



TaxNewsFlash

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Proposed regulations: Eligible terminated S corporations (text of regulations)

The U.S. Treasury Department and IRS this afternoon released for publication in the Federal Register proposed regulations (REG-131071-18) providing rules concerning:

- The definition of an eligible terminated S corporation (ETSC)
- Distributions of money by an ETSC after the post-termination transition period (PTTP)
- Revisions to existing regulations to extend the treatment of distributions of money during the PTTP to all shareholders of the corporation and to update and clarify the allocation of current earnings and profits to distributions of money and other property

The [proposed regulations](#) [PDF 303 KB] are scheduled to appear in the Federal Register on November 7, 2019. Comments and requests for a public hearing must be received by a date that is 45 days after November 7, 2019.

The purpose of this report is to provide text of the proposed regulations. A more detailed discussion of these regulations will be provided in a follow-up report from KPMG LLP.

Background

The U.S. tax law enacted in 2017 (Pub. L. No. 115-97, known as the “Tax Cuts and Jobs Act”) provided two generally favorable provisions applicable to “eligible terminated S corporations.” The provisions appeared to be based on an expectation that some S corporations may revoke their S corporation status following enactment of the new law. For purposes of both provisions, an eligible terminated S corporation is any C corporation: (1) that was an S corporation on the day before the date of enactment (December 22, 2017) and revokes its S corporation election in the two-year period beginning on the date of such enactment; and (2) the owners of the stock of which (determined on the date on which such revocation is made) are the same as, and such owners hold the stock in the same proportions as, on the date of enactment.

The first provision related to accounting method changes required as a result of an S corporation's conversion to a C corporation. Specifically, the 2017 tax law provides that, in the case of an eligible terminated S corporation, any section 481 adjustment arising from an accounting method change attributable to the corporation's revocation of its S corporation election will be taken into account ratably during the six-tax year period beginning with the year of the method change. Thus, a corporation that must change a method of accounting as a result of the revocation of its S corporation election would include any income resulting from that change over six tax years (as opposed to four years).

The second provision revised the treatment of distributions made by certain corporations following their conversion to C corporation status. Under the pre-enactment law, distributions by an S corporation generally were treated as coming first from the S corporation's accumulated adjustments account (AAA), which effectively measured the income of the S corporation that had been taxed to its shareholders but remained undistributed. If AAA was exhausted by the distribution, the excess distribution was treated as coming from any earnings and profits (E&P) of the corporation generated when it was a C corporation (or inherited from a C corporation under section 381). For a shareholder, distributions out of AAA generally were more favorable, as such distributions were tax-free to the extent of the shareholder's basis in its S corporation stock and then gave rise to capital gain. In contrast, distributions out of E&P were treated as dividends and taxed accordingly.

If a corporation's S corporation election terminates, special rules apply to distributions made by the resulting C corporation during the post-transition termination period (PTTP). The PTTP begins on the day after the last day of the corporation's last tax year as an S corporation and generally ends on the later of: (1) the day that is one year after that day; or (2) the due date for filing the return for such last year as an S corporation (including extensions). However, the PTTP may be extended in certain situations. A distribution of cash made by a C corporation with respect to its stock during the PTTP is applied against and reduces the shareholder's basis in the stock to the extent the amount of the distribution does not exceed the corporation's AAA. Thus, cash distributions by a former S corporation may be subject to the generally beneficial S corporation treatment of distributions, but only during the PTTP. After expiration of the PTTP, any distributions made by the former S corporation would be treated as coming first from the corporation's E&P and thus taxable as a dividend to the extent thereof.

The 2017 tax law extended in part the generally beneficial treatment of distributions for certain former S corporations beyond the PTTP. Specifically, a distribution of money by an eligible terminated S corporation following the PTTP would be treated as coming out of the corporation's AAA or E&P in the same ratio as the amount of the corporation's AAA bears to the amount of the corporation's accumulated E&P.

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