.
ABC's recognized built-in gain on the sale is limited by its RBIG limitation to $140,000 ($200,000 - $60,000).

Example H

ABC, Inc. makes a valid federal and California S election on 1/1/96.
On that date, ABC contributes Asset #1, 5-year property, with a basis of $0; FMV of $40,000. An unrelated party contributes $40,000 cash. Each own 50% partnership interest in partnership, PS.
PS adopts the traditional method under IRC section 1.704-3(b). If PS sold Asset #1 immediately after contribution for $40,000, PS's $40,000 gain would be allocated to ABC under IRC section 704(c).
Instead, PS sells Asset #1 in 1999 for $36,000 and recognizes a $36,000 gain ($36,000 - $0). Under IRC section 704(c), ABC is allocated only $16,000 because of book depreciation of $8,000 per year ($36,000 - ($8,000 x 3 years)).
The remainder gain of $20,000 ($36,000 - $16,000) is allocated 50% between the partners per IRC Section 704(b).
ABC is allocated a gain of $26,000 ($16,000 + $10,000). ABC, however, treats the entire $36,000 gain as a partnership built-in gain items on PS's sale of Asset #1.

Example I

ABC, Inc. makes a valid federal and California S election on 1/1/96.
ABC owns 50% of partnership, PS, on the election date. On 1/1/96, PS owns land with a basis of $20,000; FMV, $40,000.
On 1/1/98, PS distributes the land to ABC, when the land had the same basis, but a FMV of $50,000.
Per IRC Section 732(a)(1), ABC has transferred basis of $20,000. On 1/1/99, ABC sells the land for $60,000 and recognizes a $40,000 gain.
Under IRC section 1374(d)(3), ABC has recognized built-in gain from the sale of $20,000, the amount of built-in gain in the land on the first day of the recognition

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period.

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051500 QUALIFIED CORPORATIONS

S Corp 051501 Qualified Corporations - Definition
S Corp 051502 Qualified Corporations - Date of Valuation as a Qualified Corporation
S Corp 051503 Qualified Corporations - Rules for Determining Gain

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051501 Qualified Corporations - Definition

An S corporation is a qualified corporation if it meets all of the following conditions:

1. It filed the S election after 1986 and before 1989,
2. If the S election was before 3/31/88: It was in existence on 8/1/86, and at all times after that date, more than 50% of the stock value was held by 10 or fewer shareholders,
3. If the S election was on or after 3/31/88: It was in existence on 8/1/86, and at all times after that date, more than 50% of the stock value was held by 10 or fewer shareholders. Those same shareholders, however, must hold their stock for at least five years from the date of the S election (or the life of the corporation, if shorter),
4. The value of the corporate stock on the date the S election was filed (or, if greater, on 8/1/86) was not more than $10 million.

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051502 Qualified Corporations - Date of Valuation as a Qualified Corporation

The date of transition from a C to an S corporation is the determining factor for purposes of establishing the value of corporate stock under the transitional rules, not the date of asset disposition in subsequent years.

Section 633 of PL 99-514 (the Act) provides qualified corporations tax relief in cases of complete liquidations before 1989 under subsection (d) - Transitional Rule for Certain Small Corporations. This Transitional Rule provides qualified corporations, as defined in Act section 633(d)(5), the benefit of the old IRC section 1374 (capital gains tax) if the applicable values of the corporations are less than $5 million (Act §633(d)(3)(A)). For applicable values between $5 million and $10 million, the corporations are provided the benefit of the old IRC section 1374 (capital gains tax) on that amount of recognized gain based on the applicable percentage that equals 100% of the value reduced by the amount that bears the same ratio to 100% as the excess of the applicable value over $5 million bears to $5 million (Act §633(d)(3) B)). The corporations with values greater than $10 million are not provided the tax relief contained in section 633(d) of the Act.

Section 633(d)(4) defines “Applicable Value ... For purposes of this subsection, the applicable value is the fair market value of all of the stock of the corporation on the date of the adoption of the plan of complete liquidation or, if greater, on August 1, 1986.” However, under section 633(d)(8) of the Act, rules similar to those applicable to a liquidating corporation under section 633(d) of the Act apply for purposes of determining whether and to what extent tax relief is available to a qualified corporation that makes an S election after December 31, 1986 and before January 1, 1989, without regard to whether such corporation is completely liquidated. Therefore, a qualified corporation that becomes an S corporation within the time referenced above may obtain the benefit of the transitional rule whether it liquidates or disposes of certain assets without regard to a plan of liquidation.

In those circumstances in which a corporation makes an S election within the referenced dates and disposes of assets under the S corporation shell, the IRS has ruled (Rev. Rul. 86-141) that the applicable valuation date for determining gain that arose while the corporation held a C status is the greater of the fair market value of all assets of the stock of the corporation on either the date a valid S election is made or August 1, 1986. A search in the literature indicates that Rev. Rul. 86-141 has neither been superseded nor repealed.

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The rationale behind comparing the dates is to prevent corporations with stock value greater than $10 million from obtaining tax relief derived from the transitional rules by disposing of assets after August 1, 1986 and before the date the corporation filed for S status (PL 99-514; 99th Cong., H.R. 3838 (Part 6 of 19 Parts); JCS-10-87). The IRS has consistently applied this interpretation of the valuation date in PLRs 88-09083, 88-46014, and 89-27045.

If a qualified corporation elected S status while the transitional rules were in effect and there were no evidence to suggest that the corporation attempted to undermine the intent of those rules, then it would seem reasonable for the FTB to accept the valuation date as the date the election was filed (or the last day of the C corporation) without requiring the corporation to provide an additional stock valuation on August 1, 1986.

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051503 Qualified Corporations - Rules for Determining Gain

The rules for determining gain on liquidating distributions by a qualified S corporation where the liquidation is completed before 1989 are applied in basically the same manner for determining gain subject to the built-in gain tax.

a. Gains Subject to Built-in Gains Tax in Full

Ordinary gains (depreciation recapture, etc.) and short-term capital gains are subject to the built-in gains tax without proration. There are no exceptions.

b. Gains Subject to Proration Between the Built-in Gains Tax and Capital Gains Tax

Long-term capital gains are subject to proration between the built-in gains tax and the tax on capital gains. If the value of the S corporation is $5 million or less, 100% of the gain is subject to the tax on capital gains. If the value of the S corporation is $10 million or greater, 100% of the gain is subject to the tax on built-in gains. If the value of the S corporation is between $5 and $10 million, the gain is prorated for purposes of applying the capital gain and built-in gain tax:

Portion of gain subject to built-in gains tax:
[(Value of the S Corporation - $5 million) / $5 million] x Gain

Portion of gain subject to capital gains tax:
[1 - ((Value of S Corporation - $5 million) / $5 million)] x Gain

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051600 BUILT-IN GAINS TAX IS A LOSS SUSTAINED BY THE CORPORATION

IRC section 1366(f)(2) allows the shareholder of an S corporation a pass-through loss in the amount of the built-in gains tax paid by the S corporation. The S corporation is not allowed a loss deduction in the amount of the built-in gains tax paid for purposes of computing California Franchise or income tax.

R&TC section 23803(b)(1) modifies this federal code section so that, for California purposes, the amount of loss sustained by the S corporation is the amount of built-in gains tax computed under California law. The amount of built-in gains tax flows through to shareholders as a loss sustained by the corporation during such taxable year, and the character of such loss is determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

Example A

		Built-In Gain	Ratio	Built-In Gains Tax @ S Corporation Level	Pro Rata Built-in Gains Tax
1.	Ordinary Gain	$100,000	.10		$9,300
2.	Capital Gain	200,000	.20		18,600
3.	IRC section 481 Income	700,000	.70		
	Total	$1,000,000	1.00	$93,000	$93,000

The shareholder would include the following in the computation of shareholder basis:

		Item of Income	Item of Loss/Deduction
1.	Ordinary Gain	$100,000	-$9,300
2.	Capital Gain	200,000	-18,600
3.	IRC section 481 Income	700,000	-65,100

If the shareholder has sufficient basis and is not restricted by other applicable limitations, the shareholder would report the following amounts per return: Ordinary Gain, $90,700 [$100,000 - 9,300], to Form 4797.

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Capital Gain, $181,400 [$200,000 - 18,600], to Schedule D.
IRC Section 481 Income, $634,900 [$700,000 - 65,100], to Schedule E.
Note: The built-in gains tax computed for California purposes is used in lieu of the federal amount.

Example B

Assume the same facts as in Example 3-2.1, except that the shareholder had insufficient basis to recognize all losses/deductions.
The shareholder would report the following amounts per return:

- Ordinary Gain, $100,000, to Form 4797.
- Capital Gain, $200,000, to Schedule D.
- IRC section 481 Income, $700,000, to Schedule E.

(built-in gains tax):

- Ordinary Loss, $9,300.
- Capital Loss, $18,600.
- IRC section 481 Loss, $65,100.

Based on the above, it may be necessary to issue Notices of Proposed Overpayment (NPO) to the corporation's shareholders anytime the built-in gains (BIG) tax is increased due to an audit of the corporation. However, NPOs would not be needed whenever the BIG tax is assessed in the same year that the corporation liquidates because the reduced flow-through income would be exactly offset by the reduction in the shareholder's stock or debt basis.

Finally, per R&TC section 23803(b)(1), the federal BIG tax is not a loss to the corporation for California purposes. If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under IRC section 1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the IRC section 1374 tax. Thus, when a corporation has the same recognized built-in gain amount for both federal and state purposes, an addition should be present on the California Schedule K for the difference between the California and federal BIG tax amounts.

Example C

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

Assume a corporation's recognized BIG and capital gain amount for both federal and state purposes is $1 million. The corporation's net capital gain for federal purposes would be $650,000 based on a 35% federal BIG tax rate ($1,000,000 - $350,000) whereas the net capital gain for California purposes would be $911,600 ($1,000,000 - $88,400) based on a BIG tax rate of 8.84%. Thus, the California Schedule K should have an addition of $261,600 – the difference between the federal and California BIG tax.

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051601 The R&TC Section 23802(e) Deduction

To prevent income from being subjected to both the S-corporation tax and the BIG tax, corporations are allowed a deduction, per R&TC section 23802(e), for income subjected to the BIG tax. For tax year 2001, the deduction is located on line 17 of form 100S. The following example illustrates the mechanics of the form.

Example A

Assume that a corporation reports a capital gain of $1 million and that the entire amount is subject to the BIG tax. Based on the form 100S for 2001, the full $1 million capital gain should be reported on line 4 of the form and then deducted on line 17. As a result, the amount subject to the BIG tax is not included in the "Net income for tax purposes" on line 21, and the BIG tax amount is reported on line 28.

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051700 EXHIBIT

Exhibit 050000-1 Public Law 99-514

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060000 LIFO RECAPTURE TAX

S Corp 060100 Overview of LIFO Inventory Method
S Corp 060200 LIFO Terms and Definitions
S Corp 060300 LIFO Inventory Methods
S Corp 060400 Example of LIFO Computation - Single Good Physical Quantity Method
S Corp 060500 Computing LIFO Recapture Amount and Tax
S Corp 060600 Revenue Procedure 94-61
S Corp 060700 Determining the Additional Tax Due to LIFO Recapture
S Corp 060800 Miscellaneous Issues

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060100 OVERVIEW OF LIFO INVENTORY METHOD

The Last In, First Out (LIFO) method allocates costs on the assumption that the cost of the last goods purchased is matched against revenue first. Increases in inventory quantities from period to period form inventory layers. If the ending inventory is never lower than the quantity on hand at the beginning of the period, the original costs remain intact in inventory. When the inventory is decreased, the most recently added inventory layer is the first layer invaded.

S Corp 060101 Advantages of LIFO
S Corp 060102 Disadvantages of LIFO

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060101 Advantages of LIFO

- More recent costs are matched against current revenues to better reflect current earnings.
- During inflationary times, cost of goods sold is higher resulting in lower taxable income and tax liabilities.
- Improved cash flow due to reduced tax liabilities.
- Future reported earnings would not be affected substantially by future price declines because inventory value is much lower than net realizable value.

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060102 Disadvantages of LIFO

- Distortion of inventory values on the balance sheet.
- Does not reflect the actual physical flow of the inventory.
- Liquidation of LIFO inventory could result in distortions of reported income and tax liabilities.
- Complex inventory valuation method.
- Subject to extensive federal code provisions and related regulations.

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060200 LIFO TERMS AND DEFINITIONS

S Corp 060201 LIFO Layers – Increment
S Corp 060202 Invasion of LIFO Layers -- Decrement / Liquidation
S Corp 060203 LIFO Inventory Valuation
S Corp 060204 Base Year
S Corp 060205 Base-Year Amounts
S Corp 060206 Current-Year Amounts

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060201 LIFO Layers -- Increment

For purposes of Specific Goods Method, an increment occurs when there is an increase in the unit quantity of an item in ending inventory over the quantity that existed in the opening inventory, applying the current-year amounts. (See Example A of S Corp 060400). For purposes of Dollar-Value Method, an increment occurs when the ending inventory at base-year amounts exceed the beginning inventory at base-year amounts. If there is an increment under the Dollar-Value Method, an index must be computed to relate current-year cost to base-year cost. (See S Corp 060302).

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060202 Invasion of LIFO Layers -- Decrement / Liquidation

A layer is invaded only when the ending inventory is less than the beginning inventory. When the inventory is decreased, the most recently added inventory layer has the first layer removed. Similar to 2-1, current-year amounts are used for Specific Goods Method, while base-year amounts are used for Dollar-Value Method.

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060203 LIFO Inventory Valuation

The valuation of LIFO inventory is the sum of all LIFO layers since the LIFO inventory method was adopted.

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060204 Base Year

The year that the taxpayer adopts LIFO.

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060205 Base-Year Amounts

The cost of inventory based on the base-year cost.

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060206 Current-Year Amounts

The cost of inventory based on current-year cost. Current-year cost can be determined by one of four options; latest acquisition cost during the year, earliest acquisition cost during the year, average acquisition costs during the year, or any other proper method that clearly reflects income.

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060300 LIFO INVENTORY METHODS

Studies have disclosed that the majority of taxpayers utilizing the LIFO method of inventory valuation use the dollar-value method or dollar-value retail method instead of inventory methods based on physical quantities. Following are brief descriptions of accepted LIFO methods.

S Corp 060301 LIFO Inventory Methods Based on Physical Quantities
S Corp 060302 LIFO Inventory Methods Based on Dollar Value

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060301 LIFO Inventory Methods Based on Physical Quantities

- **Single Goods / Unit LIFO**

Each good sold is matched with each good in inventory. This method is most practical in situations where relatively few inventory items are handled such as jewelry, automobiles, furniture, special order manufacturing, etc., but is impractical in businesses that have numerous goods in inventory. (See Example A of S Corp 060400).

- **LIFO Pools**

Goods are combined into natural groups or pools. Each pool is assumed to be one unit for purposes of costing. One significant disadvantage to this pooled approach is that businesses must continuously redefine their pools and are subjected to a higher risk of invading LIFO layers.

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060302 LIFO Inventory Methods Based on Dollar Value

Dollar-Value LIFO

Inventory increases and decreases are determined and measured in terms of total dollar value. New layers are formed only when the ending inventory at base-year prices exceed the beginning inventory at base-year prices. Layers are computed based on price indexes, which adjusts base-year prices to current-year prices or vice versa. The indexes include, but are not limited to:

Consumer Price Index for Urban Consumers (and other published price indexes by the government, commodity exchange, or trade associations).

Double-Extension Method -- units in inventory are extended at both base-year prices and current-year prices, by dividing current-year amounts by the base-year amounts to arrive at the LIFO index. (See Example A of S Corp 060500).

Link-Chain Method -- base cost of ending inventory is determined by applying a cumulative index to the dollar value of the ending inventory. The cumulative index is the relationship of the current-year prices to those of the prior year multiplied by the prior year's cumulative index; thus each year's index may be characterized as a link in a chain of indexes back to the base year.

LIFO Retail

A LIFO inventory method that converts cost to retail by applying markups and markdowns to goods purchased during the current period and not to the beginning period.

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060400 EXAMPLE OF LIFO COMPUTATION - SINGLE GOOD PHYSICAL QUANTITY METHOD

Example A

	LIFO Layer Increments			LIFO Layer Invasions			
Year	Units	Cost/Unit	Subtotal	Units	Cost/Unit	Subtotal	LIFO Value
1991	22,000	5.00	$110,000				$110,000
1992	5,000	7.00	35,000				145,000
1993	8,000	12.00	96,000				241,000
1994	6,000	15.00	90,000				331,000
1995	2,000	17.00	34,000				365,000
1996				2,000	17.00	34,000	
				2,000		30,000	301,000

				LIFO Layer Invasions			
Year	Units	Cost/Unit		Units	Cost/Unit		LIFO Value
			al			al	
1997				4,000		60,000	
				6,000	12.00		169,000
1998		22.00	66,000				235,000
				2,000	22.00	44,000	

Explanation of Transactions:

1991 First year; ending inventory = 22,000 units.

1992 Ending inventory = 27,000 units; 5,000 unit layer created (27,000 EOY - 22,000 BOY).

1993 Ending inventory = 35,000 units; 8,000 unit layer created (35,000 EOY - 27,000 BOY).

1994 Ending inventory = 41,000 units; 6,000 unit layer created (41,000 EOY - 35,000 BOY).

1995 Ending inventory = 43,000 units; 2,000 unit layer created (43,000 EOY - 41,000 BOY).

1996 Ending inventory = 39,000 units; complete invasion (liquidation) of 1995 layer (2,000 units) and partial invasion of 1994 layer (2,000 units).

1997 Ending inventory = 29,000 units; complete invasion (liquidation) of remaining 1994 layer (4,000 units) and partial invasion of 1993 layer (6,000 units).

1998 Ending inventory = 32,000 units; 3,000 unit layer created (32,000 EOY - 29,000 BOY).

1999 Ending inventory = 31,000 units; partial invasion of 1998 layer (2,000 units).

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060500 COMPUTING LIFO RECAPTURE AMOUNT AND TAX

The following conditions must be met in order to assess the LIFO Recapture Tax for California purposes:

1. The corporation was a C corporation on its last taxable year before the first taxable year in which the California S election was effective, and
2. The corporation inventoried goods under the LIFO method for such last taxable year.

The LIFO recapture amount is defined as the inventory amount of the inventory assets under the First In, First Out (FIFO) method in excess of the inventory amount of such assets under the LIFO method as of the close of the last taxable year as a C corporation (IRC §1363(d)(3)(A)-(B)).

LIFO Recapture Amount = Inventory Calculated Using FIFO - Inventory Calculated Using LIFO

IRC section 1363(d)(1) requires the above LIFO recapture amount to be included in the gross income of its last year as a C corporation with appropriate adjustments to the basis of the inventory to account for this LIFO recapture inclusion into gross income.

IRC section 1363(d)(2) allows for the increase in tax relating to the inclusion of the LIFO recapture amount to be paid in 4 equal installments -- the first installment in its last year as a C corporation; the 3 remainder installments in the 3 succeeding taxable years.

Example A

In 1984, ABC, Inc. elected dollar-value, double-extension LIFO using the latest acquisitions method of determining current year cost.

On 1/1/90 it elected California S status effective beginning 1/1/90. Its LIFO inventory schedules were as follows:

Base-Year Layer	Base-Year Amounts	LIFO Index	Current-Year Amounts
	$1,400,000	1.00	$1,400,000
1984	400,000	1.20	
1985		1.30	650,000
	200,000	1.35	270,000

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1987	0	1.40	
1988	400,000		600,000
1989		1.60	800,000
Total	$3,400,000		$4,200,000

ABC, Inc. can readily determine the LIFO recapture amount as of 12/31/89 since the FIFO method requires inventory to be valued at cost. FIFO is determined based on the following formula:

Current-Year Amounts ÷ Base-Year Amounts = LIFO Index in the Final C Year
x ÷ $3,400,000 = 1.60
x = 1.60 x $3,400,000
x = $5,440,000

	FIFO	LIFO
LIFO recapture amount =	$5,440,000	$4,200,000

Net income for California tax purposes before inclusion of the LIFO recapture amount was $3,500,000. Since California has a single franchise tax rate, unlike federal's graduated corporate tax rates, coupled with the fact that ABC, Inc. reported net income for tax purposes before inclusion of the LIFO recapture amount, the additional tax attributable to the LIFO recapture amount in IYE 12/89 is $115,320 ($1,240,000 x 9.3%). This amount is required to be reported in 4 equal installments between IYE 12/89-12/92.
If ABC, Inc. had reported a taxable loss of ($1,000,000) before inclusion of the $1,240,000 LIFO recapture amount, the additional tax attributable to inclusion of the LIFO recapture amount would have been $ 21,720 (($1,000,000) + 1,240,000) x 9.3% - $600 minimum franchise tax).

$1,240,000 inclusion into income (regardless of whether additional tax was created):

LIFO Carrying Value + Recapture Amount = Adjusted Basis (FIFO)

$4,200,000 + $1,240,000 = $5,440,000

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060600 REVENUE PROCEDURE 94-61

Revenue Procedure 94-61, I.R.B. 1994-38,56, (Sep. 19, 1994) provides procedures for reporting the LIFO recapture amount as required by IRC section 1363(d). This procedure states that the LIFO recapture amount is the amount by which the C corporation's inventory under the FIFO method (determined by using cost or market, whichever is lower) authorized by IRC section 471 exceeds the inventory amount under the LIFO method. This provision generally applies in the case of S elections made after December 17, 1987. Following are the procedures outlined in Rev. Proc. 94-61.

Question 1 Does inclusion of the LIFO recapture amount in gross income of a C corporation under IRC Section 1366(d) result in the termination or discontinuance of the LIFO method?

Answer 1 Inclusion of the LIFO recapture amount in gross income will not result in a termination or discontinuance of a taxpayer's LIFO method. IRC Section 472(e) and Treas. Reg. Section 1.472-5 provide that an election made to adopt and use the LIFO method is irrevocable. The method, once adopted, shall be used in all subsequent taxable years, unless the use of another method is required by the Commissioner or authorized pursuant to a written application filed as provided in Treas. Reg. Section 1.446-1(c). Taxpayers complying with Rev. Proc. 88-15, 1988-1 C.B. 683 may expeditiously obtain the consent of the Commissioner to discontinue the use of the LIFO method.

Question 2 How does a taxpayer make the appropriate adjustment to the basis of inventory required by IRC Section 1363(d)(1)?

Answer 2 The appropriate method to effect the adjustment to the basis of inventory under IRC Section 1363(d)(1) is to collapse any LIFO layers and add the LIFO recapture amount to the LIFO value of the ending inventory as of the end of the taxpayer's last taxable year as a C corporation. Collapsing the LIFO layers is appropriate because (1) the revaluation of ending inventory to FIFO (using the lower of cost or market as of the date of conversion to S status) is inconsistent with the LIFO layering approach, and (2) IRC Section 1363(d) was enacted to create parity between LIFO and FIFO taxpayers when LIFO taxpayers elect to be taxed as S corporations.

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The following example illustrates the appropriate method. Assume that a taxpayer elected LIFO in 1988, and the LIFO carrying value on December 31, 1991, is $1,600, comprised of the following layers:

	Base-Year Cost	Index	LIFO Carrying Value
01/01/88 base-year	$1,000	100%	$1,000
12/31/88 layer	200	110%	220
12/31/89	---	115%	---
12/31/90 layer	100	120%	120
12/31/91 layer	200	130%	260
	$1,500		$1,600

The above assumes that the taxpayer experienced a decrement for the year ending December 31, 1989, when the end-of-the-year inventory expressed in terms of base-year cost was less than the beginning-of-the-year inventory expressed in terms of base-year cost.

Assume further that the inventory is valued at $1,900 under the FIFO method using cost or market, whichever is lower. Therefore, if the taxpayer elected to be taxed as an S corporation effective January 1, 1992, the LIFO recapture amount is $300 ($1,900 less $1,600).

The appropriate adjustments are made by collapsing the LIFO layers and adding the $300 LIFO recapture amount to the LIFO carrying value of the ending inventory as of the end of the 1991 taxable year. The index is then changed to reflect the adjusted relationship between the new LIFO carrying value ($1,900) and base-year costs ($1,500). The base year and base-year costs do not change. Accordingly, the adjusted index and LIFO carrying value are as follows:

	Base-Year Cost	Index	LIFO Carrying Value
01/01/88 base-year	---	100%	---
12/31/88 layer	---	110%	---
12/31/89	---	115%	---
12/31/90 layer	---	120%	---
layer resulting from IRC Section 1363(d)	$1,500	126.67 %	$1,900

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adjustment

Note that the beginning inventory is $1,900 for the 1992 taxable year, which is the first year the taxpayer is taxed as an S corporation. Also, note that for a taxpayer using the link-chain method, the cumulative index is not recomputed. The cumulative index at December 31, 1991, is 130 percent, even though the adjusted index for the special collapsed layer resulting from the IRC Section 1363(d) adjustment is 126.67 percent. The cumulative index at December 31, 1992, will be the product of 130 percent and the annual link for the December 31, 1992 taxable year.

The above index for the special collapsed 1991 layer is relevant only for the purpose of computing the LIFO-carrying value of a decrement in the event there is a decrement to the LIFO inventory as of or prior to December 31, 1991, in a taxable year subsequent to the taxable year ending December 31, 1991. Thus, this index would be used only if the end-of-year inventory, expressed in terms of base-year cost for a taxable year subsequent to the taxable year ending December 31, 1991, is less that $1,500. For example, if, in 1992, the taxpayer's ending inventory at base-year cost is $1,400 (a decrement of $100), the LIFO carrying value will decrease by $126.67 ($100 x 126.67%).

However, if a taxpayer has experienced a decrement in its LIFO inventory for a taxable year ending before September 19, 1994, the IRS will accept as appropriate any reasonable method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount.

Question 3 If a taxpayer makes the appropriate adjustment to the tax basis of its inventory, as required by IRC Section 1363(d), but does not make such adjustment for financial reporting purposes, is the LIFO conformity requirement violated?

Answer 3 Section 472(c) provides that the LIFO method may be used only if the taxpayer establishes that, with respect to the first taxable year for which the method is used, no other method of valuing inventory has been used in ascertaining income, profit, or loss for credit purposes or for a report or statement to shareholder, partners, other proprietors, or beneficiaries. Section 472(e)(2) imposes similar restrictions for subsequent years.
Section 1.472-2(e)(1)(vi) provides that a taxpayer may use a costing method or accounting method to ascertain income, profit, or loss for credit purposes or for purposes of financial reports if such costing method or accounting method is neither inconsistent with the inventory method referred to in Treas. Reg. Section

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1.472-1 nor at variance with the requirement referred to in Treas. Reg. Section 1.472(c), regardless of whether such costing method or accounting method is used by the taxpayer for federal income tax purposes. Treas. Reg. Section 1.472-1 refers to the LIFO inventory method. Treas. Reg. Section 1.472-2(c) provides rules for the opening inventory of the taxable year for which the LIFO method is first used.

A taxpayer that uses a method for costing its LIFO inventory for financial reporting purposes without taking into account the basis adjustment under IRC Section1363(d) made to its LIFO inventory for tax purposes is neither inconsistent with the LIFO inventory method referred to in Treas. Reg. Section 1.472-1 nor at variance with the requirement referred to in Treas. Reg. Section 1.472-2(c). Accordingly, the taxpayer does not violate the LIFO conformity requirement contained in §472(c) or §472(e)(2) by making the appropriate adjustment to the basis of its inventory for tax purposes but not for financial reporting purposes.

Question 4 Is a taxpayer entitled to reduce its gross income if the amount of its inventory under the LIFO method exceeds the amount of its inventory under the FIFO method?

Answer 4 The taxpayer may not reduce gross income if the amount of its inventory under the LIFO method exceeds the amount of its inventory under the FIFO method. IRC Section 1363(d)(3) states that “the term ‘LIFO recapture amount’ means the amount (if any)” by which the inventory amount of the inventory asset under the FIFO method exceeds the amount of such asset under the LIFO method. If the amount of inventory under the LIFO method exceeds the amount of inventory under the FIFO method, there is no LIFO recapture amount to include in gross income.

Question 5 May a net operating loss (NOL) carryover be applied against the LIFO recapture amount included in the gross income of a C corporation?

Answer 5 Subject to applicable code restriction, an NOL carryover may be applied against the LIFO recapture amount included in the gross income of the C corporation. To the extent the NOL carryover offsets the LIFO recapture amount, there would be no increase in tax by reason of IRC Section 1363(d). However, the appropriate adjustment to the basis of inventory required under IRC Section 1363(d) is the LIFO recapture amount unreduced by the NOL carryover.

Question 6 If the LIFO method has been used for less than four taxable years prior to a taxpayer’s first year as an S corporation, should the

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number of, or period over which, installment payments for the additional tax resulting from the LIFO recapture amount be reduced from the four equal installment required in IRC Section 1363(d)(2)?

Answer 6 Neither the number of installments nor the period for their payment should be reduced. Under IRC Section 1363(d)(2), any increase in the tax imposed as a result of including the LIFO recapture amount in gross income shall be payable in four equal installment with the first installment being paid by the due date of the return for the electing corporation's last taxable year as a C corporation. The other three installments are due by the respective due dates of the S corporation's returns for the three succeeding taxable years without regard to the number of years the C corporation may have used the LIFO method.

Question 7 Should an S corporation's obligation to pay an installment of tax resulting from the LIFO recapture amount be taken into account in determining the amount of estimated tax an S corporation is required to pay?

Answer 7 An S corporation should not include the obligation to pay an installment of tax resulting from the LIFO recapture amount in its determination of its estimated tax payment under IRC Section 6655.

Question 8 If an S corporation files a final return, are any unpaid annual installments of the increase in tax required under IRC Section 1363(d) (that otherwise would be payable in subsequent taxable years) due and payable with the S corporation's final return?

Answer 8 Any remaining unpaid annual installments of the increase in tax resulting from the application of IRC Section 1363(d), which would have been due by the respective due dates of the S corporation's returns for the succeeding taxable year, are accelerated and are due and payable with the S corporation's final return.

Note that part of Answer 1 from the Revenue Procedure 94-61 cross references to Treas. Reg. section 1.446-1(c) when in reality the correct reference should be Treas. Reg. section 1.446-1(e).

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060700 DETERMINING THE ADDITIONAL TAX DUE TO LIFO RECAPTURE

1988-15 I.R.B. 47 provides instructions for determining the additional federal tax due to LIFO recapture as follows:

To determine the additional tax due to LIFO recapture, the corporation must complete lines 1 through 9b of Schedule J of the Form 1120 based on income that includes the LIFO recapture amount. On a separate worksheet, using the Schedule J format, the corporation must then complete the entire worksheet (lines 1 through 10) based on taxable income that excludes the LIFO recapture amount. (For this purpose, the exclusion of the LIFO recapture amount may cause certain items, such as the foreign tax credit, to be recalculated.) The total of lines 1 through 9b of Schedule J must then be compared to line 10 of the worksheet. The difference is the additional tax due to LIFO recapture.

To determine the additional tax due to LIFO recapture for California purposes, the above instructions apply in the same manner, with appropriate modifications for California items.

Note: The above line references are for 1998 forms.

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060800 MISCELLANEOUS ISSUES

- The LIFO recapture amount, included into income in the last C corporation year, increases C corporation earnings & profits. This will impact the taxability of distributions made in future S corporation years when distributions exceed AAA. If the corporation did not include, in whole or part, the LIFO recapture amount into income in its last C corporation year but was subject to such provisions, the C corporation earnings & profits should include the portion omitted from income in the last C corporation year.
- The LIFO recapture tax provisions apply when a C corporation using the LIFO inventory method merges into an S corporation in a nonrecognition transaction.
- If an S corporation spins off one or more of its activities into other S corporations, none would be subject to the LIFO recapture tax because none were C corporations at the time of the spin-off.

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070000 EXCESS NET PASSIVE INCOME TAX

S Corp 070100 Federal and California Background
S Corp 070200 Computing the ENPI Tax
S Corp 070300 Taxable Income Limitation
S Corp 070400 Deduction for ENPI Tax at the Shareholder Level
S Corp 070500 Computing Subchapter C E&P
S Corp 070600 Consent Dividends
S Corp 070700 S Corporation Revocation due to ENPI
S Corp 070800 Effect on Built-In Gains Tax
S Corp 070900 Exhibits

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070100 FEDERAL AND CALIFORNIA BACKGROUND

S Corp 070101 Federal Background
S Corp 070102 California Background

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070101 Federal Background

The purpose of the tax on excess net passive income (ENPI) is to discourage a C corporation with accumulated earnings and profits (E&P) from becoming (or functioning as) a holding company in order to obtain favorable tax treatment under Subchapter S. In accordance with IRC section 1375, beginning on or after January 1, 1982, the ENPI tax is imposed on S corporations that meet both of the following conditions:

1. The corporation has accumulated E&P from Subchapter C years at the end of that taxable year. Thus, an S corporation will not be subject to the tax on ENPI if it has been an S corporation for each of its taxable years; and
2. The corporation's passive investment income exceeds 25% of its gross receipts. The term “passive” as contained in “ENPI” does not follow the passive activity loss rules as contained in IRC section 469. A more accurate term is “excess net investment income.” For such purpose, investment income includes interest, dividends, royalties, etc. (IRC §§1362(d)(2)(C) and 1375(b)(3))

ENPI is limited to the taxable income of the corporation determined without regard to the net operating loss (NOL) deduction or special corporate deductions under IRC section 241 through IRC section 249 (other than IRC §248 organizational expenditures). (IRC §1375(b)(1)(B)) For such purposes, the corporation's taxable income is computed as though it were a C corporation, but without deducting any NOLs under IRC section 172 or any of the special corporate deductions under Part VIII of Subchapter B (other than the deduction for organizational expenditures under IRC §248). (IRC §1375(b)(1)(B)) This means that if the corporation has no taxable income, no ENPI tax can be imposed because there is no ENPI to tax. If the ENPI is limited for such reason, the ENPI tax is completely avoided. Therefore, the tax is not suspended until the corporation has adequate taxable income.

Shareholders of the S corporation can take proportionate deductions on their individual returns for the ENPI tax paid by the S corporation. The tax is netted against the income to which it relates in computing the pass-through to the shareholder. The amount of any tax paid reduces the amount of each item of passive investment income that passes through to the shareholders. The tax is allocated proportionately based on passive investment income (IRC §1366(f)(3)).

If the S corporation distributes all of its accumulated E&P on or before the end of the taxable year, the corporation will not be subject to the ENPI tax. Under IRC

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section 1375(d), the IRS may waive the ENPI tax if the S corporation shows to the satisfaction of the IRS that:

1. The S corporation determined in good faith that it had no accumulated E&P from Subchapter C years at the close of a taxable year; and
2. Within a reasonable period of time after it was determined that it did have accumulated E&P from Subchapter C years at the close of that taxable year, the E&P were distributed. (See the sections on Computing Subchapter C E&P and Consent Dividends which follow.)

Under Treas. Reg. section 1.1375-1(d)(1), the S corporation has the burden of establishing that the waiver is warranted by the relevant facts and circumstances. Therefore, the IRS may waive the ENPI tax if an S corporation establishes the following requirements:

- It acted in good faith and used due diligence in determining that it had no accumulated E&P from Subchapter C years at the close of a taxable year, and
- It distributed E & P that were determined later on audit within a reasonable time afterwards.

The IRC provides a passive investment income limitation for an S corporation that possesses accumulated E&P from years in which the entity was a C corporation. If such a corporation has passive income in excess of 25% of its gross receipts for three consecutive taxable years, the S election is terminated as of the beginning of the fourth taxable year. (IRC §1362(d)(3)) It is not necessary that the taxpayer pay the ENPI tax for such revocation to take place.

Any ENPI subject to this tax could also be subject to the built-in gains tax. To prevent the imposition of more than one corporate-level tax on the same income, passive investment income is determined by excluding recognized built-in gains and losses for any year during the ten-year recognition period (IRC §1375(b)(4)).

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070102 California Background

Generally, California conforms to the federal IRC section 1375 under R&TC section 23811, with one major exception. This exception is that the California ENPI tax is computed only on passive investment income attributable to California sources. Other exceptions include:

1. If the corporation does not have ENPI for federal purposes, then the corporation is not subject to California ENPI tax. (R&TC §23811(a))
   Note: Do not confuse the wording of this subdivision. It does not state that if the corporation is not subject to **federal ENPI tax** they are automatically not subject to **California ENPI tax**. This only means that if the corporation does not have **federal ENPI** then it is not subject to **California ENPI tax**.
2. For California purposes, the S corporation shareholder(s) can only deduct the California amount of ENPI tax paid on their respective California individual returns - not the federal amount (R&TC §23803(b)). Accordingly, the shareholder should make a corresponding positive state adjustment required by the amount of the deduction stemming from the federal ENPI Tax.
3. The term "Subchapter C E&P" used in IRC section 1375 and section 1362(d)(3) will be the Subchapter C E&P of the corporation attributable to California sources (R&TC §23811(d)). The tax is imposed on the California S corporation if the E&P of the corporation are attributable to California sources (R&TC §23811). E&P are attributable to California sources if the taxable income of prior years was fully subjected to the California income/franchise taxes (therefore not apportioning income), or the amount allocated or apportioned to California.
4. California allows S corporations to deduct the amount of California ENPI subject to California's ENPI tax for purposes of calculating the S corporations' taxable income subject to the franchise or income tax (R&TC §23802(e)). In other words, the ENPI is only taxed at one rate. Since there is no S corporation tax for federal purposes, no comparable provision exists in federal law.
5. IRC section 1375(d) provides waiver provisions if the S corporation is subject to ENPI tax. California has its own relief provision in R&TC section 23811(e).
   Note: Before making an adjustment on ENPI tax, read R&TC section 23811(e) carefully.
6. The tax is assessed at the highest corporate tax rate of 9.3% for any taxable year beginning before January 1, 1997, and 8.84% for taxable years beginning on or after January 1, 1997. (R&TC §§23151 and 23811(b)(1))
7. The tax cannot be reduced by any credits allowed under the Bank and Corporation Tax Law (R&TC §23811(c)).

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070200 COMPUTING THE ENPI TAX

S Corp 070201 Computing ENPI
S Corp 070202 Passive Investment Income Defined
S Corp 070203 Gross Receipts Defined
S Corp 070204 Net Passive Income Defined

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070201 Computing ENPI

General Federal Computation

$$\text{ENPI} = \frac{\text{Passive Investment Income in excess of 25\% of *gross receipts}}{\text{Passive Investment Income}} \text{ Multiplied by } \text{Net Passive Investment Income}$$

*gross receipts includes investment passive income (Treas. Reg. 1.1375-1(b)).

Generally, *passive investment income* means "gross receipts" derived from royalties, rents, dividends, interest, annuities, and gains from the sale or exchange of stock or securities not derived in the ordinary course of a trade or business (IRC §§1375(b)(3) and 1362(d)(3)(D)).

If income is generated in the ordinary course of business or a lessor provides significant services above and beyond customary lessor duties, it is nonpassive or active income and, therefore, not included. (Treas. Reg. § 1.1362-2(c)(5)) For purposes of the 25% rule, *gross receipts* means 100% of the company's gross receipts, including *passive investment income*. (Treas. Reg. § 1.1362-2(c)(4)) *Net passive income* means passive income reduced by any deductions directly connected with the production of such income. (Treas. Reg. § 1.1375-1(b)(2))

General California Computation

Use the following formula to compute ENPI:

$$\text{ENPI} = \frac{\text{CA Passive Investment Income in excess of 25\% of *CA gross receipts}}{\text{CA Passive Investment Income}} \text{ Multiplied by } \text{Net Passive Investment Income}$$

*CA gross receipts includes CA investment passive income

Generally, California conforms to the federal statute and regulations. However, the California ENPI tax is computed <u>only</u> on *passive investment income* attributable to California sources. Similarly, for purposes of the 25% rule, *gross receipts* means 100% of the company's California gross receipts, including California *passive investment income*. *Net passive income* means *California*

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passive investment income reduced by any deductions directly connected with the production of California sourced income.

Example A

At the end of 1996, XYZ Corporation, an electing S corporation, has gross receipts totaling $264,000 (of which $110,000 is passive investment income). Expenditures directly connected to the production of the passive investment income total $30,000. Therefore, XYZ has net passive investment income of $80,000 ($110,000 - $30,000), and the amount by which its passive investment income for the year 1996 exceeds 25% of its gross receipts is $44,000 [$110,000 passive investment income less $66,000(or $264,000 * .25)]. Excess net passive income (ENPI) is $32,000, calculated as follows:

ENPI= ($44,000/$110,000) * $80,000= $32,000

Consequently, XYZ Corp's passive investment income tax for 1996 is $2,976 ($32,000 x 9.3%). Additionally, XYZ must reduce its Net Income for state purposes by $2,976 for purposes of computing the Franchise Tax. Also, XYZ Corp. must also reduce, as a Schedule K-1 state adjustment, the amount of income flowing through to the shareholder(s) by $2,976. The shareholders are responsible for adding, as a state adjustment, any federal ENPI tax paid.

The following discussion provides a detailed explanation defining the components used in computing the ENPI tax, including Passive Investment Income, Gross Receipts, and Net Passive Investment Income.

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070202 Passive Investment Income Defined

If income is generated in the ordinary course of business duties, it is nonpassive or active income, therefore, is not included in "passive investment income." Often classification of income as passive is difficult to determine and turns upon the facts in each particular case. Many such cases and rulings are discussed below. Also discussed are several of the numerous private letter rulings that the IRS has issued to guide what constitutes passive investment income. For example, in LTR 9510064, the IRS ruled that income the S corporation received on its sale of certain property, the proceeds of which it invested in securities, was not passive investment income.

Under IRC section 1375(b)(3), the term “passive investment income” has the same meaning as when used in IRC section 1362(d)(3), which deals with S corporation terminations because of having ENPI while holding C-Corp E&P for three consecutive years. The following is an excerpt from IRC section 1362 (d)(3)(C), which provides a definition for “passive investment income”:

"For purposes of this paragraph –

(i) In general. Except as otherwise provided in this subparagraph, the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains there from).

(ii) Exception for interest on notes from sales of inventory. The term “passive investment income” shall not include interest on any obligation acquired in the ordinary course of the corporation's trade or business from its sale of property described in IRC Section 1221(a)(1).

(iii) Treatment of certain lending or finance companies. If the S corporation meets the requirements of IRC Section 542(c)(6) for the taxable year, the term “passive investment income” shall not include gross receipts for the taxable year which are derived directly from the active and regular conduct of a lending or finance business (as defined in IRC Section 542(d)(1)).

(iv) Treatment of certain liquidations. Gross receipts derived from sales or exchanges of stock or securities shall not include amounts received by an S corporation which are treated under IRC Section 331 (relating to corporate

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liquidations) as payments in exchange for stock where the S corporation owned more than 50 percent of each class of stock of the liquidating corporation."

Generally, California conforms to the federal statute and regulations. However, the California ENPI tax is computed only on *passive investment income* attributable to California sources. Therefore, for nonapportioning taxpayers, the federal and California *passive investment income* would be the same. However, for apportioning taxpayers, the California *passive investment income* would generally be the amount properly allocated to California Schedule R Nonbusiness Income.

The main types of income items discussed below include royalties, rents, dividends, interest, annuities, certain capital gains, and certain partnership income items. For purposes of the ENPI tax, passive investment income includes:

Royalties, such as:

- mineral royalties,
- oil royalties,
- gas royalties,
- amounts received for the privilege of using patents,
- amounts received for the privilege of using copyrights,
- amounts received for the privilege of using secret processes,
- amounts received for the privilege of using formulas,
- goodwill,
- trademarks,
- trade brands,
- franchises, and
- other like property.

Under Treas. Reg. section 1.1362-2(c)(5)(ii)(A)(2), the gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing tax income.

Under Treas. Reg. section 1.1362-2(c)(5)(ii)(A)(1), royalties do not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation:

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- created the property; or
- performed significant services or incurred substantial costs with respect to the development or marketing of the property.

Example A

S is an S corporation with accumulated E&P from Subchapter C years. In S's first taxable year as an S corporation, S has gross receipts of $75,000: $5,000 is royalty payments received with respect to Trademark A; $8,000 is royalty payments received with respect to Trademark B; and $62,000 is gross receipts from operations. S created Trademark A, but S did not create Trademark B or perform significant services or incur substantial costs with respect to the development or marketing of Trademark B.
Because S created Trademark A, the royalty payments with respect to Trademark A are derived in the ordinary course of S's business and are not included within the definition of royalties for purposes of determining S's passive investment income. However, the royalty payments with respect to Trademark B are included within the definition of royalties for purposes of determining S's passive investment income. S's passive investment income for the year is $8,000
Note that the exception for self-created property appears to apply only when the property was created by the S corporation, but it does not apply when the property was created by the shareholder and contributed to the S corporation. Accordingly, in order to take advantage of the exception, the auditor should verify if the corporation created the property, rather than the shareholder creating and contributing the property to the corporation.

Royalties **do not** include:

- Copyright royalties, mineral royalties, oil royalties, and gas royalties if the income from those royalties would not be treated as personal holding company income under IRC section 543(a)(3) and (a)(4) if the corporation were a C corporation (Treas. Reg. §1.1362-2(c)(5)(ii)(A)(3));
- Amounts received upon disposal of timber, coal, or domestic iron ore with respect to which the rules of IRC Section 631(b) and (c) apply (Treas. Reg. §1.1362-2(c)(5)(ii)(A)(3)); and
- Active business computer software royalties as defined under IRC Section 543(d) (without regard to IRC §543(d)(5)). (Treas. Reg. §1.1362-2(c)(5)(ii)(A)(3))

Rents, such as:

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- Amounts received for the use of, or right to use, property (whether real or personal) of the corporation (Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(1));
- "Delay rentals" paid under an oil, gas, or mineral lease;
- Gross receipts from the rental of an associate membership seat on a board of trade;
- Portions of monthly rental payments that would be credited to the purchase price if the option to buy the rented property contained in the lease were exercised;
- Payments received from occupants of dwellings to be razed to allow for construction of a motel. Although the taxpayer argued that, since the corporation acquired the land with the intent to demolish the dwellings, the cost basis of the land should be reduced by the rents received, the Tax Court (TC) treated the payments as rents and concluded that Treas. Reg. section 1.165-3(a)(1) on which the taxpayer relied (under pre-1984 law) were intended to cover an instance of a razed building with a salvage value and were not intended to apply to a building that is used to produce rental income before demolition; and
- Gross receipts received under a long-term timber contract.

Example B

Corporation A entered into a 45-year contract with M, wherein A sold and M bought all timber growing and to be grown on A's timberland. M also had options to buy the land and extend the contract. M was required to make minimum yearly payments regardless of actual timber output. M bore all taxes and maintenance costs. Since payments in excess of the fair market value of the existing timber at the time of the execution of the contract are not proceeds from the sale of timber, the excess payments are rent.

Although rents are classified by the Code as passive investment income, rents do not fall into this category if the corporation (landlord) renders significant services to the occupant (tenant) (Treas. Reg. §1.1362-2(c)(5)(ii)(B)(2)). This exception is similar to the material participation test for passive activity income of IRC section 469.

Example C

corporation provides utilities for the building, maintains the lobby in the building, and furnishes trash collection for the tenants, this does not constitute the rendering of significant services for the occupants. Thus, the rents paid by the

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tenants of the building are passive investment income to XYZ Corporation. (Treas. Reg. §1.1362-2(c)(5)(ii)(B)(2)) *Bramlette Building Corp., Inc.,* 52 T.C. 200 (1969), *aff'd* in70-1 USTC ¶9361, 25 AFTR2d 70-1016, 424.F.2d 751 (CA-5, 1970)].

Example D

Assume the facts in the previous example, except that XYZ also furnishes maid services to its tenants. Now the services rendered are significant in that they go beyond what one might normally expect the landlord of an apartment building to provide. Under these circumstances, the rent income no longer constitutes passive investment income.

Rents **do not** include:

- Rents derived in the active trade or business of renting property;
- Produced film rents as defined in IRC section 543(a)(5);
- Income from leasing self-produced tangible property; or
- Payments designated as rents that are really a share of operating profits. For example, if a ferry company received payments designated as rents under a management agreement, but the purported rents were really a share of operating profits because the president of the ferry company exercised control over the operations, the ferry company would not receive rents for such purposes.

Dividends, in accordance with IRC section 1362(d)(3)(C)(i), which includes:

- Dividends as defined in IRC section 316;
- Amounts to be included in gross income under IRC section 551 (relating to foreign personal holding company income taxed to U.S. shareholders); and
- Consent dividends as provided in IRC section 565 (Treas. Reg. §1.1362-2(c)(5)(ii)(C)).

Interest, which includes any amounts received for the use of money including:

- Tax-exempt interest. Although tax-exempt interest is normally not subject to tax, the tax-exempt interest may, in some situations, be subject to the tax on ENPI;
- Amounts treated as interest on deferred payments under IRC section 483;
- Amounts treated as original issue discount under IRC section 1272;

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- Amounts treated as interest under the rules for debt issued for nonpublicly traded property in IRC section 1274; and
- Amounts treated as interest under the rules for below- market loans under IRC section 7872 (Treas. Reg. §1.1362-2(c)(5)(ii)(D)).

In determining the amount of income associated with interest, it should be noted that interest expense cannot be netted against such interest income. Generally, interest expense is not taken into account in determining whether the corporation is subject to the ENPI tax. However, interest expense incurred in order to earn the interest income is deducted from such interest income subjected to the ENPI tax, to arrive at "net passive income." (Treas. Reg. §1.1375-1(b)(2))

Example E

not passive investment income. During Year 1, S buys a bond portfolio as an investment and finances its purchase of the bond portfolio by short-term borrowings. S earns interest of $1,000 on its bond portfolio and pays interest of $950 on its short-term debt. S is subject to the ENPI tax, since its passive investment income ($1,000) is more than 25% of its gross receipts ($375, [i.e., gross receipts of $1,500 ($500 + $1,000) × 25%]). However, the tax is imposed only on the excess net passive investment income of $31.25 [($625 ÷ $1,000) × $50].

Generally, California law conforms to the federal statutes and regulations with regard to passive investment interest income. However, California only includes interest income in the passive investment income computation to the extent that the income is attributable to, or apportioned to, California sources.

Annuities. Under IRC section 1362(d)(3)(C)(i), gross receipts derived from annuities are passive investment income. “Annuities” means the entire amount received as an annuity under an –

- Annuity;
- Endowment; or
- Life insurance contract, if any part of the amount would be includible in gross income under IRC section 72. (Treas. Reg. §1.1362-2(c)(5)(ii)(E))

Example F

Where an S corporation with Subchapter C earnings receives the proceeds of a

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key man life insurance policy as an annuity, the entire amount of the proceeds are passive investment income even if only a small portion of the proceeds are included in gross income.

Gains from sales or exchanges of stocks and securities

Gross receipts from the sale or exchange of stock or securities are passive investment income. However, they are only passive investment income to the extent of gains from the sales or exchanges. Therefore, losses on sales of stock or securities are not netted against gains. (Treas. Reg. §1.1362-2(c)(4)(ii)(B) and (c)(5)(ii)(F))

Long-term capital gains from the sale of securities are passive investment income. The inclusion of gains from the sale of securities within the definition of passive investment income can create ENPI issues for S corporations that deal mainly in security transactions if C corporation E&P exist.

Example G

S is an S corporation with Subchapter C E&P. In S's first tax year as an S corporation, S recognizes a gain of $25,000 on the sale of Corporation P stock and a loss of $12,000 on sale of the Corporation O stock. S held the P and O stock for investment rather than for sale in the ordinary course of a trade or business. S's passive investment income is the $25,000 gain on sale of P stock (loss on O stock not taken into account).
Note:
Note that there is no exception for gross receipts from the sale or exchange of stock or securities in the ordinary course of business. Accordingly, gains from the sale or exchange of stock or securities are passive investment income even if the S corporation is a dealer in stock or securities.

Computation of gross receipts

Gains from disposition of capital assets (other than stocks and securities): Only the ***net gain*** from the disposition of capital assets (other than stocks and securities) is taken into account in computing gross receipts. Therefore, a net loss would not be included in passive investment income. (Treas. Reg. §1.1362-2(c)(4)(ii))

Partnership Income

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Note that an income from a passive partnership activity, as defined under IRC section 469, is not considered passive investment income as it applies here. You must look at each income and loss item generated by the partnership and apply the provisions of these code sections to determine whether it would qualify as passive investment income.

Corporation income from investments in partnerships retains its character for purposes of determining whether the income is passive or not. In LTR 8736052, the IRS ruled that an S corporation's income from two separate partnerships retained its character as earned by the partnerships. In one case, the income from operating partnership hotels was not considered "rents." In the other case, rents from the lease of retail stores and office space did constitute tainted passive income.

When an S corporation is a limited partner in a partnership, it could be argued that all income it derives from the limited partnership interest is passive investment income. However, in LTR 8852021 the IRS took the position that the S corporation's income from the partnership is characterized by reference to whether that income is passive investment income when earned by the partnership. Thus, only the portion of the partnership income consisting of rents, royalties, dividends, interest, annuities, and gain from sales or exchanges of stock or securities passes through to the S corporation as passive investment income.

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070203 Gross Receipts Defined

Under IRC section 1375(b)(3), the term “gross receipts” has the same meaning as when used in IRC section 1362(d)(3), which deals with the S corporation termination because of S corporation's having ENPI while holding C-Corp E&P for three consecutive years. The following is an excerpt from IRC section 1362(d)(3)(B), which states that "gross receipts" includes:

"Gross receipts from sales of capital assets (other than stock and securities). For purposes of this paragraph, in the case of dispositions of capital assets (other than stock and securities), gross receipts from such dispositions shall be taken into account only to the extent of the capital gain net income therefrom".

Gross receipts are defined in Treas. Reg. section 1362-2(c)(4) to include total amounts received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions. In other words, gross receipts do not mean the same thing as gross income.

Generally, California conforms to the federal statute and regulations. R&TC section 23811 states that "Except as otherwise provided in this section, there is hereby imposed a tax on "passive investment income" attributable to California sources, determined in accordance with the provisions of IRC section 1375, relating to tax imposed on passive investment income, as modified by this section." Accordingly, California modifies the definition of "passive investment income", and "gross receipts" to include only California sourced income.

Therefore, for purposes of the 25% rule, *gross receipts* means 100% of the company's California sourced gross receipts (and not 100% of gross receipts), including California *passive investment income*. Accordingly, for nonapportioning taxpayers, the federal and California *gross receipts* would be the same. However, for apportioning taxpayers, the California *gross receipts* would generally be the amount properly allocated to California Schedule R for apportioning rate computational purposes.

As a general guideline, gross receipts include the following (Treas. Reg. §1.1362-2(c)(4)):

- Income from a trade or business activity, which includes passive investment income such as royalties, rents, dividends, interest (including non-taxable), annuities, and gains from the sales or exchanges of stock or securities;

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- An amount received in a nontaxable sale or exchange is not included except to the extent the gain is recognized by the S corporation on the sale or exchange;
- Capital gain net income, *not* gross proceeds, from the sale of capital assets. In other words, the excess of capital gains over capital losses is considered the gross receipts. If capital losses exceed capital gains, the net capital loss is not included;

Example A

An S corporation sells a capital asset (as defined in IRC §1221) (other than stock or securities) for a gain and another capital asset (other than stock or securities) for a loss. The amount of gross receipt is limited to the exent of the amount of capital gain

- Sales of IRC section 1231 assets increase the gross receipts by the full amount of the sales proceeds. The term "IRC section 1231 assets" refers to property held more than one year and used in the taxpayer's trade or business or as rental property. This includes any depreciable property and land used in the taxpayer's business and rental activity;
- Gross payments received on installment sales during the year; and
- Gain(s) on the sale or exchange of stock or securities. Losses do not offset gains for purposes of determining gross receipts. In other words, stock and security sales resulting in a gain are aggregated and included in gross receipts.

Example B

C years. S sells an IRC section 1231 depreciable asset (held for more than one year) which is used in the corporatin's business. S receives payment for the asset partly in money and partly in the form of a note payable at a future time. S elects not to report the sale on the installment method. The amount of money and the face amount (or issue price if different) of the ntoe received from the business asset are considered gross receipts in the taxable year of sale and are not reduced by the adjusted basis of the property, costs of sale, or any other amount.

Investments in Partnerships

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Gain on disposition of a general partnership interest is treated as sale or exchange of stock or security. For tiered partnerships, look through each tier. Except as provided below, if an S corporation disposes of its general partner interest in a partnership, the gain on the disposition is treated as gain from the sale of stock or securities. Such gain is the amount that the S corporation would have received as a distributive share of gain from the sale of stock or securities held by the partnership. In other words, an assumption is made that all of the stock and securities held by the partnership had been sold by the partnership at fair market value at the time the S corporation disposes of the general partner interest. In applying this rule, the S corporation's distributive share of gain from the sale of stock or securities held by the partnership is not reduced to reflect any loss that would be recognized from the sale of stock or securities held by the partnership. (Treas. Reg. §1.1362-2(c)(4)(ii)(B)(4))

Example C

S is an S corporation with Accumulated E&P from Subchapter C years. S is a calendar year taxpayer. In S's first year as an S corporation, S and two of its shareholders form a general partnership, RPS, to indirectly invest in marketable stocks and securities. S contributes cash to PRS and receives a 50% interest in the capital and profits of PRS. The only assets of PRS are the stock, securities and certain real and tangible personal property. In the next year, S needs cash in its business and sells its partnership interest at a gain rather than having PRS sell the marketable stock or securities that have appreciated. The gain on S's disposition of its interest in PRS is treated as gain from the sale or exchange of stock or securities. Such gain is the amount of the distributive share of gain S would have received from the sale of stock or securities held by PRS, if PRS had sold all of its stock or securities at fair market value at the time S disposed of its interest in PRS.

An S corporation that disposes of a general partner interest may treat the disposition in the same manner as the disposition of an interest as a limited partner. Accordingly, gains on the disposition of a limited partnership interest are treated as gains on dispositions of stock and securities, i.e., that generate passive investment income to the extent of the gain. (Treas. Reg. §1.1362-2(c)(4)(ii)(B)(4)(ii))

Example D

S, an S corporation with accumulated E&P from Subchapter C years, holds a

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50% general partnership interest in Partnership Q. Q holds Stock Z ($200 basis and $500 FMV) and IRC section 1231 property ($800 basis and $1,000 FMV).

If S sells its interest in Q for $750 and does not make the election to treat the disposition as a disposition of a limited partnership interest, it will have gross receipts of $250 and passive investment income of $150 (50% of the $300 gain on the deemed sale of Z). However, if it makes the election, it will have gross receipts and passive investment income of $250 ($750 proceeds on the sale of its interest minus its basis of $500). Therefore, S should not make the election on the sale of Q.

Gross receipts from partnerships

An S corporation's distributive share of gross receipts from a partnership (not its share of the venture's loss) is used in applying the passive income test. Thus, if a corporation ownes and operates movie theaters and is a partner in a joint venture that ownes and operates another theater, the corporation's gross receipts include the corporation's share of the partnership's gross receipts, not its share of the partnership's operating loss. (See Rev. Rul. 71-455, 1971-2 CB 318.)

The character of the partnership's gross receipts passes through to the S corporation. Thus, if an S corporation is a general partner in a limited partnership that ownes and operates a recreational vehicle park (produced rents that are not passive investment income), the S corporation does not have passive income because the partnership's rents are not passive investment income. (See PLR 9411034.) This rule also applies to the situation where an S corporation is a member of an LLC that is treated as a partnership. Thus, if the LLC produces rents that are not passive investment income, the S corporation does not have passive investment income. (See PLR 9536007; PLR 9536008.)

The same rule applies to the situation where the S corporation is a limited partner. If an S corporation is a limited partner in a publicly traded partnership, the partnership has to “separately state” its gross receipts from its natural gas operations (nonpassive income, in this case), and the S corporation partner includes its share of the gross receipts. (See PLR 9144024.) An S corporation's distributive share of income of a limited partnership (in which the S corporation is a limited partner) consisted of royalties, rents, dividends, etc. is treated as passive investment income. (See LTR 8852021.)

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070204 Net Passive Income Defined

Net Passive Income (NPI) can be defined as passive investment income less deductions directly connected with the production of passive income (proximate and primary relationship to the income). These deductions include such expenses as property taxes and depreciation related to rental property, or investment interest expense related to interest income, but exclude such deductions as the dividends received deduction (IRC §1375 (b)(2)).

Generally, California conforms to the federal statute and regulations. However, for California purposes, *Net passive income* means *California passive investment income* reduced by any deductions directly connected with the production of California sourced income.

Under Treas. Reg. section 1.1375-1(b)(3)(i), to be directly connected with the production of income, a deduction item must have a proximate and primary relationship to the income. Expenses, depreciation, and similar items attributable solely to that income qualify for the deduction. These expenses include:

- Brokerage fees,
- Interest expenses,
- Safe deposit box rentals, and
- Investment advisory fees.

Under Treas. Reg. section 1.1375-1(b)(3)(ii), if an item of deduction is attributable partly to passive investment income and partly to other income, the deduction is allocated between the two types of income on a reasonable basis. The portion of the deduction that is allocated to passive investment income is treated as directly connected with the production of that income.

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070300 TAXABLE INCOME LIMITATION

IRC section 1375(b)(1)(B) imposes a taxable income limitation on the amount of ENPI that is subject to the ENPI tax. The taxable income limitation refers to an S corporation's taxable income determined by using all rules applying to C corporations (IRC §63(a), as modified by IRC §1375(b)(1)(B)). California conforms to the above provisions.

IRC section 1375(b)(1)(B) disregards the following deductions in computing the taxable income limitation:

- IRC section 172 - Net operating loss deduction (R&TC §24416);
- IRC section 241 - Allowance of special deductions (R&TC §24401);
- IRC section 243 - Dividends received by corporations (R&TC §24402);
- IRC section 244 - Dividends received on certain preferred stock (R&TC §24402);
- IRC section 245 - Dividends received from certain foreign corporations (R&TC §24402);
- IRC section 246 - Rules applying to deductions for dividends received (R&TC §24402);
- IRC section 246A - Dividends received deduction reduced where portfolio stock is debt financed;
- IRC section 247 - Dividends paid on certain preferred stock of public utilities (R&TC §24402); and
- IRC section 249 - Limitation on deduction of bond premium on repurchase (R&TC §24439).

Note: If ENPI is limited by the taxable income limitation, there are no carryover provisions unlike with the imposition of the built-in gains tax.

Example A

As reported per return:

21.	$50,000
2. Foreign or domestic tax based on income or profits and California franchise or income tax	15,000
3. Interest on government obligations	1,000
4. Net capital gain from Schedule D (100S), Section B	850,000
5. Depreciation and amortization adjustments	-25,000

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6. Portfolio income		910,000
7. Contributions		-1,000
8. Net income (loss) after state adjustments		$1,800,000
9. Net income (loss) for state purposes		
10.R&TC Section 23802(e) deduction	911,000	
	*889,000	1,800,000
12.Net income for tax purposes		$0

Total net operating loss carryover = $1,500,000.

The taxable income limitation for California purposes is $1,800,000 – net income after state adjustments. The net operating loss carryover of $1,500,000 is not part of the taxable income limitation computation.

deductions required to be added back to net income (loss) after state adjustments for purposes of computing the taxable income limitation.
In this example, ENPI taxable income is $911,000. If it had exceeded $1,800,000, the excess would not have been subject to the tax and would not have been carried over into subsequent years.

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070400 DEDUCTION FOR ENPI TAX AT THE SHAREHOLDER LEVEL

Under R&TC section 23802(e), S corporations are required to reduce the amount of income subject to the franchise or income tax by the amount of passive investment income subject to the ENPI tax. Additionally, the ENPI tax is allowed as a deduction to the shareholder under IRC section 1366(f)(3). R&TC section 23803(b)(2) modifies IRC section 1366(f)(3) to allow, as a deduction to the shareholder, the amount of ENPI tax computed under California law. Unlike the built-in gains tax, the ENPI tax is allowed to reduce each passive investment income item proportionately by the amount of tax. It is not treated as a current distributive loss. As shown in the following example, each item of ENPI is reduced, by an amount which bears the same ratio to the amount of such item to the total passive investment income for the taxable year.

Example A

	Amount of Excess Net Passive Income	Ratio	S Corporation Level Excess Net Passive Income Tax @9.3%	Pro Rata Excess Net Passive Income Tax
1.		$900,000	.90	83,700
2.	Dividend Income	100,000	.10	9,300
	Total	$1,000,000	1.00	$93,000

The shareholder would include the following in the computation of shareholder basis:

Item of Income		
1. Interest Income	$816,300	[$900,000 - 83,700]
2. Dividend Income	90,700	[$100,000 - 9,300]

The shareholder would report the following amounts per return:

Dividend Income, $90,700, to Schedule B.

is used instead of the federal ENPI tax amount.

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As the example shows, the California ENPI tax is netted against the income to which it relates in computing the pass-through to the shareholder. Accordingly, the shareholder should make a corresponding positive state adjustment by the amount of the deduction stemming from the federal ENPI tax.

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070500 COMPUTING SUBCHAPTER C E&P

S Corp 070501 Federal E&P
S Corp 070502 California E&P

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070501 Federal E&P

While the IRC does not define the term *earnings and profits* (E&P), IRC section 312 lists certain transactions that affect E&P. Incidentally, E&P does possess similarities to the accounting concept of retained earnings (earnings retained in the business). However, E&P and retained earnings are often not the same. E&P represents the corporation's economic ability to pay dividends without impairing its capital. The effect of a specific transaction on the E&P account can be determined simply by considering whether or not the transaction increases or decreases the corporation's ability to pay dividends. S corporations themselves never generate E&P. (See IRC §1362(d)(3)(B)) Nevertheless, C Corporation E&P could be acquired by an S corporation from a regular corporation when there is an E&P carry over under IRC section 381 (e.g., due to a merger), or they could be earned in years before the S election.

Note: An S corporation is required to check a box on Schedule B of the federal Form 1120S if it has E&P from Subchapter C years at the close of its taxable year.

The ENPI tax cannot be assessed in the final year of liquidation. Liquidating a corporation by distributing all of its property to shareholders should eliminate any Subchapter E&P at the close of the liquidating taxable year. Thus, the ENPI tax would not be a problem in an S corporation's final year. See LTR 9747035 (corporation's final taxable year closes after the liquidating distribution).

The following is a summary of the most common E&P adjustments:

E&P ADJUSTMENTS

Nature of Transaction	*Effect on Taxable Income in Arriving at Current E&P*
Tax exempt income	ADD
Federal income taxes	SUBTRACT
Loss on sale between related parties	SUBTRACT
Payment of premiums on insurance policy on life of corporate officer	SUBTRACT
Collection of proceeds of insurance policy on life of corporate officer	ADD
Excess charitable contribution (over 10% limitation)	SUBTRACT
Deduction of excess charitable contribution in succeeding taxable year (increases E&P because deduction reduces taxable income while E&P was	ADD

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reduced in a prior year)	
Realized gain (not recognized) on an involuntary conversion	NO EFFECT
Percentage depletion (only cost depletion can reduce E&P)	ADD
Accelerated depreciation (E&P is reduced only by straight-line, units of production, or machine hours depreciation)	ADD
Deferred gain on installment sale (all gain is added to E&P in year of sale)	ADD
Intangible drilling costs deducted currently (reduce E&P in future years by amortizing costs over 60 months)	ADD
Mine exploration and development costs (reduce E&P in future years by amortizing costs over 120 months)	ADD

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070502 California E&P

To determine whether the corporation has Subchapter C E&P for California purposes, both federal and California S election dates are considered, depending on when the California S election was made.

- In general, the corporation has no Subchapter C E&P if it began as a California S corporation on the first day of incorporation.
- If the corporation was a C corporation prior to making a valid S election for California purposes, it may have Subchapter C E&P.

"Look-Back" Rule - If the corporation became a California S corporation during income year 1987 or 1988 but was a federal S corporation at such time, **use the federal S election date** to determine whether the corporation had Subchapter C E&P for California purposes (R&TC §23801(a)(2)(C) and (a)(3)(D)). For example, if the federal S election date is 1/1/84 and the California S election date is 1/1/88, compute California's Subchapter C E&P as if it became a California S corporation on 1/1/84.

If the California S election is after 12/31/88, **use the California S election date** to determine whether the corporation has any Subchapter C E&P.

To determine whether the corporation has California Subchapter C E&P, it must compute its Subchapter C E&P attributable to California sources as determined under the Bank & Corporation Tax Law, modified for consent dividends (R&TC §23811(d) and (e)).

It is possible for a corporation that has always been a federal and California S corporation to "acquire" Subchapter C E&P through mergers and acquisitions. If an S corporation merges with another corporation which has Subchapter C E&P on the date of the merger, the Subchapter C E&P carryover to the successor corporation. (See IRC §381(c)(2) for carryover of E&P.)

Example A

ABC, Inc. incorporated on 6/12/92 and made a valid federal S election on the same date. It was deemed to be a California S corporation and did not file an election to be treated as a California C corporation.

because it was always an S corporation.

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Example B

ABC, Inc. incorporated on 6/12/92 and made a valid federal S election on the same date. It was deemed to be a California S corporation and did not file an election to be treated as a California C corporation.
On 12/31/92, ABC acquired XYZ, Inc. (a C corporation) through merger. On that date, XYZ had Subchapter C E&P of $500,000.
Beginning on 12/31/92, ABC has Subchapter C E&P of $500,000.

Example C

ABC, Inc. incorporated on 7/1/82 and made a valid federal S election on the same date. It filed as a California S corporation beginning in IYE 12/87.
On 1/1/87, ABC had California Subchapter C E&P of $100,000.
ABC falls under the "look-back" rule in R&TC section 23801(a)(2)(C) whereby it is deemed to have made its California S election on the same day as its federal S election for purposes of computing its Subchapter C E&P.
Because ABC incorporated and made the federal S election on the same day, ABC is deemed to have no Subchapter C corporation E&P for California purposes.
Note: ABC is deemed to have no Subchapter C E&P for the imposition of ENPI tax, but still has Subchapter C E&P of $100,000 for termination purposes. The provisions under R&TC section 23801(a)(2)(C) specifically state that the federal "look-back" rules apply for the imposition of the ENPI tax and are silent regarding application for termination purposes.

Example D

ABC, Inc. incorporated on 7/1/82 and made a valid federal S election on the same date. It filed as a California S corporation beginning in IYE 12/89.
On 1/1/89, ABC had California Subchapter C E&P of $100,000.

the ENPI tax until such time as full distribution has been made of the $100,000.

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070600 CONSENT DIVIDENDS

A California S corporation with Subchapter C E&P may eliminate the E&P by distributing consent dividends to the shareholders after the close of the taxable year. The elimination of E&P negates the effect of IRC section 1375 ENPI tax. Consent dividends, as provided in IRC section 1368(e)(3) and R&TC section 23811(e), decrease Subchapter C E&P after an S election is made.

A consent dividend is a hypothetical distribution that any shareholder who owns consent stock on the last day of the tax year of the corporation agrees to treat the distribution as an actual dividend. For the S corporation, consent stock means all of the stock outstanding because there is only a single class of stock allowed. Once the consent is filed, the amount specified as consent dividend is treated as though it were a cash dividend to the shareholder on the last day of the tax year, followed by the shareholder's immediate recontribution of the money to the corporation as paid-in-capital. (Treas. Reg. §1.1368-1(f)(3)) The consent dividend is taxable to the shareholders if the source of the payment is from Subchapter C E&P.

R&TC section 23811(e) allows the S corporation to amend its return after the Franchise Tax Board (FTB) issues the Notice of Proposed Assessment (NPA) on ENPI tax. Thus, even after receiving the ENPI NPA, the corporation may file an amended return to retroactively distribute Subchapter C E&P to shareholders. Once the consent dividend election is made, the S corporation would no longer be subject to the ENPI tax for the year. The following is an excerpt from R&TC section 23811(e) - Consent Dividends:

(1) In the case of a corporation which elects to be treated as an “S corporation” for purposes of this part for its first taxable year beginning in 1987, or for its first taxable year for which it has in effect a valid federal S election, there shall be allowed as a deduction in determining that corporation's Subchapter C earnings and profits at the close of any taxable year the amount of any consent dividend (as provided in paragraph (2)) paid after the close of that taxable year.

(2) In the event there is a determination that a corporation described in paragraph (1) has Subchapter C earnings and profits at the close of any taxable year, that corporation shall be entitled to distribute a consent dividend to its shareholders. The amount of the consent dividend shall not exceed the difference between the corporation's Subchapter C earnings and profits determined under subdivision (d) at the close of the taxable year with respect to which the determination is made and the corporation's Subchapter C earnings

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and profits for federal income tax purposes at the same date. A consent dividend must be paid within 90 days of the date of the determination that the corporation has Subchapter C earnings and profits. For this purpose, the date of a determination means the effective date of a closing agreement pursuant to R&TC Section 19441, the date an assessment of tax imposed by this section becomes final, or the date of execution by the corporation of an agreement with the FTB relating to liability for the tax imposed by this section. For purposes of Part 10 and this part, a corporation must make the election provided in IRC Section 1368(e)(3) for any consent dividend.

As the excerpt from the CA statute states, the S corporation must distribute the consent dividend within 90 days after the determination date. The determination date is deemed to be the effective date of a closing agreement with the Franchise Tax Board, the date an assessment of Bank and Corporation tax becomes final, or the date the corporation executes an agreement with the FTB relating to the ENPI tax liability (R&TC §23811(e)(2)). In other word, the termination date is the date on which the FTB issues an ENPI NPA.

A corporation that distributes a consent dividend must reduce Subchapter C E&P by filing an amended return with the FTB within 120 days after the determination date. The collection of the ENPI tax stays for 120 days after the date of determination, whether or not the corporation files an amended return. If the corporation files an amended return with the FTB, the collection of the tax stays until the FTB acts on the amended return. (See R&TC §23811(e)(3) through (e)(5).)

In addition, in order to elect consent dividend treatment, the corporation must make the election provided in IRC section 1368(e)(3). Under IRC section 1368(e)(3), an S corporation, with the consent of all affected shareholders, is allowed to make distributions from its Subchapter C E&P, before making distributions out of the AAA. Any remaining portion of the distribution is treated as a distribution from an S corporation that has no earnings and profits in the manner provided in IRC section 1368(b)(3). (See R&TC §23811(e)(2), last sentence.)

Basically, the above provisions cure the corporation's federal and California Subchapter C E&P balance discrepancies that were caused by the corporation's delaying the California S election. (See the second sentence of R&TC §23811(e)(2).)

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Example A

ABC, Inc., incorporated in 1977, makes a valid federal S election in 1986.

has $1,000,000 California Subchapter C E&P and $50,000 federal Subchapter C E&P. Assuming there are no future adjustments to either California or federal Subchapter C E&P, the amount of consent dividend ABC may make for California purposes is up to $950,000 ($1,000,000 - $50,000) per R&TC section 23811(e)(1). The amount of consent dividend ABC may make for federal purposes is up to $50,000 per IRC section 1368(e)(3).
On 3/31/91, ABC makes a consent dividend of $50,000 for federal and $400,000 for California purposes, reducing ABC's California Subchapter C E&P to $600,000 ($1,000,000 - $400,000) and federal Subchapter C E&P to zero. After making the consent dividend, ABC's remaining allowable consent dividend is $550,000 ($950,000 - $400,000) for California purposes and zero ($50,000 - $50,000) for federal purposes.
On 12/31/92, ABC distributes $600,000 from California Subchapter C E & P. Of the $600,000 distributions, $550,000 is treated as a consent dividend for California purposes. The remaining $50,000 is dividends distributions from California Subchapter C E&P.

Example B

ABC is an S corporation that supplies widgets. ABC does business only in California. ABC has $40,000 federal Subchapter C E&P and $60,000 California Subchapter C E&P. ABC's current year earnings are $200,000, increasing the AAA ending balance to $220,000. ABC decides to eliminate its Subchapter C E&P by making an IRC section 1368(e)(3) election and distributes $100,000 to its shareholders. Of the $100,000 distributions, $40,000 must be treated as dividend distributions from Subchapter C E&P and dividend income by the shareholders. For California purposes, the S corporation may elect to make a $20,000 ($60,000-$40,000) consent dividend distribution in addition to the $40,000 dividend distributions. The consent dividend is allowed because the S corporation made an IRC section 1368(e)(3) election at the federal level. The income reportable by the shareholders for California purposes is $260,000 ($200,000 + $40,000 + $20,000).
Assume that ABC has been an S corporation from inception for federal purposes. Assume also that the California S election was made in 1990, after the "relation back" provision had expired. The California consent dividend provision is not available to the S corporation because the corporation does not make an IRC section 1368 (e)(3) election for federal purposes. However, the S Corporation will

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not be assessed ENPI tax under R&TC section 23811(a), which provides that the ENPI tax will not be imposed on an S corporation that has no ENPI for federal purposes.

As shown above, existing S corporations with passive income can avoid the ENPI tax and Revocation (discussed in S Corp 070700) by distributing their Subchapter C E&P as a taxable dividend to shareholders. Because both the ENPI tax and Revocation rules look to Subchapter C E&P "at the close" of the taxable year, distributions made during the taxable year can eliminate passive income problems, as long as Subchapter C E&P have been completely eliminated by the close of the year. (See IRC §§1362(d)(3)(A)(i)(I) and 1375(a)(1); and Treas. Reg.§ 1.1375-1(a).)

For purposes of applying IRC section 1375(a), Accumulated E&P at the close of the year is reduced by the liquidating distributions under IRC section 312. Accordingly, a corporation that liquidates by distributing all of its property to shareholders eliminates any ENPI problems in an S corporation's last year. See LTR 9747035 (corporation's final taxable year closes after the liquidating distribution). The liquidation is governed by IRC section 331, <u>not</u> IRC section 301 or section 1368.

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070700 S CORPORATION REVOCATION DUE TO ENPI

The IRC provides a passive investment income limitation for an S corporation that possesses accumulated E&P from years in which the entity was a C corporation. If such a corporation has passive investment income in excess of 25% of its gross receipts for three consecutive taxable years, the S election is terminated as of the beginning of the fourth year. (See IRC §1362(d)(3)(A)(ii).) Even if the tax is *not* assessed due to various limitations noted above, the corporation's S election may be revoked if the corporation has three consecutive tax years of gross passive investment income exceeding 25% of gross receipts.

There may be instances where the S corporation is subject to the tax for California purposes, but no tax is assessed because it failed to be subject to tax under federal provisions. In this situation, each year (in which the S corporation would have paid the tax, had it not been for federal provisions) counts as one year in regards to revocation. The S Corporation has ENPI whether or not the ENPI tax is imposed; therefore, a logical reading of R&TC section 23811(a) is that the S Corporation could be subject to the termination provisions.

Example A

For 1994, 1995, and 1996, XYZ Corporation, a calendar year S corporation, derived passive investment income in excess of 25% of its gross receipts. If XYZ holds accumulated E&P from years in which it was a C corporation, its S election is terminated as January 1, 1997.

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070800 EFFECT ON BUILT-IN GAINS TAX

Passive investment income that is subject to the ENPI tax could also be subject to the built-in-gains tax. To prevent the imposition of more than one corporate level tax on the same income, passive investment income is determined by excluding recognized built-in-gains and losses for any year during the ten-year recognition period. **(**See IRC §1375(b)(4).)

Example A

$500. X elects S status for Year 2. During Year 2, X sells the stock for $1,200. X's passive investment income is $200 ($700 gain on the stock minus the $500 that is a recognized built-in gain).

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070900 EXHIBITS

Exhibit 070000-1	Federal Statute, IRC section 1375
Exhibit 070000-2	California Statute, R&TC section 23811
Exhibit 070000-3	Federal Regulations, Treas. Reg. section 1375-1
Exhibit 070000-4	Federal Statute, IRC section 1362(d)
Exhibit 070000-5	Computing the Tax on ENPI
Exhibit 070000-6	Sample Problem and Solution

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080000 DISTRIBUTIONS/ACCUMULATED ADJUSTMENTS ACCOUNT (AAA)

S Corp 080100 The Accumulated Adjustments Account (AAA)
S Corp 080200 The Importance of the Accumulated Adjustments Account
S Corp 080300 Do I Have an AAA Issue?
S Corp 080400 Items Affecting AAA (IRC §1368(e), IRC §1367)
S Corp 080500 AAA Ordering Rules
S Corp 080600 Taxability of Distributions (IRC §1368(a), (b), (c))
S Corp 080700 Distributions Which Bypass AAA (IRC §1368(e)(3), R&TC §23811(e))
S Corp 080800 Other Adjustments Account and Schedule M-2
S Corp 080900 Miscellaneous Items
S Corp 081000 Exhibit

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080100 THE ACCUMULATED ADJUSTMENTS ACCOUNT (AAA)

The Accumulated Adjustments Account (AAA) is an account of the S corporation before considering shareholder basis and/or subchapter C earnings and profits. The S corporation maintains the AAA to track undistributed income that has been taxed during the period its S election is in effect. (Treas. Reg. §1.1368-2(a))

It is not mandatory to track AAA if the S corporation does not have subchapter C corporation earnings and profits. (Internal Revenue Code (IRC) §1368(b)) However, it may be beneficial to those corporations to maintain the AAA for future purposes. For example, if a corporation with subchapter C earnings and profits is acquired through merger, the S corporation acquires the AAA of the merged corporation as well as its subchapter C earnings and profits. The taxability of future distributions is computed using the combined AAA. (IRC §381(c)(2) and Treas. Reg. §1.1368-2(d)(2))

The auditor should prepare AAA schedules for **all** S corporations regardless of whether the S corporation has subchapter C earnings and profits.

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080200 THE IMPORTANCE OF THE ACCUMULATED ADJUSTMENTS ACCOUNT

The importance of AAA is to determine the taxability of distributions at the shareholder level. AAA (to the extent of basis) can be distributed to the shareholders free of further tax at the individual level. If distributions exceed AAA and S Corporation has subchapter C earnings and profits, the excess is applied to reduce any subchapter C earnings and profits remaining at year-end. Distributions from subchapter C earnings and profits are taxable as dividend distributions to the shareholder(s). (IRC §1368(c)(2)) However, if the S corporation does not have subchapter C earnings and profits, then distributions from AAA are not taxable to the extent of shareholder stock basis (IRC §1368(b)(1)). But, to the extent the distribution exceeds shareholder stock basis, the excess is treated as a capital gain (IRC §1368(b)(2)).

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080300 DO I HAVE AN AAA ISSUE?

In general, adjustments are made to both the shareholder basis and AAA for items of income (losses). (IRC §1368(e)(1)(A)) If aggregate adjustments are positive, the shareholder is not taxed on this amount when actually distributed. In other words, if the distribution is not in excess of the AAA at the time of distribution, it is nontaxable to the shareholder as long as distribution does not exceed shareholder basis.
The following are common situations in which AAA may be an audit issue.

- On the S corporation return, AAA would be an audit issue if the S corporation, having subchapter C earnings and profits, made distributions during the year that may be in excess of AAA. This information can be found on Schedules K, K-1, and M-2. Schedule M-2 should provide the most information in regards to this issue. If the distribution is greater than the AAA balance before distributions and the S corporation had subchapter C earnings and profits, you may have an AAA issue. (Note: Schedule M-2 contains a check box for subchapter C earnings and profits. Reporting trends have identified that this box is not consistently checked when subchapter C earnings and profits exist. Do not assume the corporation has no subchapter C earnings and profits if this box is not checked.)

  On the other hand, if the S corporation does not have subchapter C earnings and profits, then AAA does not become an issue. Instead, the taxability of the distributions made by the S corporation is determined by the adjusted basis of the shareholder's stock (IRC §1368(b)).

- In California Revenue and Taxation Code (R&TC) section 23800(a), S corporation tax treatment is determined in accordance with Subchapter S of the IRC, except as otherwise provided. Within R&TC, there are no special provisions for AAA. Therefore, California follows federal law for maintaining AAA. Treas. Reg. section 1.1368-2(a) states, "On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero." Because California did not recognize S corporations until 1987, there are many instances when federal and California S election dates will be different. As a result, the AAA balance will also be different for federal and California purposes. Auditors should always verify that the AAA they are working with is that of California.

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- In addition, California AAA is always different from federal AAA due to federal/state differences such as franchise taxes, depreciation, etc. Compare the federal and California AAA balances to determine whether the corporation made the proper California adjustments.

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080400 ITEMS AFFECTING AAA (IRC §1368(E), IRC §1367)

S Corp 080401 Pro-Rata Distributive Share Items That Increase AAA
S Corp 080402 Pro-Rata Distributive Share Items That Decrease AAA

IRC section 1368(e)(1) defines the Accumulate Adjustments Account as follows:

Except as otherwise provided in this paragraph, the term "accumulated adjustments account" means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under IRC section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase "(but not below zero)" shall be disregarded in IRC section 1367(b)(2)(A)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

IRC section 1367 refers to adjustments to shareholder stock basis whereas IRC section 1368(e)(1)(A) refers to adjustments to AAA. Differences between adjustments to shareholder stock basis and AAA are:

- AAA, unlike basis, cannot be increased for tax-exempt income.
- AAA, unlike basis, cannot be decreased for expenses related to tax-exempt income.
- AAA, unlike basis, cannot be decreased for federal taxes attributable to any taxable year in which the corporation was a C corporation.
- AAA, unlike basis, can go below zero.

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080401 Pro-Rata Distributive Share Items That Increase AAA

IRC section 1368(e)(1)(A); by reference section 1367(a)(1)	Also Known As	Specific Income Items
(A) Items of income (**excluding tax-exempt income**), the separate treatment of which could affect the liability for tax of any shareholder.	Separately stated items	• Rental income, real estate and other. • Interest and dividend income. • Royalties. • Capital gains. • Other portfolio income. • IRC section 1231 gain. • Other income.
(B) Nonseparately computed income.	Nonseparately stated items	Schedule K-1: Ordinary income from trade or business activities.
(C) The excess of deductions for depletion over the basis of the property subject to depletion.		

In *Heller v. Franchise Tax Board*, (1994) 21 Cal. App. 4th 1730, the Third Circuit Court of Appeals overturned the department's position that tax-exempt interest income is not included in AAA. The issue addressed whether AAA is based on corporate level taxability. The taxpayer argued that it reported T-bill interest as taxable S corporation income and paid taxes accordingly at the corporate level, therefore, AAA should be increased. The department will follow the *Heller* decision and apply it in situations with tax-exempt interest. Therefore, any tax-exempt **interest** income received by an S corporation will increase AAA (distinguishable from federal). However, any **other** source of tax-exempt income will not increase AAA. (IRC §1368(e)(1)(A))

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080402 Pro-Rata Distributive Share Items That Decrease AAA

IRC Section 1368(e)(1)(A); by reference Section 1367(a)(2)	Also Known As	Specific Income Items
(A) Distributions by the corporation that were not includible in the income of the shareholder by reason of section 1368.	Return of capital distributions	
(B) Items of loss or deduction, the separate treatment of which could affect the liability of any shareholder.	Separately stated items	• Rental losses, real estate and other. • Capital losses. • Charitable contributions. • Political contributions. • Expense deductions for recovery property. • Deductions related to portfolio income (loss). • Other deductions. Note: Credits are not an item of loss or deduction.
(C) Nonseparately computed loss.	Nonseparately stated items	Schedule K-1: Ordinary loss from trade or business activities.
(D) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account.	Noncapital, nondeductible expenses	Treas. Reg. section 1.1368-2(a)(3)(i)(C) • Nondeductible portion of meals and entertainment expenses. • Wages that are nondeductible because of targeted jobs tax credit. • Research and development expenditures that are not deductible

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		because of the R&D credit. • Nondeductible fines and penalties. • Nondeductible life insurance premiums. • Nondeductible franchise tax. These include only those items for which no loss/deduction is allowable and do not include items the deduction for which is deferred to a later taxable year.
(E) The amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under IRC section 613A(c)(11)(B).		

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080500 AAA ORDERING RULES

Like shareholder basis, AAA is adjusted on the last day of the taxable year. Prior to January 1, 1997, the ordering rules for the adjustments (Treas. Reg. §1.1368-2(a)(4)) are as follows:

- Items that increase shareholder basis except tax exempt income increases AAA;
- Items that decrease shareholder basis except tax exempt deductions and distributions decreases AAA;
- Ordinary distribution decreases AAA;
- Redemption distribution can increase or decrease AAA.

The only time AAA balance cannot go below zero is from ordinary distributions (IRC §1368(b) or (c)(1), whichever is applicable).

Note 1: The examples used in the Shareholder Basis (S Corp 090000) and Distributions/Accumulated Adjustment Account (AAA) (S Corp 080000) are simplified. They have not been computed on a per day, per share basis as in the Treas. Reg. examples. If you have situations that have multiple stock purchase days, please be aware you need to compute the basis/AAA on a per day, per share basis.

Example A (Prior to 1/1/97)

		AAA
1.	Beginning Balance	
2.	Ordinary Income	
	Subtotal	
3.	IRC section 1231 Loss	
4.		-$700,000

Unlike shareholder basis, the IRC section 1231 Loss was allowed to reduce AAA below zero.

Example B (Prior to 1/1/97)

1.	Beginning Balance	
2.		100,000
	Subtotal	100,000

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3.	IRC section 1231 Loss	-900,000
4.	Subtotal before Distributions	
5.	Distributions ($500,000)	
6.		-$800,000

No portion of the $500,000 distribution would reduce AAA.

The ordering rules for the adjustments to AAA changed for taxable years on or after August 18, 1998.

The new ordering rules were the same as the old rules unless the S corporation had a "net negative adjustment." A "net negative adjustment" is defined as the excess (if any) of the **negative adjustments** over the **positive adjustments** to AAA without considering the distributions (IRC §1368(e)(1)(C)(ii)). If the S corporation does have a "net negative adjustment", then the ordering rules for the adjustments (Treas. Reg. §1.1368-2(a)(4)) are as follows:

- Items that increase shareholder basis except tax exempt income increases AAA;
- Items that decrease shareholder basis except tax exempt deductions, "net negative adjustment", and distributions decreases AAA;
- Ordinary distribution decreases AAA;
- Net negative adjustment decreases AAA;
- A redemption distribution decreases AAA.

Example C After 8/18/1998 with Net Negative Adjustment

1.	Beginning Balance	$100,000
2.	Ordinary Income	100,000
3.	IRC section 1231 Loss -900,000	-100,000
	Subtotal	100,000
4.	Net Negative Adjustment	-$800,000
5.	Ending Balance	-$700,000

In this example, the shareholder could have received a “tax free” distribution of $100,000 before taking into consideration the net negative adjustment, (subject to basis limitations). If the shareholder had taken the distribution, the ending balance in the AAA would be –800,000.

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Example D After 8/18/98 with Net Negative Adjustment

1.	Beginning Balance	$0
2.	Ordinary Income	100,000
3.	IRC section 1231 Loss -900,000	-100,000
	Subtotal	0
4.	Distributions ($500,000)	
5.	Net Negative Adjustment	-$800,000
6.	Ending Balance	-$800,000

No portion of the $500,000 distribution would reduce AAA.

Example E After 8/18/98 with No Net Negative Adjustment

1.	Beginning Balance	$0
2.	Ordinary Income	400,000
	Subtotal	400,000
3.	IRC Section 1231 Loss	-100,000
4.	Subtotal before Distributions	$300,000
5.	Distributions ($500,000)	-300,000
6.	Ending Balance	-$0

The portion of the $500,000 distribution from AAA was $300,000. Taxability of the remainder $200,000 distribution would follow the rules in IRC section 1368 by reference from IRC section 1368(c)(3). Note that the result is the same for taxable years prior to 1/1/1997 because there are no "net negative adjustments".

Example F After 8/18/97

ABC, Inc., a federal and California S corporation, reported the following “net negative adjustment” for federal purposes in IYE 12/97:

Interest income	$10,000
Capital gain	100,000
Ordinary loss from trade or business activities	-500,000
Charitable contributions	-10,000
Net negative adjustment	-400,000

ABC reported a beginning federal AAA balance of $150,000 and made distributions totaling $350,000 in IYE 12/97. ABC would compute its AAA as

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follows:

1.	Beginning Balance	$150,000
2.	Distribution ($350,000)	-150,000
	Subtotal	0
3.	Net negative adjustment	-400,000
4.	Ending Balance	-$400,000

ABC disregarded its "net negative adjustment" and reduced AAA first by the distribution not in excess of AAA ($150,000). The AAA was then reduced by the "net negative adjustment" (-$400,000) to bring the AAA balance below zero. Taxability of the remainder $200,000 distribution ($350,000 - $150,000) would follow the previous ordering rules in IRC section 1368 by reference from IRC section 1368(c)(3).

Note that there is a gap between the effective date of the amendments to IRC section 1368 of (taxable years beginning after 12/31/96) and the effective date of the final regulations on ordering rules for adjustments to AAA (8/18/1998). Treas. Reg. section 1.1368-4 provides a transitional rule where the S corporation can apply a reasonable method, taking into account the statute and legislative history for the period January 1, 1997 to August 18, 1998. Thus, during this gap, either of the two ordering rules would be allowed.

Furthermore, the ordering rules for AAA and shareholder basis are different. Thus, the auditor should review the following chapter, Shareholder Basis (S Corp 090000), for a comparison.

The new ordering rules allow the S corporation to disregard any "net negative adjustment" for such taxable year. A "net negative adjustment" is the excess (if any) of

- The reductions in the account for the taxable year (other than for distributions), or
- The increases in such account for such taxable year.

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080600 TAXABILITY OF DISTRIBUTIONS (IRC §1368(A), (B), (C))

A shareholder may report income on the distributions made by the S corporation. The character of the income to the shareholder (ordinary income versus capital gain) will depend on the applicability of AAA in conjunction with subchapter C earnings and profits or shareholder basis. If the S corporation has subchapter C earnings and profits, then to the extent distributions are taken from subchapter C earnings and profits, the income is ordinary and reported as dividend income on Schedule B. Distributions can be taken from subchapter C earnings and profits from the distribution ordering rule below or S corporation may elect with the consent of all shareholders to make distributions directly from subchapter C earnings and profits (IRC §1368(e)(3)).

However, if the S corporation does not have subchapter C earnings and profits, then the taxability of the distribution depends on the amount of shareholder stock basis not AAA (See S Corp 090000 - Shareholder Basis). This is the reason that the statute does not require AAA be maintained if an S corporation does not have subchapter C earnings and profits (IRC §1368(b)). Further, the income, when the distribution is compared against shareholder stock basis, is capital because the excess of the distribution over stock basis is considered a sale or exchange of property (IRC §1368(b)(2)).

Distributions are taxable in this general order:

S Corporations With E&P

Nontaxable to the extent AAA is zero as long as the distribution does not exceed basis.
If stock basis is zero and AAA is still positive, then capital gain to the extent the distribution exceeds stock basis.
If AAA is zero, dividend to the extent of subchapter C earnings & profits.

S Corporations Without E&P

Nontaxable return of capital to extent of remaining stock basis.
Capital gain to the extent stock basis exceeded.

Example A	Distribution	AAA	Subchapter C Earnings	Stock Basis

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				& Profits		
Balance before distribution		$30,000		$30,000		$25,000
Distribution	100,000	25,000	(a)	30,000	(c)	-25,000
Subtotal		5,000		0		0
Capital Gain		-5,000	(b)			
Ending Balance		$0		$0		$0

(a) Nontaxable to the extent AAA and stock basis not exceeded, $25,000.
(b) Capital gain to the extent AAA not exceeded, but stock basis exceeded, $5,000.
(c) Dividend to the extent of C corporation earnings & profits, $30,000.
(d) Nontaxable return of capital to extent of remaining stock basis, $0.
(e) Remaining balance is capital gain, $40,000 (100,000 - 25,000 - 5,000 - 30,000).

The shareholder would report the following per return:

a. Dividend, $30,000, to Schedule B.
b. Capital gain, $45,000 (5,000 + 40,000), to Schedule D.

Note

1. The $25,000 distribution from AAA is nontaxable and will not appear on the shareholder's return
2. In most instances, stock basis is higher than AAA.

Treas. Reg. section 1.1368-1(b) states that a "distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder." Therefore, AAA is adjusted in the year the S corporation makes the distribution, regardless of when the distribution was declared by the S corporation or the shareholder that received the distribution. Furthermore, in general, distributions made during the taxable year are deemed to have been made at the end of the tax year because adjustments to distributions cannot be made until after income adjustments for basis, which occurs at the end of the tax year (IRC §1367).

Example B After 8/18/97

Distribution when there are Subchapter "C" Earnings and Profits (AE&P) and no "Net Negative Adjustment". Further, S corporation does not make an IRC section 1368(e)(3) election to distribute AE&P first.

		AE&P	Stock Basis
Beginning Balance	$200,000	$100,000	$200,000
Ordinary Income	200,000		200,000
Subtotal			400,000
Non-taxable distribution 150,000			-150,000
IRC section 1231 Loss	-150,000		150,000
Subtotal before distribution	250,000		

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Distribution	-150,000		
End of Year Balance	$100,000	$100,000	$100,000

No part of the distribution is from AE&P.
The S corporation could have made a "tax free" distribution from AAA of $250,000 without getting into AE&P. Refer to S Corp 090000 - Shareholder Basis for ordering rules.

Example C Treas. Reg. Section 1.1368-1(e) After 8/18/97

Distribution by S corporation with AE&P and a "Net Negative Adjustment". Further, S corporation does not make an IRC section 1368(e)(3) election to distribute AE&P first.

	AAA	AE&P	Stock Basis
Beginning Balance	$200,000	$100,000	$200,000
Ordinary Income	200,000		200,000
Subtotal			400,000
IRC section 1231 Loss – 350,000	-200,000		
Subtotal before distribution	200,000		
Distribution –250,000	-200,000	-50,000	-200,000
Subtotal	0	50,000	200,000
Net negative adjustment	-150,000		
IRC section 1231 Loss			-200,000
End of Year Balance	-$150,000	$50,000	$0

The taxpayer has suspended losses of $150,000.
$50,000 of the distribution is from AE&P, which is subject to dividend income to the shareholder.
Refer to S Corp 090000 - Shareholder Basis for ordering rules.

Example D After 8/18/97

Distribution by S corporation without AE&P.

	AAA	Stock Basis	Loss Suspended
Beginning Balance	$100,000	$10,000	
Ordinary Income	50,000	50,000	
Subtotal		60,000	
IRC section 1231 Loss	-30,000		

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Subtotal before distribution	$120,000		
Distribution	-40,000	-40,000	
Subtotal		20,000	
IRC section 1231 Loss		-20,000	-10,000
End of Year Balance	$80,000	$0	-$10,000

Refer to S Corp 090000 - Shareholder Basis for ordering rules.

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080700 DISTRIBUTIONS THAT BYPASS AAA (IRC §1368(E)(3), R&TC §23811(E))

The most favorable distribution to an S corporation shareholder is a nontaxable distribution from AAA. However, there are certain situations when taxable distributions from subchapter C earnings and profits are more desirable. Thus, the S corporation with the consent of all shareholders makes IRC section 1368(e)(3) elections to distribute out of subchapter C earnings and profits.

- The corporation is vulnerable to involuntary termination of its S election due to excess passive investment income (IRC §1362(d)(3)). The threat of termination applies only if the S corporation has excess passive investment income at the end of the third consecutive year. (See S Corp 070000 - Excess Net Passive Income Tax).
- The corporation is subject to excess net passive income tax (IRC §1375, R&TC §23811). The tax applies only if the corporation has subchapter C earnings and profits.
- The shareholder has losses on the Personal Income Tax (PIT) return that can be utilized if offset by income.
- The shareholder has investment interest expenses that cannot be deducted unless the shareholder reports investment income, etc.

IRC section 1368(e)(3) provides that a corporation may make an election to distribute subchapter C earnings and profits before AAA <u>on the return</u>. The election has to be made and attached to the return (refer to the Federal Package X or California Form 100S Instructions). (Treas. Reg. §1.1368-1(f)) There are three methods in which to make the election.

- Election to distribute subchapter C earnings and profits first. The corporation can make an actual distribution from subchapter C earnings and profits first and issue a 1099-DIV to each shareholder. The shareholders report the taxable dividends on their individual returns.
- Election to make a deemed dividend distribution. A deemed dividend distribution is treated as if it were a pro rata distribution of money to the shareholders, received by the shareholders, and immediately contributed back to the corporation all on the last day of the income year.
- Election to forgo Previously Taxed Income (PTI). This is a federal provision for tax years prior to the Subchapter S Reform Act of 1982, therefore, does not apply for California purposes.

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Any election stated above is **irrevocable** and applies only for the tax year for which the election was made. The S corporation must attach the election statement to the **original** or **amended** return and all affected shareholders must consent to the election.

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080800 OTHER ADJUSTMENTS ACCOUNT AND SCHEDULE M-2

The Other Adjustment Account (OAA) is used as a reconciliation account. The OAA is used to determine basis where nontaxable events have occurred. Tax-exempt income and expenses are the most common items contained in the OAA. These items increase basis but not AAA, with the exception of tax-exempt interest income pursuant to the *Heller vs. Franchise Tax Board* decision.

Schedule M-2 (AAA) is an important area to check when scoping the S corporation return. Reporting trends have identified that corporations do not properly account for taxable vs. nontaxable distributions on this schedule. During scoping, compare Schedule M-2 distributions with those reported on Schedules K and K-1 to determine, with more confidence, the taxable and nontaxable portions of the distribution. In the Federal Package X, Form 1120S, Schedule M-2, Column (b) and the related instructions is the only reference to the OAA. It is not mentioned in Subchapter S or the regulations promulgated under Subchapter S.

Request copies of the S corporation's AAA schedules if not provided on the tax return. Compare these schedules with those computed per audit. Any material discrepancies should be discussed with the taxpayer.

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080900 MISCELLANEOUS ITEMS

- The AAA is a corporate-level account. If a shareholder disposes of his shares to another shareholder, the succeeding shareholder can receive a distribution out of the prior AAA balance, even though the succeeding shareholder may not have reported any distributive share income that generated prior AAA balance. This is different from basis whereby basis attaches to the shareholder. When a shareholder disposes of his shares, the succeeding shareholder cannot carry over the prior shareholder's basis. Instead, the succeeding shareholder's basis is his cost in acquiring the stock.
- Cash distributions during the post-termination transition period are nontaxable to the extent of the ending balance of AAA (but limited to the shareholder's stock basis). The post-termination transition period generally begins on the day after the corporation's last day of S status and ends on the later of (1) one year after such last day or (2) the due date (including extensions) of that year's tax return. (IRC §1371(e)(1))
- The regulations under IRC section 1368 also provide a new election to split the tax year in two in case of a "substantial stock disposition." If a shareholder disposes of 20% or more of the corporation's issued stock in one or more transactions with any 30 day period during the corporation's tax year, the corporation can elect to treat the tax year as if it consists of separate years (for purposes of allocating income and loss, adjusting AAA, basis, and subchapter C earnings and profits, and determining the taxability of distributions). (Treas. Reg. §1.1368-1(g)(1))
- If an S corporation is not paying a "reasonable" salary to a shareholder-employee, distributions to that shareholder may be recharacterized as wages subject to payroll taxes. (Treas. Reg. §1.1361-1(l)(2)(vi))
- Disproportionate distributions, constructively or actually made, may result in a deemed second class of S corporation stock if the distributions are designed to defeat the one class of stock rule. (Treas. Reg. §1.1361-1(l)(2)(i))

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081000 EXHIBIT

Exhibit 080000-1 A checklist of the items affecting stock basis and the AAA. Adjustments to basis, AAA, and subchapter C earnings and profits during the Post-Termination Transition Period.

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090000 SHAREHOLDER BASIS

S Corp 090100	Importance of Computing Shareholder Basis
S Corp 090200	Scoping a Shareholder Basis Issue
S Corp 090300	Initial Stock Basis
S Corp 090400	Items Affecting Shareholder Basis
S Corp 090500	Shareholder Basis in Indebtedness
S Corp 090600	Rules For Computing Stock And Debt Basis
S Corp 090700	Loan Repayments on Reduced Debt Basis
S Corp 090800	Application of the Basis Rules
S Corp 090900	Election To Divide The Taxable Year
S Corp 091000	Nonliquidating Stock Sales/Dispositions - Computing Gain (Loss), Treatment of Suspended Losses & Unrestored Debt Basis
S Corp 091100	Complete Liquidation - Computing Gain (Loss)
S Corp 091200	Post Termination Transition Period
S Corp 091300	Interaction between Suspended Losses and Net Operating Loss Carryovers.
S Corp 091400	Alternative Minimum Tax & Suspended Losses
S Corp 091500	Information Document Requests
S Corp 091600	Audit Techniques

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090100 IMPORTANCE OF COMPUTING SHAREHOLDER BASIS

Note: The examples used in S Corp 090000 (Shareholder Basis) and S Corp 080000 (Distributions/AAA) are simplified. They have not been computed on a per day, per share basis as in the Treas. Reg.' examples. If you have situations that have multiple stock purchase days, please be aware you need to compute the basis/AAA on a per day, per share basis.

- To determine the amount of losses and deductions allowed to be recognized currently.
- To determine the taxability of distributions from the S corporation.
- To determine the taxability of debt repayments.
- To determine the gain (loss) on stock redemption/disposition.

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090200 SCOPING A SHAREHOLDER BASIS ISSUE

It is imperative that the corporate folder and all returns filed by the shareholder(s) be obtained before selecting the basis issue for an audit. With the exception of stock redemptions/dispositions, the basis issue is a timing difference issue.

Example A

Note: During scoping it may be difficult to locate flow-through losses (generated by S corporation) on each shareholder's tax return. It is because certain loss items may be limited by various limitations.
Schedule K-1 items should be traced to each shareholder's return. Recognized losses and deductions may have already been limited due to shareholder basis, at-risk, passive activity losses, capital loss, charitable contributions, and similar limitations.

Schedule K-1 charitable contribution	$1,000,000
Shareholder basis limitations applied	400,000
Federal AGI limitations applied	3,000

The S corporation generated a pass-through charitable contribution of $1,000,000. The shareholder recognized only $3,000 per Schedule A after applying the shareholder basis and federal AGI limitations.

Example B

Even with a beginning basis of zero, the shareholder is allowed to recognize losses/deductions equal to his/her current distributive income items.

Beginning shareholder basis	$0
Interest income per Schedule K-1	600,000
Ordinary loss per Schedule K-1	-1,000,000

The shareholder would report $600,000 interest income on Schedule B and is entitled to an offsetting loss of -$600,000 on Schedule E.
If the shareholder reported a loss in excess of -$600,000 on Schedule E, the maximum audit adjustment would be the amount in excess of the -$600,000.

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090300 INITIAL STOCK BASIS

Internal Revenue Code (IRC) section 1367(a)(1)-(2) (R&TC §23804) provides for adjustments to the basis of shareholder stock in an S corporation. It does not address initial stock basis. IRC section 1371(a) (R&TC §23806) -- Coordination with Subchapter C, remedies this problem by requiring application of subchapter C provisions when there are no provisions under subchapter S.

Initial stock basis is determined under the general basis rules beginning with IRC §§ 1011 and 1012. For your convenience, a list of general rules follows:

How Stock is Acquired	How Basis is Determined
Purchase	If the shares were purchased outright, initial basis is the cost of the shares.
S corporation capitalized	If the shares were received when the S corporation was capitalized under IRC section 351, the basis in the stock is equal to the basis of the property transferred to the corporation, reduced by the amount of property received from the corporation, increased by gain recognized on the transfer, and decreased by any boot received (IRC §358).
Prior C corporation	Initial basis in S corporation stock is the basis in the C corporation stock at the time of conversion.
Gift	The recipient's basis in shares received by gift is generally the donor's basis (IRC §1015). Suspended passive activity losses can increase the basis of a gift (IRC §469(j)(6)).
Inheritance	The basis of inherited stock is its fair market value at the date of death, or, if elected, the alternate valuation date (IRC §1014).
Services rendered	Basis in stock received in exchange for services is measured by the stock's fair market value, rather than by the value of the services (Treas. Reg. §1.61-2(d)(2)).

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090400 ITEMS AFFECTING SHAREHOLDER BASIS

The basis adjustment rules under IRC section 1367 are similar to the partnership rules under IRC section 705. However, while a partner has a unitary basis in his partnership interest, the adjustments to the basis of stock of an S corporation are applied on a **separate share basis**.

S Corp 090401 Pro-Rata Distributive Share Items That Increase Stock Basis
S Corp 090402 Pro-Rata Distributive Share Items That Decrease Stock Basis
S Corp 090403 Items Not Affecting Stock Basis

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090401 Pro-Rata Distributive Share Items That Increase Stock Basis

IRC Section 1367(a)(1)	Also Known As	Specific Income Items
(A) Items of income (including tax-exempt income), the separate treatment of which could affect the liability for tax of any shareholder.	Separately stated items	• Rental income, real estate and other. • Interest and dividend income. • Royalties. • Capital gains. • Other portfolio income. • IRC section 1231 gain. • Tax-exempt income. • Other income. • Cancellation of Indebtedness (COD) Income. See *Gitlitz v. Commissioner* (2001) 531 U.S. 206 and AB1122 (Stats. 2002, Ch 35).
(B) Nonseparately computed income.	Nonseparately stated items	Schedule K-1: Ordinary income from trade or business activities.
(C) The excess of deductions for depletion over the basis of the property subject to depletion.		

Separately and nonseparately stated income items will adjust stock basis only if shareholders include them in gross income as reported on their individual income tax returns (if required to be reported). (IRC §1367(b)(1))

a. Tax-Exempt Income

The general rule of IRC section 1367(b)(1) does not apply to income that is not required to be included in gross income, such as tax-exempt interest income.

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b. IRC Section 108 COD Income

Caution: Congress passed a provision in January of 2002 to reverse the U.S. Supreme court's decision (explained below) and not permit shareholders to increase their basis in the S corporation's stock. The state law conforms to the new January 2002 federal provision.

The U.S. Supreme Court, reversing the 10th Circuit court, held in *Gitlitz* v. *Commissioner*, (2001) 531 U.S. 206, that the S Corporation's *excluded discharge of debt* is an item of income that passes through to the shareholders pursuant to IRC section 1366(a)(1)(A).

The cancellation of debt (COD) income increases the shareholder's stock basis before the tax attributes reduction takes place pursuant to IRC section 108(b)(4)(A).

Previously, the Franchise Tax Board (FTB) took a position consistent with the 10th Circuit Court, which states that the S Corporation's COD income does not pass through to the shareholder before reduction of tax attributes. FTB revised our position to conform to the U.S. Supreme Court decision to allow the S Corporation to pass the COD income to the shareholder and increase the shareholder's basis. The basis increase takes place at the time of the discharge (the year in which the COD income is incurred), and before the tax attributes reduction (the year following the discharge). This is the FTB's position for all years that the SOL is open. Treas. Reg. section 1.1366(a)(2)(viii) was recently amended to specifically state that the COD income is not tax-exempt income. Nevertheless, the U.S. Supreme Court decision holds that S Corporation COD income is an item of income for pass through purposes per IRC section 1366. Treas. Reg. section 1.1366(a)(2)(viii) no longer has a bearing on the COD income issue.

In summary,

- The S corporation COD income is "an item of income" for pass through purposes.
- The S corporation COD income will pass through to the shareholders.
- The S corporation COD income will pass through to the shareholders in the year of the discharge, prior to the tax attributes reduction under IRC section 108.
- The Supreme Court has considered that the taxpayer will receive the "double windfall" benefit. (TP incurred no payout but received basis). The Supreme

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Court indicated that the double benefit realized by the taxpayer was required by the plain text of the statute. Note that Congress is considering legislative changes that would have the effect of reversing the result of the decision in *Gitlitz v. Commissioner* (2001) 531 U.S. 206.

Note: See AB1122 (Stats. 2002, Ch. 35) for California conformity to the January 2002 federal provision that does not permit shareholders to increase their basis in the S corporatin's stock.

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090402 Pro-Rata Distributive Share Items That Decrease Stock Basis

IRC Section 1367(a)(2)	Also Known As	Specific Loss/Deduction
(A) Distributions by the corporation that were not includible in the income of the shareholder by reason of IRC section 1368.	Return of capital distributions	
(B) Items of loss or deduction, the separate treatment of which could affect the liability of any shareholder.	Separately stated items	• Rental losses, real estate and other. • Capital losses. • Charitable contributions. • Political contributions. • Expense deductions for recovery property. • Deductions related to portfolio income (loss). • Other deductions. Note: Credits are not an item of loss or deduction.
(C) Nonseparately computed loss.	Nonseparately stated items	Schedule K-1: Ordinary loss from trade or business activities.
(D) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account.	Noncapital, nondeductible expenses	• Illegal bribes, kickbacks, and other payments not deductible under IRC section 162(c). • Nondeductible portion of meals and entertainment expenses, under IRC section 274. • Income taxes attributable to the corporation's operations as a C corporation. • Wages that are

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		nondeductible because of targeted jobs tax credit. • Research and development expenditures that are not deductible because of the R&D credit. • Nondeductible fines and penalties, under IRC section 162(f). • Nondeductible interest expense, such as interest on a loan used to purchase tax-exempt securities, under IRC section 265. • Nondeductible life insurance premiums. • Nondeductible franchise tax. • Losses for which the deduction is disallowed under IRC section 267(a)(1). • The two-thirds portion of treble damages paid for violating antitrust laws not deductible under IRC section 162. These include only those items for which no loss/deduction is allowable and do not include items the deduction for which is deferred to a later taxable year.
(E) The amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent		

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such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under IRC section 613(c)(13)(B).		

a. Charitable Contributions

Charitable contributions decrease basis to the extent of the pass-through deduction, without reference to the contributed asset's basis. Shareholder basis is reduced by the fair market value of the asset contributed, regardless of any limitation on deductibility of the contribution applicable at either the S corporation or shareholder level. (IRC §§1367(a)(2) and 1366(a)(1)(A))

b. Life Insurance Premiums

Life insurance premiums paid by a corporation are not deductible if the corporation is the beneficiary of the policy and may decrease shareholder basis as noncapital, nondeductible expenses. (R&TC §24424(a)(1) and IRC §1367(a)(2)(D))

c. Loss/Deduction Amounts Used for Shareholder Basis v. Franchise Tax

Amounts contained on Schedules K and K-1 may differ from amounts reported in the determination of the S corporation's franchise tax liability. Capital losses, charitable contributions, passive activity losses, etc. are limited at the S corporation level for purposes of applying the 1.5% tax. Schedules K and K-1, however, should reflect 100% of income, loss, and deduction items generated currently by the S corporation.

Example A		
	S	Schedule K

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	Corporation Return Recognized (1.5% Tax)	
Capital Loss:		
Year 1 - Loss generated but limited	-$50,000	-$500,000
Year 2 - Carryover, limited	-150,000	0
Year 3 - Carryover, limited	-75,000	0
Year 4 - Carryover, recognized in full	-225,000	0
Total	-$500,000	-$500,000

In Year 1, Schedule K should reflect a separately stated capital loss of $500,000.

In Years 2-4, Schedule K should reflect no separately stated capital loss from the transaction generated in Year 1. If it does, the shareholder probably included the loss in his/her basis computation again. In this situation, you would have an audit adjustment to disallow any decreases to basis in excess of the $500,000 taken in Year 1.

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090403 Items Not Affecting Stock Basis

Transactions between the shareholder and S corporation are not items that increase (decrease) basis. Such transactions include:

- Salary from the S corporation Interest, rent, and royalty payments.
- Gain (loss) on the sale of property.
- Distributions from the S corporation treated as gains or dividends.
- Expenses paid on behalf of the S corporation by the shareholder.
- Interest paid by the shareholder to the S corporation relating to debt-financed stock acquisitions.

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090500 SHAREHOLDER BASIS IN INDEBTEDNESS

IRC section 1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under IRC section 1366(a) for any taxable year cannot exceed the sum of:

(A) the adjusted basis of the shareholder's stock in the subchapter S corporation, and
(B) the shareholder's adjusted basis of any indebtedness of the subchapter S corporation to the shareholder.

S Corp 090501 Concept of Indebtedness
S Corp 090502 Summary of Case Law

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090501 Concept of Indebtedness

While IRC section 1366 requires that the debt of the corporation run directly to the shareholder, form is only one part of the analysis under IRC section 1366. A shareholder must establish indebtedness of the S corporation to the shareholder. IRC section 1366 does not specifically set forth what constitutes “the shareholder’s adjusted basis of any indebtedness of the S corporation to the shareholder.” However, the report of the Senate committee on Finance accompanying prior legislation indicates that the purpose of that section is to limit the amount of a subchapter S corporation’s net operating loss that may be deducted by a shareholder to the “adjusted basis of the shareholder’s investment in the corporation.” (S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958))

In applying the concept of indebtedness to be comparable with actual capital investment by S corporation shareholders, courts have consistently held that "indebtedness of the S corporation to the shareholder" is meant to suppose an **actual economic outlay** by the shareholder that finds a shareholder poorer in a material sense after the transaction than when the transaction began. (See S Corp 090502(d) for details.) The determination of whether there is an **actual economic outlay** by a shareholder such that the shareholder is poorer in a material sense depends on the facts and circumstances of each case.

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090502 Summary of Case Law

Case law supports different results based on whether the obligee on the shareholder's note is a bank – an arms-length loan with a disinterested third party – or whether the shareholder has interjected himself as the middleman in several loan obligations between his controlled business entities.

a. Arm's Length Loans with Disinterested Third Parties and Shareholder Loan Guarantees

Through a succession of cases, courts have developed a rule that a shareholder has no basis in debt for purposes of IRC section 1366(d) where the shareholder merely guarantees an S corporation's debt or executes a surety agreement with respect to the corporation's debt. Only after the guarantor or surety performs on his contract of guaranty does the debtor's liability to the creditor become an indebtedness to the guarantor.

a1. Rev. Rul. 70-50, 1970-1 CB 178

An S corporation incurred net operating losses for two consecutive years and the shareholder's portion of the loss for the second year was greater than the adjusted basis of his stock in the corporation. In the third year, the corporation defaulted on a bank loan guaranteed by a shareholder. The shareholder paid the bank loan in satisfaction of his guarantee.

Although the shareholder's guaranty of the corporation's indebtedness did not create an indebtedness of the corporation to the shareholder, when the shareholder later paid the corporation's creditor in satisfaction of his guaranty, the corporation became indebted to the shareholder under the doctrine of subrogation.

a2. Rev. Rul. 71-288, 1971-2 CB 319

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Clarified Rev. Rul. 70-50 to provide that the indebtedness of the corporation to the shareholder arising in the third year upon payment by the shareholder under his guaranty did not relate back to the second year, and would not entitle the shareholder to deduct any portion of the corporation's losses in the second year in excess of the adjusted basis of his stock in that year.

a3. Rev. Rul. 75-144, 1975-1 CB 277

The facts are the same as in Rev. Rul. 70-50, except that instead of actually paying money to the bank in satisfaction of his guaranty, the shareholder, in the third year, executed his own promissory note for the full amount due and substituted it for the note of the corporation. The bank accepted the note in satisfaction of the guaranty and relieved the corporation of its liability on the old note. The shareholder made no payment on his own note until the fourth year.

The execution of a note by a shareholder, together with the acceptance of the note by a bank, under the circumstances described above, cause the indebtedness of the corporation to accrue to the shareholder, and created a basis in the indebtedness for purposes of computing his share of net operating losses of the corporation, if any, in the third year, or any subsequent taxable year of the corporation.

a4. *Raynor v. Commissioner*, 50 TC 343 (1968)

A taxpayer owned stock in three S corporations and made various loans to the corporations along with other shareholders. In addition to these loans from shareholders, the corporation received loans from third parties that were co-signed or guaranteed by the shareholders, and the shareholders executed notes to one of the third parties as additional security for the corporation's debt.

The court stated that the fact that the shareholders may be primarily liable on indebtedness of a corporation to a third party does not mean that this indebtedness is "indebtedness of the corporation to the shareholder" within the meaning of IRC section 1374(c)(2)(B).

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No form of indirect borrowing, may it be a guaranty, surety, accommodation or *co making*, or otherwise give rise to indebtedness (emphasis added). Thus the shareholders were not allowed debt basis for the amount of the loans they co-signed/guaranteed.

A long succession of cases follows Raynor.

a5. *Duke vs. Commissioner,* 35 TCM 229, TC Memo 1976-50

Notes were obtained by the corporation, signed by the officer-shareholders of the corporation, both loan exceeded the corporation's net worth.

The corporation reflected the loan as a loan from the bank in its books and records. The equity ac

The court held that "the evidence is unmistakably clear that, even though petitioner signed the note capital contributions to SEA, and all payments on the notes were made by SEA." Thus the court held that the shareholders were guarantors of the loan and did not have debt basis.

a6. *Harrington vs. United States,* (D. Del, 1985) 605 F. Supp. 53

The taxpayers' basis in their stock of the corporation at the end of the 1980 tax year was $2.50, but they claimed that they had a pro rata share of indebtedness to shareholders of $5,000. During 1980, the taxpayers and four other shareholders executed a $200,000 note to secure a credit line with a bank. The proceeds were to be used for equipment for the corporation, which was added as a signatory to the note at the insistence of the bank to enable the bank to get a lien on the equipment. The wives of the shareholders were also added to the note at the insistence of the bank. The taxpayers argued that since they provided the collateral and were co makers on the note, they substantively received the loan and then made a separate loan to the corporation. The court indicated that *Raynor* would apply only if it was first determined that there was no economic outlay. There, because the shareholders had made no loan repayments, the court found that no economic outlay had been made and applied the reasoning in *Raynor*.

Absent actual economic outlay, indirect borrowing cannot give a shareholder basis in the debt. Guarantors, sureties, accommodation parties, co-makers etc.

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are indirect borrowers. An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it. If a shareholder is an accommodation party, the shareholder is an indirect borrower. If there is no economic outlay, then the shareholder is not entitled to any basis in the debt. (See also *RESER v. COMMISSIONER* (1995) TC Memo 1995-572 (70 TCM. 1472); and *GROJEAN v. COMMISSIONER* (1999) TC Memo 1999-425 (78 TCM. (CCH) 1249))

a7. *Gilday v. Commissioner*, TC Memo 1982-242

Shareholders of an S corporation gave their personal notes to a bank in cancellation of the corporation's note. (The corporation's notes were cancelled). The substitution of the shareholder's note for that of the corporation created valid debt from the corporation to the shareholder and thus increased the shareholder's basis in the stock.

A8. *Leavitt, Estate of Daniel v. Commissioner*, 875 F. 2d 420

The Court of Appeals for the Fourth Circuit, affirming the Tax Court, refused to find that the taxpayers had bases in loans from a bank to an S corporation where the taxpayer had personally guaranteed those loans. At the time of the loan, the corporation's liabilities exceeded its assets, it had virtually no cash flow, and it offered no assets as collateral. The bank would not have made the loan without the shareholder guaranties. The corporation's returns and financial statements reflected that the loan was from the shareholders. The court focused on how the parties actually treated the loan, not on how they nominally reported it on their returns and financial statements. The corporation paid the principal and interest to the bank, and neither the corporation nor the shareholder treated the corporate payments on the loan as corporate payments to the shareholders. The taxpayers argued that the loan was in substance a loan to them and then a subsequent loan to the corporation.

The court found the taxpayers' position inconsistent with the true form of the transaction and concluded that there had been no economic outlay, as the shareholders had not been called upon to make payment on the guaranty.

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A9. *Harris v. United States Court of Appeals*, (5th Cir. 1990) 902 F.2d 439

The taxpayers formed Harmar, an S corporation, which was initially capitalized by its two shareholders with $1,000 and a loan for $475,000. Harmar received a $700,000 loan from Hibernia National Bank to purchase a movie theater. To secure the loan with Hibernia, Harmar executed two notes in the amount of $350,000. Assets of the first shareholder secured one, while the second was secured by a mortgage on the theater. The mortgage also secured any other debt of Harmar to Hibernia. Each shareholder also executed personal guaranties of Harmar's debt. The Commissioner disallowed a loss claimed by the shareholder as it exceeded their bases. The taxpayers sought to have the court ignore the form of the transaction, namely, that the $700,000 loan was to them and that they subsequently contributed such amounts to Harmar's account. This allegation was supported by a bank officer's testimony that the bank looked primarily to the shareholders for repayment.

Harmar received the interest notices, paid all principal payments, and deducted those interest payments on its income tax returns. Harmar's books and records reflected that the loan was not made by Hibernia until 1986, 4 years after the year in question, when it was reflected as being made by the taxpayers. Harmar's 1982 return showed no loan repayments to the shareholders, which it would have done if the loan had been one from the taxpayers to Harmar. The loan made by Hibernia was earmarked by Hibernia for a specific use by Harmar. Finally, the return indicated a $2,000 capital investment and a $68,000 loan from the taxpayers, which fell far short of the claimed $700,000 loan. The court concluded that the return was wholly inconsistent with the position of the taxpayers and, refusing to recast the bank loan to Harmar as being substantively from the bank to the shareholders to Harmar, found that no economic outlay had been made.

A10. *Nigh, Charles v. Commissioner*, TC Memo 1990-349

The shareholders of a corporation signed two notes to a bank as co makers. The corporation's assets were collateral on the loan. *The bank had the right to go against the shareholders before repossessing the collateral.* During some years the shareholders personally contributed money to the corporation to pay the indebtedness each month.

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The court stated: "a shareholder's guarantee of a loan to a subchapter S corporation may not be treated as an equity investment in the corporation absent an economic outlay by the shareholder. In the instant case, petitioners were co-makers rather than guarantors, but this does not change our analysis. See *Estate of Leavitt v. Commissioner*, (1988) 90 TC 206, 212-218, aff'd (4th Cir. 1989) 875 F.2d 420. Accordingly, we reject petitioner's argument" (that as co makers of the loans they had in substance borrowed funds and made contributions to the corporation's capital that increased their basis).

The parties agreed that the petitioners are entitled to basis for the funds they personally contributed to the corporation to pay the loans.

a11. *Reser, Don C. v. Commissioner,* (1995) TC Memo 1995-572

The taxpayers formed Don C. Reser, P.C. (DRPC), an S corporation, which was initially capitalized by its sole shareholder, Don Reser, with $6,000. During 1985, Don Reser and DRPC together obtained a line of credit from North Frost Bank. Both Reser and DRPC submitted financial statements to Frost Bank. The credit line was documented by 14 promissory notes, each payable 90 days after execution. They were dated October 7, 1985, through January 10, 1989. The final note, dated January 10, 1989, states a cumulative principal loan balance of $467,508.54. Don Reser and DRPC were jointly and severally liable on the notes for repayment of the loan.

The loan was not collateralized with any property of Don Reser or DRPC. On November 16, 1986, a guaranty agreement was executed by Don Reser, DRPC, and Don Test, under which Don Test would guarantee the loan for a fee of $14,998.50 for each 90-day period that the guaranty was outstanding. Don Reser and DRPC were jointly and severally liable to Don Test for payment of the fee. Frost Bank would have granted the line of credit to either Don Reser or DRPC individually, but to neither without Don Test's guaranty. Don Test was not a shareholder or otherwise related to the corporation.

The line of credit was used both as a source of operating capital for DRPC and for Don Reser personally. The credit line funds went directly into DRPC's account, and any proceeds petitioner used were drawn out of DRPC. Don Reser

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apparently did not make any repayments on the notes to Frost Bank; DRPC may have made the only principal payments on the notes. In 1989, pursuant to the guaranty agreement, Don Test apparently paid the balance of the notes.

In this case, there is one factor different than in *Harrington*, and that is rather than a shareholder making a personal guaranty, as in *Harrington*, here there was a third-party guarantor, Don Test, who was actually paid by the corporation. The court found this much stronger evidence that the corporation was the primary obligor, and that Don Reser was the accommodation party and not entitled to basis for any amount of the debt with Frost Bank.

A12. *Salem, Richard v. Commissioner*, TC Memo 1988-63

An accountant advised shareholders of an S corporation that "the safest course of action and the one we recommend is to restructure the loans so that you are a co maker rather than a guarantor. In this way, you can clearly demonstrate that you have basis in the losses which flow through on your individual income tax return and take full advantage of the concomitant tax benefits".

Shareholders executed replacement notes, which were signed by the shareholder as vice president on behalf of the corporation and the shareholders as individuals. The security on the replacement notes remained the same. The corporation made all payments on the loans. The corporation return reflects loans payable to shareholders while its ledger for the year reflects loans payable to the bank. There were never any loan documents executed among the corporation and the shareholders evidencing loans from the shareholders to the corporation.

The court held that, in order to qualify for indebtedness under IRC section 1366(d), the indebtedness of the S corporation to the shareholder must have arisen as a result of an actual economic outlay by the shareholder, *Harris v. United States*, 902 F. 2d 439, 443 (5th Cir.); *Estate of Leavitt v. Commissioner*, 875 F. 2d 420 (4th Cir 1989). In *Raynor*, the court held that no form of indirect borrowing, be it guaranty, surety, accommodation, or co making gives rise to indebtedness from an S corporation to the shareholders unless and until the shareholders pay part or all of the indebtedness, *Raynor v. Commissioner*, 50 TC 343 (1968).

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Thus the court held that a shareholder signing as a co maker of a note payable to a bank does not give rise to debt basis. The fact that the shareholders "were co makers rather than guarantors does not change our analysis, *Nigh v. Commissioner*, TC Memo, 1990-349.

Other cases which discuss arm's length loans with disinterested third parties and/or shareholder loan guarantees are:

- *Blum, Peter*, (1972) 59 TC 436
- *Perry, William*, (1966) 47 TC 159
- *Thompson, Mark*, TC Memo 1977-35
- *Brown, J.W.*, TC Memo 1979-220
- *Brown, Frederick*, TC Memo (6th Cir. 1981) 706 F.2d 755
- *Bader, Lewis*, TC Memo 1987-30

Special Note: *Selfe, Edward M. and Jane B. v. U.S.*, 86-1 USTC 9115 (11th Cir.)

In December 1985, the Eleventh Circuit reviewed a district court decision, *Selfe*, which resulted in the allowance of shareholder loan guarantees as qualified indebtedness even though the shareholder had never been called upon to satisfy the debt guarantee on behalf of the corporation. This case prompted extensive litigation from shareholders who guaranteed the loans of their S corporations. The facts in *Selfe* were similar to those in many of the cases that taxpayers had argued unsuccessfully.

Mr. Selfe, who represented himself before the Eleventh Circuit, cited an old case that did not involve an S corporation. In *Plantation Patterns, Inc. v. Commissioner*, on which Mr. Selfe relied, the IRS had prevailed in reclassifying debt as equity. [*Plantation Patterns, Inc. v. Commissioner*, 72-2 USTC 9494 (5th Cir.), cert. denied]. There have been numerous cases in which debt from a C corporation has been reclassified as equity, but these cases involve loans from shareholders to the corporation. The *Plantation Patterns* case went one step further than the usual debt versus equity case. In it the IRS reclassified a debt from a third-party lender to the corporation as if the debt were a loan from the lender to the shareholder, followed by a contribution to the corporation's capital by the shareholder.

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In the *Plantation Patterns* case, in which the IRS prevailed, three of the apparently most important aspects were as follows:

- The corporation was extremely thinly capitalized.
- The shareholder who guaranteed the loan had substantial assets.
- The IRS secured a deposition from the loan officer that the lender was looking primarily to the shareholder, rather than to the corporation, for repayment.

Selfe was able to establish that his facts were practically identical to those in *Plantation Patterns*. His wife, Jane Selfe, was the sole shareholder. The corporation was thinly capitalized, and Jane had substantial assets. The Selfes secured a deposition from the lending officer that the bank was looking primarily to Mrs. Selfe, rather than to the corporation, for repayment of the loan. The Court looked to substance rather than form and treated the loan as equity contributions, in accordance with the precedent set in *Plantation Patterns*. Mrs. Selfe was allowed to deduct her loss. Shortly after the *Selfe* decision was published, taxpayers began to litigate the issue. To date, however, no courts, other than the Eleventh Circuit, have been willing to follow the *Selfe* decision.

One of the first cases heard by the Tax Court after *Selfe* was *Estate of Leavitt [Leavitt, Estate of Daniel*, 90 TC 206 (1988)], which the Tax Court could easily have rejected as being entirely different from *Selfe*. There were several shareholders involved, and the facts were quite different. The Tax Court went much farther, however. It stated its disagreement with the Eleventh Circuit decision in *Selfe*, holding that the *Plantation Patterns* doctrine was inappropriate for S corporations. It refused to accept a shareholder guarantee as the economic outlay necessary to create basis. One concurring opinion distinguished *Leavitt* from *Selfe* because the corporation in *Leavitt* had seven shareholders, each of whom claimed basis from guarantee.

The *Selfe* opinion has stood alone up to this point. The Tax Court and several circuits disagree with the reasoning set forth by the 11th Circuit. The reasoning in *Selfe* should not be followed, even though taxpayers may cite this case to support their positions.

The auditor should be extremely cautious to identify cases using arguments presented in *Selfe* and *Plantation Patterns*. For instance, in *James A. Lane, Bankrupt v. United States Court of Appeals*, 742 F. 2d 1311 (11th Circuit), the court determined that the amounts advanced to the S corporations by the shareholder did not constitute debt, but were equity in the corporations. The bad

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debt deductions taken by the shareholder were disallowed due to the determination that the advances from the shareholder did not constitute a loan (debt) but were contributions to capital (equity) and, therefore, not deductible. The court cited *Plantation Patterns*, along with similar cases, to support it's holding.

Not only are taxpayers citing *Selfe* to support the inclusion of debt guarantees as qualified indebtedness, but are citing it as the "substantial authority" exception to the imposition of the accuracy-related penalty. Again, the auditor must use extreme caution in this situation. The *Selfe* decision was published in 1985. The *Leavitt* decision, which clearly stated the inappropriate reasoning presented in *Selfe*, was published in 1988. Several cases followed, none of which were decided in the taxpayer's favor with the exception of the Eleventh Circuit. The taxpayer's use of this case as "substantial authority" should be evaluated as follows: (1) what is the audit year in question and how far removed is it from the *Leavitt* decision in 1988, (2) how many published court decisions cited the *Selfe* decision as inappropriate for S corporations, (3) when did the tax services begin discussing the ramifications of using this case as citable authority, (4) have there been any federal cases which upheld the assessment of the penalty when the taxpayer cited *Selfe*, etc.

b. Related Party Loans - Restructuring After the Fact

The Tax Court's opinion in *Underwood v. Commissioner*, 63 TC 468 which was followed by several cases with similar fact patterns, held that there was no actual economic outlay because the debt did not come directly from the shareholders. A sample fact pattern found in these cases involved loans from one wholly owned or controlled corporation to another wholly owned or controlled corporation (an S corporation) of a taxpayer. The S corporation suffers a loss during the year at issue. Near the end of the year, the shareholder(s) restructure the entity level loans so that the debt runs from the related corporation.

Case	Type of Restructure
Underwood v. Commissioner, 63 TC 468	Substitution of notes
Private Ruling 9403003, September 29,1993 (not citable)	Substitution of notes
Wilson v. Commissioner, TC Memo 1991-544	Distribution of note
Shebester v. Commissioner, TC Memo, 1987-246	Journal entries

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Griffith v. Commissioner, TC Memo, 1988-445	Journal entries
Burnstein, Sanford, TC Memo 1984-74	Journal entries

Often, the entire transaction prevents any loss from actually being suffered by the shareholder. When shareholders put themselves between their controlled S corporations, it is not clear that taxpayers will ever make demand upon themselves for payment. Therefore, in these situations, the *Underwood* line of cases follows the rationale in the guarantee line of cases and, unless there is actual payment, there is no economic outlay and the shareholder has not made the kind of investment required in order to realize additional losses pursuant to IRC section 1366(d).

c. Related Party Loans - Original Structure

In the previous section, the related party loans involved restructuring after the fact to transfer basis from a profitable corporation to a loss corporation. But what if the series of transactions were initially structured in a manner that cash and/or property was transferred from a related profitable entity into the S corporation via the shareholders? There is little guidance from case law in this area.

The most important aspects of examining such a situation is to obtain all facts relevant to the series of transactions. It is recommended that the auditor obtain the following documents (this list is not intended to be all-inclusive):

- Loan documents from the shareholder to the S corporation.
- Journal entries booking the loan(s) from the shareholder.
- Canceled checks from the shareholder's account into the S corporation.
- Loan amortization schedules between the S corporation and shareholder.
- Journal entries reflecting principal and interest repayments.
- Canceled checks for principal and interest payments. Identify the shareholder's source of funds for financing the loan(s) to the corporation – for example (a) analyze whether the shareholder had the economic wherewithal to finance the loan from personal funds, (b) determine if the shareholder holds interest in other entities from which funds could have been obtained, (c) examine the shareholder's bank statements to determine whether a large deposit was made prior to the check date and trace its origin, etc.

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- If the funds were obtained from a related entity, obtain copies of the journal entries booking the transaction from the related entity to the shareholder and all relevant supporting documentation.
- If the funds were obtained through a lending institution, identify the primary obligor and the ownership of assets guaranteeing the loan.

Note: Only request information that is reasonable and relevant to the audit.

In two recent memorandum decisions, the Tax Court found that under the facts and circumstances of the particular case, the back-to-back loan arrangement yielded a sufficient economic outlay to allow an increase in the shareholder's S corporations basis for purposes of the IRC section 1366(d)(1) limitation. Therefore, full factual development including obtaining all relevant documents, even if they are not contemporaneous, and conducting interviews with any potential witnesses is critical to the final outcome of a back-to-back loan case. (See *Culnen v. Commissioner* (2000) TC Memo 2000-139 [79 TCM 1933]; and *Yates v. Commissioner* (Oct. 11, 2001) TC Memo 2001-280.)

In *Culnen v. Commissioner* (2000) TC Memo 2000-139 [79 TCM 1933], the Tax Court held that the taxpayer/shareholder had made an economic outlay in that money deemed to have been loaned to him from another wholly owned S corporation was in turn deemed to have been loaned by him to his majority owned cash-strapped S Corporation. The court found that the funds provided to the S corporation comprised an economic outlay by the taxpayer and the taxpayer was therefore eligible for basis in the deemed loan. In *Culnen v. Commissioner* (2000)*, supra,* the Tax Court rejected the government's argument that as a matter of law, '[t] he fact that all payments to Wedgewood Associates, Inc. came directly from Culnen and Hamilton, precludes petitioner from claiming those amounts as his basis in Wedgewood and thus, the Sch. E losses.

The Tax Court then stated in pertinent part:

"If respondent is suggesting that the question of whether Culnen & Hamilton lent those amounts to petitioner is irrelevant since, as a matter of law, direct payments by Culnen & Hamilton to Wedgewood establish Culnen & Hamilton's status as the investor in Wedgewood, he is wrong. In Hitchins v. Commissioner, 103 TC 711 (1994), in explaining the statutory requirement that the indebtedness of the S corporation must run directly to the shareholder, we made it clear that an indebtedness to an entity with pass-through characteristics that has advanced the funds to the S corporation and is closely related to the taxpayer does not satisfy the statutory requirement.

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See id. at 715. We did not say, however, that the fact that the borrowed funds originate with the closely related entity precludes the indebtedness of the S corporation from running directly to the shareholder. Certainly, where there is a close relationship among the S corporation, the taxpayer, and the related entity, we will scrutinize the relationships established with respect to the transfer of funds to ensure that those relationships comport with the statutory requirement."

Relying on *Culnen v. Commissioner* (2000)*, supra,* and without analysis or explanation, the Tax Court in *Yates v. Commissioner* (Oct. 11, 2001) TC Memo 2001-280 reached a similar result for apparently the same reasoning.

Because of the decision made in *Culnen*, auditors must obtain all the evidence to determine whether the loan from the profitable related entity is a bona-fide loan. Although not conclusive, evidence useful to make such determination is as follows:

- Loan agreement
- Note with stated rate of interest and a payment schedule
- Journal entries booked for the loan
- Journal entries booked for interest payments
- Canceled checks for payments made on the loan
- Canceled checks for interest payments

Because this type of loan is a closely related party transaction, the transaction must be held at the higher level of scrutiny than the normal third-party transactions.

d. Actual Economic Outlay

d1. Introduction:

IRC section 1366(a) provides that an S corporation shareholder may deduct his pro rata share of the S corporation's net operating loss. However, IRC section 1366(d)(1) provides that the deduction is limited to the shareholder's adjusted basis of the corporation's stock and the adjusted basis of any indebtedness of the corporation to the shareholder.

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The phrase "adjusted basis of any indebtedness of the corporation to the shareholder" appears straightforward at first glance. That is, the shareholder can have debt basis only for those loans made directly from the shareholder to the S corporation.

Observation: Any loans made between two entities do not qualify as indebtedness from the shareholder to the S corporation, and those loans are not included in the shareholders basis (IRC §1366(d)(1)). Also see *Frankel v Commissioner* 61 TC 343 (loans from partnership to S corporation), *Prashker v Commissioner* 59 TC 172 (loan from estate to S corporation), and *Burnstein et al v. Commissioner* TC Memo 1984-74 (loans between two S corporations).

d2. The Issue:

The "adjusted basis of any indebtedness of the corporation to the shareholder" cannot be determined merely by looking to whether there are "notes" between the shareholder and the corporation. The issue turns on whether the shareholder made an “actual economic outlay," and “directly incurred the indebtedness."

In order to determine whether the taxpayer made an actual economic outlay, the particular facts and circumstances of the case should be developed.

Questions to the shareholder/representative should be tailored to obtain relevant information:

- Information as to where the shareholder obtained the funds to "loan" to the S corporation.
- Bank statements of the S corporation will show any deposits made by the shareholder.
- Shareholder's bank statements to show where cash advance(s) were made to the S corporation.
- On the shareholder's bank statement; look for deposits from other sources that are similar in amount to the "cash advances" to the S corporation. Inquire further of any large deposits.
- If there are deposits in the shareholder's account from a related entity, pull the related entity's tax returns.

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Once all the facts and circumstances of the particular case are developed, the next step is to determine whether the entire transaction qualifies as an "actual economic outlay."

The following court cases are summarized to demonstrate what may and may not constitute an "actual economic outlay." Please note that this is just a starting point and should not replace any research performed by the auditor.

d3. Court Cases - Factors Considered in Finding Actual Economic Outlay

Actual Payment

Generally, an economic outlay exists when a shareholder lends his *own* cash or property to his S corporation. In this situation, there would be an actual payment to the S corporation that would leave the taxpayer poorer in a material sense.

"Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense." *Perry v. Commissioner,* 54 TC 1293 aff'd [71-2 USTC ¶9502].

Borrowed Funds

"This, of course, does not rule out the possibility that a shareholder could borrow the money personally and then loan the money to the corporation. In that event the corporation's debt would run directly to the shareholder." *Prashker v. Commissioner* [59 TC 172] For the shareholder to borrow the money "personally", "the involvement of an independent third party lender is critical to the result because there is no question that a lender such as a bank intends to force repayment, truly placing the shareholder's money at risk." *Bergman v. United States* (8th Cir. 1999) 474 F.3d 928

Loan Restructuring (back to back loans)

It is also possible for a loan made as part of a loan restructuring to create additional basis for the shareholder. For example, in *Gilday v Commissioner,*

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[43 TCM 1295], basis is created when a shareholder, who had previously only guaranteed a loan to an S corporation (not considered as part of basis), borrowed funds in an arm's length transaction from a bank and then loaned the borrowed funds to the corporation.

However, not all loan restructuring transactions result in an "actual economic outlay." In *Underwood v. Commissioner* [76-2 USTC ¶9557], loans were originally between a C corporation and an S corporation. After the restructuring of the debt, the loan went from the C corporation to the shareholders and then from the shareholders to the S corporation. The court noted:

"In the transaction at issue in this case, the taxpayers in 1967 merely exchanged demand notes between themselves and their wholly owned corporation; they advanced no funds to either Lubbock or Albuquerque. Neither at the time of the transaction, nor at any other time prior to or during 1969 was it clear that the taxpayers would ever make a demand upon themselves, through Lubbock (the profitable corporation) for payment of their note. Hence, as in the guaranty situation, until they actually paid their debt to Lubbock in 1970, the taxpayers had made no additional investment in Albuquerque (the unprofitable corporation) that would increase their adjusted basis in an indebtedness of Albuquerque to them." (5th Cir. 1976) 535 F.2d 309.

In footnote #2 of this case, the court noted the distinction between obtaining funds from a bank, an outsider that stood ready to enforce the obligation, and that of related parties where it is not clear that a demand for payment would ever be made. In footnote #3, the government admits that when the shareholders make payment on the first note, the taxpayers increased their basis in the S corporation for the other note. Also see *Wilson v Commissioner,* [TC Memo 1991-544]; *LeRoy Griffith v. Commissioner* [TC Memo 1988-445]; and *Bergman v. United States* (8th Cir. 1999) 474 F.3d 928.

Borrowed Funds Contributed to S Corporation

In *JH Harris and William J Martin v. United States* (5th Cir. 1990) 902 F.2d 439, the loan was originally between the S corporation and the bank. The transaction was restructured to be a loan to the shareholders who then "contributed" the borrowed funds to the S corporation. The court denied the

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increase to debt basis because the documentation indicted that the form chosen and followed at all times was a loan from the bank to the S corporation. The taxpayer's testimony was contradictory to the evidence and unambiguous documentation. All transactions were directly between the bank and the corporation.

In *Silverstein v United States* (E.D.La. 1972) 349 F.Supp 527, shareholders of an S corporation "contributed" a note to their S corporation at year-end in order to increase their bases in the S corporation so as to take advantage of the net operating loss of the corporation. The court denied an increase in basis noting that there was no "actual economic outlay." "The taxpayers' advisers, solely to minimize their client's tax liability, designed an elaborate form having neither business purpose nor economic substance." No payments were made on the principal of the note and minimal payments were made for interest.

Distributions From One Entity and Loaned to the S Corporation

In *Shebester v. Commissioner* (TC Memo 1987-246), the loans were originally between the two S corporations—one profitable and one not profitable. After the restructuring, the profitable corporation made a "distribution" to the shareholder; and the shareholder in turn "loaned" it to the unprofitable corporation. The shareholder included the distribution on his tax return as income. The court was not persuaded with the taxpayer's claim that the transaction was intended to be distributions as the structure was between the two entities. As for the "loan", the court found that there was no actual economic outlay. The court noted:

"Although the entries in Hennessey's book [profitable corporation] technically reduced the taxpayer's book equity, such entries could not, absent liquidation of Hennessey, leave the taxpayer poorer in a material sense.

Moreover, because the taxpayer had complete control over when and under what circumstances Hennessey would liquidate, and because the record is devoid of any evidence suggesting that petitioner would cause Hennessey to liquidate in the foreseeable future, we conclude that it was unlikely that the taxpayer would ever make an economic outlay in payment of A&L's (the unprofitable corporation) debt."

Distributed loans and then the "loan" to the S corporation were also seen in *Wilson v Commissioner* (TC Memo 1991-544).

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Bona Fide Loan/At Risk

In *Bhatia et ux. V. Commissioner* (TC Memo 1996-429), the court noted that the close relationship between the shareholder and his closely held entities need not necessarily be fatal to the "actual economic outlay" issue so long as the "other" elements are present which clearly establish the bona fides of the transactions and their economic impact. In this court case, there was no evidence in respect of the actual existence of an indebtedness of the corporations, or of the amounts or terms of that indebtedness as to interest or time of repayment, or of the taxpayer's basis in the S corporation before or after the transaction. Therefore, it was found that there was no actual economic outlay.

Other court cases have also emphasized that a shareholder's "loan" to their S corporation would not create basis for the shareholder when it is not clear their money is in fact at risk. See *Brown v. Commissioner* (6th Cir. 1983) 706 F.2d 755 and *Hafiz v. Commissioner* (75 TCM 1982)(1998).

Transfers of Funds Between Entities

After many court cases denying debt basis to shareholders, shareholders are structuring the transaction from the onset to be "loans" from one entity to the shareholder and then loans from the shareholder to the S corporation. Yet, the funds are transferred directly between the two entities. In this situation, the underlying documents must be examined to determine the true nature of the transaction.

In *Bolding v. Commissioner* (5th Cir. 1997) 117 F.3d 270, TC Memo 1995-326 *reversed*, even though the bank transferred the funds directly to the S corporation, the true nature of the transaction was a loan from the bank to the shareholder and then a loan from the shareholder to the S corporation. The taxpayer was found to have made an actual economic outlay.

Payments directly between a bank and the S corporation have also been seen in *Gilday v. Commissioner* (43 TCM 1295). In footnote #8 the court points out that the payments were made directly between the S corporation and the bank.

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The court noted that to pay the shareholders and have the shareholders pay the bank would seem to be the utilization of fruitless steps.

Debt Converted to "Equity"

To overcome the "actual economic outlay" test, shareholders receive a "distribution" from one related entity and then "contribute" it to their S corporation.

While there are no court cases specifically addressing these particular facts and circumstances, in *Underwood v. Commissioner* (5th Cir. 1976) 535 F.2d 309, the court applied the actual economic outlay theory to "investments" as follows:

The report of the Senate Committee on Finance accompanying the Subchapter S legislation indicates that the purpose of the section is to limit the amount of the Subchapter S corporation's net operating loss that may be deducted by a shareholder to the "adjusted basis of the shareholder's *investment* in the corporation." (citation omitted.) Construing this language of the committee report in *Perry v. Commissioner* (1976) 54 TC 1293, affd. in unpub. Opin. (8th Cir. 1971), the Tax Court said:

"It appears to us that, given its most familiar meaning, the use of the word "investment" reveals intent, on the part of the committee, to limit the applicability (IRC §1366(d)) to the actual economic outlay of the shareholder in question.

The rule that we reach by this interpretation is no more than a restatement of the well-settled maxim that requires that "Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense."

Thus, it appears that whether the transaction is structured as a contribution or a "loan", the basic test is whether the taxpayer is "poorer" in a material sense after the transaction than before the transaction.

e. Court Decisions on Miscellaneous Qualifying/Nonqualifying Indebtedness

Partnership Indebtedness

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Rev. Rul. 69-125, 1969-1 CB 207: Partnership loans to an S corporation are not debts owed directly to the shareholder and thus do not provide basis when the partnership is controlled by the corporation's shareholder.

Allen, Edward, (1988) TC Memo 1988-166: In order to be considered part of the basis, the indebtedness must run directly from the corporation to the shareholder.

Frankel, E.J. (1973) 61 TC 343: A loan from the partnership to the S corporation did not give the shareholder/partner debt basis.

Common Control of Two S Corporations - Basis Cannot be Combined

Meissner, Douglas v. Commissioner, TC Memo 1995-191: Taxpayer, the sole shareholder of two S corporations, asserted that the loans from one to the other should be attributed to him due to the mere fact that he is the sole shareholder of both. The court held that the taxpayer could not ignore the corporate form in which he chose to do business – as two separate S corporations. The loans made to Corporation 1 cannot be attributed to Corporation 2 for purposes of recognizing net operating losses from Corporation 2.

Shareholder and S Corporation Are Co-Makers or Jointly Liable on Note

Nigh, Charles, TC Memo 1990-349, *Duke, Albert D.*, TC Memo 1976-50: The Tax Court ruled that the shareholder did not make an equity investment and excluded the loans from shareholder basis.

Note Given to Shareholder for Unpaid Compensation

Wise, George W., TC Memo 1971-38, *Borg, Joe E.*, 50 TC 257 (1968): The court ruled that the note could not be included in debt basis unless the shareholder included the amount of the note into income.

Debt to trust as loan to shareholder-remainderman.

Robertson, James Y. v. U.S., 73-2 USTC ¶9645: No consideration is given if the remainderman is also the trustee.

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090600 RULES FOR COMPUTING STOCK AND DEBT BASIS

Once you have identified initial stock basis, items that increase and decrease stock basis, and qualifying indebtedness, you now have all the components necessary to compute shareholder basis.

S Corp 090601 Timing of Adjustments to Stock and Debt Basis
S Corp 090602 Ordering Rules for Adjustments to Stock and Debt Basis

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

090601 Timing of Adjustments to Stock and Debt Basis

All basis adjustments are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. (Treas. Reg. §1.1367-1(d)(1); and PLR 200106009.) If a shareholder disposes of stock during the corporation's taxable year, the adjustment with respect to that stock are effective immediately prior to the disposition as will be discussed later.

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090602 Ordering Rules for Adjustments to Stock and Debt Basis

a. Pre-1997 Rules

IRC section 1367 and Treas. Reg. section 1.1367-1(e) provides the general and special ordering rules for adjusting basis for taxable years beginning before January 1, 1997 as follows:

General Rule:

- IRC section 1367(a)(1)(A)-(C); Increase stock basis by separately and nonseparately stated income items and depletion deduction.
- IRC section 1367(a)(2)(D)-(E); Decrease stock basis, but not below zero, by nondeductible, noncapital expenses, and the oil and gas depletion deduction.
- IRC section 1367(a)(2)(B)-(C); Decrease stock basis, but not below zero, by separately and nonseparately stated losses and deductions.
- IRC section 1367(a)(B)(A); Decrease stock basis, but not below zero, by non-taxable distributions.

Special Rule:

IRC section 1367(b)(2)(A); Decrease debt basis, but not below zero, for losses/deductions in excess of those used in IRC section 1367(a)(2)(B)-(E). Distributions do not reduce debt basis.

IRC section 1367(b)(2)(B); If unrestored debt basis exists and there is a 'net increase', restore debt basis by the 'net increase'. '**Net increase' is the excess of income items in IRC section 1367(a)(1)(A)-(C) over the loss/deduction items in IRC section 1367(a)(2)(A)-(E).** This will be explained in detail later in this chapter.

Federal Regulations

Treas. Reg. section 1.1367-1(e) provides additional guidance as to the ordering rules contained in IRC section 1367. According to this regulation, each adjustment category must be recognized in whole before recognizing the next category as follows:

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Adjustment Category 1 (IRC §1367(a)(1)(A)-(C))	Separately stated income. Nonseparately stated income. The excess of the deductions for depletion.
Adjustment Category 2 (IRC §1367(a)(2)(D)-(E))	Noncapital, nondeductible expenses. Oil and gas depletion deduction.
Adjustment Category 3 (IRC §1367(a)(2)(B)-(C))	Separately stated losses/deductions. Nonseparately stated losses/deductions.
Adjustment Category 4 (IRC §1367(a)(2)(A))	Distributions.

Treas. Reg. section 1.1367-1(g) allows a shareholder to elect to have Adjustment Category 3 apply before Adjustment Category 2. The shareholder must make this election by attaching a statement to the return and must continue to use this elective ordering unless the Commissioner grants permission.

Note: Treas. Reg. section 1.1367-1 and section 1.1367-2 did not become effective until taxable years beginning on or after 1/1/94. Treas. Reg. section 1.1367-3, however, stipulates that for taxable years beginning before 1/1/94, basis computations must be determined in a reasonable manner, taking into account the statute and the legislative history. Return positions consistent with Treas. Reg. section 1.1367-1 and section 1.1367-2 are reasonable.

b. Post-1996 Rules

For taxable years beginning on or after January 1, 1997, the ordering rules for basis adjustment changed. The adjusted basis of the shareholder's stock for purposes of computing the limitation on the amount of S corporation losses is computed after the shareholder's basis is reduced by the year's nontaxable distributions made to the shareholder. (IRC §1366(d)(1)(A)) IRC section 1368(d) also provides that in order to determine the tax treatment of distributions made during the year the adjusted basis of the shareholder's stock must be increased by the shareholder's share of the S corporation's income items for the year, without reducing the basis for the shareholder's share of the S corporation's losses for the year.

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Treas. Reg. section 1.1367-1(f) reflects the rule described above by providing that adjustments to the bases of a shareholder's stock are made in the following order:

1. Any increase in basis attributable to the income items described in IRC section 1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in IRC section 1367(a)(1)(C);
2. Any decrease in basis attributable to a distribution by the corporation described in IRC section 1367(a)(2)(A);
3. Any decrease in basis attributable to noncapital, nondeductible expenses described in IRC section 1367(a)(2)(D), and the oil and gas depletion described in IRC section 1367(a)(2)(E); and
4. Any decrease in basis attributable to items of loss or deduction described in IRC section 1367(a)(2)(B) and (C).

c. Special Rules for Debt Basis

c1. Shareholder Advances/Line of Credit

Treas. Reg. section 1.1367-2(a) states that shareholder advances not evidenced by separate written instruments and repayments on the advances are treated as a single indebtedness.

c2. Multiple Indebtedness

Pursuant to Treas. Reg. section 1.1367-2(b)(3), if a shareholder holds more than one indebtedness at the close of the corporation's taxable year, as evidenced by separate written instruments or treated as separate obligations by the S corporation, each basis is reduced and restored proportionally based on total indebtedness. This provision is crucial for purposes of reducing and restoring basis of indebtedness.

c3. Special Rules - Treas. Reg. Section 1.1367-2

Reduction in Basis of Indebtedness

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- If the debt is paid off or disposed of during the taxable year, it is not held by the shareholder at the close of that year and is not subject to basis reduction. (Treas. Reg. §1.1367-2(b)(1))This rule applies to terminations of shareholder interest in the S corporation during the taxable year as well. If the shareholder disposes of his/her stock during the year and debt had been paid off or disposed of prior to stock disposition, the debt is not held by the shareholder on the date of stock disposition and is not subject to basis reduction.
- "If the shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder." (Treas. Reg. §1.1367-2(b)(3))

Restoration of Basis in Indebtedness

- Pursuant to Treas. Reg. section 1.1367-2(c)(1), restoration rules apply only to debt held by the shareholder as of the beginning of the taxable year in which the "net increase" arises. Any previous reduction to the shareholder's basis in indebtedness must be restored prior to any net increase is applied to restore the shareholder's basis in the S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under IRC section 1016(a), excluding any adjustments under IRC section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.
- Pursuant to Treas. Reg. section 1.1367-2(c)(2), if the shareholder holds more than one indebtedness as of the beginning of a corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness proportionally.

d. Allocation of Losses/Deductions

IRC section 1366 and related regulations do not provide guidance for allocating deductible loss and deduction items that exceed basis. Treas. Reg. section 1.469-2T(d)(6)(ii)(B) – coordination with other limitations on deductions that apply

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before IRC section 469 – provides guidance for the allocation of losses/deductions in excess of stock and debt basis as follows.

Pursuant to Treas. Reg. section 1.1367-2(d)(ii)(B), "[I]f any amount of an S corporation shareholder's pro-rata share of an S corporation's loss for the taxable year is disallowed under IRC section 1366(d), a ratable portion of the taxpayer's pro-rata share of each item of deduction or loss of the S corporation is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of such item multiplied by the fraction obtained by dividing

(1) The amount of the shareholder's pro-rata share of S corporation loss that is disallowed for the taxable year, by
(2) The sum of the shareholder's pro-rata shares of all items of deduction and loss of the corporation for the taxable year."

Example A

		Schedule K-1 Items		Stock and Debt Basis	Suspended Losses
2.	Beginning Balance Subtotal	$40,000		40,000	
3.	Ordinary Loss	-20,000	.13		-$13,500
	Capital Loss	-100,000	.67	-33,500	-66,500
	Rental Loss	-30,000	.20	-10,000	-20,000
	Total	-150,000	1.00		-100,000
4.	Ending Balance	$0		$0	-$100,000

After losses/deductions are allocated on a pro-rata basis, those that cannot be recognized currently are carried over and treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder (IRC §1366(d)(2)). Suspended losses/deductions are carried over and combined with the next year's losses/ deductions. No distinctions are made in regards to when the actual losses/deductions were generated.

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090700 LOAN REPAYMENTS ON REDUCED DEBT BASIS

S Corp 090701 Debt Repayment on Single Debt (with Formal Note, not Line of Credit)
S Corp 090702 Debt Repayments on Separate Multiple Loans:
S Corp 090703 Debt Repayments on Open Single Account (Line of Credit):

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090701 Debt Repayment on Single Debt (with Formal Note, not Line of Credit)

In *Smith v. Commissioner* (1967) 48 TC 872, the Tax Court had to decide how to treat loan repayments, from an S corporation to its shareholder, where the shareholder's basis in the loan was reduced below the face amount of the loan due to the shareholder's deduction of net operating losses generated by the S corporation. The Tax Court decided that a portion of the repayment should be treated as a return of the shareholder's basis and the rest of the repayment should be treated as taxable income to the shareholder. The court also set forth the following formula for determining the taxable income portion of the repayment:

(Face Amount of Debt – Adjusted Debt Basis) / Face Amount of Debt x Loan Repayment

The remaining portion of the loan repayment, after subtracting out the portion determined to be taxable income, is treated as a return of basis.

Example A

Face Amount of the Debt (principal balance) = $100,000.
Adjusted Debt Basis (basis in indebtedness) = $40,000.
Loan Repayment = $30,000.

Taxable Portion:
[(100,000 - 40,000) / 100,000] x 30,000 = $18,000.

Return of Basis:
$30,000 - 18,000 = $12,000.
After taking into consideration the loan repayment, face amount of the debt (principal balance) would be $70,000 (100,000 - 30,000) and the adjusted debt basis would be $28,000 (40,000 - 12,000).

The shareholder would report a capital or ordinary gain of $18,000 per return.

If a written instrument evidences the indebtedness, the taxable portion is treated as a capital gain. (Rev. Rul. 64-162, 1964-1 C.B. 304.) If no written instrument

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exists, the taxable portion is treated as an ordinary gain. (Rev. Rul. 68-537, 1968-2 C.B. 372.)

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090702 Debt Repayments on Separate Multiple Loans:

Where the S corporation shareholder has made multiple loans to the S corporation, and each loan is evidenced by a formal written note, each loan will be treated separately for purposes of computing the shareholder's gain on repayments. (See *Cornelius v. Commissioner* (1972) 58 TC 417, *affd.* (5th Cir. 1974) 494 F.2d 465.) Therefore, each loan repayment will be associated with a specific loan (or note) and the gain on the repayment will depend upon the S corporation shareholder's basis in that specific loan.

If the S corporation passes through losses to the S corporation shareholder, the S corporation shareholder must reduce his or her basis in all of the outstanding loans to the S corporation, held by the S corporation shareholder at the close of the S corporation's taxable year, in the same proportion that the basis of each loan bears to the aggregate basis of all the loans. (Treas. Reg. §1.1367-2(b)) If the S corporation passes-through income to the S corporation shareholder in subsequent years, the income is used to restore the S corporation shareholder's basis in all of the loans to the S corporation held by the S corporation shareholder at the beginning of the year in which the income arises. (Treas. Reg. §1.1367-2(c)(1)) Where the S corporation shareholder held more than one loan at the beginning of the S corporation's taxable year, the increase in basis is applied:

- First, to restore the reduction in basis repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment; and
- Any remaining increase in basis is applied to restore the basis in all of the other loans. (Treas. Reg. §1.1367-2(c)(2))

In summary, if the corporation has income (net increase) at the close of its taxable year, the "net increase" in the shareholder's basis will be used to restore the basis of any loan repaid during the taxable year first. If the corporation has a “net decrease” at year-end, then the loss will not be computed (further reduce the debt basis) until after the loan repayment has been computed. The intention of this law is to minimize the gain on the shareholder loan repayments.

The above rules are applicable to the open account loan (line of credit) also. (Treas. Reg. §1.1367-2(a))

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090703 Debt Repayments on Open Single Account (Line of Credit):

In some instances, the shareholder's loans to an S corporation will not be evidenced by a formal note, instead the shareholder will loan money to the S corporation through a single account, such as a line of credit. When the S corporation needs money, it will just withdraw funds from that account, and when the S corporation has funds available, it will repay (deposit) funds back into the same account. This may occur several times a year and throughout several years.

In the case of loans on an open account, the key issue is whether to allow the taxpayer to "net" repayments against additional advances throughout the year, so that the taxable portion of the "net repayment" will be calculated at the end-of-the-year using the taxpayer's end-of-the-year basis.

Many taxpayers have raised just such an issue and argued that they are not subject to tax at all where the additional advances throughout the year exceed the amount of the loan repayments received during the taxable year. Using the taxpayers' interpretation, in the examples below, there would be no taxable repayment since total additional loans/advances ($6,500) exceed total repayments ($5,000).

Netting arguments should be disregarded because the law is clear and netting is not allowed. The primary case on the netting issue is *Sam Novell et al v. Commissioner*, TC Memo 1970-31.In that case the court specifically provided that:

We think that the fraction of any payments in 1964 that represents income should have as its numerator the difference between the face amount of the total indebtedness to the shareholder and the shareholder's basis therein and as its denominator the total indebtedness. By "total indebtedness" we mean the aggregate of the balance of Accounts No. 1 and No. 2 at *the time of such payments*. (Emphasis added).

Following the court's interpretation of the calculation of a repayment on an open line of credit, the following example calculates the taxable portion of the repayment.

Example A

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Loan Repayments - Calculation of Taxable Portion
(Line of Credit Cases)

	Income or (Losses)	(A) Stock Basis	(B) Debt Basis	(C) Total Indebtedness	(D) Repayments	(C - D) Face Amount of Indebtedness	(C -B)/C * D Taxable Repayment
Initial Investment		11,000.00					
1998							
Loan			6,000.00	6,000.00			
Losses	(13,500.00)	(11,000.00)	(2,500.00)				
12/31/98		-	3,500.00	6,000.00	-	6,000.00	
1999							
Loan 1/15/99			4,000.00	4,000.00		4,000.00	
Net			7,500.00	10,000.00	-	10,000.00	
Repayment 3/15/99				-	(2,000.00)		
Subtotal			7,500.00	10,000.00	(2,000.00)	10,000.00	500.00
Nontaxable Repayment			(1,500.00)	(2,000.00)		(2,000.00)	
Loan 6/15/99			2,500.00	2,500.00		2,500.00	
Repayment 8/15/99							
Subtotal			8,500.00	10,500.00	(3,000.00)	10,500.00	571.43
Nontaxable Repayment			(2,428.57)	(3,000.00)		(3,000.00)	
Income/Loss	0						
Adj. Basis 12/31/99		-	6,071.43	7,500.00		7,500.00	

Note 1: The face amount is the amount any "net increase" will restore. Net increases can only restore debt basis to its face amount. (Treas. Reg. section 1.1367-2(c)(1).)
Note 2: Under the old method of "netting", it is interesting to note that the total loans of $6,500 exceed the repayments of $5,000 and there would not have been a taxable gain.

3/15 repayment taxable portion: $2,000 x (10,000-7,500)/10,000 = 500

8/15 repayment taxable portion: $3,000 x (10,500 - 8,500)/10,500 = 571

The above example assumes that there is no income or loss for the year 1999. The next example will show how the calculation will be done when there is a loss "net decrease" for the year.

Example B

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LOAN REPAYMENTS - CALCULATION OF TAXABLE PORTION
(Line of Credit Cases)

	Income or (Losses)	(A) Stock Basis	(B) Debt Basis	(C) Total Indebtedness	(D) Repayments	Face Amount of Indebtedness	(C -B)/C * D Taxable Repayment
Initial Investment		11,000.00					
1993							
Loan			6,000.00	6,000.00			
Losses	(13,500.00)	(11,000.00)	(2,500.00)				
12/31/93		-	3,500.00	6,000.00	-	6,000.00	
1994							
Loan 1/15/94			4,000.00	4,000.00		4,000.00	
Net			7,500.00	10,000.00	-	10,000.00	
Repayment 3/15/94				-	(2,000.00)		
Subtotal			7,500.00	10,000.00	(2,000.00)	10,000.00	500.00
Nontaxable Repayment			(1,500.00)	(2,000.00)		(2,000.00)	
Loan 6/15/94			2,500.00	2,500.00		2,500.00	
Repayment 8/15/94					(3,000.00)		
Subtotal			8,500.00	10,500.00	(3,000.00)	10,500.00	571.43
Nontaxable Repayment			(2,428.57)	(3,000.00)		(3,000.00)	
Income/Loss	(1,500.00)		(1,500.00)				
Adj. Basis 12/31/94		-	4,571.43	7,500.00		7,500.00	

Note 1: The face amount is the amount any "net increase" will restore. Net increases can only restore debt basis to its face amount.

Everything is the same, even the taxable portion of the repayments are the same. Except the ending balance is different because the net decrease won't be computed until after the loan repayment computation has been completed.

The third example will show how the calculation will be done when there is a net increase at the close of the corporation's taxable year.

Example C

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LOAN REPAYMENTS - CALCULATION OF TAXABLE PORTION
(Line of Credit Cases)

	Income or (Losses)	(A) Stock Basis	(B) Debt Basis	(C) Total Indebtedness	(D) Repayments	Face Amount of Indebtedness	(C -B)/C * D Taxable Repayment
Initial Investment		11,000.00					
1993							
Loan			6,000.00	6,000.00			
Losses	(13,500.00)	(11,000.00)	(2,500.00)				
12/31/93		-	3,500.00	6,000.00	-	6,000.00	
1994							
Increase from n.i.			1,500.00				
Loan 1/15/94			4,000.00	4,000.00		4,000.00	
Net			9,000.00	10,000.00	-	10,000.00	
Repayment 3/15/94				-	(2,000.00)		
Subtotal			9,000.00	10,000.00	(2,000.00)	10,000.00	200.00
Nontaxable Repayment			(1,800.00)	(2,000.00)		(2,000.00)	
Loan 6/15/94			2,500.00	2,500.00		2,500.00	
Repayment 8/15/94							
Subtotal			9,700.00	10,500.00	(3,000.00)	10,500.00	228.57
Nontaxable Repayment			(2,771.43)	(3,000.00)		(3,000.00)	
Income/Loss	1,500.00						
Adj. Basis 12/31/94		-	6,928.57	7,500.00		7,500.00	

Note 1: The face amount is the amount any "net increase" will restore. Net increases can only restore debt basis to its face amount.

Note 2: Under the old method of "netting", it is interesting to note that the total loans of $6,500 exceed the repayments of $5,000 and there would not have been a taxable gain.

3/15 repayment taxable portion: $2,000 x (10,000 – 9,000)/10,000 = $200

8/15 repayment taxable portion: $3,000 x (10,500 – 9,700)/10,500 = $228.57

You can see the taxable amounts are less than the previous two examples because the S corporation has income (net increase) for the year and can restore the debt basis before the computation of the taxable repayments.

In summary, Treas. Reg. section 1.1367-2 and the Tax Court's decision in *Novell, supra*, indicate that:

- Taxpayers cannot net repayments and advances occurring within the same taxable year;
- Each particular repayment stands alone for purposes of determining the taxable portion of each repayment; and
- The taxability of each repayment will be determined as of the date of the repayment (taking into account the rules for net increases discussed above).

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090800 APPLICATION OF THE BASIS RULES

Following is a series of problems detailing the intended application of the basis rules under the code, regulations, and corresponding court decisions.

Problem 1	General Rule - Stock Basis
Problem 2	General Rule - Stock Basis with Suspended Losses
Problem 3	General and Special Rule - Stock and Debt Basis Reduced to Zero
Problem 4	General Rule - Distribution in Excess of Stock Basis with Existing Debt Basis
Problem 5	Special Rule - Debt Restoration
Problem 6	General Rule - Unrestored Debt and Net Decrease
Problem 7	Ordering Rules – 1996 and Prior
Problem 7a	Ordering Rules - 1997 and After
Problem 7b	Ordering Rules Example - 1997 and After
Problem 8	Ordering Rules/Proration of Suspended Losses - 1996 and Prior
Problem 8a	Ordering Rules/Proration of Suspended Losses 1997 and After
Problem 9	Ordering Rules/Proration of Suspended Losses - 1996 and Prior
Problem 10	Debt Repayment/Debt Repaid in Part
Problem 11	Debt Repayment/Debt Paid in Full During Year - Net Increase
Problem 12	Allocation on a Per Share, Per Day Basis

Click To View Problems

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090900 ELECTION TO DIVIDE THE TAXABLE YEAR

Problem 12 of this section illustrates how income (losses) is allocated when there is an ownership change during the year. As stated in that problem, it assumes that the S corporation generates income and losses evenly throughout the year. To alleviate potential distortion of income (losses) allocated to the shareholders involved in ownership changes, special provisions are available to allow the S corporation to divide its taxable year into two short years - the first short year ending at the close of the day on which the qualifying ownership change occurs and the second short year covering the remaining taxable year.

S Corp 090901 Making the Election
S Corp 090902 Effective Date
S Corp 090903 Dispositions Qualifying for This Election
S Corp 090904 Mechanics of Dividing the Taxable Year

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090901 Making the Election

Treas. Reg. section 1.1368-1(g)(2)(C)(iii) requires the S corporation to file a statement with its return stating that an election is being made under this regulation, the date of election, the qualifying event, and a statement that each shareholder who held stock in the corporation during the taxable year consents to this election with their respective signatures. **Note: An election made under this regulation is irrevocable.**

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090902 Effective Date

An election for qualifying dispositions is effective for taxable years beginning on or after 1/1/94. For taxable years prior to 1/1/94, only entire stock dispositions were allowed to make this election.

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090903 Dispositions Qualifying for This Election

- If an entire ownership interest is disposed of during the taxable year (IRC §1377(a)(2)), or
- When a qualifying disposition occurs for taxable years beginning on or after 1/1/94 (Treas. Reg. §1.1368-1(g)(2)(ii)):
  - A disposition by a shareholder of 20% or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year,
  - A redemption treated as an exchange under IRC section 302(a) or IRC section 303(a) of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30 day period during the corporation's taxable year, or
  - An issuance of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more new shareholders during any 30 day period during the corporation's taxable year.

This election cannot be made pursuant to the death of a shareholder. Therefore, items of income and loss would be allocated on a pro-rata basis as contained in Problem 12 of this section and reported on the shareholder's final return (IRC §1366(a)(1)). Income and losses after the shareholder's death would be reported on the fiduciary return or by the beneficiary/purchaser of the decedent's stock.

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090904 Mechanics of Dividing the Taxable Year

Division of a taxable year into two short years affects only the allocation of income (losses) to the shareholders. It does not require the S corporation to file separate returns. At the end of the taxable year, the S corporation files one return with Schedule K-1's reflecting allocation of income (losses) for the divided taxable year. A corporation making this election must treat the short years as separate taxable years for purposes of:

- Allocating items of income and loss,
- Making adjustments to the AAA,
- Making adjustments to earnings and profits,
- Making adjustments to shareholder basis,
- Determining the taxability of distributions.

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091000 NONLIQUIDATING STOCK SALES/DISPOSITIONS - COMPUTING GAIN (LOSS), TREATMENT OF SUSPENDED LOSSES & UNRESTORED DEBT BASIS

S Corp 091001 Computing Gain (Loss)
S Corp 091002 Treatment of Suspended Losses in a Nonliquidating Stock Sale/Disposition
S Corp 091003 Treatment on Repayment of Shareholder Loans that have an Unrestored Debt Basis

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091001 Computing Gain (Loss)

Stock and debt basis must be adjusted for the shareholder's pro-rata share of income and loss items as of the last day in which the shareholder owned stock in the corporation. Pro-rata shares are determined either (1) on a per share, per day basis or (2) by dividing the S corporation's taxable year pursuant to an election involving a qualifying disposition. The gain (loss) on the nonliquidating stock sale/disposition reflects the difference between the sales proceeds and the adjusted stock basis. Adjusted debt basis is not used in computing the gain (loss).

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Example A

		from Prior Year	Schedule K-1 Items	Total Current Items	Stock Basis	Basis	Actual Debt
	Beginning Balance				$0	$0	$100,000
2.	Ordinary Income		$300,000	$300,000			
	Capital Loss	-$50,000	-70,000	-120,000			
	Rental Loss	-$20,000	-$15,000	-35,000			
	Net Increase			$145,000	45,000	100,000	
3.	Balance				45,000	00	$100,000
4.	Proceeds from Stock Sale				300,000		
5.	Gain (loss) on Stock Sale				$255,000		

Disregarding other applicable limitations, the shareholder would report the following amounts per return:
Ordinary Income, $300,000 to Schedule B.

Rental Loss, $35,000 to Schedule E.

Note: The adjusted debt basis of $100,000 is not used in computing the gain (loss) on the stock sale.

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091002 Treatment of Suspended Losses in a Nonliquidating Stock Sale/Disposition

Loss/deduction items in excess of stock and debt basis are treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder, therefore, belong to the shareholder who owns the stock, not to the stock itself. (IRC §1366(d)(2)) As a result, no part of the excess losses/deductions can be carried over and used by the new shareholder. Gain on the stock disposition does not increase the disposing shareholder's basis.

Example A

		Carryover Losses from Prior Year	Schedule K-1 Items	Total Current Items	Stock Basis	Current Suspended Losses
1.	Beginning Balance				$0	
2.	Interest Income		$10,000	$10,000		
	Ordinary Loss		-70,000	-120,000	-7,742	-$112,258
	Rental Loss	-20,000	-$15,000	-35,000	-2,258	-32,742
	Net Decrease			145,000		
3.	Ending Balance				0	
4.	Proceeds from Stock Sale					
5.	Gain (loss) on Stock Sale				0	

Disregarding other applicable limitations, the shareholder would report the following amounts per return:
Interest Income, $10,000 to Schedule B.

Rental Loss, $2,258 to Schedule E.
Capital Gain, $300,000 to Schedule D [stock sale].

his/her stock and will be lost. They cannot be carried over and used by the new

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shareholder.
Ordinary Loss, $112,258.
Rental Loss, $32,742.

increase basis for purposes of recognizing current suspended losses.

a. Treatment of Suspended Losses Incident to Divorce

LTR 9552001 (August 31, 1995) addresses the transferability of suspended losses incident to a divorce when each spouse separately owns shares. The ruling concluded that the wife may not deduct losses disallowed and suspended under IRC section 1366(d)(1) at a time when the former husband owned the S corporation stock. IRC section 1366(d)(2) provides that any loss disallowed by the basis limitation in IRC section 1366(d)(1) is treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder. Prior to the enactment of IRC section 1366(d)(2), an S corporation shareholder was not permitted to carryover losses. IRC section 1366(d)(2) provides an S corporation shareholder with the opportunity to carryover losses indefinitely. In permitting the shareholder to carryover losses that would otherwise expire, Congress restricted the transfer of any losses to another shareholder. The use of the words “with respect to that shareholder” in IRC section 1366(d)(2) requires that all losses be personal to a shareholder and that the losses not be transferred in any manner.

IRC section 1041 does not contradict the ruling. No gain or loss is recognized on the husband’s transfer of his stock to his wife. The transfer is treated as a gift; therefore, the wife’s basis in the stock is the husband’s adjusted basis in the stock at the time of the transfer.

In the Ruling, the S corporation stock was separate property prior to the divorce. Little guidance has been provided regarding community property laws and the role they play in determining stock ownership prior to the divorce in which one spouse is awarded sole ownership incident to divorce. If community property laws are a factor and the couple resides in a community property state in which the S corporation stock is clearly not separate property prior to the divorce, IRC section 1366(d)(2) would restrict the transfer of suspended losses between spouses incident to the divorce.

b. Treatment of Suspended Losses Pursuant to Death of Spouse

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As with divorce, little guidance has been provided regarding community property laws and the role they play in determining stock ownership pursuant to the death of a spouse. However, the same logic applies. If community property laws are a factor and the couple resides in a community property state in which the S corporation stock is clearly not separate property prior to the death, IRC section 1366(d)(2) would restrict the transfer of the decedent's suspended losses to the surviving spouse.

Keep in mind that the decedent's stock basis is adjusted to the fair market value at the date of death (or alternate valuation date if elected). If the stock reverts to the surviving spouse, only those shares acquired from the decedent will receive a stepped-up basis.

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091003 Treatment on Repayment of Shareholder Loans that have an Unrestored Debt Basis

IRC section 1016(a)(17) states that the adjusted basis for determining the gain or loss from the sale or other disposition of property shall be the basis adjusted to the extent provided in IRC section 1367 in the case of indebtedness owed to shareholders of an S corporation. Rev. Rul. 64-162 expands on this code section as follows.

Where a shareholder-creditor of an electing small business corporation has reduced his basis in the corporation's note by the amount by which his share of the corporation's net operating loss sustained in a prior year exceeded his basis in the corporations stock, the repayment of the note is considered to be an amount received in exchange for a capital asset, where the note is a capital asset in the shareholders hands. Installment received in retirement of the note must be allocated in part to a return of the shareholder's basis in the loan and in part to income.

This revenue ruling recharacterizes indebtedness, evidenced by a written instrument, to a capital asset. Repayments on the reduced basis indebtedness would be allocated part to return of the shareholder's basis in the loan and part to income regardless of whether the individual is a current or former shareholder of the S corporation. If no written instrument exists, there is no sale or exchange when the debt is paid. Thus, a payment by an S corporation of a debt to a shareholder that is carried on an open account will be ordinary income to the extent of the amount paid over the adjusted basis of indebtedness (Rev. Rul. 68-537, 1968-2 CB 372).

Example A

		Basis	Actual Debt
1.	Balance on the Date of Stock Disposition	$20,000	$180,000
2.	Loan Repayment After Stock Disposition		-100,000
3.	Repayment]	-11,111	
4.	Remaining Balance	$8,889	$80,000

Taxable Portion of Loan Repayment:

Deemed Debt Repayment [Return of Debt Basis]:

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$100,000 - 88,8889 = $11,111.
The shareholder would report a capital or ordinary gain of $88,889.
If the note then became uncollectible, the shareholder would be entitled to a bad debt deduction of $8,889 - his/her adjusted basis in the note.

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091100 COMPLETE LIQUIDATION - COMPUTING GAIN (LOSS)

Please refer to S Corp 150000 - S Corporation Liquidation.

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091200 POST TERMINATION TRANSITION PERIOD

Recall that items of income, loss, and deduction affecting stock and debt basis are treated as incurred on the last day of the S corporation taxable year. Special provisions apply in cases where losses/deductions were limited due to insufficient basis if it is the last taxable year of a corporation for which it is an S corporation (IRC §1366(d)(3)).

These special provisions refer to the "post termination transition period." The aggregate losses/deductions lost due to insufficient basis are treated as incurred on the last day of the 'post termination transition period'. In other words, the shareholder is allowed a grace period in which to make additional stock contributions to the S corporation for purposes of recognizing suspended losses/deductions. There are no provisions for recognizing losses/deductions against debt basis during the post termination transition period.

The post termination transition period means (IRC §1377(b)):

- The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of (1) the day which is one year after such last day, or (2) the due date for filing the return for such last year as an S corporation (including extensions) (IRC §1377(b)(1)(A) and pre-1997 SBA §1377(b)(1)(A)); and
- The 120-day period beginning on the date of a determination that the corporation's election under IRC section 1362(a) had terminated for a previous taxable year. (IRC §1377(b)(1)(C) and pre-1997 SBA §1377(b)(1)(B)) A determination is defined as (1) a court decision that becomes final, (2) a closing agreement, or (3) a written agreement with the IRS acknowledging that the corporation does not qualify as an S corporation, or (4) an implied agreement with the IRS due to the fact that the IRS made a determination that the corporation does not qualify as an S corporation and no timely filing of a petition under IRC section 6226 or IRC section 6213 has been filed. (IRC §1377(b)(2) and Treas. Reg. §1.1377-2)(c))

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Example A

Year:	Schedule K-1 Items	Stock Basis	Debt Basis	ed Items
1. Beginning Balance, 1/1/93		$10,000		$0
2. Ordinary Income	5,000	5,000		
Subtotal			100,000	
3. Section 1231 Loss	-250,000	-15,000	-100,000	$135,000
4. Ending Balance, 12/31/93		0	0	
Post Termination Transition Period:				
5. Capital Contributions, 12/31/94		120,000		
Subtotal		120,000		
6. Suspended Losses		-120,000		
7. Ending Balance, 12/31/94		$0		$15,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:
Last S Corporation year:
Ordinary Income, $5,000 to Schedule E.
1231 Loss, $115,000 to Form 4797.
Post Termination Transition Period:
1231 Loss, $120,000 to Form 4797.
The shareholder would lose the following losses/deductions:
1231 Loss, $15,000.

stock disposition, is zero. Future loan repayments would be taxable in whole as either capital or ordinary gains. If the shareholder had made a loan to the S corporation during the post termination transition period, he/she still could not have recognized the suspended $15,000.

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091300 INTERACTION BETWEEN SUSPENDED LOSSES AND NET OPERATING LOSS CARRYOVERS.

Because California allows only a 50% net operating loss carryover (R&TC §24416(b)(1)), it is more beneficial for a shareholder to suspend losses/deductions due to insufficient basis when they have a taxable loss for the year.

Example A Sufficient Basis with NOL Carryover

		e K-1 Items	Stock/Debt Basis	Suspended Losses	Per Return
1.	Beginning Balance		$2,000,000		
	Interest Income	$10,000	10,000		$10,000
	Ordinary Loss	1,000,000	-1,000,000	0	-$1,000,000
3.	Ending Balance		$1,010,000		
4.	Net Operating Loss				-990,000
5.	(50%)				-495,000
6.	Tax benefit from NOL carryover @ 11% *				$54,450

* The tax rate depends on the tax year.

Example B Insufficient Basis

		e K-1 Items	Stock/Debt Basis	Suspended Losses	Per Return
1.	Beginning Balance		$0		
2.	Interest Income	$10,000			

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	Ordinary Loss	-1,000,000		$990,000	-$10,000
3.			$0		
4.		0			
5.	Allowable Future Losses	$990,000			
6.	Tax benefit from basis limitation @ 11% *	$108,900			

* The tax rate depends on the tax year.

In **Example A**, the shareholder had sufficient basis to recognize 100% of his Schedule K-1 income and losses. Assuming this was the shareholder's only source of income (loss), a net operating loss was generated. California imposes a 50% net operating loss carryover limitation. As a result, the shareholder "lost" 50% of his pro-rata share of losses/deductions from the S corporation.

In **Example B**, however, the shareholder had insufficient basis. His pro-rata share of losses/deductions in excess of stock and debt basis were suspended and allowed to be carried over in full into the next tax year. As a result, the shareholder did not "lose" any excess losses/deductions pursuant to the 50% net operating loss limitations.

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091400 ALTERNATIVE MINIMUM TAX & SUSPENDED LOSSES

The S corporation is not subject to AMT; however, there will be AMT adjustment and preference items generated by the S corporation that affect the shareholder's AMT computation. These AMT items will be shown on Schedule K-1.

For purposes of determining the AMT adjustment, you must compute shareholder basis separately for Regular Tax and for AMT. IRC section 59(h) states that limitation of IRC section 1366(d) shall be applied for purposes of computing the alternative minimum taxable income of the taxpayer for the taxable year with the adjustments of IRC section 56, IRC section 57, and IRC section 58.

Example A

		Schedule K-1 Items	Stock Basis Regular Tax	Suspended Losses Regular Tax	Stock Basis AMT	Suspended Losses AMT
Year 1						
1.	Beginning Balance		$10,000	$0	$10,000	$0
2.	Regular Tax:					
	Interest Income	$20,000				
	Ordinary Loss	-100,000				
	Net Decrease	-80,000	-10,000	-70,000		
3.	AMT:					
	Interest Income	20,000				
	Ordinary Loss	-100,000				
	AMT Depreciation	90,000				
	Net Increase	$10,000				0
4.	Ending Balance		$0	-$70,000	$20,000	$0

	Schedule K-1 Items	Stock Basis Regular Tax	Suspended Losses Regular Tax	Stock Basis AMT	Suspended Losses AMT

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Year 2						
1.	Beginning Balan		$0	-$70,000	$20,000	$0
2.	Regular Tax					
	Capital Gain	$500,000				
	Ordinary Loss	-25,000				
	Suspended Loss	-70,000				
	Net Increase	405,000	405,000			
3.	AMT					
	Capital Gain	500,000				
	Ordinary Loss	-25,000				
	AMT Basis Adj.	-10,000				
	AMT Depreciatic	-25,000				
	Net Increase	$440,000				
4.	Ending Balance		$405,000	$0	$460,000	$0

The AMT adjustment to be reported on Schedule P is the difference between the net increase (decrease) actually recognized against stock and debt basis for AMT and Regular Tax. In Year 1, there is an AMT adjustment of +20,000 [10,000 - (-10,000)]. In Year 2, there would be an AMT adjustment of +35,000 (440,000 - 405,000).

When the S corporation stock is sold/disposed, the AMT basis adjustment will be the difference between ending Regular Tax and AMT stock basis.

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091500 INFORMATION DOCUMENT REQUESTS

Following are suggestions for information and documents to be requested from the shareholder:

- Computation of shareholder basis: adjusted stock basis, adjusted debt basis, and actual debt. Request computations covering either (a) the first year as a California S corporation to present or (b) the first open statute year to present.
- Copies of shareholder returns and California Schedule K-1's. (Request this information only when it is not available in-house.)
- Supporting documentation to substantiate the shareholder's initial capital contribution. (Use discretion if the corporation was incorporated many years ago.)
- Copies of notes for all loans made to the corporation.
- Copies of canceled checks, or other documents, to support the transfer of money from the shareholder to the S corporation. Request corporate journal entries to verify how the corporation booked the loan.
- Copies of journal entries computing interest payments on the notes and actual interest payments made.
- Copies of journal entries for actual repayment(s) on the note.
- Copies of trial balance workpapers for the years you are computing shareholder basis for. This includes the trial balance workpapers for all business enterprises that have intercompany transfers affecting shareholder basis.

Note: If the requested documentation is not available, consider alternative documentation. When requesting alternative documentation, please be sure that the information is reasonable and relevant to the issue under audit.

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091600 AUDIT TECHNIQUES

- Maintaining the shareholder basis computation is the responsibility of the shareholder. Examination of this issue should be conducted at the shareholder level. Thus, contact letters must be sent to each shareholder, and examinations must be conducted independently.
- If other issues are selected for examination, complete these issues before proceeding with the basis issue. Facts may change during the course of your examination, and the changes may adversely impact the tax potential of the shareholder basis issue.
- **Subsequently filed shareholder returns should always be obtained before completion of the audit to reevaluate tax potential.**

Example A

The auditor obtains (1) ABC, Inc.'s corporate folder and (2) the sole shareholder of ABC, John's, 1993-1995 individual returns. He sends a contact letter to John on 12/1/96. The auditor determines that John recognized $1,000,000 of losses in excess of basis for tax year 1995. Prior to completion of the audit, John files his 1996 individual return reporting a pass-through capital gain from ABC, Inc. totaling $25,000,000.
Since John had sufficient basis in 1996 to take the $1,000,000 suspended loss from 1995, the tax potential on the 1995 adjustment will be impacted due to the timing adjustment.

- Determine whether (a) the shareholder recognized losses against debt basis during any of the open statute years, (b) the shareholder reported taxable loan repayments during any of the open statute years, and (c) there would be overall tax effect after taking into consideration of losses suspended at the shareholder basis level (100% carryover) versus losses recognized at the shareholder basis level but carried over as the net operating loss (50% carryover).

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100000 AT-RISK LIMITATIONS

S Corp 100100	General Overview – IRC Section 465, R&TC Section 17551, and R&TC Section 24691
S Corp 100200	Amount At-Risk
S Corp 100300	Contributions of Cash or Other Property
S Corp 100400	Contributions of Cash or Other Property Purchased with Borrowed Funds
S Corp 100500	Amounts Borrowed from Persons Having an Interest in the Activity
S Corp 100600	Corporate-Level Indebtedness
S Corp 100700	Purchase of Stock
S Corp 100800	Adjustments to At-Risk Amount
S Corp 100900	Multiple Activities - Separately Computed & Aggregation Rules
S Corp 101000	Disposition of Stock

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100100 GENERAL OVERVIEW – IRC SECTION 465, R&TC SECTION 17551, AND R&TC SECTION 24691

A shareholder's ability to deduct losses passing through to the shareholder from an S corporation is limited in two ways. First, the shareholder can only deduct losses to the extent that the shareholder has a sufficient basis in the stock and debt of the S corporation. (IRC §1366(d)(1)) Second, the shareholder can only deduct losses to the extent that the shareholder has a sufficient amount at-risk with regard to the shareholder's investment in the S corporation. (IRC §465) Common parlance has used the term "at-risk" to refer to both of these limitations on the deduction of S corporation losses, but the term "at-risk" technically applies only to the latter limitation. Oftentimes a shareholder's stock and debt bases will be the same as the shareholder's amount at-risk; however, the shareholder's amount at-risk can be lower than the shareholder's stock and debt bases due to the fact that some transactions that give rise to additional basis do not provide an addition to the shareholder's amount at risk. (IRC §465(b)(3) and (4))

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100200 AMOUNT AT-RISK

An S corporation shareholder is considered at risk for the sum of the following (IRC §465(b)(1)):

- The amount of money and the adjusted basis of other property contributed by the shareholder to the activity; and
- Amounts borrowed with respect to such activity (as determined under IRC §465(b)(2)).

An S corporation shareholder's amount at-risk, as determined above, must be increased and decreased by the S corporation's items of income, deduction, and loss, and distributions, having an affect on the shareholder's basis in the S corporation. However, the items described in IRC section 465(b)(3) and (4) must be disregarded in making the adjustments. (Temporary Reg. §7.465-2(b))

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100300 CONTRIBUTIONS OF CASH OR OTHER PROPERTY

IRC section 465(b)(1)(A) provides that the taxpayer, including a shareholder of an S corporation, is at- risk for an activity with respect to the amount of money and the adjusted basis of "other property" contributed by the taxpayer to the activity. Proposed Reg. section 1.465-22(a) elaborates by providing that a taxpayer's amount at-risk in an activity will be increased by the "personal funds" the taxpayer contributes to the activity. Proposed Reg. section 1.465-9(f) provides that "personal funds" means funds that satisfy all of the following conditions:

- They are owned by the taxpayer;
- They are not acquired through borrowing; and
- They have a basis equal to their fair market value.

Personal funds do not necessarily include amounts an S corporation shareholder borrows and then contributes or lends to the S corporation. An S corporation shareholder is only considered at-risk with respect to borrowed funds if the S corporation shareholder is personally liable for the repayment of the borrowed funds or has pledged property, other than property used by the S corporation, as security for the borrowed funds. (IRC § 465(b)(2))

IRC section 465(b)(1)(A) provides the general rule that a taxpayer's at-risk amount is increased by the adjusted basis of property, other than money, contributed to the activity. However, where an S corporation shareholder contributes unencumbered property to an S corporation that was purchased with borrowed funds, the S corporation shareholder's amount at-risk is only increased to the extent that the S corporation shareholder is personally liable for, or has pledged property to secure, repayment of the borrowed funds. (Proposed Reg. §§ 1.465-20(a) and 1.465-23(a))

Proposed Reg. §1.465-23(a)(2) sets forth rules for determining the increase in a taxpayer's at-risk amount where the taxpayer contributes encumbered property to an activity. Where a taxpayer contributes property subject to liabilities for which the taxpayer is personally liable (recourse liabilities), the taxpayer's at-risk amount is increased by the adjusted basis of the contributed property just as if the contributed property were unencumbered. (Proposed Reg. §1.465-23(a)(2)) Where the contributed property is subject to a nonrecourse liability, the taxpayer's amount at-risk is increased by the taxpayer's adjusted basis in such property and then the taxpayer's amount at-risk is decreased by the amount of the nonrecourse liability. (Proposed Reg. §1.465-23(a)(2)(ii)) For purposes of

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determining the increase in the taxpayer's at-risk amount caused by property contributions, Proposed Reg. section 1.465-23(b)(1) requires use of the adjusted basis of the contributed property that would have been used in determining the loss if the contributed property were sold immediately after being contributed to the activity.

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100400 CONTRIBUTIONS OF CASH OR OTHER PROPERTY PURCHASED WITH BORROWED FUNDS

As mentioned above, where an S corporation shareholder contributes or loans borrowed money to an S corporation or contributes unencumbered property purchased with borrowed funds, the shareholder's at-risk amount will increase only to the extent such shareholder is at-risk with respect to such borrowed amount. IRC section 465(b)(1)(B) provides that a taxpayer will be at-risk with respect to amounts borrowed for use in an activity to the extent provided in IRC section 465(b)(2). This section sets forth rules for determining a taxpayer's at-risk amount for borrowed funds, depending on whether the loan is recourse or nonrecourse.

A taxpayer is at-risk with respect to amounts borrowed for use in an activity to the extent personally liable for repayment of the loan. (IRC § 465(b)(2)(A)) Thus, where an S corporation shareholder borrows funds on a recourse basis, such shareholder generally will be at-risk for the loan proceeds thereafter actually contributed or loaned to the S corporation.

In the case of amounts borrowed on a nonrecourse basis for use in an activity, the taxpayer will be at-risk where the taxpayer has pledged property, other than property used in such activity, as security for the amounts borrowed to the extent of the "net fair market value" of the taxpayer's interest in the pledged property. (IRC § 465(b)(2)(B)) For this purpose, a shareholder's stock in the S corporation conducting the activity for which the funds are borrowed is property used in the activity. (See the last sentence of IRC § 465(b)(2) and Proposed Reg. § 1.465-25(b)(1), which applies this rule to partnerships.) Thus, an S corporation shareholder is not at-risk for amounts contributed or loaned to an S corporation obtained through a nonrecourse loan secured only by the shareholder's S corporation stock.

Example A

Sam and Joel form an S corporation.
Sam contributes $100,000 of his personal funds in exchange for 50% of the stock.
Joel borrows $100,000 on a nonrecourse basis secured only by a pledge of the S corporation stock. Joel contributes the $100,000 in exchange for 50% of the stock.
Sam's shareholder basis at the beginning of Year 1 is $100,000; his at-risk-basis, $100,000.
Joel's shareholder basis at the beginning of Year 1 is $100,000; his at-risk basis, $0.

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Assuming the S corporation reported an ordinary loss of ($150,000), Sam and Joel would report the following:

	Sam	Joel	
		Recognized	Suspended
1st Loss Limitation Level - Shareholder Basis			
Beginning stock basis	$100,000	$100,000	
Ordinary loss	-75,000	-75,000	
Ending stock basis	25,000	25,000	
2nd Loss Limitation Level - At-Risk			
Beginning at-risk basis	100,000	0	
Ordinary loss	-75,000	0	-$75,000
Ending at-risk basis	$25,000	$0	

Sam is allowed to recognize ($75,000) ordinary loss after application of the shareholder basis and at-risk limitations.
Joel is allowed to recognize $75,000 ordinary loss after application of the shareholder basis, but cannot recognize any of the loss at the at-risk level.

Proposed Reg. section 1.465-25(a)(4) provides that the net FMV of property pledged as security is the excess of the property's FMV as of the date it is pledged over the total superior liens to which such property is subject. Subsequent changes in the property's FMV are not taken into account for purposes of determining net FMV; however, to the extent the amount of superior liens changes during the taxable year, the net FMV is adjusted as of the close of such taxable year.

To the extent the superior liens to which pledged property is subject to increase during the taxable year, the taxpayer's at-risk amount will be decreased. (Proposed Reg. § 1.465-25(a)(4)) To the extent the amount of such superior liens decreases during the taxable year, the taxpayer's at-risk amount will increase. (Proposed Reg. § 1.465-25(a)(4)) Additionally, where property used outside the activity has been pledged as security for a nonrecourse loan, and the taxpayer subsequently contributes the pledged property to the activity, the net FMV of the pledged property is reduced to zero (which will reduce the taxpayer's at-risk amount in the activity), and the taxpayer will be considered to have contributed unencumbered property to the activity (which will increase the taxpayer's at-risk amount by the adjusted basis of the pledged property). (Proposed Reg. § 1.465-25(a)(3))

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S Corp 100401 Qualified Nonrecourse Financing

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100401 Qualified Nonrecourse Financing

Although an S corporation shareholder will generally not be at-risk for amounts contributed or loaned to the corporation obtained through nonrecourse financing secured only by property used in the activity, a limited exception is available under IRC §465(b)(6) for "qualified nonrecourse financing." Under this rule, a taxpayer is at-risk with respect to qualified nonrecourse financing that is secured by real property used in the activity of holding real property. IRC Section 465(b)(6)(B) provides that qualified nonrecourse financing is financing:

- Borrowed by the taxpayer with respect to the activity of holding real property.
- Borrowed by the taxpayer from a "qualified person" (or from a federal, state, or local government or instrumentality thereof, or guaranteed by such an entity).
- With respect to which no person is personally liable for repayment.
- That is not convertible debt.

A "qualified person" is a person who is actively and regularly engaged in the business of lending money and not:

- A related person with respect to the taxpayer, except where the financing from such related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons.
- A person from whom the taxpayer acquired the property (or a related person to such person).
- A person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person). (IRC §§49(a)(1)(D)(iv) and 465(b)(6)(D))

Thus, a taxpayer is at-risk for amounts borrowed on a nonrecourse basis that are secured by and used in the activity of holding real property if the loan is made by a person actively and regularly engaged in the business of lending money (including related persons, where the financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons). In the S corporation context, this provision will have limited applicability since shareholders of an S corporation generally are not permitted to increase their stock or debt basis by corporate-level indebtedness. Generally, IRC section 1366(d)(1) will prevent the S corporation shareholder from deducting losses, even though nonrecourse financing may permit the S corporation shareholder to satisfy the at-risk limitation.

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Where, however, qualified nonrecourse financing is structured as a “back-to-back” loan or capital contribution between the shareholder (as the primary debtor to the qualified lender) and the S corporation; the shareholder should be able to take advantage of this provision. Thus, if an S corporation shareholder borrows money on a nonrecourse basis from a qualified lender secured only by real property used by the S corporation in real property activities, and the shareholder thereafter contributes or loans such funds to the S corporation, such shareholder’s at-risk amount and basis amount will be increased by the loan proceeds contributed or loaned to the S corporation. In Example A of S Corp 100400, if the S corporation used the capital contributions made to it to purchase real property to be used in the activity of holding real property, and Joel had obtained his loan from a qualified lender and secured such loan by the S corporation’s real property rather than by a pledge of his S corporation stock, Joel’s at-risk amount would increase to $100,000, the same as his basis in his S corporation stock.

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100500 AMOUNTS BORROWED FROM PERSONS HAVING AN INTEREST IN THE ACTIVITY

An S corporation shareholder is generally not at-risk with regard to funds borrowed from a person who has an interest in the S corporation or a person related to a person having an interest in the S corporation. (IRC §465(b)(3)(A)) However, if the lender's interest in the S corporation is only an interest as a creditor, the S corporation shareholder will be considered at-risk with regard to the borrowed funds. (IRC §465(b)(3)(B)(i)) Therefore, an S corporation shareholder will not be considered at-risk with regard to funds borrowed from other shareholders because the other shareholders have an interest in the S corporation that is not merely an interest as a creditor.

Proposed Reg. section 1.465-8 sets forth rules for determining when a person has an interest in an activity other than as a creditor. In the case of recourse loans, Proposed Reg. section 1.465-8(b)(1) provides that the lender will have an interest in the activity other than as a creditor if the lender has either a capital interest in the activity (a shareholder of the S corporation) or an interest in the net profits of the activity. Under Proposed Reg. section 1.465-8(b)(2), a capital interest in an activity is an interest in the assets of the activity that is distributable to the owner of the interest upon liquidation of the activity. Thus, an S corporation shareholder has a capital interest in the activities conducted by the S corporation. Proposed Reg. section 1.465-8(b)(3) provides that a person has an interest in the net profits of an S corporation if any part of the person's compensation is determined with regard to the net profits of the S corporation (i.e. employees and independent contractors), regardless of whether such person holds any of the incidents of ownership with respect to the S corporation.

In the case of nonrecourse loans secured by assets having a readily ascertainable FMV, the lender will be a person with an interest in the activity other than as a creditor only if the lender has either a capital interest in the activity or an interest in the net profits of the activity. (Proposed Reg. §1.465-8(c)(1)) An interest in the gross receipts of an S corporation is not a net profits interest for this purpose. (Proposed Reg. §1.465-8(b)(4), Example (2))

In the case of nonrecourse loans secured by assets not having a readily ascertainable FMV, however, the lender will be a person with an interest in the activity other than as a creditor if the lender stands to receive financial gain (1) other than interest from the activity (i.e. - compensation for services rendered in connection with the organization or operation of the activity) or (2) from the sale of an interest in the activity. (Proposed Reg. §1.465-8(d)(1))

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Thus, a promoter who organizes the activity or solicits potential investors in the activity will generally have an interest in the activity other than as a creditor with respect to nonrecourse loans secured only by property not having a readily ascertainable FMV.

S Corp 100501 Limited Application

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100501 Limited Application

Although the previous section discussed the related party rules contained in IRC section 465(b)(3) as if they applied to all S corporation shareholders, these rules do not automatically apply to S corporation shareholders. The related party rules contained in IRC section 465(b)(3) only apply to S corporation shareholders to the extent the S corporation is involved in the following five activities listed in IRC section 465(c)(1):

- Holding, producing, or distributing motion picture films or video tapes;
- Farming (as defined in IRC §464(e));
- Leasing any IRC section 1245 property (as defined in IRC §1245(a)(3));
- Exploring for, or exploiting, oil and gas resources as a trade or business or for the production of income; or
- Exploring for, or exploiting, geothermal deposits (as defined in IRC §613(e)(2)).

The reason for this limitation is statutory. When IRC section 465 was originally enacted in 1976, it only applied to the five activities listed above. (See P.L. 94-455.) IRC section 465(c)(3) was added to the Code in 1978 and thereby extended the application of IRC section 465 to include activities engaged in by the taxpayer in carrying on a trade or business or for the production of income, which would include investments in an S corporation. (See P.L. 95-600.) However, when Congress enacted IRC section 465(c)(3), Congress limited the application of the related party rules to these newly covered activities by enacting IRC section 465(c)(3)(D), which provides that the related party rules will only apply to the new activities to the extent provided by the regulations. Unfortunately, the Treasury has never promulgated the regulation required by Congress and in 1990 the Tax Court held that the related party rules could not be applied to the newly covered activities until the IRS promulgates such regulations. (See *Alexander v. Commissioner* (1990) 95 T.C. 467.)

If an auditor encounters a situation where an S corporation shareholder would not be entitled to increase his or her at-risk amount if the related party rules of IRC section 465(b)(3) were applied, but the rules cannot be applied due to the fact that the S corporation is not involved in one of the five activities discussed above, the auditor should review the transaction with regard to IRC section 465(b)(4). Under IRC section 465(b)(4), "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements."

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100600 CORPORATE-LEVEL INDEBTEDNESS

As mentioned above, S corporation shareholders generally are not permitted to increase their at-risk amount for their share of corporate-level indebtedness representing loans from third parties or from other shareholders of the S corporation. It is important to distinguish differences between at-risk basis of the S corporation separate from the at-risk basis of the shareholder.

In general, S corporations determine their amount at-risk in the same manner as any other taxpayer. (Proposed Reg. §1.465-10(b)(1)) However, where the S corporation borrows funds from its own shareholders for use in an activity governed by IRC section 465, the borrowed funds will increase the S corporation's amount at-risk, despite the fact that the shareholders have an interest in the S corporation's activities, that is not merely an interest as a creditor. (Proposed Reg. §1.465-10(b)(2))

Pursuant to Proposed Reg. section 1.465-6(d), an S corporation shareholder's personally guarantee for a loan made directly to the S corporation does not increase the S corporation shareholder's amount at-risk. However, if the S corporation shareholder actually repays all or a part of the debt, the S corporation shareholder will be entitled to increase his or her amount at-risk by the amount of the payments when the S corporation shareholder no longer has a legal right to seek indemnification from the primary obligor on the loan (i.e. the S corporation or another shareholder). (Proposed Reg. §1.465-6(d))

An S corporation shareholder can increase his or her amount at-risk with regard to the S corporation for what otherwise might appear to be corporate indebtedness if, under the terms of the loan agreement:

- The S corporation shareholder is the primary obligor on the loan;
- The loan is made directly to the S corporation shareholder; and
- The S corporation shareholder contributes or loans the borrowed funds to the S corporation. (Proposed Reg. §1.465-10(d))

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100700 PURCHASE OF STOCK

Under Proposed Reg. section 1.465-22(d), the amount paid by a purchaser for an interest in an activity, such as stock in an S corporation, is treated as a contribution to the activity. Thus, where an S corporation shareholder purchases stock from an existing shareholder, the purchasing shareholder will be at-risk to the extent the purchase price (contribution) would increase the shareholder's at-risk amount. For example, if the stock were paid for in cash from the purchasing shareholder's personal funds, the at-risk amount would equal the purchase price of the stock. However, if the stock purchase were financed through a nonrecourse loan secured only by a pledge of the purchased stock, the purchasing shareholder's initial at-risk amount would be zero. (Proposed Reg. §1.465-25(b)) The rules for determining whether other property constitutes an interest in the activity are contained in Proposed Reg. section 1.465-8.

S Corp 100701 Conversion from C to S Corporation Status

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100701 Conversion from C to S Corporation Status

When a C corporation converts to an S corporation status, the shareholder's initial amount at-risk will be the shareholders adjusted basis in the corporation, determined by disregarding amounts described in IRC section 465(b)(3) and (4). Presumably, a shareholder's adjusted cost basis in stock and loans made by such shareholder to the corporation as of the date of the conversion would be amounts at-risk for such shareholder. (Proposed Reg. §§7.465-2(a) and 1.465-76(a))

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100800 ADJUSTMENTS TO AT-RISK AMOUNT

An S corporation shareholder's pro rata share of the S corporation's items of income, including tax-exempt income, will increase the shareholder's at-risk amount. (Proposed Reg. §1.465-22(e)(1)) In addition, gain recognized on the disposition of an activity or an interest in an activity will be treated as income from such activity. (Proposed Reg. §§1.465-12(a) and 1.465-66(a)) Also, a shareholder's at-risk amount will be increased by additional capital contributions of cash and property and for loans made by the shareholder to the S corporation, subject to the exceptions contained in IRC section 465(b). (IRC §465(b)(1) and Proposed Reg. §1.465-10(c)) However, where there is an increase in a shareholder's at-risk amount immediately prior to the end of the S corporation's taxable year, which is followed by a corresponding decrease in such shareholder's at-risk amount shortly thereafter in the succeeding taxable year, such increase would be ignored under the proposed regulations except in limited circumstances. (Proposed Reg. §1.465-4(a))

A shareholder's pro rata share of an S corporation's items of loss or deduction, including nondeductible expenses not properly chargeable to a capital account, will decrease the shareholder's at-risk amount, but only to the extent the loss or deduction would be allowed to the taxpayer under IRC section 465(a). (Proposed Reg. §1.465-22(c)(2)) Also, an S corporation shareholder's at-risk amount will be reduced by distributions of money, whether in the form of a distribution made with respect to stock (out of the shareholder's stock basis or out of the accumulated adjustments account) or in the form of a loan repayment, to the extent of any decrease in the shareholder's adjusted basis in such indebtedness. (Proposed Reg. §1.465-22(b))

An S corporation's distribution of property other than money to a shareholder will decrease the shareholder's at-risk amounts in the activity in which the property was used. The decrease will equal the property's adjusted basis less any liabilities to which the property is subject for which the shareholder is not personally liable. The subsequent repayment of such liability by the taxpayer following the distribution will not increase the taxpayer's at-risk amount. (Proposed Reg. §1.465-23(c))

Where an S corporation shareholder has incurred recourse indebtedness and contributed or loaned the borrowed funds to his or her S corporation, Proposed Reg. §1.465-24(b) provides rules for determining the effect of the shareholder's loan repayments to the creditor on the taxpayer's at-risk amount. In general, loan repayments on a recourse loan will not increase the shareholder's amount at-risk.

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However, there are two situations where the repayments will decrease the shareholder's at-risk amount. First, where the S corporation shareholder uses assets that are already used in the activity, such as stock in the S corporation, to repay the recourse indebtedness, the S corporation shareholder's amount at-risk will decrease by the adjusted basis of the assets (as defined in Proposed Reg. §1.465-23(b)(1)). (See Proposed Reg. §1.465-24(b)(2).) Second, where the S corporation shareholder uses funds, which would not increase the S corporation shareholder's at-risk amount if contributed directly to the S corporation, to repay the recourse indebtedness, the S corporation shareholder's amount at-risk will be decreased by the amount of such funds. For example, where an S corporation shareholder repays a recourse loan with the proceeds of a nonrecourse loan secured by the S corporation shareholder's interest in the S corporation, the S corporation shareholder's amount at-risk will be decreased by the amount of the repayment.

Where an S corporation shareholder has incurred nonrecourse indebtedness and contributed or loaned the borrowed funds to his or her S corporation, Proposed Reg. section 1.465-25(b)(2) provides rules for determining the effect of loan repayments. In the case of nonrecourse loans, repayments may either increase or decrease the S corporation shareholder's amount at-risk depending upon two factors. The first factor is whether the nonrecourse loan increased the S corporation's shareholder's at-risk amount at the time it was incurred. The second factor is whether the funds or property used to make the repayment would increase the S corporation shareholder's amount at-risk if the funds or property were contributed directly to the S corporation. If the S corporation shareholder's nonrecourse loan did not increase the S corporation shareholder's amount at-risk at the time it was incurred, subsequent repayments of the loan will result in an increase in the S corporation shareholder's amount at-risk. (Proposed Reg. §1.465-25(b)(2)(i)) However, if the amounts used to repay the nonrecourse indebtedness would not have increased the S corporation shareholder's amount at-risk if contributed directly to the S corporation, the S corporation shareholder's amount at-risk is unaffected by the repayment. If the S corporation shareholder's nonrecourse loan did increase the S corporation shareholder's amount at-risk at the time it was incurred, subsequent repayments will not increase the S corporation shareholder's amount at-risk. However, if the amount used to repay this type of nonrecourse loan would not increase the S corporation shareholder's at-risk amount if contributed directly to the S corporation, the repayment will actually decrease the S corporation shareholder's at-risk amount.

If an S corporation shareholder's recourse loan is converted to a nonrecourse loan, the S corporation shareholder's amount at-risk must be adjusted for the

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rules applicable to nonrecourse indebtedness. If an S corporation shareholder's nonrecourse loan is converted to recourse, the S corporation shareholder's amount at-risk must be adjusted for the rules applicable to recourse indebtedness. However, there are special rules for recourse loans, which become nonrecourse upon the happening of an event or a lapse of time (i.e. contingencies). Under such circumstances, the S corporation shareholder is only considered at-risk with regard to the loan while it was recourse if:

- There was a business purpose for incurring such indebtedness (determined by applying all of the facts and circumstances);
- The primary motivation for incurring the indebtedness was not the income tax consequences (also determined by applying all of the facts and circumstances); and
- The loan agreement is consistent with the normal commercial practice for financing the activity for which the money is being borrowed. (Proposed Reg. §1.465-5)

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100900 MULTIPLE ACTIVITIES - SEPARATELY COMPUTED & AGGREGATION RULES

S Corp 100901 Separate Computation
S Corp 100902 Aggregation Rules

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100901 Separate Computation

When an S corporation is engaged in multiple activities described in IRC section 465(c)(1) and (3), the S corporation shareholder's at-risk amount must be separately computed for each activity. (IRC §§ 465(c)(2) and 465(c)(3)(B))

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100902 Aggregation Rules

In general, a taxpayer's activity with respect to each film or videotape, leased IRC section 1245 property, farm, oil or gas property, or geothermal property is a separate activity. (IRC §465(c)(2)(A)) However, under IRC section 465(c)(2)(B)(i), all activities with respect to IRC section 1245 property that are leased or held for lease and placed in service in a particular taxable year of an S corporation may be aggregated as a single activity. In addition, Temporary Reg. section 1.465-1T permits S corporation shareholder's and S corporation's themselves to aggregate activities within each of the other four enumerated categories (motion picture film and videotape activities, farming activities, oil and gas activities, and geothermal activities) as a single activity if more than one activity within a single category are engaged in by the S corporation. However, except as discussed below, different categories of activities within the five enumerated categories may not be aggregated as a single activity.

Under IRC section 465(c)(3)(B), activities (other than the five enumerated IRC section 465(c)(1) activities) that constitute a trade or business will be a single activity if the taxpayer actively participates in the management of such trade or business, or such trade or business is carried on by an S corporation and 65% or more of the losses for the taxable year are allocable to persons who actively participate in its management. Thus, S corporation shareholder's who actively participate in the S corporation's activities can always aggregate all of the activities that constitute a trade or business, and S corporation shareholders who do not actively participate in the S corporation's activities will still be able to aggregate such activities so long as the second test described above is satisfied by other shareholders. Active participation in management depends upon the facts and circumstances of each situation. "Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the trade or business, actually performing services for the trade or business, or hiring and discharging employees (as compared to only the person who is in charge of the trade or business)." (See H.R.Rep. No. 95-1445, 2d Sess., pp. 69 and 70 (1978).) "Factors which tend to indicate a lack of active participation include lack of control of management and operations of the trade or business, having authority only to discharge the manager of the trade or business, and having a manager of the trade or business who is an independent contractor rather than an employee." (See H.R.Rep. No. 95-1445, 2d Sess., pp. 69 and 70 (1978).) Thus, the sole action of hiring an independent contractor as the manager of an activity will not constitute active participation in the management of a trade or business.

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101000 DISPOSITION OF STOCK

An S corporation shareholder who has suspended deductions, because of either an insufficient at-risk amount under IRC Section 465(a)(2) or the loss recapture rules under IRC section 465(e), may be able to use such deductions upon the sale or other disposition of S corporation stock. See Proposed Reg. section 1.465-12(a) and Proposed Reg. section 1.465-66(a) for the rules applicable to determining when gain on the sale of an activity or an interest in the activity will be treated as income from the activity.

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110000 CANCELLATION OF INDEBTEDNESS INCOME

S Corp 110100	The Tax Treatment of Cancellation of Indebtedness Income – In General
S Corp 110200	Discharge That Occurs in a Title 11 Case or When a Taxpayer is Insolvent - IRC Section 108(a)(1)(A) and (a)(1)(B)
S Corp 110300	Special Rules for Discharge of Qualified Farm Indebtedness - IRC Section 108(a)(1)(C)
S Corp 110400	Discharge of Indebtedness Income from Qualified Real Property Business Indebtedness for Taxpayers Other than a C Corporation - IRC Section 108(a)(1)(D) and (c)
S Corp 110500	Purchase-Money Debt Reduction for Solvent Debtor Treated as Price Reduction - IRC Section 108(e)(5)
S Corp 110600	Reduction of Tax Attributes - IRC Section 108(b)
S Corp 110700	Time and Manner for Making Election - IRC Section 108(d)(9) and Treas. Reg. Section 1.108(a) Filing and Disclosure Requirements
S Corp 110800	Effect of Excluded CODI on Shareholder Basis in the S Corporation
S Corp 110900	Exhibits

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110100 THE TAX TREATMENT OF CANCELLATION OF INDEBTEDNESS INCOME – IN GENERAL

The receipt of borrowed funds or borrowed property is not income to the borrower. (Commissioner v. Tufts (1983) 461 U.S. 300, 307) However, when the creditor cancels of all or a portion of a debt without receiving adequate consideration, the forgiveness or discharge of a debt could constitute income to the debtor. (United States v. Kirby Lumber Co. (1931) 284 U.S. 1) The Supreme Court's decision is codified in Internal Revenue Code section 61(a) (12) and Revenue and Taxation Code Section 17071 which include the amount of a taxpayer's discharge of indebtedness in gross income.

Note that a prerequisite to the general rule that receipt of loan proceeds is not income is that the loan is bona fide indebtedness. While the determination of whether the loan is bona fide indebtedness is beyond the scope of this chapter, this issue should be carefully examined.

For purposes of this chapter, the statutory term "discharge of indebtedness" (from IRC §§61 and 108) will be used interchangeably with the terms "cancellation of indebtedness", "cancellation of indebtedness income", "COD income", or "CODI".

For purposes of the IRC section 108 insolvency test, the relevant taxpayer is either an individual, a partner in a partnership (IRC §108(d)(6)), an S corporation (IRC §108(d)(7)) or a C corporation. The insolvency test is not applied to S corporation shareholders or partnerships.

Currently, there exist several provisions in federal income tax law that allows a taxpayer to defer the recognition of debt discharge income. Following is a list of those provisions we will discuss in this chapter:

- Discharge that occurs in a title 11 case without regard to whether the bankruptcy is filed under Chapter 7, Chapter 11, or Chapter 13 (IRC §108(a)(1)(A), S. Rep. No. 96-1035, 2nd Sess.),
- Discharge that occurs when a taxpayer is insolvent (IRC §108(a)(1)(B)),
- Discharge of indebtedness originating from qualified farm indebtedness (IRC §108(a)(1)(C)),
- In the case of a taxpayer other than a C corporation, the discharge of indebtedness originating from qualified real property business indebtedness (IRC §108(a)(1)(D)),

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- Discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction. (IRC §108(e)(2)), and
- In the case of a purchase-money debt reduction for solvent debtor treated as a price reduction (IRC §108(e)(5)).

In general, California income tax law incorporates IRC section 108 by reference in R&TC section 17024.5 and R&TC section 17131, as modified by R&TC section 17144 and R&TC section 24307.

In addition, California income tax law conforms to IRC section 108 precedence rules. That is, the exclusion for title 11 cases takes precedence over an insolvency case or in cases in which the debt discharge originated from qualified farm indebtedness or qualified real property business indebtedness. (IRC §108(a)(2)(A)) Excluding debt discharge income under the insolvency provision takes precedence over cases in which the discharge that gave rise to the income originated from qualified farm indebtedness and qualified real property business indebtedness. (IRC §108(a)(2)(B))

The first four deferral provisions listed above offer current year tax relief under specific situations. IRC section 108(e)(2) provides that taxpayers do not realize debt discharge income to the extent that had a taxpayer paid the item, a tax deduction would have resulted. This provision may be used in combination with any other debt discharge exclusion provision (IRC §108(e)(2)). In fact, there is nothing in the Code that prevents a taxpayer from availing him or herself of any combination of the debt discharge exclusion provisions listed, provided the precedence rules are observed and the exclusion provision is applicable.

Once you have determined that the transaction under examination has given rise to CODI, and that the taxpayer excluded or deferred the recognition of that income under IRC section 108 on a timely filed return, you should

- Determine if the taxpayer applied the appropriate non-recognition provision(s) correctly, and
- Verify if the pass-through entity's basis in property was correctly computed through the beginning of the tax year following the year the of debt discharge.

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110200 DISCHARGE THAT OCCURS IN A TITLE 11 CASE OR WHEN A TAXPAYER IS INSOLVENT - IRC SECTION 108(A)(1)(A) AND (A)(1)(B)

In general, the protections provided to insolvent taxpayers are the same whether a taxpayer formally files bankruptcy or chooses not to obtain bankruptcy protection. However, the most notable difference concerns those assets that are exempt in determining whether and to what extent a taxpayer is insolvent. The Code offers the most protection to those taxpayers who are attempting to reorganize its debt structure so as to provide the taxpayer the best possible opportunity to survive after its re-organization. However, taxpayers who file bankruptcy under Chapter 7 and Chapter 13 are also given the same protection. In either case, the tax consequence is similar and therefore, title 11 cases and insolvency cases will be presented together.

S Corp 110201 Bankruptcy Tax Act

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110201 Bankruptcy Tax Act

IRC section 108 (a)(1)(A) states that gross income does not include discharge of indebtedness income if the discharge occurs in a Title 11 case. California conforms to federal law by reference (R&TC §17131). Under IRC section 108(d)(2), the term "Title 11 case" means a case under the Bankruptcy Code if: (1) the taxpayer is under the jurisdiction of the court and, (2) the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court. Under IRC section 108(b), amounts excluded from income under section 108(a)(1)(A) must be applied to reduce certain specific tax attributes. It is the reduction of these attributes that result in the recognition of the income at a later date, but only to the extent there are attributes to reduce.

The Bankruptcy Tax Act also provides for exclusion from gross income of any amounts arising from a discharge of indebtedness outside bankruptcy. IRC section 108(a)(1)(B) states that gross income does not include amounts otherwise includible in income because of the discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. California conforms to federal law by reference (R&TC §17131). Under IRC section 108(a)(2)(A), the insolvency provision does not apply to a discharge that occurs in a bankruptcy case.

Under IRC section 108(a)(3), the amount excluded from gross income by reason of the insolvency cannot exceed the amount by which the taxpayer is insolvent. IRC section 108(d)(3) defines insolvency as the excess of liabilities over the fair market value of assets. This determination is based on assets and liabilities held immediately before the discharge and may be referred to as the balance sheet insolvency test. (IRC §108(d)(3))

The statutory language of IRC section 108(d)(3) does not specify which assets and which liabilities are taken into consideration for determining the definition of "insolvent." However, the Tax Court offers some guidance in *Hunt, et al. v. Commissioner*, (1989) TC Memo 1989-335. Note that this is only an issue for partner and individual taxpayers.

In the above referenced case, the Tax Court held that in determining whether a taxpayer was insolvent is based on exempting only those assets that are exempt from the claim of creditors under state law (Also see *Marcus Est. v. Commissioner*, (1979) TC Memo 1979-9 and TAM 9130005). Where a state's law allows debtors who file bankruptcy petitions under Title 11 to claim the greater of the state law exemptions or the Federal Bankruptcy Code exemptions, a taxpayer not in bankruptcy must use only the state law exceptions to determine

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whether the taxpayer is insolvent (*Hunt, et al. v. Commissioner*, TC Memo 1989-335, *Marcus Est. v. Commissioner*, TC Memo 1979-9 and TAM 9130005). Generally, corporation taxpayers will not have exempt assets, as this tax attribute is available only to individual taxpayers.

California has enacted legislation "opting out" of the federal exemptions for bankruptcy purposes (Cal. Civ. Proc. Code §703.130). Therefore debtors in California are only permitted to exempt property under state law or federal law other than 11 U.S.C. section 522(d).

California law makes available two alternative sets of exemptions in bankruptcy cases. Cal. Civ. Proc. Code Section 703.140(a) states that if a bankruptcy petition is filed, a “debtor may utilize all the exemptions provided in chapter 1 of title 9 of the Cal. Civ. Proc. Code except for those listed in section 703.140(b); alternatively, a debtor may elect to utilize Cal. Civ. Proc. Code Section 703.140(b) exemptions in lieu of all other exemptions in the chapter, subject to the following conditions:”

- A husband and wife filing jointly must both elect the same alternative (Cal. Civ. Proc. Code Section 703.140(a)(1));
- A married debtor filing individually can only elect the Cal. Civ. Proc. Code Section 703.140(b) exemptions if both the debtor and the non-filing spouse waive in writing the right to claim the other exemption alternative during the pendency of the case in any other bankruptcy case concerning either of them (Cal. Civ. Proc. Code §703.140(a)(2));
- An unmarried debtor may elect either alternative, but not both (Cal. Civ. Proc. Code §703.140(a)(3)).

Thus, the alternatives are mutually exclusive and may not be combined on an individual petition, a joint petition, or on separate petitions filed simultaneously by married debtors. Cal. Civ. Proc. Code Section 703.140(b) is based upon, and is practically identical in wording to, the 11 U.S.C. section 522(d) as it existed prior to being amended by the Bankruptcy Amendments and Federal Judgeship Act of 1987 (Pub. L. No. 98-353).

Not explicitly addressed by Cal. Civ. Proc. Code section 703.140 is the extent of availability in bankruptcy proceedings of exceptions that are created by other chapters of California law. These exemptions (and those created for a bankruptcy proceeding) are presented in Exhibit 110000-1, but its effect in a bankruptcy context is unclear. However, this circumstance may not create a

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substantial audit issue, as the FTB may not have an occasion to audit a bankruptcy case.

At a minimum, assets accounted for an insolvency determination (without regard to whether the case is under the jurisdiction of the court) includes property subject to claims of the taxpayer's creditors. Such assets include personal property such as automobiles, appliances, furniture, bank accounts and so on. Property statutorily subject to creditor claims is delineated in Cal. Civ. Proc. Code section 487.010. A taxpayer whose spouse was not insolvent and held assets immediately before the debt discharge may not include his or her spouse's separate property for determining whether and to what extent he or she is insolvent because the spouse's separate property is not subject to claims of the taxpayer's creditor claims. This is without regard to whether the taxpayer and his or her spouse filed a joint or separate income tax return. (See PLR 89-20019.) The following is a summary list:

- Interest in real property except leasehold estates with unexpired terms of less than one year.
- Accounts receivable, chattel paper, and general intangibles arising out of the conduct by the taxpayer of a trade, business, or profession, except any such individual claim with a principal balance of less than $150.
- Equipment.
- Farm products.
- Inventory.
- Final money judgments arising out of the conduct by the taxpayer of a trade, business, or profession.
- Money on the premises where a trade, business, or profession is conducted by the taxpayer and, except for the first $1,000.
- Negotiable documents of title.
- Instruments.
- Securities.
- Minerals or the like to be extracted (i.e., oil or gas).

Property not within the reach of creditor claims is provided in Cal. Civ. Proc. Code section 487.020. Except as provided elsewhere, the following property is exempt from attachment:

- All property exempt from enforcement of a money judgment.
- Property that is necessary to earn a living.

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- Compensation payable by an employer to an employee (Cal. Civ. Proc. Code §706.011(a)).
- All property not subject to attachment pursuant to Cal. Civ. Proc. Code section 487.010.

Outside of a bankruptcy proceeding, California law does not provide taxpayers the protection offered to those who make such a filing because exempt assets may not be excluded from the taxpayer's net worth. Therefore, in making an insolvency determination where the discharge occurs outside of a bankruptcy proceeding, the auditor need only obtain the FMV of all (material) assets of the taxpayer.

Under certain situations, interest that has not yet been paid is cancellation of debt income along with principal that has been canceled. These situations arise when a taxpayer is on an accrual method of accounting. Under Revenue Ruling (Rev. Rul.) 67-200 and Rev. Rul. 70-406, the amount of any interest that has been accrued and deducted (but not paid) in prior years by the taxpayer is considered cancellation of debt income under IRC section 61 and R&TC Section 17071. However, if the taxpayer can show that the prior year deduction resulted in no tax benefit, then under IRC section 111, Treasury Regulation (Treas. Reg.) section 1.111-1 and R&TC section 17131 (tax benefit rules) it will be excluded from gross income.

Under IRC section 108(d)(6), Subsection 108(a), (b) and (g) exclusions are applied at the partner level if the income realized was done so from debt discharge in a partnership context.

However, if the debt discharge occurred under an S corporation shell, then IRC section 108(a), (b), (c), and (g) is applied at the corporation level (IRC §108(d)(7)(A)). IRC section 108(a) provides for that amount of debt discharge income that may be deferred or not included; Subsection (b) details the rules for the reduction of tax attributes; and Subsection (g) provides for special cases in which the debt discharge originated from qualified farm indebtedness.

In addition, where a debtor has property subject to nonrecourse debt in excess of the value of the property, the excess of the amount of the nonrecourse debt over the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, the debtor is insolvent only to the extent that the excess debt is discharged. The reason for this is that the excess nonrecourse debt that is not discharged does not affect the debtor's solvency. Thus, even though the cancellation of nonrecourse debt in excess of the value of

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the property is treated as taxable income, the excess nonrecourse debt that is not canceled is not taken into account in determining solvency (Rev. Rul. 92-53, Situation 1, 1992-2 CB 48).

Also, note that when a debtor engages in two (or more) exchanges as part of one plan for discharge of debt, for purposes of determining solvency, the debtor is treated as engaging in both exchanges simultaneously (Rev. Rul. 92-53, Situation 3, 1992-2 CB 48). In these cases, it will be necessary to compute the taxpayer's state of solvency for each debt discharge date and then give the taxpayer the outcome that offers the most tax relief.

The amount of debt discharge income eligible for deferred recognition is going to depend on the particular taxpayer's facts and circumstances. For determining the application of IRC section 108(a), the relevant taxpayer facts and circumstances include (1) at the individual level, whether the debt discharge occurred outside of a partnership or corporation, (2) the partner level, whether the debt discharge occurred under a partnership shell and, (3) at the S and C corporation level whether the debt discharge occurred under these shells. Under no circumstance does the solvency of the partnership have a direct bearing on a taxpayer's (i.e., individual, partner, S or C corporation) insolvency determination. (See Exhibit 110000-2, Part 1.)

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110300 SPECIAL RULES FOR DISCHARGE OF QUALIFIED FARM INDEBTEDNESS - IRC SECTION 108(A)(1)(C)

IRC section 108(a)(1)(C) provides that gross income does not include any amount which would be includible in income by reason of a discharge of indebtedness if the indebtedness discharged originated from qualified farm indebtedness. Therefore, a taxpayer must meet three requirements in order to defer the recognition of debt discharge income under this provision:

- The taxpayer must have tax attributes available in order to recognize the income at a later date,
- The debt must be incurred from a qualified person, and
- The debt must be incurred in connection with a farm trade or business–gross receipts test.

A “qualified person” and “qualified farm indebtedness” are defined in IRC section 49(a)(1)(D)(iv) and IRC section 108(g), respectively:

For purposes of this paragraph, the term “qualified person” means any person which is actively and regularly engaged in the business of lending currency and which is not:

- a related person with respect to the taxpayer,
- a person from which the taxpayer acquired the property (or a related person to such person), or
- a person who receives a fee with respect to the taxpayer’s investment in the property (or a related person to such person). (IRC §49(a)(1)(D)(iv))

For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if:

- such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and
- 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming. (IRC §108(g)(2))

IRC section 108(g)(3)(C) defines “qualified property” as any property used or held for use in a trade or business or for the production of income. In addition, if a

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taxpayer availed him or herself of the insolvency provision, then the adjusted basis of the qualified property and the amount of the adjusted tax attributes shall be determined after any reduction by reason of amounts excluded from gross income under IRC section 108(a)(1)(B).

In the absence of meeting these requirements, the taxpayer will recognize the debt discharge income in the tax year it occurred. See Exhibit 110000-2, Part 2.

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110400 DISCHARGE OF INDEBTEDNESS INCOME FROM QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS FOR TAXPAYERS OTHER THAN A C CORPORATION - IRC SECTION 108(A)(1)(D) AND (C)

IRC section 108(a)(1)(D) and (c) allows solvent taxpayers who would otherwise be required to recognize "qualified real property business indebtedness" discharge income under IRC section 61(a)(12) (R&TC §17071) to defer that recognition to the extent a taxpayer has depreciable property basis to reduce. This subparagraph was added to the IRC on August 10, 1993, effective December 31, 1992. Recall that although the amount of indebtedness discharged is excluded from income in the year of discharge, the taxpayer may only be deferring recognition of the amount.

However, for California purposes there is a different effective date than for federal. As noted previously, in general, California incorporates IRC section 108 by reference in R&TC section 17024.5, R&TC section 17131, and R&TC section 24307. In addition, California uses the concept of a specified date to identify which version of the IRC applies to which taxable years. (R&TC §17024.5) The amendment adding IRC section 108(a)(1)(D) and (c) was not enacted until August 10, 1993. At that time, the date specified in the R&TC was January 1, 1993. (R&TC §17024.5) Therefore, IRC section 108(a)(1)(D) and (c) did not apply for California purposes.

In 1996, legislation was enacted in California which specifically provided that IRC section 108(a)(1)(D) and (c) applies to discharges occurring on or after January 1, 1996 in taxable years beginning on or after January 1, 1996. (R&TC §§17144 and 23417.) Note that R&TC section 17144 was amended in 1999 to remove the specific provision regarding the applicability of IRC section 108(a)(1)(D) and (c) to discharges and taxable years beginning after 1/1/96. However, at that time, the specified date of the IRC was 1/1/98 so those provisions applied under the general principles of conformity. In addition, it does not retroactively repeal those provisions for the earlier years.

This provision was added to the code because of the decline in real property values in 103rd Congress, House Report 103-111, Section 5. In some cases, the decline in real property values was so severe that the property could no longer support the debt that it secured. Congress legislated that where an individual has discharge of indebtedness income resulting from a decline in the value of business real property securing that indebtedness, "it is appropriate to provide for deferral, rather than current inclusion, of the resulting income. Generally, that

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deferral should not extend beyond the period that the taxpayer owns the property.

IRC section 108(a)(1)(D) is significant because prior to the RRA, a solvent taxpayer who realized COD income from QRPBI could not defer that income; the income would be included in current year gross income. (QRPBI is defined in Treas. Reg. §1.108(a)-1(a)(2)). As far as GTA is concerned, a taxpayer includes individual persons, which includes partners and not partnerships, and S corporations. C corporations are not provided the benefit of IRC §108(a)(1)(D).

In order to effect the income deferral, the taxpayer is required to reduce depreciable basis in real property as prescribed by IRC section108(C). This section along with IRC section 1017 (as amended by the RRA, §13150(C)) provides guidance on how real property basis is reduced.

In general, IRC section 108 and IRC section 1017 operate as illustrated in the following example:

Example A

A taxpayer incurs debt to purchase nonresidential real property on January 1, 1994. (Investment A). The purchase price is $100,000,000. The entire cost is financed. Of that $100,000,000 cost base, $80,000,000 is allocated to building, which is a depreciable base. The appropriate depreciation method is straight-line, with a recovery period of 39 years and zero salvage value. (For simplicity, assume California conformed). Accordingly, the allowable depreciation per calendar tax year is $2,050,000 (approx.). This is without regard to the mid-month convention.
For income year ending (IYE) 12/94, the taxpayer incurred a $5,000,000 loss on this property. However, his spouse had income from another nonresidential real property investment. (Investment B). The income for IYE 12/94 was $7,500,000. The taxpayers' commercial property management firm along with other investment properties owned by non-related parties managed both investments. The management firm operated under a C corporation shell. Each spouse was paid an executive salary of $650,000 and $950,000, which essentially cashed out the C corp. Consequently; the taxpayers' AGI for IYE 12/91 was $4,100,000.
For IYE 12/95, the taxpayers incurred the same income and loss; investment A incurred a loss of $5,000,000; investment B had income of $7,500,000; and executive salaries paid equaled $650,000 and $950,000. Therefore, the taxpayers' AGI was only $4,100,000 for year.
For IYE 12/96, the taxpayers incurred the same income and loss as IYE 12/94 and 12/95 with one exception. The loan on Investment A was renegotiated. The

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bank agreed to discharge $45,000,000 of the outstanding debt. The discharge occurred on 12/31/96. At that time, the taxpayers still owed $100,000,000. Since the taxpayers were solvent, they could not obtain COD income deferral under the insolvency provision of IRC section 108. Their only available tax relief is the QRPBI provision; the discharge occurred after December 31, 1992 and the IYE was also after that date (Federal requirement), and the discharge occurred after 1/1/96 for income year beginning after 1/1/96. So the taxpayers would qualify relief under IRC section 108(a)(1)(D) and R&TC section 17144. If the taxpayer elects to defer the COD income, the election is not revocable under California law.

By operation of the QRPBI provision, the taxpayers' AGI would remain the same for IYE 12/96 as for IYE 12/95 and 1/94. However, the taxpayers would have to reduce depreciable base in real property that was used to secure the liability that was partially discharged on 12/31/96 (IRC §108(c), IRC §1017, and R&TC §17144). The adjusted basis of the building for investment A on 12/31/96 is $73,850,000 - $80,000,000 cost basis less three years of depreciation ($6,150,000). Since the taxpayers elected (time and manor provided for in TR) to defer the recognition of the $45,000,000 of COD income, the taxpayers make the adjustment to depreciable base for income year beginning after the tax year the debt was discharged. Accordingly, on 1/1/97 the adjusted basis of the building is reduced by the $45,000,000 of deferred COD income, which is now equal to $28,850,000.

This $28,850,000 depreciable base is used as the base amount for re-computing depreciation over the remaining 36-year recovery period. As a result, the amount of allowable deprecation for IYE 12/97 and subsequent years is $801,300 per tax year. If we assume the taxpayers' business operating activity remained the same with the exception of this depreciation adjustment, for IYE 12/97 and subsequent, the taxpayers will have gross income increased by the difference between the deprecation allowable prior to the debt discharge of ($2,050,000) and depreciation allowable after the debt discharge ($801,300) for a net increase to AGI equal to $1,248,700. This additional gross income multiplied times 36 years equals approximately $45,000,000.

In effect, the taxpayers are allowed to spread the COD income over at least a 36-year period. Although the total amount of income recognized over the 36 years will be the same amount as if the income was recognized over in the year of the debt discharge, because of the time value of money, the amount recognized over the 36 years is materially less than if it were all recognized in IYE 12/96. If we assume the taxpayers' cost of capital is 9%, then the present value of 36 payments of $1,248,700 is $13,250,000.

Please refer to the California modifications to federal law in R&TC section 17144(e)(1) and (e)(2) and R&TC section 24307(f)(2) and (f)(3).

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110500 PURCHASE-MONEY DEBT REDUCTION FOR SOLVENT DEBTOR TREATED AS PRICE REDUCTION - IRC SECTION 108(E)(5)

This provision originated from judicial doctrine and evolved over a 50-year period. Like the 1993 amendment adding "qualified real property business indebtedness" as a category eligible for deferral under IRC section 108, the reduction-of-purchase-price doctrine was also prompted by a sharp decline caused by the Great Depression.

The theory, as presented in the principle case, *Hirsch v. Commissioner*, 40-2 USTC ¶ 9791, was that the debtor "received 'nothing of taxable exchangeable value;' he received a credit upon the cost of a capital investment; he merely entered into a transaction whereby he procured a decrease in his capital loss...But his ultimate gain or loss cannot be determined until liquidation of his capital investment." This rational was reiterated approvingly in subsequent cases (*Commissioner v. Sherman*, 43-1 USTC ¶ 9367, and *Helvering v. A.L. Killian Co.*, 42-2 USTC ¶ 9487). This doctrine was developed solely in the context of recourse debt (*Hirsch v. Commissioner*, 40-2 USTC ¶ 9791).

However, applying the reduction-of-purchase-price doctrine to third party or non-recourse debt has since been discredited both by the courts (*Helvering v. American Chicle Co.*, 4 USTC ¶ 1240, *Edwards v. Commissioner*, 19 TC 275), and the Internal Revenue Service (Rev. Rul. 92-99), except in the limited case of fraud (*Commissioner v. Sherman*, 43-1 USTC ¶ 9367). In its judicial formulation, it now applies, if at all, only to reduction in purchase-money encumbrances on property retained by a solvent debtor following the discharge and negotiated directly by him or her with the seller (*Nutter v. Commissioner*, 7 TC 408). It is this application of the doctrine that was codified by the Bankruptcy Tax Act of 1980.

IRC section 108(e)(5) sets forth the following three requirements:

- That the debt be purchase-money debt from the purchaser to the seller;
- That the reduction not arise while the debtor is bankrupt or insolvent; and
- That "but for" this statutory exception, the reduction would be treated as debt-discharge income.

Three additional requirements, not apparent from the face of the statute but reflective of the doctrine's judicial evolution, are set forth in the legislative history. The requirements are:

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- That no transfer of the debt has been made by the seller to a third party;
- That no transfer of the debt-financed property has been made by the purchaser to a third party; and
- That the debt reduction occurs as a result of a direct agreement between the seller and the buyer, rather than because of extraneous factors such as the running of the statue of limitations on enforcement (H.R. Rep. No. 96-833, 96th Cong., 2d Sess. 13 (1980)).

Provided that these conditions are met, then, as under the common law doctrine, the debt reduction results in no debt discharge income even if the discharge is occasioned by the debtor's inability to pay rather than by a dispute over sales terms.

Although the statute does not expressly so provide, apparently a reduction in the basis of debt-financed property is required to reflect the price reduction. This follows both from legislative history, which provides that a reduction satisfying the requirements of the statue is to be treated (for both the seller and the buyer) as a purchase price adjustment on that property (H.R. Rep. No. 96-833, 96th Cong., 2nd Sess. 13 (1980)), and from case law, which regarded the debt reduction as a credit against the cost of the capital investment and imposed a corresponding basis reduction (*Hirsch v. Commissioner*, 40-2 USTC 9791, *Commissioner v. Sherman*, 43-1 USTC ¶ 9367, and *Helvering v. A.L. Killian Co.*, 42-2 USTC ¶ 9487).

The IRS has taken the position in Revenue Procedure 92-92 that they would not challenge a purchase price adjustment as long as the transaction would otherwise qualify as a purchase price reduction within the meaning of IRC section 108(e)(5). Thus, if a direct debt of a bankrupt or insolvent partnership–purchaser of the property to the seller is reduced and the reduction would result in cancellation of debt income to the purchaser, but for IRC section 108(e)(5), Revenue Procedure 92-92 applies. If the original purchaser transfers the property to another person or if the seller assigns the purchaser's obligation, then IRC section 108(e)(5) does not apply.

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110600 REDUCTION OF TAX ATTRIBUTES - IRC SECTION 108(B)

The amount excluded by reason of the insolvency exclusion must be applied in reduction of tax attributes under IRC section 108(b) in the same manner excluded by reason of the bankruptcy exclusion. Under IRC section 108(b)(1) (R&TC §17131), taxpayers who exclude cancellation of debt income under IRC section 108(a)(1)(A), (B), and (C) must apply the attribute reduction and ordering rules. The amount of excluded income is applied to reduce the taxpayer's tax attributes pursuant to these rules. In general, tax attributes are taxpayer specific and are not tied to a particular taxpayer activity. Therefore, tax attributes that originated from an activity that did not give rise to the debt discharge income may also be subject to the attribute reduction.

In general, the attributes are reduced, in the order given, as follows (IRC §108(b)(2)):

1. NOL–any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year (IRC §108(b)(2)(A)),
2. General Business Credit–Any carryover to or from the taxable year of the discharge of an amount for purposes for determining the amount allowable as a credit (IRC §108(b)(2)(B), modified by R&TC §24307). In the case where more than one credit is allowable, the credit is reduced on a pro rata basis (R&TC §17144(a) and (c)),
3. Minimum Tax Credit–This attribute was added to the 1993 RRA effective January 1, 1993. California income tax law incorporated IRC section 108(b)(2)(C) with SB 38, effective January 1, 1996.
4. Capital Loss Carryovers–Any capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under IRC section 1212 (IRC §108(b)(2)(D)),
5. Basis Reduction–The basis of the property of the taxpayer (IRC §108(b)(2)(E)). Real property held as inventory may also be reduced (S. Rep. No. 96-1035, 2d. Sess.),
6. Passive Activity Loss and Credit Carryover– This attribute was added to the 1993 RRA on an amendment that was enacted subsequent to January 1, 1993. California income tax law incorporates IRC section 108(b)(2)(F) effective January 1, 1996.

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7. Foreign Tax Credit Carryover–IRC section 108(b)(2)(G) is not subject to attribute reduction for California income tax purposes (R&TC §24307(c)).

Tax attributes are reduced after taxable income is determined for the year the discharge occurred without regard to the reduction of tax attributes (IRC §108(b)(4)(A)).

Non-credit tax attributes are reduced on a dollar for dollar basis (IRC §108(b)(3)(A)). Thus, one dollar of NOL is reduced for every dollar of debt discharge income deferred. However, credit tax attributes are reduced at a rate of 33.3 cents and 11.1 cents per debt discharge income dollar deferred for Federal and State income tax purposes, respectively (IRC §108(b)(3)(B) and R&TC §24307(d)). In addition, current year NOLs and Capital Losses are reduced prior to reducing carryover amounts in the order in which the carryover amounts arose (IRC §108(b)(4)(B)). Credits are reduced in the order in which it would be applied against taxable income (IRC §108(b)(4)(C)). For California income tax purposes, if more than one credit is available, all credits are reduced on a pro rata basis (R&TC §17144(c)).

The taxpayer may, however, elect to apply basis reductions first against depreciable property under IRC §§108(b)(5) and 1017(b)(3)(E) in order to preserve current year tax deductions or credits. This election limits the amount of depreciable basis that may be reduced in lieu of or prior to reducing other tax attributes. Depreciable property (as defined in IRC Section 1017(a)(3)(B)) basis reduction may not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs (IRC §108(b)(5)(B)). Any excess debt discharge income not applied to basis reduction is then used to reduce other tax attributes except depreciable property basis (IRC §108(b)(5)(C)).

If the taxpayer elects, or by default, to reduce tax attributes in the order specified in IRC §108(b)(2), (i.e., NOL, General Business Credit, Capital Losses, Basis reduction, etc.), and is either bankrupt or insolvent, then any basis reduction may not exceed the excess of the aggregate basis of the property held by the taxpayer immediately after the discharge, over the aggregate of the liabilities of the taxpayer immediately after the discharge (IRC §1017(b)(2)). However, this basis limitation does not apply if the taxpayer elects to apply reductions first against depreciable property under IRC §108(b)(5) (IRC §1017(b)(2)). (See IRC §1017(b)(1) and Treas. Reg. §1.1017-1 for property basis reduction ordering rules. Essentially, the regulation indicates that trade or business depreciable property basis is reduced first followed by non-depreciable basis, inventory,

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notes and accounts receivable, and then non-trade or non-business property basis).

Example A

Jon, a California resident, is in financial difficulty, but he has been able to avoid declaring bankruptcy. This year he reached an agreement with his creditors, whereby they agreed to forgive $10,000 of debt, in return for his setting up a schedule for repayment of the rest of his debt.
Before the debt cancellation, Jon's liabilities totaled $120,000 and the FMV of his assets was $100,000. His total basis in all assets was $90,000. Therefore, Jon was insolvent by $20,000. He may exclude from income the entire $10,000 debt cancellation since it is not more than the amount by which he was insolvent.
Among Jon's assets, his only depreciable asset is a rental condominium with an adjusted basis of $50,000. Of this, $10,000 is allocated to the land, leaving a depreciable basis of $40,000. During the tax year of the debt discharge, Jon had a net capital loss of $5,000 resulting from sales of stock. He also has a net operating loss carryover to this year of $3,000 from a previous tax year.
Jon's AGI for the year, without considering the discharge of debt income, the capital loss, or the net operating loss carryover, is $20,000. He does not itemize deductions, and he has no general business credit arising in the year of the debt discharge or carried to this year.
In applying the $10,000 debt discharge amount to reduce tax attributes, Jon would first eliminate his $3,000 net operating loss carryover, and then his $5,000 capital loss. He would then have $2,000 remaining to apply to basis reduction, but he would not have to reduce his basis because his total basis in the assets ($90,000) was less than his total liabilities, immediately after the debt cancellation ($120,000-$10,000=$110,000).
However, Jon figures that it is better for him to preserve his current deductions of $3,000 for NOL carryover and $3,000 for the net capital loss, plus the $2,000 capital loss carryover to the following year. He may do this by choosing to reduce the basis of his depreciable property before making other attribute reductions.
Jon elects to reduce basis first. Therefore, Jon can reduce the depreciable basis of the rental condominium (his only depreciable asset) by $10,000. The tax effect of doing this will be to reduce Jon's depreciation deductions for years following the year of the debt cancellation. However, if Jon later sells the condominium at a gain, the part of the gain attributable to the basis reduction will be taxable as ordinary income.

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In neither IRC section 108 nor section 1017 does the code provide guidance on whether the taxpayer is required to re-compute the rate of depreciation over the remaining life of the asset subsequent to basis reduction. Without a specific requirement, it is reasonable to expect taxpayers to continue depreciating affected assets at the depreciation rate scheduled when the asset was originally acquired. If the depreciation rate is not adjusted, a taxpayer will completely eliminate the depreciable base sooner than if the rate was re-computed. In either case, the gain recognized would be dependent on the adjusted basis of the property that is reduced as depreciation expense is used to offset income.

However, legislative history suggests the collection of tax on ordinary debt discharge income deferred pursuant to IRC section 108 should occur within a reasonable amount of time. The FTB could argue legislative intent requires the rate of depreciation on depreciable property be re-computed to accommodate the reduction of depreciable base.

In cases that exclude or defer debt discharge income under the insolvency and the qualified farm indebtedness provisions, the attribute reduction is first applied by reducing tax attributes by that amount excluded by reason of insolvency (IRC §108(g)(3)(D)). Any remaining debt discharge income that qualifies for qualified farm indebtedness treatment is then limited to attributes remaining after reduced by reason of insolvency. If there is debt discharge income left, then that income is recognized under IRC section 61(a)(12) and R&TC section17071.

Both IRC section 108(c) and IRC section 1017(b)(3)(F) also provide guidance on the mechanics of reducing depreciable property basis on a dollar for dollar basis. To the extent the taxpayer has depreciable real property tax basis, he or she may elect to defer the recognition of the debt discharge income in exchange for basis reduction.

Any IRC section 1231 property subject to IRC section 1245 or IRC section 1250 treatment that is reduced in order to defer debt discharge income recognition is subject to recapture under IRC section 1017(d). Regardless of the depreciation rate used for tax purposes, the gain recognized in a disposition as a result of basis reduction will be given ordinary income treatment. However, for purposes of IRC section 1250(b), the determination of what would have been the depreciation adjustment under the straight-line method shall be made as if there had been no reduction under IRC section 1017.

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110700 TIME AND MANNER FOR MAKING ELECTION - IRC SECTION 108(D)(9) AND TREAS. REG. SECTION 1.108(A) FILING AND DISCLOSURE REQUIREMENTS

As mentioned earlier, the income recognition deferral benefit contained in IRC section 108(a) is mandatory with the exception of IRC section 108(a)(1)(D) (Treas. Reg. §1.108-5-1T and H.R. Rep. No. 111, 103 Cong., 1st Sess. 623 (1993)). However, in all cases the taxpayer is required to file federal Form 982 with the original income tax return reporting (1) the amount and the relevant facts that gave rise to the debt discharge (filing and disclosure requirement) and (2) indicating what amount of debt discharge income is used to reduce tax attributes.

In order to take advantage of IRC section 108 income exclusion, the taxpayer must file a consent to applicable regulations relating to the adjustment of basis, in accordance with Treas. Reg. section 1.108-5. California law conforms to Federal law in filing consents (R&TC §17024.5(e) and (f)).

In all cases the consent shall be made by or on behalf of the taxpayer on federal Form 982 with the original return for the taxable year in question (Treas. Reg. §1.108-5). This section applies to indebtedness incurred or assumed either (i) by a corporation, or (ii) by an individual in connection with property used in their trade or business; and it covers any such indebtedness for which the corporation or individual taxpayer is liable or subject to which the taxpayer holds property (Treas. Reg. §1.108(a)-1(a)(1)). However, in special cases where the taxpayer establishes reasonable cause for failure to file the necessary consent with their original return, they may file the consent with an amended return or claim for credit or refund; and in such cases, the consent shall be to the regulations which, at the time of filing the consent, are applicable to the taxable year for which such consent is filed (Treas. Reg. §1.108-5). In all cases, the consent shall be made by or on behalf of the taxpayer on Form 982 in accordance with regulations and instructions on the form (Treas. Reg. §1.108-5).

For purposes of IRC section 108(a) and Treas. Reg. section 1.108-5, the determination as to whether an indebtedness is incurred or assumed by an individual in connection with property used in a trade or business depends on the facts of each particular case. Where indebtedness (whether secured or unsecured) is incurred or assumed by an individual and where the proceeds of such indebtedness are used to purchase, improve, or repair property used in the trade or business, IRC section 108(a) shall apply to the discharge of such indebtedness (Treas. Reg. §1.108-5).

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For California purposes, a taxpayer is deemed to make a proper election if the election filed with the IRS is filed in accordance with the IRC or regulations issued by "the secretary" (R&TC §17024.5(e)(1)) unless otherwise provided for in the R&TC. To obtain treatment other than that elected for federal purposes, a separate election shall be filed at the time and in the manner required by the FTB (R&TC §17024.5(e)(3)). However, within the conformity provision in the R&TC section 17024.5, it states that whenever this part—California's personal income tax law—allows or requires a taxpayer to file an application or seek consent, the rules set forth in subdivision (e) of R&TC section 17024.5 shall be applicable with respect to any such application or consent (R&TC §17024.5(f)). Therefore, if a taxpayer desires treatment other than that elected for federal purposes, they are required to make an election for California purposes at the time and manner required under federal law. (Note: California regulations reference the code (R&TC §17024.5) on this issue).

If a taxpayer fails to file federal Form 982 with the original return, the taxpayer may not reduce tax attributes in any order other than that specified in IRC Section 108(b).

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110800 EFFECT OF EXCLUDED CODI ON SHAREHOLDER BASIS IN THE S CORPORATION

The FTB is revising its position on the S corporation COD income treatment following the US Supreme Court decision.

The US Supreme Court, reversing the Tenth Circuit court, held in *Gitlitz v. Commissioner* (2001) 531 U.S. 206, held that an S corporation's excludable discharge of debt is an item of income that passes through to the shareholders pursuant to IRC section 1366(a)(1)(A). The COD income increases the shareholder's stock basis before the tax attributes reduction takes place pursuant to IRC section 108(b)(4)(A).

Treas. Reg. section 1.1366(a)(2)(viii) was recently amended to specifically state that the COD income is not tax-exempt income. Nevertheless, the US Supreme Court decision holds that S corporation COD income to be an item of income for pass-through purposes per IRC section 1366.

The FTB will apply this position for all tax years retroactively. Please keep in mind that the statute of limitations for all tax years is still applicable and requests for refunds must be filed prior to the expiration of the statute of limitations. As with any other claims/amended returns, the returns may be subject to examination, and the taxpayers should be prepared to provide supporting documents upon request.

Taxpayers may consider filing an amended return if the statute of limitations is open and if the taxpayer's S corporation:

- had COD income,
- was insolvent at the time of the discharge,
- shareholder basis was not increased by their proportionate share of the S corporation's COD income, and
- previously filed a return and/or paid taxes based on the FTB's previous position.

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110900 EXHIBITS

Exhibit 110000-1	Checklist of California Exemptions
Exhibit 110000-2	Insolvency \ Qualified Farm Indebtedness \ Accuracy-Related Penalty Case

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120000 S CORPORATION AND SHAREHOLDER CREDITS

S Corp 120100 California/Federal Differences
S Corp 120200 Available Credits
S Corp 120300 Expired Credits
S Corp 120400 Taxes Not Reduced by Credits and Credit Carryovers
S Corp 120500 Credit Recaptures
S Corp 120600 Credit Carryovers From C Corporation Years
S Corp 120700 Credits Generated In S Corporation Years
S Corp 120800 Credits Carried Over to C Corporation Years
S Corp 120900 Reducing Expenses by the Amount of Credit Taken
S Corp 121000 Economic Development Areas Tax Credits
S Corp 121100 Manufacturers' Investment Credit
S Corp 121200 Research and Development Credit

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120100 CALIFORNIA/FEDERAL DIFFERENCES

In contrast to federal law that exempts an S corporation from federal income tax, California subjects all S corporations (except financial corporations) to the franchise and income tax at a reduced rate of 1.5%. (R&TC §23802) The corporate level tax may be offset by credits. (R&TC §23803) However, the amount of any S corporation's credit against the 1.5% corporate franchise and income tax is limited to one-third of the amount otherwise allowable under the Corporation Tax Law. (R&TC §23803(a)(1)(A))

In addition, the S corporation may carryover a majority of the credits claimed against the 1.5% corporate franchise and income tax. (R&TC §23803(a)(1)(B)) Finally, unlike federal law, the credit carryovers from C corporation years to S corporation years are allowed against California's S corporation tax, at one-third of the entire credit value. (R&TC §23803(a)(1)(C))

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120200 AVAILABLE CREDITS

S Corp 120201 Available Credits
S Corp 120202 Other State Tax Credit

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120201 Available Credits

The California Form 100S Booklet provides a list of available credits. Each credit has certain requirements that must be satisfied to claim the credit. Therefore, it is important to read the applicable credit statute and accompanying regulations, if any.

Three common credits claimed are: (1) the Economic Development Area tax credits, (2) the manufacturer's investment credit, and (3) the research development credit. Each of these credits is discussed below.

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120202 Other State Tax Credit

R&TC section 18006 - "Other State Tax Credit" allows an S corporation shareholder to treat his/her pro-rata share of net income taxes paid to another state by the S corporation as if it had been paid directly by the shareholder. The corporation must have a valid California S election. In addition, the other state must either impose a tax at the S corporation level or not recognize the S corporation status. Finally, the shareholder must also satisfy the general requirements of either R&TC section 18001 or R&TC section 18002. (See CCR §§18001 and 18001-2.)

Example A

In 2000, ABC, Inc., a California S corporation, paid net income tax of $3,000 to State A, which does not allow corporations to elect to be treated as S corporations. During 2000, ABC had three nonresident shareholders who each owned 33.3% of ABC's stock. Pursuant to R&TC section 18006, each nonresident shareholder can claim his or her pro rata share of the taxes paid to State A (i.e., $1,000) as an "other state tax credit," assuming that each shareholder can satisfy R&TC section 18002.

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120300 EXPIRED CREDITS

FTB Form 3540, Credit Carryover Summary, lists all the credits that have been repealed but which have carryover provisions. The taxpayer may claim these credits only if carryovers are available from a prior year.

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120400 TAXES NOT REDUCED BY CREDITS AND CREDIT CARRYOVERS

In general, credits and credit carryovers are allowed to offset tax at the S corporation level. (R&TC §23803) However, credits and credit carryovers may not reduce the following S corporation taxes.

Minimum Franchise Tax

R&TC section 23802(c) imposes a minimum franchise tax as provided in R&TC section 23153. The tax imposed for any taxable year shall not be less than the minimum franchise tax. (R&TC §23151.1(e))

QSUB Annual Tax

A QSUB is subject to an annual $800 annual tax, which is paid by the S corporation. (R&TC §23800.5(b)(1)(B))

Built-In-Gains Tax

IRC section 1374 imposes a tax on built-in gains and allows certain credits to reduce such tax. R&TC section 23809(b) modifies IRC section 1374 by disallowing credits against the California built-in gains tax.

Excess Net Passive Income (ENPI) Tax

IRC section 1375 imposes a tax on excess net passive income and allows certain credits to reduce such tax. R&TC section 23811(c) modifies IRC section 1375 by disallowing credits against the California ENPI tax.

Increase in tax imposed for the deferral of installment sale income

R&TC section 23802(b) subjects corporations that qualify under Chapter 4.5 (Tax Treatment of S corporations & Their Shareholders) to taxes imposed under Chapter 2 (Corporation Franchise Tax - commencing with R&TC §23101) and Chapter 3 (Corporation Income Tax - commencing with R&TC §23501). Therefore, the increase in tax required by either R&TC section 24667(e)(1) or (f)(2) is not considered a “tax” and cannot be reduced by the credits.

Under Chapter 1 (General Provisions & Definitions for the Corporation Tax Law) R&TC section 23036(a)(2) defines the term “tax” not to include any amount

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imposed under paragraph (1) of subdivision (e) of R&TC section 24667, Reporting Income from Installments Sales, or paragraph (2) of subdivision (f) of R&TC section 24667.

Installment of LIFO recapture tax

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120500 CREDIT RECAPTURES

The requirements for tax credits often have provisions requiring that the amount of the credit taken by a taxpayer in an earlier year be added back to the taxpayer's tax (or "recaptured") in a subsequent year if the taxpayer does not meet specified standards of performance. These recapture provisions are often tied to the creation or retention of a specific number of jobs. Another common recapture provision is to require use of the property for a specified period or in a specified geographic location. The following are identified credits containing recapture provisions:

- Employer Child Care Program/Contribution Credit:
  FTB Form 3501: Employer Child Care Program/ Contribution Credit
  R&TC Section 17052.17(j)(2) and R&TC Section 23617(j)(2)
- Hiring Credit (Enterprise Zone & Program Areas):
  FTB Form 3805Z: Hiring Credit - Enterprise Zone, & Program Areas
  R&TC Section 17053.74(e)(1) and R&TC Section 17053.11(f) (repealed effective January 1, 1997), R&TC Section 23622.7(e)(1) and R&TC Section 23623 (repealed effective January 1, 1997)
- Hiring Credit & Sales or Use Tax Credit (LARZ):
  FTB Form 3806: Hiring Credit & Sales or Use Tax Credit – Los Angeles Revitalization Zone
  R&TC Section 17053.10(h) (repealed effective December 1, 1998, although carry-forward provisions continue until the credit is exhausted), R&TC Section 17053.17(c) (repealed effective December 1, 1998, although carry-forward provisions continue until the credit is exhausted), R&TC Section 23623.5(c) (repealed effective January 1, 1997, although carry-forward provisions continue until the credit is exhausted), and R&TC Section 23625(h)(1) (repealed effective December 1, 1998, although carry-forward provisions continue until the credit is exhausted)
- Hiring Credit & Sales or Use Tax Credit (LAMBRA):
  FTB Form 3807: Hiring Credit & Sales or Use Tax Credit - Local Area Military Base Recovery Area
  R&TC Section 17053.46(d) (effective until December 31, 2000), R&TC Section 17053.46(e) (effective beginning January 1, 2001), R&TC Section 23646(e).
- Hiring Credit (MEA): FTB Form 3808: Hiring Credit - Manufacturing Enhancement Area
  R&TC Section 17053.47(d) and R&TC Section 23622.8(d).
- Hiring Credit (TTA): FTB Form 3809: Hiring Credit - Targeted Tax Area

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R&TC Section 17053.34(f) and R&TC Section 23634(f).

- MIC: FTB Form 3535: Manufacturers' Investment Credit
  R&TC Section 17053.49(g) and R&TC Section 23649(g); CCR Section 17053.49-8 and CCR Section 23649-8

Example A

ABC, Inc. utilizes the Employer Child Care Program credit (R&TC §23617). The childcare center is disposed of or stops operating within 60 months after completion. The portion of credit claimed that represents the remaining portion of the 60-month period must be recaptured (R&TC §23617(j)(2)) ABC must add the recapture amount to its tax liability in the taxable year of disposition or nonuse.

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120600 CREDIT CARRYOVERS FROM C CORPORATION YEARS

In general, the IRC does not permit credit carryovers between C corporation and S corporation years. (IRC §1371(b)(1)) However, for purposes of determining the California S corporation franchise or income tax, California modifies this general rule to allow credit carryovers from a C corporation year, subject to the following provisions. (R&TC §23803(a)(1)(C))

Credit carryovers from C corporation years are reduced to one-third for the first taxable year, but not the subsequent years. (R&TC §23803(a)(1)(C)) The remaining two-thirds credit is disregarded. (R&TC §23803(a)(1)(B)(ii)) No portion of the credit passes through to the shareholders. (R&TC §23803(a)(1)(E))

Example A

ABC, Inc. made a valid California S election in 1993.
In 1992, ABC claimed a Recycling Equipment Credit of $70,000 as allowed under R&TC section 23612.5. Its tax liability in 1992 was $10,800. ABC used $10,000 of the credit in 1992 to reduce its tax liability, but not below the minimum franchise tax. The remaining $60,000 was carried over to the next tax year.
In 1993, ABC reduced the credit to $20,000 ($60,000 x 1/3) upon conversion from a C corporation to an S corporation. In 1993, ABC's tax liability was $15,800. ABC used $15,000 of the remaining $20,000 to reduce its tax liability, but not below the minimum franchise tax. ABC may carry forward the remaining $5,000 credit to 1994. The credit generated and carried over from C corporation years is not allowed to be passed through to the shareholders. Thus, ABC's shareholders are not entitled to any portion of the $20,000 recycling equipment credit.
Note: The Credit for Recycling Equipment expired effective December 1, 1994, however, it may be carried over until fully utilized.

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120700 CREDITS GENERATED IN S CORPORATION YEARS

For California purposes, an S corporation and its shareholders are subject to both Corporation Tax Law (CTL) and Personal Income Tax Law (PITL). Credits generated at the S corporation level may require application of the PITL for purposes of computing the allowable credit at the shareholder level. (IRC §§1363 and 1366; R&TC §23800, R&TC §23802, and R&TC §23803.)

If the credit is allowed only under the CTL, one-third of the credit may be utilized to offset the franchise or income tax at the S corporation level. The remaining two-thirds is disregarded and may not be carried over. No part of the credit may be passed through to the shareholders. (R&TC §23803(a))

Note: When calculating the credit, apply the CTL to determine whether the S corporation is entitled to a particular credit, then reduce the allowable credit by two-thirds as provided in R&TC §23803(a)(1). (See R&TC §23802.) S corporation may utilize only one-third of credit.

Example A

In 2000, ABC, Inc., a California S corporation, computed its allowable Manufacturers' Investment Credit of $86,250 (R&TC §23649). ABC, Inc. may utilize only $28,750 ($86,250 x 1/3) to offset its liability. The remaining $57,500 ($86,250 - $28,750) is disregarded.
ABC's tax liability in tax year 2000 was $5,800. It recognized $5,000 of the credit, which reduced its tax liability, but not below the minimum franchise tax. The remaining $23,750 ($28,750 - $5,000) is carried over into the 2001 tax year.

If the credit is only allowed under the PITL, the full credit may be passed through to the S corporation's shareholders, and the S corporation may not use any part of the credit. (See R&TC §23803(a)(1)(F).)

Note: When calculating the PIT credit amount, apply the PITL (if different from the CTL) to determine the allowable credit. This amount passes through to the shareholders.

If a particular credit is allowed under both the CTL and PITL, one-third of the credit as determined under CTL may be utilized by the S corporation to offset the tax on net income at the S corporation level. (R&TC §23803(a)(1)(A)) The remaining two-thirds must be disregarded and may not be used as a carryover.

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(R&TC §23803(a)(1)(B)) However, the full credit amount as calculated under the PITL may be passed through to the shareholders. (R&TC §23803(a)(1)(F))

Note: Separate calculations are required at the corporate level and shareholder levels when a credit is allowed under both the CTL and the PITL. Calculate the credit using the CTL to determine the allowable credit at the S corporation level and calculate the credit using the PITL to determine the allowable credit at the shareholder level.

Example B

ABC, Inc. has a valid federal and California S election for taxable year 2000. Two individuals each own 50% of ABC.
ABC incurred $600,000 in costs that qualify for the Manufacturers' Investment Credit (MIC) under R&TC section 23649, which resulted in an allowable credit of $36,000 ($600,000 x 6%).

- The allowable credit at the S corporation level is $36,000, which is limited to 1/3 of the amount otherwise allowable. ABC may use $12,000 ($36,000 x 1/3) to offset the 1.5% tax in taxable year 2000.
- R&TC section 17053.49 is identical to R&TC section 23649. Each shareholder is entitled to $18,000 credit (his/her pro-rata share of $36,000).

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120800 CREDITS CARRIED OVER TO C CORPORATION YEARS

If a corporation generates a credit during an S year and later converts back to a C corporation through termination of its S election, any unused credit cannot be used to reduce C corporation taxes after conversion. IRC section 1371(b) prohibits carry-forwards and carry-backs between C and S corporation years. California made one modification to this provision by allowing unused C corporation credits to be carried over, reduced to 1/3, and used against tax assessed at the S corporation level. (R&TC §23803(a)(1)(C)) The R&TC has made no modifications to allow credits generated at the S corporation level to be carried over and used by a C corporation.

Example A

ABC, Inc., a California S corporation, generated a Research & Development (R&D) credit of $300,000 in taxable year 1999. The credit allowed to reduce the franchise tax imposed against ABC was $100,000 ($300,000 x 1/3). It reported a taxable loss in this year; therefore, ABC could not recognize any portion of the credit.
Effective January 1, 2000, ABC terminated its federal and California S election by revocation. ABC may not carry over the unsued $100,000 R&D credit into C corporation years. There are no provisions contained in federal or California law that allow carryovers between C and S corporation years. If ABC makes a valid federal and California S election effective January 1, 2005 (five years from the date of termination), the credit can be used at this time. In other words, the credit is not lost upon conversion from an S to C corporation but is suspended until it becomes an S corporation again. (R&TC §23803(a)(1)(B)(i))
Note: The R&D credit of $300,000 generated in 1999 is passed through to the shareholders. The shareholders are entitled to recognize the credit after conversion from an S to a C corporation but are still subject to the credit limitations under IRC section 41(g).

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120900 REDUCING EXPENSES BY THE AMOUNT OF CREDIT TAKEN

In general, certain credits require expenses be reduced by the amount of credit generated. However, other credits may require expense reduction only up to the amount of credit recognized currently. For S corporations, expense reductions will be different for the amount reduced at the S corporation level and at the shareholder level.

Example A

ABC, Inc., a California S corporation, generated a credit of $90,000 for wages paid to employees in an Enterprise Zone in tax year 2000.
Per R&TC section 23622.7(h), "any deduction otherwise allowed under this part for the wages or salaries paid or incurred by the taxpayer upon which the credit is based shall be reduced by the amount of credit, prior to any reduction required by subdivision (i) or (j) [credit in excess of tax for the income year and credit carryovers from prior years]."

an S corporation] shall be limited to one-third of the amount otherwise allowable."
The question arises as to which credit "amount" is used for expense reduction regarding S corporations: (1) the amount of any credit to be claimed, $90,000, or (2) one-third of the amount otherwise allowable, $30,000 ($90,000 x 1/3).
The "amount" in question is $30,000, one-third of the amount otherwise allowable. In addition, ABC would be required to reduce its wage or salary deduction by $30,000 regardless of whether it was able to recognize the entire $30,000 in 2000.

<u>Credit at the S Corporation Level</u>

- State Adjustment, Other Additions (face of Form 100S): **+ $30,000**.
- [Wage or salary expense reduction by the amount of credit]
- Credit: $30,000

<u>Credit at the Shareholder Level</u>

- Schedule K, line 1, ordinary income (loss) from trade or business activities, state adjustments column: **+ $90,000**. [Full amount of the shareholders' credit]
- Schedule K, credit for wages paid to employees in an Enterprise Zone: $90,000.

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As you can see, the S corporation must add-back wage deductions equal to its credit of $30,000 while the shareholders must add-back wage deductions equal to their credit of $90,000.

adjustments applicable to nonseparately stated items contained on the face of Form 100S should not agree with the amount on Schedule K, line 1 - state adjustments if the taxpayer prepared the form properly.

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121000 ECONOMIC DEVELOPMENT AREAS TAX CREDITS

California currently has four types of Economic Development Areas (EDAs) that have related tax incentives (e.g., tax credit, net operating losses, business expense deductions). These areas are:

- Enterprise Zones (EZs)
- Local Agency Military Base Recovery Areas (LAMBRAs)
- Manufacturing Enhancement Areas (MEAs)
- The Targeted Tax Area (TTA)

Taxpayers who conduct business activities within the boundaries of one of these areas or zones may qualify for special state tax incentives. In prior years, special tax incentives were also available for taxpayers that conducted business activities within the boundaries of the former:

- Los Angeles Revitalization Zone (LARZ). The LARZ incentives applied to taxable years beginning on or after January 1, 1992, and before January 1, 1998.
- Program Areas. The Program Area incentives applied to taxable years beginning on or after January 1, 1985, and before January 1, 1997. For taxable years beginning on or after January 1, 1997, Program Areas were converted to EZs and are entitled to the benefits available to EZs.

Because the Economic Development Areas Manual ("EDAM") discusses the statutory provisions for each of the EDA tax incentives and how each incentive applies to S corporations and their shareholders, this manual will not discuss the specifics with regard to the EDA Tax Credits, other than to provide a chart indicating the credits available to S corporations and where they can be found in the EDAM.

For more information on Economic Development Areas, go to the EDAM.

S Corp 121001 EDA Tax Credits

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121001 EDA Tax Credits

The specific EDA tax credits available to S corporations are:

	Hiring Credit	**Sales or Use Tax Credit**	**General Hiring Credit**	**Constructio n Hiring Credit**
EZ	EDAM Chapter 2	EDAM Chapter 3		
LAMBRA	EDAM Chapter 12	EDAM Chapter 13		
TTA	EDAM Chapter 8	EDAM Chapter 9		
MEA	EDAM Chapter 16			
LARZ (**Repealed**)		EDAM Chapter 18	EDAM Chapter 17	EDAM Chapter 17
Program Area (**Repealed**)	EDAM Chapter 22	EDAM Chapter 23		

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121100 MANUFACTURERS' INVESTMENT CREDIT

The Manufacturers' Investment Credit, or MIC, is equal to 6% of the *qualified costs* paid or incurred for acquiring, constructing, or reconstructing *qualified property*. It is available to *qualified taxpayers* engaged in certain manufacturing activities. The credit is generated in the taxable year the qualified property is placed in service in California. (See R&TC §23649.)

The credit cannot be claimed for any property for which a California sales or use tax exemption (R&TC §6377) or refund (R&TC §6902.2) has been claimed (CCR §23649-11(c) and (d)).

The MIC cannot reduce the S Corporation:

- Minimum franchise tax,
- Built-in gains tax,
- Excess net passive income tax, or
- Alternative minimum tax. (See R&TC §§23036(a) and 23649(a)(1).)

However, these credits can reduce the regular tax below tentative minimum tax. (R&TC §23030(d)(1)(Q))

The terms *qualified taxpayer*, *qualified costs*, and *qualified property* are defined uniquely for California's MIC. Each of the MIC qualification requirements is briefly discussed in the following sections. Sections on Leased Property, Carryovers, S corporations and Credit Recapture for S corporations and their shareholders are also included.

For more information on the MIC, see R&TC section 17053.49 and R&TC section 23649 and the accompanying regulations. See also the MIC web page.

S Corp 121101 Qualified Taxpayer
S Corp 121102 Qualified Costs
S Corp 121103 Qualified Property
S Corp 121104 Non-Qualified Property
S Corp 121105 Leased Property
S Corp 121106 Credit Carryover
S Corp 121107 S Corporation and Their Shareholder(s)

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121101 Qualified Taxpayer

Qualified taxpayer means any taxpayer engaged in those lines of business described in Division D, Manufacturing, of the Standard Industrial Classification (SIC) Manual, published by the United States Office of Management and Budget, 1987 edition. Generally, this means that a taxpayer must have, as part of its overall "enterprise", at least one establishment that is properly classified under a SIC Code in Division D of the SIC Manual. Division D includes SIC Code number 2011- SIC Code number 3999, inclusive. For taxable years beginning on or after January 1, 1998, a qualified taxpayer also includes any taxpayer engaged in a line of business described under SIC Code 7371, SIC Code 7372, and SIC Code 7373, inclusive. (R&TC §23649(c); CCR §23649-3 or CCR §23649-3(b))

The determination of whether a taxpayer is engaged in a line of business described in Division D or SIC Code 7371, SIC Code 7372, and SIC Code 7373 of the SIC Manual is made by reference to the classification of business activity rules contained in the introduction and description of industries in the SIC Manual (CCR §23649-3(b))

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121102 Qualified Costs

To qualify for the credit, costs must meet all of the following requirements (R&TC §23649(b)(1)):

- The costs must be paid or incurred on or after January 1, 1994, for the construction, reconstruction, or acquisition of qualified property.
- Costs must be amounts upon which California sales or use tax has been paid, except for capitalized labor, and
- Costs must be amounts that are properly chargeable to the capital account of the qualified taxpayer, except for lease payments under operating or true leases.

In order for costs to qualify for the MIC, California sales or use tax must be paid, on the qualified property acquired. The sales or use tax may be paid either directly or indirectly by the qualified taxpayer, as a separately stated contract amount or as established from the books and records of the qualified taxpayer. (R&TC §23649(b)(1)(B); CCR §23649-4(b))

Where the Board of Equalization (BOE) has examined a taxpayer's fixed assets in connection with a sales and use tax audit for the same year in which a MIC is claimed, and the taxpayer can establish that the assets upon which the MIC is claimed are included within the scope of the BOE audit, the department will accept the BOE audit determinations for the payment of both sales and use tax. FTB Notice 2001-6.

Example A

M, a qualified taxpayer, enters into a “fixed-price, turn-key” contract with *O*, the terms of which requires *M* to pay *O* a total of $540,000 upon delivery and installation of two compressors in *M*’s manufacturing facility in Auburn, California. Instead of delivering a resale certificate to *W*, a wholesale distributor of the air compressors, *O* pays $40,000 ($500,000 x 8%) in California sales tax to *W* on its purchase of the compressors. Under *O*’s contract with *M*, the $40,000 California sales tax paid by *O* is a separately stated item. Since the sales tax was separately stated in *M*’s contract with *O* and paid by *O* on behalf of *M*, *M* is treated as having satisfied the sales tax payment requirement. However, because $40,000 of the total contract price represents the sales tax paid indirectly by *M*, the amount of *M*’s qualified cost is $500,000. (CCR §23649-4(a).)

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Qualified costs must be properly chargeable to the capital account (i.e., capitalized, not currently expensed) of the qualified taxpayer in order to qualify for the MIC. (R&TC §23649(b)(1)(C); CCR §23649-4(a)) To meet the capitalization requirement, costs must be included in the tax basis for computing depreciation under the taxpayer's method of tax accounting. Costs not included in the depreciable basis for tax purposes are not eligible for the MIC. For example, amounts currently expensed under IRC section 179 and similar provisions such as the LARZ business expense deduction and the EZ business expense deduction are not qualified costs for the MIC. Similarly, qualified costs for the MIC are limited to the reduced basis amounts resulting from IRC §§ 1031 and 1033 transactions. (CCR §23649-4(c))

Capitalized labor costs for the construction or modification of qualified property may also qualify for the MIC, provided the labor costs meet the definition of "direct" costs of labor under the Federal uniform capitalization (UNICAP) rules contained in IRC section 263A. This is an exception to the sales or use tax payment requirement. (R&TC §§23649(b)(1)(B) and 23649(d)(3); CCR §§23649-2(b) and 23649-4(d)) Direct costs of labor include wages, overtime pay, vacation, payroll taxes and sick pay, but do not include training costs, officer's compensation, pension and other related costs, and employee benefit expenses. (CCR §23649-2(b)) See FTB Legal Ruling 1998-1, *Manufacturers' Investment Credit-Capitalized Costs of Labor for Engineering and Design* and Legal Ruling 2000-1, *Manufacturers' Investment Credit-Capitalized Costs Under Third-Party Contracts* for more information on MIC capitalized labor costs.

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121103 Qualified Property

Qualified property includes new or used tangible personal property as defined in IRC section 1245(a). (R&TC §23649(d)(1); CCR §23649-5(a)) For taxable years beginning on or after January 1, 1998, qualified property also includes computer and computer peripheral equipment (as defined in IRC §168(i)(2)(B)) that is used in operating establishments classified under SIC Code 7371, SIC Code 7372, and SIC Code 7373. (R&TC §23649(d)(2)) Computer and computer peripheral equipment must be used to primarily develop or manufacture prepackaged software or custom software prepared to the special order of the purchaser who uses the program to produce and sell or license copies of the program as prepackaged software. Qualified property for taxpayers involved in computer businesses described in SIC Code 7371, SIC Code 7372, and SIC Code 7373 does not include any IRC section 1245(a)(3)(A) tangible personal property other than computers and computer peripheral equipment. (R&TC §23649(d)(2))

Tangible personal property eligible for the MIC is generally considered to mean any tangible property except land and improvements thereto, such as buildings, other inherently permanent structures and their structural components. The classification of property as tangible property or personal property for local property tax purposes does not determine its classification as tangible personal property for MIC purposes. (CCR §23649-5(b)(1)) The department is utilizing the factors contained in *Whiteco Industries, Inc. v. C.I. R.,* (1975) 65 T.C. 664, to determine whether large items of property are tangible personal property or inherently permanent structures.

The tangible personal property must be used in both an activity that is described in Division D of the SIC Manual and used primarily in any of the following qualified activities. (R&TC §23649(d)(1)(A-E)):

- Manufacturing, processing, refining, fabricating, or recycling;
- Research and development;
- Maintaining, repairing, testing or measuring other qualified property;
- Pollution controls meeting or exceeding established state or local government agency standards; or
- Recycling.

a. Exceptions

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There are exceptions to the MIC's tangible personal property rule for:

Off-The-Shelf Software

Off-The-Shelf software is pre-packaged software purchased and applied without modification. A separate MIC section was inserted for this product because at the time it was not clear whether this type of software constituted "tangible personal property" under the general MIC provision in R&TC section 23649(d)(1). Because of the placement of this provision in R&TC section 23649(d)(5), no capitalized labor costs are allowed in connection with this property (capitalized labor is only allowed in connection with property described in R&TC section 23649(d)(1) and (d)(2)). In addition, the acquisition of custom software (made to the specific specifications of the end user) is generally not subject to sales tax under California sales tax law (it is treated as a service as opposed to goods). Accordingly, costs for custom software are generally not qualified costs for the MIC.

Special Purpose Buildings and Foundations

Special purpose buildings and foundations may also be considered "qualified property", but only for taxpayers engaged in manufacturing activities within the following specified SIC Codes:

- *SIC Code 3571, SIC Code 3572, SIC Code 3573, SIC Code 3574, SIC Code 3575, SIC Code 3576, SIC Code 3577, SIC Code 3578, and SIC Code 3579* (Computer and Office Equipment);
- *SIC Code 3671, SIC Code 3672, SIC Code 3673, SIC Code 3674, SIC Code 3675, SIC Code 3676, SIC Code 3677, SIC Code 3678, and SIC Code 3679* (Electronic Components and Accessories);
- *SIC Code 8731* (Commercial Physical and Biological Research);
- *SIC Code 2833, SIC Code 2834, SIC Code 2835, and SIC Code 2836* (Biopharmaceutical Activity, Drugs);
- *SIC Code 3761, SIC Code 3762, SIC Code 3763, SIC Code 3764, SIC Code 3765, SIC Code 3766, SIC Code 3767, SIC Code 3768, and SIC Code 3769* (Space vehicles and parts);
- *SIC Code 3663 and SIC Code 3812* (Space Satellites and Communications Satellites and Equipment), but only with respect to “qualified property” that is placed in service on or after January 1, 1996; and

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- *SIC Code 3559* (Semiconductor Equipment) but only with respect to “qualified property” that is placed in service on or after January 1, 1997. (R&TC §23649(d)(4); CCR §23649-5(c))

A *special purpose building and foundation* is a structure that has been specifically designed for exclusive use in a specific manufacturing process. (R&TC §23649(d)(4)(A); CCR §23649-5(c)(1)) One example is a "clean room," where stringent environmental conditions are required due to the nature of the item being manufactured, such as semiconductor wafer fabrication (CCR §23649-5(c)(4)) The value of any capitalized direct labor costs that are directly allocable to the construction or modification of special purpose buildings and foundations may also qualify for the MIC. (R&TC §23649(d)(4)(B); CCR §23649-4(d))

For more information on special purpose buildings and foundations see R&TC section 23649(d)(4) and CCR section 23649-5(c).

Other tangible property

For qualified taxpayers engaged in refining activities properly classified in SIC Code 2911, "qualified property" also includes “other tangible property” that is defined in IRC section 1245(a)(3)(B) and that satisfies each of the following requirements:

- Used in that line of business properly classified in SIC Code 2911;
- Used primarily in refining; and
- Used to produce "reformulated gasoline" or "oxygenated gasoline.”

For more information on this specific requirement see CCR section 23649-5(f).

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121104 Non-Qualified Property

The following types of property are specifically excluded from the definition of "qualified property" for purposes of the MIC (R&TC §23649(d)(6); CCR §23649-5(d)):

- Furniture;
- Facilities used for warehousing purposes, after completion of the manufacturing process;
- Inventory;
- Equipment used in the extraction process (e.g.- oil, gas, water, etc. extraction from the earth);
- Equipment used to store finished products; and
- Tangible personal property used in administration, general management, or marketing.
- Vehicles for which a low-emission vehicle credit (R&TC §§17052.11 and 23603) is claimed.

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121105 Leased Property

Property acquired pursuant to either an *operating lease (true lease)* or a *finance lease (capital lease)* may also qualify for the MIC, provided the property meets all other qualification requirements. The credit amount allowed to a lessee is generally equal to the purchase price on which California sales or use tax has been paid by the lessor, plus qualified capitalized labor costs. The MIC statute and regulations discuss specific criteria that must be met in order for leased property to be eligible for the credit. (R&TC §23649(f); CCR §23649-6))

First, the *lessor* is never entitled to claim the MIC with respect to any item of qualified property it leases to another party, regardless of whether the lessor is a qualified taxpayer. (R&TC §23649(f)(1)) Only the lessee is entitled to claim the MIC on the leased asset. The lessee must be a qualified taxpayer, and the leased property must be qualified property used in a qualified activity.

Second, in order for leased property to be eligible for the MIC, California sales or use tax must be paid on the construction, reconstruction or acquisition of leased property. In an *operating or "true lease"* arrangement, the lessor must elect to pay the sales tax up front when the lessor acquires the property. (R&TC §23649(f)(3)(iii); CCR §23649-6(b)(2)(C)) Under a *finance lease*, either the lessor or lessee must elect to pay the California sales or use tax based on the **lessee's** acquisition price, excluding any capitalized labor costs, of the leased property at the time of the purchase. (R&TC §23649(f)(4)(C); CCR §23649-6(c)(2)(C))

Example A

P, a financing institution, leases two drill presses to *Q*, a qualified taxpayer. The total cost under the terms of the lease is $500,000 (*P*'s acquisition cost), plus $35,000 in California sales tax and a finance charge equal to the market rate of interest for loans for a similar period. Assume *Q* will be using the drill presses in its manufacturing facility in Los Angeles. If either *P* (the lessor) or *Q* (the lessee) remits the $35,000 sales tax to the California State Board of Equalization, then *Q* will be entitled to claim the MIC on the acquisition cost of $500,000.

If the lessor leased the property to a predecessor lessee under a previous *operating lease* and the MIC was claimed, and the property is re-leased to another qualified taxpayer, then the qualified cost of property must be reduced by the amount of the original cost used in computing the MIC. However, this

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reduction is not required to the extent the predecessor lessee was required to recapture the MIC. (R&TC §23649(f)(3)(B)(i) and (ii); CCR §23649-6(b)(4)(C)) Also, if a lessor acquires qualified property that was previously leased from another lessor under an operating lease, the original cost to the new lessor for MIC purposes is reduced by the amount of the qualified cost used in computing the MIC by the predecessor lessee. (R&TC §23649(f)(3)(B)(iii); CCR §23649-6(b)(4)(D)) This generally results in both cases in the reduction of qualified costs to zero for purposes of computing the MIC unless the lessor pays California sales or use tax on the acquisition.

Under an operating or true lease, the lessor generally does not pay sales or use tax upon acquisition of the leased property and instead collects use tax payments from the lessee, measured by the lessee's rental payment stream to the lessor. (CCR §23649-6(c)(2)(C)) In order to claim the MIC the parties must alter normal business practices and the lessor must pay the sales or use tax up front upon acquisition of the property.

Example B

R, a financing company, leases qualified property to *S*. *R* does not pay California sales or use tax at the time of purchase. *R* delivered a resale certificate to *S*. *R* instead collects use tax from *S* over the lease term as part of the monthly lease agreement. According to California sales and use tax law, this transaction would be treated as a finance lease. However, in this case, the property would not qualify for the MIC because neither *R* (the lessor) nor *S* (the lessee) paid California sales or use tax at the time the property was acquired (up-front).

Third, the general requirement that qualified costs must be chargeable to the qualified taxpayer's capital account does not apply to a lessee's rental payments under an *operating or true lease* arrangement. (CCR §23649-6(b)(2)(E)) Thus, a lessee may take a current deduction of rent expense and still claim the MIC. However, in the case of a *finance or capital lease*, the qualified costs must be chargeable to the capital account. (CCR §23649-6(c)(2)(E))

Fourth, in the case of an *operating or true lease*, the lessor must provide the lessee with a written statement within 45 days after the close of the lessee's income year, containing the amount of the lessor's qualified cost. That is, the amount of such cost upon which the lessor has paid California sales or use tax. In addition, the lessor must provide the amount eligible for the credit, which would include qualified capitalized labor costs, if any. (R&TC §23649(f)(5)(A); CCR §23649-6(b)(6))

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For more information on the special rules for leased property, see R&TC section 23649(f) and CCR section 23649-6.

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121106 Credit Carryover

There is no limitation on the amount of credit that a taxpayer may be entitled in any taxable year. However, the amount of the credit that a taxpayer can use may be limited. Any unused credit may be carried forward for a maximum of eight (8) years. (R&TC §23649(h)(1)) If the qualified taxpayer meets the definition of a "small business" as of the last day of the taxable year, in which the credit is first allowed, then the carryover period is ten (10) years. (R&TC §23649(h)(2)) The credit cannot be carried back and applied against a prior year's tax.

The length of credit carryover period generated by an S corporation is determined at the pass-through entity level. (CCR §23649-9(e))

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121107 S Corporation and Their Shareholder(s)

In the case of an S corporation, the determination of whether a taxpayer is a "qualified taxpayer" is made at the entity level. (R&TC §23649(c)(2)) S corporations may claim only 1/3 of the credit against the 1.5% entity-level tax. (R&TC §23803(a)(1)(A)) One hundred percent (100%) of the credit is passed through to the S corporation shareholders in accordance with their ownership interest. (R&TC §§23803(a)(1)(F) and 23649(c)(2))

a. Recapture of MIC to S Corporations and Their Shareholders

In general, the MIC is not allowed, or is subject to recapture, if the property upon which the credit is claimed is disposed of within one year or less from the date the property was first placed in service in California. "Disposition" includes:

- Removal of qualified property from California;
- Use of property primarily in a non-qualified activity;
- Disposition of qualified property to an unrelated party;
- Acquisition by the lessee of qualified property leased by such lessee (R&TC §23649(g); CCR § 23649-8(b)); and
- The sale of stock for which an election was made or deemed to have been made pursuant to IRC Section 338(g) or IRC Section 338(h)(10) will not be treated as a disposition of qualified property to an unrelated party for purposes of R&TC section 23649(g).

If the disposition occurs during the taxable year the property is placed in service, no MIC is allowed. (R&TC §23649(g); CCR §23649-8(d)) If the disposition occurs in the subsequent taxable year, any MIC claimed must be added back to the taxpayer's tax liability in the year of disposition. However, if there is any MIC carryover, then the available credit carryover must first be reduced to the full extent before adding any recaptured amount to the current year tax liability. (CCR §23649-8(e))

The amount of any MIC that is recaptured by the S corporation is added to the 1.5% corporate level tax. However, the recapture amount that is added to the tax must first be reduced by the two-third amount by which the S corporation was required to reduce the credit. (CCR §23649-8(f)(2)(A)) The amount of MIC

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subject to recapture is allocated among the shareholders in the same ratio that the MIC was allocable to each shareholder. (CCR §23649-8(f)(2)(B)) This amount is added to the tax of the shareholder for the taxable year in which the qualified property is disposed of, removed from this state or put to a non-qualifying use. (Note: For an S corporation, the recapture amount for the shareholder(s) will differ from the amount recaptured by the S corporation on Form 100S, Schedule J, since S corporations can only claim 1/3 of the credit.)

Example A

Q, an S corporation, has three equal shareholders, *E*, *F*, and *G*. *Q* is allowed a MIC in 2000 that *Q* is fully able to utilize to reduce its 1.5% S corporation tax liability. *E*, *F* and *G* each claims one-third (1/3) share of the MIC allowed to *Q* and each is able to utilize their entire distributive share of the credit on their 2000 California tax returns. In 2001, within one year of the date the qualified property was placed in service in California, *Q* uses the property in a non-qualified activity. Under these facts, *Q*, *E*, *F* and *G* must each recapture the MIC allowed and claimed by each on their respective 2000 California tax returns by adding the recapture amount to their 2001 California “tax” or “net tax.” (Note: If there is any MIC carryover amounts, then those amounts are first reduced to the full extent before adding any recaptured amount to the current tax liability for *Q, E*, *F* and *G.)*

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121200 RESEARCH AND DEVELOPMENT CREDIT

California allows taxpayers to claim a credit for their research expenses using either the regular research credit method or the alternative incremental credit method (R&TC §23609). The regular credit is an incremental credit tied to a taxpayer's increase in research expenditures, expressed as a percentage of revenues, as compared with a historical fixed base. (IRC §41(a)(1)) Taxpayers may elect the alternative incremental credit, which is based on a three-tiered rated schedule for all research expenses exceeding one percent of sales. (IRC §41(c)(4)) That is, the alternative incremental credit is based on a specified formula, which does not depend on the taxpayer's incremental research and development expenditures.

Because of the numerous federal and state differences, as well as several law changes effective for 1993 and after, you should refer to the statue and accompanying regulations for the year under audit.

R&TC section 23609 conforms California law to IRC section 41 with the following modifications:

- The reference to 20% contained within IRC section 41(a)(1) is modified to 8% for taxable years beginning before January 1, 1997 (R&TC §23609(a)(1)), 11% for taxable years beginning on or after January 1, 1997 and before January 1, 1999 (R&TC §23609(b)(1)(A)), 12% for taxable years beginning on or after January 1, 1999 and before January 1, 2000 (R&TC §23609(b)(2)(A)), and 15% for taxable years beginning on or after January 1, 2000 (R&TC §23609(b)(3)(A)).
- The reference to 20% contained within IRC section 41(a)(2) is modified to 12% for taxable years beginning before January 1, 1997 (R&TC §23609(a)(2)), 24% for taxable years beginning on or after January 1, 1997, and before January 1, 1999 (R&TC §23609(b)(1)(B)), 24% for taxable years beginning on or after January 1, 1999 and before January 1, 2000 (R&TC §23609(b)(2)(B)), and 24% for taxable years beginning on or after January 1, 2000 (R&TC §23609(b)(3)(B)).
- The term "qualified research" and "basic research" includes only research conducted in California (R&TC §23609(c)(2)). However, California does not allow a credit against 1.5% S corporation tax or personal income tax for basic research payments (IRC §41(e)(7)(E)(i)).
- The definition of "qualified organization" includes hospitals run by public universities and certain cancer centers (R&TC §23609(e)(1)).

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- The R&D credit may not be carried back (R&TC §23609(f)).
- The R&D credit applies to expenses paid or incurred in taxable years beginning after 1986 and is available indefinitely thereafter, whereas the federal credit does not apply to amounts paid or incurred after June 30, 1995 and before July 1, 1996, or after June 30, 2004 (R&TC §23609 and IRC §41(h)(1)).
- Unlike federal law, California does not allow the R&D credit for expenses incurred to purchase property for which sales and use tax exemption for tele-production or other post-production property is claimed (R&TC §23609(c)(1)).

The research credit may reduce tax below the tentative minimum tax.

S Corp 121201	Qualified Research Expenditures
S Corp 121202	Alternative Incremental Credit
S Corp 121203	Credit Computation
S Corp 121204	Members of a Controlled Group
S Corp 121205	Reduced Credit
S Corp 121206	S Corporations

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

121201 Qualified Research Expenditures

In order to qualify for the credit, the expense must qualify as research and experimental expenditures under IRC section 174 (IRC §41(d)(1)(A)) and meet the following additional requirements:

- The research must be undertaken to "discover information that is technological in nature" (IRC §41(d)(1)(B)(i));
- The taxpayer must intend to use the information to develop a new or improved business component (IRC §41(d)(1)(B)(ii)); and
- The taxpayer must pursue a "process of experimentation" for a new or improved function, performance, reliability or quality during substantially all the research (IRC §41(d)(1)(C)).

Qualified research expenditures are defined under IRC section 41(b)(1) as the sum of in-house research expenses and contract research expenses. The term "in-house" research expenses include wages, supplies and amounts paid or incurred to another person for the right to use computers in the conduct of qualified research. Contract research expense includes payments to another person for performance on behalf of the taxpayer of services that would constitute qualified services within the meaning of IRC section 41(b)(2). Only 65% (75% for tax years beginning on or after January 1, 1997 for payments made to qualified research consortium) of contract research expense is allowed. (IRC §§41(b)(3)(A) and 41(b)(3)(C))

The Revenue Reconciliation Act of 1989 expanded the definition of qualified research expense so "start-up" companies not yet in a trade or business may be entitled to the credit. Under this Act, a taxpayer is deemed to meet the trade or business requirement with respect to in-house research expenses if, at the time the expenses are incurred, the principal purpose of the taxpayer in making such expenditures is to use the result of the research in the active conduct of a future trade or business of the taxpayer. (IRC §41(b)(4))

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121202 Alternative Incremental Credit

Instead of the regular credit, an S corporation may elect the alternative incremental credit in which it is assigned a smaller three-tiered fixed base percentage and a reduced three-tiered credit rate. Election for the alternative incremental credit may be made for tax years beginning on or after January 1, 1998. However, once made the election applies to the current taxable year and all subsequent years unless the FTB consents to revoke the election. (IRC §41(c)(4); R&TC §23609(h)(2))

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121203 Credit Computation

The research credit amount is 15% of the excess of qualified research expenses for the taxable year over the base period research expenses. (R&TC §23609(b)(2)) The base amount is equal to the fixed base percentage multiplied by the taxpayer's average annual gross receipts for the four taxable years preceding the credit year (i.e., the year in which the amount of credit is being computed). (IRC §41(c)(1)) However, the base amount cannot be less than 50% of the current year qualified research expenses. (IRC §41(c)(2))
The fixed base percentage depends on whether the taxpayer is a “start-up” company or existing company. A “start-up” company is one that has both gross receipts and qualified research expenses either: (1) for the first time in a taxable year beginning after 1983, or (2) for fewer than 3 taxable years beginning after 1983 and before January 1, 1989. The fixed-base percentage for a “start-up” company is 3% for each of the company’s first 5 taxable years beginning after 1993 for which it has qualified research expenses. See IRC section 41(c)(3)(B)(ii) for a company’s fixed base percentage for its 6th through 10th years.

The fixed base percentage for an existing company is determined by dividing the aggregate qualified research expenses for taxable years beginning after 1983 and before 1989 by the aggregate gross receipts for those tax years. (IRC §41(c)(3)) However, the maximum fixed base percentage is 16%.

For purposes of the base amount and fixed base percentage, the average annual gross receipts is computed using the gross receipts of the four taxable years preceding the tax year for which the credit is being determined. (IRC §41(c)(1)(B)) R&TC section 23609(h)(3) modifies the definition of gross receipts to take into account only those gross receipts from the sale of property held primarily for sales to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of F.O.B. point or other condition of sale.

Unlike the federal definition of gross receipts, pursuant to R&TC section 23609(h)(3) states that the property sold must be <u>delivered or shipped to a purchaser within this state</u>. It is the department's position that gross receipts for R&D Credit purposes should include receipts from the sale of real, tangible, or intangible property held for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state. This would *include* sales to the U.S. government, which could be identified as delivered in California. *Excluded* receipts would include "throwback" sales and receipts from services, rents, operating leases and interest. In addition, royalties and license payments would generally be excluded from the definition of

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gross receipts for research credit purposes. However, transactions that operate as a sale of property based on the terms of the contract would need to be evaluated on a case-by-case basis.

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121204 Members of a Controlled Group

California conforms to the federal rules for assigning the research credit among members of a controlled group. (IRC §41(f)) For purposes of the research credit, all members of a “controlled group” are to be treated as a single taxpayer. All of the components that comprise the research credit calculation are aggregated and the total credit generated is computed as if the controlled group is a single taxpayer. The total credit amount is then assigned to the members of the controlled group based upon their proportionate share of the qualified research expenses and basic research payments. It should be noted the aggregation rules apply to controlled trades and businesses as well as controlled corporations. Controlled trades and businesses include sole proprietorships, partnerships, and estates and trusts.

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121205 Reduced Credit

Unless the taxpayer makes an election to reduce the research credit, deductions under IRC section 174 or any other deduction or credit provision for research expenses or basic research payments must be reduced by the amount of the current year's research credit. In other words, the taxpayer must add back to income the amount of the credit. (R&TC §24440(b)(1); IRC §280C(c)) The election to take a reduced credit must be made on the taxpayer's original return for the year the credit is generated. The reduced credit is an annual irrevocable election under IRC section 280C(c)(3).

The shareholder(s) election of the reduced credit must be consistent with that of the S corporation's. For example, if ABC, Inc., an S corporation, elects the reduced credit, then its shareholder(s) must also reduce their pro rata share of the research credit. However, the credit reduction percentage may differ from that of the S corporation.

The applicable credit reduction percentage is R&TC section 17270(c) and R&TC section 24440(b)(2):

- 90.7% (.907) for individuals and estates or trusts (R&TC §17041),
- 91.16% (.9116) for corporations (R&TC §23151(f)), and
- 98.5% (.985) for S corporations (R&TC §23802(b)(1)).

The taxpayer must note in the supplementary information section on the Schedule K-1 the shareholder's applicable credit reduction percentage. If the taxpayer does not know what type of entity the shareholder is, then the taxpayer should report the pro rata share amount of the research credit on the Schedule K-1 without the credit reduction.

Example A

T, an S corporation, has one shareholder, *H. T* generated $30,000 in research credit for tax year 2000. *T* elects the reduced research credit. *T* computes its research credit as follows:
Step 1: $30,000 x 1/3 = $10,000
Step 2: $10,000 x 98.5% (.985) = $9,850
This amount, $9,850, is the research credit available to *T* for its 2000 taxable year.
H, the sole shareholder, materially participates in the business, holds no interest

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in any passive activity, and does not have any non-passive activity credit carryover from previous years. The election by *T* to the reduced credit also applies to *H* and his pass-through credit is computed as follows:
Step 1: $30,000 x 100% = $30,000
Step 2: $30,000 x 90.7% = 27,210
This amount is the pass-through research credit available to *H* for his 2000 taxable year. Note: Amounts received from S corporations may be limited due to IRC section 41(g) and the related regulations.

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121206 S Corporations

S corporations may claim 1/3 of the research credit against the 1.5% entity-level tax after applying the limitations relating to passive activity losses and credits. However, S corporations are not eligible for the “basic research” credit. (IRC §41(e)(7)(E)(i)) S corporations can pass through 100% of this credit to their shareholders on a pro-rata basis.

The amount of research credit passed through to the shareholder on the Schedule K-1 may be limited to the amount of tax attributable to the shareholder’s interest in the S corporation (IRC §41(g)). To determine the shareholder’s credit limitation, see FTB Form 3523 – Line 40 instructions.

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130000 DEDUCTION FOR TAXES AT THE S CORPORATION AND SHAREHOLDER LEVELS

S Corp 130100 Summary of Taxes Deductible at the S Corporation and Shareholder Levels
S Corp 130200 Franchise Tax
S Corp 130300 Built-in Gains (BIG) Tax
S Corp 130400 Excess Net Passive Income (ENPI) Tax

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130100 SUMMARY OF TAXES DEDUCTIBLE AT THE S CORPORATION AND SHAREHOLDER LEVELS

There are differences in the deductibility of the taxes at the S corporation level and the shareholder level as shown in the chart below.

	S Corporation Level		Shareholder Level	
Type of Tax	**Deductible**	**R&TC**	**Deductible**	**R&TC**
Franchise Tax 2.5% / 1.5%	No	R&TC Section 23036(a)(1)(D) and R&TC Section 24345	No	R&TC section 17220(b)
BIG Tax	No	R&TC section 24345	Yes	IRC Section 1366(f)(2)
ENPI Tax	No	R&TC section 24345	Yes	IRC Section 1366(f)(3)
LIFO Recapture	No		No	

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130200 FRANCHISE TAX

The S corporation franchise tax is neither deductible to the corporation nor to its shareholders (R&TC §23036(a)(1)(D), R&TC §17220(b)(2), and R&TC §24345(a)).

This tax is treated as a noncapital, nondeductible item of deduction for purposes of computing the Accumulated Adjustments Account and shareholder basis. (Treas. Reg. §1.1368-2(a)(3))

Example A

ABC, Inc., a California S corporation, reported a state adjustment of +$100,000 for taxes based on franchise taxes. It is a noncapital, nondeductible item. ABC, however, is allowed to reduce its Accumulated Adjustments Account by $100,000.

taxes based on franchise taxes. It is a noncapital, nondeductible item. ABC's shareholders, however, must reduce their basis in the S corporation by each shareholder's pro rata share of the $100,000. (IRC §1367(a)(2)(D)

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130300 BUILT-IN GAINS (BIG) TAX

S Corp 130301 S Corporation Level
S Corp 130302 Shareholder Level

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130301 S Corporation Level

The built-in gains tax is not deductible by the corporation for purposes of computing its franchise or income tax at 2.5% / 1.5% (R&TC §24345(a)). However, R&TC section 23802(e) permits the S corporation to exclude the built-in gains, which were subject to the built-in gains tax, for purposes of computing the S corporation's franchise or income tax. This provision is designed to prevent double taxation by ensuring that the built-in gains are not taxed twice, first by the built-in gains tax and again by the franchise or income tax.

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130302 Shareholder Level

Built-in gains tax is allowed as a deduction to the shareholder in IRC section 1366(f)(2). R&TC section 23803(b)(1) modifies this federal code section to allow, as a deduction to the shareholder for California purposes, the amount of built-in gains tax computed under California law. The built-in gains tax is treated as a loss sustained by the corporation during such taxable year; the character of such loss is determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax. (IRC §1366(f)(2))

Example A

		Amount of Built-In Gain	Ratio	Built-In Gains Tax @ S Corporation Level	Built-in Gains Tax
1.		$100,000			$9,300
2.	Capital Gain		.20		18,600
3.		700,000	.70		65,100
	Total	$1,000,000	1.00	$93,000	$93,000

The shareholder would include the following in the computation of shareholder basis:

		Item of Income	Item of Loss/Deduction
1.	Ordinary Gain	$100,000	-$9,300
2.	Capital Gain	$200,000	-$18,600
3.	IRC Section 481 Income	$700,000	-$65,100

If the shareholder has sufficient basis and is not restricted by other applicable limitations, the shareholder would report the following amounts per return:

- Ordinary Gain, $90,700 [$100,000 - 9,300], to Form 4797.
- Capital Gain, $181,400 [$200,000 - 18,600], to Schedule D.

Note: The built-in gains tax computed for California purposes is used in lieu of the federal amount.

Example B

Assume the same facts as in Example A, except the shareholder had insufficient basis to recognize all losses/deductions.

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The shareholder would report the following amounts per return:

- Ordinary Gain, $100,000, to Form 4797.
- Capital Gain, $200,000, to Schedule D.
- IRC Section 481 Income, $700,000, to Schedule E.

The shareholder would currently suspend the following losses/deductions (built-in gains tax):

- Ordinary Loss, $9,300.
- Capital Loss, $18,600.
- IRC Section 481 Loss, $65,100.

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130400 EXCESS NET PASSIVE INCOME (ENPI) TAX

S Corp 130401 S Corporation Level
S Corp 130402 Shareholder Level

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130401 S Corporation Level

The ENPI tax is not deductible to the corporation for purposes of computing its franchise or income tax at 2.5% / 1.5% (R&TC §24345). R&TC section 23802(e) does not provide for the deduction of the ENPI tax. This section provides for the deduction of the ENPI for purposes of computing the franchise or income S corporation tax at 2.5% / 1.5%. This code section prevents the ENPI, subject to the excess net passive income tax, from being taxed a second time by the corporation's franchise or income tax.

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130402 Shareholder Level

The ENPI tax is allowed as a deduction to the shareholder in IRC section 1366(f)(3). R&TC section 23803(b)(2) modifies this federal code section to allow, as a deduction to the shareholder for California purposes, the amount of ENPI tax computed under California law. Each item of passive investment income shall be reduced by an amount that bears the same ratio to the amount of such tax as the amount of such item bears to the total passive investment income for the taxable year. (IRC §1366(f)(3))

$$\text{The Amount of Reduction for Item N} = \text{ENPI Tax} \times \frac{\text{Passive Investment Income of N}}{\text{Total Passive Investment Income}}$$

Unlike the built-in gains tax, the ENPI tax is allowed to reduce each passive investment income item proportionately by the amount of tax. It is not treated as a current distributive loss.

Example A: (Sole Shareholder)

		Amount of Excess Net Passive Income		Excess Net Passive Income Tax @ S Corporation Level	Pro Rata Excess Net Passive Income Tax
1.	Interest Income		.90	$ 83,700	
2.	Income	100,000		9,300	
	Total	$1,000,000	1.00		$93,000

basis:

1.	Interest Income	$816,300	[$900,000 - 83,700]
2.	Dividend Income	$90,700	[$100,000 - 9,300]

The shareholder would report the following amounts per return:

- Interest Income, $816,300, to Schedule B.
- Dividend Income, $90,700, to Schedule B.

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Note: The excess net passive income tax computed for California purposes is used in lieu of the federal amount.
Also Note: The deduction allowed by IRC section 1366(f) is not treated as a loss, it is merely a reduction of passive investment income. It is not a part of the basis limitation computation.

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140000 QSUB/QSSS

S Corp 140100 Introduction to QSub/QSSS
S Corp 140200 Basic Federal Law
S Corp 140300 California Differences
S Corp 140400 LLC vs. QSub (For California Purposes)
S Corp 140500 Audit Issues
S Corp 140600 Additional Resources
S Corp 140700 Exhibit

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140100 INTRODUCTION TO QSUB/QSSS

According to House of Representatives Report No. 104-586, HR 3448, Public Law No 104-188 (also known as the Small Business Job Protection Act), small businesses are the most vibrant segment of our economy. They are responsible for the lion's share of job growth and ingenuity in this country. However, the House Ways and Means Committee was aware that recordkeeping and other actions required to comply with the tax laws impose significant costs on small businesses. Their intent is for the tax laws to be easier for small businesses to comply with and as small of a burden as possible.

S Corp 140101 Pre-Qualified Subchapter S Subsidiary (QSub) Law
S Corp 140102 Reasons for Change

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140101 Pre-Qualified Subchapter S Subsidiary (QSub) Law

A small business corporation could not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Therefore, an S corporation could not own 80 percent or more of the stock of, or be owned by, another corporation (whether an S corporation or a C corporation).

Prior to the Small Business Job Protection Act, IRC section 1361(b)(1)(A) allowed a maximum of 35 shareholders to an S Corporation.

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140102 Reasons for Change

The House Ways and Means Committee understood that there are situations where taxpayers may wish to separate different trades or businesses in different corporate entities. The Committee believes that, in such situations, shareholders should be allowed to arrange these separate corporate entities under parent-subsidiary arrangements as well as brother-sister arrangements.

Therefore, the Small Business Protection Act of 1996 repealed IRC section 1362(b)(2(A), which did not allow a subchapter S corporation to own 80 percent or more of another corporation's stock. In addition, an S corporation could not have as a shareholder another corporation whether an S corporation or a C corporation. (House Report No. 104-586 (PL 104-188), II.C.8 (sec. 1308 of the Bill))

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140200 BASIC FEDERAL LAW

S Corp 140201 What is a Qsub
S Corp 140202 Who can be a QSub
S Corp 140203 How to become a QSub
S Corp 140204 Election's Effect
S Corp 140205 Termination of QSub Election

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140201 What is a Qsub

QSub stands for Qualified Subchapter S Subsidiary. It is also known as a QSSS. Because of possible confusion of QSSS with QSST (Qualified Subchapter S Trust), QSub is becoming the term of choice. Because the latest revenue procedure from the Internal Revenue Service refers to the Qualified Subchapter S Subsidiary as a QSub, that will be the term used in this discussion. QSub provisions are effective for income or taxable years beginning after December 31, 1996.

IRC section 1361(b)(3)(B) defines a QSub as any domestic corporation which is not an "ineligible corporation" if an S corporation holds 100 percent of that corporations stock and it elects to treat that subsidiary as a QSub.

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140202 Who can be a QSub

To qualify as a QSub, the parent S corporation must own 100 percent of the stock of the eligible subsidiary corporation. The following is a discussion of who is eligible to be a QSub.

An S corporation is a small business corporation with an election under IRC section 1362(a) in effect. A small business corporation is defined as a domestic corporation which is not an "ineligible corporation" and which does *not* have:

- more than 75 shareholders,
- a shareholder, a person (other than an estate, a trust described in IRC section 1361(c)(2)), or certain exempt organizations described in IRC section 1361(c)(6) who is not an individual,
- a nonresident alien shareholder, and
- more than 1 class of stock. (IRC §1361(b)(1))

Ineligible corporations include:

- Financial institutions using the reserve method for bad debts described in IRC
- section 585;
- Insurance companies subject to tax under Subchapter L;
- Corporations subject to a IRC section 936 election (Puerto Rico and possession); or
- Domestic international sales corporations (DISCs) or former DISCs. (IRC §1361(b)(2))

Exceptions to the list of ineligible corporations include certain casualty insurance companies and qualified oil companies. (Treas. Reg. §1.1361-1(d)(2))

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140203 How to become a QSub

Election

Currently, an S corporation owning 100 percent of the stock of a corporation that is eligible for QSub status makes the QSub election by completing federal Form 8869, Qualified Subchapter S Subsidiary Election. (IRC §1361(b)(3))

The S corporation parent may make the election at any time during the taxable year. The effective date of the QSub election cannot be more than:

- **Two months and 15 days prior to the date of filing the election or**
- Twelve months after the date of filing the election. (Treas. Reg. §1.1361-3(a)(4))

If the election specifies a date falling earlier than the date in item 1, it will be treated as being effective 2 months and 15 days prior to the date of filing the election. If the election specifies a date falling later that the date in 2, it will be treated as being effective 12 months after the date of filing the election. If no date is specified, the election is effective on the date Form 8869 is filed.

Example A

several years. Big S acquires the stock of Big C, a qualified calendar year C corporation, on March 1, 1998. On July 10, 1998, Big S files an election to treat Big C as a QSub. Unless otherwise specified on the election form, the election will be effective as of July 10, 1998. If specified on the election form, the election may be effective on some other date that is not more than 2 months and 15 days prior to July 10, 1998 (April 25, 1998), and not more than 12 months after July 10, 1998 (July 10, 1999).

For federal purposes, an extension of time to make a QSub election may be available under the procedures applicable under Treas. Reg. §§ 301.9100-1 and 301.9100-3. Requests for extension will be granted when the taxpayer provides evidence to establish, to the satisfaction of the Commissioner, that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government. (Treas. Reg. §301.9100-3(a)) Numerous letter rulings have been issued granting extension for filing the QSub election.

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Rev. Proc. 98-55, issued 11/4/98, provides relief for late S corporation and QSub elections. A corporation that is not requesting relief under section 4 (relief for late S corporation elections) of this revenue procedure may be granted additional time for a valid QSub election. To be eligible for *automatic* relief for late QSub election, the following requirements must be met:

- The subsidiary corporation fails to qualify as a QSub on the desired effective date solely because the parent S corporation failed to file a timely election to treat the subsidiary as a QSub.
- The due date for the S corporation's tax return (excluding extensions) for the first taxable year of the S corporation for which it intended to treat the subsidiary as a QSub has not passed; and
- The S corporation has reasonable cause for its failure to timely make the QSub election.

Detailed procedures for relief are described in section 5.02 of Rev. Proc. 98-55. When the IRS receives the application for relief, it will determine whether the requirements have been met and will notify the corporation of its determination (§5.03).

For California purposes, California has not conformed to IRC section 7805(f), which authorizes the Commissioner to provide the procedures as outlined in Treas. Reg. Section 301.9100-1 and Treas. Reg. Section 301-9100-3. However, if an S corporation receives an extension for filing the QSub election by the Commissioner, California will honor the extension because an independent election for QSub status is not allowed for California purposes. (R&TC §23800.5(b)(3))

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140204 Election's Effect

a. Separate Existence Ignored

Under the final regulations, the QSub election's effect is that the existing subsidiary is not to be treated as a separate corporation. Generally, the QSub is deemed to be liquidated under IRC Section 332 and IRC Section 337. (Treas. Reg. § 1.1361-4(a)(2)) All assets, liabilities, and items of income, deduction, and credit of a QSub are to be treated as those of the parent S corporation. (IRC §1361(b)(3)) Items of the subsidiary, which become attributable to the parent S corporation, include accumulated earnings and profits, passive investment income and built-in gains. (House Report No. 104-586 (PL 104-188), II.C.8 (sec. 1308 of the Bill)) Transactions between the parent S corporation and the QSub are not taken into account. (House Report No. 104-586 (PL 104-188), II.C.8 (sec. 1308 of the Bill))

Example A

Quantum, an S corporation, is the single member of Little L, an LLC. Little L owns 100 percent of the stock in Quad, a corporation that could be an eligible QSub. The "check-the-box" regulations allow Little L to be a disregarded entity separate from Quantum, its owner. (Treas. Reg. §301.7701-2(c).) Quantum is

status for Quad.

Example B

Sophia & Co., an S corporation, wholly owns Quincy, a corporation, which has a valid QSub election in effect. Quincy owns all of Quality's stock. Quality is a corporation that could be an eligible QSub. Quincy is a disregarded entity separate from Sophia & Co. Quincy's assets, including its stock in Quality, are deemed owned by Sophia & Co. Sophia & Co. can elect QSub status for Quality.

Example C

Assume same facts as **Example B**, except that Quincy owns 60 percent of Quality and Sophia & Co. owns the other 40 percent. Sophia & Co. is deemed the owner of 100 percent of the stock of Quality and can elect QSub status for Quality.

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Example D

Assume same facts as **Example B,** except that Quincy is a C corporation. While Quincy is eligible for QSub status, no election for QSub status has been made. Quincy is considered the sole owner of Quality. Therefore, Sophia & Co. is unable to elect QSub status for Quality.

Jazz, an S corporation, owns 100 percent of Country, a corporation for which a QSub election is in effect. On April 12, 1998, a date on which the QSub election is in effect, Jazz issues Country a $10,000 note that matures in ten years with a market rate of interest. Country is not treated as a separate corporation, and Jazz's issuance of the note to Country on April 12, 1998, is disregarded for federal tax purposes. Interest paid by Country is disregarded as an expense to Country and the interest income to Jazz is disregarded for tax purposes. If Country defaults on the note, Jazz is not allowed a bad debt expense. Likewise, Country would not recognize any cancellation of debt income.

The QSub's debt issued to the shareholders of the parent S corporation is treated as the parent's debt for purposes of determining the amount of loss that can be deducted by the shareholders of the parent S corporation. (House Report No. 104-586 (PL 104-188), II.C.8 (sec. 1308 of the Bill))

b. Deemed Liquidation

Generally, if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation under IRC Section 332 and IRC Section 337. (Treas. Reg. §1.1361-4(a)(2)(i)) When the QSub election is filed, the making of the election is generally treated as the adoption of a plan of liquidation under IRC section 332. (Treas. Reg. §1.1361-4(a)(2)(iii))

The tax treatment of the deemed liquidation or of the larger transaction that includes the liquidation must take into consideration the IRC and the general principles of federal tax law, including the step transaction doctrine. The step transaction doctrine treats the steps of a corporate reorganization, if related, as one transaction. The tax consequences of the transaction (who is in control of the

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transferee/QSub) will be determined after all the steps are completed, not at each step of the transaction. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, there will be no deemed liquidation of the new subsidiary. Instead, the corporation will be deemed to be a QSub from its inception. (Treas. Reg. §1.1361-4(a)(2))

A transitional rule exempts a QSub election from the step transaction doctrine if the S corporation and the QSub are related "persons" as defined in IRC section 267(b) prior to the S corporation's partial or total acquisition of the QSub's stock. This exemption applies to QSub elections effective before January 1, 2001. (Treas. Reg. §1.1361-4(a)(5))

The examples below provide some of the most common situations we may encounter. The intent behind the law allowing QSubs is to allow some flexibility in the way small businesses are allowed to separate different trades or businesses in different corporate entities, but at the same time not create situations where there is the potential for abuse.

Generally, the deemed liquidation occurs the day before the QSub election. However, if an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSub election or the acquisition is in coordination with IRC section 338 elections, then the deemed liquidation occurs the day after the S corporation acquires 100 percent of the subsidiary or the completion of IRC section 338. By making the deemed liquidation effective on the day after the acquisition or the completion of IRC section 338, the taxable event of the acquisition, if applicable, must be recognized before the effective date of the QSub. (Treas. Reg. §1.1361-4(b))

Example A

Success, an S corporation, owns 100 percent of the stock of Jasmine, a C corporation. (The stock was acquired from an unrelated party on January 6, 1998.) On May 2, 1998, Success makes a valid QSub election for Jasmine, effective May 2, 1998. Assume that, under general principles of tax law, including the step transaction doctrine, Success' acquisition of the Jasmine stock and the subsequent QSub election would not be treated as related. The liquidation described in Treas. Reg. section 1.1361-4(a)(2) occurs at the close of the day on May 1, 1998, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Jasmine's taxable year and separate existence for federal tax purposes end at the close of May 1, 1998.

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Tax consequences:
Jasmine
The shareholder(s) of Jasmine recognize the applicable gain or loss on the sale of stock. Jasmine, a calendar year taxpayer, files a short period return for January 1, 1998 through May 1, 1998. No gain or loss is recognized by Jasmine under IRC section 337.
Success
Success, a calendar year S corporation, files a tax return, which includes Jasmine as of May 2, 1998. No gain or loss is recognized on the deemed liquidation of Jasmine under IRC section 332. Assuming there is no debt owed to Success by Jasmine on May 2, 1998 (Treas. Reg. §1.332-7), Success will carry over Jasmine's basis in the assets. (IRC §334(b)(1).)

Example B

Xavier owns 100 percent of the stock of Chess. Both companies are C corporations. On December 31, 1998, Xavier makes an election under IRC section 1362 to be treated as an S corporation and a valid QSub election for Chess. Both are effective January 1, 1999. Assume that, under general principles of tax law, including the step transaction doctrine, Xavier's acquisition of the Chess stock and the subsequent QSub election would not be treated as related (IRC §267(b)). The liquidation occurs at the close of December 31, 1998, the day before the QSub election is effective. The QSub election for Chess is effective on the same day that Xavier's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when Xavier is still a C corporation. Chess' taxable year ends at the close of December 31, 1998. See Treas. Reg. section 1.381(b)-1 for the operating rules applicable to carryovers in certain acquisitions.
Tax consequences:

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Keep in mind the ramifications of going from a C corporation to an S corporation. For example, built-in gains (BIG), distribution of C corporation earnings and profits. See S Corp 140204(d): *Carryover of Tax Attributes* and the S corporation manual for a detailed discussion. Assuming that these issues are not present here, the tax consequences of Xavier and Chess are as follows:

Xavier

1998

Xavier files a C corporation income tax return. No gain or loss is recognized assuming no debt exists between Xavier and Chess.

1999

included in Xavier's income tax return.

Chess

1998

Chess files a C corporation income tax return. No gain or loss is recognized assuming no debt exists between Xavier and Chess.

1999

included in Xavier's income tax return.

Example C

On January 1, 1998, Super S, an S corporation, acquires 100 percent of the stock of Duper S, an existing S corporation, for $75,000 cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under IRC section 338. Super S immediately makes a QSub election for Duper S effective January 2, 1998, and also makes a joint election under IRC Section 338(h)(10) with the shareholder of Duper S. Under IRC section 338(a) and Treas. Reg. section 1.338(h)(10)-1, Duper S is treated as having sold all of its assets with a basis of $50,000 at the close of the acquisition date, January 1, 1998. (Duper S has no liabilities.) Duper S is treated as a new corporation, which purchased all of those assets as of the beginning of January 2, 1998, the day after the acquisition date. (IRC §338(a)(2)) The QSub election is effective on January 2, 1998, and the liquidation under Treas. Reg. section 1.1361-4(a)(2) occurs immediately after the deemed asset purchase by the new corporation.

Tax consequences:

Super S, a calendar year taxpayer, files an income tax return for 1998 including all items of income and deduction of Super S beginning on January 2, 1998. However, on January 1, 1998, short year return, Duper S recognizes a gain of $25,000 (Sales price of $75,000 less Basis of assets of $50,000). As a result of Duper S recognizing the gain of $25,000, the assets of Duper S are given a stepped-up in basis to $75,000. This basis amount of $75,000 is carried into the

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parent Super S upon their QSub election.

c. Carryover of Disallowed Losses and Deduction

If an S corporation (S1) acquires the stock of another S corporation (S2) in a transaction in which the basis of the S2 stock is determined in whole or in part by reference to the transferor's basis, and S1 makes a QSub election with respect to S2 effective on the day of the acquisition, any loss or deduction disallowed under IRC section 1366(d) with respect to a former shareholder of S2 is available to that shareholder as a shareholder of S1. (Treas. Reg. §1.1361-4(c)) Thus, a loss or deduction of a shareholder of S2 disallowed prior to or during the taxable year of the transaction is treated as incurred by S1 with respect to that shareholder if the shareholder is a shareholder of S1 after the transaction.

Example A

Embassy, an S corporation, acquires 100 percent of the stock of Ambassador, another S corporation, in a transaction in which the basis of the Ambassador stock is determined in whole or in part by reference to the transferor's (Ambassador's) basis. Embassy elects to treat Ambassador as a QSub effective on the day of the acquisition. Any loss or deduction disallowed under IRC section 1366(d) with regard to a former shareholder of Ambassador remains available to that shareholder as a shareholder of Embassy. Therefore, a loss or deduction of a former Ambassador shareholder disallowed prior to or during the year of the transaction is treated as incurred by Embassy with respect to that shareholder provided the shareholder is a shareholder of Embassy after the transaction.

Example B

Same facts as Example A. The 100 percent shareholder of Ambassador (who is now a 100 percent shareholder of Embassy) had zero basis and carryover losses of $5,000 from Ambassador at the time of the Qsub election. If Embassy has pass-through income items in the amount of $10,000 that increase basis to the former shareholder of Ambassador, the shareholder may offset the carryover losses ($5,000) against the income from Embassy ($10,000) (IRC §1367).

Example C

Same facts as Example A.. Sharon, a former 50 percent shareholder of

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Ambassador (who is now a 30 percent shareholder of Embassy), had zero basis and carryover losses of $2,500 (50% X $5,000) from Ambassador at the time of the QSub election. If Embassy has pass-through income items in the amount of $3,000 (30% X $10,000) to Sharon, which increase her basis, she may offset the carryover losses ($2,500) against the income from Embassy ($3,000) (IRC §1367).

d. Carryover of Tax Attributes

Treas. Reg. section 1.1361-4(b) provides that in general QSub is treated as if it were liquidated into the S corporation. If this occurs, then generally, IRC section 381 allows the acquiring corporation to succeed to and take into account the tax attributes of the subsidiary. These attributes include, among other things:

- NOL carryovers;
- General business credits;
- Method of accounting;
- Depreciation methods;
- Capital loss carryovers.

Thus, in general if the acquiring corporation and the subsidiary are both S corporations, then the acquiring corporation will succeed to and take into account the tax attributes of the subsidiary. However, tax attributes generally will not carryover between C year and S year. (IRC §1371(b)) There are two instances that this could occur. First, both acquiring corporation and subsidiary could have been a C corporation prior to acquiring corporation electing S status and QSub for the subsidiary. Second, the acquiring corporation is an S corporation that acquires a C corporation prior to electing QSub. In both these situations, the rules would be similar to a regular C corporation electing S corporation status. For example, the NOL carryovers and general business credits from C years can only be utilized if the S corporation had recognized built-in gains tax. (See S Corp 050000 - Built-in Gains Tax.)

338 Election

If an S corporation acquires the stock of the subsidiary in a qualified stock purchase (IRC §338(h)(10)), then generally the tax attributes do not carryover to the acquiring corporation because, for tax purposes, the transaction is treated as an asset sale rather than a stock sale. Therefore, there are no tax attributes of

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the subsidiary subject to transfer. (See the Sale of Stock & Election of IRC Section 338(h)(10) chapter.)

Note: Despite the fact that an S corporation cannot have carryovers or carrybacks from tax years when it was not an S corporation, each year the corporation is an S corporation counts as a year for the purpose of figuring the year to which carrybacks or carryovers can be taken. (IRC §1371(b)(3))

e. Built-In Gains (BIG) Tax

There are several ways an S corporation with a QSub can be subject to BIG tax. First, the S corporation could have been a C corporation prior to acquiring the subsidiary and electing S and QSub status. Second, the S corporation could have acquired a C corporation before electing QSub status. Third, there could have been a tax-free reorganization with a QSub election, involving an S and a C corporation where the S corporation acquired C corporation assets. However, the transaction arose, an S corporation with a QSub will be subject to BIG tax as long as the S corporation acquires an asset and the S corporation's basis in such asset is determined (in whole or in part) by reference to the basis of such asset (or any other property) in the hands of a C corporation (insert footnote here with a reference to IRC section 1374(d)(8)).

Thus, for example, if a C corporation elects to be treated as an S corporation and, at the same time, makes a QSub election for the subsidiary, the assets held by the QSub at the time of the election are treated as assets transferred to an S corporation which are taken into consideration for purposes of the BIG tax. This is in addition to the potential BIG tax on the assets of the S corporation itself. Keep in mind that the 10-year recognition period begins at the date of the S election of the date of the assets acquisition (Insert a footnote here with a reference to Treas. Reg. section 1.1374-1(d)). Thus, if an S corporation acquires a C corporation subsidiary and elects QSub status, the 10-year recognition period begins on the date of the acquisition and QSub election.

Oceana owns 100 percent of the following: Ship, Boat and Yacht. The corporations are all C corporations. Oceana elects S status on 1/1/98 and QSub status for Ship, Boat and Yacht on 1/2/98. The assets of Ship, Boat and Yacht are not subject to BIG tax due to the deemed tax-free liquidation of the subsidiaries at the time of the QSub election. However, the BIG tax does become a possible issue when the assets of Oceana, Ship, Boat and Yacht are

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sold.

f. Gain on Liquidation

The QSub election may be tax free under IRC Section 332, IRC Section 337, and IRC Section 368. However, if the subsidiary is insolvent and is indebted to the parent S corporation, (Rev. Rul. 59-296, 1959-2 C.B. 87 and Treas. Reg. §1.332-7) or has liabilities in excess of the adjusted basis of its assets, (IRC §§368(a)(1)(D) and 357(c)(1)) the election may trigger a taxable event. For discussion, see S Corp 140500, Audit Issues.

Example A

Stormy, an S corporation owns 100 percent of the stock of Cyclone, a C corporation. At the time when Cyclone is indebted to Stormy for an amount that exceeds the fair market value of Cyclone's assets, Stormy makes a QSub election for Cyclone effective on the date it is filed. The liquidation described in Treas. Reg. section 1.1361-4(a)(2) does not qualify under IRC section 332 and IRC section 337. Cyclone must recognize gain or loss on the assets distributed, subject to the limitations of IRC
section 267.

Example B

Same facts as **Example A**. Cyclone is indebted for a note payable to Stormy. The note has a principle balance of $375,000. Cyclone owns a single asset of land with a fair market value of $250,000. Cyclone recognizes gain in the amount of $125,000.

g. Treatment of Banks

If an S corporation is a bank, or if an S corporation makes a valid QSub election for a subsidiary that is a bank, any special rules applicable to banks under the IRC and R&TC continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub under Treas. Reg. section 1.1361-4(a)(2) had not occurred. However, for any QSub that is a bank, all assets, liabilities, and items of income, deduction and credit of the QSub (as

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determined in accordance with the special bank rules) are treated as assets, liabilities, and items of income, deduction and credit of the S corporation. For purposes of this section, the term "bank" has the same meaning as in IRC section 581. (Treas. Reg. §1.1361-4(a)(3))

Banks cannot elect S status if they use the reserve method. (IRC §1361(b)(2)(A)) However, there is one exception; the S corporation status can be elected if the entity changes its accounting method from the bad debt reserve method to the specific write-off method. The corporation is required to recapture its bad debt reserve and pay built-in gains tax thereon (FTB Notice 1998-3 and Rev. Proc. 99-49, I.R.B. 1999-52, 725).

Example A

bank as defined in IRC section 581. Rocky owns 100 percent of Shaky, a corporation for which a valid QSub election is in effect. Shaky is a bank as defined in IRC section 581. According to Treas. Reg. section 1.1361-4(a)(3)(i), any special rules applicable to banks under the IRC continue to apply to Shaky and do not apply to Rocky. However, all of Shaky's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as those of Rocky. For example, IRC section 582(c), which provides special rules for sales and exchanges of debt by banks, applies only to sales and exchanges by Shaky. However, any gain or loss on such a transaction by Shaky that is considered ordinary income or ordinary loss according to IRC section 582(c) is treated as ordinary income or ordinary loss of Rocky.

Example B

Same facts as Example A, Shaky has ordinary income of $50,000 from the sale of a bond. The ordinary income from the sale of the bond $50,000 then becomes ordinary income of $50,000 to Rocky.

h. Determination of Basis

To Transferor Parent S Corporation

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The basis of stock received is equal to the basis of the property transferred less the value of boot received plus the amount of gain recognized. Liabilities assumed by the QSub are treated as boot for this purpose unless such liabilities are excluded under IRC section 357(c)(3). (IRC §358(a)(1)(d))

To QSub

The basis of property received is equal to the basis of the property in the hands of the transferor parent S corporation plus gain recognized by the transferor in the exchange under IRC Section 362(a)(1). IRC section 362 does *not* allow the QSub to increase basis to reflect liabilities it assumes *unless* the transferor is forced to recognize gain under IRC section 357, and then only to the extent of the gain recognized.

Example A

On January 1, 1998, Veggie, an S corporation parent, acquires Squash, an S corporation, for $75,000 and makes a valid QSub election for Squash effective January 2, 1998. At December 31, 1997, Squash is indebted to Moneybags for a note with a principal balance of $100,000. As part of the contract for the acquisition of Squash, Veggie assumes Squash's liability to Moneybags. Squash has a single asset, land, with a basis and fair market value of $75,000. On Squash's income tax return for income year ending December 31, 1997, Squash recognizes income of $25,000 (Principal balance of loan $100,000 less FMV of land $75,000). Veggie's basis in the Squash stock:

Basis of the property transferred	$ 75,000
Value of boot received	-0-
Amount of gain recognized by Squash	25,000
Total basis in Squash stock	$100,000

Example B

of Moneybags. Because Veggie would recognize a loss of $25,000 (Principal balance note $100,000 less FMV of land $75,000) and Squash would recognize a gain of $25,000, Squash stock would remain at $75,000.

Example C

On June 1, 1998, Zippy, an S corporation parent, acquires Poky, an S

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corporation, for $70,000 cash and makes a valid QSub election for Poky effective June 2, 1998. On May 31, 1998, Zippy is indebted to Big Bucks for a note with a principal balance of $30,000. As part of the sales agreement, Poky agrees to assume Zippy's debt to Big Bucks and Zippy receives a parcel of land that includes a building with a basis and FMV of $100,000. Poky recognizes no gain or loss (Basis of property and building $100,000 less liability assumed $30,000 less cash received $70,000). Zippy's stock basis in Poky is:

Basis of the property transferred	$100,000
Value of boot received	
Amount of gain recognized by Poky	-0-
Total basis in Poky stock	$ 70,000

i. Allocation of AAA and Earnings & Profits (E&P)

Triple A and E&P are accounts maintained by the corporations. Thus, when a parent S corporation acquires a subsidiary with AAA and/or E&P and elects QSub, these amounts carryover to the parent S corporation.

Under the rules similar to those governing a non-recognized spin-off pursuant to IRC section 368(a)(1)(D) and IRC section 355, the AAA and E&P generally are allocated between the "distributing" (parent S) corporation and the "controlled" corporation (QSub) in proportion to the FMV of the business and assets retained by the parent S corporation and the business and assets transferred to the QSub. (Treas. Reg. §1.1368-2(d)(3))

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140205 Termination of QSub Election

a. In General

Once the QSub election is made, it remains in effect until terminated. The QSub election terminates if a QSub fails to meet the QSub criteria, if the parent's S election terminates or the election is voluntarily revoked. (Treas. Reg. §1.1361-5(a)) If the election is terminated, IRS consent is generally required for another QSub election with regard to the former QSub (or its successor) for any tax year before the fifth tax year after the first tax year in which the termination took effect. (Treas. Reg. §1.1361-5(c))

A QSub election may be revoked by filing a statement of revocation, which may specify an effective date at any time within the period beginning two months and 15 days before the filing date and ending 12 months after the filing date. (Treas. Reg. §1.1361-3(b)) If the parent 's S election terminates, the QSub election will terminate at the close of the last day on which an event occurs that renders the subsidiary ineligible for QSub status. A person authorized to sign the S corporation's tax return must sign the revocation. The notice of termination is to be included with the return for the taxable year in which the termination occurs. California follows the federal rules for termination.

If the QSub election terminates because an event renders the subsidiary ineligible for QSub status, the S corporation must attach to its tax return for the taxable year in which the termination occurs the following information:

- notification of the QSub termination
- the date of the termination
- names, addresses, and employer identification number of both the parent corporation and the QSub. (Treas. Reg. §1.1361(5)(a)(2))

Example A

Termination because parent's S election terminates.
Seesaw, an S corporation, owns 100 percent of SoSo. A QSub election is in effect for SoSo for 1998. Effective on January 1, 1999, Seesaw revokes its S election. Because Seesaw is no longer an S corporation, SoSo no longer qualifies as a QSub at the close of December 31, 1998.

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Example B

Termination due to transfer of QSub stock.
Prince, an S corporation owns 100 percent of the stock of Slippery. A QSub election is in effect for Slippery in 1998. On December 15, 1998, Prince sells one share of Slippery stock to Cindy, an individual. Because Prince no longer owns 100 percent of Slippery, Slippery no longer qualifies as a QSub. Accordingly, the QSub election made for Slippery terminates at the close of December 15, 1998.

Example C

No termination on stock transfer between QSub and parent.
Silly, an S corporation, owns 100 percent of Sassy and Sassy owns 100 percent of the stock of Sissy. QSub elections are in effect for Sassy and Sissy. Sassy transfers all of its Sissy stock to Silly. Because Silly is treated as owning the stock of Sissy both before and after the transfer of stock solely for purposes of determining whether the requirements of IRC section 1361(b)(3)(B)(i) and Treas. Reg. section 1.1361-2(a)(1) have been satisfied, the transfer of Sissy stock does not terminate Sissy's QSub election. Because the stock of Sissy is disregarded for all other federal tax purposes, no gain is recognized under IRC section 311.

b. Effect of Termination of QSub Election

When the QSub election terminates, the QSub is treated as a new corporation that acquires all of its assets and assumes all its liabilities immediately before the termination from the parent S corporation in exchange for stock of the new corporation. The tax treatment of this transaction will be determined under the IRC and general principles of tax law, including the step transaction doctrine. (Treas. Reg. §1.1361-5(b)) The deemed issuance of the subsidiary's stock for its assets will generally qualify as a tax-free IRC section 351 transfer if the parent S corporation is still in control of the subsidiary by continuing to own at least 80 percent of the subsidiary's stock.

Example A

Season, an S corporation, owns 100 percent of the stock of Spring, a QSub. Season sells 21 percent of the Spring stock to Summer, an unrelated

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corporation, for cash. This transaction terminates the QSub election because Season no longer owns 100 percent of the Spring stock. Spring is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Spring stock immediately before the QSub termination. The deemed exchange by Season of assets for Spring stock does not qualify under IRC section 351 because Season owns less than 80 percent of Spring's stock after the sale of stock to Summer. Season must recognize gain, if any, on the assets transferred to Spring in exchange for its stock. Season's losses, if any, on the assets transferred are subject to the limitations of IRC section 267.

Example B

Spring stock, Summer contributes a piece of land with a basis and FMV of $60,000 to Spring in exchange for 21 percent of the Spring stock which had a basis of $60,000 to Season. Spring is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Spring stock immediately before the termination. The transaction qualifies as an IRC section 351 because Season and Summer are co-transferors that control the transferee immediately after the transfer. Therefore, no gain or loss is recognized by Season or Spring.

Example C

Spice, an S corporation, owns 100 percent of the stock of Mace, a QSub. Spice distributes all of the Mace stock pro rata to its shareholders, and the distribution terminates the QSub election. The transaction can qualify as a distribution to which IRC section 368(a)(1)(D) and IRC section 355 apply if the transaction otherwise satisfies the requirements of those sections. (Treas. Reg. §1.1361-5(b)(3))

Example D

Sport, an S corporation, owns 100 percent of the stock of Baseball, a QSub. The valid QSub election was effective January 1, 1998. Sport revokes the QSub election on December 31, 1998. On January 1, 1999, Baseball is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in a deemed exchange for Baseball stock. On June 1, 1999, Sport sells 21 percent of the stock of Baseball to Ballet, an unrelated corporation, with a basis of $50,000. Assume that under general principles of tax law including the step transaction doctrine, the sale on June 1, 1999 is not taken into account in determining whether Sport is in control of Baseball immediately after the deemed exchange of assets for stock on June 2, 1999. The deemed exchange by Sport of assets for

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Baseball stock and the deemed assumption by Baseball of its liabilities qualify under IRC Section 351 because Sport is in control of Baseball immediately after the transfer on January 1, 1999. - Therefore, no gain or loss is recognized by Sport or Baseball on December 31, 1998.

If a QSub election terminates because the S corporation distributes the QSub stock to some or all of the S corporation's shareholders in Type D reorganization or a spin-off distribution (IRC §§355 and 356), any loss or deduction disallowed under the basis limitation rules (IRC §1366(d)) is allocated between the S corporation and the former QSub with respect to the shareholder. The amount of the disallowed loss or deduction allocated to the shareholder of S corporation can be an amount that carries the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the S corporation bears to the total value of the shareholder's stock in both the S corporation and the former QSub, determined immediately after the distribution. (Treas. Reg. §1.1361-5(b)(2))

Relief from the consequences of an unintentional termination of a QSub election may be available under the standards established by the Commissioner for the unintentional termination of an S election under Treas. Reg. section 1.1361-5(c)(1) and Rev. Proc. 98-55.

Example E

Forest, a parent S corporation, owns 100 percent of Tree. Forest has a valid QSub election in effect for Tree on January 1, 1999. On December 1, 1999, Forest terminates the QSub election as of January 1, 2000. The termination date has incorrectly been specified as November 1, 1999. Forest submits a corrected termination election with explanation. The termination of the QSub election will take effect January 1, 2000.

c. Election after QSub Termination

Unless the IRS grants permission, following a QSub election termination, a subsequent S election or QSub election cannot be made for the former QSub corporation before its fifth tax year that begins after the first tax year for which the termination was effective. (IRC §1361(b)(3)(D)) If the QSub termination occurs as a result of a disposition of the subsidiary corporation's stock, then the corporation may, without requesting consent from the IRS, make an S election or have a QSub election made for it before the expiration of the five-year waiting period, on the following conditions:

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- Immediately following the disposition of its stock, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it; and
- The S or QSub election is made effective immediately following the disposition of the corporation's stock. (Treas. Reg. §1.1361-5(c)(2))

Termination upon distribution of QSub stock to shareholders.

Sky's shareholders. The distribution terminates the QSub election because Sky no longer owns 100 percent of Star. Assuming Star is otherwise eligible to be treated as an S corporation, Star's shareholders may elect to treat Star as an S corporation effective on the date of the stock distribution without requesting IRS consent.

Example B

Sale of 100 percent of QSub stock.

the stock of Planet to Comet, an unrelated S corporation. Comet may elect to treat Planet as a QSub effective on the date of purchase without requesting IRS consent.

If the corporation is not eligible for any of the exceptions as described in Treas. Reg. section 1.1361-5(d)(2), it can file a Private Letter Ruling (PLR) request for permission to reelect QSub status or make an S election before the end of the five-year period.

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140300 CALIFORNIA DIFFERENCES

S Corp 140301 Election
S Corp 140302 Annual Franchise Tax

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140301 Election

An election made by the parent S corporation under IRC section 1361(b)(3) to treat the corporation as a QSub for federal purposes is treated as a binding election for California purposes. An election different from the federal QSub election may not be filed for California. (R&TC §23800.5(b)(3)) However, if the federal parent S corporation elects C status for California, then the QSub election for federal is not applicable to California in which case the subsidiary will also be a C corporation for California. (Legislative Change Notice 97-19) If the federal QSub is qualified to transact business (registered with the California Secretary of State) in California or is "doing business" in California, then the S corporation is obligated to file an income tax return.

California Form 100S (Side 1), Question E (2001 Form 100S) should be checked "Yes" to indicate that the return includes one or more QSubs. Per Form 100S, Section D instructions, California requires that the parent S corporation attach a copy of the Federal Form 966 for each QSub doing business or qualified to do business in California to the return for the income year during which the QSub election was made. This form should also be included for any subsequent years that there is a QSub addition or termination. The S corporation parent should include Schedule QS (Qualified Subchapter S Subsidiary Information Worksheet) with California Form 100S each year that a QSub election is in effect.

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140302 Annual Franchise Tax

A QSub is assessed the annual franchise tax under the following conditions:

- the QSub is incorporated in California
- qualified to transact business in California, or
- "doing business" in California (R&TC §23800.5(b)(1))

The activities of the QSub will be attributed to the S corporation parent for purposes of determining whether the S corporation is "doing business" in California. (R&TC §23800.5(b)(2)(B)) R&TC section 23101 defines "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." If the S corporation parent is not doing business in California and is not a qualified corporation in California, but the QSub is, then the S corporation parent is deemed to be qualified and/or doing business in California. This situation then subjects the S corporation parent to the annual minimum franchise tax.

Example A

Scoop, an S corporation parent, owns three QSubs (Vanilla, Chocolate and Strawberry). Scoop began business as an S corporation in 1997. It made valid QSub elections for Vanilla, Chocolate and Strawberry in 1998. Vanilla and Chocolate are qualified and doing business in California, Scoop and Strawberry are not. For income year 1998, Scoop is deemed to be doing business in California because of Vanilla and Chocolate's business activities in California and is subject to California franchise tax, in an amount at least equal to the minimum franchise tax. For income year 1998, Scoop is responsible for its own franchise tax (the greater of the minimum franchise tax or 1.5 percent of net income for tax purposes) plus two annual taxes for the QSubs Vanilla and Chocolate.

The S corporation parent must pay estimated taxes that include the annual minimum tax for each of its QSubs. (R&TC §23800.5(b)(1), R&TC §19023, R&TC §19025, R&TC §19147, and R&TC §19149.) The QSub annual tax is subject to the estimated tax rules and penalties, and is the liability of the S corporation parent. An S corporation's first estimated tax installment payment may not be less than its minimum tax and the annual minimum tax for each of its QSubs. An S corporation's QSub first becomes subject to the annual tax after the last day of the third month of the parent S corporation's income year. However, the parent S corporation is not liable for the QSub annual taxes until the due date for the next

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estimated tax installment. (R&TC §19025(c)) For example, if the QSub is acquired during the income year, the QSub annual tax is due with the S corporation's next estimated tax installment. An amount equal to the greater of the minimum franchise tax or 1.5 percent of net income for tax purposes for the parent S corporation **plus** the QSub(s) annual tax (es) is to be reflected on Form 100S, line 22: Tax.

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140400 LLC VS. QSUB (FOR CALIFORNIA PURPOSES)

- Both single member Limited Liability Companies (LLCs) and single member QSubs are permitted.
- Liability: Corporate veil is difficult to pierce. The law is less settled whether 100 percent ownership of an LLC justifies relaxation of the standards under which the owner can be treated as the alter ego of the business entity.
- Type of business: Corporations are pretty much unrestricted in the type of business they conduct. However, as discussed above, a QSub cannot be a foreign corporation, financial institutions using the reserve method for bad debts, insurance companies, corporations subject to an IRC section 936 election, or Domestic international sales corporations (DISCs) or former DISCs. California imposes the following restriction on LLCs: an LLC cannot be any business required to obtain a license under the Business and Professional Code. This is in addition to the federal restriction of not allowing the traditional professions of law, accountancy and medicine to become an LLC. (NOTE: there is pending legislation clarifying those professions which are not permitted to be LLCs. AB 229 was approved by FTB 4/9/99.)
- SOS requirements: the LLC is required to register and file articles of organization with the California SOS; the QSub as a corporation (whether C to S to QSub or S to QSub) is required to register and file articles of incorporation.
- Taxation: both the LLC and the QSub are subject to the annual franchise tax. In addition to the annual tax, the LLC is also subject to a Limited Liability Company Fee based on total annual income. (R&TC §17941, R&TC §17942, and R&TC §17942(b)(1)) The fee is applicable to total annual income greater than or equal to $250,000 and the fee range is from $500 to $4,500 for 1998. The QSub's income becomes the income of the parent S corporation that is currently subject to a 1.5% income tax. Let's compare an LLC with total annual income and a QSub with taxable income of $750,000. The LLC fee would be $1,500; the QSub tax liability of the parent S corporation would be $11,250--assuming the parent S corporation and any other QSubs have no offsetting losses. When considering the QSub income on its own, the LLC fee is the better bargain when compared with the QSub's S corporation tax. The entities are comparable when the LLC has total annual income less than $250,000 and the QSub has zero or less taxable income because both the LLC and the QSub have an annual franchise tax. (NOTE: the computation of the LLC's total income for purposes of the LLC fee is different in that it is gross receipts without any deductions.)

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- Ownership: the QSub having one owner is allowed only one class of stock; the LLC faces no restrictions on separate classes of ownership interests. Therefore, the LLC can transfer control and ownership from generation to generation easier than an S corporation and/or a QSub.

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140500 AUDIT ISSUES

When examining assets and liabilities, the auditor should review California Form 100S, Schedule L. Assets can sometimes be viewed in BETS conversation R108.

BETS conversation R108 provides the following information:

- Details of financial adjustment transactions
- Details of line items on a return
- Recent changes to a return
- Totals of tax, penalty, interest and assessment for a specific period

BETS conversation R118 includes the following information:

- Business start date
- Business end date and reason
- Date of incorporation
- Entity type

Questions regarding BETS screens/conversations can be directed to the BETS Help Desk, extension 7000.

S Corp 140501 Deemed Liquidation May Be Taxable
S Corp 140502 AAA/ C Corporation Earnings & Profits
S Corp 140503 Built-In Gains (BIG)
S Corp 140504 Excess Net Passive Income (ENPI) Tax

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140501 Deemed Liquidation May Be Taxable

If the deemed liquidation of a subsidiary does not qualify under IRC §§ 332 and 337 as a tax-free liquidation, the subsidiary and/or the parent S corporation must recognize the gain and/or loss on the transaction.

a. Potentially Taxable Events

a1. Liabilities Exceed Tax Basis of Assets at Time of Contribution

For various reasons, liabilities can exceed the tax basis of property at the time of QSub election. Some of these reasons can include:

- Fully depreciated property used to collateralize a loan;
- IRC section 179 deduction;
- Enterprise zone business deduction and sales tax credit for qualified assets.

This list is by no means all-inclusive and is for illustrative purposes only.

a2. QSub Indebted to Parents S Corporation

If the QSub is indebted to the parent S corporation for an amount greater than the FMV of the QSub's assets when the QSub election is made, then the transaction does not qualify under IRC §§332 and 337. Gain or loss, subject to the limitations of IRC section 267, is recognized by the subsidiary for the difference between the subsidiary's indebtedness to the parent S corporation and the FMV of the subsidiary's assets.

Example A

Mozart, an S corporation, owns 100 percent of the stock of Beethoven, a C corporation. At a time when Beethoven is indebted to Mozart in an amount that exceeds the fair market value of Beethoven's assets, Mozart makes a QSub election effective on the date it is filed with respect to Beethoven. The liquidation described in Treas. Reg. section 1.1361-4(a)(2) does not qualify under IRC

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Section 332 and IRC Section 337. Therefore, Beethoven recognizes gain or loss on the assets distributed, subject to the limitations of IRC section 267. Because the liquidation is not tax-free, Beethoven's tax attributes generally will not carry over to Mozart (IRC §381). However, Mozart may be able to deduct a loss under the worthless stock rules. (IRC §165(g) and Treas. Reg. §1.1361-4(d), Example 5)

a3. Termination of QSub Election

When the QSub election terminates, the QSub is treated as a new corporation that acquires all of its assets and assumes all its liabilities immediately before the termination from the parent S corporation in exchange for stock of the new corporation. The tax treatment of this transaction will be determined under the IRC and general principles of tax law, including the step transaction doctrine. (Treas. Reg. §1.1361-5(b)) The deemed issuance of the subsidiary's stock for its assets will generally qualify as a tax-free IRC section 351 transfer if the parent S corporation is still in control of the subsidiary by continuing to own at least 80 percent of the subsidiary's stock.

The step-transaction doctrine applies when the QSub election terminates. (Treas. Reg. §1.1361-5(b)(1)) If the termination occurs because the subsidiary no long qualifies as a QSub, it normally takes place on a disposition of a portion of the S corporation parent's equity ownership in the QSub.

Under the step-transaction doctrine, when an S corporation's equity ownership in the QSub is below 100 percent, a new corporation is deemed to have been formed. (Treas. Reg. §1.1361-5(b)(1)) If the parent retains at least an 80 percent interest in the subsidiary, the formation of the subsidiary by the parent S corporation would be tax-free, as long as the liabilities deemed contributed to the newly formed corporation do not exceed the tax basis of the assets contributed. (See item "b" above.) If the parent is not in control (< 80 percent) of the subsidiary immediately following the formation, the necessary control requirement for acquisitive related party (IRC §267) reorganizations and tax-free contributions to capital would not be met. Therefore, the parent would be deemed to have sold its assets to subsidiary at FMV.

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140502 AAA/ C Corporation Earnings & Profits

Treas. Reg. section 1.1368-2(a) states, "On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero." An issue may arise when the QSub was a C corporation prior to the valid QSub election and has undistributed C corporation earnings and profits. Distributions are taxable as follows:

1. Nontaxable to the extent AAA and stock basis is not exceeded.
2. Capital gain to the extent AAA is not exceeded, but stock basis is exceeded.
3. Dividend to the extent of C corporation earnings & profits.
4. Nontaxable return of capital to extent of remaining stock basis.
5. Capital gain to extent stock basis exceeded.

(For a detailed discussion, see S Corp 080000 - Distributions/AAA.)

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140503 Built-In Gains (BIG)

Under IRC section 1374, S corporations are taxed on appreciation in corporate assets that occurred prior to the corporation's S corporation election, if it is recognized within ten years of the date the election took effect. For California purposes (R&TC §23809), IRC section 1374 is modified to apply the California corporate tax rate to these "built-in gains," instead of the federal tax rate. (For a detailed discussion see S Corp 050000 - Built-In Gains Tax.)

BIG may become an issue when the QSub was a C corporation prior to the QSub election and has substantially appreciated assets that are sold after the valid QSub election.

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140504 Excess Net Passive Income (ENPI) Tax

The purpose of the tax on excess net passive income is to discourage a C corporation with accumulated earnings and profits from becoming (or functioning as) a holding company in order to obtain favorable tax treatment under Subchapter S. ENPI may become an issue when the QSub was a C corporation prior to the QSub election and had accumulated earnings and profits. When reviewing a tax return, the auditor should look for *investment* income such as interest, dividends and royalties.

(For a detailed discussion see S Corp 070000 - Excess Net Passive Income Tax.)

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140600 ADDITIONAL RESOURCES

IRS: LTR 9801015	S corporation defined; Tax imposed on built-in gains
AICPA: *The Tax Adviser*	QSSS prop. regs; IRS proposed regulations concerning qualified Subchapter S February 1, 1999 subsidiary corporations
CCH EXP: 99 FED ¶32,026.065	Elements of an S Corporation: Qualification as S Corporation: Ownership of subsidiaries
99 FED ¶16,052.02	Complete Liquidation of Subsidiary: Complete liquidation of another corporation.
NPRM-PENDING 99 FED ¶49,699	Subsidiaries of S corporations: (Apr. 22, 1998)
FTC 2d: ¶ D-1452.1	Qualified subchapter S subsidiaries (QSSSs or QSubs) not treated as separate corporation.
¶ D-1452.2	Effect of qualified subchapter S subsidiary (QSSS or QSub) election.
¶ D-1452.3	Termination of qualified subchapter S subsidiary (QSSS or QSub) status.
¶ D-1452.4	Reelection after loss of qualified subchapter S subsidiary (QSSS or QSub) status.
¶ D-1452.5	Qualified subchapter S subsidiaries (QSSSs or QSubs) defined.
¶ D-1452.6	How to make and revoke the qualified subchapter S subsidiary (QSSS or QSub) election.
¶ D-1452.6A	Relief for failure to file a timely qualified subchapter S subsidiary (QSSS or QSub) election.
¶ D-1452.7	Qualified subchapter S subsidiaries (QSSSs or QSubs) treated as separate corporations.

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140700 EXHIBIT

Exhibit 140000-1 Federal Tax Form 966 – Corporate Dissolution or Liquidation

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150000 S CORPORATION LIQUIDATIONS

S Corp 150100 Overview
S Corp 150200 Liquidation-Asset Sale
S Corp 150300 Installment Income Reporting Upon Cessation of Business
S Corp 150400 Miscellaneous Issues

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150100 OVERVIEW

There are several reasons that an S corporation may choose to liquidate. The S corporation may choose to liquidate because of a sale of substantially all it's assets, a change in the form of entity (other than conversion to C corporation status), or a winding down of its business affairs. Whatever the reasons are an S corporation liquidation will almost always have some tax consequences. In order to determine if self-compliance is met when an S corporation liquidates, an auditor must comprehend all of the other issues in this manual.

The most common circumstances in which corporate liquidation issues will arise for an S corporation and its shareholders are a sale of the S corporation's business assets and a sale of all of the S corporation's stock where both the seller and the buyer elect to apply IRC Section 338(h)(10). Applicable to income years beginning on or after January 1, 1993 pursuant to R&TC section 24451, California generally conforms to Subchapter C of the Internal Revenue Code (IRC), including IRC section 338. Once an IRC Section 338(h)(10) election is made with respect to a stock sale, the sale is recast in the form of a sale of the S corporation's assets for income tax purposes. Once one of these two transactions occurs, the S corporation generally liquidates because it no longer has a reason to keep the business active.

The primary difference between a sale of an S corporation's assets and a sale of the S corporation's stock with an IRC Section 338(h)(10) election is that the latter is treated as a stock sale for purposes of the sales and use tax, while both are treated as an asset sale for income tax purposes. This allows the buyer in a stock sale with an IRC §338(h)(10) election to avoid paying sales and use tax on the tangible assets that were acquired. The question then is why would a buyer buy the assets of an S corporation instead of completing a stock sale with an IRC Section 338(h)(10) election if the benefits are the same under both approaches (i.e. stepped-up basis in the assets acquired) and the sales and use tax burden is greater with regard to the asset sale. Perhaps the reason for not choosing the IRC Section 338(h)(10) method is the complexity of the computations that are involved or perhaps the corporation has no tangible assets to consider. In either case, the income tax ramifications of both of these transactions are very similar.

This chapter will primarily focus on the sale of the business assets of the S corporation. (See the Sale of Stock and Election of IRC Section 338(h)(10) chapter for related information). But, keep in mind that similar issues will arise when an S corporation ceases doing business and distributes all of its assets to the shareholders, or if an S corporation decides to convert to another entity, such as an LLC.

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150200 LIQUIDATION-ASSET SALE

S Corp 150201 In General
S Corp 150202 Gain or Loss from Sale of Assets
S Corp 150203 Gain or Loss on Liquidation

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150201 In General

The most common way of acquiring the business of an S corporation is by purchase. Where the buyer purchases the assets of an S corporation directly, the buyer will receive a stepped-up fair market value basis in the assets received, which will be equivalent to the total purchase price for all of the assets acquired, allocated over the various assets. Generally, the seller will cease doing business and liquidate after it sells all the assets. This creates a two-step process for computing tax. First, the S corporation seller must compute its gain or loss from the sale of its assets. Secondly, the shareholder(s) must compute gain or loss from the liquidation.

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150202 Gain or Loss from Sale of Assets

The first step in the S corporation asset sale is to determine the appropriate gain or loss on the sale itself. Secondly, determine if there are Built-in Gain considerations. Third, determine the amount of flow through gain or loss to the shareholder(s) and make appropriate stock and/or debt basis adjustment.

To determine the gain or loss on the sale of assets, the auditor should compare the sales price to the adjusted basis of the properties sold in the hands of the S corporation. (IRC §1001, IRC §1011, IRC §1012, and IRC §1016)

Example A

Seller Corp., an S corporation from its inception, is in the business of leasing office space in the building it owns. Seller Corp. sold its business for $15 million to Buyer Corp. on 12/30/2000. The assets sold included a building, land, and goodwill. The purchase price was allocated $5 million to goodwill and $10 million to the building and land. Seller Corp.'s adjusted basis in the building and land was $9 million (the building has accumulated depreciation of $2 million) and goodwill was accrued ratably from the inception of the corporation. Seller Corp. would recognize a total gain of $6 million, $1 million as ordinary income as a result of IRC section 1250 recapture and $5 million capital gain from goodwill. The $6 million gain will all be taxed at 1.5% for a total tax of $90,000, computed as follows:

	Land	Goodwill
Sales Price	$10,000,000	$5,000,000
Less: Adjusted Basis	(9,000,000)	(0)
Total Gain on Sale	$1,000,000	$5,000,000
Tax (1.5%)	$15,000	$75,000

After the gain at the S corporation level is determined, the amount of the gain should be appropriately taxed at the S corporation level, either 1.5% or 8.84% if subject to Built-In Gains Tax (See S Corp 050000 - Built-In Gains Tax).

The second example considers Built-in-Gains Tax.

Example B

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In addition to the same facts as in **Example A**, assume that Seller Corp. incorporated on 1/1/92. Seller Corp. has a 100% shareholder, Mr. Seller. Seller Corp. elected S status effective on 1/1/97. On the date of its election, the FMV of the building and land was $9 million and FMV goodwill was $2 million. Thus, when Seller Corp. sold all its assets on 12/30/2000, it would still report the same $6 million gain as in **Example A**. However, $4 million will be taxed at the 1.5% tax rate ($1 million from the sale of building and land and $3 million from goodwill accrued during the S years) and $2 million (goodwill accrued during C years) will be taxed at the 8.84% tax rate for Built-in Gains Tax. Thus, the total tax for Seller Corp. from this transaction will be $236,800. BIGs tax of $176,800 and regular 1.5% tax of $60,000.

Once the appropriate tax is determined at the S corporation level, the next step is to analyze the amount of gain/loss that flows-through to the shareholder(s) of the S corporation. Thus, in Example B, Mr. Seller would report $1 million as ordinary income as a result of the IRC section 1250 recapture. He would also report a capital gain of $4,823,200. Note: R&TC section 23803(b)(1) allows a reduction in the amount of gain from goodwill by the Built-in Gains Tax paid by the S corporation. Thus, the amount of capital gain that will flow-through for goodwill to Mr. Seller is $4,823,000, which is $5 million less the Built-in Gains Tax of $176,800.

To avoid double taxation on the income recognized by the shareholder(s), an adjustment should be made to the shareholder(s) basis and the S corporations' Accumulated Adjustment Account (S Corp 080000 and S Corp 090000). Computing the correct shareholder(s) basis is the single most important aspect of liquidation, which leads us to the second step in the S corporation asset sale.

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150203 Gain or Loss on Liquidation

a. General

When an S corporation is being liquidated, apply the Subchapter C rules. (R&TC §17321) Under IRC section 331(a), amounts received by shareholder(s) in complete liquidation of their corporation are treated as in full payment in exchange for their stock. In other words, a liquidation is treated as a sale by the shareholder(s) to the S corporation of their stock by comparing the total liquidating distribution with the shareholder(s) stock basis to determine the gain or loss on the liquidation. (Treas. Reg. §1.331-1(b)) Therefore, it is critical that the shareholder(s) basis is appropriately adjusted before the exchange.

Example A

Assume the same facts as in **Example B**, except that Mr. Seller (100% shareholder) had stock basis of $9 million prior to the sale. In addition, the corporation made a liquidating distribution of $16 million cash in exchange for his stock. Mr. Seller would report a liquidating capital gain of $1,236,700, computed as follows:

Beginning Stock Basis	$9,000,000
Ordinary Income -1250 Recapture	1,000,000
Capital Gain from Goodwill Less BIG Tax	4,823,300
Tax other than BIG – Non-Deductible Expense	(60,000)
Stock Basis Prior to Exchange	$14,763,300
Liquidating Distribution	$16,000,000
Stock Basis of Stock Exchanged	(14,763,300)
Liquidating Gain	$1,236,700

b. Accumulated Earnings and Profit

An S corporation may have Accumulated Earnings and Profits (AE & P) from prior C corporation years. Normally, distributions made from AE & P are considered dividends to the shareholder(s). (IRC §§301 and 316) However, in a complete liquidation, AE & P are treated as part of the exchange for stock, and

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thus becomes a capital item instead of an ordinary dividend. (IRC §331(b)) Therefore, in **Example A**, the result would be the same even if the S corporation had AE & P. Generally, this is the case when you have a liquidating gain.

c. Complete Liquidation

To determine whether or not distributions are made pursuant to complete liquidation, the appropriate document to review is the corporation's plan of liquidation, which is to be filed with the IRS (Form 966). (IRC §346(a)) Basically, the plan will explain what the distribution or series of distributions were. If there is no formal plan of liquidation, the auditor should use their judgment and review the facts and circumstances of the case to determine if the distribution(s) is made pursuant to a plan of complete liquidation. In the above examples, there should be no question that the distribution is made pursuant to a complete liquidation because the S corporation sold all of its assets and liquidated shortly after. Issues arise when the S corporation does not liquidate immediately and/or it continues to conduct part of its trade or business.

d. Built-In Gains Tax and Shareholder Basis

The Built-In Gains Tax and Shareholder Basis issues work in tandem. Built-In Gains Tax paid by the S corporation reduces the flow-through gain to the shareholder(s) by the amount of the tax, which in turn reduces the shareholder(s) basis. (IRC §1366(f)(2)) As much as this provides some relief to shareholder(s), the relief is only a tax deferral. Like most tax deferrals, liquidation is an event that requires the deferred tax to be paid. Thus, when auditors identify a Built-In Gains issue when the S corporation liquidates, it is important to keep in mind that any adjustment that was previously made for Built-In Gains Tax at the shareholder level should likewise reduce the shareholder(s) basis. The effect of this is to offset or wash the loss deduction given to the shareholder(s) for Built-In Gains Tax in the year the S corporation liquidates (see S Corp 050000 - Built-In Gains Tax).

The refund is not given to the shareholder(s) because the Built-In Gains Tax reduces the shareholder(s) basis by the same amount. Thus, the liquidating distribution for full payment in exchange for the shareholder(s) stock will create a larger liquidating gain or a smaller liquidating loss by the amount of the Built-In Gains Tax the auditor has assessed. This negates the refund when the

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shareholder(s) do not consider the effects of Built-In Gains Tax when they compute their liquidating gain or loss.

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150300 INSTALLMENT INCOME REPORTING UPON CESSATION OF BUSINESS

S Corp 150301 In General
S Corp 150302 Liquidating Distributions of Installment Obligations to S Shareholders
S Corp 150303 Contingent Payment Obligations

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

150301 In General

In some instances, an S corporation will sell some or all of its assets under the installment method. Thus, the S corporation will have a note receivable, which may be distributed as part of the liquidating distribution. One reason an S corporation may not want to distribute the note receivable is to avoid acceleration of gain on the installment note at the entity level. This can be a large tax burden to an S corporation if the installment note is a Built-in Gain item. However, if the S corporation does not liquidate and distributes the note receivable, it may encounter an Excess Net Passive Income issue, since interest income is considered passive in this context (See S Corp 070000 - Excess Net Passive Income).

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150302 Liquidating Distributions of Installment Obligations to S Shareholders

a. Tax Treatment to the S Corporation

R&TC section 24672 imposes a 1.5% franchise tax on the S corporation if the S corporation ceases to be subject to tax, which generally involves filing a tax clearance certificate with the Franchise Tax Board. Also, any built-in gains tax or excess net passive income tax imposed pursuant to IRC section 1374 or IRC section 1375 due to a liquidating distribution of an installment obligation to a shareholder is not precluded pursuant to IRC section 453B(h). Under R&TC section 24667 California conforms to IRC section 453B(h).

b. Tax Treatment to the S Corporation Shareholders

While the S corporation must accelerate the gain from an installment obligation in a liquidating distribution, the shareholder(s) may not have to, if they meet certain criteria.

IRC section 453(h)(1)(A) states –

If, in a liquidation to which IRC §331 applies, the shareholder receives (in exchange for the shareholders stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted and the liquidation is completed during such 12-month period, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

This section places a 12-month time limit, starting from the date the S corporation adopts a plan of complete liquidation, for the S corporation to distribute the installment note, which must be satisfied in order for the S corporation shareholder(s) to use the installment method to report the gain from the complete liquidation. The 12-month period is unique because IRC section 346(a) does not place a similar time constraint on other liquidating distributions, not involving installment notes. Therefore, where an S corporation shareholder wants to use the installment method to report gain from the complete liquidation of an S

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corporation, the auditor should verify that the installment note was acquired by the S corporation and distributed to the S corporation shareholder within 12-months of the date the S corporation adopted a plan of complete liquidation.

When an S corporation distributes an installment obligation to its shareholder in complete liquidation and IRC section 453(h)(1)(A) applies, the effect on the shareholder must be determined by recasting all of the liquidating distributions to the particular shareholder as a sale of the shareholder's stock in return for all of the property received in the liquidating distributions.

First, the liquidating distribution of the installment note is recast in the form of a transaction whereby the shareholder sold his or her stock to the original issuer of the installment obligation (Treas. Reg. §1.453-11(a)(2)(i)) for a newly issued installment note, issued on the date of the liquidating distribution. (Treas. Reg. §1.453-11(a)(2)(ii)(A))

Second, the issue price for the installment obligation is recalculated as the sum of the adjusted issue price of the installment obligation on the date of the distribution and the amount of any qualified stated interest (as defined in Treas. Reg. §1.1273-1(c)) that has accrued prior to the distribution but that is not payable until after the distribution. (See Treas. Reg. §1.453-11(a)(2)(ii)(A) for this rule and rules governing the treatment of unstated interest.)

Third, all of the amounts distributed to the shareholder in complete liquidation, including cash, the issue price of the distributed installment obligation as recalculated above, and the fair market value of other property, are treated as received by the shareholder in exchange for the shareholder's stock in the S corporation. (Treas. Reg. §1.453-11(a)(3))

Fourth, any corporate debt (recourse or nonrecourse) assumed by the shareholder with regard to the liquidation is added to the shareholder's basis in the stock of the S corporation. (Treas. Reg. §1.453-11(a)(4))

Fifth, the gross profit ratio for the entire transaction must be re-determined using the amount received (as determined in the third step discussed above) and the shareholder's adjusted basis in the stock (as increased by the assumption of corporate debt). (Treas. Reg. § 1.453-11(a)(5) Example (2))

Once the gross profit ratio is re-determined, all of the payments received on the installment obligation and all of the other property, including cash, received from the S corporation in liquidating distributions, will be taxable to the S corporation shareholder based upon the re-determined gross profit ratio. The end result of

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these computations is to treat the S corporation shareholder as if he or she were reporting all of the liquidating distributions under the installment method.

Example A

Seller Corp., an S corporation, sold all tangible assets for their book value and goodwill for a $4 million note on 11/30/00 with an adequate stated interest rate. Mr. Seller, 100% shareholder, had a stock basis of $1,060,000 prior to the sale. Seller Corp. pursuant to a plan of liquidation, makes a final liquidating distribution to Mr. Seller on 12/30/00 of $1 million cash and the $4 million installment note. Assume that there are no Built-in Gains.
First, Seller Corp. recognizes $60,000 tax on the distribution of the installment note ($4 million X 1.5%), which reduces Mr. Seller's stock basis to $1 million ($1,060,000 minus $60,000). Note there is no gain or loss on the tangible assets because they were sold for book value.
Second, Mr. Seller recognizes a liquidating capital gain of $800,000 on $1 million cash received with $200,000 being recovery of basis because the $1 million is treated as a payment on the newly created installment note to Mr. Seller. Further, Mr. Seller would recognize 80% of the installment collection as a capital gain on collection of the note and 20% as recovery of basis on his individual return, computed as follows:

Sale Price ($1 M cash plus $4 M note)	$5 million
Less: Shareholder Basis	(1) million
Realized Gain on Liquidation	$4 million
Gross Profit Percentage ($4 M / $5 M)	80%

Example A indicates the difference in the gross profit percentage between maintaining the installment note within the S corporation versus distributing the note to shareholder in a complete liquidation. If the S corporation did not liquidate, it would report collection of the installment note as 100% income; whereas, the shareholder, who received the note pursuant to a complete liquidation, reports income at 80% of the installment collection. The effect of this treatment is to allocate the shareholder stock basis to all assets distributed, including the installment note, thus causing the distribution of $1 million cash to be taxable. This is a common error that is made in accounting for liquidations of an S corporation involving installment notes. Typically, taxpayers will take the $1 million cash, tax free, as a return of basis and continue to report the installment collection as 100% income when the payments are collected.

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Sometimes, a shareholder will assume the liabilities of the S corporation or receive a property distribution subject to liabilities in a complete liquidating distribution. In both these cases, the amount of the liability assumed by the shareholder(s) increases his/her stock basis. (Treas. Reg. §1.453-11(a)(4)) This ultimately will reduce the amount of the gross profit percentage on the installment note distribution.

Further, there are special rules for installment sales of inventory items. To have the installment method apply to inventory items, they must be sold in a bulk sale to one person in one transaction and also involve a sale of substantially all of such property attributable to the trade or business of the corporation. (IRC §453(h)(1)(B))

Finally, recapture income from IRC section 1245 or IRC section 1250 property is not subject to installment method reporting. Therefore, the S corporation and the shareholder(s) will recognize the recapture income in the year of disposition. (IRC §453(i))

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150303 Contingent Payment Obligations

Frequently, an S corporation will sell its business with part of the payments being contingent on certain future events. For example, a sales contract might include a clause that if a certain milestone, in terms of gross receipts, is met with the business over the next three years, the buyer will pay additional amounts ranging from $100,000 to $1 million per year to the seller corporation or its shareholder(s). In such a case, the S corporation in the example has two options. One is not to liquidate until the 3-year time period is up and the S corporation can determine the amount of the contingent payment actually received and the other is to liquidate and follow the guidance provided in Temp. Reg. section 15a.453-1(c), which provides that contingent payment sales are to be reported using the installment method. (IRC §453(j))

If the S corporation chooses to liquidate within the 12-month period from the adoption of the plan of complete liquidation, Temp. Reg. section 15a.453-1(c)(2) provides that the issue price of the distributed installment obligation will be increased to include the maximum possible contingent payment provided for in the sales contract, which is referred to in the regulations as the "stated maximum selling price". Therefore, it is assumed that the maximum amount stated on the contract will be collected at the earliest possible time to determine the sales price and gross profit percentage.

Example A

Seller Corp., S corporation, sold all the tangible assets of its business for $1,000,000 book value on 11/30/00. On that date the $1,000,000 was paid in cash. Further, it was agreed that the buyer would pay between $250,000 to $1 million per year over the next 4 years, depending on the amount of the gross receipts in each of five years. The buyer is to pay $250,000 if gross receipts are between $0 and $4,999,999; $500,000 if gross receipts are between $5 million and $9,999,999; and $1 million if gross receipts are $10 million and above. Amounts are payable on 12/31 of each year together with adequate stated interest. Mr. Seller, the100% shareholder, had a stock basis of $1,060,000 prior to the sale. Seller Corp. pursuant to a plan of liquidation, makes a final liquidating distribution to Mr. Seller on 12/30/00 of $1 million cash and the contingent payment sales agreement. Assume no Built-in Gains.
First, Seller Corp. calculates $60,000 in tax on the distribution from the contingent sales agreement because it is treated as an installment note, stated at the maximum price collectible ($4 million X 1.5%). This reduces Mr. Seller's stock

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basis to $1 million ($1,060,000 minus $60,000). Note there is no gain or loss on the tangible assets because they were sold for book value.
Second, Mr. Seller recognizes a liquidating capital gain of $800,000 on cash received of $1 million the $200,000 being a recovery of basis. Further, Mr. Seller would recognize 80% of installment collection as capital gain on the collection of the note and 20% as recovery of basis on his individual return, computed as follows:

Sale Price ($1 M cash plus $4 M max. contingent note)		$5 million
Less: Shareholder Basis		(1) million
Gain on Liquidation		$4 million
Gross Profit Percentage ($4 M / $5 M)	80%	

Contingent payment sales can be arranged in many different ways. Contingent payments may be dependent upon the buyer achieving specified amounts of gross receipts (see **Example A**), net receipts, the occurrence, or non-occurrence of any other event agreed to by the buyer and seller. However, the sales contract must specify the maximum selling price or provide for a fixed period of payments, in order to prevent the sales contract from being scrutinized and possibly re-characterized as a lease or license, rather than a sale. (Temp. Reg. §15a.453-1(c)(4))

For liquidation purposes, the maximum selling price is the most important factor. If the stated maximum selling price is certain, then like **Example A**, the computation is certain, especially with the acceleration of the 1.5% tax at the corporate level when the S corporation liquidates. At the shareholder level, the recalculated gross profit percentage will apply until all contingent payments are collected.

The more difficult question arises when there is neither a maximum selling price nor a fixed period for the contingent payment sales. In this situation, the auditor should review all facts surrounding the transaction to determine if in fact a sale has occurred. If the auditor concludes that a sale has occurred and that the S corporation made a distribution in complete liquidation within the 12-month period required by IRC section 453(h)(1)(A), the shareholder's basis must be allocated equally over a 15-year period commencing with the date of the sale. (Treas. Reg. §15a.453-1(c)(4)) However, the shareholder may use an alternative method for allocating basis if the shareholder can demonstrate that the 15-year method will substantially and inappropriately defer the shareholders recovery of basis and

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the IRS or the Franchise Tax Board may use an alternative method for allocating basis if either agency determines that the 15-year method will substantially and inappropriately accelerate the shareholder's recovery of basis. (Treas. Reg. § 15a.453-1(c)(7)) For purposes of determining the S corporation's gain on the liquidating distributions, the installment obligation can be valued using any reasonable method.

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150400 MISCELLANEOUS ISSUES

S Corp 150401 Liquidating Distribution of Appreciated/Depreciated Property
S Corp 150402 Suspended Losses
S Corp 150403 Loans to Shareholders
S Corp 150404 Loans from Shareholders

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150401 Liquidating Distribution of Appreciated/Depreciated Property

When a shareholder receives appreciated property as part of a liquidating distribution, the transaction is treated as a sale from the S corporation to the shareholder(s). (IRC §336(a)) Therefore gain is reported by the S corporation (either 1.5% or 8.84% for Built-in Gain Tax) and to the shareholder(s) as a flow-through item. In addition, the shareholder(s)'s basis is adjusted to reflect the gain with the distribution amount being the fair market value of the appreciated property.

Losses may not be allowed in the case of loss property distributed in a liquidation to a related party as defined in IRC section 267, if the distribution is either non pro-rata or the property is "disqualified property". (IRC §336(d)) Disqualified property is defined as property acquired by the corporation in an IRC section 351 transaction or as a contribution to capital within the five-year period ending on the date of the distribution. (IRC §336(d)(1)(B)) The purpose of this limitation is to prevent shareholders from infusing the corporation with loss property prior to liquidating.

Further, there is a second limitation for losses on property distributions as well as for property sales if the purpose for acquiring the property prior to distribution or sale was for the liquidating corporation to recognize loss. (IRC §336(d)(2)) Unlike the first limitation above, the second limitation can apply to minority shareholders as well as majority shareholders if the built-in loss property was contributed as capital or the corporation acquired the property in an IRC section 351 transaction within two years of filing the plan of liquidation. If this limitation applies, the adjusted basis of the distributed property for purposes of computing the loss is reduced by the amount of the built-in loss that existed on the date the property was contributed to the corporation.

Example A

Seller Corp. liquidated on 11/30/00. Seller Corp. distributed land that was contributed by a majority shareholder a year earlier to a minority shareholder. The contributor's basis was $1 million with FMV of $750,000. At the time of the distribution, the basis of the land remained the same, but the FMV was reduced to $650,000. Assuming Seller Corp. can't rebut the presumption that the contribution was for tax avoidance, Seller Corp. will realize a $350,000 loss but will only recognize a $100,000 loss.

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150402 Suspended Losses

In a complete liquidation, pass-through losses that were suspended because of basis limitations are lost forever unless the shareholder(s) contributes additional capital to free-up suspended losses. (IRC §1366(d)(1)) Otherwise, the suspended losses do not decrease a liquidating capital gain or increase a liquidating capital loss.

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150403 Loans to Shareholders

If a loan from an S corporation to its shareholder is still outstanding at the time the S corporation completes its liquidation, the outstanding balance is treated as a deemed distribution or payment in exchange for the shareholders stock. (IRC §331(a) and Treas. Reg. §§1.1001-1(a) and 1.1001-2(a)(1)) Therefore, if the note exceeds the shareholder(s) stock basis, then the excess becomes a capital gain to the shareholder. Notes receivable from shareholders are not subject to installment reporting on a liquidating distribution. (Treas. Reg. §1.453-11(c)(2))

Example A

Seller Corp. made a loan to the shareholder on 1/1/99 in the amount of $1 million. On 12/30/00 Seller Corp. liquidates and distributes the note, which is its only asset, to the sole shareholder, Mr. Seller. Mr. Seller had stock basis of $750,000 prior to the liquidating distribution. Mr. Seller would recognize a liquidating capital gain of $250,000.

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150404 Loans from Shareholders

Loans from shareholder that are forgiven by the shareholder after filing a plan of liquidation are not treated as forgiveness of indebtedness. Instead, they are re-classified as paid-in capital prior to liquidation. (Treas. Reg. §1.61-12(a))

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160000 SALE OF STOCK & ELECTION OF IRC SECTION 338(H)(10)

S Corp 160100 Corporation Acquisition – In General
S Corp 160200 IRC Section 338(h)(10) - Overview
S Corp 160300 Law Updates
S Corp 160400 Mechanics of IRC Section 338(h)(10)
S Corp 160500 Qualifications of Taxpayer and Events
S Corp 160600 Manner of Making the Election
S Corp 160700 Transactions – Purchasing Corporation, New Target, Old Target Corporation, and Selling Shareholders
S Corp 160800 Installment Method of Income Recognition
S Corp 160900 Audit Issues

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160100 CORPORATION ACQUISITION – IN GENERAL

There are two basic ways to acquire a corporation – (1) stock purchase and (2) asset purchase.

Stock purchase is simple. In general, a purchaser buys stock from shareholders of a corporation. The selling shareholders treat the transaction as sale of stock and realize capital gain or loss. The selling shareholder's amount realized is the stock selling price. The adjusted basis is the adjusted basis in the stock sold. When the stock transaction is completed, the purchaser owns the target corporation. The target corporation continues to operate as if nothing had happened. The basis of the assets held by the target corporation (now owned by the new shareholder) stays the same.

When a purchaser purchases the target assets instead, the purchaser's basis in the assets acquired is the purchaser's cost allocated among the assets pursuant to Internal Revenue Code (IRC) section 1060. Therefore, the basis of assets held by the purchaser is stepped up by the amount of gain that is realized by the target corporation (providing the purchase price of assets is more than the adjusted basis of assets). Having higher basis is beneficial to taxpayers for various reasons. However, this method can be quite troublesome for the seller and the purchaser – such as sales tax, property title transfer, relocation of tangible assets, etc.

One way to have the ease of a stock purchase together with the benefit of basis step-up is for the purchaser to purchase stock and to elect IRC section 338. The election of IRC section 338 treats the stock sale as if the target's assets were sold to an unrelated person (New Target). The deemed sale of assets usually gives basis step-up in the assets deemed sold. For this purpose, the target corporation must realize gain on deemed sale of assets. In addition, the selling shareholder must report gain on sale of stock. Therefore, electing IRC section 338 results in double taxation.

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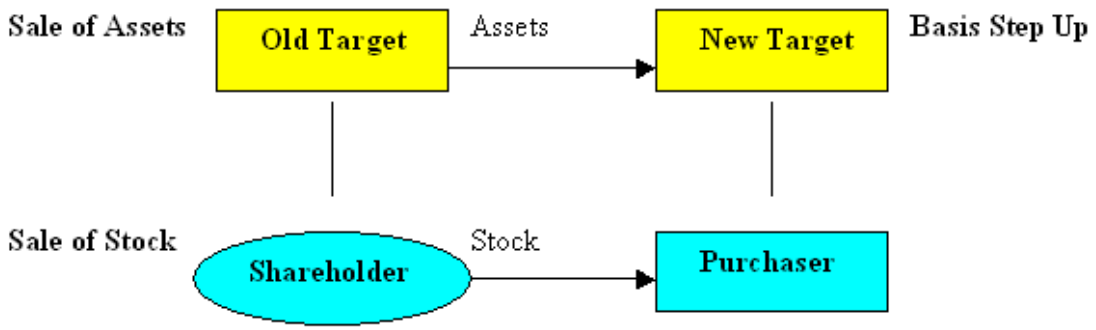

To avoid double taxation, if the parties agree and if certain requirements are met, the selling party and the purchaser can make a joint election of IRC Section 338(h)(10).

Note that in a 338 election (made under 338(g)), the purchaser only makes the election. For a 338(h)(10) election, both the buyer and seller must jointly elect. In order to make a valid election for California tax purposes, the person or entity making the election must be a California taxpayer for California purposes. For a corporation to be considered a California taxpayer, it must be incorporated in California, qualified to do business in California, conducting business in California, or a member of a combiner report group with at least one member that is a California taxpayer. See Revenue and Taxation Code (R&TC) section 23037 and Cal. Code Reg. §25106.5-3(b).

For detailed discussion of who is eligible to make a 338 election and a 338(h)(10) election for California purposes, see Technical Advice Memorandum 200206 (September 15, 2000).

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160200 IRC SECTION 338(H)(10) - OVERVIEW

The election of IRC Section 338(h)(10) treats the stock transaction as if Old Target, transferred all of its assets to an unrelated person (New Target) in exchange for consideration that includes the discharge of liabilities in a single transaction at the close of the acquisition date and then transferred all of its assets (the sales proceeds) to the selling shareholders and ceased to exist. (Treas. Reg. §1.338(h)(10)-1(d)(3) and Treas. Reg. §1.338(h)(10)-1(d)(4)) The stock transaction is ignored for tax purposes.

Note that under Treas. Reg. section 1.338(h)(10)-1(d)(2), New Target remains liable for the new tax liabilities of Old Target, including the tax liability for the deemed sale. In the case of tiered targets, the deemed asset sale of the parent corporation is considered to precede that of its subsidiary under Treas. Reg. section 1.338(h)(10)-1(d)(3)(ii) and the deemed transfer of the subsidiary precedes the deemed transfer of the parent under Treas. Reg. section 1.338(h)(10)-1(d)(4)(ii).

The transfer of the sales proceeds to the selling shareholders may be treated, for example (Treas. Reg. §1.338(h)(10)-1(d)(4)):

- as a distribution as part of a reorganization,
- as a distribution or one in a series of distributions in redemption of stock as part of a plan of liquidation, or
- as a part of a circular cash flow.

Treas. Reg. section 1.338(h)(10)-1(d)(4) states that "[I]n most cases, the transfer will be treated as a distribution in complete liquidation to which [Internal Revenue Code] section 336 or 337 applies."

The transaction is viewed as if actual asset sale occurred for all purposes of determining income or franchise tax. If the federal regulations fail to address a particular situation, the issue should be analyzed as if the deemed sale transactions actually occurred. (Treas. Reg. §§1.338(h)(10)-1(d)(4) and 1.338(h)(10)-1(d)(9))

California has conformed to IRC section 338 by virtue of its conformity to Subchapter C in R&TC section 24451.

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160300 LAW UPDATES

The regulations under IRC section 338 contain explanations and examples of how the 338 rules apply, including the IRC Section 338(h)(10) rules and their application to S corporation targets. R&TC section 23051.5(d) states "regulations promulgated in final form or issued as temporary regulations by the 'secretary' shall be applicable as regulations issued under this part to the extent that they do not conflict with this part or with regulation issued by the Franchise Tax Board." Final or temporary federal regulations apply so long as California has conformed to the underlying law. The last date of conformity listed in R&TC section 17024.5 is January 1, 1998. Even though final or temporary regulations are promulgated after January 1, 1998, those regulations still apply so long as they support a federal code section to which our general conformity date applies. If a federal code section was enacted before January 1, 1998 and California conformed to that code sections, final or temporary regulations promulgated after the date of conformity still apply so long as the underlying statute has not been changed.

Treas. Reg. section 1.338(h)(10)-1 applies to IRC Section 338(h)(10) elections in addition to the rules of Treas. Reg. section 1.338-1 through Treas. Reg. section 1.338-10, unless rules within Treas. Reg. section 1.338(h)(10)-1 overrides those general rules. (Treas. Reg. §1.338(h)(10)-1(a))

Temporary regulations were promulgated in a piecemeal fashion from 1982 through 1991, with many changes being made during that time period. (See T.D. 7855, 1982-2 C.B. 79, T.D. 7942, 1984-1 C.B. 93, T.D. 7975, 1984-2 C.B. 81, T.D. 8021, 1985-1 C.B. 96, T.D. 8068, 1986-1 C.B. 165, T.D. 8072, 1986-1 C.B. 111, T.D. 8074, 1986-1 C.B. 126, T.D. 8088, 1986-1 C.B. 52, T.D. 8092, 1986-2 C.B. 49, T.D. 8215, 1988-2 C.B. 304 and T.D. 8339, 1991-1 C.B. 52.) Regulations finalized in 1994 apply generally to the acquisition of targets on or after January 20, 1994 but before January 6, 2000. (See T.D. 8515, 1994-1 C.B. 89 and T.D. 8516, 1994-1 C.B. 119.) Many of the 1994 regulations were re-designated or reissued in temporary form in January of 2000. (See T.D. 8858, 2000-4 I.R.B. 332.) For acquisitions occurring after January 5, 2000 but before March 16, 2001, these temporary regulations apply.

In February of 2001, the temporary regulations were made final and apply to qualified stock purchases occurring after March 15, 2001. (See T.D. 8490, 66 Fed. Reg. 9925 (2/13/01)) References to the regulations contained within this manual are to the final regulations effective March 15, 2001.

For qualified stock purchases occurring prior to that date, please refer to the temporary or final regulations in effect at that time. Each version of the

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regulations contains changes, some of which are significant. Therefore, it is important to make sure that the correct regulations are used.

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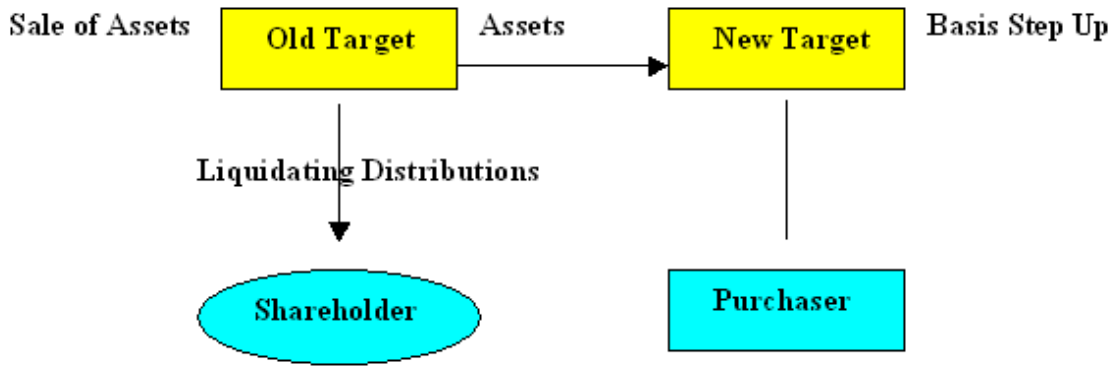
160400 MECHANICS OF IRC SECTION 338(H)(10)

Qualified taxpayers can make a joint election to treat the stock transaction as if the target corporation (Old Target) sold assets to another corporation (New Target), followed by the termination of Old Target's existence. Therefore, there are two tax transactions that must be considered – (1) deemed sale of assets by the target corporation and (2) deemed transfer of the sales proceeds to the shareholders and cessation of the existence of the corporation (typically via a liquidation). The stock sale is ignored. (IRC §338(h)(1)(A) and Treas. Reg. §1.338(h)(10)-1(d)(5)(iii)) When these transactions are completed, the purchaser owns the New Target, which holds the Old Target's assets with a higher basis.



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160500 QUALIFICATIONS OF TAXPAYER AND EVENTS

The election of IRC Section 338(h)(10) may be made when a qualified purchasing taxpayer purchases stock of a qualified target corporation in a qualified stock purchase.

Qualified Purchaser

A qualified purchaser must be a corporation. (IRC §§338(d)(1) & (3)) If an individual establishes a corporation and has the corporation purchase stock from a qualified seller, the purchaser still qualifies. (Treas. Reg. §1.338-3(b)(1))

An S corporation can be a purchaser. Former IRC section 1371(a)(2) stated that for purposes of subchapter C transactions, an S corporation was treated as an individual. Therefore, it could not be a purchaser in an IRC section 338 transaction. IRC section 1371(a)(2) was repealed in 1996, thus allowing S corporations to be purchasers. Moreover, the prohibition against S corporations being members of an affiliated group was also repealed such that S corporations may own subsidiaries.

To be eligible to make an IRC Section 338(h)(10) election for California purposes, a purchaser must be a California taxpayer or a member of a combined reporting group that has at least one member that is a California taxpayer. (Cal. Code Reg. §25106.5-3) Note that the determination of the purchaser's eligibility to make an election is made after the stock purchase, not at the stock purchase.

For detailed discussion of who is eligible to make an IRC section 338 election and an IRC Section 338(h)(10) election for California purposes, see Technical Advice Memorandum 200206 (September 15, 2000).

Qualified Seller

A qualified seller must be a member of a selling consolidated group, a selling affiliate, or an S corporation shareholder. (Treas. Reg. §1.338(h)(10)-1(c)) It must be a California taxpayer or a member of a combined reporting group that has at least one member that is a California taxpayer. If the S corporation owns a subsidiary that is a Target, then the S corporation could be a qualified seller. Changes in IRC section 1361(b) in 1996 resulted in the ability of S corporations to own subsidiaries.

Qualified Events

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a. 80% ownership requirement
A purchasing corporation must purchase 80% or more of a target stock within a 12-month period. (IRC §338(d)(3)) The 80% requirement can be met by redemption of stock by a target corporation's shareholder, if the redemption results in the purchasing corporation's holding 80% or more of outstanding target stock. The last day to meet the 80% requirement is the date of purchase.

Note that under Treas. Reg. section 1.338(h)(10)-1(d)(1), an automatic election is deemed to have been made for nonrecently purchased target stock. Also, the 12-month requirement may be extended under IRC section 338(e)(3) and (i). (Treas. Reg. §1.338-8(j)(2))

Treas. Reg. section 1.338(h)(10)-1(d)(3) states that the S election continues in effect through the close of the acquisition date, including the time of the deemed asset sale and termination of Old Target, notwithstanding IRC section 1362(d)(2)(B). Since the S corporation target is acquired by a qualified purchaser that must be a corporation, the S election will be automatically terminated under IRC section 1362(d)(2)(B) because corporations are not permitted to be S corporation shareholders.

b. Qualified Purchase
To qualify, the purchaser and the seller must be unrelated, and the seller must recognize all of the gain or loss on the sale under IRC Section 338(h)(3). (See Treas. Reg. §§1.338-3(b)(2) and (3) for a discussion of the term "purchase" and the meaning of "related.") Thus, IRC section 351, IRC section 354, IRC section 355, and IRC section 356 transactions are not qualified purchases of stock. (IRC §338(h)(3)(ii))

c. Post Acquisition Event
Because the law requires the purchaser to be a true purchaser, if the purchaser existed only for the purpose of making the election, the qualification of the transaction may be questionable. (Treas. Reg. §1.338-3(c)(2)) For example, a taxpayer establishes a corporation to acquire another corporation and elects IRC Section 338(h)(10). If immediately after the election another corporation acquires the purchasing corporation, the purchasing corporation may be a transitory subsidiary and may not be a qualified purchaser. To determine who the true purchaser is, we may use "step transaction" analysis.

If an individual taxpayer wants to acquire stock of a target and take advantage of IRC section 338, the individual may form a corporation (New P) to acquire the stock. New P may not be considered the true purchaser if, for example, New P is merged into the target, liquidated or otherwise disposed of after the purported

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qualified purchase. (Treas. Reg. §1.338-3(b)(1)) The same would apply for a partnership that wants to make a qualified purchase.

Elimination of the target (by liquidation, for example) on or after the acquisition date will not invalidate the IRC section 338 election. (Treas. Reg. §1.338-3(c)(1))

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160600 MANNER OF MAKING THE ELECTION

The election must be made by the 15th day of the 9th month after the acquisition date by filing federal Form 8023. (Treas. Reg. §1.338(h)(10)-1(c)(2)) Note that as long as taxpayers filed Form 8023 timely, the election is valid.

The purchaser and the S corporation shareholders must jointly make the election. S corporation shareholders who do not sell their stock must also consent to the election. (Treas. Reg. §1.338(h)(10)-1(c)(2)) Federal Form 8023 did not clearly reflect the need for the non-selling shareholders to sign the form. Treas. Reg. section 1.338(i)-1 states that if the non-selling shareholders failed to sign the September 1997 revision of Form 8023, the IRC Section 338(h)(10) election will not be invalidated if the S corporation and all its shareholders (including non-selling shareholders) report the tax consequences with the results under IRC Section 338(h)(10).

An IRC Section 338(h)(10) election is irrevocable. (Treas. Reg. §1.338(h)(10)-1 (c)(3)) If an IRC Section 338(h)(10) election is made, then an IRC section 338 election is deemed made. (Treas. Reg. §1.338(h)(10)-1 (c)(3)) If a valid election is made for federal tax purposes, the election automatically applies for California tax purposes under R&TC section 17024.5(e) and R&TC section 23051.5(e).

In general, the purchaser and the seller could jointly elect out of the federal IRC Section 338(h)(10) election <u>for California</u>, if both parties make the election out for California within the time frame stated above, as provided by R&TC section 23051.5(e)(3). The result of California election out would be reflected as California adjustments on the Old Target's tax return. However, for transactions on or after January 1, 1998, S corporations or their shareholders are not allowed to elect out of the federal IRC Section 338(h)(10) election <u>for California</u> under R&TC section 23806(a) and (b).

If a stock transaction does not qualify for the IRC Section 338(h)(10) election (an invalid election is made), it cannot qualify for the regular IRC section 338 election. The deemed section 338 election is invalid as well. (Treas. Reg. §1.338(h)(10)-1 (c)(4)) When an invalid election is made, the transaction is treated as a simple stock transfer. Therefore, the New Target does not receive basis step up.

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160700 TRANSACTIONS – PURCHASING CORPORATION, NEW TARGET, OLD TARGET CORPORATION, AND SELLING SHAREHOLDERS

As explained in S Corp 160400 (Mechanics of IRC Section 338(h)(10)), there are four parties to the transaction – Old Target, Selling Shareholders, New Target, and Purchasing Corporation. Selling Shareholders sell Old Target stock to Purchasing Corporation, making Purchasing Corporation the new owner of New Target.

To reflect the stock transaction with election of IRC Section 338(h)(10) on their books, each party must do the following:

S Corp 160701	Purchasing Corporation
S Corp 160702	New Target
S Corp 160703	Old Target Corporation
S Corp 160704	Selling Shareholders

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160701 Purchasing Corporation

A purchasing corporation must determine the grossed-up basis of Target's stock. The grossed-up basis of Target's stock is the cost incurred to purchase stock including capitalized purchasing costs. (IRC §1012)

Example A

Susan (a sole shareholder of an S corporation, S Mart) sold all of issued and outstanding S-Mart stock to P-Mart (a C corporation) for $1 million. A valid, joint IRC Section 338(h)(10) election was made regarding the stock sale. P-Mart paid an additional $60,000 to close the stock purchase.

As a new stockholder, P-Mart's computes its grossed-up basis of S-Mart stock as follows:

Stock purchase price	$1,000,000
Capitalized cost	60,000
Grossed-up basis of S-Mart stock	$1,060,000

The $1,060,000 is P-Mart's basis in S-Mart stock.

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160702 New Target

New Target's basis in asset is the amount for which New Target is deemed to have purchased and is called the adjusted grossed-up basis (AGUB). (IRC §338(b)(2) and Treas. Reg. §§1.338(h)(10)-1(d)(2) and 1.338-5(a))

The AGUB is the sum of (Treas. Reg. §1.338-5(b)(1)):

- The grossed-up basis in the purchasing corporation's recently purchased Target stock (IRC §338(b)(1)(A) and Treas. Reg. §1.338-5(c));
- The purchasing corporation's basis in non-recently purchased Target stock (IRC §338(b)(1)(B) and Treas. Reg. §1.338-5(d)); and
- The liabilities of New Target IRC §338(b)(2) and Treas. Reg. §1.338-5(e).

Recently purchased stock is stock held by the Purchaser on the acquisition date and purchased by Purchaser during the 12-month acquisition period. (IRC §338(b)(6)(A) and (h)) Non-recently purchased stock is stock held by the Purchaser on the acquisition date that was not purchased during the 12-month acquisition period. (IRC §338(b)(6)(B) and (h))

If a taxpayer or an affiliate of the taxpayer makes a 338 election for acquired stock, IRC section 338(e) and Treas. Reg. section 1.338-8 require that other asset and stock purchases made a year before or after the 12 month acquisition period be treated consistently in that a taxpayer cannot have 338 treatment for one purchase and not another and vice versa. Under the old rules, the IRS could deem certain transactions to be subject to IRC section 338. Under the new regulations, assets acquired during the consistency period may be required to take a carry over basis rather than a stepped up basis. If there are multiple acquisitions of stock or assets of a target or target affiliate by a purchaser or purchasing affiliate, the consistency rules need to be looked at.

1. The grossed-up basis in the purchasing corporation's recently purchased Target stock (if Target has a single class of outstanding stock) is the total price that Purchasing Corporation would have paid for all outstanding Target stock, except for the amount allocated to the non-recently purchased stock.

The basis of recently purchased stock is determined at the beginning of the day after the acquisition date without regard to acquisition costs. This basis is then multiplied by a fraction, the numerator of which is 100 minus the number that is the percentage of Target stock (by value, determined on the acquisition date)

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attributable to the Purchaser's non-recently purchased stock, and the denominator of which is the number equal to the percentage of Target stock (by value, determined on the acquisition date) attributable to the Purchaser's recently purchased stock. Acquisition costs that Purchaser incurred in connection with its purchase of recently purchased stock, such as brokerage commissions, are then added in to determine the grossed up basis of recently purchased stock. (Treas. Reg. §1.338-5(c))

If Target was an S corporation, the grossed-up basis in the purchasing corporation's recently purchased Target stock would be the stock sale price plus any capitalized purchasing cost. This is because if the Target is an S corporation, the first time that its stock is purchased by a corporation in a 338 transaction, the S election will be terminated under IRC section 1362(d)(2)(B) because it will have a corporate shareholder. Treas. Reg. section 1.338(h)(10)-1(d)(3) specifies that if an S corporation is a target in an IRC Section 338(h)(10) transaction, the S election will continue in effect through the close of the acquisition date, including the time of the deemed asset sale and the deemed transfer, notwithstanding IRC section 1362(d)(2)(B).

Note, however, that the seller or purchaser could be an S corporation and the acquisition or sale of a subsidiary of an S corporation will not terminate the parent corporation's S election.

2. The purchasing corporation's basis in non-recently purchased target stock is Purchaser's basis in that stock, unless it makes an election under IRC section 338(b)(3).

If Target is an S Corporation, there will be no non-recently purchased stock because the acquisition of the stock of an S corporation by a corporation will terminate the S election under IRC section 1362(d)(2)(B) (the S corporation cannot have a corporation as a shareholder). In order to qualify for the 338 election, Purchaser must be a corporation.

3. The liabilities of new target are Target's liabilities assumed by New Target. (Treas. Reg. §1.338-5(e))

AGUB is initially determined at the beginning of the day after the date of the acquisition of Target. (Treas. Reg. §1.338-5(b)(2)(i)) AGUB may need to be redetermined if there is an increase or decrease, for example, in the amount paid for the stock. See Treas. Reg. section 1.338-5(b)(2)(ii) for a discussion regarding the redetermination of AGUB.

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Once New Target determines the AGUB, New Target must allocate the AGUB among each class of assets and then to each asset in accordance with Treas. Reg. section 1.338-6 and Treas. Reg. section 1.338-7. (Treas. Reg. §1.388(h)(10)-1(d)(2)) The method described under Treas. Reg. section 1.338-6 is called Residual Method.

Using the Residual Method, AGUB is assigned to each class of asset, from Class I through Class IV, up to the fair market value. Refer to the valuation training material for the discussion of FMV and how to determine FMV. Then, the remainder is assigned to Class V (Goodwill). Assets are classified as follows:

Class I:	Cash and Demand Deposit
Class II:	Marketable Securities, CD's Foreign Currency
Class III:	All others except Classes I, II, IV, and V
Class IV:	All intangibles except Goodwill
Class V:	Goodwill

Once AGUB is allocated among the five classes of assets, New Target must further apportion the new basis (assigned to each class) to each asset within a class proportionately. The amount of basis applied to each asset is the opening balance of the New Target balance sheet.

Example A

In addition to the facts in Example A of S Corp 160701, S-Mart had $100,000 A/P and a $200,000 Long-Term Loan at the time of the stock sale. New S-Mart computes the adjusted grossed-up basis (AGUB) in the assets deemed acquired from Old S-Mart as follows:

AGUB:	Grossed-up basis of S-Mart stock	$1,060,000
	S-Mart's liabilities assumed (A/P $100,000, N/P $200,000)	$300,000
		$1,360,000

Also, Old S-Mart had the following assets at the time of the stock sale:

Assets	A/B	FMV
Cash	$50,000	$50,000
Inventory	$150,000	$150,000
A/R	$100,000	$100,000
N/R	$20,000	$20,000
Equipment	$140,000	$160,000
Land/Building		$300,000
Total Assets	$630,000	$780,000

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Using the residual method, New S-Mart allocates the AGUB among each class of assets as follows:

Class	Assets	FMV	Allocation	Residual
I	Cash	$50,000	$50,000	$1,310,000
II	N/A			
III	Inventory	$150,000		
	A/R	$100,000		
	N/R	$20,000		
	Equipment	$160,000		
	Land/Building	$300,000	$730,000*	$580,000
IV	N/A			
V	Goodwill		$580,000	$0
Total Assets			$1,360,000	

* $730,000 will be allocated to each class III asset proportionately.

New S-Mart's opening balance sheet should look like this…

Assets		Liab. & Equity	
Cash	$50,000	N/P	$200,000
		A/P	$100,000
Inventory	$150,000	Total Liab	$300,000
A/R	$100,000		
N/R	$20,000		
Equipment	$160,000		
Land/Building	$300,000		
Goodwill	$580,000	Equity	$1,060,000
Total Assets	$1,360,000	Total Liab. & Equity	$1,360,000

As explained in S Corp 160200, S-Mart's assets received a basis step-up when the transaction was completed.

Example B

Using Example A of S Corp 160702, but if S-Mart stock was sold for $550,000, the acquisition cost was $20,000, and Old Target's liabilities were $100,000 (A/P $30,000, N/P $70,000):

AGUB: Grossed-up basis of S-Mart stock $570,000

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S-Mart's liabilities assumed (A/P $30,000 & N/P $70,000)	$100,000
	$670,000

At the time of stock sale, Old S-Mart had the following assets:

Assets	A/B	FMV
Cash	$50,000	$50,000
Inventory	$150,000	$150,000
A/R	$100,000	$100,000
N/R	$20,000	$20,000
Equipment	$140,000	$160,000
Land/Building	$170,000	$300,000
Total Assets	$630,000	$780,000

Using the residual method, New S-Mart allocates the $670,000 AGUB among each class of assets as follows:

	Assets	FMV		Residual
I	Cash	$50,000	$50,000	
II				
	Inventory			
	A/R $100,000			
	N/R	$20,000		
	Equipment			
	Land/Building		$620,000*	$0
IV	N/A			
V			$0	$0
	Total Assets		**$670,000**	

* New S-Mart allocates the $620,000 to each asset proportionately as follows:

Class III Assets		Ratio	Allocation
Inventory		0.20547	$127,397
A/R		0.13698	$84,932
N/R	$20,000	0.02739	$16,986
Equipment		0.21917	$135,890
	$300,000	0.41095	
Total Class III Assets	$730,000		$620,000

New S-Mart's balance sheet should look like this…

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Assets		Liab. & Equity	
Cash	$50,000	A/P	$30,000
Inventory	$127,397		$70,000
A/R	$84,932	Total Liab	
N/R	$16,986		
Equipment			
Land/Building	$254,795	Equity	$570,000
	$670,000		$670,000
		Equity	

corporation, unrelated to Old Target, that has no tax attributes (including no net operating losses and no earnings and profit). (Treas. Reg. §1.338-1(b)(1).) New Target may make new accounting period and method elections. (Treas. Reg. §1.338-1(b)(1)) For non-income/franchise tax purposes, such as payroll tax, New Target is a continuation of Old Target. (Treas. Reg. §1.338-1(b)(2))

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160703 Old Target Corporation

Old Target Corporation must book transactions as if it had sold all of its assets to an unrelated corporation (New Target) in exchange for consideration that includes the discharge of liabilities in a single transaction at the close of the acquisition date, transferred the proceeds to Seller, and terminated its existence. (Treas. Reg. §1.338(h)(10)-1(d)(3) and Treas. Reg. §1.338-10(a)(1)) Therefore, except as provided in Treas. Reg. section 1.338(h)(10)-1(d)(8) (regarding the installment method), Old Target recognizes all the gain realized on the deemed sale of assets and report the result as an S corporation on its final year return. (Treas. Reg. §1.338(h)(10)-1(d)(3) and Treas. Reg. §1.338-10(a)(1) and (5)) The return is due on the 15th day of the 3rd month following the month in which the acquisition occurs. (Treas. Reg. §§1.338(h)(10)-1(d)(3)(i) and 1.338(a)(6)(i)) Target's S election continues in effect through the close of the acquisition date (including the time of the deemed asset and the deemed transfer) notwithstanding IRC section 1362(d)(2)(B).

As mentioned before, New Target is treated as a new corporation that is unrelated to Old Target and receives no tax attributes from Old Target. (Treas. Reg. §1.338-1(b)(1))

The gain or loss on the deemed sale of each asset is determined by reference to the aggregate deemed sales price (ADSP). (Treas. Reg. §§1.338(h)(10)-1(d)(3)(i) and 1.338-4.) ADSP is the amount for which Target is deemed to sell its assets. (Treas. Reg. §1.338-4(a)) ADSP is the sum of the grossed-up amount realized on the sale to Purchaser of Purchaser's recently purchased Target stock (as defined in IRC §338(b)(6)(A)) and the liabilities of Old Target. (Treas. Reg. §1.338-4(b)(1)) ADSP is initially determined at the beginning of the day after the acquisition date of Target. (Treas. Reg. §1.338-4(b)(2)(ii)) ADSP may need to be redetermined, for example, because of an increase or decrease in the amount realized or because liabilities not originally taken into account are subsequently taken into account. (Treas. Reg. §1.338-4(b)(2)(ii)) ADSP may not be applied in such a way as to contravene other applicable rules. (Treas. Reg. §1.338-4(f))

For purposes of calculating ADSP, the liabilities of Old Target are measured as of the beginning of the day after the date of acquisition. In order to be taken into account in ADSP, a liability must be a liability of Target that is properly taken into account in amount realized under general principles of tax law that would apply if Old Target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. (Treas. Reg. §§1.338-4(d)(1) and 1.1001-2(a))

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ADSP is then allocated among Target's assets in accordance with Treas. Reg. section 1.338-6 to determine the amount for which each asset is deemed to have been sold. (Treas. Reg. §1.338-4(a)) If ADSP is redetermined, then Treas. Reg. section 1.338-7 is used to allocate the redetermined ADSP.

Once the ADSP is computed, Old Target allocates ADSP among the assets deemed sold to determine the character and the amount of gain/loss on each asset. (Treas. Reg. §§1.338(h)(10)-1(d)(3)(i) and 1.338-6) The method used (the residual method) is the same as the method used by New Target in allocating AGUB among the deemed purchased assets from Old Target.

If an IRC section 338 election (instead of IRC §338(h)(10)) was made for an S corporation Target, Old Target must file tax return reporting the deemed sale of assets as a C corporation, under Treas. Reg. section 1.338-10(a)(3). This is because the S election is terminated when the corporate purchaser acquires the stock. Special rules apply to extend the S election for IRC Section 338(h)(10) elections until after the deemed sale and transfer transactions (Treas. Reg. §1.338(h)(10)-1(d)(3)(i)), but no such rule exists for an IRC §338(g) election.

If no IRC Section 338(h)(10) election were made at the time of the stock sale, there would be only one transaction – a sale of stock by selling shareholders to a purchasing corporation. Selling shareholders would have gain or loss on sale of stock, and Purchasing Corporation would have cost basis in Target's stock. If Target Corporation was an S corporation, Target Corporation's S status would be revoked under IRC section 1362(d)(2)(B).

Example A

Using the facts in Example A of S Corp 160702, Old S-Mart computes the aggregate deemed sales price (ADSP) of the assets deemed sold to New S-Mart. The selling cost incurred for the stock sale was $30,000, and liabilities assumed by New S-Mart totaled $300,000.

ADSP:	$1,060,000
S-Mart liabilities (A/P $100,000, N/P $200,000)	$300,000
Acquisition cost incurred by the purchasing corporation	($60,000)
Selling cost incurred by the seller	

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Old S-Mart allocates the $1,270,000 among the assets held at the time of stock sale:

Assets	A/B	FMV
Cash	$50,000	$50,000
Inventory	$150,000	$150,000
A/R	$100,000	
N/R	$20,000	
Equipment	$140,000	$160,000
Land/Building	$170,000	$300,000
	$630,000	

Using the residual method, New S-Mart first allocates the $1,270,000 ADSP among each class of assets:

Class	Assets		Allocation	
I		$50,000	$50,000	
	N/A			
III	Inventory	$150,000		
	A/R	$100,000		
	N/R	$20,000		
	Equipment	$160,000		
	Land/Building	$300,000		$490,000
IV	N/A			
V	Goodwill		$490,000	$0
	Total Assets		$1,270,000	

* $730,000 will be allocated to each class III asset proportionately.

Old S-Mart computes the amount and the character of gain on sale of each asset as shown below:

	A/R	A/B	Gain/(Loss)
Cash	$50,000	$50,000	
Inventory	$150,000	$150,000	
		$100,000	
N/R	$20,000		
Equipment	$160,000	$140,000	
Land/Building	$300,000	$170,000	$130,000 Gain
Goodwill	$490,000		$490,000

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			Gain
Total Assets	**$1,270,000**	**$630,000**	**$640,000**

Auditors must pay special attention to the types of gains or losses from the deemed sale of assets. They may trigger additional tax issues (such as built in gains tax), as discussed later in this chapter.

Example B

Using the facts in Example B of S Corp 160702, S-Mart stock was sold for $550,000, the acquisition cost was $20,000, and Old Target's liabilities were $100,000 (A/P $30,000, N/P $70,000):

ADSP:		$570,000
	S-Mart liabilities assumed (A/P $30,000 & N/P $70,000)	$100,000
	Acquisition cost incurred by the purchasing corporation	($20,000)
	Selling cost incurred by the seller	
		$620,000

At the time of stock sale, Old S-Mart had the following assets:

Assets		FMV
Cash		$50,000
Inventory	$150,000	$150,000
A/R	$100,000	$100,000
N/R		$20,000
Equipment	$140,000	$160,000
Land/Building	$170,000	$300,000
Total Assets	$630,000	$780,000

Using the residual method, Old S-Mart allocates the $620,000 ADSP among each class of assets as follows:

Class	Assets	FMV	Allocation	Residual
I	Cash	$50,000		$570,000
II				
	Inventory	$150,000		
	A/R			
	N/R			
	Equipment			
	Land/Building		$570,000*	$0

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IV	N/A		
V	Goodwill		$0
	Total Assets	$620,000	

* Old S-Mart allocates the $570,000 to each asset proportionately as follows:

Class III Assets	FMV		Allocation
Inventory	$150,000	0.20547	$117,123
	$100,000	0.13698	
N/R	$20,000	0.02739	$15,616
Equipment	$160,000	0.21917	$124,932
Land/Building		0.41095	$234,247
Total Class III Assets	$730,000		$570,000

asset as shown below:

Assets	A/R		Gain/(Loss)
		$50,000	
Inventory	$117,123		
A/R	$78,082	$100,000	
N/R	$15,616		
Equipment	$124,932	$140,000	($15,068)
Land/Building		$170,000	$64,247
Total Assets	$630,000	$640,000	

deemed sale of assets. They may trigger additional tax issues, as discussed later in this chapter.

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160704 Selling Shareholders

The S corporation shareholders, whether or not they sell their stock, take their pro rata share of the deemed sale tax consequences into account under IRC section 1366 and increase or decrease their basis in the Target stock under IRC section 1367. (Treas. Reg. §1.338(h)(10)-1(d)(5)(i)) This occurs because the S corporation Target will report the deemed gain on its final S corporation tax return. (Treas. Reg. §1.338(h)(10)(d)(3)(i)) The selling S shareholders treat the transaction as if (after the deemed sale and before the close of the acquisition date) Old Target transferred the assets (the sales proceeds) to the shareholders. In most cases, the transfer of the assets (the sales proceeds) will be treated as a distribution in complete liquidation to which IRC section 331 or IRC section 332 applies. (Treas. Reg. §1.338(h)(10)-1(d)(5)(i)) Therefore, shareholders realize capital gain or loss on the exchange. The amount realized is the stock price, and the adjusted basis is the shareholders' basis in the stock. In computing the gain/loss, the shareholders basis in the stock should be increased by the flow-through gain/loss recognized on deemed sale of assets by the corporation, pursuant to IRC section 1367(a). Often, because of the increase in stock basis, there will be no gain or loss recognized by the shareholders on the deemed liquidation.

As mentioned before, an IRC Section 338(h)(10) election is irrevocable. If an IRC Section 338(h)(10) election is made, then an IRC section 338 election is deemed made. If a stock transaction does not qualify for the IRC Section 338(h)(10) election (an invalid election is made), it cannot qualify for the regular IRC Section 338 section election. Therefore, the deemed IRC section 338 election is invalid as well. If an invalid election is made, the transaction is treated as a simple stock transfer. Therefore, the New Target does not receive basis step up, and the selling shareholders compute gain/loss pursuant to IRC section 1001(a).

S corporation shareholders who do not sell their stock of Target are treated as acquiring the retained stock on the day after the acquisition date for its fair market value. (Treas. Reg. §1.338(h)(10)-1(d)(5)(ii)) The holding period for the stock starts on the acquisition date. The fair market value of the Target stock equals the grossed-up amount realized on the sale to the Purchaser of recently purchased Target stock. The S shareholders recognize no gain or loss on the sale of Target stock, although gain or loss may be recognized in the deemed transfer. (Treas. Reg. §1.338(h)(10)-1(d)(5)(iii))

Gain or loss on the actual sale of Target stock is ignored in an IRC Section 338(h)(10) transaction. (IRC §338(h)(10)(A) and Treas. Reg. §1.338(h)(10)-1(d)(5)(iii))

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Example A

Using the facts in Examples A of S Corp 160701, S Corp 160702, S Corp 160703, Susan sold all of issued and outstanding S-Mart stock to P-Mart for $1 million. A valid, joint IRC Section 338(h)(10) election was made regarding to the stock sale. Old S-Mart recognized $640,000 gain (no built-in gains) on deemed sale of assets and passed through the gain (along with other flow-through items) to Susan.
Susan's stock basis was $330,000, excluding effects of the IRC Section 338(h)(10) elections, but including all other flow-through items. Susan must recognize the $640,000 flow-through gain and increase her stock basis in Old S-Mart to $970,000.
Under IRC section 331(a), Susan computes her gain on deemed liquidation of S-Mart as follows:

Amount Realized (Stock Price)	$1,000,000
Adjusted Basis (Stock Basis)	($970,000)
Capital Gain on Sale of Stock	$30,000

If Susan was a California resident, her total gain recognized from the IRC Section 338(h)(10) election should be $670,000 ($640,000 flow-through gain and $30,000 capital gain under IRC section 331(a)).

Example B

Using the facts in Examples B of S Corp 160701, S Corp 160702, S Corp 160703, Susan sold all of issued and outstanding S-Mart stock to P-Mart for $550,000. A valid, joint IRC Section 338(h)(10) election was made regarding the stock sale. Old S-Mart recognized $49,179 gain (no built-in gains) on deemed sale of assets and passed through the gain (along with other flow-through items) to Susan.
Susan's stock basis was $330,000, excluding effects of the IRC Section 338(h)(10) election, but including all other flow-through items. Susan must recognize the $49,179 flow-through gain and increase her stock basis in Old S-Mart to $379,179.

Mart as follows:

Amount Realized (Stock Price)	$550,000
Adjusted Basis (Stock Basis)	($379,179)

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Capital Gain on Sale of Stock	$170,821

If Susan was a California resident, her total gain recognized from the 338(h)(10) election should be $220,000 ($49,179 flow-through gain and $170,821 capital gain under IRC section 331(a)).

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160800 INSTALLMENT METHOD OF INCOME RECOGNITION

Treas. Reg. section 1.338(h)(10)-1(d)(8) modifies the general rules for the tax consequences of IRC Section 338(h)(10) elections when applying the installment sales method and rules of IRC section 453, IRC section 453A and IRC section 453B to Old Target in the deemed asset sale and to Old Target and its shareholders in the deemed liquidation (if applicable). Note that the regulations merely discuss the consequences of the application of the installment sales rules. The regulations do not override the requirements and limitations of the installment sales rules but merely describe the nature of the transactions when the installment sales rules apply in the context of an IRC Section 338(h)(10) transaction. California has generally conformed to the federal installment sales provisions, but because the last federal conformity date is as of January 1, 1998, any changes to the federal installment sales rules are not part of California law until the date is modified or there are specific conforming legislations. See Example 10 of Treas. Reg. section 1.338-1(h)(10)-1(e).

With respect to the deemed asset sale, Old Target is treated as receiving New Target installment obligations, the terms of which are identical (except for the obligor) to the Purchasing Corporation's installment obligations issued for recently purchased stock of Target. Old Target is treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, Old Target liabilities. For example, Old Target is treated as receiving in cash any amounts attributable to the grossing-up of amount realized under Treas. Reg. section 1.338-4(c). The amount realized for recently purchased stock and ADSP are redetermined to reflect amounts paid under an installment obligation for the stock when the total payments under the installment obligation are greater or less than the amount realized.

With respect to a deemed liquidation, Old Target is treated as distributing (in the deemed liquidation) the New Target installment obligations that it is treated as receiving in the deemed asset sale. The S corporation shareholders are treated as receiving (in the deemed liquidation) the New Target installment obligations (that correspond to the Purchasing Corporation installment obligations they actually receive individually) in exchange for their recently sold stock. The New Target installment obligations may be recharacterized under other rules. For example, Treas. Reg. section 1.453-11(a)(2) may, in certain circumstances, treat the New Target installment obligations deemed distributed by Old Target as if New Target issued them in exchange for the stock in Old Target owned by the S shareholders. The S shareholders are treated as receiving all other consideration in the deemed liquidation in cash.

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See below for the mechanism of computing gain/loss by Old Target and the selling shareholders:

Example A

On 12/31/98 a sole shareholder of Target sold Target stock to a qualified purchasing corporation for $75 and received a $40 installment note and $35 cash. Target's liabilities assumed by the purchasing corporation were $25. Total Adj. Basis of assets deemed sold was $30. In year 2000 the shareholder collected $40 in full. Shareholders' basis in the stock was $20 immediately before the sale.

(a) Mechanics of an IRC Section 338(h)(10) with Installment Method of Income Recognition for Federal

1. Old Target reports $32.67 gain in 1998:

Amt. Realized	$100 ($75 + $25 liabilities assumed)
A/B of Assets	$30
Gross Profit	$70
Profit %	93.34% ($70/$75)*
Cash Receipt	$35
Gain	$32.67 *

* The profit percentage should be computed by dividing the gross profit by the contract price pursuant to IRC section 453(c).

* Gain (attributable to deemed sale of assets) flows through to shareholder under IRC section 1366(a) and increases shareholders' basis under IRC section 1367 (a)(1).

2. Selling Shareholder reports $10.42 in 1998:

Under IRC section 453(h)(1)(A), when a shareholder receives an installment note in a liquidation of corporation during the 12-month winding-down period, the shareholder must treat installment payments as payments in exchange for stock. Therefore, profit percentage must be computed and applied to cash receipts to compute gain on installment payments.

Amt. Realized	
A/B stock	$52.67 ($20 plus $32.67 flow-through gain)
Gross Profit	$22.33
	29.77% ($22.33 / $75)
Cash Receipt	$35
Rec. Gain	$10.42

$11.91 gain in 2000:

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Cash Receipt	$40
Profit %	29.77%
Rec. Gain	

(b) Mechanics of an IRC Section 338(h)(10) with Installment Method Transaction for California

California conforms to the federal provision of installment method of income recognition under IRC section 453. However, for California Franchise Tax purpose, Target must report the unrecognized portion of the gain realized on deemed sale of assets in 1998, pursuant to R&TC section 24672(a) as follows:

1. Old Target reports $70 gain in 1998:

Amt. Realized	assumed)
A/B	$30
Gross Profit	$70
Profit %	93.34% ($70/$75)
Cash Receipt	$35
	$32.67 -- flow-through gain
CR & TC 24672(a) gain	$37.33 *Total reportable gain $70.00

* The $37.33 gain does not flow-through to shareholders since we allow the installment method of income recognition.

2. Selling Shareholder reports $10.42 in 1998:

payment as payment in exchange for stock.

Amt. Realized	$75 (Stock Price)
A/B stock	$52.67 ($20 plus $32.67 flow-through gain)
Gross Profit	$22.33
	$35
Cash Receipts	$10.42
	29.77% ($22.33 / $75)

3. Selling Shareholder receives $40 installment payment in 2000 and reports $11.91 in 2000:

Cash Receipts	$40
Profit %	29.77%
Rec. Gain	$11.91

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160900 AUDIT ISSUES

As explained in previous sections, the IRC Section 338(h)(10) election treats Target as if it had sold all assets and then ceased to exist. All tax provisions that are applicable to sale of assets and a corporate liquidation apply to Old Target and to the selling shareholders. Auditors should be aware of the following issues:

- Old Target's IRC section 1245 recapture which reclassifies IRC section 1231 gain to Ordinary Income
- Old Target's Built-in Gains (see S Corp 050000 - Built-In Gains)
- Selling Shareholders' flow-through gain or loss from Old Target may be California source income or loss.
- Selling Shareholders' capital gain or loss on stock exchange is sourced at the shareholders' residence in the case of an individual shareholder.

a. IRC Section 1245 Recapture:
When a corporation sells IRC section 1245 assets with accumulated depreciation and realizes gain, a portion of the gain must be classified as ordinary income instead of IRC section 1231 gain. This is called IRC section 1245 recapture. It is because the gain on sale of IRC section 1245 assets is the result of the basis reduction by depreciation expenses (reducing ordinary income) and is not the result of appreciation. Therefore, it is fitting to characterize such gain as "ordinary" instead of "capital." The amount classified as ordinary income must be reported in the year realized and must not be deferred under the installment method pursuant to IRC section 453(i)(A).

Taxpayers tend to allocate more of ADSP to goodwill and less to Class III assets, to reduce the amount of possible IRC section 1245 recapture. Therefore, it is imperative that auditors carefully analyze the fair market value of each class/type of asset. Refer to the valuation training material for the discussing of FMV and how to determine FMV.

b. BIGs:
If the target corporation is an S corporation with unrealized built-in gain at the time of S election, auditors should be concerned with the built-in gain issue. Although IRC Section 338(h)(10) triggers <u>deemed</u> sale of assets by the target corporation, all tax provision applicable in <u>true</u> sale of assets applies to the deemed sale of assets, including the built-in gain tax provision. Please refer to S Corp 050000 - Built-in Gains for details.

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c. Selling Shareholders' Flow-Through Gain or Loss
Under IRC section 1366(b), the character of flow-through gain/loss that resulted from the deemed sale of assets is decided at the corporate level. If Target has California source income, the sourcing passes through to the shareholders. Even a non-California resident shareholder must report his/her share of flow-through gain/loss on deemed sale of assets. (See California Court of Appeal, Fourth Appellate District, Division One, Gene Valentino et al. v. Franchise Tax Appeal Board) As in the case of *Valentino*, often non-California resident shareholders exclude their share of flow-through gain (on deemed sale of assets) from California taxable income by classifying the income as income recognized on sale of stock -- intangible asset. However, such treatment is erroneous. If a valid IRC section 338 election is in place, the transaction is treated as a sale of assets by Target Corporation and not as sale of stock by the shareholders.

d. Selling Shareholders' Capital Gain/Loss on Target Liquidation
Under IRC §§ 338(h)(10) and 331(a), shareholders compute gain/loss as if they had exchanged stock for deemed liquidating distributions. The shareholders' amount realized is the stock price; their adjusted basis is their basis in the stock sold.

As mentioned above, because the shareholders' stock basis received an increase when they reported flow-through gain on deemed sale of assets by the corporation, the selling shareholders avoid double taxation on the gain by electing IRC Section 338(h)(10).

Unlike flow-through gain, the character of gain/loss realized on deemed liquidating distributions is decided at the shareholder level, following Personal Income Tax law. Therefore, non-California resident individual shareholders report the gain/loss on deemed liquidating distributions to the state they live in, not to California.

In a case where the selling S shareholders are non-residents and the installment method of income recognition was used to report income, the character of the gain/loss reportable by the non-resident shareholders on installment payments should be determined pursuant to IRC section 453B(h)(1) and (2) and IRC section 1366(b).

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170000 MISCELLANEOUS

S Corp 171100	Treatment of Fringe Benefits – Background
S Corp 171200	Treatment of Fringe Benefits - Federal/California Law
S Corp 171300	Method of Reporting 2-Percent Shareholder Fringe Benefits
S Corp 171400	Treatment of Fringe Benefits - Method 1: Shareholder as Self-Employed Individual
S Corp 171500	Treatment of Fringe Benefits - Method 2: Guaranteed Payments
S Corp 172100	Special Rules Applicable to S Corporation Interest (Timing Rules, Imputed Interest, and Single Class of Stock
S Corp 172200	Below-Market Interest Rate Loans; IRC Section 7872

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171100 TREATMENT OF FRINGE BENEFITS - BACKGROUND

Generally, we do not pursue fringe benefits as an independent issue. However, we will pursue fringe benefit issues in conjunction with other issues if tax potential warrants such examination. This chapter identifies special rules applicable to fringe benefits provided by S corporations.

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171200 TREATMENT OF FRINGE BENEFITS - FEDERAL/CALIFORNIA LAW

Generally, the rules applicable to C corporations apply to fringe benefits provided by S corporations. However, where the employee receiving the fringe benefit is also a "2-percent shareholder" in the S corporation special "partnership" rules apply. (See IRC §1372.)

Pursuant to IRC section 1372 (R&TC §23807), the rules applicable to fringe benefits provided by a partnership to a partner apply to fringe benefits provided by an S corporation, if the recipient is a "2-percent shareholder". A recipient is a "2-percent shareholder if the recipient owns more than 2 percent of the outstanding stock of the S corporation or stock possessing more than 2 percent of the total combined voting power of all stock in such corporation, on any day during the S corporation's taxable year, taking into account the attribution rules contained in IRC section 318. (IRC §1372(b)) Once the recipient is determined to be a "2-percent shareholder," the fringe benefit rules are applied as though the S corporation was a partnership and the "2-percent shareholder" was a partner. (IRC §1372(a))

While IRC section 1372 does not identify the specific fringe benefits to which it applies, the legislative history indicates that IRC section 1372 was intended to govern the following types of statutory fringe benefits:

- Group term life insurance exclusion of $50,000 (IRC §79);
- Death benefit exclusion of $5,000 (IRC §101(b));
- Accident or medical health insurance plans (IRC §§105 and 106); and
- Meals and lodging furnished for the convenience of the employer (IRC §119).
- (Sen. Rep. No. 97-640, 2nd Sess., p. 22 (1982))

In addition, IRC section 1372 may apply to other fringe benefits that are only available to C corporations, such as cafeteria plans (IRC §125).

The following list includes fringe benefits that are available to partners in a partnership, which should not be affected by IRC section 1372:

- Employee achievement awards (IRC §74(c));
- Qualified group legal services plans (IRC §120);
- Educational assistance programs (IRC §127);
- Dependent care assistance programs (IRC §129);

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- No-additional-cost services (IRC §132(b));
- Qualified employee discounts (IRC §132(c));
- Working condition fringe benefits (IRC §132(d));
- De minimis fringe benefits (IRC §132(e)); and
- On-premises athletic facilities (IRC §132(j)(4)).

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171300 METHOD OF REPORTING 2-PERCENT SHAREHOLDER FRINGE BENEFITS

There is currently only one acceptable method for reporting fringe benefits although an IRS Publication 589 (1990) suggested a second acceptable method for reporting fringe benefits S corporations provide to their 2-percent shareholders. The first method, which treats the 2-percent shareholder as a self-employed individual and requires the fringe benefits to appear as separately stated items on the 2-percent shareholder's schedule K-1, is no longer an acceptable method. IRS Publication 589 (1990) is outdated and no longer in circulation. Pub 589 is not accessible online at the IRS website so the publication is no longer in circulation. Method one is inconsistent with the statute and it is certainly inconsistent with the later published Rev. Rul. 91-26. It also has a different tax effect inasmuch as the shareholder is not required to include the fringe benefit amount in income as compensation, but is allowed to deduct the amount. The second method treats the fringe benefits as guaranteed payments under IRC section 707(c), which must be reported as compensation on the 2-percent shareholder's Form W-2. (See Rev. Rul. 91-26.) The instructions to IRS Form 1120S only specifically refer to the second method. Accordingly, if a shareholder reports fringe benefits under Method One, it should be adjusted to conform to Method Two, which is consistent with the IRC section 1372.

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171400 TREATMENT OF FRINGE BENEFITS - METHOD 1: SHAREHOLDER AS SELF-EMPLOYED INDIVIDUAL

The first of two allowable methods for determining the tax treatment of employee fringe benefits refers to the shareholder as a self-employed individual. In this case, the S corporation cannot deduct shareholder fringe benefits on the corporation return. Instead, these benefits pass through to the shareholders.

Method 1

The corporation is not allowed a deduction for payment of fringe benefits to its greater than 2% shareholders. These shareholders are treated as self-employed individuals. The shareholder is allowed a “self-employed” deduction for the fringe benefit on their individual return.

Example A

ABC, Inc., an S corporation, paid fringe benefits for health insurance worth $5,000 on behalf of its more than 2 percent shareholders. The corporation treats these shareholders as self-employed individuals and their health benefits are not considered compensations. Payment of the $5,000 is not deductible by ABC, but passes through to the shareholders as an item of deduction on their individual returns.
The shareholders also treat the health insurance benefits as if they are self-employed and take a deduction limited to 30 percent of the expenditure (30% of $5,000 = $1,500). They treat the balance of the health insurance expenditure ($5,000 - $1,500 = $3,500) as an itemized deduction that is subject to the 7.5 percent AGI limitation.
Note: Before January 1, 1995, the deduction was limited to 25 percent instead of 30 percent.

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171500 TREATMENT OF FRINGE BENEFITS - METHOD 2: GUARANTEED PAYMENTS

The second method treats fringe benefits as "guaranteed payments" under IRC section 707(c), which means that the S corporation may deduct the fringe benefits as compensation for services and the 2-percent shareholder must include the fringe benefits in gross income as wages. This method comes from Rev. Rul. 91-26, which held that "fringe benefits paid or furnished by an S corporation to or for the benefit of its 2-percent shareholder-employees in consideration for services rendered, are treated for income tax purposes like partnership guaranteed payments under section 707(c) of the Code." Where guaranteed payment treatment applies, the S corporation's deduction is permitted by IRC section 162.

Method 2

The S corporation treats the fringe benefit as a wage expense.
The shareholder treats the fringe benefit as compensation.

Example A

ABC, Inc., an S corporation, provides fringe benefits such as health insurance to any two percent shareholders. ABC paid $5,000 in insurance premiums. The corporation treats the shareholders as having received the health insurance as additional compensation and includes the insurance expenditure as W-2 wage income. The $5,000 is deducted by ABC as compensation and is subject to payroll taxes. The shareholders report the health insurance as income.

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172100 SPECIAL RULES APPLICABLE TO S CORPORATION INTEREST (TIMING RULES, IMPUTED INTEREST, AND SINGLE CLASS OF STOCK

This section discusses (1) the basis for the interest deduction (IRC §163); (2) the timing of the S corporation's deduction for interest paid to shareholders and related parties (IRC §267); (3) imputed interest (IRC §7872); and (4) the prohibition against having more than one class of stock (IRC §1361).

S Corp 172101 Timing Rules

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172101 Timing Rules

If an S corporation pays interest to persons who are related to the S corporation, the S corporation is not entitled to the deduction for interest contained in IRC section 163 until the year that the related person's accounting method would require the inclusion of the interest in the related person's income. (IRC §267(a)(2)) IRC section 267 governs the deductibility with respect to transactions between related persons. For purposes of this timing rule, related persons include:

- A shareholder in the S corporation;
- Members of a shareholder's family;
- A C corporation, if the same persons own more than 50% in value of the outstanding stock of the S corporation and the C Corporation;
- Another S corporation, if the same persons own more than 50% in value of the outstanding stock of both S corporations; and
- A partnership, if the same persons own more than 50% in value of the outstanding stock of the S corporation and more than 50% of the capital interest, or profits interest in the partnership. (IRC §§267(b) and (e))

In addition, for purposes of determining whether a payee of interest is a related person described above, special attribution rules apply, which are contained in IRC section 267(c).

Verify that the related persons/creditors are reporting interest income in the same year that the S corporation is deducting interest expense in regard to S corporation indebtedness to the related persons/shareholders. If not, the interest expense is not an allowable deduction to the S corporation in that year.

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172200 BELOW-MARKET INTEREST RATE LOANS; IRC SECTION 7872

S Corp 172201 In General
S Corp 172202 Interest on Shareholder Loans to S Corporations
S Corp 172203 Interest on S Corporation Loans to Shareholders

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172201 In General

IRC section 7872 governs the tax effect of loans with no stated interest rate or a below-market interest rate.

IRC section 7872 applies to term loans made after June 6, 1984, and to amounts outstanding on demand loans after such date. Any loan that is renegotiated, extended, or revised after June 6, 1984 is treated as a loan made after that date. (P.L. 98-369, Section 172) R&TC section 17024.5(c)(1), R&TC section 18180, and R&TC section 24993 conformed and became applicable to IRC section 7872 on or after January 1, 1987.

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172202 Interest on Shareholder Loans to S Corporations

When corporate-shareholder loans have a stated interest rate that is less than the applicable federal rate (AFR), the difference between the amount of interest called for by the terms of the loan (i.e., stated interest), if any, and the amount of interest that would be required using the AFR is called “forgone interest.” When this occurs, IRC section 7872 prescribes the tax ramifications for the shareholders and the corporation: (1) the S corporation and the shareholder will be treated as if the shareholder loaned the forgone interest to the S corporation on the last day of the calendar year; and (2) the S Corporation and the shareholder will be treated as if the S corporation immediately paid the forgone interest back to the shareholder.

The below-market loan rules can be applied in a three-step process:

Determine if the transaction falls within the scope of IRC section 7872 (i.e., produces a below-market loan).

A term loan is a below-market loan if the amount loaned exceeds the present value of all payments due under the loan, determined as of the day the loan is made, using a discount rate equal to the AFR in effect for the day the loan is made. (IRC §7872(e)(1)(B))

A demand loan is a below-market loan if interest is payable at a rate less than the AFR. (IRC §7872(e)(1)(A))

If it does, calculate the forgone interest.

The amount and timing of forgone interest differs for demand loans and term loans. Refer to Proposed Regulation §1.7872-13.

Determine the character and timing of the deemed transfers.

The deemed transfer of the forgone interest from a shareholder to an S corporation is considered a capital contribution by the shareholder followed by simultaneous payment of interest by the corporation to the shareholder. (Treas. Reg. §1.7872-4(d)) IRC section 7872 treats the shareholder as if he paid interest at the applicable federal rate, which has the effect of requiring the S corporation to recognize interest income that will flow through to all of the S corporation's shareholders. The shareholder would receive a “deemed” distribution of this

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amount. The shareholder would also receive an interest deduction, depending on the use of the loan proceeds determined under PIT law. The treatment of loans from the S corporation to its shareholder includes: (1) the deemed transfer of the forgone interest from the S corporation to the shareholder is treated as a distribution of money subject to IRC section 1368; and (2) the shareholder is treated as if he immediately paid back the forgone interest amount as interest. (Treas. Reg. §1.7872-4(d)) The deemed transfers with regard to demand loans are deemed to occur on December 31. (IRC §7872(a)(2)) The deemed transfers with regard to term loans are deemed to have occurred on the date the loan was made or, if later, the date the loan first became subject to IRC section 7872. (IRC §7872(b)(1))

The affect of IRC section 7872 might result in a wash for some shareholders. If the shareholder is the sole shareholder in the S corporation, or all of the S corporation's shareholders have made proportional loans with identical percentages of forgone interest, the shareholders will each get an increased basis, receive taxable interest income, and receive an offsetting interest deduction passing-through from the S corporation. The following conditions could cause the imputed interest not to result in a wash:

- If the corporation reports on a fiscal year, the timing of the imputed interest can cause an acceleration or deferral of the tax consequences. The shareholder will report the interest income in one year and get the benefit of the reduced pass-thru in the following year.
- If the corporation has multiple shareholders, and loans are not made in proportion to stock ownership, the imputed interest will not wash because the corporation’s deduction for the imputed interest expense would pass through in proportion to stock ownership. Overall, however, it would result in a wash when considering that the other shareholders would receive reduced pass-thru items.
- If the interest expense pass-thru to the shareholder is considered from a passive activity, a certain portion of the pass-thru interest income will be treated as passive (not portfolio) income. This is referred to as self-charged interest.
- If the shareholder has limited investment interest expense, the imputed interest would allow a corresponding amount of investment interest expense to be deducted.

Please be aware of the de minimis exception contained in IRC section 7872(c)(3), and the exception for transactions with no significant tax effect contained in IRC section 7872(h)(1)(C).

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Example A

ABC, Inc. is an S corporation, and Mark owns all of its outstanding stock. Mark loans $100,000 to ABC and receives a written demand note with no stated interest rate. Assume the blended annual short-term AFR pertinent to demand loans is 7.5% and further assume that ABC has $100,000 of pass-thru income. The following illustrates the tax consequences with and without adjustment for imputed interest:

	Without Imputed Interest	7872 Interest Adjustment
Pass-thru income from Schedule K-1	$100,000	$92,500
IRC section 7872 interest income to Mark	-	$7,500

Under IRC section 7872, ABC is assumed to have paid Mark $7,500 of interest (7.5% x $100,000 outstanding loan for the year). The corporate income is reduced for the imputed interest expense, and Mark's personal interest income is increased. Also, Mark is deemed to have made a simultaneous contribution of capital to the corporation in the amount of the $7,500, thereby increasing his tax basis in the stock by $7,500. The $7,500 interest payment by ABC would decrease AAA. In this example, AAA would be increased by $92,500, not $100,000.

In this example, there would be no tax effect, with the exception of the 1.5% (2.5%) reduction in tax at the S corporation level in regards to the interest expense deduction.

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172203 Interest on S Corporation Loans to Shareholders

In regard to the loans from the S Corporation to the shareholders, because the interest is treated as a deemed distribution, the question arises as to whether a disproportionate distribution results which could result in a second class of stock and terminate the S election. (IRC §1361)

A below market loan between an S corporation and one or more of its shareholders will not cause the corporation to have more than one class of stock under the Regulations, provided that the loan agreement was not entered into with the principal purpose to circumvent the single-class-of-stock requirement and, therefore, was not a “governing provision” (Treas. Reg. §1.1361-1(l)(2)(v), Example 5).

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180000 TAX RESEARCH

S Corp 180100 Steps In Tax Research
S Corp 180200 Overview of Primary (Authoritative) and Secondary Sources
S Corp 180300 Statutory Source - The Internal Revenue Code
S Corp 180400 Administrative Authority - Regulations And Rulings
S Corp 180500 Federal Judicial Interpretations
S Corp 180600 California Law
S Corp 180700 Using Citators
S Corp 180800 Reference Sources
S Corp 180900 Exhibits

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180100 STEPS IN TAX RESEARCH

Once the tax issue is established, following is suggested methodology to assist in your tax research. There are 6 major steps to tax research:

- **Establish the facts.**

Evaluate the tax issue and obtain all relevant facts. To make a proper determination regarding a tax issue, it is necessary to ascertain and factually develop, i.e. document for the file, all the pertinent facts and circumstances pertaining to the issue under examination.

- **Organize what you need to do.**

Establish the implications of the tax issue and tax law - the correct reporting of the item and whether it impacts future taxable events. There are two distinguishable categories in regards to this step - fact and law. Issues of fact are those involving dates, amounts, reasonableness, intent, and purpose. Issues of law are those involving well-established facts. Uncertainty may arise (1) in the language of the statute itself, (2) between the language of the statute and the intent of the statute, or (3) between interpretations of the statute.

- **Locate the references and resources (the focus of this chapter)**.

- **Evaluate the authority.**

Evaluate the authorities (authoritative and references) and form recommendations towards the handling of the tax issue.

- **Develop conclusions and recommendations.**

Make formal recommendations based on conclusions drawn from research.

- **Communicate the recommendations.**

Communicate recommendations to the taxpayer/client. (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), Chapter 2)

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180200 OVERVIEW OF PRIMARY (AUTHORITATIVE) AND SECONDARY SOURCES

This step requires gathering pertinent information from sources such as Congress, the courts, federal and state governmental agencies, and various tax services.

Legal sources differ in the relative weight they are accorded. Some are binding authority; some are only persuasive in varying degrees; and some are useful only as tools for locating other materials. Researchers must evaluate the sources they find, and place them in the hierarchy of authority. The most important distinction is between *primary* (authoritative) and *secondary sources.* (Cohen, Morris L. and Olson, Kent C., *Legal Research In a Nutshell*, (West Publishing Company, 2000), Chapter 1)

S Corp 180201 Federal Primary Sources
S Corp 180202 Federal Secondary Sources

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180201 Federal Primary Sources

Primary authority (authoritative sources) comes from statutory, administrative, and judicial sources. [Caution: Some authoritative sources cannot be cited.]

Statutory sources include the Constitution, tax treaties, and tax laws that have been passed by Congress. Statutory authority is the basis for all tax provisions - the Internal Revenue Code (IRC).

Hierarchy of Tax Authorities

Authority	Issued By	Binding On	Cite
Internal Revenue Code	Congress	All Taxpayers	IRC §
Legislative Regulations [Authorized by specific Code section (other than IRC §7805)	Treasury	All Taxpayers	Reg. §
Interpretive Regulations (Issued under blanket authority of IRC §7805)	Treasury	All Taxpayers	Reg. §
Temporary Regulations	Treasury	All Taxpayers	Temp. Reg. §
Proposed Regulations	Treasury	Not binding until final	Prop. Reg. §
Procedural Regulations	IRS	IRS (sometimes)	26 C.F.R. §
Revenue Rulings	IRS	All Taxpayers	Rev. Rul.
Revenue Procedures	IRS	All Taxpayers	Rev. Proc.
Letter Rulings	IRS	Taxpayer Who Requested	P.L.R. or Ltr.Rul.
Technical Advice Memorandum	IRS	Taxpayer on Whose Behalf Issued	T.A.M.
Acquiescence or Nonacquiescence	IRS	No one	*Acq. Or Nonacq*.

[Taken from *Tax Procedure and Tax Fraud* by Patricia T. Morgan, *In a Nutshell Series*]

Administrative authority functions to interpret and explain the applicable provisions of the IRC and the intent of Congress. These are the various rulings of the Treasury Department and IRS Regulations, Revenue Rulings, and other pronouncements.

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Summary of IRS Rulings, Positions, and Practices			
Statement	**Issued/Made By**	**Publicized**	**Reliability**
Treasury Regulations	Secretary of the Treasury	Published in *Federal Register*	Most reliable statements of position
Revenue Rulings	Assistant Commissioners of Internal Revenue	Published in *Internal Revenue Bulletin* and collected in bound form in the *Cumulative Bulletin*	Intended to be relied on by IRS employees & taxpayers whose circumstances are substantially the same as described in the ruling
Letter Rulings	Assistant Commissioners of Internal Revenue	Available for inspection under Sec. 6110, not published by IRS. Published in *Internal Revenue Bulletin*	Binding on IRS only as to party to whom issued
Revenue Procedures	Assistant Commissioners of Internal Revenue	Published in *Internal Revenue Bulletin* and collected in bound form in the *Cumulative Bulletin*	Same reliability as revenue rulings
Technical Advice	Assistant Commissioners of Internal Revenue	Available for inspection under Sec. 6110, not published by IRS	Same as letter rulings
Determination Letters	District Offices in most cases	Available for inspection under Sec.	Binding only as to requesting taxpayer

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		6110	
Internal Revenue Manual	National Office	Available for inspection under Freedom of Information Act	Generally not binding on IRS
Information Releases	National Office	Published	May be binding on IRS
Information Letters	National Office/ District Offices	Issued to requester	Not binding
IRS Publications	National Office	Published	Not binding
Oral Communications	Any IRS official	Not Published	Generally not binding on IRS

Judicial authority consists of the collected rulings of the various courts.

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180202 Federal Secondary Sources

Works that are not themselves the law, but which discuss or analyze legal doctrine, are considered secondary sources. These include, but not limited to:

- Tax Services: Annotated or Topical
- Journals
- Textbooks
- Treatises
- Newsletters, etc.

[An annotated tax service is one organized in IRC order like CCH. A topical service is organized by topic like RIA.]

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180300 STATUTORY SOURCE - THE INTERNAL REVENUE CODE

The Constitution of the U.S. is the source for all federal laws of the country, including both tax and nontax provisions. Statutory sources include the Constitution, tax treaties, and tax laws that have been passed by Congress. Statutory authority is the basis for all tax provisions - the IRC.

S Corp 180301 Legislative Process to the Federal Tax Law
S Corp 180302 Committee Reports
S Corp 180303 Organization and Contents of the Internal Revenue Code

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180301 Legislative Process to the Federal Tax Law

Most tax legislation begins in the House of Representatives. In the House, the Ways and Means Committee considers tax law changes. Upon approval by this committee, the bill is sent to the full House of Representatives for approval. The bill is then sent to the Senate, where it is referred to the Finance Committee. When the Finance Committee approves the bill, the entire Senate considers the proposal.

If any differences between the House and Senate versions of the tax bill exist (which frequently occurs), the bill is referred to a Joint Conference Committee to resolve such differences. Both houses of Congress must approve the compromise bill before it is forwarded to the President. If the President signs the bill, the new provisions are incorporated into the IRC. If the President vetoes the bill, it is not enacted unless Congress overrides the veto with a sufficient revote. (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 56)

At each step in the legislative process, the appropriate committee of Congress produces a Committee Report.

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180302 Committee Reports

As stated above, the appropriate committee of Congress produces a Committee Report explaining the elements of the proposed changes and the reasons for each proposal. Committee reports are generally considered the most authoritative sources of congressional intent. (Cohen, Morris L. and Olson, Kent C., *Legal Research In a Nutshell*, (West Publishing Company, 2000), Chapter 6) These reports can provide insight concerning the meaning of a specific phrase of the statute or the intention of Congress concerning a certain provision of the law. A Public Law number generally refers to committee Reports. An example would be the Tax Reform Act of 1986, which was designated as P.L. 99-514. "P.L." stands for Public Law. The prefix "99" refers to the session of Congress that passed the law. The suffix "514" indicates that this was the 514th bill that this session of Congress adopted.

When a new tax law is passed, the Committee Report is printed in the IRS' weekly *Internal Revenue Bulletin.* The weekly IRS reports are reorganized and published every 6 months in the *Cumulative Bulletin*. However, texts of the 1954 Committee Reports relative to the IRC are found in the *United States Code Congressional and Administrative News*. All pre-1939 Revenue Act Committee Reports are reprinted in the 1939 *Cumulative Bulletin*.

Committee Reports can be found in:

- Cumulative Bulletins published by the Government Printing Office (GPO);
- Primary Sources published by Bureau of National Affairs (like the *Tax Management Portfolios*);
- Public Law Legislative History published by CCH;
- CCH's Citator Volume M-Z has a Committee Reports Index; and
- "Thomas" Federal Legislative Info.

Hint: Even though you can use the Lexis/Nexis database to find Committee Reports, these searches can literally produce hundreds of pages of text. A suggested alternative would be to look in the Cumulative Bulletin or the Working Papers of BNA's Tax Management Portfolios, which sometimes contain the applicable Committee Report.

Under the FEDTAX Library using the file called LEGIS, you will be able to locate the Reports. If you have the report's number, you can enter for your search, "Cite" then in "()" put the Report's number.

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Caution: Lexis/Nexis has Committee Reports dated from 1990. Access to these Reports dated prior to 1990 is questionable.

In addition to Committee Reports, there are the Floor Debate Reports. These reports include a summary of what was said on the House or Senate floor concerning the proposed bill. Floor debates are generally not as influential as Committee Reports. Floor Debate Reports can be found in the *Congressional Record* for the day of the debate.

The *Congressional Record* gives the following congressional history of a revenue act:

- The date the bill was introduced in the House Ways & Means Committee;
- The date it passed the House;
- The date it was introduced to the Senate Finance Committee;
- The date it passed the Senate;
- The date it was signed by the President.

The CCH Congressional Index or U.S. Code and Administrative News can trace this history.

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180303 Organization and Contents of the Internal Revenue Code

The IRC is part of the United States Code (USC), which is a codification of all of the federal laws of the U.S. The USC is organized alphabetically and assigned Title numbers. The IRC is Title 26 of the USC.

Organization of the IRC

1. Subtitles
2. Chapters
3. Subchapters
4. Parts
5. Subparts
6. Sections
7. Subsections (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 61)

IRC Citation

IRC §1031(a)(3)(B)(i)

1031	Section number 1031
(a)	Subsection a
(3)	Paragraph 3
(B)	Subparagraph B
(i)	Clause (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 65)

Summary of the IRC Subtitles and Chapters

(Listed are the most common subtitles and chapters that you may use for purposes of examining a tax issue.)

Subtitle A – Income Taxes

Chapter 1 - Normal Taxes and Surtaxes
Chapter 2 - Tax on Self-Employment Income
Chapter 3 - Withholding of Tax on Nonresident Aliens & Foreign Corporations
Chapter 4 - Repealed (Rules Applicable to Recovery of Excessive

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Profits on Government Contracts)
Chapter 5 - Tax on Transfers to Avoid Income Tax
Chapter 6 - Consolidated Returns
Subtitle B - Estate and Gift Taxes
Chapter 11 - Estate Tax
Chapter 12 - Gift Tax
Chapter 13 - Tax on Certain Generation-Skipping Transfers
Chapter 14 - Special Valuation Rules
Subtitle C - Employment Taxes and Collection of Income Tax
Chapter 21 - Federal Insurance Contributions Act
Chapter 22 - Railroad Retirement Act
Chapter 23 - Federal Unemployment Tax Act
Chapter 23A - Railroad Unemployment Repayment Tax
Chapter 24 - Collection of Income Tax at Source
Chapter 25 - General Provisions Relating to Employment Taxes and Collection of Income Taxes at Source
Subtitle D - Miscellaneous Excise Taxes
Chapter 31 - Retail Excise Taxes
Chapter 32 - Manufacturers Excise Taxes
Chapter 33 - Facilities and Services
Chapter 34 - Policies Issued by Foreign Insurers
Chapter 35 - Taxes on Wagering
Chapter 36 - Certain Other Excise Taxes
Chapter 37 - Repealed (Sugar)
Chapter 38 - Environmental Taxes
Chapter 39 - Registration-required Obligations
Chapter 40 - General Provisions Relating to Occupational Taxes
Chapter 41 - Public Charities
Chapter 42 - Private Foundations and Certain Other Tax-Exempt Organizations
Chapter 43 - Qualified Pension, Etc., Plans
Chapter 44 - Qualified Investment Entities
Chapter 45 - Repealed (Windfall Profit Tax on Domestic Crude Oil)
Chapter 46 - Golden Parachute Payments
Chapter 47 - Certain Large Group Health Plans
Subtitle F – Procedure and Administration
Chapter 61 - Information and Returns
Chapter 62 - Time and Place for Paying Tax
Chapter 63 - Assessment
Chapter 64 - Collection
Chapter 65 - Abatements, Credits, and Refunds
Chapter 66 - Limitations

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Chapter 67 - Interest
Chapter 68 - Additions to the Tax, Additional Amounts, and Assessable Penalties
Chapter 69 - General Provisions Relating to Stamps
Chapter 70 - Jeopardy, Receiverships, Etc.
Chapter 71 - Transferees and Fiduciaries
Chapter 72 - Licensing and Registration
Chapter 73 - Bonds
Chapter 74 - Closing Agreements and Compromises
Chapter 75 - Crimes, Other Offenses, and Forfeitures
Chapter 76 - Judicial Proceedings
Chapter 77 - Miscellaneous Provisions
Chapter 78 - Discovery of Liability and Enforcement of Title
Chapter 79 - Definitions
Chapter 80 - General Rules
Subtitle I - Trust Fund Code
Chapter 98 - Trust Fund Code

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180400 ADMINISTRATIVE AUTHORITY - REGULATIONS AND RULINGS

Administrative authority functions to interpret and explain the applicable provisions of the IRC and the intent of Congress. These are the various rulings of the Treasury Department and the IRS. Regulations, Revenue Rulings, and other pronouncements are summarized as follows.

4-1 Pronouncements by the IRS
- 4-1.1 Regulations
- 4-1.2 Revenue Rulings
- 4-1.3 Revenue Procedures
- 4-1.4 Letter Rulings
  - 4-1.4(a) Private Letter Rulings
  - 4-1.4(b) Determination Letters
  - 4-1.4(c) Technical Advice Memorandums

4-2 IRS Acquiescence and Nonacquiescence
4-3 Internal Revenue Bulletin
4-4 Bulletin Index-Digest System
4-5 Chief Counsel Memoranda

Miscellaneous Publications and Assistance

IRS Publications - Pub 17, etc.
FTB Publications and Assistance
Public: Pub X, Tax News, GTAM, MATM, etc.
Internal: Audit Branch Procedure Statements (ABPS), GTA-Xaminer, Trends, Legal Branch: Legal Reference and Legal Bulletin Board. There will be further discussion in this chapter regarding other forms of tax services and publications.
The Secretary of the Treasury has the general responsibility for administering the tax law. The IRS is the division of the Treasury Department assigned to manage the day-to-day operations associated with the administration of the provisions of the IRC. To facilitate the IRS' administration of the tax laws, the Code authorizes the Treasury Secretary to prescribe the rules and regulations that are necessary to administer the Code (IRC §7805(a)).

S Corp 180401 Pronouncements by the IRS
S Corp 180402 IRS Acquiescences and Nonacquiescences
S Corp 180403 Internal Revenue Bulletin
S Corp 180404 Bulletin Index-Digest System

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180401 Pronouncements by the IRS

There are generally four types of pronouncements: (1) Regulations, (2) Revenue Rulings, (3) Revenue Procedures, and (4) Letter Rulings.

a. Regulations

Regulations are issued in the form of Treasury Decisions (TD), which are published in the *Federal Register* and, at a later date, in the *Internal Revenue Bulletin*. Before a TD is published in its final form, it must be issued in proposed form for a period of at least 30 days before it is scheduled to become final. Before and during the hearing process, the TD's are referred to as "Proposed Regulations." Unlike Final Regulations, proposed regulations do not have the effect of law.

"Final Regulations" are integrated with previously approved TD's and constitute the IRS Regulations. Found in Title 26 of the Code of Federal Regulations, final regulations are either interpretive or legislative. IRC section 7805(a) authorizes the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement" of the statutes. Regulations issued pursuant to this broad authorization are referred to as *Interpretive Regulations*. In contrast, *Legislative Regulations* are issued for Code sections in which Congress has included a specific grant of authority, allowing IRS experts to write rules for highly technical areas. (See, e.g., IRC §469(l): "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, . . . ") Legislative regulations are regarded has having the force and effect of law. Therefore, a court is not free to strike down legislative regulations that are properly issued procedurally and that are within the scope of the legislative grant. (Morgan, Patricia T., Tax Procedure and Tax Fraud *In a Nutshell*, (West Publishing Company, 2000), Chapter 2.

Temporary Regulations are issued in response to congressional or judicial changes in tax law/interpretation. These types of regulations are effective immediately upon publication, but expire 3 years after issuance (per IRC §7805). IRC section 7805(e) requires that temporary regulations issued after November 20, 1988 also must be issued as proposed regulations. The issuance of these kinds of regulations is to provide the taxpayer with guidance concerning a new provision of the tax law. Temporary Regulations are treated as though they are final until Final Regulations are issued. Temporary Regulations must be followed

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until they are superseded, whereas Proposed Regulations, having been issued only to solicit comments and expose the IRS' proposed interpretation of the law, do not carry the full force of the law.

Because Treasury decisions have the specific approval of the Secretary of the Treasury, they are at the highest level of administrative interpretations of the IRC. This high rank is significant chiefly because of its binding effect on all IRS personnel including the Commissioner of the Internal Revenue. The Commissioner cannot change the regulations and the court will not sustain the Commissioner if a position contrary to the regulations is taken. Regulatory changes can only be made through the Treasury, not the courts. (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 80)

The section numbers of the Treasury Regulations are numbered in the same manner as the code section to which they relate, preceded by a numerical prefix indicating which tax is involved. The following table lists the major prefixes:

Prefixes for Treasury Regulations

Income Tax	1	Generation Skipping Tax	26
Estate Tax	20	Procedure and Administration	301
Gift Tax	25	IRS Procedural Rules	601

Thus, any citation of an income tax Regulation begins with the part number "1."and is followed by the number of the Code section to which it pertains.

<u>Regulation Citation</u>

Reg. §1.61-2(a)(1)

1.	Type of Regulation
61	Related Code Section
-2	Regulation Number
(a)	Regulation Paragraph
(1)	Regulation Subparagraph (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 82)

Whenever a Code section is amended, existing regulations should be reconsidered. They may no longer be relevant or may even be invalid. If a

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regulation appears to contradict statutory language, check the date of its most recent TD to see if it predates the Code section. (Richmond, Gail Levin, *Federal Tax Research-Guide to Material and Techniques*, (The Foundation Press, Inc., 1997) pg., 87)

b. Revenue Rulings

Revenue Rulings (abbreviated "Rev. Rul.") are official pronouncements of the national office of the IRS in which the Code and Regulations are applied to specific factual situations for the purpose of informing and advising taxpayers. Rev. Ruls. do not carry the force and effect of a Regulation. A ruling is an informal statement of the Service's position. Rev. Ruls. may be relied on and cited if the facts and circumstances are "substantially the same" as those described in the revenue ruling. They can be found weekly in the *Internal Revenue Bulletin (I.R.B.)* and later in the *Cumulative Bulletin (C.B.)*.

A regulation has priority over a revenue ruling in the event of conflicting positions.

A court may declare a revenue ruling invalid, however, the IRS is bound by the ruling until such time as it is revoked or modified. Court cases may be cited which support a reporting position that opposes the government's position as reflected in the revenue ruling.

Citation of a Revenue Ruling - Temporary Citation

Rev. Rul. 95-45, IRB 1995-4, p. 10. (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 85)

95	Year Ruling was issued (1995)
-45	Ruling number for that year
IRB 1995	Reference to the *IRB*
-4	Weekly issue of the IRB
p, 10	First page in the IRB that includes the Ruling

Citation of a Revenue Ruling - Permanent Citation

Rev. Rul. 95-45, 1995-1 CB 54 (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 87)

95	Year Ruling was issued

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-45	Ruling number for that year
1995-1	Volume number of the *CB*
CB	Reference to the CB
54	First page in the CB that includes the Ruling

The current status of a revenue ruling or other IRS rulings is contained in the most current index to the *C.B.* It is crucial to verify the ruling has not been superseded or revoked.

c. Revenue Procedures

Revenue Procedures (abbreviated "Rev. Procs.") deal with the internal practice and procedures of the IRS in its administration of the tax laws. They are statements of procedure that affect the rights and duties of taxpayers or other members of the public under the Code, or information that should be a matter of public knowledge. While they have less force and effect than Treasury Regulations, the IRS is bound by them and taxpayers may rely upon them.

Revenue Procedures are first published in the weekly *I.R.B.* Later, they are included in the *C.B.* Like Revenue Rulings, Rev. Procs. are first adopted temporarily and later become permanent.

The first three Rev. Procs. issued by the IRS each year details the rules concerning how to request a private ruling, national office advice request, and issues on which they will not rule.

Because the IRS often reviews revenue rulings and procedures for their continued relevance, it is important to verify the current status of the ruling or procedure. The following is a list of terms and their definitions frequently used in revenue rulings and procedures.

Terminology Used in Revenue Rulings and Procedures

Amplified - describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to "A", and the new ruling holds that the same principle also applied to "B", the earlier ruling is amplified (compare to *modified*, which is described below).

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Clarified - is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, confusion. It is not used where a position in a prior ruling is being changed.

Distinguished - describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified - is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to "A" but not to "B", and the new ruling holds that it applies to both "A" and "B", the prior ruling is modified because it corrects a published position.

Obsolete - describes a previously published ruling that is not considered determinative with respect to future transactions.

Revoked - describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded - describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling(s).

Supplemented - is used in situations in which a list, such as a list of name of countries, is published in a ruling and that list is expanded to include additional names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes an aggregate list as contained in the original and all subsequent rulings. The new ruling supersedes all prior rulings in the series.

Suspended - is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Definitions came from the Cumulative Bulletin's section called "Definition of Terms".

d. Letter Rulings

Letter Rulings are issued in several forms: (1) Private Letter Rulings, (2) Determination Letters, and (3) Technical Advice Memorandums.

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IRC section 6110(k)(3) specifically limits the precedent use of any of these written determinations - "written determinations may not be used or cited as precedent." They cannot be cited as authority in a tax matter, but can be used as guidelines in respect to a tax problem. Although these Letter Rulings cannot be cited as precedence in defending a tax position, their analysis and conclusion can be presented.

The FTB generally follows federal regulations, procedures, and rulings where provisions of the California tax law substantially conform to provisions of the IRC. (FTB Notice 89-277; R&TC §§17024.5(d) and 23051.5(d)) However, federal regulations and procedures are not binding on the department for California tax purposes if an authorized FTB officer or employee publicly indicated in writing that the FTB would not follow a particular ruling or procedure (FTB Notice 89-277).

While there is no official publication that maintains Letter Rulings, Private Letter Rulings are available on most computerized tax research services such as Lexis/Nexis and CCH. CCH also has a Private Letter Ruling tax service called *Private Revenue Service Letter Rulings*, where the pronouncements are provided in summary form in a binder. Full text of the determinations is available through the IRS, the *Daily Tax Report* (Bureau of National Affairs), IRS Private Letter Rulings (Washington Service Bureau, Inc.) and *Tax Notes* (Tax Analysts and Advocates).

d1. Private Letter Rulings (PLR)

PLR's (private rulings or letter rulings) are issued by the IRS (National Office of the IRS) in response to a taxpayer's request for the Service's position on a specific tax issue. A PLR is issued only to the taxpayer who requested the Ruling. However, this Ruling can be used as "substantial authority" upon which the taxpayer (any taxpayer, not just the taxpayer requesting the PLR) may rely to avoid certain statutory penalties.

Although PLR's are an important source of IRS information, they cannot be cited as authority. Their analysis and conclusion, however, can be presented as the basis for an audit determination.

PLR's many times serve to inspire the issuance of Revenue Rulings describing similar situations. The IRS will issue Rev. Ruls. in situations where they

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determine a need. For example, increased public interest in a particular issue, or numerous PLR requests.

d2. Determination Letters

The office of the local IRS District Director issues determination Letters. These letters generally deal with issues and transactions not overtly controversial, but are completed transactions rather than proposed. Generally, determination letters concern inquires regarding employee plans and exempt organizations.

Only the taxpayer to whom it is issued may rely on a determination letter, and may be revoked or modified if found to be in error.

d3. Technical Advice Memoranda (TAM)

A TAM is issued by the IRS' National Office, which makes it similar to a PLR but not a Determination Letter. An IRS agent requests a TAM during the course of an examination. The request, based on a completed transaction, is made in situations where the agent's local office cannot provide satisfactory technical guidance. Like PLR's, a TAM may be relied on only by the taxpayer for whom the technical advice was requested. Other taxpayers cannot rely upon the TAM.

Although we can use the TAM's analysis and conclusions to support an audit determination, it cannot be cited as authority. TAM's can lead to the creation of a Rev. Rul.

e. Chief Counsel Memoranda

A General Counsel's Memorandum (GCM)/Technical Memoranda/Actions on Decisions (AOD) is generated upon the request of the IRS. The GCM typically is requested to assist the IRS in the preparation of Rev. Ruls. and PLR's. GCM's are seldom issued except to repeal old GCM's. Like Private Letter Rulings and Technical Advice Memorandums, GCM's cannot be cited as authority but can be used as a guideline in arriving at an audit recommendation. GCM's also qualify

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as “substantial authority”. The full text of the memoranda is unofficially published in *Tax Notes* as well as in Lexis. *IRS Positions* by CCH maintains these publications as well.

f. Action on Decision

An Action on Decision (AOD) is prepared when a significant adverse decision is rendered against the IRS by a trial or appellate court. The text of the AOD recommends the action, if any, that the IRS should take in response to the adverse decision. The recommendation is summarized as an acquiescence, a nonacquiescence, or an acquiescence in result only.

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180402 IRS Acquiescences and Nonacquiescences

When the IRS loses a regular decision in the Tax Court (TC), the Commissioner of the IRS may acquiesce or nonacquiesce to the decision.

- If the Commissioner *acquiesces*, this indicates that the TC decision, although it was adverse to the IRS, will be followed in similar situations.
- If the Commissioner *nonacquiesces*, the IRS disagrees with the adverse decision in the case and will follow it only for the specific taxpayer whose case resulted in the adverse ruling.
- An acquiescence or nonacquiescence is not issued if the IRS prevails in a regular TC case, since the IRS agrees with the pertinent holdings.

Nonacquiescence may indicate to the tax practitioner that the IRS is likely to challenge a similar decision for the taxpayer in a case that has a similar fact situation. The issuance of an acquiescence does not necessarily mean that the IRS agrees with the adverse decision, but rather only that it will not pursue the matter.

Acquiescence and nonacquiescence are indicated in the citations of TC decisions in the tax services and citators. An “A” or “Acq” is contained in parentheses after the citation to indicate acquiescence, “NA” or “Nonacq” to indicate nonacquiescence. (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West’s Federal Tax Research*, (West Publishing Company, 1991), pg. 96)

IRS acquiescence and nonacquiescence are published in the *I.R.B.* prior to 1993 and, thereafter, in the *C.B.* The *I.R.B.* index lists acquiescence and nonacquiescence alphabetically and in code section order. Beginning in 1993, the use of acquiescence and nonacquiescence expanded to cover civil tax cases, memorandum Tax Court Opinions, U.S. district courts, Claims Court and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will be published in the *I.R.B.*

(Note: In regard to IRB’s prior to 1993 - a statement that “prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular TC opinions The *Cumulative Bulletin 1993-1* was the first CB after *Cumulative Bulletin 1992-2* to publish the acquiescence/non-acquiescence decisions in this manner. To better understand this, you may want to refer to the Cumulative Bulletins.)

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180403 Internal Revenue Bulletin

The *Internal Revenue Bulletin* (*I.R.B.*) is the IRS's official publication of its pronouncements. You will find publications of:

- IRS Revenue Rulings
- Revenue Procedures
- Acquiescence and nonacquiescence to regular Tax Court decisions (prior to 1993)
- Acquiescence/nonacquiescence to other courts (beginning in 1993)
- New tax (public) laws
- Committee Reports
- New Tax Treaties
- Treasury Decisions (which become Regulations)
- Other notices.

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180404 Bulletin Index-Digest System

In the *I.R.B.*, a comprehensive index of matters is published quarterly consisting of 4 separate services:

- *Income Tax*, Publication 641
- *Estate and Gift Taxes*, Publication 642
- *Employment Taxes*, Publication 643
- *Excise Taxes*, Publication 644

The System contains separate finding lists for Revenue Rulings and Procedures, Public Laws amending the IRC, and Treasury Decisions amending the pertinent Regulations. There are a number of special finding lists for each of the following:

- Supreme Court Decisions
- Certain Tax Court Decisions
- Revenue. Rulings and Revenue Procedures issued under Tax Conventions
- Miscellaneous items published in the Bulletin
- Lists of Revenue Rulings and Revenue Procedures
- Actions relative to published Revenue Rulings and Revenue Procedures
- Public Laws that have been published in the Bulletin
- Tax conventions and related items published in the Bulletin

A major portion of the System consists of digests, i.e. - brief summaries of: (1) Revenue Rulings and Procedures, (2) Supreme Court decisions, (3) adverse (to the government) TC decisions in which the Commissioner has announced acquiescence or nonacquiescence, and (4) Executive Orders, Treasury Department Orders, Delegation Orders, and certain other miscellaneous items that have been published in the *C.B.*

The Bulletin Index-Digest System is organized to identify the IRS' position on any tax issue published in the IRB. It can be used by "Subject Matter" or "Code Section."

The "Subject Matter" approach is one that entails - (1) scanning of the list of topical headings under which the digests are arranged, (2) the identification of a key word or words that best describe the research issue, (3) a review of the digests that are indexed under the chosen key word or words, and (4) a selection of the relevant digests for further study.

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The “Code Section” approach is one that entails - (1) a location in the System finding lists of the desired Code or Reg. Section that pertains to the issue, (2) identification of those items that are listed under the selected Code or Reg. Section that pertains to the research issue, and (3) scanning related digests for the chosen items to ascertain whether the facts that are addressed in the identified Bulletin digest are substantially the same as those of the client for whom the research is being conducted. The System does not have a finding list for revenue rulings, revenue procedures, Supreme Court decisions or Actions on Decisions of the Tax Court that relate to the 1939 Code. (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West’s Federal Tax Research*, (West Publishing Company, 1991), pg. 98)

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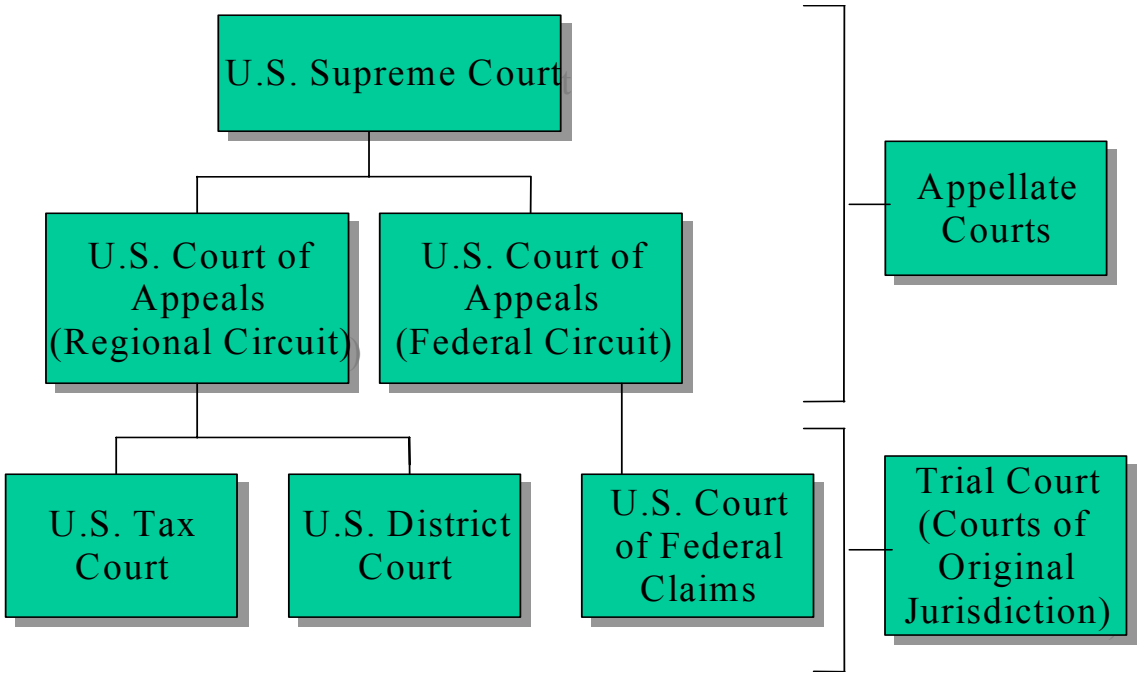
180500 FEDERAL JUDICIAL INTERPRETATIONS

Judicial interpretations are those that are determined under the federal court system. When additional issues regarding the proper interpretation or intended application of the law, which are not answered either in the law itself or in the administrative pronouncements, the judicial system is left with this task.

For the federal system, all litigation between the taxpayer and the government begins in a trial court. Following is a pictorial elaboration of the federal court system.

The Federal Court System



Note that prior to October 1, 1982, decisions of a court called the U.S. Court of Claims (now the U.S. Court of Federal Claims) could be appealed only to the U.S. Supreme Court.

S Corp 180501	Tax Courts (TC)
S Corp 180502	The District Court
S Corp 180503	U.S. Court of Federal Claims
S Corp 180504	U.S. Courts of Appeal

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

S Corp 180505 Supreme Court
S Corp 180506 The Federal Judicial Obstacle Course: Selected Attributes of the Trial-Level Courts

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180501 Tax Courts (TC)

The TC, referred to as the Board of Tax Appeals (BTA) prior to 1943, issues "regular" and "memorandum" decisions by judges who have more expertise in handling tax matters. There are a total of 13 circuits in the U.S.; the state of California is in the 9th Circuit. A regular decision generally involves a new or unusual point of law, as determined by the Chief Judge of the Court. If the Chief Judge believes, however, that the decision concerns only the application of existing law or an interpretation of factual questions, the decision is issued as a memorandum decision. Note that the Court has not always strictly followed this policy. Memorandum decisions may address significant points of law or other issues. (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 116)

Because the TC is a national court, it hears cases that may be appealed to the Courts of Appeal (refer to chart above - The Federal Court System) in different geographical regions or Circuits. The TC would follow the Court of Appeals that has jurisdiction over the taxpayer whose case is before the TC (*Jack E. Golsen and Sylvia H. Golsen vs. Commissioner*, 54 TC 742(1970)). If the Court of Appeals that has jurisdiction over the taxpayer has not ruled on the matter, the TC will decide the case on the basis of its own interpretation of the item under dispute. This *Golsen* rule means that the TC may issue opposite rulings based on identical fact patterns for taxpayers who can be differentiated solely by the geographical area in which they live.

An example of jurisdictional precedence can be found in *Selfe v. U.S.*, 778 F.2d 769, 86-1 USTC 9115, 57 AFTR 2d 86-464 (11th Cir. 1985)]. In this case, the 11th Circuit rendered a decision regarding shareholder guarantees as qualifying indebtedness in an S corporation (refer to S Corp 090000 for a detailed analysis of this case and the ramifications thereof). California follows 9th circuit decisions, therefore, we are not obligated to follow the *Selfe* decision rendered in the 11th Circuit. In addition, *Selfe* severely limited its application through facts and circumstances. As a result, subsequent TC cases have taken contrary positions by distinguishing the fact patterns.

It should be noted that distinguishing between the circuits is one point of reference that can be used in arriving at a tax recommendation and should not be used as a stand-alone point of reference.

<u>Temporary Citation - Tax Court Regular Decision</u>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

Manson Western Corp., 76 TC -, No. 91 (1981) (Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 116.)

Manson Western Corp.	Case Name
76	Volume Number of Tax Court Reporter
TC	Reference to Tax Court Reporter
No. 91	Tax Court Decision Number
(1981)	Year Opinion was Issued

Note: Temporary citations include no page numbers for the case because it has not yet been published.

Permanent Citation-Tax Court Regular Decision

Once the Government Printing Office publishes the decision in a permanent bound edition of the regulation TC cases, the temporary citation becomes obsolete.

Manson Western Corp., 76 TC 1161 (1981)

Manson Western Corp.	Case Name
76	Volume Number of Tax Court Reporter
TC	Reference to Tax Court Reporter
1161	First Page in the Tax Court Reporter that Includes the Case
(1981)	Year Opinion Issued

Note: A more traditional citation would be *Manson Western Corp. v. U.S. or Manson Western Corp. v. Commissioner*. The citation in the example above is common practice (where defendant in action is omitted) because it is the government who is the defendant and such reference could be inferred from the notation for the court in which the lawsuit is heard.

Temporary Citation-Tax Court Memorandum Decision
(Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 119)

Walter Johnson, TC Memo 1975-245

Walter Johnson	Case Name
TC Memo	Reference to TC Memo Decision
1975	Year Opinion was Issued
-245	Memo Decision Number

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Permanent Citation - Tax Court Memorandum Decision
(Raabe, William A.; Whittenburg, Gerald E.; and Bost, John C., *West's Federal Tax Research*, (West Publishing Company, 1991), pg. 120)

Walter Johnson, 34 TCM 1056 (1975)

Walter Johnson	Case Name
34	Volume Number of the TCM Reporter
TCM	Reference to the TCM Reporter
1056	First Page in the TCM Reporter that Includes the Case
(1975)	Year Opinion Issued

Note: Above is a CCH citation. An example of a Prentice Hall Citation is: PH TC Memo Dec. ¶75,245

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180502 The District Court

Federal district courts hear cases involving legal issues that are based upon the entire body of federal law and the U.S. Constitution, not just the IRC. Therefore, these judges are typically generalists.

There are three sources for finding district court decisions:

- West Publishing has the Federal Supplement Series - abbreviated as 'Fsupp'.
  Ex: *Simons-Eastern v. U.S.,* 354 FSupp 1003 (D.Ct. Ga., 1972)
- Prentice Hall had the American Federal Tax Reports - abbreviated as 'AFTR'. The second series of this reporter is in use where '2d' will follow after 'AFTR'.
  Ex: *Simons-Eastern v. U.S.,* 31 AFTR2d 73-640 (D.Ct. Ga., 1972)
- Commerce Clearing House has the U.S. Tax Cases - abbreviated as "USTC".
  Ex: *Simons-Eastern v. U.S. 73-1 USTC* ¶ 9279 (D.Ct. Ga., 1972)

Note: the Research Institute of America (RIA) purchased Prentice Hall (PH).

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180503 U.S. Court of Federal Claims

On October 1, 1982, two new courts replaced the U.S. Court of Claims: the U.S. Claims Court and the U.S. Court of Appeals for the Federal Circuit. In 1992, the Claims Court was renamed the U.S. Court of Federal Claims. (Morgan, Patricia T., Tax Procedure and Tax Fraud *In a Nutshell*, (West Publishing Company, 2000), Chapter 6.)

The U.S. Court of Federal Claims is located only in Washington, D.C. but is authorized to hold sessions throughout the country. While the judges do hear a large number of tax refund cases, they generally are not specialists in technical tax law.

The Court of Federal Claims must follow the decisions of the former Court of Claims, the U.S. Court of Appeals for the Federal Circuit and the U.S. Supreme Court. Unlike the TC or federal district courts, the U.S. Court of Federal Claims is not bound by the regional Circuit Courts of Appeal that have ruled on similar issues or by the Court of Appeal for the Circuit in which the taxpayer works or resides (*Golsen* rule). This may be important to a taxpayer whose Circuit has held adversely to his or her position on the disputed issue.

Like the federal district courts, West, PH, and CCH publish the U.S. Claim Court citations. These are example citations for finding U.S. Claim Court cases by these publishers:

- (West) *Ambrose v. U.S.*, 4 ClCt 352 (1984)
- (PH) *Ambrose v. U.S.*, 53 AFTR2d 84-650 (ClsCt).
- (CCH) *Ambrose v. U.S.,* 84-1 USTC ¶9185 (ClsCt)

Note: Since October 30, 1992, cases decided by the U.S. Court of Federal Claims can also be found in the U.S. of Federal Claims Reporter (Fed. Cl.).

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180504 U.S. Courts of Appeal

This is the first level of the federal appellate courts. It considers both tax and nontax litigation. The 11 Courts of Appeal are organized geographically into circuits.
Like the federal district courts and U.S. Claims Court, West, PH and CCH publish the Court of Appeals citations. These are example citations for finding U.S. Court of Appeals cases by these publishers:

- (West) *D.C. Crummey v. U.S.,* 397 F2d 82 (CA-9, 1968)
- (PH) *D.C. Crummey v. U.S.,* 22 AFTR2d 6023 (CA-9, 1968)
- (CCH) *D.C. Crummey v. U.S.,* 68-2 USTC ¶12,541 (CA-9)

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180505 Supreme Court

The U.S. Supreme Court is an appellate court and the highest court in the nation. This is the final level of appeal and the sovereign legal authority. The cases are heard in Washington, D.C. A U.S. citizen does not have an automatic right to have his or her case heard by the Supreme Court. The Court's permission to present the case is petitioned by a *Writ of Certiorari*. Under this procedure, "certiorari is granted" when the Court decides to hear the case; "certiorari is denied" if the Court refuses to hear the case. Neither the citizen nor the government can appeal a Supreme Court decision.

If the Court denies the petition for certiorari, the Supreme Court is not "upholding", or in any way confirming, a lower court decision. Only about a dozen tax cases are heard each year.

The following publishers make U.S. Supreme Court citations: West, PH, CCH, Lawyer's Cooperative, and GPO. These are example citations for finding U.S. Supreme Court citations by these publishers:

- (West) *Helvering v. Clifford,* 60 SCt 554 (1940)
- (PH) *Helvering v. Clifford,* 23 AFTR 1077 (USSC, 1940)
- (CCH) *Helvering v. Clifford,* 40-1 USTC ¶ 9265 (USSC)
- (Lawyer's Cooperative) *Helvering v. Clifford,* 84 L.Ed. 788(1940)
- (GPO) *Helvering v. Clifford,* 309 US 331 (1940)

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180506 The Federal Judicial Obstacle Course: Selected Attributes of the Trial-Level Courts

Item	Tax Court	District Courts	Court of Federal Claims
Jurisdiction	Tax cases only	Legal issues - based on entire U.S. Code	Monetary claims against U.S.
Judges	Tax law specialists	Tax law generalists	Tax law generalists
Domain	National court, but judges travel	Limited geographical area	National court, but judges travel
Jury Trial Available	No	Yes	No
Number of judges hearing the case	One, reviewed by Chief Judge - “en banc” hearing for certain issues	One	One to five
Small Cases division available	Yes	No	No
Payment of tax	Trial, then payment	Payment, then trial	Payment, then trial
Precedents court must follow	Supreme Court; pertinent Circuit Court; Tax Court	Supreme Court; pertinent Circuit Court; own District court	Supreme Court; Federal Circuit Court; Claims Court

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180600 CALIFORNIA LAW

S Corp 180601 The California Legislative Process
S Corp 180602 Legislative Intent
S Corp 180603 The California Code
S Corp 180604 The California Regulations
S Corp 180605 California Rulings
S Corp 180606 The California Court System

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180601 The California Legislative Process

Like the federal process, there is a multi-step process that creates tax law for California. For a summary and pictorial diagram of California's legislative process see Exhibit 180000-1.

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180602 Legislative Intent

Federal law expresses its congressional intent in the way of Committee Reports. California legislative intent (for a bill) can be found in the following:

- *California State Tax Reporter (CCH)*
- *West's Annotated California Codes*

The CCH *California State Tax Reporter* maintains the State Legislature Committee Reports. *West's Annotated California Codes* does not provide the intent, but provides a good source of legislative history.

In regards to the Lexis/Nexis database, the following is available:

- To find Committee events, check the California legislative committee analysis for California legislation from 1989. This can be done by issue or bill number/committee. Use the Library called "CODES", the File called "CACOMM", and enter the state bill number (s.b. #) or issue.

  This allows you to analyze the intent of the legislation for the tax law and summarize what took place for this bill in committee.

- To view California bill summaries and texts, use the Library called "CODES", the File called "CABILL", and enter the issue.

- To see what all 50 states are doing in regards to summaries and legislative history of bills pending in state legislatures, use the Library called "CODES", select the File called "STTRCK", and enter the issue.

- If you are interested in a particular state, use the Library "CODES" and select the File for the particular state. For instance, the state of Georgia would be under the file "GATRCK", the state of Tennessee, "TNTRCK".

- If you were interested in tracking the legislation that took place for a particular year (1994 for instance), use the Library "CODES", the file "TRCK94" (to track the year 1994), and enter the issue.

- The Lexis/Nexis database researches the full text and summaries of bills dating back to 1991, which is available for all 50 states.

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180603 The California Code

In 1993, the California Code was organized into three portions:

- Personal Income Tax Law (PITL) - Part 10
- Administrative Law- Part 10.2
- Corporation Tax Law (CTL) - Part 11

Each portion has its own topical index, cross-reference chart, and detailed law table of contents. Prior to 1993, administrative provisions were contained in both Parts 10 and 11. Beginning in 1993, a new Part (Part 10.2) was created to omit duplication of administrative provisions under both the PITL and CTL. As a result, repealed sections were renumbered and placed in Part 10.2.

The California code is organized as follows:

- Title
- Division
- Part
- Chapter
- Article
- Section
- Subdivision
- Paragraph
- Subparagraph
- Clause
- Subclause

Following is a comparison of the organization between the federal and California codes:

Federal Term	Example		Example
U.S. Code	Internal Revenue Code	California Code	Revenue & Taxation Code
Title	26 - Income, Employment, Estate, & Gift Tax Provisions	Title	18 - Public Revenues
Subtitle	A - Income Taxes	Division	2 - Other Taxes

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Chapter	1 - Normal Surtaxes	Part	10 - PIT Law 10.2 - Administrative Law 11 – Corp Tax Law
Subchapter	A - Determination of Tax Liability	Chapter	3 - Computation of Taxable Income
Part	IV – Nonrefundable Credits	Article	II - Items Specifically Included in Gross Income
Subpart	A - Nonrefundable Personal Credits	No Comparable Term	----------
Section	21 - Child Care Credit	Section	17052.6 - Child Care Credit
Subsection	(e)	Subdivision	(a)
Paragraph	(4)	Paragraph	(2)
Subparagraph	(A)	Subparagraph	(A)
Clause	(i)	Clause	(i)
Subclause	(II)	Subclause	(II)

Source: Legislative Services Bureau's Legislative Bill Analysis Handbook for Program Staff Contacts.

The California Code utilizes two types of languages:

- Independent language or "stand alone" language, and
- "Pick-up language" (incorporation of federal law by reference).

Independent language ("stand alone") provisions are sections that do not rely on the IRC to determine California law.

"Pick-up language" (incorporation of federal law by reference) is that which California does not automatically conform to added/amended provisions of the IRC. The incorporation process requires specific language in state law. In some instances, there are substantial portions of federal law incorporated into California law, such as an entire subchapter. However, there are situations where an individual section or subsection may be incorporated by reference. When federal language is incorporated, there is usually a "related to" clause that describes the subject area. These clauses are descriptive in nature and are not intended to be a limitation. In general, the "related to" clause is merely the title of the section (or subsection) of federal law that is being incorporated.

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California's conformity with federal law can be found in various publications. *Bock* and *CCH - California Income Tax Laws and Regulation Annotated* also contains a cross-reference listing.

In situations involving "pick-up language", it is crucial to determine which version of the IRC is applicable. Refer to the end of the amended/added provision. This section contains all prior readings of the code and/or public law and the applicable conformity date(s).

Since the IRC is constantly changing, it was necessary for California to create the concept of a "specified date" to identify which version of the IRC California has conformed. The "specified date" freezes state law to that which is already known and precludes unintended conformity to subsequent changes in federal law. Changes in federal law do not automatically change state law. The State legislature must first review federal changes and modify the "specified date" before such changes can become effective.

Note: R&TC section 17024.5(a)(1) has not been modified since 1998. Unless specifically provided in the code for all years beginning on or after January 1, 1998, the applicable version of the IRC is as it read on January 1, 1998. R&TC section 17024.5, however, contains a partial list of federal provisions that are not applicable for state purposes.

In regards to the Lexis/Nexis database, use the *Lexstat* feature to retrieve a code section. For example, if you were looking for Idaho Code section 63-3027b, you would enter: lxt id code 63-3027b.

If you want to research all of the 50 states' codes for a particular issue, use the Library called "CODES", select the File called "ALLCDE", and enter your issue. If you want a particular state, use the same Library ("CODES"), the File for that particular state (California, use the File "CACODE"), and enter your issue.

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180604 The California Regulations

Although Federal Treasury Regulations are applicable to California law, there may be exceptions due to California's own "set" of regulations.

The California Regulations are organized as follows:

- Title
- Division
- Chapter
- Subchapter
- Article
- Section

California regulations are in Title 18, Public Revenues, Division 3, and Franchise Tax Board. The remainder of California's regulations fall under their perspective Chapters, Subchapters, etc. There may not always be a subchapter or an article for the regulation.

The resource for finding California Regulations is *Barclays Official Code of Regulations* (a loose-leaf binder) or a binder containing a CCH publication of the regulations. Because the regulation numbers in large part parallel the law section, the regulation text also follows the law text in CCH - *California Income Tax Laws and Regulations Annotated.*

California regulations can be found at any on-line research service, such as Lexis/Nexis, RIA and CCH.

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180605 California Rulings

Generally, there are two types of California Rulings: Published and Private Advance Rulings/Correspondence (See FTB Notice 1989-277).

a. Published Rulings

Published Rulings are issued as an on-going effort to keep the public informed about FTB's interpretation of certain tax laws and to provide general procedures to be followed by taxpayers with respect to administrative procedures. Published Rulings consists of Legal Rulings, FTB Notices, and Informal Announcements or News Releases.

a1. Legal Rulings

Legal Rulings are state equivalents to the IRS Revenue Rulings, and are issued to publish FTB's official conclusion on how the law is applied to a specific set of facts. Legal Rulings are mere interpretation of existing tax law and therefore have retroactive effect, unless otherwise stated in the ruling.

If a Legal Ruling is published, the ruling can be cited as an interpretation of the tax law. Legal Rulings are not authoritative, however, they can be cited as FTB's official interpretation of the tax law. The Board of Equalization as well as the California court system may consider and attribute some weight to Legal Rulings in their decisions. For example, in *Tenneco West, Inc. v. Franchise Tax Board,* (1991) 234 Cal. App. 3d 1510, the court relied on FTB Legal Ruling 413, concluding that the apportionment factor in the year of the installment sale should be applied against subsequent receipt of the installment payments, rather than the apportionment factor in the year of receipt for installment payments.

Legal Rulings can be found at any on-line research service, such as Lexis/Nexis, RIA, and CCH, as well as FTB's legal web page. The more recent Legal Rulings are cited as "Legal Ruling 01-04 or FTB LR 2001-4", which identifies the year of the ruling as well as the legal ruling number.

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a2. FTB Notices

FTB Notices are state equivalents to the IRS Revenue Procedures and Notices, and are generally issued to provide information concerning procedural compliance issues, well-established principles, statutory changes, court decisions, new or revised FTB publications, proposed regulations, or other matters of an administrative nature. Unlike Legal Rulings, FTB Notices are not offered as substantive interpretation of the tax law, therefore are not generally cited by auditors.

FTB Notices can be found on the FTB's legal web page.

a3. FTB Informal Announcements or News Releases

Informal Announcements or News Releases are information sources published by the FTB to inform taxpayers of certain tax laws, important court or administrative decisions, or policy by FTB. Informal Announcements or News Releases can be found in the *Tax News* newsletter, FTB's website (www.ftb.ca.gov), speaking engagements provided by FTB to the public, etc.

b. Private Advance Rulings and Correspondence

FTB answers inquiries of individuals and organizations, when appropriate in the interest of sound tax administration, about their status for tax purposes and the tax effects of their acts or transactions. FTB has the discretionary authority to issue advance rulings. FTB will normally decline to issue an advance ruling in areas including, but not limited to, where:

- The request involves an area in which the IRS has announced that it will not issue advance rulings, including alternative plans of proposed transactions and hypothetical situations;
- Either the taxpayer's name or identifying number is not provided;
- The requester is a professional preparer or representative acting on behalf of a taxpayer and has not provided his or her legal analysis and conclusion with the request;
- The law is clear and reasonably thorough research would provide the answer;
- State and federal law are the same (unless a specific statutory or regulatory authority requires such a ruling);
- The answer to the question depends on factual issues. For example: whether a unitary business exists, or the value of property as of a certain date; and

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- The question involves an issue that is subject to an existing audit, appeal or protest with respect to that taxpayer or where the issue is currently on appeal or in court.

Otherwise, FTB issues three types of private advance rulings: Chief Counsel Rulings, Opinion Letters, and Information Letters.

b1. Chief Counsel Rulings

Chief Counsel Rulings are the FTB counterparts to the IRS Letter Rulings. A Chief Counsel Ruling is a written statement that interprets and applies California tax law to the taxpayer's specific set of facts.

R&TC section 21012(a)(1) provides that taxes, interest, additions to tax and penalties may be relieved if a person's failure to make a timely return or payment was due to the person's reasonable reliance on the written advice of a legal ruling by the chief counsel, and all the conditions set forth in R&TC section 21012(b) are met. Thus, only the taxpayer making the request will be entitled to rely on these rulings, and can be relieved of tax, penalties, interest, and additions as long as all the conditions set forth in R&TC section 21012(b) are met, which includes the following:

- The person or representative requested in writing that the FTB advise him or her whether a particular prospective activity or transaction is subject to tax, and fully described the facts and circumstances of the transaction or activity in the request. If the request is for a Chief Counsel Ruling, the request shall specifically so state.
- The FTB responded in writing, stating whether the described activity is subject to tax, or stating the conditions under which the activity or transaction is subject to tax.
- The person reasonably relied on the advice and did not remit the tax due.
- The ruling was not rescinded or revoked before the taxpayer relied on it or before the occurrence of the procedure, transaction or activity.
- There has not been a change in applicable state or federal law or in the taxpayer's facts and circumstances.

b2. Opinion Letters

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Opinion Letters are the FTB counterparts to the IRS Determination Letters. Opinion Letter is a written statement that applies the principles and precedents previously announced by the FTB to a specific set of facts. It is issued when a determination can be made based on clearly established rules in a statute, regulations, or based on a conclusion in a Legal Ruling, Board of Equalization opinion or court decision that specifically answers the question presented.

A taxpayer making the request for Opinion Letters is also entitled to R&TC section 21012(a)(1) relief as long as R&TC section 21012(b) requirements are met.

b3. Information Letters

Information Letters are the FTB counterparts to the IRS Information Letters. An information Letter provides a general discussion of a well-established interpretation of tax law without applying it to a specific set of facts. Information Letters are only advisory and have no binding effect on the FTB; therefore the relief provisions of R&TC section 21012 do not apply.

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180606 The California Court System

The California court system for tax cases is generally comprised of three tiers; Superior Court, Court of Appeals, and Supreme Court. Any case issued for publication within the California court system is citeable; however, the higher the court, the more precedence the case will have to an auditor.

a. Superior Courts

Superior Courts have exclusive original jurisdiction over tax cases (Cal. Civ. Proc. Code §86(a)(1)). If a taxpayer is subject to an audit examination by the FTB and a tax assessment was issued and affirmed by the protest unit, the taxpayer has the option of taking its case directly to Superior Court or to the Board of Equalization (See Cal. Civ. Proc. Code Section 6-6(d) for Board of Equalization proceedings). If a taxpayer chooses to take its case to the Superior Court, they must first pay the tax assessment and file a claim for refund (California Constitution, Article XIII, Section 32). In *Dan J. Agnew v. State Board of Equalization*, (1999) 21 Cal.4th 310, the court held that the payment of accrued interest and penalty was not a prerequisite to either an administrative refund claim or a subsequent action for refund of taxes; the only requirements are that the tax be paid and a claim for refund be filed.

The Superior Court will generally hear arguments of the case and review the facts submitted to the court before reaching its decision. Once the decision is reached, either party can appeal the decision to the Court of Appeals.

b. Court of Appeals

All tax cases decided by the Superior Court can be appealed to the Court of Appeals for further review. The Court of Appeals will determine if the Superior Court reached the correct decision by generally affirming or reversing the Superior Court's decision (Cal. Civ. Proc. Code §904.1). The Court of Appeals will generally make its decision based on correct legal standards and evidence provided during theSuperior Court, and rarely will they hear new evidence at the appeals level. Once the Court of Appeals issues their decision, either party can appeal to the Supreme Court for further review.

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c. Supreme Court

Supreme Court has sole discretion as to whether or not they will review the Court of Appeals' decision (California Constitution, Article VI, Section 12).

d. Board of Equalization

As an alternative to the California court system, taxpayers in a tax case can appeal the findings of the FTB to the State Board of Equalization (BOE) as long as taxpayers exhaust all administrative remedies. The BOE is comprised of five elected Board Members, serving as the appellate body in final actions of the FTB. The five elected members issue opinions and render decisions interpreting and defining California's income tax laws after obtaining all relevant facts about the case.

Once the elected members render a decision, either party, within 30 days of the decision, can petition the BOE for a rehearing. If the rehearing is denied, then the proceeding at the BOE ends. FTB has no other recourse once the proceeding ends with the BOE. However, taxpayers who are not satisfied with the decision reached by the BOE can find additional relief by going through the State court system as discussed above.

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180700 USING CITATORS

A citator is a book or set of volumes which lists all federal court cases involving matters of taxation under Title 26 of the U.S. Code. It provides the court(s) in which the case was heard, whether the IRS acquiesced, and subsequent cases that cited and followed such case. The citator is a useful tool in determining the strength of a holding in a particular case. In general, the case being analyzed is identified as the "cited case"; the case being referred to is identified as the "citating case".

There are three citators: (1) CCH, (2) Prentice Hall (which has been purchased by RIA), and
(3) Shepherd's.

CCH's citator is part of their Standard Federal Tax Reports. The Main Citator is contained in 2 volumes - Volume A-L and Volume M-Z. The Main Citator is supplemented by the Current Citator Table, which is issued quarterly. For the court decisions that are no longer applicable, they are indicated by a dagger symbol and no citating cases are listed. Cited cases are noted in bold followed by paragraph references. The bold dots that are placed along the citator's left margin facilitate a reconstruction of the judicial history of the cited case, with the highest level court to address the case listed first, and the trial-level case listed last.

Note that you will want to check the Latest Additions to the Citator table (placed in front of the Current Citator Table) to see whether there are recent citating cases that might assist your audit determination.

One of the main differences that CCH has in comparison to PH's and Shepherd's is that PH and Shepherd list all the cases that have mentioned the cited case. Although this provides thoroughness, one should be careful of being overwhelmed and not focusing on the true landmark cases cited. It can also be mentioned that with CCH you would be relying on the editorial evaluation of CCH in regards to case precedence.

The Citator is also helpful in your finding court cases that have precedence. The precedent setting case is listed first. All cases that cite and/or follow the precedent setting case are listed next.

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180800 REFERENCE SOURCES

S Corp 180801 Annotated Tax Services
S Corp 180802 Other Sources

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180801 Annotated Tax Services

IRC section numbers organizes annotated tax services. In this chapter, we will assume that you are familiar with the annotated tax service CCH-Standard Federal Tax Reports.

Topical tax services divide the tax law into its function components. RIA and BNA are distinguishable in regards to the structure of their material, not the structure of their indexes. The 6 most popular topical tax services are:

- Research Institute of American's Federal Tax Coordinator 2d (RIA)
- Bureau of National Affairs' Tax Management Portfolios (BNA)
- Single Topic Treatises (devoted to detailed analysis of a selected narrow range of federal or other tax issues) - Warren, Gorham, and Lamont's Bittker's Federal Taxation of Income, Estates and Gifts (Bittker); Clark Boardman Callaghan's S Corporations: Federal Taxation; Warren, Gorham, and Lamont's S Corporations
- Callaghan's Mertens' Law of Federal Income Taxation (Mertens)

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180802 Other Sources

- *Journal of S Corporation Taxation (published quarterly*)
- *Treatises by Warren, Gorham, Lamont or Clark, Boardman, Callahan*
- *Taxes*
- *Tax Notes (weekly)*
- *State Tax Notes (weekly)*
- *PPC Binders, etc.*

In regards to the Lexis/Nexis database and *State Tax Notes* (by Tax Analysts, Inc.), use the Library called "STTAX", select the File called "STN", and enter the issue to research. *State Tax Notes* provides current details on developments in all areas of state-level tax - legislative activity (proposed and pending), state tax agency releases, court decisions, etc.

You can track what the public officials and the private enterprises are "saying" concerning California's regulations governing certain issues by using the Library called "REGNWS", selecting the File called "CANWS", and entering the issue you want to track.

If you have the citation for a case (federal or state), a private letter ruling, revenue ruling, public law, *I.R.B.*, Congressional bill, RIA Federal Tax Coordinator, *C.B.*, Tax management portfolios, etc. - use the Lexsee feature of the Lexis/Nexis database as follows.

- Case (federal or state) - lexsee 410 us 113 or lexsee 132 ariz 337
- Private Letter Ruling - lexsee plr 7711003
- Revenue Ruling - lexsee rev rul 74-56 or lexsee revrul 74-56
- Public Law - lexsee 100 pl 297
- Internal Revenue Bulletin - lexsee 1990-8 irb 18
- Congressional Bill - lexsee 103 hr 3600
- RIA Federal Tax Coordinator - lexsee riaftc b 3500
- Cumulative Bulletin - lexsee 1985-1 cb 550
- Tax Management Portfolios - lexsee 731 tm 1

There is also the Lexstat feature of the Lexis/Nexis database. The Lexstat feature can be used if you have the full citation for a state code or statute section, the U.S. Code, the U.S. Code of Federal Regulations, state administrative codes, etc. The following lists examples of Lexstat searches:

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- California Code - (CA has annotated statutes offered in the database) - lexstat ca gov 20022
- New York Code - lexstat ny gen mun 370
- Washington, D.C. Code - lexstat dc code 6-3401
- U.S. Code - lexstat 5 uscs 5901

Under the Lexstat feature, the following Code topics are available for the California statutes:

Bus. & Prof.	Finance	Labor	Rev. & Tax.	Uncod. Water
Civil	Fish & Game	Military & Veteran	Sts. & High.	Uncod. Init.
Civil Procedure	Food & Agriculture	Penal	Unemp. Ins.	
Corporations	Government	Probate	U.C.C.	
Education	Harbor & Navy	Pub. Cont.	Vehicle	
Election	Health & Safety	Pub. Res.	Water	
Evidence	Insurance	Public Util.	Welf. & Inst.	

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180900 EXHIBITS

Exhibit 180000-1	PL 99-514
Exhibit 180000-2	Summary of the Legislative Process to the California Tax Law
Exhibit 180000-3	How a Bill Becomes a Law

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