

**DESCRIPTION OF H.R. 4453,
A BILL TO MAKE PERMANENT THE
REDUCED RECOGNITION PERIOD FOR
BUILT-IN GAINS OF S CORPORATIONS**

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
on April 29, 2014

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 4454, a bill to Make Permanent the Reduced Recognition Period for Built-In Gains of S Corporations on April 29, 2014. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 4454, a Bill to Make Permanent the Reduced Recognition Period for Built-In Gains of S Corporations* (JCX-39-14), April 25, 2014. This document can also be found on our website at www.jct.gov.

**A. Reduced Recognition Period for Built-In Gains of S Corporations Made Permanent
(sec. 1374 of the Code)**

Present Law

In general

S corporations

A small business corporation² may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.³

A corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation's net recognized built-in gain⁴ that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, (*i.e.*, the 10-year period beginning with the first day of the first taxable year for which the S election is in effect).⁵ If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no built-in gain tax is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year.⁶ Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method⁷ during or after the recognition period, that income is subject to the built-in gain tax.⁸

The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or

² This term is defined in section 1361(b).

³ Sec. 1366.

⁴ Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

⁵ Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374-1(d).

⁶ Sec. 1374(d)(2).

⁷ Sec. 453.

⁸ Treas. Reg. sec. 1.1374-4(h).

other property) in the hands of the C corporation.⁹ In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.¹⁰

The amount of the built-in gains tax is treated as a loss by each of the S corporation shareholders in computing its own income tax.¹¹

For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.¹² Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year that the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the fifth year in the corporation's recognition period preceded such taxable year.¹³ Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the S corporation election was in effect for five years preceding the taxable year beginning in 2011.

For taxable years beginning in 2012 and 2013, the term "recognition period" in section 1374, for purposes of determining the net recognized built-in gain, is applied by substituting a five-year period¹⁴ for the otherwise applicable 10-year period. Thus, for such taxable years, the recognition period is the five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C corporation apply). If an S corporation with assets subject to section 1374 disposes of such assets in a taxable year beginning in 2012 or 2013 and the disposition occurs more than five years after the first day of the relevant recognition period, gain or loss on the disposition will not be taken into account in determining the net recognized built-in gain.

⁹ Sec. 1374(d)(8).

¹⁰ Sec. 1374(d)(8)(B).

¹¹ Sec. 1366(f)(2). Shareholders continue to take into account all items of gain and loss under section 1366.

¹² Sec. 1374(d)(7)(B).

¹³ Sec. 1374(d)(7)(C).

¹⁴ The five-year period refers to five calendar years from the first day of the first taxable year for which the corporation was an S corporation.

If an S corporation subject to section 1374 sells a built-in gain asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received will be governed by the provisions of section 1374(d)(7) applicable to the taxable year in which the sale was made.

Application to real estate investment trusts and regulated investment corporations

Under Treasury regulations, a regulated investment company (“RIC”) or a real estate investment trust (“REIT”) that was formerly a C corporation not taxed as a REIT or RIC (or that acquired assets from such a C corporation) generally is subject to the built-in gain tax rules as if the RIC or REIT were an S corporation, unless the relevant C corporation elects “deemed sale” treatment, requiring recognition of all C corporation built-in gain and loss at the time of the conversion or asset acquisition.¹⁵ Deemed sale treatment is not permitted if its application would result in the recognition of a net loss.¹⁶ For this purpose, net loss is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.¹⁷

Description of Proposal

The proposal makes permanent the five-year recognition period for built-in gains of S corporations. Under current Treasury regulations, this five-year recognition period also would apply to real estate investment trusts and regulated investment companies that do not elect “deemed sale” treatment.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2013.

¹⁵ Treas. Reg. secs. 1.337(d)-7(a) and 1.337(d)-7(b).

¹⁶ Treas. Reg. sec. 1.337(d)-7(c)(1).

¹⁷ Treas. Reg. sec. 1.337(d)-7(c)(1).

B. Estimated Revenue Effects

Fiscal Years [Billions of Dollars]												
<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2014-19</u>	<u>2014-24</u>
---	-0.2	-0.2	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-1.0	-1.5
