TaxNewsFlash

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Final regulations: Eligible terminated S corporations

The IRS today posted on its website a version of final regulations (T.D. 9914) as guidance on the definition of an eligible terminated S corporation and rules relating to distributions of money by such a corporation after the post-termination transition period.

Overview

The final regulations also amend current regulations to extend the treatment of distributions of money during the post-termination transition period to all shareholders of the corporation and clarify the allocation of current earnings and profits to distributions of money and other property.

Read the **final regulations** [PDF 235 KB] (49 pages)

Today's release finalizes regulations that were proposed in November 2019, but with certain modifications (described below) in response to the comments received in response to the proposed regulations.

The version of the final regulations released today includes the following statement:

> *This document has been submitted to the Office of the Federal Register (OFR) for publication and will be pending placement on public display at the OFR and publication in the Federal Register. The version of the final rule released today may vary slightly from the published document if minor editorial changes are made during the OFR review process. The document published in the Federal Register will be the official document.*

Background

The U.S. tax law enacted in 2017 (Pub. L. No. 115-97) the law that is often known as the "Tax Cuts and Jobs Act" (TCJA), 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

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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 TCJA 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 (including any required change from the cash to accrual method as a result of a conversion from an S corporation to a C corporation) 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 "post-termination transition 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 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.

In November 2019, the IRS and Treasury issued proposed regulations interpreting the changes in law. Read a general description about and KPMG's initial impression relating to the proposed regulations: ***TaxNewsFlash***

Final regulations

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The final regulations included in today's release generally follow the proposed regulations, but with certain modifications or clarifications in response to the comments received in response to the proposed regulations. Of particular interest, the final regulations:

- Clarify that a corporation may test compliance with the revocation requirement and the shareholder identity requirement on either the date the revocation was made or, in the case of a revocation with a retroactive effective date, the date the revocation was effective.
- Confirm that section 7503 (which extends certain due dates that arise on weekends or legal holidays to the following business day) applies such that a revocation made on Monday, December 23, 2019, will be treated as made during the relevant two-year period.
- Confirm that a corporation is an ETSC even if it did not have E&P on the effective date of its revocation.

Note that, despite numerous comments requesting it, Treasury and the IRS in the final regulations declined to extend the application of the extended period of time under section 481(d) to qualified subchapter S subsidiaries owned by an ETSC. Thus, for example, the extended period of time will not apply to the cash method payables of the subsidiary, regardless of the fact that the receivables were treated as receivables owned by the ETSC prior to the revocation.

KPMG observation

Curiously, Treasury and the IRS also declined to include a provision confirming that ETSC status and AAA of a corporation are items that may be succeeded to in a reorganization or a tax-free liquidation under section 381(a) because the "issue exceeds the scope of the final regulation because whether a AAA constitutes a tax item to which a successor may succeed under section 381 is not limited to the ETSC context." In this regard, it is interesting to note that Reg. section 1.1368-2(d)(2) already provides for the carryover of AAA from one S corporation to another in S corporation in a section 381 transaction.

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