

Seven-year S corporation built-in gains tax recognition period applies for 2009 and 2010

Dear Reader:

Your corporation elected S corporation status for the 2002 tax year. At that time, I informed you about the effects of the built-in gains tax that may apply when appreciated assets held by the corporation at the time of the conversion are disposed of within the 10-year recognition period.

Although an S corporation is normally not subject to tax, where a C corporation converts to S corporation status the tax law imposes a tax at the highest corporate rate (35%) on the net built-in gains of the corporation. The idea is to prevent the use of an S election to escape tax at the corporate level on the appreciation that occurred while the corporation was a C corporation. The tax applies to the lowest of the following:

- (1) the amount that would be the taxable income of the S corporation for the tax year taking into account only recognized built-in gains and recognized built-in losses;
- (2) the corporation's taxable income for that tax year; or
- (3) the excess of the net unrealized built-in gain over the net recognized built-in gain for earlier tax years during the recognition period.

For tax years 2009 and 2010, the American Recovery and Reinvestment Act of 2009, which was passed by Congress as part of the stimulus package, has shortened from 10 years to 7 years the period during which the built-in gain tax is applicable. Accordingly, the recognition period ends at the beginning of the 2009 tax year if the S corporation election was made for the 2002 tax year, and the recognition period ends at the beginning of the 2010 tax year if the S corporation election was made for the 2003 tax year. Since your corporation is a calendar year taxpayer, the built-in gain period has ended for the corporation and you can make dispositions during 2009 and 2010 without being concerned about the built-in gains tax.

Although the built-in gains tax will generally not apply to your corporation, it may still apply to any assets that your corporation acquired from a C corporation in a carryover basis transaction during a post-2002 year.

If you have any questions regarding the application of the built-in gains tax, please call.