



# **BODILLY** S Corporation Taxes in General

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The S corporation can be subject to various taxes.

When a C corporation makes an S election, the corporation is no longer subject to any of the income taxes that apply to C corporations. Such taxes include the regular corporate income tax, the alternative minimum tax and companion environmental tax, the accumulated earnings tax, and the personal holding company tax. Nevertheless, S corporations can be subject to one or more of three distinct taxes. Each of these taxes is summarized below.

## **Built-In Gains Tax**

All corporations electing S status are subject to a tax on their net recognized built-in gains. In general, the tax (imposed at a flat 35% rate) applies during the first 10 years from the date the corporation converts to S status. In general, the tax applies to the recognition, during the 10-year period, of any item of income or gain that is attributable to prior C corporation years, such as the collection of cash basis accounts receivable or the sale of inventory owned on the conversion date.

The gain subject to tax is subject to various limitations. First, recognized built-in gains may be reduced by built-in losses; that is, any losses on the disposition of assets or deductions that relate to prior C corporation years. Second, the income subject to tax cannot exceed the corporation's taxable income.

However, any built-in gain sheltered from current tax by the taxable income limitation is carried forward and treated as recognized built-in gain in later S corporation years to the extent of taxable income (not otherwise composed of recognized built-in gains). Third, the maximum amount of recognized built-in gains subject to tax is limited to the excess of the fair market value of all the corporation's assets over their aggregate adjusted bases on the conversion date. Fourth, the tax may be offset by any NOL, capital loss, minimum tax credit, or general business credit carryovers from prior C corporation years.

## **Passive Investment Income Tax**

An S corporation may be subject to a tax for any year it has (1) passive investment income in excess of 25% of gross receipts, and (2) accumulated earnings and profits at the close of the year (from prior C corporation years). If these two conditions are met, a 35% tax is imposed on the lesser of the corporation's excess net passive income or its taxable income.

Passive investment income generally includes all gross receipts from dividends, interest, rents, royalties, and gains from the sale or exchange of stock or securities. Accumulated earnings and profits includes any earnings and profits from prior C corporation years (including C corporation years of corporations acquired in tax-free reorganizations, divisions, and liquidations).

If the two conditions specified above apply for three consecutive years, the corporation's election will automatically terminate at the beginning of the fourth year.

## **LIFO Recapture Tax**

If a C corporation uses the LIFO inventory method and makes an S election, the LIFO reserve must be recaptured in the corporation's last C corporation year. The LIFO reserve is the excess of the corporation's inventory amount under FIFO (lower of cost or market) over the inventory amount using LIFO. Any resulting increase in tax for the final C corporation return is payable in four equal installments. The first installment is due by the due date for the final C corporation return and one of each of the remaining three installments are due by the due date of each of the corporation's next three tax returns. The amount recaptured increases the corporation's ending inventory for the final C corporation year.