7.0 EXCESS NET PASSIVE INCOME TAX

7.1 FEDERAL AND CALIFORNIA BACKGROUND

7.1.1 Federal Background

The purpose of the tax on excess net passive income (ENPI) is to discourage a C corporation with accumulated earnings and profits (E&P) from becoming (or functioning as) a holding company in order to obtain favorable tax treatment under Subchapter S. Passive income as defined in IRC Section 1362(d)(3) differs from the rules for determining income or loss from passive activities under IRC Section 469(c). A more accurate term is "excess net investment income." The ENPI tax is assessed at the maximum corporate tax rate as provided under IRC Section 1374(a).

The ENPI tax is imposed on S corporations that meet both of the following conditions under IRC Section 1375:

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

Thus, an S corporation will not be subject to the tax on ENPI if it has been an S corporation for each of its taxable years.

ENPI is limited to the taxable income of the corporation computed as though it were a C corporation, without deducting any net operating loss deductions under IRC Section 172 or special corporate deductions under IRC Sections 241 through 249, other than the deduction for organizational expenditures under IRC section 248 as provided under IRC Section 1375(b)(1). Therefore, the ENPI tax will not be imposed if the corporation does not have taxable income (before NOLs and special deductions). See Section 7.3 of this manual for additional information. In addition, the ENPI tax may be avoided if the S corporation distributes all of its accumulated E&P on or before the end of the taxable year.

If a corporate level tax is imposed on ENPI, each item of an S corporation's passive investment income that is passed through to a shareholder is reduced by a pro rata part of that tax. (IRC Section 1366(f)(3))

The IRS may waive the ENPI tax if the S corporation shows to the satisfaction of the IRS that:

1. It determined in good faith that it had no Subchapter C E&P at the close of a taxable year; and
2. During a reasonable period of time after it was determined that it did have accumulated E&P from Subchapter C years at the close of that taxable year, those E&P were distributed. The S corporation has the burden of establishing that the waiver is warranted by the relevant facts and circumstances. (IRC Section 1375(d) and Treas. Reg. §1.1375-1(d)(1))

7.1.2 California Background

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

If the corporation does not have ENPI for federal purposes, then the corporation is not subject to California ENPI tax. (R&TC Section 23811(a))

Note: Do not confuse the wording of this subdivision. It does not state that if the corporation is not subject to federal ENPI tax they are automatically not subject to California ENPI tax. This only means that if the corporation does not have federal ENPI then it is not subject to California ENPI tax.

The term “Subchapter C E&P” used in IRC Sections 1375 and 1362(d)(3) will be the Subchapter C E&P of the corporation attributable to California sources (R&TC Section 23811(d)). The tax is imposed on the California S corporation if the E&P of the corporation is attributable to California sources. (R&TC Section 23811) E&P is attributable to California sources if the taxable income of prior years was fully subjected to the California income/franchise taxes (therefore not apportioning income), or if the amount was allocated or apportioned to California.

California allows S corporations to deduct the amount of California ENPI subject to California's ENPI tax for purposes of calculating the S corporations' taxable income subject to the franchise or income tax. (R&TC Section 23802(e)) In other words, the ENPI is only taxed at one rate. Since there is no S corporation tax for federal purposes, no comparable provision exists in federal law.

For California purposes, the S corporation shareholder(s) can only deduct the California amount of ENPI tax paid on their respective California individual returns - not the federal amount. (R&TC section 23803(b)) Accordingly, the shareholder should make a corresponding positive state adjustment required by the amount of the deduction stemming from the federal ENPI Tax.

If a determination is made that the corporation has subchapter C earnings and profits, the corporation is entitled to distribute a consent dividend to its shareholders. The consent dividend must be paid within 90 days of the determination that the corporation has subchapter C E&P as provided under R&TC Section 23811(e). For California purposes, the S corporation is allowed a deduction for the amount of the consent dividend solely for purposes of determining the corporation's subchapter C E&P.

The ENPI tax is assessed at the highest corporate tax rate of 8.84%. (R&TC Sections 23151 and 23811(b)(1))

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

7.2 COMPUTING THE ENPI TAX

7.2.1 Computing ENPI Tax

To compute the ENPI tax, complete the following steps.

1. Determine the amount of passive investment income over 25% of gross receipts
2. Determine net passive income (NPI)
3. Determine ENPI
4. Determine if there is a taxable income limitation
5. Compute the tax

Excess net passive income is computed under a formula in which (1) the passive investment income in excess of 25% of gross receipts for the taxable year is divided by the corporation's passive investment income for the taxable year; and (2) the net passive income (less deductions) is multiplied by this percentage to arrive at excess net passive income. (IRC Section 1375)

General Federal Computation

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

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

General California Computation

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

*CA gross receipts includes CA investment passive income

Generally, California conforms to the federal statute and regulations for purposes of computing ENPI tax. However, the California ENPI tax is computed only on passive investment income attributable to California sources. Similarly, for purposes of the 25% rule, gross receipts means 100% of the company's California gross receipts, including California passive investment income. Net passive income means California passive investment income reduced by any deductions directly connected with the production of California sourced income.

Example A

XYZ Corporation, an S corporation with C corporation accumulated earnings and profits, has gross receipts totaling $264,000 (of which $110,000 is passive investment income from California sources for taxable year ending (TYE) 12/15). Expenditures directly connected to the production of the passive investment income total $30,000. Therefore, XYZ has net passive investment income of $80,000 ($110,000 - $30,000). The amount by which its passive investment income exceeds 25% of its gross receipts is $44,000 [$110,000 passive investment income less $66,000(or $264,000 * .25)]. ENPI is $32,000, calculated as follows:

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

XYZ Corporation's ENPI tax for TYE 12/15 is $2,829 ($32,000 x 8.84%). XYZ must reduce its net income for state purposes by $32,000 for purposes of computing the franchise or income tax.

XYZ Corporation's Schedule K and Schedule K-1s will reflect a reduction to income (as a state adjustment) of $2,829 (for the amount of the tax). The shareholders are responsible for adding, as a state adjustment, any federal ENPI tax paid by the S corporation and deducted by the shareholder.

7.2.2 Passive Investment Income Defined

Generally, passive investment income means "gross receipts" derived from royalties, rents, dividends, interest, and annuities as provided under IRC Sections 1375(b)(3) and 1362(d)(3)(C).

Note: The IRS has not yet amended Treas. Reg. Section 1.1362-2 to reflect changes made by the Small Business Protection Act of 2007 (SBWOTA) P.L. 110-28. Treas. Reg. Section 1.1362-2(c)(5)(i)) includes sales or exchanges of stock or securities in the definition of passive investment income. However, for taxable years beginning after May 25, 2007, gains from the sale or exchange of stock or securities **are included in gross receipts, but such gains are not treated as passive investment income.**

The proper classification of income may be difficult to determine and turns upon the facts in each particular case. Under Treas. Reg. 1.1362-2(c)(5)(ii)(G), passive investment income will not include income which is identified by the IRS by regulation, revenue ruling or revenue procedure **as income derived in the ordinary course of a trade or business.**

For non-apportioning taxpayers, the federal and California passive investment income would be the same. However, for apportioning taxpayers, the California passive investment income is income from California sources.

For purposes of the ENPI tax, passive investment income includes royalties, rents, interest, dividends, and annuities as discussed below.

Royalties

Royalties **includes** all royalties, including mineral, oil, and gas royalties, (with exceptions) and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing taxable income. (Treas. Reg. Section 1.1362-2(c)(5)(ii)(A)(1).)

Royalties **does not include** royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation created the property, or performed significant services, or incurred substantial costs with respect to the development or marketing of the property. (Treas. Reg. Section 1.1362-2(c)(5)(ii)(A)(2))

Exceptions to the definition of royalties:
Royalties **does not include** copyright royalties, nor mineral, oil and gas royalties if the income from those royalties would not be treated as personal holding company income under IRC Sections 543(a)(3) and (a)(4) if the corporation were a C corporation.

Royalties **does not include** amounts received upon disposal of timber under IRC Section 631(b), the disposal of coal or domestic iron ore with a retained economic interest under IRC Section 631(c) and active business computer software royalties as defined under IRC Section 543(d), without regard to paragraph (d)(5). (Treas. Reg. Section 1.1362-2(c)(5)(ii)(A)(3))

In PLR 8328037, franchise payments were treated as royalty income. The IRS did not accept the taxpayer's contention that franchise payments should be excluded as passive income if significant services were provided. (A significant services rule applies to the classification of rental income)

Example A

T is an S corporation with accumulated E&P from Subchapter C years. In T's first taxable year as an S corporation, T has gross receipts of $75,000: $5,000 is royalty payments received with respect to Trademark A; $8,000 is royalty payments received with respect to Trademark B; and $62,000 is gross receipts from operations. T created Trademark A, but T did not create Trademark B or perform significant services or incur substantial costs with respect to the development or marketing of Trademark B.

Because T created Trademark A, the royalty payments with respect to Trademark A are derived in the ordinary course of T's business and are not included within the definition of royalties for purposes of determining T's passive investment income. However, the royalty payments with respect to Trademark B are included within the definition of royalties for purposes of determining T's passive investment income. T's passive investment income for the year is $8,000

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

Rents

Rents **includes** amounts received for the use of, or right to use, property (whether real or personal) of the corporation. (Treas. Reg. Section 1.1362-2(c)(5)(ii)(B)(1))

Rents **does not include** rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation). None of the other categories of passive income have a similar exception. The IRS has rejected the application of the significant services rule to other passive income categories. (Treas. Reg. Section 1.1362-2(c)(5)(ii)(B)(2))

Rents **does not include** produced film rents as defined under IRC Section 543(a)(5) as provided under Treasury Regulation Section 1.1362-2(c)(5)(ii)(B)(3). In addition, rents does not include compensation for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type as provided under Treas. Reg. Section 1.1362-2(c)(5)(ii)(B)(4).

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

There are many IRS rulings and tax court cases on what constitutes rent, frequently focusing on whether the taxpayer provided significant services. Here are a few of these rulings and case that arose under prior law. It is noted that the law may still be relevant because the current regulations continue to use the concept of "significant services".

In Revenue Ruling 70-206, 1970-1 C.B. 177, the IRS ruled that payments received for making television sets available to hospital patients and for required services, including unlocking and locking and adjusting and repairing the sets, are not rents.

In Revenue Ruling 65-83, 1965-1 C.B. 430, the IRS set forth examples of payments for the use of personal property which did not constitute rents because significant services were rendered by the corporation in connection with such payments. The kinds of personal property used in the examples were construction barricades, golf carts, cranes and dress suits.

In Nigh V. Commissioner, T.C. Memo 1990-349, the Tax Court found that an S corporation's income from its barge operations was not passive income in the form of rents. The IRS contended that since the company used an outside manager to operate its barges, it was really a lease arrangement with rental proceeds to the S corporation. However, the court concluded that the arrangement was an agency relationship and that the activities of the managing agent were attributable to the S corporation itself.

Example B

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

Example C

XYZ Corporation owns and operates an apartment building. Although the corporation provides utilities for the building, maintains the lobby in the building, and furnishes trash collection for the tenants, this does not constitute the rendering of significant services for the occupants. Thus, the rents paid by the tenants of the building are passive investment income to XYZ Corporation. (Treas. Reg. Section 1.1362-2(c)(5)(ii)(B)(2)) Bramlette Building Corp., Inc., 52 T.C. 200 (1969), aff'd in 70-1 USTC ¶9361, 25 AFTR2d 70-1016, 424.F.2d 751 (CA-5, 1970).

Dividends
Dividends **include** dividends as defined in IRC Section 316 (related to dividends from earnings and profits), amounts to be included in gross income under IRC Section 551 (related to foreign personal holding company income taxed to U.S. shareholders), and consent dividends as provided in IRC Section 565 (related to stockholders entitled to payment of dividends). (Treas. Reg. Section 1.1362-2(c)(5)(ii)(C))

Passive income **does not include** dividends received by an S corporation from a C corporation in which the S corporation has an 80% or greater ownership interest to the extent that dividends are attributable to the E&P of the C corporation derived from the active conduct of a trade or business. (IRC Section 1362(d)(3)(C)(iv))

Interest
Interest means **any amount received for the use of money** (including tax-exempt interest and amounts treated as interest under IRC Sections 483, 1272, 1274, or 7872, related to deferred payments, original issue discount on debt obligations, certain debt instruments and loans with below market interest). Therefore, tax-exempt income can be subject to the ENPI tax even though those amounts would not be subject to regular tax. (Treas. Reg. Section 1.1362-2(c)(5)(iii)(D)(1))

Interest expense **may not be used** to reduce interest income for purposes of the passive investment income determination. (Llewellyn v. Commissioner, 70 T.C, 370 (1978).) However, interest expense incurred in order to earn the interest income is deducted from such interest income subjected to the ENPI tax, to arrive at "net passive income" as provided under Treas. Reg. Section 1.1375-1(b)(2).
Interest **does not include** interest on any obligation acquired from the sale of property described in IRC Section 1221(a)(1) (related to inventory) or the performance of services in the ordinary course of a trade or business of selling the property or performing the services as provided under Treas. Reg. Section 1.1362-2(c)(5)(iii)(D)(2). In PLR 8515056, the IRS ruled that the interest an S corporation received as a real estate developer on installment notes held on the sale of lots was not passive investment income.

Special rules relate to the treatment of interest in certain businesses.
As provided under Treas. Reg. Section 1.1362-2(c)(5)(iii)(B), passive investment income **does not include** interest (as well as gain) that are directly derived in the ordinary course of a trade or business of lending or financing, dealing in property, purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages. In PLR 199938035, the IRS ruled that the interest income derived from interests in loans held by a partnership holding interests in bank loans, would be gross receipts directly derived in the ordinary course of a trade or business and would not be considered passive investment income.

However, interest earned from the investment of idle funds in short-term securities **does not constitute gross receipts directly derived in the ordinary course of business** under the provisions of Treas. Reg. Section 1.1362-2(c), and therefore would constitute passive investment income under these rules.

For banks or a depository institution holding company as defined in Section 3(W)(1) of the Federal Deposit Insurance Act, the term "passive investment income" **does not include** interest income or dividends earned by such bank or company. (IRC Sections 581 and 1362(d)(3)(C)(v))

Example D

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

Annuities

Annuities **includes** the entire amount received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includible in gross income under IRC section 72. (Treas. Reg. Section 1.1362-2(c)(5)(ii)(E))

Example E

Where an S corporation with accumulated E&P receives the proceeds of a key man life insurance policy as an annuity, the entire amount of the proceeds are passive investment income even if only a small portion of the proceeds are included in gross income.

Partnership Income

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

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

When an S corporation is a limited partner in a partnership, it could be argued that all income it derives from the limited partnership interest is passive investment income. However, in PLR 8852021 the IRS took the position that the S corporation's income from the partnership is characterized by reference to whether that income is passive investment income when earned by the partnership. Thus, only the S corporation's distributive share of the partnership's passive investment income (i.e., rents, royalties, dividends, interest, and annuities,) was treated as passive investment income of the S corporation.

7.2.3 Gross Receipts Defined

The term "gross receipts" is not specifically defined in either IRC Sections 1362 or 1365. As provided under Treas. Reg. Section 1.1362-2(c)(4)(i), gross receipts means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income with no reduction for returns, allowances, cost of goods sold, or deductions. Gross receipts also includes the amount received or accrued from the sale or exchange of property including property used in the corporation's trade or business (IRC Section 1231 property), income on investment property, and for services rendered by the corporation. Special rules apply to the sales of capital assets, stock, and securities as discussed below. In addition, net gains from the sale of stock or securities are included in gross receipts, however sales or exchanges of stock or securities are not considered passive investment income for purposes of the ENPI computation.

IRC Section 1231(a) provides that if the recognized gains on sales or exchanges of property used in the taxpayer's trade or business as defined in IRC Section 1231(b) and involuntary conversions exceed the recognized losses, such gains and losses will be considered to be long-term capital gains and losses. IRC Section 1250 provides for the taxation as ordinary income of the applicable percentage of gain from the sale of depreciable realty.

Example A
Sale of inventory

T is an S corporation with accumulated earnings and profits. T sells inventory at a sales price of $500. The cost of the inventory is $275. $500 is included in gross receipts. Gross receipts are not reduced by the cost of goods sold.

Example B
Sale of business asset (IRC Section 1231 property)

T is an accrual method S corporation with accumulated E&P. T sells an IRC Section 1231 depreciable asset which is used in the corporation's business. T receives payment for the asset partly in money and partly in the form of a note payable at a future time. T elects not to report the sale on the installment method. The amount of money and the face amount (or issue price if different) of the note received from the business asset are considered gross receipts in the taxable year of sale and are not reduced by the adjusted basis of the property, costs of sale, or any other amount.

Special rules for sales of capital assets, stock and securities

Sales of capital assets (other than stock or securities)
For purposes of determining the amount to include in gross receipts from the sale of capital assets, gross receipts includes only the total net capital gains from sales of capital assets as defined in IRC Section 1221 (other than stock and securities). Therefore, only the excess of capital gains over capital losses are included in the computation of ENPI. (IRC Section 1362(d)(3)(B)(i))

Capital assets as defined in IRC Section 1221 is property held by the taxpayer (whether or not connected with their trade or business), but does not include inventory, property used in the trade or business, a copyright, or similar property.

Example C
Sale of capital asset

T is an S corporation with accumulated earnings and profits. T sells a capital asset (as defined in IRC Section 1221) (other than stock or securities) for a gain of $50 and sells another capital asset (other than stock or securities) for a loss of ($10). Only the net capital gain of $40 is included as a gross receipt.

Sales of stock or securities
Gross receipts from the sale or exchange of stock or securities are taken into account only to the extent of the gains therefrom. Therefore, losses do not offset gains. (IRC Section 1362(d)(3)(B)(ii))

Note that this treatment differs from the sale of capital assets other than stock or securities in that losses may be taken into account.

Stock or securities for purposes of determining gross receipts from the sale thereof include: shares or certificates of stock, stock rights or warrants, a limited partnership interest, interest or participation in any profit sharing agreements, interest in oil, gas or other mineral property, a lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange or obligations issued by or on behalf of a State, Territory or political subdivision thereof. (Treas. Reg. Section 1.1362-2(c)(4)(ii)(B)(3)

Example D
Sale of stock

T is an S corporation with accumulated earnings and profits. T sells stock resulting in a gain of $100, and sells another stock at a loss of $100. T has gross receipts of $100 from the sale of stock. Gross receipts are not reduced for the loss of ($100).

Additional considerations
Gross receipts do not include: amounts received from a loan, repayment of a loan, a contribution to capital or the issuance by the corporation of its own stock, amounts received in nontaxable sales or exchanges and amounts relating to certain liquidations. (Treas. Reg. Sections 1.1362-2(c)(4)(ii)(B)(2) and ((c)(4)(iii))

California modifies the definition of "passive investment income", and "gross receipts" under IRC Section 1375 to include only California sourced income as provided under R&TC Section 23811. Therefore, for purposes of the 25% rule, gross receipts means 100% of the company's California sourced gross receipts (and not 100% of gross receipts overall), including California passive investment income. Accordingly, for non-apportioning taxpayers, the federal and California gross receipts would be the same. However, for apportioning taxpayers, the California gross receipts would generally be the amount properly allocated to California Schedule R for apportioning rate computational purposes.

Disposition of partnership interests

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

Exception for disposition of partnership interest:
An S corporation that disposes of a general partner interest may treat the disposition in the same manner as the disposition of an interest as a limited partner (treated as a disposition of stock and securities). Treas. Reg. Section 1.1362-2(c)(4)(ii)(B)(4)(ii))

Example E
Disposition of partnership interest

T is a calendar year S corporation with accumulated E&P. In T's first year as an S corporation, T and two of its shareholders form a general partnership, RPS, to indirectly invest in marketable stocks and securities. T contributes cash to PRS and receives a 50% interest in the capital and profits of PRS.

The only assets of PRS are the stock, securities and certain real and tangible personal property. In the next year, T needs cash in its business and sells its partnership interest at a gain rather than having PRS sell the marketable stock or securities that have appreciated.

The gain on T's disposition of its interest in PRS is treated as gain from the sale or exchange of stock or securities to the extent such gain is the amount of the distributive share of gain T would have received from the sale of stock or securities held by PRS, if PRS had sold all of its stock or securities at fair market value at the time T disposed of its interest in PRS.

Example F
Exception for disposition of partnership interest

T, an S corporation with accumulated E&P , holds a 50% general partnership interest in Partnership Q. Q holds Stock Z ($200 basis and $500 FMV) and IRC Section 1231 property ($800 basis and $1,000 FMV).

Not treated as a disposition of an LP interest
If T sells its interest in Q for $750 and does not treat the disposition as a disposition of a limited partnership interest, it will have gross receipts of $250 and passive investment income of $150 (50% of the $300 gain on the deemed sale of Z).

Treated as a disposition of an LP interest
However, if T decides to treat the sale as a disposition of a LP interest, it will have gross receipts and passive investment income of $250 ($750 proceeds on the sale of its interest minus its basis of $500). Therefore, T should not make the election on the sale of Q.

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

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

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

7.2.4 Net Passive Income Defined

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

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

Under Treas. Reg. Section 1.1375-1(b)(3)(i), to be directly connected with the production of income, a deduction item must have a proximate and primary relationship to the income. Expenses, depreciation, and similar items attributable solely to that income qualify for the deduction. These expenses include, but are not limited to:

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

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

To prevent the imposition of more than one corporate-level tax on the same income, passive investment income is determined by excluding income subject to the IRC Section 1374 built in gain rules. Therefore, if a gain is potentially subject to both the built in gains tax and the ENPI tax, the gain is taxed under the built in gains tax rules (Treas. Reg. Section 1.1375-1(c)(2)).

7.2.5 Taxable Income Limitation

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

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

- IRC Section 172 - Net operating loss deduction. (R&TC Section 24416)
- IRC Section 241 - Allowance of special deductions. (R&TC Section 24401)
- IRC Section 243 - Dividends received by corporations. (R&TC Section 24402)
- IRC Section 244 - Dividends received on certain preferred stock (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 247 - Dividends paid on certain preferred stock of public utilities. (R&TC Section 24402.
- IRC Section 249 - Limitation on deduction of bond premium on repurchase. (R&TC Section 24439)

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

Example A

As reported per return(100S):

1. Ordinary income (loss) 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		$850,000
5. Depreciation and amortization adjustments		($25,000)
6. Portfolio income		$910,000
7. Contributions		($1,000)
8. Net income (loss) after state adjustments		$1,800,000
9. Net income (loss) for state purposes		$1,800,000
11.Net operating loss carryover deduction	889,000	
12.Net income for tax purposes		$911,000

The taxable income limitation for California purposes is $1,800,000(net income after state adjustments).

Note: In this example there are no IRC Section 241 or IRC Section 249 deductions required to be added back to net income (loss) after state adjustments for purposes of computing the taxable income limitation. The net operating loss deduction is disregarded in computing the taxable income limitation.

In this example, ENPI taxable income limitation is $1,800,000. If it had exceeded $1,800,000, the excess would not have been subject to the tax and would not have been carried over into subsequent years.

7.3 DEDUCTION FOR ENPI TAX AT THE SHAREHOLDER LEVEL

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

Example A
Pass through deduction to the S corporation shareholder for the ENPI tax. This example is applicable to a 100% CA resident shareholder.
In TYE ending 12/31/15 XYZ Corporation had ENPI of $1,000,000 and an ENPI tax of $350,000 for federal purposes ($1,000,000 *35% tax rate) and $88,400 for California ($1,000,000 *8.84% tax rate).

Passive Investment Income included income from interest and dividends. The ENPI tax is allowed to reduce each passive investment income item proportionately by the amount of tax.

	ENPI	**Ratio**	**Federal Adjustment**	**CA Adjustment**
Interest	$900,000	.90	($315,000)	($79,560)
Dividends	$100,000	.10	($35,000)	($8,840)
Total tax		1.00	($350,000)	($88,400)

The Schedule K-1 issued to the 100% shareholder would include the following items (in addition to other income and loss items if applicable)

	Amount from federal Schedule K-1	**California Adjustment**	**Total Amount Using CA law**
Interest Income	$585,000	$235,440	$820,440
Dividend Income	$65,000	$26,160	$91,160

The shareholder would include the following in the computation of **federal** shareholder basis.

Interest income	$585,000	($900,000- $315,000)
Dividend income	$65,000	($100,000-$35,000)

The shareholder would include the following in the computation of **California** shareholder. basis

Interest income	$820,440	($900,000-$79,560)
Dividend income	$91,160	($100,000- $8,840)

The shareholder would include the following amounts on their CA income tax return:
Interest income: $585,000 on Schedule B, and a California adjustment of $235,440 on Schedule CA

Dividend income:$65,000 on Schedule B, and California adjustment of $26,160 on Schedule CA.

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

7.4 COMPUTING ACCUMULATED E&P

7.4.1 Federal Accumulated Earnings and Profits (E&P)

The term "subchapter C earnings and profits" with respect to S corporations which were once C corporations was replaced by the term "accumulated earnings and profits" in IRC Section 1375(d). Under Treas. Reg. Section 1.1362-2(c)(3), "subchapter C earnings and profits" are defined as the E&P of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an election under IRC section 1362(a) is not in effect. The regulations have not been amended to reflect the change in terminology from "subchapter C earnings and profits" to "accumulated earnings and profits".

While the IRC does not define the term "accumulated earnings and profits", IRC Section 312 lists certain transactions that affect E&P. Incidentally, E&P does possess similarities to the accounting concept of retained earnings (earnings retained in the business). However, E&P and retained earnings are often not the same. E&P represents the corporation's economic ability to pay dividends without impairing its capital. The effect of a specific transaction on the E&P account can be determined simply by considering whether or not the transaction increases or decreases the corporation's ability to pay dividends.

S corporations do not generate E&P. Nevertheless, an S corporation can acquire accumulated E&P in certain acquisitions to which IRC Section 381 applies (e.g., due to a merger), or it could be earned in years before the S election.

Note: An S corporation is required to enter the amount of their accumulated earnings and profits at the close of its taxable year on Schedule B (1120S).

The ENPI tax cannot be assessed in the final year. Liquidating a corporation by distributing all of its property to shareholders should eliminate any accumulated E&P at the close of the liquidating taxable year. (PLR 9747035 (corporation's final taxable year closes after the liquidating distribution))

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

Nature of Transaction	Effect on Taxable Income in Arriving at Current E&P
Tax exempt income	ADD
Federal income taxes	SUBTRACT
Loss on sale between related parties	SUBTRACT
Payment of premiums on insurance policy on life of corporate officer	SUBTRACT
Collection of proceeds of insurance policy on life of corporate officer	ADD
Excess charitable contribution (over 10% limitation)	SUBTRACT
Deduction of excess charitable contribution in succeeding taxable year (increases E&P because deduction reduces taxable income while E&P was reduced in a prior year)	ADD
Realized gain (not recognized) on an involuntary conversion	NO EFFECT
Percentage depletion (only cost depletion can reduce E&P)	ADD
Accelerated depreciation (E&P is reduced only by straight-line, units of production, or machine hours depreciation)	ADD
Deferred gain on installment sale (all gain is added to E&P in year of sale)	ADD
Intangible drilling costs deducted currently (reduce E&P in future years by amortizing costs over 60 months)	ADD
Mine exploration and development costs (reduce E&P in future years by amortizing costs over 120 months)	ADD

7.4.2 California Accumulated E&P

To determine whether the corporation has accumulated E&P for California purposes, both federal and California S election dates are considered.

In general, the corporation does not have accumulated E&P if it began as a California S corporation on the first day of incorporation.

If the corporation was a C corporation prior to making a valid S election for California purposes, it may have accumulated E&P.

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

If the California S election is after 12/31/88 or before 1/1/02, use the California S election date to determine whether the corporation has any accumulated E&P.

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

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

Example A

ABC, Inc. incorporated on 6/12/15 and made a valid federal S election on the same date. It was deemed to be a California S corporation.

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

Example B

ABC, Inc. incorporated on 6/12/15 and made a valid federal S election on the same date. It was deemed to be a California S corporation.

On 12/31/15, ABC acquired XYZ, Inc. (a C corporation) through merger. On that date, XYZ had accumulated E&P of $500,000.

Beginning on 12/31/15, ABC has accumulated E&P of $500,000.

7.5 DIVIDENDS FROM EARNINGS AND PROFITS

7.5.1 Distributions from accumulated E&P

An S corporation may want to reduce its accumulated earnings and profits (E&P) to zero to avoid the ENPI tax. The S corporation can either:

1. Make an election to make a distribution from accumulated E&P (IRC Section 1368(e)(3)) or,
2. Make an election to make a deemed dividend from accumulated E&P (Treas. Reg. section 1.1368-1(f)

Elections under IRC Section 1368(e)(3) or Treas. Reg. section 1.1368-1(f)
The corporation must attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. A copy must be attached to the California Form 100S. In the statement, the corporation must identify the election it is making and must state that each shareholder consents to the election. The statement of election to make a deemed dividend must include the amount of the deemed dividend distributed to each shareholder.

Distribution from accumulated E&P
Under IRC Section 1368(e)(3), an S corporation, with the consent of all affected shareholders, is allowed to make distributions from its accumulated E&P, before making distributions out of the AAA. Any remaining portion of the distribution is treated as a distribution from an S corporation that has no earnings and profits in the manner provided in IRC Section 1368(b). (R&TC Section 23811(e)(2))

Example A
Election to distribute accumulated earnings and profits first
ABC Inc., (ABC) incorporated in 2011 and made a valid federal S election on 1/1/2013. On 1/1/2013, ABC has $500,000 of accumulated E&P for federal and state purposes. ABC is subject to the ENPI tax on income of $600,000 and reported taxable income of $1,000,000 for the taxable year ending 12/31/13 resulting in an increase to the shareholder's stock basis of $1,000,000. ABC would like to make a distribution of $1,000,000 to the sole shareholder and they would also like to avoid the tax on ENPI income. ABC makes a proper election to distribute earnings and profits first. Of the $1,000,000 distribution, $500,000 is a taxable dividend distribution to the shareholder and the remaining $500,000 is treated as a nontaxable return of shareholder stock basis.

See Section 8 (Distributions / Accumulated Adjustments Account) and Section 9 (Shareholder Basis) of the S corporation manual for information on S corporation shareholder stock basis and the taxability of distributions to shareholders.

Deemed dividend distributions
If the S corporation has trouble raising cash to distribute, they may reduce their accumulated E&P by way of deemed dividends. (Treas. Reg. Section 1.1368-1(f)(1)(ii) and 1.1368-1(f)(3). The deemed dividend may not exceed year-end subchapter C earnings and profits, reduced by any actual distributions of such earnings and profits. The deemed distribution is treated as a pro rata distribution of money to the shareholders, received by the shareholders, and immediately contributed back to the corporation, all on the last day of the tax year. Accordingly, a deemed distribution is a taxable distribution to shareholders followed by an increase to their stock basis in the S corporation.

Example B
Election to make a deemed dividend from accumulated E&P.
ABC Inc., (ABC) incorporated in 2011 and made a valid federal S election on 1/1/2013. On 1/1/2013, ABC has $500,000 of accumulated E&P for federal and state purposes. ABC is subject to the ENPI tax on income of $600,000 and reported taxable income of $1,000,000 for the taxable year ending 12/31/13 that results in an increase of $1,000,000 to the sole shareholder's stock basis.

ABC would like to avoid the ENPI tax, but they do not want to make a cash distribution to the shareholder. ABC makes a proper election to make a deemed dividend distribution from accumulated E&P in the amount of $500,000.

The sole shareholder is treated as if they received a $500,000 taxable dividend and the shareholder receives an increase of $500,000 to their stock basis in the S corporation
See Section 8 (Distributions / Accumulated Adjustments Account) and Section 9 (Shareholder Basis) of the S corporation manual for information on S corporation shareholder stock basis and the taxability of distributions to shareholders.

7.5.2 California ENPI adjustments to income

R&TC Section 23811(e) allows the S corporation to amend its return to distribute a consent dividend to its shareholders. The S corporation must pay a consent dividend within 90 days after the determination date. The determination date is deemed to be the effective date of a closing agreement with the Franchise Tax Board, the date an assessment of Bank and Corporation tax becomes final, or the date the corporation executes an agreement with the FTB relating to the ENPI tax liability (R&TC Section 23811(e)(2)).

The amount of the consent dividend may not exceed the difference between the corporation's subchapter C earnings and profits under California law at the close of the taxable year in which the determination is made and the corporation's accumulated E&P for federal income tax purposes at the same date. Once the consent dividend election is made and the consent dividend distributed, the S corporation may no longer be subject to the ENPI tax for the year.

An S corporation that distributes a consent dividend must reduce accumulated E&P by filing an amended return with the FTB within 120 days after the determination date. The collection of the ENPI tax is stayed for 120 days after the date of determination, whether or not the corporation files an amended return. If the corporation files an amended return with the FTB, the collection of the tax is stayed until the FTB acts on the amended return as provided under R&TC Section 23811(e)(3) through (e)(5).

Note: California law under R&TC Section 23811(e) uses the term "consent dividend". A consent divided is also known as a deemed divided. California law under R&TC Section 23811(e)(2) provides that the corporation must make the election provided in IRC Section 1368(e)(3) for any consent dividend. However, IRC Section 1368(e)(3) applies to paid dividends and not consent dividends. Therefore, if an amended return is filed under R&TC section 23811 consult with Legal for further guidance.

7.6 S CORPORATION REVOCATION DUE TO ENPI

If an S corporation, which was formerly a C corporation with accumulated E&P, has passive investment income in excess of 25% of its gross receipts for three consecutive taxable years, the S election is terminated as of the beginning of the fourth year as provided under IRC Section 1362(d)(3)(A)(ii) Pursuant to R&TC Section 23801(g), IRC Section 1362 (d)(3) does not apply unless the "S" election is terminated for federal income tax purposes.
The IRS will reconsider reinstating the election under IRC Section 1362(f), if the S corporation can demonstrate that its status terminated inadvertently because for example there was a good faith underestimation of accumulated E&P, and if within a reasonable period of discovering the error, the accumulated E&P is distributed. The IRS may require the S corporation to pay the ENPI tax and require shareholders to amend returns to reflect the distribution of E&P as taxable dividends. (PLR 9024023)

Example A

For taxable years ending 12/13, 12/14 and 12/15, XYZ Corporation, a calendar year S corporation, derived passive investment income in excess of 25% of its gross receipts. If XYZ holds accumulated E&P from years in which it was a C corporation, its S election is terminated as January 1, 2016.

7.7 EFFECT ON BUILT-IN GAINS

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

7.8 EXHIBITS

Exhibit 7.8.1 ENPI Checklist
Exhibit 7.8.2 Sample Problems and Solutions

EXHIBIT 7.8.1

<table>
<tr><th colspan="2">ENPI Checklist</th></tr>
<tr><td>1</td><td>Does the S corporation have ENPI (not tax) for federal purposes?
If not, then the tax is not imposed for California purposes.</td></tr>
<tr><td>2</td><td>Does the S corporation have C corporation E&P at the close of the taxable year?
Verify whether the corporation was ever a federal C corporation by reviewing the returns in the taxpayer's folder.
Verify whether the corporation has exhausted E&P through prior year distributions.
Verify whether the corporation elected to bypass AAA, allowing the distribution of E&P.</td></tr>
<tr><td>3</td><td>Does the S corporation report Net Passive Income?
Check that the corporation is reporting "separately stated" items, including interest, dividends, royalties, capital gains, etc.
Check whether the corporation is reporting "other income" consisting of interest, dividends, royalties, capital gains, etc.</td></tr>
<tr><td>4</td><td>Passive Investment Income more than 25% of Gross Receipts?</td></tr>
<tr><td>5</td><td>Compute Gross Receipts for ENPI purposes, including the following:
Income from a trade or business activity.
Amount received in nontaxable sale or exchange is not included except to the extent the gain is recognized by the S corporation on the sale or exchange.
Capital gain net income, not gross proceeds, from the sale of capital assets other than stocks or securities. In other words, the excess of capital gains over capital losses is considered the gross receipts. If capital losses exceed capital gains, the net capital loss is not included.
Gain on the sale or exchange of stock or securities. Losses do not offset gains for purposes of determining gross receipts. In other words, stock and security sales resulting in a gain are aggregated and included in gross receipts.
Gain on disposition of a general partnership interest is treated as sale or exchange of stock or security. If tiered partnerships, you must look through each tier.
Gross payments received on installment sales during the year.
The S corporation's share of a partnership's gross receipts. In other words, you must apply the gross receipts test to each of the partnership's gross receipts and include in total gross receipts (S corporation and partnership) the S corporation's profit and loss percentage</td></tr>
<tr><td></td><td></td></tr>
</table>

6	Compute Passive Investment Income for ENPI purposes, including the following: • Royalties. • Rents. • Dividends. • Interest. • Annuities. • An amount received in a nontaxable sale or exchange is not included except to the extent the gain is recognized by the S corporation on the sale or exchange. • Capital gain net income, not gross proceeds, from the sale of capital assets other than stocks or securities. In other words, the excess of capital gains over capital losses is considered the gross receipts. If capital losses exceed capital gains, the net capital loss is not included. • Gain on the sale or exchange of stock or securities. Losses do not offset gains for purposes of determining gross receipts. In other words, stock and security sales resulting in a gain are aggregated and included in gross receipts. • Gain on disposition of a general partnership interest is treated as sale or exchange of stock or security. If tiered partnerships, you must look through each tier. • Gross payments received on installment sales during the year. • The S corporation's share of a partnership's gross receipts. In other words, you must apply the gross receipts test to each of the partnership's gross receipts and include in total gross receipts (S corporation and partnership) the S corporation's profit and loss percentage. • Remember to reduce the income items noted above by any deductions directly connected with the production of such income.
7	Use the following formula to compute ENPI: $$\text{ENPI} = \frac{\text{Passive Investment Income in Excess of 20\% of gross receipts}}{\text{Gross Passive Investment Income for the year}} \times \text{Net Passive Investment Income for the year}$$
8	Multiply ENPI by 8.84% to arrive at ENPI tax
9	Did the corporation report a net loss, when computing its income as if a C corporation? • Recompute Taxable Income assuming it's a C corporation
10	Remember to reduce the passive income passing through to shareholder(s) by the amount of the ENPI tax on a proportionate basis.

11	Remember to reduce the S corporation's net income subject to the franchise or income tax by the amount of ENPI subject to the ENPI tax.
12	If the corporation with E&P has passive income in excess of 25% of its gross receipts for three consecutive taxable years, the S election is terminated as of the beginning of the fourth taxable year. • It is not necessary that the corporation pay the ENPI tax for such revocation to occur.
13	ENPI Tax Example For TYE12/15, XYZ Corporation, an electing S corporation, has gross receipts from California sources totaling $264,000 (of which $110,000 is passive investment income). Expenditures directly connected to the production of the passive investment income total $30,000. Therefore, XYZ has net passive investment income of $80,000 ($110,000 - $30,000), and the amount by which its passive investment income for the year exceeds 25% of its gross receipts is $44,000 [$110,000 passive investment income less $66,000(or $264,000 * .25)]. ENPI (ENPI) is $32,000, calculated as follows: ENPI= ($44,000/$110,000) * $80,000= $32,000 Consequently, XYZ Corporation's ENPI tax for TYE 12/15 is $2,829 ($32,000 x 8.84%). Incidentally, XYZ must reduce its Net Income for state purposes by $32,000 for purposes of computing its income tax. Also, XYZ Corporation must also reduce, as a Schedule K-1 state adjustment, the amount of income passing through to the shareholder(s) by $2,829.

EXHIBIT 7.8.2

Sample Problems and Solutions

Problem #1

Corp M, an S corporation, is a calendar year taxpayer. At the end of its taxable year, M has accumulated E&P from Subchapter C years on hand from a year it was not an S corporation. M's gross receipts for that taxable year are $1,500,000, its passive investment income is $750,000, and its taxable income as a C corporation would be $500,000. Deductions directly connected with the production of passive investment income are $50,000.

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

Solution #1

- M's gross passive investment income is $750,000.
- M's net passive income is $700,000 (i.e., $750,000 of passive investment income less $50,000 of allowable deductions).
- M's excess passive investment income is $375,000 (i.e., $750,000 - $375,000 (25% of gross receipts of $1,500,000)).
- The ENPI tax is [($375,000/$750,000) * $700,000] = $350,000 *8.84%= $30,940.

Problem #2

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

- What is M's ENPI tax?

Solution #2

The ENPI tax is $8,840 ($100,000 * 8.84%).

Revised Date: December 2018