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Larry's Tax Law

# A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part II - Code Sections 1375 and 1362(d)(3)

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This second installment of my multi-part series on Subchapter S is focused on two Code Sections, namely IRC Section 1375 and IRC Section 1362(d)(3).

**Background**

While most of my readers are all quite familiar with these two Code sections, there are some obscure practical implications of these provisions that I want to bring to your attention or remind you.

These Code Sections only apply to S corporations that have retained earnings and profits from C corporation years ("C E&P"). In a nutshell, under Code Section 1375, S corporations that have C E&P at the close of the taxable year and "passive investment income" totaling more than 25 percent of gross receipts will be subject to a tax imposed at the highest corporate income tax rate under Code § 11 (which is currently a flat 21 percent). The tax is based upon the lessor of the corporation's "taxable income" or its "excess net passive investment income."

**PRACTICE ALERT:** Under Code Section 1362(d)(3), if "passive investment income" of an S corporation that has C E&P exceeds this 25 percent threshold for three consecutive tax years, its S election will be terminated at the beginning of the fourth tax year. Consequently, for S corporations with C E&P, paying close attention to levels of "passive investment income" is imperative.

The purpose of these two Code Sections is to prevent shareholders from doing through an S corporation what they cannot do in a C corporation because of the personal holding company tax rules. Absent these rules, shareholders of a C corporation with C E&P could phase out the corporation's business, sell the corporation's assets, make an S election, use the sale proceeds to make passive investments, and operate the corporation as an investment company going forward.

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At a time like the present when the highest corporate income tax rate (i.e., 21 percent) is less than the highest individual income tax rate (i.e., 37 percent), gain on the sale of the assets of a C corporation would be taxed at the lower (corporate) tax rate. By not liquidating the corporation, the after-tax gain on the sale would avoid individual taxation. If an S election was made by the corporation following the sale, it would avoid the personal holding company tax problems applicable to C corporations and permit it to make passive investments with the proceeds of the sale which would stay in corporate solution. Code Sections 1375 and 1362(d)(3) are designed to prohibit this type of tax planning.

**Passive Investment Income Defined**

"Passive investment income" is defined in Code Section 1362(d) to include gross receipts derived from royalties, rents, dividends, interest, annuities and gains from sales and exchanges of stocks or securities.

- Interest derived from sales of inventory is excluded from the definition of "passive investment income."
- Interest income of lending and finance companies generated in the course of loan transactions is excluded from the definition of "passive investment income."
- Treasury takes the position that tax-exempt interest income is "passive investment income" subject to the Code Section 1375 tax. The theory is that Code Section 103 only excludes tax-exempt income from "gross income," not "passive investment income" tax imposed by Code Section 1375.
- Royalty income received in the ordinary course of business from the licensing or franchising of corporate property is excluded from the definition of "passive investment income." Royalty income is received in the ordinary course of business if the corporation created the underlying property or performed significant services or incurred significant costs with respect to the development or marketing of the property.
- Copyrights, mineral, oil and gas royalties, and active business computer software royalties are also excluded from the definition of "passive investment income." Provided, however, in order for copyrights, mineral, oil and gas royalties, and active business computer software royalties to be exempt, the personal holding company tax exclusions under Code Sections 543(a)(3), 543(a)(4) and 543(d) (ignoring (d)(5)) respectively must be met.

Code Section 543(a)(4) applies to copyrights. It provides that income is excluded from the personal holding company tax if:

- Such income (except royalties received for works created in whole or in part by any shareholder) constitutes at least 50 percent of ordinary gross income; and
- The personal holding company income for the taxable year (ignoring royalties received for work created in whole or part by any shareholder owning more than 10 percent of the stock, and dividends received from corporations 50 percent or more of which the corporation owns, but including mineral, oil and gas royalties) is not more than 10 percent of ordinary gross income; and

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- The total deductions (under Code § 162 only) which are allocable to such royalties (other than personal service compensation paid to shareholders and royalties paid to others) are 25 or more of the amount which equals ordinary gross income less royalties paid or accrued and Code § 167 depreciation deductions allowable with the respect to the copyright royalties.

Code Section 543(a)(3) applies to mineral, oil and gas royalties. It provides that income is excluded from the personal holding company tax if:

- Such income constitutes at least 50 percent of ordinary gross income;
- The personal holding company income for the taxable year is not more than 10 percent of the ordinary gross income; and
- The total deductions (under Code Section 162 only) which are allocable to such royalties (other than personal service compensation paid to shareholders) are at least 15 percent of ordinary income adjusted in accordance with Code Section 543(b)(2) (subtracting depreciation, property taxes, interest, rent, etc.).

Code Section 543(d) applies to active business computer software royalties. It provides that income is excluded from the personal holding company tax if:

- Such income constitutes at least 50 percent of ordinary gross income.
- The deductions allowable under Code Sections 162, 174 and 195 allocable to such royalties are at least 25 percent of ordinary gross income for the taxable year.

"Rents" mean any amounts received for the "use of, or right to use, property" of the corporation. Specifically excluded are:

- Produced film rentals (defined in Code Section 543(a)(5) as payments for use of or right to use a film, provided the interest being rented was acquired by the corporation before the film was substantially completed, and any payments to a producer for actively participating in the film production).
- Rents derived in the active trade or business of renting property. To qualify as a trade or business, significant services must be rendered or substantial costs must be incurred relative to the rental business. A fact and circumstance analysis is required - look at the number of employees in the rental business, and types of expenses (non-depreciation) incurred.

Net passive income is simply "passive investment income" less allowable deductions directly allocable to such production of income.

Excess net passive income is computed as follows:

[Passive investment income for tax year
less 25 percent of gross receipts for tax year]

[divided by]

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[Passive investment income for taxable year]

[multiplied by]

[Net passive investment income for taxable year]

**EXAMPLE:** During a tax year, Corporation X has gross receipts of $5,000,000, passive investment income of $2,000,000, Code Section 162 expenses directly allocable to the passive income of $200,000, and taxable income of $1,500,000. Corporation X has "excess net passive income" of $675,000:

Passive Investment Income

$2,000,000

Less 25% of gross receipts

(1,250,000)

750,000

Passive Investment Income

$2,000,000

Directly Allocable Expenses

(200,000)

Net Passive Income

1,800,000

[$750,000 ÷ 2,000,000] x 1,800,000 equals $675,000

Corporation X will owe Code Section 1375 tax on the lessor of its "taxable income" or the "excess net passive investment income." Since "excess net passive income" ($675,000) is less than Corporation X's taxable income ($1,500,000), it will pay Code Section 1375 tax on the "excess net passive income." The highest corporate income tax rate will be utilized (currently a flat 21 percent). The resulting Federal income tax under Code Section 1375 will be $141,750 (21 percent x $675,000 = $141,750).

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**PRACTICE ALERT:** If the taxable income of Corporation X can be reduced to zero, the Code Section 1375 tax can be avoided in that taxable year. Unlike Code Section 1374, the tax avoided by the taxable income limitation under Code Section 1375 is not carried over to future taxable years. Consequently, the taxable income limitation under Code Section 1375 places a premium on creating deductions in the year in which the passive investment income tax comes into play for S corporations with C E&P. Of course, the expenses that reduce the taxable income of Corporation X (e.g., compensation to shareholder employees) must be ordinary, necessary and reasonable.

**PRACTICE ALERT:** Even if the taxable income of Corporation X is reduced to zero, while the Code Section 1375 tax may have been avoided in that taxable year, if C E&P exist at the end of the third consecutive year in which passive income exceeds 25 percent of gross receipts, at the beginning of the fourth taxable year, Corporation X's S election will be terminated. It becomes a C corporation. Accordingly, carefully monitoring C E&P and having a clear understanding whether and to what extent C E&P exist at the time of electing S corporation status is imperative. Likewise, if considering a merger with or an acquisition of a corporation with a C corporation history, critically examining the extent to which, if any, the target has C E&P is vital. The existence of C E&P could expose the successor entity to the sting tax under Code Section 1375 and a potential termination of its S election under Code Section 1362(d)(3). **Caution is advised.**

**Waiver**

There is one that aspect of Code Section 1375 tax that is worthy of mention as it may be overlooked or simply forgotten. The Secretary has legislative authority to waive the Code Section 1375 tax if two criteria are met, namely:

- In good faith, the corporation believed it had no C corporation earnings and profits at the close of the taxable year; **and**
- During a reasonable time after the corporation determined that it actually had C corporation earnings and profits, it distributed the earnings and profits to its shareholders.

A request for waiver must be made in writing. Interestingly, the request must be filed with the IRS District Director. The outcome is based upon the facts and circumstances of each case.

The request, which is filed in the same format as a private letter ruling request, must contain:

- All relevant facts to establish the aforementioned waiver criteria;
- A description of how and when the corporation determined it originally had no C corporation earnings and profits;
- How and when it discovered that it actually had C corporation earnings and profits;
- The steps that were taken to distribute the C corporation earnings and profits; and

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- The timetable for making the distributions of all remaining C corporation earnings and profits if they have not yet been made.

**PRACTICE ALERT:** On the date a waiver is approved by the District Director, all earnings and profits must have been distributed by the corporation to its shareholders.

**Conclusion**

Subchapter S, due to numerous legislative changes, as well as cases, rulings and regulations, has become complex. There are numerous obscure aspects of Subchapter S and several traps that exist for unwary taxpayers and their tax advisers. I hope this blog post on Code Sections 1375 and 1362(d)(3) provides some insight into some of the obscure aspects of Subchapter S and traps that may catch the unwary.

I will provide guidance on some of the other not so obvious aspects of Subchapter S in upcoming blog posts. Stay tuned!

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*Tagged as A Journey Through Subchapter S, C corporation, IRC Section 1362(d)(3), IRC Section 1375, passive investment income, S corporation*

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