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Tax Tip

By Stephen L. Owen

Planning for the S Corporation "Big" Tax

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Subchapter S of the Internal Revenue Code[1] offers special (favorable) tax treatment for certain corporations.[2] In general, corporations are subject to tax under Subchapter C of the Code.[3] Subchapter C is that special area of the tax law that imposes a "double tax" on the income generated by a corporation. If a corporation generates $1.00 of taxable income, there is a tax at the corporate level[4] of $0.35, leaving $0.65 for distribution to the stockholders. The $0.65 distribution, if and when made, is subject to another tax of $0.15.[5] A similar analysis applies when the C corporation sells its assets and liquidates.[6]

> **Example 1.** C Corp, a corporation subject to tax, owns a hotel having a basis of $1 million. C Corp will sell the hotel to X Co for $11 million, producing a taxable gain of $10 million and a resulting corporate tax of $3.5 million. When the net proceeds of $7.5 million are distributed to the stockholders in liquidation (assuming they have a nominal basis in their stock), there will be a tax at the stockholder level of $1.125 million, leaving net proceeds of $6.375 million.[7]

> **Example 2.** Assume the same facts as Example 1 except that C Corp is instead a partnership for tax purposes. A partnership or LLC is not subject to tax at the entity level.[8] It is a pure "flow through" entity in that all of its tax items flow through to the partners/members. Thus, if the hotel were sold for $11 million producing a taxable gain of $10 million, the tax would be $1.5 million,[9] leaving net proceeds of $9.5 million.

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As a general rule, an S corporation is taxed in the same "flow-through" manner as a partnership or LLC.

Example 3. Assume the same facts as in Example 2 except that C Corp is an S corporation for income tax purposes and that it had always been an S corporation. On these facts, the result in Example 2 in the case of a partnership would be the same in this Example 3 in the case of an S corporation.

Why don't owners of C corporations avoid the double tax problem by simply liquidating the corporation and continuing to operate the business as a partnership or LLC? The reason is that the liquidation of a corporation is treated as if the corporation had sold all its assets at fair market value.[10] The distribution of assets would trigger gain to the corporation (even though there is no cash generated from the transaction).

Example 4. Assume the same facts as Example 1 except that the hotel is not sold but is simply distributed to the stockholders. The tax cost would be identical to Example 1 except there would be no cash generated to pay the tax. Note also that the distributed assets in the hands of the stockholders would obtain a basis step up to fair market value.[11]

What if a C corporation makes an S election? An S election is not treated as a deemed liquidation of a C corporation. Thus, a C corporation that qualifies for S status could make an S election and achieve flow-through tax treatment without adverse tax consequences[12] (unlike the case where the C corporation liquidates or otherwise converts into a partnership or LLC).

However, the tax laws are not so simple. If a C corporation could avoid the onerous double tax bite simply by making an S election, a glaring loophole would exist in the United States corporate tax regime. If a C corporation wanted to sell assets and then liquidate and avoid the corporate-level tax, it would simply make an S election and then sell its assets, thereby avoiding the corporate-level tax!

Code Sec. 1374 is designed to close this "loophole."[13] Code Sec. 1374 provides that an S corporation that was formerly a C corporation will remain subject to a *corporate-level* tax if the corporation recognizes a "built-in gain" within the 10-year period (the "recognition period") following the effective date of the S election.[14]

Example 5. Assume the same facts as in Example 1 except that, effective as of January 1, 2010, C Corp makes an S election. As of this date, C Corp has built-in gain in its hotel of $10 million ($11 million value over its $1 million basis). If the hotel is sold or distributed by C Corp within 10 years following the S election, the lesser of the $10 million built-in gain or the actual gain on the sale will be taxed at the corporate level *in addition* to the "regular" tax imposed by Subchapter S at the stockholder level on the amount of the actual gain less the built-in gain tax imposed on the corporation.[15] If the hotel is sold for $20 million during this period, the post-S election appreciation of $9 million is *not* subject to corporate level tax. If the hotel is sold for $8 million during this period, the entire $7 million of actual gain is subject to corporate-level tax.

Code Sec. 1374 only applies to assets that were owned by the corporation at the time of the S election; subsequently acquired assets are excluded.[16] In addition, Code Sec. 1374 generously does not apply to S corporations that have always been S corporations.[17] However, if an S corporation acquires the assets of a C corporation ("C Target") in a transaction in which the tax basis of C Target's assets carries over to the S corporation (for example, in a tax-free merger), Code Sec. 1374 would apply to the built-in gain attributable to C Target's assets if they are sold within the 10-year period following the acquisition.[18]

Example 6. Assume that S Corp has always been an S corporation. Further assume that C Corp described in Example 1 merges into S Corp in a tax-free reorganization with S Corp surviving. S Corp's S status continues. However, the hotel formerly owned by C Corp is now a built-in gain asset just as if C Corp had made an S election as in Example 5.

REITs. The rules of Code Sec. 1374 also are applied in the real estate investment trust (REIT) area where a C corporation converts to REIT status or acquires property from a C corporation in a carryover basis transaction.[19]

Installment Sales. Assume C Corp in Example 5 sells the hotel in 2009 after the effective date of the

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S election. Instead of receiving cash, C Corp receives a promissory note providing for interest only until 2020 when the entire principal will be payable. Is the built-in gain attributable to the hotel excluded from Code Sec. 1374 because it is recognized outside of the 10-year recognition period? No. The regulations make clear that the deferred gain is subject to Code Sec. 1374 tax[20] if the sale of an asset occurs "before or during" the recognition period and if the income is reported using the installment sale method either "during or after" the recognition period.

Exchange Property. What if C Corp in Example 5 does not sell the hotel after the S election but exchanges the hotel in a Code Sec. 1031 transaction? Code Sec. 1374 applies to *recognized* built-in gains. A like-kind exchange under Code Sec. 1031 and certain other nontaxable transactions[21] do not trigger gain recognition. However, the new property received will carry the Code Sec. 1374 taint; if the new property is disposed of during the recognition period, corporate tax will be applied.[22]

Partnership Interests and Partnership Assets: The regulations[23] promulgated under Code Sec. 1374 explain how to handle the built-in gains tax when a corporation owns a partnership interest at the time of the S election, when a built-in gain asset is contributed to a partnership during the recognition period and when partnership property is distributed from a partnership to the corporation during the recognition period.

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Example 7. Jones Corp was a C corporation that made an S election on January 1, 2010. At the time of the S election, the only asset that Jones Corp owned was a 50-percent partnership interest in the JK Partnership. JK Partnership owned a hotel having a value of $11 million and a basis of $1 million. Jones Corp's basis in its JK Partnership interest is $500,000. Under the regulations, if Jones Corp sells its JK Partnership interest during the recognition period, the built-in gain of $5 million (assuming no valuation discounts are available—see further discussion below) will be subject to corporate tax. Alternatively, if the hotel is sold by JK Partnership during the recognition period, Jones Corp will have a corporate tax on its share ($5 million) of the built-in gain.[24]

What if the value of a partnership interest is subject to discounting? Consider the recent Tax Court decision in *Ringgold Telephone Co.*[25] There, a C corporation ("Taxpayer") elected S status effective January 1, 2000. As of this date, the Taxpayer owned a 25-percent partnership interest in Cellular Radio of Chattanooga (CRC), with the remaining three partners (including Bell South) each owning a 25-percent interest as well. CRC's primary asset was a 29.54-percent limited partnership interest in Chattanooga MSA Limited Partnership (CHAT). The general partner of CHAT was a Bell South subsidiary that owned 55.31 percent of CHAT. In March of 2000, Taxpayer hired an investment banking firm to market its 25-percent interest in CRC. In November of 2000 (less than a year after the S election), Bell South purchased Taxpayer's 25-percent interest in CRC for $5.2 million.

In determining the amount of gain subject to Code Sec. 1374, Taxpayer determined that its 25-percent interest in CRC had a value of only $2.98 million as of the date of the S election because of the application of customary discounts for minority interest and lack of marketability. Taxpayer's valuation expert reached this conclusion by giving equal weight to two valuation approaches ("business enterprise" and "distribution yield"). The government's expert opined that the purchase price in the Bell South transaction was the best evidence of value because the purchase was a "reasonably contemporaneous arm's-length sale" and because there were no intervening events that would have changed the value between January 1, 2000 and November 27, 2000.

Taxpayer argued that the Bell South purchase price should be ignored because Bell South was willing to pay a premium (even though it already had control) to ensure that the two other partners in CRC would not exercise their rights of first refusal. The Tax Court concluded that, while Taxpayer's expert was more credible and persuasive than the government expert, Taxpayer's expert should have given weight to the actual purchase price paid in November of 2000. As a result, the Tax Court arrived at a value of $3.7 million for the 25-percent interest as of the date of the S election. Accordingly, Taxpayer was required to compute its built-in gains tax on $3.7 million, with the balance of $1.5 million escaping this extra level of tax.[26]

Suppose that, instead of Taxpayer's selling its 25-percent interest in CRC, CHAT had sold all of its assets to a third party with the S corporation receiving $5.2 of proceeds (and being allocated the related taxable gain)? Would the regulations under Code Sec. 1374 permit the application of the $3.7 million discounted value for Taxpayer's 25-percent

interest in CRC even though the sale by CHAT of all of its assets would not carry any discount and would result in full realization of value by Taxpayer? Yes.[27] However, there is an "anti-abuse" rule where the partnership is formed or availed of to reduce the built-in gains tax.[28]

Example 8. Assume the same facts as in Example 7 except that during the recognition period JK Partnership liquidates and distributes a 50-percent undivided interest in the hotel to Jones Corp. Jones Corp then sells the 50-percent undivided interest for $5.5 million. The regulations[29] make clear that the $5 million gain is subject to corporate level tax.

What would be the result if the partnership interest in JK Partnership held by Jones Corp on January 1, 2010 had a discounted value of, say, $3.7 million? Would the built-in gains tax applicable to the post-distribution sale of the 50-percent undivided interest be limited to $3.7 million less $500,000 basis? The answer is no, unless the value of the 50-percent undivided interest in the hands of JK Partnership on January 1, 2010 would be discounted to $3.7 million.[30]

Example 9. Assume that, at the time of the S election by Jones Corp, JK Partnership was not in existence. Jones Corp owned a 50-percent undivided interest in the hotel. After the S election, Jones Corp contributed the 50-percent undivided interest to JK Partnership in exchange for a 50-percent partnership interest. The 50-percent undivided interest in the hotel was built-in gain property having a value of $5.5 million and a basis of $500,000. After the contribution to JK Partnership, what if Jones Corp sells its JK Partnership interest or JK Partnership sells the hotel?

In either case, Jones Corp would be taxed on the built-in gain of $5 million. This would be true even if the value of the JK Partnership interest received by Jones Corp would be discounted.[31]

Discounting and Single Member LLCs. Valuation discounts are applicable in the case of partnership interests and LLC interests where these interests represent "bifurcated" ownership in the underlying assets of the entity.[32] If a C corporation owns all the general and limited interests in a limited partnership at the time of the S election, discounts would be difficult to sustain[33] In *S.J. Pierre*,[34] the Tax Court recently approved valuation discounts on the *transfer* of LLC membership interests in a single-member LLC that was a "disregarded entity" (the transferor owned 100 percent of the interests prior to the transfer). In the context of Code Sec. 1374, however, discounting the interest of a single-member LLC owned by the corporation at the time of the S election would not be viable because the corporation owned 100 percent of the interests at that time (there would be no "bifurcation" of ownership).

Suppose that C corporation makes an S election on January 1, 2011. At this time, the corporation (S Corp) owns 90 percent of the membership interests (nonvoting) in Sub LLC. The remaining 10 percent of the interests (voting) in Sub LLC are owned by QSUB, a corporation, all of the stock of which is owned by the S Corp (*i.e.*, QSUB is a disregarded entity). Sub LLC would be a disregarded entity. In light of *S.J. Pierre*, would it be possible to argue that the 90-percent nonvoting interests in Sub LLC held directly by S Corp should be discounted for purposes of Code Sec. 1374? The 10-percent voting interests in Sub LLC held by QSUB would not be eligible for a discount.

Tracking Separately Acquired Interests In Same Partnership. Suppose that S Corp has been an S corporation for more than 10 years. S Corp has owned a 10-percent interest in Smith Partnership for more than 10 years. In 2009, S Corp acquired all the stock of Smith Target, Inc., a C corporation, and subsequently liquidated Smith Target under Code Sec. 332. Smith Target owned a 30-percent interest in Smith Partnership at time of liquidation. This 30-percent partnership interest is a built-in gain asset in the hands of S Corp for the 10-year period following the liquidation.[35]

S Corp now wishes to sell its 10-percent interest in Smith Partnership that is not subject to Code Sec. 1374. Can S Corp track interests in the same partnership separately in order to avoid Code Sec. 1374? *Rev. Rul. 84-53*[36] provides that a partner has a single basis in its partnership interests even if the partner is both a general partner and a limited partner. If this rule is interpreted to cause S Corp to "blend" its entire Smith Partnership interests, the result would be that a proportionate share of the gain on S Corp's sale of the 10-percent interest would be taxed under Code Sec. 1374. The Service has ruled privately that, at least in the publicly traded partnership context, separate tracking of partnership interests is permitted.[37] However, outside of the publicly traded partnership context, separate tracking could be problematic.[38]

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Code Sec. 481 and Income Spreads: In a recent Tenth Circuit case, *MMC Corp*[39] a C corporation using the accrual method of accounting took a substantial deduction by marking to market its accounts receivable in 1997. In 1998, Congress changed the law and MMC was required to return to face value accounting, which required the 1997 tax benefit be recognized as income. However, Congress permitted the income to be reported over a four-year period—in this case, 1998, 1999, 2000 and 2001.

For 1998 and 1999, MMC reported a ratable portion of this income on its C corporation tax return. MMC made an S election effective 2000. For 2000 and 2001, MMC reported the remainder of the income as an S election tax item but did not report the income as built-in gain under Code Sec. 1374. In affirming the decision of the Tax Court,[40] the Tenth Circuit concluded that the income that was spread over four years by virtue of Code Sec. 481 was built-in gain under Code Sec. 1374. The regulations[41] provide that when an S corporation accounts for an item of income during the recognition period, the item is built-in gain if the taxpayer would have included the item as income prior to the recognition period assuming the accrual method. In the case of Code Sec. 481 adjustments such as in *MMC Corp.*, the adjustments are built-in gain to the extent the adjustments relate to items attributable to periods before the recognition period (using the accrual method).

The result in *MMC Corp.*, therefore, was the imposition of a *forced double tax* on the 2000 and 2001 adjustments.

Economic Stimulus Change. As part of the "Economic Stimulus" legislation,[42] Congress has amended Code Sec. 1374 by shortening the recognition period to 7 years, but *only* for built-in gain recognized in taxable years beginning in 2009 and 2010. Although not clear,[43] it appears that this change will apply to REITs as well.

Example 10. Smith Corp was a C corporation that made an S election effective as of January 1, 2002. The Code Sec. 1374 recognition period would normally expire on December 31, 2011. However, under the new legislation, the recognition period would end on December 31, 2008, but only for purposes of determining the taxation of built-in gain recognized in 2009 or 2010. If Smith Corp were to sell assets it held on January 1, 2002 in 2011, Code Sec. 1374 would continue to apply to built-in gain on those assets. If Smith Corp's S election was effective as of January 1, 2003, the recognition period would end on December 31, 2009, so that built-in gains would not be taxed if recognized in 2010 but would be taxed if recognized in 2009, 2011 or 2012.

Example 11. If Smith Corp made an S election that was effective as of January 1, 2001 (or earlier), the recognition period would end on December 31, 2008.

Example 12. If Smith Corp made its S election on January 1, 2007, the new legislation would not provide any benefit.

Example 13. If Smith Corp made its S election on January 1, 2009, the new legislation would not provide any benefit.

Estate and Gift Valuation Planning: In valuing the stock of an S corporation for estate and gift tax purposes, valuation experts will typically determine the fair market value of the assets and business of the S corporation and then will apply discounts for minority interests and lack of marketability.

Example 14. Smith owns 45 percent of the stock of Smith Corp (all nonvoting). Smith Corp was a C corporation until January 1, 2009, when it made an S election. As of January 1, 2010, Smith Corp owned a farm having a value of $9 million and a basis of $1 million. This $8 million built-in gain will be subject to Code Sec. 1374 if the farm is sold within the next 10 years. Smith dies on February 1, 2010 and his Smith Corp stock is included in the estate. The valuation expert starts with 45 percent of $9 million or $4,050,000. He then applies discounts for minority interest and lack of marketability of 30 percent, reducing the value to $2,835,000. But wait. There is also an important fact. If the Smith Corp farm is sold within the next 10 years, there will be a Code Sec. 1374 tax of 35 percent (or $2,800,000). The estate argues that Smith Corp is only worth $6,200,000 instead of $9 million. This could cause the valuation of the 45-percent stock to be reduced. The amount of the reduction will depend upon the specific facts of each case.

This approach was accepted by the Tax Court in the recent case of *M.D. Litchfield Estate*.[44]

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Endnotes

[1] Code Secs. 1361–1379. All references herein to "Code Sec." of the Internal Revenue Code, or the "Code," shall mean the Internal Revenue Code of 1986, as amended.

[2] *See* Code Sec. 1361.

[3] *See* Code Secs. 301–385.

[4] *See* Code Sec. 11. Note that C corporations are not eligible for favorable capital gains rates.

[5] *See* Code Secs. 1(h), 301, 316. Note that this rate likely will increase after 2010.

[6] *See* Code Secs. 331, 336. The same result applies where appreciated assets are distributed to the stockholders in liquidation of a corporation. Code Sec. 336.

[7] Under current law, a 15-percent rate would apply. *See* Code Secs. 1(h), 331.

[8] *See* Subchapter K of the Code (Code Secs. 701–755).

[9] This assumes that the entire gain is eligible for the 15-percent capital gain rate. As a practical matter, a portion probably would be subject to a 25-percent rate as unrecaptured Code Sec. 1250 gain. Code Sec. 1(h).

[10] Code Sec. 336.

[11] Code Sec. 334(a).

[12] This rule is subject to exceptions like LIFO recapture. *See* Code Sec. 1363(d).

[13] Code Sec. 1374.

[14] Prior to 1986, Code Sec. 1374 of the Internal Revenue Code of 1954 applied a "three-year" recognition period applicable to all gains (not just those built-in at the time of the S election) recognized during the three-year recognition period. Also note that the recognition period is seven years for 2009 and 2010 sales—*See* text accompanying note 43, *infra*.

[15] Note that this is a *forced* double tax on the recognized built-in gain. Code Sec. 1374 applies a corporate-level tax on the $10 million and then the $10 million (reduced by the corporate-level tax) is subject to stockholder-level tax as well. If C Corp, a C corporation, sold the hotel, there would be a corporate-level tax, but the stockholder-level tax would only apply if and when the proceeds were distributed to the stockholder.

[16] This can sometimes be unclear in the case of goodwill that may have existed at the time of the S election. It may be prudent to have the corporation's assets appraised at the time of the election.

[17] Code Sec. 1374(c)(1).

[18] Code Sec. 1374(d)(8).

[19] Reg. §1.337(d)-7. Thus, if a C corporation elects REIT status or a REIT acquires the assets of a C corporation in a carryover basis transaction, the REIT will be subject to tax on built-in gain under rules substantially identical to those of Code Sec. 1374.

[20] Reg. §1.1374-4(h)(1).

[21] *See, e.g.*, Code Secs. 1031, 1033, 721, 351.

[22] Code Sec. 1374(d)(6).

[23] Reg. §1.1374-4(i).

[24] Note that there is no "double counting" of built-in gains because Jones Corp's basis in its JK Partnership interest will be increased by its proportionate share of the gain recognized and, as a result, when the cash is distributed to Jones Corp no further gain will be recognized.

[25] *Ringgold Telephone Co.*, 99 TCM 1914, Dec. 58,214(M), TC Memo. 2010-103.

[26] Cases such as *Ringgold Telephone Co.* are important because they illustrate that valuation discounts are appropriate for corporate income tax purposes (where the corporate income tax liability is determined by the value of interests in partnerships and LLCs owned by corporations). Compare *Pope & Talbot, Inc.*, CA-9, 99-1 USTC ¶50,158, 162 F3d 1236 (no discounts permitted under Code Sec. 311 for distributions of partnership interests to stockholders). *See also* TAM 200443032 (July 13, 2004) (same). *Pope & Talbot* should be limited in scope to its unique facts.

[27] Regs. §§1.1374-4(i)(2), (4) & (8), Ex. 3.

[28] Reg. §1.1374-9.

[29] Reg. §1.1374-4(i)(7).

[30] *Id.*

[31] Reg. §1.1374-4(i)(4)(i).

[32] *See* Rev. Rul. 93-12, 1993-1 CB 202.

[33] *Id.*

[34] *S.J. Pierre*, 113 TC—, No. 2, Dec. 53,454 (2009).

[35] *See* Code Sec. 1374(d)(8).

[36] 1984-1 CB 159. The regulations under Code Sec. 704(b) also provide that a partner has a single capital account.

[37] *See* LTR 200909001 (Feb. 27, 2009).

[38] This should not be the correct result. However, to be safe, the S corporation might "house" the separately acquired partnership interests in separate subsidiary entities that are not disregarded entities.

[39] *MMC Corp*, CA-10, 2009-1 USTC ¶50,155, 551 F3d 1218.

[40] *MMC Corp.*, 94 TCM 514, Dec. 57,188(M), TC Memo. 2007-354.

[41] Reg. §1.1374-4(b).

[42] Act. Sec. 1251 of the American Recovery and Reinvestment Act of 2009 (P.L. 111-5).

[43] Application of the shortened recognition period to REITs is not entirely clear because a REIT's treatment of built-in gain property is governed by Reg. §1.337(d)-7, which expressly references the 10-year recognition period. The new legislation amends only Code Sec. 1374(d) and does not specifically mention whether or not REITs are eligible for the reduced recognition period. However, it is reasonable to infer that the shortened recognition period is applicable to REITs because Reg. §1.337(d)-7 states that the rules of Code Sec. 1374 apply to built-in gain property held by a REIT.

[44] *M.D. Litchfield Est.*, 97 TCM 1079, Dec. 57,723(M), TC Memo. 2009-21. *See also F. Jelke Est.*, CA-11, 2007-2 USTC ¶60,552, 507 F3d 1317; *B.E.J. Dunn Es.e*, CA-5, 2002-2 USTC ¶60,446, 301 F3d 339, *rev'g.*, TC Memo. 2000-12; *H.B. Jameson*, CA-5, 2001-2 USTC ¶60,420, 267 F3d 366, *vac'g and rem'g*, TC Memo. 1999-43; *I. Eisenberg*, CA-2, 98-2 USTC ¶60,322, 155 F3d 50, *vac'g and rem'g*, T.C. Memo. 1997-483; *A.D. Davis Est.*, 110 TC 530, Dec. 52,764 (1998), *E.M. Dailey*, 82 TCM 710, Dec. 54,506(M), TC Memo. 2001-263; and *C.A. Borgatello Est.*, 80 TCM 260, Dec. 54,013(M), TC Memo. 2000-264.

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