



August 14, 2019

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Ms. Holly Porter
Associate Chief Counsel
Passthrough & Special Industries
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

RE: Guidance Concerning Adjustments Attributable to Conversions from S Corporation to C Corporation under Section 481(d) of the Internal Revenue Code

Dear Messrs. Kautter and Desmond, and Ms. Porter:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) to address the need for guidance related to new Internal Revenue Code provisions enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (the “TCJA”).

Specifically, the AICPA submits comments related to section 481,¹ adjustments required by changes in method of accounting, and requests expeditious guidance concerning adjustments attributable to conversions from S corporation to C corporation under section 481(d).

The AICPA is the world’s largest member association representing the CPA profession, with more than 429,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America’s largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Robert Keller, Chair, AICPA S

¹ Unless otherwise indicated, references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and references to a “Treas. Reg. §” are to the Treasury regulations promulgated under the Code.

Corporation Taxation Technical Resource Panel, at (504) 584-1030 or rkeller@kpmg.com; Amy Wang, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9264 or Amy.Wang@aicpa-cima.com; or me at (612) 397-3071 or Chris.Hesse@CLAconnect.com.

Sincerely,

A handwritten signature in blue ink that reads "Christopher W. Hesse". The signature is fluid and cursive, with a prominent flourish at the end.

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

AMERICAN INSTITUTE OF CPAs

Guidance Concerning Adjustments Attributable to Conversions from S Corporation to C Corporation under Section 481(d) of the Internal Revenue Code

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Overview

The TCJA provides for a reduction in the income tax rates imposed on C corporations under section 11(b).¹ Given the significance of the reduction, Congress anticipated that some S corporations might revoke their S elections and convert to C corporation status to benefit from the reduced corporate tax rate.

In many instances, an S corporation on the cash method of accounting that converts to a C corporation is required to change its overall method of accounting to an accrual method of accounting. Under the general rule of section 481, a taxpayer that changes from the cash method of accounting to an accrual method of accounting is permitted to take into account ratably over four taxable years any positive section 481(a) adjustment (*i.e.*, an adjustment that increases taxable income).² In recognition of the likelihood that S corporations might convert to C corporations as a result of reduced corporate tax rates, the TCJA provides additional relief for an S corporation that converts to a C corporation and satisfies certain requirements. Specifically, section 481(d) provides rules regarding section 481(a)(2) adjustments for an “eligible terminated S corporation,” including adjustments that result from the corporation’s change from the overall cash method of accounting to an accrual method of accounting.

An eligible terminated S corporation is a C corporation if (i) it was an S corporation immediately prior to the enactment of the TCJA; (ii) it revokes its S corporation election during the two-year period beginning on the date of enactment of the TCJA; and (iii) the owners of the stock of the corporation, determined on the date of the revocation, are the same owners (and in identical proportions) as on the date of enactment of the TCJA.³ Section 481(d) provides that if an eligible terminated S corporation is required to take into account an adjustment under section 481(a)(2), that corporation must take into account any resulting section 481(a) adjustment over six taxable years instead of four years (for a positive adjustment) or in one year (in the case of a negative adjustment).

Under this rule, if an eligible terminated S corporation changes from the cash method of accounting to an accrual method of accounting as a result of the corporation’s revocation of its S election, the allocation period is extended to a six-year period. Significant questions about the application of section 481(d) arise, however, when an eligible terminated S corporation on the cash method of

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² Rev. Proc. 2015-13, 2015-5 I.R.B. 419, § 7.03(1).

³ Section 481(d)(2).

accounting owned a qualified subchapter S subsidiary (“QSub”) immediately before the S corporation’s revocation.

In general, a corporation that is a QSub is not treated as a separate corporation from its S corporation parent. The QSub’s assets, liabilities, and items of income, deduction, and credit are treated as those of the S corporation. When an S corporation revokes its S election, the QSub is treated as a new corporation that acquired all of its assets and assumed all of its liabilities from the S corporation in exchange for newly issued stock of the former QSub at the close of the last day of the parent corporation’s last taxable year as an S corporation.⁴ Because it is deemed a newly formed corporation, the former QSub must adopt new accounting methods. It is unclear whether and how section 481(d) should apply in this situation when the former QSub (now a C corporation for federal tax purposes) must use an accrual method of accounting.

Recommendation

Treasury and the IRS should provide administrative guidance on the potential application of section 481(d) to section 481(a) adjustments with respect to receivables and other items of the newly formed corporation that result from the termination of a QSub election with respect to a subsidiary owned by an eligible terminated S corporation.

Analysis

As noted above, it is unclear whether and how section 481(d) should apply to an entity that is not an eligible terminated S corporation, but rather a QSub owned by an eligible terminated S corporation at the time revocation of its S status was effective. The following example highlights the uncertainty.

Example:

Individual A owns 100% of the outstanding stock of Corporation X (an S corporation), which owns 100% of the outstanding stock of Corporation Y (a QSub). Corporation X is a holding company whose only asset is stock in Corporation Y. Corporation Y is an operating company whose assets include certain accounts receivable (the “Cash Basis Receivables”). Corporation Y has no liabilities. Because Corporation X (and its division Corporation Y) is on the overall cash method of accounting, the accounts receivable have a zero basis. Corporation X reports all of the items of income, deduction, gain, and loss of Corporation Y on Corporation X’s Form 1120S as if Corporation Y were a division of Corporation X.

Within two years of the enactment of the TCJA, Corporation X revokes its election to be an S corporation. Assume that all other requirements are satisfied, such that Corporation X is (and continues to be) an eligible terminated S corporation for purposes of section 481(d).

As a result of Corporation X’s revocation of its S election, Corporation Y’s QSub election terminates effective as of the close of the last day of Corporation X’s last taxable year as

⁴ Section 1361(b)(3)(C); Treas. Reg. § 1.1361-5(a)(1)(ii).

an S corporation under Treas. Reg. § 1.1361-5(a)(1)(ii). Therefore, Corporation Y is treated as a new corporation that acquired all of its assets and assumed all of its liabilities from Corporation X in exchange for stock in Corporation Y under section 1361(b)(3)(C). This deemed exchange should qualify for nonrecognition treatment as a transfer under section 351.

Because Corporation X is a C corporation after revocation of its S corporation election and no longer qualifies to use the cash method of accounting, Corporation X must change its accounting method from the cash method to an accrual method effective as of its first day as a C corporation. If the only asset of Corporation X subject to that accounting method change is stock in Corporation Y, this conversion has minimal effect on Corporation X. This example raises the question, however, of how to treat the Cash Basis Receivables of Corporation Y.

As a newly formed corporation for federal tax purposes, Corporation Y is required to adopt an overall accrual method of accounting following the termination of its QSub election. Corporation X's accounting methods do not carry over to Corporation Y in the deemed transfer under section 351 because the transaction is not described in section 381(a); instead, Corporation Y must adopt new accounting methods.⁵ Under general rules, Corporation Y's adoption of new accounting methods is not a change in a method of accounting (even though the new methods adopted differ from the accounting methods previously used with respect to Corporation Y's operations when it was a QSub). Thus, prior to the enactment of section 481(d), section 481(a) would not have been applicable to Corporation Y because no accounting method change occurs. Under the principles of Hempt Bros., Inc.,⁶ Revenue Ruling 80-198,⁷ and section 362(a), when a cash basis business is transferred to a corporation on the accrual basis in a section 351 transfer, the transferee corporation takes into account the cash basis accounts receivable as collected.

Under the principles described in the example above, it is unclear whether Corporation Y will have the ability to apply the rule in section 481(d).

If section 481(d) does not apply in this instance, Corporation Y cannot take into account the Cash Basis Receivables over a six-year period. Instead, Corporation Y is required to recognize income from the Cash Basis Receivables as they are collected, which results in a significant acceleration of its federal income tax liability from the Cash Basis Receivables when compared with the treatment generally prescribed for an eligible terminated S corporation. This acceleration appears contrary to congressional intent in enacting section 481(d). Not applying section 481(d) to the Cash Basis Receivables in the example described effectively means that section 481(d) will only apply to S corporations to the extent that their operations are not conducted through QSubs (or that enter into pre-revocation restructuring as described below).

The issue highlighted in the example is unresolvable by filing an accounting method change when Corporation X is still an S corporation. If Corporation X were to change its overall method of

⁵ EZO Products Co. v. Commissioner, 37 T.C. 385 (1961).

⁶ 490 F.2d 1172 (3rd Cir. 1974).

⁷ 1980-2 C.B. 113.

accounting from the cash method to an accrual method, the section 481(a) adjustment attributable to Corporation Y and its Cash Basis Receivables in the example would accelerate into Corporation X's final taxable year as an S corporation.⁸ In certain circumstances, the issue highlighted in this example *is* resolvable with advance planning if Corporation Y converts to a limited liability company disregarded as separate from its owner before Corporation X revokes its S election. In such a case, Corporation Y would remain disregarded as an entity separate from Corporation X. Thus, section 481(d) would apply to the Cash Basis Receivables because no actual or deemed transfer of the business to a new corporation occurs. In certain regulated industries, however, business activities must be conducted in an entity organized as a corporation under state law (*e.g.*, banks, alcoholic beverage companies, industries where state law requires organization as a corporation, or entities operating in states where management of actual or contingent liabilities requires organization as a corporation), in which case this self-help measure is not available. In addition, some S corporation taxpayers not properly advised on this issue may have already revoked their S elections.

Prior Guidance in Similar Areas

The IRS addressed a similar issue when it released regulations under section 263A (the "UNICAP Rules"). By way of background, in response to the enactment of inventory costing rules under section 263A, some taxpayers transferred their inventories to newly-created subsidiaries immediately prior to the effective date of section 263A in a manner intended to avoid the negative consequences of new section 263A. With these transactions, taxpayers were attempting to avoid the application of the new UNICAP Rules because the accounting method history of a transferor of assets in a transaction to which section 351 applies does not carry over to the transferee in the transaction. As a result, when the transferee was required to change its method of inventory costing to the UNICAP Rules, there was no section 481(a) adjustment attributable to the inventories received by the new subsidiary created in the section 351 transaction.

The IRS addressed avoidance of the UNICAP Rules by promulgating an anti-avoidance rule in Treas. Reg. § 1.263A-7(c)(4)(ii). The anti-avoidance rules required taxpayers to apply the UNICAP Rules and section 481(a) to inventory transferred in the section 351 transaction as if no transfer had occurred. Similarly, the IRS and Treasury could use their authority to apply section 481(d) to situations in which S corporations own QSubs in a manner similar to the promulgation of the anti-abuse rule in the UNICAP Regulations. A similar method is available such that section 481(a) and 481(d) apply appropriately in cases where a QSub election is terminated as a result of an S corporation's revocation of its subchapter S election.

Conclusion

Failure to apply section 481(d) to QSubs owned by an eligible terminated S corporation effectively means that section 481(d) will apply only to S corporations to the extent that their operations are not conducted through QSubs. The acceleration of income, if section 481(d) does not apply, would severely limit the application of section 481(d) and would subject similarly situated taxpayers to two different sets of rules. This process appears contrary to congressional intent in enacting section

⁸ See, section 7.04 and section 3.04(2)(a) of Rev. Proc. 2015-13; Shore v. Commissioner, 69T.C. 689 (1978), *aff'd*, 631 F.2d 624 (9th Cir. 1980).

481(d), which presumably was to ease the federal income tax burden associated with converting from S corporation to C corporation status in response to the TCJA's reduced corporate income tax rate.

For the reasons described above, we respectfully request that Treasury and the IRS provide administrative guidance on the application of section 481(d) to eligible terminated S corporations that own QSubs. Expedient guidance in this situation is needed because the impending tax return filing deadlines (*i.e.*, the extended due date for calendar year S corporations is September 16, 2019) mean that corporations must soon conclude as to whether the benefit of section 481(d) is available.