

## 5.0 BUILT-IN GAINS TAX

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### 5.1 PURPOSE OF THE BUILT-IN GAINS TAX

Prior to 1986, a corporation was allowed to distribute appreciated assets to its shareholders, allowing a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax. This was called The General Utilities rule which tended to undermine the corporate income tax by granting a permanent exemption from the corporate income tax. The General Utilities rule was adopted from the court case *General Utilities Co vs. Helvering*, 296 U.S. 200 (1935). Under normally applicable tax principles, non-recognition 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.

In 1986 Congress repealed the General Utilities Doctrine. As a result, a corporation will generally recognize a gain or loss on the distribution of assets. Thus, the principle of corporate 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 to an S corporation, and then liquidating 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 following the date of an S election. To preserve equality, IRC Section 1374 allows built-in gains to be offset by any built-in losses or net operating losses attributable to C corporation years.

## 5.2 TAXATION OF C CORPORATION GAINS v. S CORPORATION BUILT-IN GAINS

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. Rather, Congress' intent was to preserve equal tax treatment of 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 @ 8.84% (beginning after 1/1/97)	8,840	\$8,840
3.	Distribution to shareholders	91,160	
4.	Shareholder tax @ 12.3%*	11,213	11,213
5.	Total tax paid		\$20,053

#### Total Tax Paid by S Corporation and Shareholder(s)

1.	Gain on asset sale	\$100,000	
2.	Built-in gain tax @ 8.84% (beginning after 1/1/97)	8,840	8,840
3.	Separately stated items per Schedule K-1:		
	Gain on asset sale	100,000	
	Built-in gains tax	-8,840	
	Subtotal	91,160	
4.	Shareholder tax @ 12.3%*	11,213	11,213
5.	Total tax paid		\$ 20,053

\*Top individual tax rate as of January 1, 2013

This example demonstrates that imposition of the built-in gains tax does not subject an S corporation and its shareholders to more tax than if the corporation had remained a C corporation. The C corporation, however, could have deferred declaration of the \$91,160 distribution until future years.

## 5.3 EXAMINING THE BUILT-IN GAINS TAX ISSUE AND GLOSSARY OF TERMS

- 5.3.1 Examining the Built-In Gains Tax Issue
- 5.3.2 Glossary of Terms

### 5.3.1 Examining the Built-In Gains Tax Issue

In general, an S corporation is subject to the built-in gains tax when it converted from a C corporation and the S corporation recognizes an item of income/gain that is attributable to tax years when the company operated as a C corporation. An examination of the built-in gain tax issue begins with determining that an S corporation has items of income/gain within the recognition period that are attributable to C corporation years. Once it is determined that the items of income/gain are attributable to C corporation years, the next step is to determine how much of the income/gain item is subject to the built-in gains tax, and the calculation of several limitations are used to determine the amount of income/gain subject to the built-in gains tax in the audit year.

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

- |  | Section |
|--|---------|
| <ul style="list-style-type: none"> <li>• 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 Section 1374(d)(7)) In another situation, the ten-year recognition period begins when an S corporation that 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 Section 1374(d)(8))</li> </ul> | 5.4     |
| <ul style="list-style-type: none"> <li>• Identify items of recognized built-in gain (loss).</li> </ul>   | 5.5     |
| <ul style="list-style-type: none"> <li>• Compute the “pre-limitation amount” (sum of recognized built-in gains, recognized built-in losses, recognized built-in gain carryovers, and IRC Section 1374 attributes).</li> </ul>  | 5.6     |
| <ul style="list-style-type: none"> <li>• Determine if the taxable income limitation applies.</li> </ul>  | 5.6     |
| <ul style="list-style-type: none"> <li>• Compute the “net unrealized built-in gain”.</li> </ul>  | 5.6     |
| <ul style="list-style-type: none"> <li>• Compute the “net recognized built-in gain”.</li> </ul>  | 5.6     |
| <ul style="list-style-type: none"> <li>• Determine the built-in gain tax deduction allowed at the shareholder level.</li> </ul>  | 5.10    |

### 5.3.2 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 1 <sup>st</sup> 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 Section 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 1 <sup>st</sup> 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. (Treasury Regulation (Treas. Reg.) Section 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 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.

For California purposes, IRC Section 1374 attributes include net operating and capital loss carryovers from C corporation

years. Revenue and Taxation Code (R&TC) Section 23809(b) does not allow credit carryovers to reduce built-in gains tax. 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 a 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.

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 (FMV) 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; increased or decreased by the corporation's 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 and (2) the corporation's adjusted basis in the assets immediately before the constructive sale.

## 5.4 RECOGNITION PERIOD

- 5.4.1 Recognition Period - In General and Exceptions
- 5.4.2 Recognition Period Exception #1- C Corporation Assets Acquired
- 5.4.3 Recognition Period Exception #2- Like-Kind Exchanges and Involuntary Conversions
- 5.4.4 Recognition Period – Federal Law and California Conformity

### 5.4.1 Recognition Period- In General and Exceptions

#### In General

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, 2005, the last day of the recognition period is July 13, 2015.

For taxable years beginning on or after January 1, 2002, California no longer allows a taxpayer that is a federal S corporation to be a California C corporation. Therefore, a corporation with a valid federal S election will be considered an S corporation for California purposes. (R&TC Section 23801) Thus, the recognition period for a corporation that was

treated as an S corporation in 2002 based on a federal S election ended on December 31, 2011. 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. (IRC Section 1374(d)(9))

## Exceptions

Even if the corporation is otherwise not subject to the built-in gains tax, it may become subject to the built-in gains tax if the corporation acquires assets that have an unrealized built-in gain. This can occur when (1) the corporation completes a tax-free merger with a C corporation or former C corporation, and/or (2) the corporation performs an exchange/conversion whereby the basis was determined by reference to unrecognized built-in gain (see examples below).

### 5.4.2 Recognition Period Exception #1 - 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 in part) by reference to the basis of such asset in the hands of a C corporation (IRC Section 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 January 1, 2004, and immediately elects S status. On January 1, 2015, a C corporation merges into ABC, an S corporation. The first day of the recognition period is January 1, 2015. The last day of the recognition period is December 31, 2024.

#### Example B

Tax-free Merger with S corporation that is Subject to Built-in Gains Tax

ABC incorporates on January 1, 2014 and immediately elects S status. XYZ (an S corporation) is subject to the built-in gains tax with its recognition period starting on January 1, 2011. On January 1, 2015, ABC acquires XYZ, pursuant to a tax-free merger. ABC's recognition period in regard to the assets acquired from XYZ begins on January 1, 2011 and ends on December 31, 2021.

Assume the same facts as above, except for XYZ's recognition period started on January 1, 2013. ABC's recognition period in regard to the assets acquired from XYZ begins on January 1, 2013 and ends on December 31, 2023.

### 5.4.3 Recognition Period Exception #2 - 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. (IRC Section 1374(d)(6)). The 10-year recognition period continues to be measured from the date of the S election, not from the date of exchange.

ABC incorporates on January 1, 2010, as a C corporation. ABC owns an apartment building and generates rental income. On January 1, 2012, ABC elects S status. On this day ABC's basis in the apartment building is \$1,000,000. On January 1, 2014, ABC completes a like-kind exchange in which the apartment building was sold and exchanged for a replacement rental property. Although the commercial rental property was acquired on January 1, 2014, the basis of the replacement property is determined by reference to ABC's basis in the apartment building that was given up in the exchange. Thus, the 10-year recognition period in the replacement property continues to be measured from the date of the S election, not from the date of the exchange. The recognition period for the replacement property ends on January 1, 2022.

### 5.4.4 Recognition Period – Federal Law and California Conformity

In recent years Congress has passed legislation that includes provisions affecting Internal Revenue Code Section 1374 and the BIG recognition period.

1. The American Recovery and Reinvestment Tax Act of 2009 temporarily shortened the BIG recognition period to **seven** years for tax years 2009 and 2010.
2. The Small Business Jobs Act of 2010 temporarily shortened the BIG recognition period to **five** years for tax year 2011.
3. The American Tax Relief Act of 2012 extended the temporary **five-year** recognition period for tax years 2012-2013.
4. The 2014 Tax Increase Prevention Act extended the temporary **five-year** recognition period for transactions completed through tax year 2014.
5. The Protecting Americans from Tax Hikes (PATH) Act of 2015 **permanently** reduced the 10-year recognition period to **five** years for tax years 2015 and subsequent tax years.

Note: California **does not conform** to any of the federal provisions noted above, and the 10-year recognition period remains in effect for California purposes for all tax years. (R&TC Section 23051.5 and 23809)

## 5.5 RECOGNIZED BUILT-IN GAIN (LOSS)

- 5.5.1 Definition of "Recognized Built-in Gain" IRC Section 1374(d)(3)
- 5.5.2 Definition of "Recognized Built-in Loss" IRC Section 1374(d)(4)
- 5.5.3 Items of Built-in Gain (Loss)
- 5.5.4 Final Regulations- Treasury Regulation Section 1.1374-4
- 5.5.5 Valuations

### 5.5.1 Definition of "Recognized Built-in Gain"

IRC Section 1374(d)(3) 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:

- (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
- (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.

### 5.5.2 Definition of "Recognized Built-in Loss"

IRC Section 1374(d)(4) 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:

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



### 5.5.3 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 FMV of the asset differed at the time the S election became effective. A built-in gain can also be triggered when an S corporation receives cash for income earned prior to S election. Likewise, a built-in loss can also be triggered when an S corporation makes a payment for an expense that was incurred prior to S election.

The following are examples of items that can trigger a built-in gain (loss):

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

#### 5.5.4 Final Regulations - Treasury Regulation Section 1.1374-4

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

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

A transaction resulting in a gain or loss recognized during the recognition period must qualify as a sale or exchange for federal income tax purposes.

b. Accrual Method Rule (Treas. Reg. Section 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: 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. (IRC Section 461(h)(2)(C) and Treas. Reg. Section 1.461-4(g))

**Example A**

## Accounts Receivable, Cash Basis S Corporation

ABC, Inc., a cash basis taxpayer, elected S status on January 1, 2015. On this date, it had accounts receivable for services rendered as follows:

Book value	\$200,000
FMV	\$150,000
Adjusted basis	\$0

## Accounts Receivable Collected During 2015

During 2015, ABC 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 2015

If ABC had disposed of the accounts receivable for \$150,000 in 2015 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 disposition.

**Example B**

## Contingent Liability, Cash Basis S Corporation – Lawsuit

ABC, Inc., a cash basis taxpayer, elected S status on January 1, 2015. In 2014, a lawsuit was filed against ABC claiming damages for \$10,000,000. The lawsuit was settled in 2015.

ABC paid damage awards of \$5,000,000 that it deducted on its 2015 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 January 1, 2015. In 2014, ABC lost a lawsuit and became obligated to pay \$10,000,000. ABC paid the damage awards in 2015, which was deducted on its 2015 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 January 1, 2015.

In 2014, ABC received \$50,000 for services to be rendered in 2015, and elected to exclude the \$50,000 from gross income in 2014 under Revenue Procedure (Rev. Proc.) 71-21, 1971-2 C.B. 549

This income would not be considered a recognized built-in gain when ABC recognizes the \$50,000 into income in 2015 because it would not have been included in gross income by an accrual method taxpayer 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 January 1, 2015.

In 2014, ABC received \$5,000 for services to be rendered in 2015 and properly included the \$5,000 into income in 2014.

In 2015, ABC, Inc. elected an accounting method change to include the \$5,000 in gross income in 2015, which resulted in a negative (\$5,000) IRC Section 481(a) change in accounting method adjustment.

The \$5,000 included in gross income in 2015 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 a negative (\$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. Section 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:

- 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
- 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 percent, 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. Section 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:

- 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
- The amount is not paid to a related party to which IRC Section 267(a)(2) applies.

e. IRC Section 481(a) Adjustments (Treas. Reg. Section 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 regarding changes in accounting methods are intended to prevent omissions or duplications of income or deductions.

**Example A**

Omitted Item Attributable to Pre Recognition Period

ABC, Inc. elects to become an S corporation effective January 1, 2012.

ABC improperly capitalizes repair costs and recovers the costs through depreciation of the related assets.

In 2015, 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.

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

Any item of income properly taken into account during the recognition period under the completed contract method (Treas. Reg. Section 1.460-4(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. Section 1.460-4(b)). 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. Section 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 Section 5.12 Special Rules for Installment Reporting.

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

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 gain or loss if the items originated in, and were taken into account directly by the S Corporation (the "look-through rule"). The final regulations have provided special rules for determining the items of built-in gains and losses in regard to partnerships. Please refer to Section 5.13 - Special Rules for Partnership Interests.

j. Valuing and Disposing of Inventory (Treas. Reg. Section 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:

- The replacement cost of the inventory,
- The expected retail selling price of the inventory,
- 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,
- 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 Section 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. Comm'r* (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 FMV 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 would not forgo all profit inherent in the work-in-process.

### 5.5.5 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 Selection. As a result, valuations are frequently provided by corporations to support FMVs as of the effective date for the Selection. Thus, a basic understanding of various valuation methods is important in completing audits with a built-in gain issue.

The most widely used valuation methods are:

- Analysis of the Actual Sale
- Analysis of Comparable Companies

A brief description of each of these methods is provided below.

Caution: Due to the complexity of valuing a company auditors are not encouraged to perform a business valuation on their own. If a business valuation is provided by taxpayers at audit, then auditors should contact the Valuation Task Force for review and consultation.

- **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 the actual sale price of the business, particularly when the sale is proximate in time to the valuation date. (See *Jung Est. v. Comm'r*, (1993) 58 TCM 1127, *Morris v. Comm'r*, (1978) 70 TC 959; *Narver v. Comm'r*, 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.

If the actual sale is within a year of 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 further 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 July 1<sup>st</sup> and then the company is sold on August 1<sup>st</sup> to an unrelated party. If there was no material event between July 1<sup>st</sup> and August 1<sup>st</sup>, the actual sales price is the best indicator of the company's value on July 1<sup>st</sup>.

#### **Example B**

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 researching the taxpayer business and industry you notice that gold stocks appreciated dramatically (Price/Earnings (P/E) ratios for many stocks in the industry doubled) between the S election date and the actual sale date. This is a material event that occurred between the S election date and the sale date, and this should be a fact that is considered in any valuation report received at audit.

- **The Comparable Sales Approach**

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 *Estate of Newhouse v. Comm'r*, (1990) 94 T.C. 193 or *Estate of Lauder v. Comm'r*, (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 non-publicly traded stock. Per Revenue Ruling (Rev. Rul.) 59-60, stock listed on an



exchange is to be considered first and over-the-counter stock second for comparison purposes.

- **Discounts and Premiums**

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

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% to 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

2) Discount for Lack of Marketability

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% to 40% range.

In *Bernard Mandelbaum, et al. v. Comm'r*, 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)."

## 5.6 CALCULATING THE NET RECOGNIZED BUILT-IN GAIN

- 5.6.1 Definition of Net Recognized Built-in Gain
- 5.6.2 Pre-Limitation Amount
  - 5.6.2.1 Computing Pre-Limitation Amount When Recognition Period Ends During the S Corporation's Taxable Year
- 5.6.3 Taxable Income Limitation
- 5.6.4 Net Unrealized Built-In Gain Limitation
  - 5.6.4.1 Computing the Net Unrealized Built-in Gain Limitation
  - 5.6.4.2 Adjustments to the Net Unrealized Built-in Gain
- 5.6.5 Net Recognized Built-in Gain Allocation Rule
- 5.6.6 Net Recognized Built-in Gain Carryover

### 5.6.1 Definition of Net Recognized Built-in Gain

Net recognized built-in gain is the amount of gain subject to the built-in gains tax during the tax year.

Under Treas. Reg. Section 1.1374-2(a) the net recognized built-in gain is the least of:

1. The Pre-Limitation Amount
2. The Taxable Income Limitation, or
3. The Net Unrealized Built-in Gain

Each of these limitations are discussed in the subsections below.

### 5.6.2 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 December 1, 1997.

On January 1, 2010, ABC made a federal and California S election.

After examination of the ABC’s books and records for TYE 12/10, 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:

	<u>Recognized Built-in Gain</u>	<u>Recognized Built-in Loss</u>	<u>Pre-Limitation Amount</u>
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	<u>0</u>		\$2,750,000
5. Sale of building		<u>-575,000</u>	-575,000
6. Total			<u>\$2,175,000</u>

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 TYE 12/09.

ABC’s pre-limitation amount is \$2,175,000.

**5.6.2.1 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 taxable year ending October 31.

ABC made a federal and California S election effective beginning November 1, 2004. It filed a calendar year end return on December 31, 2004.

ABC’s recognition period is the 120-month period covering November 1, 2004 to October 31, 2014.

In TYE 12/14, ABC reported the following gains on asset dispositions for assets held on November 1, 2004 (the date of conversion to an S corporation):

1. Land (sold on September 3, 2014)	\$1,000,000
2. Building (sold on September 3, 2014)	5,000,000
3. Building (sold on November 30, 2014)	10,000,000

In computing ABC's "pre-limitation amount", only asset sales occurring from –January 1, 2014, to October 31, 2014, are included (last 10 months of recognition period). The building sold on November 30, 2014 for a \$10,000,000 gain would fall outside the recognition period and would not be included in the "pre-limitation amount".

### 5.6.3 Taxable Income Limitation

The taxable income limitation is determined by using all rules applying to C corporation (IRC Section 63(a)), as modified by IRC Section 1375(b)(1)(B). Basically, this limitation is the S corporation's taxable income as normally computed, but disregards any net operating loss carryovers and certain deductible dividends allowed under IRC Sections 241-249. (Treas. Reg. Section 1.1374-2(a)(2))

For reference, the following deductions allowed under IRC Sections 21-249 are disregarded.

- IRC Section 241 – Allowance of special deductions (R&TC Section 24401)
- IRC Section 243 – Dividends received by corporations (R&TC Section 24402)
- IRC Section 245 – Dividends received from certain foreign corporations (R&TC Section 24402)
- IRC Section 246 – Rules applying to deductions for dividends received (R&TC Section 24402)
- IRC Section 246A – Dividends received deduction reduced where portfolio stock is debt financed
- IRC Section 249 – Limitation on deduction of bond premium on repurchase (R&TC Section 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. (Treas. Reg. Section 1.1374-2(d))

**Example A**

As Reported per Return:

1.	Ordinary income (loss) from trade or business activities from Federal Form 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 adjustments		-25,000
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.

**5.6.4 Net Unrealized Built-in Gain Limitation**

The net unrealized built-in gain is the maximum net recognized built-in gain subject to the built-in gains tax during the recognition period. (IRC Section 1374(c)(2)(A))

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

**5.6.4.1 Computing Net Unrealized Built-in Gain Limitation**

The net unrealized built-in gain 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).

(See Treas. Reg. Section 1.1374-3)

**Example A**

ABC, Inc. is a calendar year C corporation using the cash method. It elects to become an S corporation on January 1, 2014 and, on this day, has assets and liabilities as follows:

<b>Assets</b>	<b>FMV on January 1, 2014</b>	<b>Adjusted Basis</b>	<b>Built-in Gain (Loss)</b>
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	<u>150,000</u>	<u>0</u>	<u>150,000</u>
<b>Total Assets</b>	<b>396,000</b>	<b>92,000</b>	<b>304,000</b>
 <b>Liabilities</b>			
Mortgage	-100,000		
Rent payable *	-10,000	0	-10,000
Supplies payable *	-5,000	0	-5,000
Wages payable *	<u>-15,000</u>	<u>0</u>	<u>-15,000</u>
<b>Total liabilities</b>	<b>-130,000</b>		<b>-30,000</b>

\*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	<u>0</u>
	<b>Net Unrealized Built-In Gain</b>	<b><u>\$574,000</u></b>

#### 5.6.4.2 Adjustments to Net Unrealized Built-in Gain

For transactions that occur in taxable years beginning after February 23, 2005, Treas. Reg. Section 1.1374-3 provides for a special adjustment to the net unrealized built-in gain. The reason for the adjustment is to ensure that the S corporation does not recognize built-in gain on both the stock of the C corporation and the assets acquired from the C corporation (see Example A below).

Treas. Reg. Section 1.1374-3

In general. If Section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to the limitations of paragraph (b)(2) of this section, such net unrealized built-in gain is adjusted to eliminate any effect that any built-in gain or built-in loss in the redeemed or canceled stock (other than stock with respect to which a loss under section 165 is claimed) had on the initial computation of net unrealized built-in gain for that pool of assets. For purposes of this paragraph, stock described in Section 1374(d)(6) shall be treated as taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation.

Treas. Reg. Section 1.1374-3 was amended with an effective date of February 23, 2005. For transactions that occur in taxable years beginning prior to February 23, 2005, the former regulation should be followed. (Treas. Reg. Section 1.1374-3 (prior to amendment))

#### Example A

X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of \$15,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of \$33,000 and an adjusted basis of \$18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has \$10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X's taxable income limitation for 2009 is \$50,000. Effective June 1, 2009, X elects under section 1361 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y's assets to X in a liquidation to which sections 332 and 337(a) apply.

The net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, therefore, is decreased by \$15,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is \$0.



**5.6.5 Net Recognized Built-in Gain 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. Section 1.1374-2(b))

**Example A**

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

1. Pre-Limitation Amount =the [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	<u>1,000,000</u>	
Total pre-limitation amount		<u>\$1,300,000</u>
2. Taxable Income Limitation		<u>\$500,000</u>
3. Net Unrealized Built-in Gain		<u>\$5,000,000</u>

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 and the built-in gain carryover are prorated as follows:

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

**5.6.6 Net 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 - lesser of:

1. Pre-Limitation Amount [sum of recognized (1) built-in gain, (2) built-in loss, and (3) built-in gain carryover]:		
Sale of machinery	\$500,000	
Installment sale income	100,000	
Sale of land	<u>1,000,000</u>	
Total pre-limitation amount		<u>\$1,600,000</u>
2. Taxable Income Limitation		<u>\$1,000,000</u>
3. Net Unrealized Built-in Gain		<u>\$5,000,000</u>

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:

<b>Pre-Limitation Item</b>	<b>Pre-Limitation Amount</b>	<b>Taxable Income Ratio</b>	<b>Pro Rata Limitation</b>	<b>Pro Rata Recognized</b>	<b>Pro Rata Carried Over</b>
Sale of machinery	\$500,000	.31		\$310,000	\$190,000
Installment sale income	100,000	.06		60,000	40,000
Sale of land	<u>1,000,000</u>	<u>.63</u>		<u>630,000</u>	<u>370,000</u>
<b>Total</b>	<u>\$1,600,000</u>	<u>1.00</u>	<u>\$1,000,000</u>	<u>\$1,000,000</u>	<u>\$600,000</u>

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.

**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 January 1, 2004.

On January 1, 2004, 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 2004, 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 December 31, 2004, 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, the ordinary income of \$15,000 and capital gain of \$5,000 must be allocated as follows:

Recognized built-in gain/ordinary income:  $(15,000 / 20,000) \times 9,600 = \$7,200$   
 Recognized built-in gain/capital gain:  $(5,000 / 20,000) \times 9,600 = \$2,400$

ABC has recognized built-in gain carryover to 2005 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.

## 5.7 IRC SECTION 1374(d)(8) ASSET ACQUISITIONS

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

### 5.7.1 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 is usually not subject to the built-in gains tax. It becomes subject to the tax only in regard to assets acquired in a transaction in which the S corporation's basis in the assets are determined (in whole or in part) by reference to a C corporation's basis in the assets. (IRC Section 1374(d)(8)) Be aware that the Anti-Stuffing Rule may be applicable to certain situations. (Treas. Reg. Section 1.1374-9)

### 5.7.2 Separate Determinations of Tax and Taxable Income Limitations

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

- Assets that the S corporation acquired in an IRC Section 1374(d)(8) transaction,
- Assets that the S corporation acquired in another IRC Section 1374(d)(8) transaction,
- Assets that were 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 taxable 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. (Treas. Reg. Section 1.1374-8(d))

**Example A**

ABC, Inc. was incorporated on January 1, 2010 and immediately made a federal S election, and a deemed California S election. Therefore, ABC, Inc. was not subject to the built-in gains tax rules for federal or California purposes.

On January 1, 2015, 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 2015, 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:

1. Pre-Limitation Amount (recognized built-in gain)	<u>\$50,000</u>
2. Taxable Income	100,000
3. Net Unrealized Built-in Gain	150,000

ABC's "net recognized built-in gain" is \$50,000.

**Example B**

ABC, Inc., a C corporation, makes a valid federal and California S election effective on January 1, 2014 and is, therefore, subject to the built-in gains tax rules for federal or California purposes.

ABC reported the following on January 1, 2014:

1. Net Unrealized Built-in Gain	\$5,000
2. Net Operating Loss Carryover	0

On January 1, 2015, XYZ (an unrelated C corporation) merges into ABC pursuant to an IRC Section 368(a)(1)(A) transaction.

XYZ reported the following on January 1, 2015:

1. Net Unrealized Built-in Gain	\$80,000
2. Net Operating Loss Carryover	0

During 2015, ABC sold built-in gain assets totaling \$30,000 (pre-limitation amount): Of this amount, \$15,000 was from assets held by ABC prior to conversion and \$15,000 was from assets acquired from XYZ.

ABC reported taxable income of \$10,000 for TYE 12/15.

“Net recognized built-in gain” for TYE 12/15 is computed in stages as follows.

	<u>ABC's Assets</u>	<u>XYZ's Assets</u>	<u>Total</u>
<u>Lesser of the Parts:</u>			
1. Pre-Limitation Amount	\$15,000	<u>\$15,000</u>	
2. Net Unrealized Built-in Gain	<u>5,000</u>	80,000	
<u>Lesser of the Totals:</u>			
3. Lesser of (1) or (2) above	5,000	15,000	20,000
4. Taxable Income			<u>10,000</u>

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	<u>\$2,500</u>	[\$10,000 x (5,000 / 20,000)]
XYZ's Assets	<u>\$7,500</u>	[\$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.

## 5.8 SPECIAL RULES FOR INSTALLMENT SALES

- 5.8.1 Installment Sales Entered Into on or After December 27, 1994
- 5.8.2 Liquidating Distribution of Installment Note

### 5.8.1 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 either prior to or during the recognition period and reports income (either during or after the recognition period) from the sale using the installment method, that income is an item of built-in gain to the extent it would have been subject to tax in prior years if the corporation had elected out of the installment method.

#### 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.

**Example A – Roll Over Rule**

ABC, Inc. makes an S election effective January 1, 2010.

On January 1, 2010, 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 IRC Section 453.

In year 2015, ABC receives full payment on the note and reports the gain on Sch. D.

ABC net income after state adjustments for 2015 is \$0.

If ABC had reported the \$100,000 gain in 2010, its net recognized built-in gain from 2010 to 2015 would have been \$75,000 greater than otherwise.

Per Treas. Reg. Section 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 2015 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 IRC 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.

**Example A – Use of Losses**

Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Y sells Whiteacre with a basis of \$0 and a value of \$250,000 in exchange for a \$250,000 note bearing a market rate of interest payable on January 1, 2006. Y does not make the election under Section 453(d) and, therefore, reports the \$250,000 gain using the installment method under Section 453. In the year 2006, Y has income of \$250,000 on collecting the note, unexpired C year attributes of \$0, loss of \$100,000 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of \$150,000, and taxable income of \$0. If Y had reported the \$250,000 gain in 1996, X's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been \$225,000 greater than otherwise. Under paragraph (h) of this section, X has \$225,000 net recognized built-in gain subject to tax under Section 1374.



**Example B – Use of Section 1374 Attribute**

Z is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Z sells Greenacre with a basis of \$0 and a value of \$500,000 in exchange for a \$500,000 note bearing a market rate of interest payable on January 1, 2011. Z does not make the election under section 453(d) and, therefore, reports the \$500,000 gain using the installment method under section 453. In the year 2011, Z has income of \$500,000 on collecting the note, loss of \$0 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of \$0, taxable income of \$500,000, and a minimum tax credit of \$60,000 arising in 1995. None of Z's minimum tax credit is limited under sections 53(c) or 383. If Z had reported the \$500,000 gain in 1996, Z's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been \$350,000 greater than otherwise. Under paragraph (h) of this section, Z has \$350,000 net recognized built-in gain subject to tax under section 1374, a tentative section 1374 tax of \$122,500 ( $\$350,000 \times .35 = \$122,500$ ), and a section 1374 tax after using its minimum tax credit arising in 1995 of \$62,250 ( $\$122,500 - \$60,000 = \$62,250$ ).

**5.8.2 Liquidating Distribution of Installment Note**

For federal purpose when an S corporation distributes an installment note it will not recognize gain under IRC Section 453B(h). However, IRC Section 453B(h)(2) excludes the preferential treatment for BIG's tax by stating, "except for purposes of any tax imposed by subchapter S". Therefore, for federal purpose the S corporation must recognize the BIG's portion of the under IRC Section 336 and pay BIG's tax under IRC Section 1374.

However, for state purposes when the installment note is distributed and the gain from installment transactions has not been fully reported, the unreported income must be included in taxable income for the last year the taxpayer is subject to a tax measured by net income. (R&TC Section 24672) (Appeal of Kavanaugh – April 20, 2007 – Cal. St. Bd. of Equal. Case No. 348937, not to be cited as precedent.)

Additionally, any built-in-gains tax associated with the transaction will be imposed pursuant to IRC Section 1374.

See S Corporation Manual Section 15.3.2 for additional details.

## 5.9 SPECIAL RULES FOR PARTNERSHIP INTERESTS

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 gain 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.

### 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 (RBIG) from its distributive share of partnership items as follows:

- Step 1: Apply the rules of IRC Section 1374(d) to the S corporation's distributive 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 IRC Section 1374 items);
- Step 2: Determine the S corporation's net recognized built-in gain without partnership IRC Section 1374 items;
- Step 3: Determine the S corporation's net recognized built-in gain with partnership IRC Section 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 Step 2 plus the partnership RBIG. (Treas. Reg. Section 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 recognized built-in loss (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 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:

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 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 increased or decreased by:

- The corporation's allocable share of the partnership's IRC Section 481(a) adjustments at the time of 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 RBIG limitation of \$0.

**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 percent 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 (Based on Examples provided in the Regulations)****Example A**

ABC, Inc. makes a valid federal and California S election on January 1, 2012.

ABC owns 50% of partnership, PS, on the S election date. On January 1, 2012, PS owns a parcel of land (Parcel #1) with a basis of \$25,000; FMV, \$45,000.

During 2012, PS buys another parcel of land (Parcel #2) for \$50,000.

In 2013, 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 ( $\$30,000 \times 50\%$ ) 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 January 1, 2010. It owned land with a basis of \$100,000; FMV of \$200,000 on this date.

On January 1, 2012, ABC contributes the land to partnership, PS, in exchange for 50% partnership interest.

On January 1, 2014, 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 January 1, 2012.

ABC owns 50% of partnership, PS, on the S 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 2012, 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 2012; \$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 January 1, 2012.

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 2012, 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 2012; \$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**

ABC, Inc. makes a valid federal and California S election on January 1, 2012.

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 2012, 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 2012; \$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 January 1, 2012.

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 2012, ABC and PS report the following built-in gain (loss) items:

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

ABC's "net recognized built-in gain" without partnership items is \$115,000 in 2012 (\$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 January 1, 2012.

ABC owns 50% of partnership, PS, on the election date. ABC's RBIG limitation in regard to PS is \$200,000; RBIL limitation, \$0. PS owns land with a basis of \$20,000; FMV, \$140,000.

In 2012, 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 2012; \$155,000 with partnership items.

ABC has a partnership RBIG of \$60,000 for the year.

In 2015, 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 January 1, 2012.

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 2015 for \$36,000 and recognizes a \$36,000 gain (\$36,000 - \$0). Under IRC Section 704(c), ABC is allocated only \$12,000 because of book depreciation of \$8,000 per year (\$36,000 - (\$8,000 x 3 years)).

The remaining gain of \$24,000 (\$36,000 - \$12,000) is allocated 50% between the partners per IRC Section 704(b).

ABC is allocated gain of \$24,000 (\$12,000 + \$12,000). ABC, however, treats the entire \$36,000 gain as a partnership built-in gain item on PS's sale of Asset #1.

**Example I**

ABC, Inc. makes a valid federal and California S election on January 1, 2012.

ABC owns 50% of partnership, PS, on the election date. On January 1, 2012, PS owns land with a basis of \$20,000; FMV, \$40,000.

On January 1, 2014, 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 January 1, 2013, 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 period.



**5.10 BUILT-IN GAINS TAX ALLOWED AS A LOSS BY SHAREHOLDERS**

IRC Section 1366(f)(2) allows the shareholder of an S corporation to treat the built-in gain tax imposed on the S corporation as pass-through loss. 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**

	Amount of 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	<u>700,000</u>	<u>.70</u>		<u>65,100</u>
Total	<u>\$1,000,000</u>	<u>1.00</u>	<u>\$93,000</u>	<u>\$93,000</u>

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.
- 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 A 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.

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.

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, 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. (Treas. Reg. Section 1.1374-9) 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**

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.

## 5.11 COMPUTATION OF TAX

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 2015, the deduction is located on line 16 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 2015, the full \$1 million capital gain should be reported on line 4 of the form and then deducted on line 16. As a result, the amount subject to the BIG tax is not included in the "Net income for tax purposes" on line 20, and the BIG tax amount is reported on line 28.

Revised Date: December 2018