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13.1 SUMMARY OF TAXES DEDUCTIBLE AT THE S CORPORATION AND SHAREHOLDER LEVELS

There are differences in the deductibility of taxes at the S corporation level and the shareholder level as shown in the chart below.

| Type of Tax | S Corporation Level | | Shareholder Level | |
|------------------------------|---------------------|-------------|-------------------|--------------------|
| | Deductible | R&TC | Deductible | R&TC |
| Franchise Tax 2.5% / 1.5% | No | R&TC §24345 | No | R&TC §17220(c) |
| BIG Tax | No | R&TC §24345 | Yes | IRC §1366(f)(2) |
| ENPI Tax | No | R&TC §24345 | Yes | IRC §1366(f)(3) |
| LIFO Recapture | No | | No | |

13.2 FRANCHISE TAX

The S corporation franchise tax is neither deductible to the corporation nor to its shareholders (R&TC §17220(c), and R&TC §24345(a)).

This tax is treated as a noncapital, nondeductible item of deduction for purposes of computing the Accumulated Adjustments Account and shareholder basis. (Treas. Reg. §1.1368-2(a)(3))

Example A

ABC, Inc., a California S corporation, reported a state adjustment of +\$100,000 for taxes based on franchise taxes. It is a noncapital, nondeductible item. ABC, however, is allowed to reduce its Accumulated Adjustments Account by \$100,000.

ABC's shareholders are not allowed a deduction on their return for the \$100,000 taxes based on franchise taxes. It is a noncapital, nondeductible item. ABC's shareholders, however, must reduce their basis in the S corporation by each shareholder's pro rata share of the \$100,000. (IRC §1367(a)(2)(D))

13.3 BUILT-IN GAINS (BIG) TAX

- 13.3.1 S Corporation Level
- 13.3.2 Shareholder Level

13.3.1 S Corporation Level

The built-in gains tax is not deductible by the corporation for purposes of computing its franchise or income tax at 2.5% / 1.5% (R&TC §24345(a)). However, R&TC §23802(e) permits the S corporation to exclude the built-in gains, which were subject to the built-in gains tax, for purposes of computing the S corporation's franchise or income tax. This provision is designed to prevent double taxation by ensuring that the built-in gains are not taxed twice, first by the built-in gains tax and again by the franchise or income tax.

13.3.2 Shareholder Level

Built-in gains tax is allowed as a deduction to the shareholder in IRC §1366(f)(2). R&TC §23803(b)(1) modifies this federal code section to allow, as a deduction to the shareholder for California purposes, the amount of built-in gains tax computed under California law. The built-in gains tax is treated as a loss sustained by the corporation during such taxable year; the character of such loss is determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax. (IRC §1366(f)(2))

Example A

| | Amount of Built-In Gain | Ratio | Built-In Gains Tax @ S Corporation Level | Pro Rata Built-in Gains |
|-----------------|-------------------------|------------|--|-------------------------|
| <u>Tax</u> | | | | |
| Ordinary Gain | \$100,000 | .10 | | \$9,300 |
| Capital Gain | 200,000 | .20 | | 18,600 |
| IRC §481 Income | <u>700,000</u> | <u>.70</u> | | <u>65,100</u> |

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

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| | | | | |
|-------|--------------------|-------------|-----------------|-----------------|
| Total | <u>\$1,000,000</u> | <u>1.00</u> | <u>\$93,000</u> | <u>\$93,000</u> |
|-------|--------------------|-------------|-----------------|-----------------|

The shareholder would include the following in the computation of shareholder basis:

| | <u>Item of Income</u> | <u>Item of Loss/Deduction</u> |
|-----------------|-----------------------|-------------------------------|
| Ordinary Gain | \$100,000 | -\$9,300 |
| Capital Gain | \$200,000 | -\$18,600 |
| IRC §481 Income | \$700,000 | -\$65,100 |

If the shareholder has sufficient basis and is not restricted by other applicable limitations, the shareholder would report the following amounts per return:

- Ordinary Gain, \$90,700 [\$100,000 – 9,300], to Form 4797.
- Capital Gain, \$181,400 [\$200,000 – 18,600], to Schedule D.
- IRC §481 Income, \$634,900 [\$700,000 – 65,100], to Schedule E.

Note: The built-in gains tax computed for California purposes is used in lieu of the federal amount.

Example B

Assume the same facts as in Example A, except the shareholder had insufficient basis to recognize all losses/deductions.

The shareholder would report the following amounts per return:

- Ordinary Gain, \$100,000, to Form 4797.
- Capital Gain, \$200,000, to Schedule D.
- IRC §481 Income, \$700,000, to Schedule E.

The shareholder would currently suspend the following losses/deductions (built-in gains tax):

- Ordinary Loss, \$9,300.
- Capital Loss, \$18,600.
- IRC §481 Loss, \$65,100.

13.4 EXCESS NET PASSIVE INCOME (ENPI) TAX

- 13.4.1 S Corporation Level
- 13.4.2 Shareholder Level

13.4.1 S Corporation Level

The ENPI tax is not deductible to the corporation for purposes of computing its franchise or income tax at 2.5% / 1.5% (R&TC §24345). R&TC §23802(e) provides for the deduction of the ENPI for purposes of computing the franchise or income S corporation tax at 2.5% / 1.5%. This code section prevents the ENPI, subject to the excess net passive income tax, from being taxed a second time by the corporation's franchise or income tax.

13.4.2 Shareholder Level

The ENPI tax is allowed as a deduction to the shareholder in IRC §1366(f)(3). R&TC §23803(b)(2) modifies this federal code section to allow, as a deduction to the shareholder for California purposes, the amount of ENPI tax computed under California law. Each item of passive investment income shall be reduced by an amount that bears the same ratio to the amount of such tax as the amount of such item bears to the total passive investment income for the taxable year. (IRC §1366(f)(3))

$$\frac{\text{The Amount of Reduction for Item N}}{\text{ENPI Tax}} = \frac{\text{Passive Investment Income of N}}{\text{Total Passive Investment Income}}$$

Unlike the built-in gains tax, the ENPI tax is allowed to reduce each passive investment income item proportionately by the amount of tax. It is not treated as a current distributive loss.

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Example A: (Sole Shareholder)

| | Amount of Excess Net Passive Income | Ratio | Excess Net Passive Income Tax @ S Corporation Level | Pro Rata Excess Net Passive Income Tax |
|-----------------|---|-------------|--|---|
| Interest Income | \$900,000 | .90 | \$ 83,700 | |
| Dividend Income | <u>100,000</u> | <u>.10</u> | <u>9,300</u> | |
| Total | <u>\$1,000,000</u> | <u>1.00</u> | <u>\$93,000</u> | <u>\$93,000</u> |

The shareholder would include the following in the computation of shareholder basis:

| | <u>Item of Income</u> | |
|-----------------|-----------------------|----------------------|
| Interest Income | \$816,300 | [\$900,000 – 83,700] |
| Dividend Income | \$90,700 | [\$100,000 – 9,300] |

The shareholder would report the following amounts per return:

Interest Income, \$816,300, to Schedule B.
Dividend Income, \$90,700, to Schedule B.

Note:

- The excess net passive income tax computed for California purposes is used in lieu of the federal amount.
- The deduction allowed by IRC §1366(f) is not treated as a loss, it is merely a reduction of passive investment income. It is not a part of the basis limitation computation.