

WILLIAM C. STALEY
Business Tax Planning

November, 2010

TWO S CORPORATION NEWS FLASHES:

**THE WAIT TO AVOID THE FEDERAL BUILT-IN GAINS TAX
WAS SHORTENED FROM TEN TO SEVEN YEARS,
BUT ONLY FOR SALES IN 2009 AND 2010 – AND FROM SEVEN TO FIVE
YEARS, BUT ONLY FOR SALES IN 2011**

Some S corporations will be able to sell assets in 2010 or 2011 without incurring the federal built-in gain tax. Only one federal tax will apply -- at the shareholder level. This temporary change could also benefit sellers in certain stock sales. Unfortunately, California tax will apply at both the shareholder and corporate level for the entire ten-year period. Generally, after ten years as an S corporation, the corporation can sell its assets and avoid both the federal and the California corporate-level taxes.

News flashes. *First* - The 10-year waiting period for an S corp to avoid the federal built-in gain tax on asset sales was reduced temporarily to 7 years by the American Recovery and Reinvestment Act of 2009.¹ *The 7-year period applies only for sales in tax years beginning in 2009 and 2010.* This generally will apply for S corpo-

ration elections that were effective in 2002 and earlier.

Second - - The 10-year waiting period for an S corp to avoid the federal built-in gain tax on asset sales was reduced temporarily to 5 years by the Small Business Jobs Act of 2010. *The 5-year period applies only for sales in tax years beginning in 2011.* This generally will apply for S corporation elections that were effective in 2005 and earlier. The 10-year waiting pe-

¹ I.R.C. § 1374(d)(7)(B).

riod is scheduled to go back into effect for sales in years beginning after 2011.

For purposes of the California built-in gain tax, the 10-year period has not changed.

What it means. Some S corporations will be able to sell their businesses or dispose of unwanted assets in 2010 or 2011 to raise cash without incurring the federal built-in gain tax.

Some S corporations will be able to sell their stock in 2009 or 2010 and make the *Section 338(h)(10) election* to give the buyer the tax benefit of a stepped up basis in the corporation's assets without incurring the federal built-in gain tax.

I would be happy to discuss possible transactions that your clients might consider to take advantage of this temporary opportunity.

Refresher. Generally, no corporate-level tax applies to an S corporation. Instead, its shareholders pay tax on its income, and there is no tax when that income is distributed in cash to the shareholders.

However, Congress was concerned that C corporations would make the S corporation election and then immediately sell assets. So special rules

were enacted in 1982 and 1986. When a C corporation elects S corporation status, its assets (including goodwill) are valued as of the effective date of the S corporation election. If those assets are disposed of by the corporation in its first 10 years (it was three years until 1986) as an S corporation, an extra corporate-level tax applies. This tax applies to the excess of the value of the asset on the date of the S corporation election over the corporation's tax basis in the asset at that time. This "*built-in gain*" is then taxed at the highest rate for C corporations – currently 35%. The full gain, less the built-in gain tax, then flows through the S corporation to the shareholders, who also pay tax on the passed-through gain at the rates for ordinary income or long-term capital gain, as applicable. There are few good ways to avoid the built-in gain tax after the S corporation election is effective, so most businesses wait out the 10-year period.

Three "Gotchas"

(1) There is also a built-in gain tax for California tax purposes (the tax rate is 8.84%), but the 10-year waiting period -- and not the special 7-year waiting period -- applies for California tax purposes. The California built-in gain tax is a nasty tax, because the flow-through gain is reduced by the

California built-in gain tax -- but not the federal built-in gain tax. So the California shareholder-level tax on built-in gain is much more than it would be if the corporation really was a C corporation and really sold the asset, paid the California and federal corporate taxes, and then distributed the balance to the shareholders, who paid tax on the amount that they received from the corporation -- which would be net of *both* the federal and California corporate taxes.

(2) If the S corporation acquired any asset in a tax-free transaction and that asset was from a C corporation or had the built-in gain "taint" for any

other reason, the 5- and 7-periods for those assets might end after the 5- or 7-year period for the corporation's other assets.

(3) The 5- and 7-year waiting periods do not apply to distributions of bad debt reserves from thrift institutions.

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I would be pleased to discuss how these new rules apply to your organization or activities.

-- William C. Staley
(818) 936-3490
www.staley.com

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