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7.0 EXCESS NET PASSIVE INCOME TAX

7.1 FEDERAL AND CALIFORNIA BACKGROUND

S Corporations, which have been C Corporations previously and have earnings and profits (E&P) accumulated from years in which they had C status may have to pay tax at the corporate level on Excess Net Passive Income (ENPI). Additionally if the corporation has passive investment income for three consecutive tax years, it may lose S status.

7.1.1 Federal Background

The purpose of the tax on 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. The term “passive income” as contained in “ENPI” does not follow the definition contained in IRC §469. A more accurate term is “excess net investment income.” For such purpose, passive investment income includes interest, dividends, royalties and gains from the sale or exchanges of stock or securities. (IRC §§1362(d)(3)(C) and 1375(b)(3).)

In accordance with IRC §1375, beginning on or after January 1, 1982, the ENPI tax is imposed on S corporations that meet both of the following conditions:

- The corporation has accumulated E&P from Subchapter C years at the end of that taxable year; and
- The corporation's passive investment income exceeds 25% of its gross receipts.

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.

The amount subject to tax is limited to the taxable income of the corporation. (See IRC §1375(b)(1)) The term "net passive income" equals passive investment income less the deductions directly connected with the production of such income (not including the dividends received deduction found in IRC §241 through IRC §249 [and the net operating loss deduction of IRC §172). (See IRC § 1375(b)(2).)

For such purposes, the corporation's taxable income is computed as though it were a C corporation, but without deducting any NOLs under IRC §172 or any of the special corporate deductions under Part VIII of Subchapter B (other than the deduction for organizational expenditures under IRC §248). 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 tax is limited for such reason, the ENPI tax is completely avoided for that taxable year. Also, the ENPI tax is avoided if the S corporation distributes all of its accumulated E&P on or before the end of the taxable year.

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).)

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

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 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. (For more detail refer to the sections on Computing Subchapter C E&P and Consent Dividends)

Under Treas. Reg. §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

During a reasonable period of time after it was determined that it did have Subchapter C earnings and profits as close of such taxable year, such earnings and profits were distributed.

The IRC provides a passive investment income limitation for an S corporation that possesses accumulated Subchapter C E&P. If the S corporation's passive investment income exceeds 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).)

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).)

7.1.2 California Background

Generally, California conforms to IRC §1375 under R&TC §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:

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.

The term “Subchapter C E&P” used in IRC §1375 and §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.

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.

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.

IRC §1375(d) provides waiver provisions if the S corporation is subject to ENPI tax.

For California purposes, the S Corporation is allowed a deduction the amount of any consent dividend. If a determination is made that the corporation has subchapter C earnings and profit, the corporation is entitled to distribute a consent dividend to its shareholders. The consent dividend must be paid within 90 days of the determination.

Note: Before making an adjustment on ENPI tax, read R&TC §23811(e) carefully for timing and limitation on days.

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))

The tax cannot be reduced by any credits allowed under the Bank and Corporation Tax Law (R&TC §23811(c)).

7.2 COMPUTING THE ENPI TAX

7.2.1 Computing ENPI

General Federal Computation

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

*** 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 considered nonpassive income (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:

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

*CA gross receipts includes CA investment passive income

Generally, California conforms to the federal statute and regulations for purposes of computing ENPI tax. However, the California ENPI tax is computed only 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 passive investment income reduced by any deductions directly connected with the production of California sourced income.

Example A

At the end of 2006, 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 2006 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 2006 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.

7.2.2 Passive Investment Income Defined

If income is generated in the ordinary course of business, it is nonpassive income (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 §1375(b)(3), the term “passive investment income” has the same meaning as when used in IRC §1362(d)(3), which deals with S corporation election terminations due to excessive net passive income for three consecutive years. The following is an excerpt from IRC §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" may 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 §1221(a)(1).

(iii) Treatment of certain lending or finance companies. If the S corporation meets the requirements of IRC §542(c)(6) for the taxable year, the term "passive investment income" may 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 §542(d)(1)).

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

Therefore, for non-apportioning 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. §1.1362-2(c)(5)(ii)(A)(1), 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 taxable income.

Under Treas. Reg. §1.1362-2(c)(5)(ii)(A)(2), 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:

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

Example A

T is an S corporation with accumulated E&P from Subchapter C years. In T's first taxable year as an S corporation, T 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. T 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 T created Trademark A, the royalty payments with respect to Trademark A are derived in the ordinary course of T's business and are not included within the definition of royalties for purposes of determining T's passive investment income. However, the royalty payments with respect to Trademark B are included within the definition of royalties for purposes of determining T's passive investment income. T's passive investment income for the year is $8,000

Note: The exception for self-created property applies only when the corporation created the property and does not apply when the property is created by the shareholder and contributed to the corporation. Therefore, the auditor should verify who created the property, the corporation or the shareholder.

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 §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 §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 §543(d) (without regard to IRC §543(d)(5)). (Treas. Reg. §1.1362-2(c)(5)(ii)(A)(3))

Rents, such as:

- 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. §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 §469.

Example C

XYZ Corporation owns and operates an apartment building. Although the 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 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 in 70-1 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 §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 §1362(d)(3)(C)(i), which includes:

- Dividends as defined in IRC §316;
- Amounts to be included in gross income under IRC §551 for tax years before 1/1/05 (relating to foreign personal holding company income taxed to U.S. shareholders); and
- Consent dividends as provided in IRC §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 §483;
- Amounts treated as original issue discount under IRC §1272;
- Amounts treated as interest under the rules for debt issued for non-publicly traded property in IRC §1274; and
- Amounts treated as interest under the rules for below- market loans under IRC §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

S, an S corporation with Subchapter C E&P, has $500 of gross receipts that are 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].

Annuities, Under IRC §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 §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 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: 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:

Note that income from a passive partnership activity, as defined under IRC §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 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 S corporation's distributive share of the partnership's passive investment income (i.e., rents, royalties, dividends, interest, annuities, and gain from sales or exchanges of stock or securities) was treated as passive investment income of the S corporation.

7.2.3 Gross Receipts Defined

Under IRC §1375(b)(3), the term “gross receipts” has the same meaning as when used in IRC §1362(d)(3), which deals with the S corporation election 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 §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 may be taken into account only to the extent of the capital gain net income there from".

Gross receipts are defined in Treas. Reg. §1.1362-2(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.

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

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;

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.

California modifies the definition of "passive investment income", and "gross receipts" to include only California sourced income. R&TC §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 §1375, relating to tax imposed on passive investment income, as modified by this section."

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 non-apportioning 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.

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 extent of the amount of capital gain net_income.

Sales of IRC §1231 assets increase the gross receipts by the full amount of the sales proceeds. The term "IRC §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

S, an accrual method S corporation, retains Accumulated E&P from Subchapter C years. S sells an IRC §1231 depreciable asset (held for more than one year), which is used in the corporation'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 note 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:

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)) For tiered partnerships, look through each tier.

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 50% general partnership interest in Partnership Q. Q holds Stock Z ($200 basis and $500 FMV) and IRC §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 owns and operates movie theaters and is a partner in a joint venture that owns 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 owns 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.)

7.2.4 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. §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, but are not limited to:

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

Under Treas. Reg. §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.

7.3 TAXABLE INCOME LIMITATION

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

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

1. Ordinary income (loss) from federal Form 1120S, line 1.	$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
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		$1,800,000
10.R&TC §23802(e) deduction	911,000	
11.Net operating loss carryover deduction	*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.

Note: In this example there are no IRC §241- IRC §249 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.

7.4 DEDUCTION FOR ENPI TAX AT THE SHAREHOLDER LEVEL

Under R&TC §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 §1366(f)(3). R&TC §23803(b)(2) modifies IRC §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. Interest Income	$900,000	.90		$ 83,700	
2. Dividend Income	100,000	.10		9,300	
Total	$1,000,000	1.00		$93,000	$93,000

The shareholder would include the following in the computation of shareholder 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.
Note: At the shareholder level, the ENPI tax computed for California purposes is used instead of the federal ENPI tax amount.

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.

7.5 COMPUTING SUBCHAPTER C E&P

7.5.1 Federal E&P

While the IRC does not define the term earnings and profits (E&P), IRC §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 §381 (e.g., due to a merger), or it 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. Liquidating a corporation by distributing all of its property to shareholders should eliminate any Subchapter C 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 reduced in a prior year)	ADD
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

7.5.2 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 or before 1/1/02, 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 6/12/05 and made a valid federal S election on the same date. It was deemed to be a California S corporation.

ABC, Inc. has no Subchapter C E&P for both federal and California purposes because it was always an S corporation.

Example B

ABC, Inc. incorporated on 6/12/05 and made a valid federal S election on the same date. It was deemed to be a California S corporation.

On 12/31/05, ABC acquired XYZ, Inc. (a C corporation) through merger. On that date, XYZ had Subchapter C E&P of $500,000.

Beginning on 12/31/05, ABC has Subchapter C E&P of $500,000.

7.6 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 §1375 ENPI tax. Consent dividends, as provided in IRC §1368(e)(3) and R&TC §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 for S corporations. Once the consent is filed, the amount specified as a 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 §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 NPA for ENPI tax, 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 §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 may 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 may be entitled to distribute a

> consent dividend to its shareholders. The amount of the consent dividend may 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 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 §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 §1368(e)(3) for any consent dividend.

As this 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)).

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 is stayed 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 is stayed 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 §1368(e)(3). Under IRC §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 §1368(b). (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).)

Example A

ABC, Inc., incorporated in 2001, makes a valid federal S election in 2003. It was deemed to be a California S Corporation.

On this date, ABC 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 §23811(e)(1). The amount of consent dividend ABC may make for federal purposes is up to $50,000 per IRC §1368(e)(3).

On 3/31/04, 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 12/31/05, 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 §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 §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 2000, 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 §1368(e)(3) election for federal purposes. However, the S Corporation will not be assessed ENPI tax under R&TC §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 §1375(a), accumulated e&p at the close of the year is reduced by the liquidating distributions under irc §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 §331, not irc §301 or §1368.

7.7 S CORPORATION REVOCATION DUE TO ENPI

If an S corporation, which was formerly a C corporation with accumulated E&P, 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 ENPI 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 §23811(a) is that the S Corporation could be subject to the termination provisions.

Example A

For 2001, 2002, and 2003, 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, 2004.

7.8 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

X, a C corporation with E&P, holds stock with a value of $1,000 and a basis of $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).

7.9 EXHIBITS

Exhibit 7.1

ENPI Checklist	
1	Does the corporation have ENPI (not tax) for federal purposes? • If not, then the tax is not imposed for California purposes.
2	C corporation E&P at the close of the taxable year. • Verify whether the corporation was ever a federal S corporation by examining the corporate folder. • Verify whether the corporation has exhausted E&P through prior year distributions. • Verify whether the corporation elected to bypass AAA, allowing the distribution of E&P.
3	Does the S corporation report Net Passive Income? • Check that the corporation is reporting "separately stated" items, including interest, dividends, royalties, capital gains, etc. • Check whether the corporation is reporting "other income" consisting of interest, dividends, royalties, capital gains, etc.
4	Passive Investment Income more than 25% of Gross Receipts?
5	Compute Gross Receipts for ENPI purposes, including the following: • Income from a trade or business activity. • Amount received in 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 other than stocks or securities. 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. • Gain 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. • Gain on disposition of a general partnership interest is treated as sale or exchange of stock or security. If tiered partnerships, you must look through each tier. • Gross payments received on installment sales during the year. • The S corporation's share of a partnership's gross receipts. In other words, you must apply the gross receipts test to each of the partnership's gross receipts and include in total gross receipts (S corporation and partnership) the S corporation's profit and loss percentage

6	Compute Passive Investment Income for ENPI purposes, including the following: • Royalties. • Rents. • Dividends. • Interest. • Annuities. • 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 other than stocks or securities. 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. • Gain 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. • Gain on disposition of a general partnership interest is treated as

	sale or exchange of stock or security. If tiered partnerships, you must look through each tier. • Gross payments received on installment sales during the year. • The S corporation's share of a partnership's gross receipts. In other words, you must apply the gross receipts test to each of the partnership's gross receipts and include in total gross receipts (S corporation and partnership) the S corporation's profit and loss percentage. • Remember to reduce the income items noted above by any deductions directly connected with the production of such income.
7	Use the following formula to compute ENPI: $\text{ENPI} = \dfrac{\text{Passive Investment Income in Excess of 20\% of gross receipts}}{\text{Gross Passive Investment Income for the year}} \times \text{Net Passive Investment Income for the year}$
8	Multiply ENPI by 9.3% to arrive at ENPI tax
9	Did the corporation report a net loss, when computing as if a C corporation? • Recompute Taxable Income assuming its a C corporation
10	Remember to reduce the passive income passing through to shareholder(s) by the amount of the ENPI tax on a proportionate basis.
11	Remember to reduce the S corporation's net income subject to the franchise or income tax by the amount of ENPI subject to the ENPI tax.
12	If the corporation with E&P 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. • It is not necessary that the corporation pay the ENPI tax for such revocation to occur.
13	ENPI Tax Example 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)]. ENPI (ENPI) is $32,000, calculated as follows: ENPI= ($44,000/$110,000) * $80,000= $32,000 Consequently, XYZ Corporation's ENPI tax for 1996 is $2,976 ($32,000 x 9.3%). Incidentally, XYZ must reduce its Net Income for state purposes by $2,976 for purposes of computing the Franchise Tax. Also, XYZ Corporation must also reduce, as a Schedule K-1 state adjustment, the amount of income passing through to the shareholder(s) by $2,976.

Exhibit 7.2

Sample Problems and Solutions
Problem #1 Corp M, an S corporation, is a calendar year taxpayer. At the end of its taxable year, M has accumulated E&P from Subchapter C years on hand from a year it was not an S corporation. M's gross receipts for that taxable

year are $1,500,000, its passive investment income is $750,000, and its taxable income as a C corporation would be $500,000. Deductions directly connected with the production of passive investment income are $50,000.

What is M's gross passive investment income?
What is M's net passive income?
What is M's excess passive income?
What is the ENPI tax?

Solution #1

M's gross passive investment income is $750,000.
M's net passive income is $700,000 (i.e., $750,000 of passive investment income less $50,000 of allowable deductions).
M's excess passive investment income is $375,000 (i.e., $750,000 - $375,000 (25% of gross receipts of $1,500,000)).
The ENPI tax is [($375,000/$750,000) * $700,000]= $350,000 *9.3%= $32,550

Problem #2

Assume the same facts as above except that M's taxable income for its taxable year would only be $100,000 if it were a C corporation for that year.

What is M's ENPI tax?

Solution #2

The ENPI tax is $9,300 ($100,000 * 9.3%).