Built-in-Gains Provisions in C-to-S Corp Conversions: Avoiding Double Taxation Through BIG Planning

TUESDAY, MARCH 2, 2021, 1:00-2:50 pm Eastern

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March 2, 2021

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Tuesday, March, 2, 2021

26 U.S. Code § 1374

(a) General rule. If for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain, there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation for such taxable year.

(b) Amount of tax

(1) The amount of the tax imposed by subsection (a) shall be computed by applying the highest rate of tax specified in section 11(b) to the net recognized built-in gain of the S corporation for the taxable year.

(2) Net operating loss carryforwards from C years allowed. Notwithstanding section 1371(b)(1), any net operating loss carryforward arising in a taxable year for which the corporation was a C corporation shall be allowed for purposes of this section as a deduction against the net recognized built-in gain of the S corporation for the taxable year. For purposes of determining the amount of any such loss which may be carried to subsequent taxable years, the amount of the net recognized built-in gain shall be treated as taxable income. Rules similar to the rules of the preceding sentences of this paragraph shall apply in the case of a capital loss carryforward arising in a taxable year for which the corporation was a C corporation.

(3) Credits

(A) Except as provided in subparagraph (B), no credit shall be allowable under part IV of subchapter A of this chapter (other than under section 34) against the tax imposed by subsection (a).

(B) Notwithstanding section 1371(b)(1), any business credit carryforward under section 39 arising in a taxable year for which the corporation was a C corporation shall be allowed as a credit against the tax imposed by subsection (a) in the same manner as if it were imposed by section 11. A similar rule shall apply in the case of the minimum tax credit under section 53 to the extent attributable to taxable years for which the corporation was a C corporation.

26 U.S. Code § 1374

(4) Coordination with section 1201. For purposes of section 1201(a)—

(a) The tax imposed by subsection (a) shall be treated as if it were imposed by section 11, and

(B) the amount of the net recognized built-in gain shall be treated as the taxable income.

(c) Limitations

(1) Subsection (a) shall not apply to any corporation if an election under section 1362(a) has been in effect with respect to such corporation for each of its taxable years. Except as provided in regulations, an S corporation and any predecessor corporation shall be treated as 1 corporation for purposes of the preceding sentence.

(2) The amount of the net recognized built-in gain taken into account under this section for any taxable year shall not exceed the excess (if any) of—

(A) the net unrealized built-in gain, over

(B) the net recognized built-in gain for prior taxable years beginning in the recognition period.

(d) Definitions and special rules. For purposes of this section—

(1) The term "net unrealized built-in gain" means the amount (if any) by which—

(A) the fair market value of the assets of the S corporation as of the beginning of its 1st taxable year for which an election under section 1362(a) is in effect, exceeds

(B) the aggregate adjusted bases of such assets at such time.

26 U.S. Code § 1374

(2) Net recognized built-in gain

(A) The term "net recognized built-in gain" means, with respect to any taxable year in the recognition period, the lesser of—

(i) the amount which would be the taxable income of the S corporation for such taxable year if only recognized built-in gains and recognized built-in losses were taken into account, or

(ii) such corporation's taxable income for such taxable year (determined as provided in section 1375(b)(1)(B)).

(B) Carryover. If, for any taxable year described in subparagraph (A), the amount referred to in clause (i) of subparagraph (A) exceeds the amount referred to in clause (ii) of subparagraph (A), such excess shall be treated as a recognized built-in gain in the succeeding taxable year. The preceding sentence shall apply only in the case of a corporation treated as an S corporation by reason of an election made on or after March 31, 1988.

(3) Recognized built-in gain. The term "recognized built-in gain" means 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.

26 U.S. Code § 1374

(4) Recognized built-in losses. The term "recognized built-in loss" means 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) Treatment of certain built-in items.

(A) Income items. Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the 1st taxable year for which the corporation was an S corporation shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account.

(B) Deduction items. Any amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the 1st taxable year referred to in subparagraph (A) shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction.

(C) Adjustment to net unrealized built-in gain. The amount of the net unrealized built-in gain shall be properly adjusted for amounts which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period.

26 U.S. Code § 1374

(6) Treatment of certain property. If the adjusted basis of any asset is determined (in whole or in part) by reference to the adjusted basis of any other asset held by the S corporation as of the beginning of the 1st taxable year referred to in paragraph (3) —

(A) such asset shall be treated as held by the S corporation as of the beginning of such 1st taxable year, and

(B) any determination under paragraph (3)(B) or (4)(B) with respect to such asset shall be made by reference to the fair market value and adjusted basis of such other asset as of the beginning of such 1st taxable year.

(7) Recognition period

(A) In General. The term "recognition period" means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase "5-year".

(B) Installment Sales. If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.

26 U.S. Code § 1374

(8) Treatment of transfer of assets from C corporation to S corporation.

(A) In general. Except to the extent provided in regulations, if—

(i) an S corporation acquires any asset, and

(ii) the S corporation's basis in such asset is determined (in whole or in part) by reference to the basis of such asset (or any other property) in the hands of a C corporation, then a tax is hereby imposed on any net recognized built-in gain attributable to any such assets for any taxable year beginning in the recognition period. The amount of such tax shall be determined under the rules of this section as modified by subparagraph (B).

(B) Modifications. For purposes of this paragraph, the modifications of this subparagraph are as follows:

(i) In general. The preceding paragraphs of this subsection shall be applied by taking into account the day on which the assets were acquired by the S corporation in lieu of the beginning of the 1st taxable year for which the corporation was an S corporation.

(ii) Subsection (c)(1) Not To Apply. Subsection (c)(1) shall not apply.

(9) Reference to 1st taxable year. Any reference in this section to the 1st taxable year for which the corporation was an S corporation shall be treated as a reference to the 1st taxable year for which the corporation was an S corporation pursuant to its most recent election under section 1362.

(e) Regulations. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section including regulations providing for the appropriate treatment of successor corporations.

Glossary

Abbreviations:

- **BIG =** Built In Gain (aka Unrealized Appreciation)
- **NUBIG =** Net Unrealized Built In Gain
- **NRBIG =** Net Recognized Built in Gain
- **RBIG =** Recognized Built In Gain
- **RBIL=** Recognized Built in Loss
- **FMV =** Fair Market Value

Background

- On December 18, 2015, President Obama signed the Protecting Americans from Tax Hikes Act, which retroactively and permanently extends the 5-year built-in gains tax recognition period.

- The BIG tax prevents "leakage" of income tax that United States ceases to recognize when company escapes double taxation regime of C corporation for pass-through taxation regime of S Corporation.

- To replicate effects of C corporation taxation, the post-conversion S corporation shareholders are subject to tax on corporate-level gain, net of corporate-level tax. This result is achieved by permitting shareholder to treat corporate-level tax as a loss that has same character as gain that gives rise to tax. Sec. 1366(f)(2).

- The BIG tax imposed on C corporation is not in lieu of tax that could be imposed on post-conversion S corporation shareholders under rules generally applicable to S corporations.

- Under BIG tax, S corporation may be subject to tax on gains from sale of assets held at time it converted to S corporation status if it sells the assets within 5 year period after making its S election ("Recognition Period").

Background

- BIG tax is imposed upon S corporation that has any history as a C corporation before effective date of its S corporation election.

- When C corporation converts to S corporation or S corporation acquires assets from C corporation in tax-free transaction, it may be subject to corporate-level BIG tax in addition to tax imposed on its shareholders.

- BIG tax is imposed on S corporation that has always been S corporation, if it acquires assets from C corporation in tax-free transaction, such as an acquisition of assets in tax-free reorganization or the tax-free liquidation of a controlled subsidiary. Sec. 1374(d)(8).

    - When the tax applies to a group of assets acquired in this manner, Recognition Period begins on the date on which assets are so acquired.

Background

- Maximum amount of gain on which S corporation can be taxed under BIG tax is based on corporation's NUBIG, which is determined on effective date of the S election (beginning of Recognition Period).
  - Secs. 1374(d)(1) and (7)(A).
- Corporation must determine whether it has NUBIG in its assets on effective date of Recognition Period.
  - If the corporation has NUBIG in its assets, it must track its dispositions of these assets for 5 years following that date.
- S corporation's NUBIG is amount (if any) by which FMV of its assets as of beginning of first year of its S election exceeds aggregate adjusted bases of assets.

A corporation's NUBIG is:

- Amount of net gain, if any, that corporation would have recognized if it had sold its assets at beginning of the Recognition Period for their FMV in a single transaction to an unrelated buyer that also assumed all of the corporation's liabilities; decreased by
- Sum of any deductible liabilities of corporation that would be included in amount realized on hypothetical sale and corporation's aggregate adjusted basis in all of its assets; increased or decreased by
- Corporation's Sec. 481 adjustments that would be taken into account on hypothetical sale; and increased by
- Any RBIL that would not be allowed as deduction under Secs. 382, 383, or 384 on the hypothetical sale. (Regs. Sec. 1.1374-3(a).)

Background

- To extent that gains recognized during the Recognition Period represent net recognized built-in gain, BIG tax is imposed on that net gain (subject to limitations) at highest C corporation tax rate (currently 39%), regardless of character of the gain.
  - Sec. 1374(b)(1) by reference to Sec. 11(b).

- S corporation's NRBIG and payment of BIG tax is limited by S corporation's taxable income, determined as if corporation were a C corporation.
  - Sec. 1374(d)(2)(A)(ii) by reference to Sec. 1375(b)(1)(B) for the definition of "taxable income."

- BIG tax is not imposed on an amount greater than taxable income that would have been reported by corporation pre-conversion had it remained C corporation.
  - Sec. 1374(d)(2)(A)(ii).

Background

- The total amount of RBIG on which BIG tax is paid cannot exceed amount of NUBIG determined on the effective date of the S election.
  - Sec. 1374(c)(2).

- NRBIG is, with respect to any tax year in Recognition Period, the lesser of amount that would be taxable income of S corporation for that tax year if only RBIGs and RBILs were taken into account, or corporation's taxable income for that tax year.
  - Sec. 1374(d)(2).

- Excess of a corporation's NRBIG in excess of its taxable income is treated RBIG in succeeding tax year subject to that succeeding year's limitations. Sec. 1374(d)(2)(B). **If the succeeding year is a year after the Recognition Period has expired, the gain escapes the BIG tax. **

Assets Subject to BIG Tax During the Recognition Period

- All assets corporation holds on date its S election takes effect are potentially subject to Sec. 1374 if they are appreciated on date of the corporation's S election and disposed of in a taxable transaction during Recognition Period.
- Assets commonly subject to BIG Tax are:
  - Accounts Receivable
  - Inventory
  - Other Ordinary Income Property (property that would have generated ordinary income rather than capital gain if the asset had been sold)
  - Intangible Assets (which may or may not appear on the corporation's balance sheet)
  - Existing liabilities giving rise to a deduction on the last day of the C corporation tax year are also included (if the taxpayer uses the cash method, assets and liabilities are based on a modified accrual method).
- See 26 CFR 1.1374-4 - Recognized built-in gain or loss.

Accounts Receivable

- The Accounts receivable of a cash basis corporation represent an item of built-in gain.

Inventory

- BIG tax may apply to individual sales of corporation's products to customers during Recognition Period.
- Under Regs. Sec. 1.1374-7(b), taxpayer must track dispositions of inventory by same inventory method used for tax purposes to determine timing of recognition of BIG.
- Consistent with principles that apply to determination of NUBIG, the regulations provide, in effect, that inventories must be valued using a "bulk sale" approach. Regs. Sec. 1.1374-7(a).
- In the case of an actual bulk sale of inventories as part of a sale of entire trade or business, IRS has provided guidelines for determining FMV of inventories and, thus, the amount of consideration that should be allocated to the inventories. Rev. Proc. 2003-51, 2003-2 C.B. 121
    - applicable only to an asset acquisition subject to Sec. 1060 or a deemed asset acquisition 'under a Sec. 338 election.
- Inventories should:
    - not be valued solely on basis of aggregate costs incurred by seller of business
    - not be valued based solely on aggregate selling prices that buyer of business would expect to realize from disposition in individual sales
- Inventories should be valued based on hybrid of both methods to allow for "fair division between the buyer and the seller of the profit on the inventory." 27 F.2d 1392 (Ct. Cl. 1975).

Ordinary Income Property

- Interest
- Dividends
- Rents
- Royalties

Intangible Assets

- Goodwill
- Patents, copyrights and licenses
- Customer lists and relationships
- Non-compete agreements
- Favorable financing
- Software
- Trained and assembled workforces
- Contracts
- Leasehold interests
- Unpatented proprietary technology
- Trademarks/Trade names

Valuation Requirements

Why it's Necessary:

- All gains during the Recognition Period are presumed to be RBIG
- Taxpayer must establish
  - The portion that constitutes post-conversion appreciation OR
  - That the asset was acquired post-conversion

Valuation Requirements

On the other hand:

- No losses during the S-Corp recognition period are presumed to be RBIL
- Taxpayer must establish
  - The portion that constitutes pre-conversion depreciation AND
  - That the asset was acquired pre-conversion

Valuation Requirements

<u>What is Subject to tax?</u>

- ANY ASSET carried from C to S Status may be subject to BIG tax

Valuation Requirements

- Qualified Appraisal
  - Conducted by a qualified appraiser
  - In accordance with generally accepted appraisal standards
  - Done as of the conversion date
  - Describes the property
  - Accounts for any terms accompanying the property

Valuation Requirements

- Qualified Appraiser
  - Demonstrated background, experience, education or professional membership
  - Regularly performs appraisals for fees

Valuation Requirements

- Fair Market Value

  Price at which the property would change hands between a hypothetical willing buyer and willing seller when neither is under compulsion to buy or sell, both parties having a reasonable knowledge of the relevant facts

Valuation Requirements

- Valuation should be of Assets and Liabilities, not of the company stock
  - Generally, no "lack of marketability" or "lack of control" discounts apply
  - Done on a non-distress, non-liquidating, bulk sale approach

- Should be done based on an asset's "Highest and Best Use"

Valuation Requirements

- Final value of assets (particularly inventory) should fall somewhere between replacement value and retail price
- Valuation not required to be done on an individual asset by asset basis….
- But doing do will likely prove helpful

Valuation Requirements

- Valuation at Conversion

Asset	Basis	FMV
Equipment A	500,000	600,000
Equipment B	300,000	250,000
Equipment C	100,000	250,000
Total Equipment	900,000	1,100,000
NUBIG		200,000

- Assume Equipment B is sold post conversion for $350,000
- If you have Equipment appraisal: $50,000 RBIG
- If you have Individual appraisal : $0 RBIG

Computing the BIG tax

- BIG tax as an S Corp may be <u>worse</u> than if the gains were realized as a C-corp
  - C Corp can generally control timing of its double taxation
  - C-Corp shareholders are double taxed upon receipt of the dividend
  - C-Corp gains recognized on graduated rate tables
  - S-Corp shareholders realizing BIG tax are double taxed immediately
  - S-Corp BIG tax imposed at the highest corporate rate

Computing the BIG tax

<u>The Recognition Period</u>

- Begins:
  - The first day of the first taxable year for which the S-Election is effective

  <u>OR</u>

  - On the date the asset was acquired by the S-Corp
- For tax years beginning after 2011: 5-year recognition period
  - PATH act of 2015 made this permanent

Computing the BIG tax

For each year in the recognition period

- BIG tax is imposed on Net RBIG

Only to the extent of:

- NUBIG

<u>over</u>

- Total Net RBIG for prior years in the recognition period

NUBIG is Comprised of

+ Realized gain if the C corporation had sold (on day 1 of the recognition period) all of its assets at FMV to an unrelated 3rd party that assumed all of the liabilities

- Deductible liabilities that would be included above
- Adjusted basis of the assets sold above
- Any 481 adjustments on the sale above

+ Any non-deductible RBIL as a result of Sec 382,383 or 384

NUBIG - Pitfalls

Be aware of in computing NUBIG

- Anti-Stuffing rules
  - Contributions of Loss property within 2 years before conversion presumed to be tax motivated (Announcement 86-128)
  - Loss assets acquired during recognition period fall under this reg as well
  - Losses and credit from these properties will be disregarded in NUBIG computation

Document: clear and substantial relationship between loss property and Corp business activity

Computing the BIG Tax

Items of Income and Deduction

- Items of Income:
- Immediate recognition: Receivables, Inventory
- BIG includes all amounts received for the item, not just the FMV at the time of conversion
- Differentiates between recognition of income, and disposition of assets

Computing BIG Tax: Income Items

- At conversion, T/P has $50,000 A/R (Income Item) that is valued at $40,000

Asset	Basis	FMV
Factory	500,000	900,000
Equipment	300,000	250,000
Acct Receivable	-	40,000
Total Asset	800,000	1,190,000
NUBIG		390,000

- If T/P collects $50,000 on the A/R, it is all BIG because they would have been included under an accrual basis C-Corp
- IF TP Sells the A/R for $45,000 there is RBIG of $40,000 as a result of the asset disposition

Computing BIG Tax: Deduction Items

- At conversion, cash basis T/P has open litigation seeking $1,000,000 in damages

Post Conversion: T/P loses and is assessed and pays $400,000 in damages

- T/P deductions $400,000 post -conversion
- T/P does not have RBIL

Because T/P would not have had the deduction as an C-Corp , on an accrual basis

Computing the BIG Tax

- RBIG occurs upon
  - Disposition of assets

    <u>OR</u>

  - Recognition of Income Items

Computing the BIG Tax

Disposition Includes:

- Sales or Exchange
- Collection of Receivables
- Completion of LT contracts

Disposition does NOT include:

- Leasing of Assets
- Licensing of Assets
- Granting of purchase Options (unless deep "in the money")

Computing the BIG tax: Step 1

STEP 1: Determine the Net RBIG

RBIG:

- Is the Gain Recognized on C-Corp assets within the 5-year post-conversion period
- Income items that are attributable to the pre-conversion period are RBIG in the year in which they are taken into account

RBIL:

- Is the Loss Recognized on C-Corp assets within the 5-year post-conversion period
- Deduction items that are attributable to the pre-conversion period are RBIG in the year in which they are taken into account

<u>Net</u> RBIG:

- Is the lesser of (RBIG — RBIL), or taxable income of the S Corporation

Computing the BIG tax: Step 2

STEP 2: Reduce Net RBIG

- Net RBIG is reduced for C-Corp NOLs
- Net RBIG is reduced for C-Corp Capital Loss Carryforwards
- Compare Net RBIG to Remaining NUBIG and take the lesser

Result is the Taxable Net RBIG

NOTE: RBIG may <u>NOT</u> be reduced by NOL carryovers from other S Corporation years

Computing the BIG tax: Step 3

STEP 3: Compute

Taxable Net RBIG (RBIG after NOLs, and Capital Losses) taxed at the top corporate tax rate (currently 21%)

Computing the BIG tax: Step 4

STEP 4: Reduce BIG tax for:

- Credits allowed under 1374(b)(3)
  - Gasoline and Special Fuels Tax Credits (Sec 34)
  - Business Credit Carryforwards (Sec 39)
  - Minimum Tax Credits (Sec 53)
- Note: credits under Sec 39 and 53 are subject to certain modifications that will require computation of AMT BIG tax

Computing the BIG tax

<u>Limitation</u>:

- Net RBIG for any given year is limited to the taxable income of the S corporation
- Any excess of Net RBIG is carried over to the subsequent year (provided it remains in the recognition period)
- Each item of Income, Gain, Loss and Deduction realized is included based on its ratable share for the year in which it arose.

NOTE: there is no carryover available for RBIL

NOTE: Gain is only Suspended for BIG purposes; For S-Corp income tax rules it passes through to the shareholder

Computing the BIG tax

- Gains Carry Over
- Losses Do Not

	Year 1	Year 2
Net RBIG(L)	100	10
C/O from Yr	1	20
Taxable Income	80	5
Taxable Net RBIG	80	5
RBIG Carryover	20	25

	Year 1	Year 2
Net RBIG(L)	(50)	10
C/O from Yr 1		
Taxable Income	80	30
Taxable Net RBIG	-	10
RBIG Carryover	NONE	-

Computing the BIG tax

- S-Corp Pays the BIG tax (Sch D Part III)
- S-Corp gets the benefit of the BIG tax deduction (Sch D)
- Shareholders pay the income tax, net of the BIG Tax (Schedule K-1)

Pass-through and Timing

- If the taxable income limitation applies, the BIG tax deduction can work out <u>unfavorably</u> for taxpayers

Computing the BIG tax

- **In Year One**

	Year 1
Net RBIG (CAPITAL GAIN)	1,400
S Corp Income (CAPITAL)	400
BIG tax deduction (35% *400)	(140)
Taxable Scorp Income	260
Taxable Net RBIG	400
Tax	140
RBIG Carryover	1,000

Computing the BIG tax

- In Year Two

Net RBIG (CAPITAL GAIN)	-
C/O from Yr 1	1,000
S Corp Income (ORDINARY)	2,000
BIG tax deduction NONE	NONE
Taxable Scorp Income	2,000
Taxable Net RBIG	1,000
Tax	350
RBIG Carryover	-

- If the taxable income limitation applies, the BIG tax deduction can work out unfavorably for taxpayers

Recognition Period Transactions

- Amounts deducted during Recognition Period but relate to periods prior to first S corporation year are considered recognized built-in losses and reduce the amount potentially subject to BIG tax. Sections 1374(d)(4) and 1374(d)(5).

- Under Sec. 1374(d)(6), the UBIG basis carries over to any replacement property received in like-kind exchange or involuntary conversion.
  - Recognition Period for replacement asset is remainder of 5-year recognition period that applied to transferred assets.

- Both like-kind exchanges and involuntary conversions can result in partial recognition of S corporation's realized gain (i.e. when boot property is received).

- Still possible to use 1031 exchanges to achieve tax-free transfer of built-in gain property for other like-kind property if replacement property is held for remainder of 5-year Recognition Period.
  - This holding period may even be reduced further if exchange is between brother-sister corporations so long as second corporation holds original property for at least two years
    - second corporation may then dispose of property without triggering BIG tax on first corporation.

Recognition Period Transactions

- RBIL offsets recognized RBIG
- Loss recognized on disposing of asset during Recognition Period is a RBIL to extent corporation establishes that:
  - Held asset on first day of Recognition Period
  - loss is no more than built-in loss that existed on that day.

  Code Section 1374(d)(4)
- Deduction during Recognition Period is RBIL if an accrual method taxpayer would have been allowed to take deduction before Recognition Period began. Code Section 1374(d)(5)(B).
- NUBIG is reduced by deductions that would be treated as RBILs if taken into account during Recognition Period, regardless of when deduction is actually recognized, if ever. Code Section 1374(d)(5)(C).
- Reducing NUBIG by UBIL is useful because the BIG for any year cannot exceed the NUBIG of all C Corporation's s assets (less RBIG from previous years in Recognition Period).Code Section 1374(c)(2).

Recognition Period Transactions: Sales of Inventory

- Disposition of Inventory based on Method used by taxpayer
- RBIG on sales in the first year
- LIFO: RBIG when taxpayer sustains a decrement to LIFO layers

Step 1:

- Using the inventory's fair market value, determine the corporation's unrealized built-in gain.

Step 2:

- Monitor disposition of inventory held at the beginning of Recognition Period to determine the amount of RBIG resulting from each sale.
- The regulations permit taxpayers, in complying with this requirement, to assume that the physical flow of goods in inventory at the beginning of the recognition period is consistent with the cost-flow assumption used for income tax purposes. Regs. Sec. 1.1374-7(b).

Step 3:

- Make sure to include and report BIG tax inventory transactions during the 5 year Recognition Period.
- Taxpayers that fail to account properly for the built-in gains tax in connection with the sale of their inventories may be subject to interest and penalties. Penalties an S corporation may be subject to include those for a substantial understatement of its tax liability (Sec. 6662) and for failure to make estimated tax payments (Sec. 6655).

Recognition Period Transactions: Sales of Inventory

More About Step 2:

- If corporation consistently uses LIFO accounting for inventories, will not be treated as having disposed of any of inventory items held at beginning of Recognition Period unless carrying value of inventories at end of a tax year is less than carrying value at the beginning of Recognition Period.
- If corporation switched to LIFO method in last tax year before converting then Sec. 1363(d) applies. Under Sec. 1363(d), LIFO recapture amount is included in C corporation's income in its final tax return.
  - LIFO recapture amount is amount by which inventory value under first-in, first-out (FIFO) lower-of-cost-or-market (LCM) method exceeds inventory value under LIFO method.
  - Tax attributable to recaptured amount is paid in 4 installments. 1st paid by unextended due date of C corporation's final tax return. Last 3 installments must be paid by unextended due date of S corporation's 3 succeeding tax returns.
  - Under Regs. Sec. 1.1363-2(e)(1), T/P must adjust basis of inventory to reflect amount of LIFO recapture included in income.
    - Rev. Proc. 94-61 explains that LIFO layers as of date of conversion must be collapsed into single layer ("conversion layer"), and LIFO recapture amount must be added to LIFO value of inventory.
  - Although Sec. 1363(d) prevents T/P from avoiding BIG tax related to LIFO recapture amount, it does not eliminate need to consider additional BIG related to LIFO inventory.
    - Even after T/P increases basis of its inventory to FIFO LCM value, this value may be less than FMV of inventory.

Recognition Period Transactions: Sales of Inventory

- If C corporation used FIFO method prior to conversion, S corporation would recognize BIG as it disposes of inventory on hand at conversion date.
  - Will probably occur during first year or two during Recognition Period, resulting in BIG tax liability for S corporation.
- Under LIFO method, inventory on hand at conversion date is not treated as being disposed of until the conversion layer is decreased.
  - Unless S corporation experiences reduction in inventory quantities that results in decrease to a conversion layer within Recognition Period, BIG tax would not apply.
  - To track remaining amount of deferred BIG, separate BIG layer can be established and there can be decrease in value of this layer on a pro rata basis in conjunction with future decreases to conversion layer. Unlikely that conversion layer would be completely reduced, if at all, by end of Recognition Period, thus eliminating need to pay BIG tax on remaining built-in gain.
- For non-LIFO taxpayers, cost-flow assumptions will generally result in taxpayer's being required to treat inventory items on hand at beginning of Recognition Period as first items disposed of during Recognition Period
  - If inventories generally turn over at least once each year, entire amount of the unrealized gain inherent in Recognition Period beginning inventory will be treated as RBIG in first year of Recognition Period.
  - Regs. Sec. 1.1374-7(b)

Recognition Period Transactions: Sales of Inventory

- Changing from LIFO method may make it easier track inventory and calculate recapture amount and BIG tax; however, corporation may lose potential benefit of deferring BIG and potentially avoiding BIG tax on excess of FMV over FIFO LCM value of inventory.
  - Notwithstanding recognition of LIFO recapture amount as income, potential permanent benefit of avoiding BIG tax by remaining on LIFO method may be a sufficient reason in particular situations to stay the course.

- For taxpayers subject to 263A: additional capitalized costs are added to inventory basis to reduce NUBIG

NOTE: Corporation that make S election and changes from LIFO to FIFO in same year will compute LIFO recapture, thus NUBIG would not be reduced by 263A costs.

Recognition Period Transactions: Accounts Receivable

- Treas. Reg. § 1.1374-4(b)(2) holds that an item is treated as a built-in loss item if item would have been properly accrued as a deduction by an accrual-method taxpayer in period before first S corporation year.

- Treas. Reg. § 1.1374-4(c) limits this rule for payments to related parties and payments for compensation. Amounts paid to related parties within the meaning of section 267(a)(2) must be paid within the first $2^1/_2$ months of the recognition period.
  - Prior to the S election date, all events establishing the fact of the liability must have occurred and the exact amount of the liability must be determined.
  - For amounts paid to nonrelated parties, the fact of the liability must be established, and the exact amount of the liability must be determined prior to the S election date, but the amount of the liability does not have to be paid within the first $2^1/_2$ months of the recognition period.

Recognition Period Transactions: Sale of Partnership Interest

- If S-Corp owns a Partnership: aggregate theory applies
- A disposition of partnership asset can trigger BIG to the S-Corp

26 CFR 1.1374-4 (i) ***Partnership interests.***

- **(1)** ***In general.*** 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 section 1374(d)(6) applies during the recognition period, the S corporation determines the effect on net recognized built-in gain from its distributive share of partnership items as follows-
  - (i) Step One: Apply the rules of 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 1374 items);
  - **(ii)** Step Two: Determine the S corporation's net recognized built-in gain without partnership 1374 items;
  - **(iii)** Step Three: Determine the S corporation's net recognized built-in gain with partnership 1374 items; and

Recognition Period Transactions: Sale of Partnership Interest

- **(iv)** Step Four: If the amount computed under Step Three (paragraph (i)(1)(iii) of this section) exceeds the amount computed under Step Two (paragraph (i)(1)(ii) of this section), the excess (as limited by paragraph (i)(2)(i) of this section) 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 Two (paragraph (i)(1)(ii) of this section) plus the partnership RBIG. If the amount computed under Step Two (paragraph (i)(1)(ii) of this section) exceeds the amount computed under Step Three ,(paragraph (i)(1)(iii) of this section), the excess (as limited by paragraph (i)(2)(ii) of this section) is the S corporation's partnership RBIL, and the S corporation's net recognized built-in gain is the remainder of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) after subtracting the partnership RBIL.

- **(2)** ***Limitations***
  - **(i)** ***Partnership RB1G.*** 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 years. The preceding sentence does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.
  - **(ii)** ***Partnership RBIL.*** 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.
- **(3)** ***Disposition of partnership interest.*** If an S corporation disposes of its partnership interest, the amount that may be 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 may be 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.

Recognition Period Transactions: Sale of Partnership Interest

Example 1:

Pre-conversion partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P and P owns (among other assets) Blackacre with a basis of $25,000 and a value of $45,000. In 1996, P buys Whiteacre for $50,000. In 1999, P sells Blackacre for $55,000 and recognizes a gain of $30,000 of which $15,000 is included in X's distributive share. P also sells Whiteacre in 1999 for $42,000 and recognizes a loss of $8,000 of which $4,000 is included in X's distributive share.

Thus, X's $15,000 gain is presumed to be recognized built-in gain and thus treated as a partnership 1374 item, but this presumption is rebutted if X establishes that P's gain would have been only $20,000 ($45,000 - $25,000=$20,000) if Blackacre had been sold on the first day of the recognition period. In such a case, only X's distributive share of the $20,000 built-in gain, $10,000, would be treated as a partnership 1374 item. X's $4,000 loss is not treated as a partnership 1374 item because P did not hold Whiteacre on the first day of the recognition period.

Recognition Period Transactions: Sale of Partnership Interest

Example 2.

RBIG limitation of $100,000 or $50,000. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of $100,000 and a RBIL limitation of $0. P owns (among other assets) Blackacre with a basis of $50,000 and a value of $200,000. In 1996, P sells Blackacre for $200,000 and recognizes a gain of $150,000 of which $75,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is $35,000 and with partnership 1374 items is $110,000.

Thus, X has a partnership RBIG of $75,000 except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is $100,000, X's partnership RBIG of $75,000 is not limited and X's net recognized built-in gain for the year is $110,000 ($35,000+$75,000=$110,000). However, if X had a RBIG limitation of $50,000 instead of $100,000, X's partnership RBIG would be limited to $50,000 under paragraph (i)(2)(i) of this section and X's net recognized built-in gain would be $85,000 ($35,000+$50,000=$85,000).

Recognition Period Transactions: Installment Sales

- An S corporation must pay BIG taxes beyond normal 5-year Recognition Period when some or all of a gain is deferred through an installment sale.
- If corporation sells an asset either before or during the Recognition Period and recognizes income from sale under installment method under Code Section 453, income is subject to BIG tax to extent it would have been taxed if corporation had elected not to use installment method for tax year in which sale was made.
- If corporation sells assets before Recognition Period, entire amount of income from sale not previously reported will be treated as having been reported in the first year of Recognition Period. 0
- All remaining unreported income on Day 1 of Recognition Period is RBIG in first year of Recognition Period

Asset	Basis	FMV
Factory	500,000	900,000
Equipment	300,000	250,000
Acct Receivable		40,000
Total Asset	800,000	1,190,000
NUBIG		390,000

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Recognition Period Transactions: Installment Sales

26 CFR 1.1374-4 (h) ***Installment method***

- **(1)** ***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 section 453 during or after the recognition period, that income is subject to tax under section 1374.
- **(2)** ***Limitation on amount subject to tax.*** For purposes of paragraph (h)(1) of this section, the taxable income limitation under § 1.1374-2(a)(2) is equal to the amount by which the S corporation's net recognized built-in gain would have been 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 section 1374 applied. For purposes of the preceding sentence, 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.
- ***(3) Rollover rule.*** If the limitation in paragraph (h)(2) of this section applies, the excess of the amount reported under the installment method over the amount subject to tax under the 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 in paragraph (h)(2) of this section 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.
- (4) *Use of losses and section 1374 attributes.* If income is reported under the installment method by an S corporation for a taxable year after the recognition period and the income is subject to tax under paragraph (h)(1) of this section, the S corporation's section 1374 attributes may be used to the extent their use is allowed under all applicable provisions of the Code in determining the 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 section 1374 tax.

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Recognition Period Transactions: Completed Contract

- **26 CPR 1.1374-4(g)** ***Completion of contract.*** Any item of income properly taken into account during the recognition period under the completed contract method (as described in § 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 (as described in § 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.

Strategies for Minimizing BIG Tax

- Look to offset BIGs with other losses, carryovers or credits:
  - If the corporation has a net operating loss carryforward from a year when it was a C corporation, the loss carryforward can offset the BIG.
  - Capital loss carryovers from a C year can offset the capital gains portion of BIG.
  - Unused business and alternative minimum tax credits from a C year can be used.

Strategies for Minimizing BIG Tax

- Corporations that are taxed consistently as C corporations from year to year are permitted to carry back or forward a number of tax attributes, including net operating losses, capital losses, excess charitable contributions, general business tax credits, minimum tax credits, and foreign tax credits.
  - S corporations, however, cannot carry forward any such tax attributes from a tax year in which it was C corporation.
  - Since policy underlying the BIG tax is to treat S corporation, for purposes of its RBIGs, in manner similar to its treatment if it had remained C corporation.
  - To bridge these policy differences, Code permits S corporation to carry forward certain tax attributes from C corporation year to S corporation year for purpose of reducing or eliminating its liability for BIG tax.
  - Corporation may carry forward a net operating loss or capital loss from C corporation year as deduction against its net RBIG for tax year.
  - After determining its liability for BIG tax, corporation may apply its unused general business ''tax credits and minimum tax credits against this tax, subject to generally applicable limitations.
  - Excess charitable contributions of C corporation may not be deducted against RBIG of an S corporation.
  - Excess foreign tax credit of a C corporation may not be used in computing S corporation's liability for BIG tax.

Pre-Conversion Strategies for Minimizing BIG Tax: Contribute Built-In Loss Assets to Corporation Before Conversion

- It may be possible to increase built-in losses by making tax free contribution (under Code Section 351) of built-in loss assets to C corporation prior to conversion.
- Beware of "Anti-Stuffing" Rule (Treasure Regulation Section 1.1374.9)
- The Rule Undoes benefit of contributing built-in loss property when contribution is made with a "principal purpose" of tax avoidance:
  - "If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under 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 section 1374 tax."
  - Transfer any questionable assets or assets to reduce BIG tax more than two years prior to conversion to S status.
- Ensure that there is a good non-tax reason for contributing the built-in loss property:
  - The more closely related built in loss property is to business of C corporation the better.
  - Watch out for possibility of a reduced basis of property in the hands of the subsidiary in situations where Code Section 362(e) applies.

Pre-Conversion Strategies for Minimizing BIG Tax: Minimize Accounts Receivable

- Accounts receivable have a zero basis in BIG calculation for every dollar collected will be subject to BIG tax.

- NUBIG includes the accounts receivable of a cash-method C corporation.

- Many C corporations are barred from cash-basis reporting, but not all (e.g., certain qualified persbnal service corporations and certain relatively small corporations). Code Section 448.

- S corporations may or may not be able to postpone sale of most built-in gain assets until the end of Recognition Period, but it cannot postpone the collection of receivables.

- S corporation may be able to sell receivables during Recognition Period, which under some circumstances can have a favorable result.

  - Sell all or part of the Accounts Receivable to Unrelated Third Party prior to Conversion since cash is not subject to the BIG tax

- Increase Accounts Payable prior to electing S status.

Pre-Conversion Strategies for Minimizing BIG Tax: Sell Receivables Before Conversion

- Sell receivables to shareholders before S election becomes effective.
- Sell receivables to third party A/R entities before the S election becomes effective.

Pre-Conversion Strategies for Minimizing BIG Tax: Contribute Built-In Gain Assets to Subsidiary Before Conversion

- Selling BIG asset before conversion will reduce built-in gain, but is taxable.
- Contributing BIG asset to a subsidiary in a tax-free transaction (Code Section 351) reduces built-in gain but is taxable.
- This particular technique only works if the S-Corp plans to own a C corporation subsidiary after conversion.
- Most S corporations elect to treat subsidiaries as qualified subchapter S subsidiaries ("QSUBs"), but some S corporations do have C corporation subsidiaries for one reason or another (for example, if the subsidiary is not wholly-owned by S corporation).

Pre-Conversion Strategies for Minimizing BIG Tax: Payment of Deferred Deduction Item to Related Party

- Accrual-method C corporation cannot deduct an amount owed to a related cash-method party until the amount is includible in related party's income. Code Section 267(a)(2).
- A deduction arising on payment is generally RBIL if as of the first day of the S corporation's year all events had occurred establishing:
  - The fact of liability.
  - The exact amount of the liability.
- A deduction arising on payment to a 5% or more shareholder is RBIL only if it is paid during the first 2 1/2 months of the first S-Corp year.
  - Treas. Reg. Section1.1374-4(c)(2).
- Be careful to actually pay the amount to the 5% shareholder within the first 2 1/2 months of the S-Corp year.
- Related Party Payment:
  - X, a C-Corp, is an accrual-method taxpayer
  - A is a 5% shareholder of X
  - X owes A $10,000 in unpaid wages
  - X becomes an S-Corp on January 1, 2016.
  - If X pays the $10,000 on or before March 15, 2016, the deduction is a recognized built-in loss.
  - If X pays the $10,000 after March 15, 2016, the deduction is not a recognized built-in loss.

Pre-Conversion Strategies for Minimizing BIG Tax: Declare Bonuses

- In Private Letter Ruling 200925005, a personal service corporation was contemplating electing S status (cash basis C corporation). The corporation billed its clients for services performed prior to conversion and as those client receivables were collected, the taxpayer paid salaries to both shareholder and non-shareholder employees.
  - The taxpayer filed for the PLR for confirmation that the salary expenses that related to the outstanding receivables as of the S election date would be considered a built-in loss item under section 1374 and therefore reduce the taxpayer's potential BIG tax liability.
  - In PLR 200925005, the IRS allowed compensation owed to shareholder employees that was attributable to receivables as of the first day of the first S corporation year and was paid within the first $2^1/_2$ months after such date to be treated as a built-in loss item .

- Payments qualify as built-in loss items under Code Section 1374(d)(5)(B).

Pre-Conversion Strategies for Minimizing BIG Tax: Earnings and Profits

- Accumulated earnings and profits existing at the time of conversion can create issues down the road.
- If the S-Corp has E&P, and its passive income totals over 25% of its gross receipts, the excess net passive income is taxable -- and at the highest corporate rate. Code Section 1375(a).
- Even worse, S-Corp status will terminate if the S-Corp has E&P, and its passive income exceeds 25% of gross, receipts for 3 years running. Code Section 1362(d)(3).
  - Passive income (or "passive investment income") generally includes gross receipts from royalties, rents, dividends, interest, and annuities. Code Sections 1362(d)(3)(C), 1375(b)(3)
  - However, recognized built-in gain is not counted in the amount of passive investment income. Code Section 1375(b)(4).
- Dividends paid by the S-Corp out of earnings and profits are taxable as C-Corp dividends. Code Section 1368(c)(2).

Pre-Conversion Strategies for Minimizing BIG Tax: Plan for Creation of Personal Goodwill over Corporate Goodwill

- Regs. Sec. 1.197-2(b)(1) defines goodwill as "the value of a trade or business attributable to the expectancy of continued customer patronage," and that "[t]his expectancy may be due to the name or reputation of a trade or business or any other factor." In Rev. Rul. 59-60, the IRS describes goodwill thus:

  > In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, a and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value.

- In *Staab,* the Tax Court has stated that goodwill is an intangible asset consisting of the excess earning power of a business. *Staab,* 20 T.C. 834 (1953).

- The accounting profession defines goodwill as "an asset representing the future economic benefits arising from other assets acquired in a business combination ... that are not individually identified and separately recognized."FASB ASC Paragraph 805-30-20.

Pre-Conversion Strategies for Minimizing BIG Tax: Plan for Creation of Personal Goodwill over Corporate Goodwill

- The concept that personal goodwill can be a separate, salable asset, distinct from the goodwill of the business, is not new. In *Thompson v. Thompson ,* 576 So.2d 267 (Fla. 1991), the Florida Supreme Court distinguished between personal goodwill and professional goodwill.
  - The court indicated that personal goodwill was the value that resulted from the continued presence of a certain person, and only that person can transfer it.
  - This principle was applied for tax law purposes in two 1998 Tax Court cases: *Martin Ice Cream Co. ,* 110 TC 189 (1998), and *Norwalk ,* TC Memo 1998-279. In all three cases, the question was who controlled the relationships with customers.

- Personal goodwill can be present when the owner's reputation, expertise, skill, knowledge, and relationships with customers are critical to the business's success and value.

- Personal goodwill may be deemed an asset of the corporation where shareholders have transferred the goodwill to the corporation through noncompetition, employment, or other agreements with the corporation.

- Plan ahead using employment contracts to create value for personal goodwill which can easily be differentiated from corporate goodwill (intangible asset)
  - Non-Competition agreements transfer personal goodwill to corporate goodwill.

Post-Conversion Strategies for Minimizing BIG Tax: Minimize Recognition-Period Income

- Taxpayers generally want to defer (or eliminate) items of taxable income and accelerate (or increase) items of taxable loss.
- This usual strategy can have an extra benefit during the recognition period.
- During the recognition period when a disposition of asset occurs you avoid the BIG Tax if the assets was not held on the date of conversion.
- Portion of gain is attributable to post conversion appreciation.
- Built-in gain tax in any given year is limited to the amount of taxable income for that year, even if the amount of recognized built-in gain (less recognized built-in loss) for the year is higher.
- To the extent the built-in gain tax is limited by the amount of taxable income, the excess is carried forward.
- If the excess is carried forward until after the recognition period ends then the built-in gains tax can be eliminated.
- However, the carry-forward of the excess during the recognition period puts a crimp in this planning technique.

Post-Conversion Strategies for Minimizing BIG Tax: Defer Sale of Built-In Gain Assets

- Wait until the Recognition Period ends to sell BIG assets.
- If sales cannot wait then, as noted before, try to offset RBIG with RBIL.