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SUBJECT: Apportioning of Net Recognized Built-In Gains for Purposes of Computing the S Corporation Built-In Gains Tax

QUESTION PRESENTED

When an S Corporation is subject to the built-in gains tax, are the built-in gains and built-in losses attributable to California determined using the apportionment factors in the year of sale or the apportionment factors in the year of conversion?

CONCLUSION

When an apportioning S corporation sells property generating net recognized built-in gain under Internal Revenue Code (IRC) section 1374 (NRBIG), the income should be apportioned according to the factors in the year of the sale (and not the apportionment factors in the year of the S corporation conversion).

ANALYSIS AND DISCUSSION

The tax for NRBIG on S corporations is set forth in IRC section 1374, to which California conforms with modifications under Revenue and Taxation Code (RTC) section 23809. As a general rule, IRC section 1374(a) states: "If for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain, there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation for such taxable year." Under RTC section 23809, the tax on an S corporation's NRBIG is the highest rate of tax on C corporations or, if applicable, financial C corporations.

In general, the recognition of income or loss occurs at the time of realization, such as the sale of property, followed by the recognition of gain.¹ The applicable apportionment factors to be used for a transaction are the ones related to the business activities from the year of

¹ IRC § 1001(a) & (c). Note that the IRC contains specific provisions, for example, that defer recognition of realization events, such as IRC § 721 partnership contributions, IRC § 351 shareholder contributions, IRC § 1031 like-kind exchanges, IRC § 332 liquidations, and IRC § 368 corporate reorganizations.

realization, as they have been for transactions where realization and recognition occur in different years, such as for installment sales, completed contract method of accounting, and the post-apportionment utilization of net operating loss carrybacks and carryforwards.² In the case of IRC section 1374 NRBIG arising from the sale of property, the realization event occurs in the year of the sale of the respective property.

The factors must reflect the business activities for the given year in which the income is realized.³ There is no realization event until there is IRC section 1374 NRBIG, which only occurs in the year of sale. Therefore, when an apportioning S corporation sells or otherwise disposes of property generating NRBIG, the income should be apportioned according to the factors in the year of the sale.

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² *Tenneco West, Inc. v. Franchise Tax Board* (4th Dist. 1991) 234 Cal.App.3d 1510, review denied January 30, 1992; *Donald M. Drake Company*, 77-SBE-012; Legal Ruling 413 (October 15, 1979); RTC § 25108(a), (c).

³ Legal Ruling 413 (October 15, 1979).