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Proposed regulations: Eligible terminated S corporations (initial impressions)

The U.S. Treasury Department and IRS on Monday afternoon, November 4, 2019, 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

In general, the proposed regulations reflect an intention to ease the transition from S corporation status to C corporation status for corporations that revoke their S corporation status within two years of the enactment of the 2017 tax law.

The **proposed regulations** [PDF 349 KB] were published in the Federal Register on November 7, 2019. Comments and requests for a public hearing must be received by January 6, 2019.

The following discussion provides initial impressions about the proposed regulations.

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 would 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 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—section 481(d)—relates 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 (ETSC), 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 within the prescribed period 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 an ETSC following its conversion to C corporation status. Under the S corporation rules, distributions by an S corporation generally are treated as coming first from the S corporation's accumulated adjustments account (AAA), which effectively measures the income of the S corporation that has already been taxed to its shareholders. If AAA is exhausted by the distribution, the excess distribution is treated as coming from earnings and profits (E&P) of the corporation (if any) generated when it was a C corporation (or inherited from a C corporation under section 381). For a shareholder, distributions out of AAA generally are more favorable, as such distributions are tax-free to the extent of the shareholder's basis in its S corporation stock and then give rise to capital gain. In contrast, distributions out of E&P are 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 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 prior to enactment of the 2017 tax law, only during the PTTP. After expiration of the PTTP, any distributions made by the former S corporation generally 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, section 1371(f) provides that a distribution of money by an eligible terminated S corporation following the PTTP is 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.

Proposed regulations

Requirements to qualify for section 1371(f) treatment

ETSC qualification requirements

The proposed regulations provide that for section 1371(f) to apply, the distributing company must be an ETSC (as defined in the 2017 tax law). There are three requirements: (1) the corporation was an S corporation on December 21, 2017; (2) during the two-year period beginning on December 22, 2017, the S corporation revoked its S election; and (3) the owners of the stock of the corporation are the same owners (in identical proportions) on December 22, 2017, and the date when the corporation

made its S corporation revocation. These are the same requirements necessary for section 481(d) to apply.

Under the proposed regulations, a revocation of an S election is validly made during the two-year period beginning on December 22, 2017, even if the effective date for the revocation occurs after the conclusion of the two-year period. Concerning the shareholder identity requirement, the proposed regulations explain that certain events would not affect the shareholder identity requirement because these events do not change in substance the identity of the shareholder. As such, the proposed regulations do identify five categories of stock transfers that do not result in an ownership change:

- Transfers of stock between a shareholder and that shareholder's trust treated as wholly owned by that shareholder for federal tax purposes;
- Transfers of stock between a shareholder and an entity owned by the shareholder that is disregarded as separate from its owner;
- An election by a shareholder trust to be treated as part of a decedent's estate or the termination of that election;
- A change in the status of a shareholder trust from one type of eligible S corporation shareholder trust to another; or
- A transaction that includes more than one of the four events (listed in the bullets above)

Requirement for corporation to have AAA

The preamble to the proposed regulations explains that if an ETSC has no AAA, then section 1371(f) has no application. Treasury and the IRS have determined that a transaction "naturally" concludes once the corporation's AAA balance reaches zero.

Conclusion of PTTP, multiple PTTPs

The proposed regulations explain the PTTP rules, and include a statement that the intention of Treasury and the IRS is for the ETSC period to resume immediately following the conclusion of an intervening audit PTTP, if the ETSC continues to have an AAA balance greater than zero.

Mechanics of section 1371(f)

Shareholders eligible to receive qualified distributions

The preamble explains that a "no newcomer rule" imposed on distributions from the S corporation would not be consistent with congressional intent to ease the transition of former S corporations to full C corporation status because such a rule would impede an ETSC's ability to exhaust its AAA (as well as to impose an administrative burden on ETSCs and create complexity). Thus, the proposed regulations do not impose a no newcomer rule with respect to the ETSC period.

Accordingly, new shareholders, whether eligible S corporation shareholders or not, that acquire stock of an ETSC on or after the date that the revocation was made may receive qualified distributions, all or a portion of which may be sourced from AAA. Because this rule differs from that currently applicable to distributions made by a corporation during the PTTP, the proposed regulations would revise those rules to be consistent with the rules applicable to distributions during the ETSC.

Implementation of ETSC proration measures

Section 1371(f) specifically requires calculation of a ratio between a corporation's AAA and AE&P for purposes of determining the federal tax consequences of distributions after the PTTP. The proposed regulations adopt a "snapshot approach" pursuant to which an ETSC generally calculates AAA and AE&P only once at the beginning of the day on which revocation of the corporation's S status is

effective (as opposed to recalculation of amounts before each qualified distribution). At that time, the ratio of AAA and AE&P is determined and continues to apply to all distributions until the corporation's AAA is exhausted. Applying this ratio to a corporation with no AE&P at the time revocation of its S status is effective, the entire amount of a distribution by the corporation will be treated as coming out of AAA until it is exhausted. This generally will provide for favorable treatment of distributions by ETSCs.

The proposed regulations also provide a "Section 1371(f) Priority Rule" that harmonizes general rules for allocating a corporation's E&P across distributions made during a year. Under this provision, the rules of the ETSC proration under section 1371(f) apply before the rules of section 301 and 316. Thus, under the Section 1371(f) Priority Rule, the ETSC proration first applies to qualified distributions during the tax year. Then, the rules of section 301 and 316, as incorporated into the Section 1371(f) Priority Rule, apply to any nonqualified distributions as well as to any qualified distributions or portions thereof that are not fully accounted for by the ETSC proration (i.e., because the corporation's AAA or AE&P are exhausted during the year).

Comments requested

Treasury and the IRS have requested comments about the approach taken in the proposed regulations and specifically concerning:

- The snapshot approach and in particular with respect to the timing of determining an ETSC's historical AAA and historical AE&P amounts and whether such amounts are to be adjusted by certain transactions as well as potential alternative approaches for calculating ETSC proration
- The advantages and disadvantages of the Section 1371(f) Priority Rule
- Other proposals that would help ease the transition of S corporation status to C corporation status
- The effect of section 381(a) transactions in which an ETSC is either the transferor or the acquiring corporation (including certain triangular acquisitions)
- The effect of an ETSC election to file a consolidated return or to join a consolidated group
- The effect of subchapter C transactions (including section 302(a) redemptions, section 355 transactions, and section 368 reorganizations)
- The effect of deemed distributions (including forgiveness of shareholder debt) on the ETSC's AAA balance

Proposed effective date

The regulations are proposed to apply to tax years beginning on or after the date when the final regulations adopting these measures are published in the Federal Register. The preamble, however, states that corporations may elect to apply certain measures as final provided that all shareholders of the corporation report consistently.

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