

## 13.0 DEDUCTION FOR TAXES AT THE S CORPORATION AND SHAREHOLDER LEVELS

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### 13.1 SUMMARY OF TAXES DEDUCTIBLE AT THE S CORPORATION AND SHAREHOLDER LEVELS

There are differences in the deductibility of taxes at the S corporation level and the shareholder level as shown in the chart below.

Type of Tax	S Corporation Level		Shareholder Level	
	Deductible	Revenue and Taxation Code Section (R&TC)	Deductible	R&TC
Franchise Tax	No	R&TC Section 24345	No	R&TC Section 17220(c)
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	

### 13.2 FRANCHISE TAX

The S corporation franchise tax is neither deductible to the corporation nor to its shareholders. (R&TC Section 17220(c) and R&TC Section 24345(a))

This tax is treated as a noncapital, nondeductible item for purposes of computing the Accumulated Adjustments Account and shareholder basis. (Treasury Regulation (Treas. Reg.) Section 1.1368-2(a)(3)(i)(C))

#### Example A

ABC, Inc., a California S corporation, reported a positive 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.

ABC's shareholders are not allowed a deduction on their return for the \$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 Section 1367(a)(2)(D))

### **13.3 BUILT-IN GAINS (BIG) TAX**

- 13.3.1 S Corporation Level
- 13.3.2 Shareholder Level

#### **13.3.1 S Corporation Level**

The built-in gains tax is not deductible by the corporation for purposes of computing its franchise or income tax at 1.5 percent. (R&TC Section 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.

#### **13.3.2 Shareholder Level**

Built-in gains tax is allowed as a deduction to the shareholder in Internal Revenue Code (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 Section 1366(f)(2))

#### **Example A**

	Amount of Built-In Gain	Ratio	Built-In Gains Tax @ S Corporation Level	Pro Rata Built-in Gains
<u>Taxable Item</u>				
Ordinary Gain	\$100,000	.10		\$8,840
Capital Gain	200,000	.20		17,680
IRC Section 481 Income	<u>700,000</u>	<u>.70</u>		<u>61,880</u>
Total	<u>\$1,000,000</u>	<u>1.00</u>	<u>\$88,400</u>	<u>\$88,400</u>
	<u>0</u>			

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

	<u>Item of Income</u>	<u>Item of Loss/Deduction</u>
Ordinary Gain	\$100,000	-\$8,840
Capital Gain	\$200,000	-\$17,680
IRC Section 481 Income	\$700,000	-\$61,880

If the shareholder has sufficient basis and is not restricted by other applicable limitations, the shareholder would report the following amounts on their individual tax return:

Ordinary Gain, \$91,160 [\$100,000 – \$8,840], to Form 4797.  
 Capital Gain, \$182,320 [\$200,000 – \$17,680], to Schedule D.  
 IRC Section 481 Income, \$638,120 [\$700,000 – \$61,880], 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 A, except 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.

The shareholder would currently suspend the following losses/deductions (built-in gains tax):

Ordinary Loss, \$8,840.  
 Capital Loss, \$17,680.  
 IRC Section 481 Loss, \$61,880.

## **13.4 EXCESS NET PASSIVE INCOME (ENPI) TAX**

- 13.4.1 S Corporation Level
- 13.4.2 Shareholder Level

### **13.4.1 S Corporation Level**

The ENPI tax is not deductible to the corporation for purposes of computing its franchise or income tax at 1.5 percent. R&TC Section 24345 and R&TC Section 23802(e) provides for the deduction of the ENPI for purposes of computing the S corporation franchise or income tax at 1.5 percent. 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.

**The information provided in this manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the last update.**

### 13.4.2 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 Section 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	Ratio	Excess Net Passive Income Tax @ S Corporation Level	Pro Rata Excess Net Passive Income Tax
Interest Income	\$900,000	.90	\$ 79,560	
Dividend Income	<u>\$100,000</u>	<u>.10</u>	<u>\$8,840</u>	
Total	<u>\$1,000,000</u>	<u>1.00</u>	<u>\$88,400</u>	<u>\$88,400</u>

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

	<u>Item of Income</u>	
Interest Income	\$820,440	[\$900,000 – \$79,560]
Dividend Income	\$91,160	[\$100,000 – \$8,840]

The shareholder would report the following amounts per return:

Interest Income, \$820,440, to Schedule B.  
Dividend Income, \$91,160, to Schedule B.

**Note:**

- The excess net passive income tax computed for California purposes is used in lieu of the federal amount.
- 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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