Revenue Ruling 86-141

S corporations; transition rules for corporations converting to S corporation status. Guidance is provided to corporations who may wish to convert to S corporation status to obtain transition relief from the corporate level tax on built-in gains recognized by a former C corporation during the 10-year period after it becomes an S corporation.

PURPOSE

Following the enactment of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. (Act), there has been uncertainty regarding the manner in which a corporation can obtain transition relief from the provisions of subtitle D of title VI of the Act by electing to be an S corporation. The provisions of subtitle D generally require a corporation to recognize gain or loss on a liquidating sale of its assets and on a liquidating or non-liquidating distribution of its assets (the repeal of the *General Utilities* doctrine). This revenue ruling interprets certain pertinent provisions of the Act and of sub-chapter S of the Internal Revenue Code that are applicable to a corporation that seeks to obtain transition relief by electing to be an S corporation.

LAW

Section 1374 of the Code, [*2] as amended by section 632 of the Act, generally imposes a corporate-level tax on the "built-in" gains recognized by a former C corporation during the 10-year period beginning with the first day of the first taxable year for which the corporation becomes an S corporation (built-in gains tax).

Section 633 (b) of the Act contains the effective date for the amendments to section 1374 of the Code. It provides that the built-in gains tax shall apply in taxable years beginning after December 31, 1986, but only if the first taxable year for which the corporation is an S corporation is pursuant to an election made after December 31, 1986. Thus, as explained in the Conference Report, the amendments to section 1374 "will generally be effective with respect to S elections made after December 31, 1986." 2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-203 (1986). Section 1374, prior to its amendment by section 632 of the Act, continues to apply in situations where section 1374, as amended by the Act, is inapplicable.

Section 1362 (a) (1) of the Code provides generally that a small business corporation, as defined in section 1361 (b) (small business corporation), may make an election (S [*3] election) to be an S corporation. Section 1362 (b) (1) provides that an S election may be made for the current or the following taxable year of the corporation, but an election may be effective for the current taxable year only if it is made on or before the 15th day of the third month of that year.

Section 18.1362-1 of the Temporary Income Tax Regulations provides that an S election should be made by filing Form 2553, Election by a Small Business Corporation, at the appropriate Internal Revenue Service Center along with the required consents of the shareholders. The regulations further provide, in effect, that section 1362 (b) (2) of the Code

(concerning certain elections that are made for a taxable year but are treated as made for the succeeding taxable year) applies only if a corporation meets all of the requirements provided in section 1361 (b) at the time the election is made.

Section 1362 (g) of the Code prohibits a small business corporation (and any successor corporation) from making a new S election with respect to any of the first five taxable years after a termination of its S election was effective pursuant to section 1362 (d), [*4] unless the Secretary consents to such new election.

Section 633 (d) (1)-(7) of the Act provides a transition rule for a qualified small corporation (qualified corporation) that completely liquidates prior to January 1, 1989. Section 633 (d) (8) of the Act provides that rules similar to the rules of section 633 (d) of the Act shall apply for purposes of applying section 1374 of the Code, as amended by the Act, in the case of a qualified corporation that becomes an S corporation before January 1, 1989.

Section 633 (d) (1) of the Act provides that if a qualified corporation completely liquidates before January 1, 1989, it generally will not be subject to the repeal of the *General Utilities* doctrine.

Section 633 (d) (2) of the Act, however, provides that section 633 (d) (1) of the Act shall not apply, and thus gain or loss will be recognized, on the liquidating sale or distribution of certain items, including assets resulting in ordinary gain or loss and capital assets held for not more than 6 months. Further, section 633 (d) (1) of the Act provides that this small corporation exception will be phased out where the applicable value of the corporation exceeds $5,000,000. If the applicable [*5] value of a corporation exceeds $5,000,000, gain or loss will be recognized to the extent that such gain or loss exceeds the applicable percentage of each gain or loss from capital assets held for more than 6 months. The applicable percentage equals 100 percent reduced by the amount that bears the same ratio to 100 percent as the excess of the applicable value over $5,000,000 bears to $5,000,000.

Section 633 (d) (5) of the Act generally defines "qualified corporation" as any corporation more than 50 percent (by value) of the stock in which is held by 10 or fewer "qualified persons," as defined in section 633 (d) (6) of the Act, and the applicable value of which does not exceed $10,000,000.

Section 633 (d) (4) of the Act defines "applicable value" as the fair market value of all of the stock of the corporation on the date of the adoption of the plan of complete liquidation (or if greater, on August 1, 1986).

ANALYSIS AND HOLDINGS

Conversion To S Corporation Status

As stated above, section 1374, as amended by the Act, is not applicable to an S corporation if its S election in effect after January 1, 1987, was made before that date. The date on which the S election is made is determinative, [*6] notwithstanding that the election may not be effective until a taxable year beginning after December 31, 1986. *n1* Conference Report at II-203. A corporation with such an election in effect is subject to section 1374 as in effect prior to its amendment by the Act. In order to avoid section 1374, as amended by the Act, a corporation whose S election was terminated before January 1, 1987, must have made a new election before January 1, 1987. For example, a corporation whose S election was made in 1976 and was terminated in 1978 must make a new, valid S election prior to January 1, 1987, in order to avoid section 1374, as amended by the Act.

Section 1362 of the Code and section 18.1362-1 of the temporary regulations provide that, to make a valid S election, a corporation must be a small business corporation at the time the Form 2553 effecting the election is filed. Accordingly, a corporation that is not a small business corporation can avoid the provisions of section 1374, as amended by the Act, only if it becomes a small business corporation and then makes a valid S election before January 1, 1987. In addition, the election must be effective for the current or succeeding taxable year.

A [*7] corporation that does not make a valid S election prior to January 1, 1987, but is a qualified corporation as defined in section 633 (d) (5) of the Act, may nevertheless qualify under section 633 (d) of the Act for partial transition relief from the built-in gains tax imposed by section 1374, as amended by the Act. Under section 633 (d) (8) of the Act, rules similar to those applicable to a liquidating corporation under section 633 (d) of the Act apply for purposes of determining whether and to what extent this relief is available to a qualified corporation that makes an S election after December 31, 1986.

Such a qualified corporation that becomes an S corporation before January 1, 1989, unlike a qualified corporation that obtains transition relief from the repeal of the *General Utilities* doctrine under section 633 (d) (1)-(7) of the Act, does not have to liquidate to qualify for relief from the amended provisions of section 1374 of the Code. This relief does not apply to the items described in section 633 (d) (2) (which include ordinary income and short-term capital gain). Thus, the built-in gains tax imposed by section 1374, as amended by the Act, will apply to recognized built-in [*8] ordinary gains and recognized built-in short-term capital gains. Moreover, for a corporation with an applicable value between $5,000,000 and $10,000,000, this relief is limited to the applicable percentage of the gain from capital assets held for more than 6 months. Thus, the built-in gains tax will apply to the amount of any recognized built-in long-term capital gains in excess of the applicable percentage of each such gain. Section 1374, as it existed prior to the amendments made by the Act, will apply to the applicable percentage of each such gain.

The applicable value of a qualified corporation that becomes an S corporation is the greater of the fair market value of all of the stock of the corporation on either the date a valid S election is made or August 1, 1986.

S Elections After Terminations

Pursuant to section 1362 (g) of the Code, the Secretary hereby consents to an election to convert to S corporation status by a small business corporation whose S election was terminated under section 1362 (d) if it meets the following two conditions. First, the corporation makes the S election prior to January 1, 1987, or, in the case of a qualified corporation, the corporation becomes an [*9] S corporation before January 1, 1989. Second, the date that a revocation, as described in section 1362 (d) (1), was filed under section 48.1362-3 of the temporary regulations or the effective date of a termination, as described in section 1362 (d) (2) (B) or section 1362 (d) (3) (A) (ii), occurred before October 22, 1986 (the date of enactment of the Act).

Any corporation that files a Form 2553 pursuant to the consent granted in the above paragraph should refer to this revenue ruling by either typing or legibly printing the following statement at the top of page 1 of Form 2553: "FILED UNDER REV. RUL. 86-141, 1986-2 C.B. 151."Also released as News Release IR-86-159, dated November 20, 1986.

FOOTNOTES:

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