Taxation and Wealth Planning
ALERT
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FOR S CORPORATIONS, NEW LAW IS A PATH TO CERTAINTY

FIVE-YEAR BUILT-IN GAINS TAX RECOGNITION PERIOD PERMANENTLY EXTENDED

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The Protecting Americans from Tax Hikes Act (PATH) was enacted on December 18, 2015. Among other changes to the Internal Revenue Code, the PATH Act makes permanent the five-year duration of the recognition period for S corporations for tax years beginning on or after January 1, 2015. This is welcome news, because taxpayers have faced uncertainty in recent years with respect to the duration of the recognition period.

General Overview of the Recognition Period

The recognition period is the period when an S corporation is subject to the section 1374 built-in gains tax (currently 35 percent) on appreciation attributable to assets held by it when it was a C corporation and to assets transferred to it by a C corporation in a nontaxable carryover basis transfer. Transactions that trigger the built-in gains tax include taxable dispositions and distributions of assets by an S corporation, and taxable dispositions of S corporation stock by S corporation shareholders (where an election is made under section 336(e) or 338(h)(10) to treat the stock sale as an asset sale).

History of the Amendments to the Recognition Period

From the time the built-in gains tax was first enacted in 1986 until 2009, the recognition period was 10 years. On February 17, 2009, the recognition period was reduced to seven years for tax years beginning in 2009 and 2010 by the American Recovery and Reinvestment Act of 2009. For tax years beginning in 2011, the Creating Small Business Jobs Act of 2010, enacted on September 27, 2010, reduced the recognition period to five years. For tax years beginning in 2012 and 2013, the American Taxpayer Relief Act of 2012 (2012 ATR Act) extended the reduced five-year recognition period. However, the 2012 ATR Act was enacted on January 2, 2013, and thus the planning environment for S corporations with built-in gains was fraught with uncertainty for the 2012 tax year. The Tax Increase Prevention Act of 2014, enacted on December 19, 2014, extended the five-year reduced recognition period to tax years beginning in 2014. However, once again, because the law was enacted at the end of 2014, S corporations with built-in gains endured an uncertain planning environment for nearly all of 2014.

Each of the changes to the recognition period prior to the PATH Act was temporary, meaning that without subsequent legislative action, the duration of the recognition period would have reverted to 10 years. The PATH Act makes permanent the five-year duration of the recognition period and applies retroactively to January 1, 2015. While S corporations with built-in gains endured another year of uncertain planning environment in 2015, it appears that the five-year recognition period will remain in effect for the time being.

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