

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. This tax is imposed where the built-in gains are recognized (i.e., the appreciated assets are sold or otherwise disposed of) during the ten-year period after the S election takes effect (referred to as the "recognition period"). 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.

The tax may apply even if the S corporation does not make any unusual asset dispositions. For instance, a cash method corporation that collects an account receivable that accrued during the C corporation period or an accrual method corporation that disposes of inventory that was acquired during the C corporation period may be subject to the built-in gains tax.

Any C corporation net operating losses (which are otherwise not usable in an S corporation year) are allowed as a deduction against net recognized built-in gain. Where net recognized built-in gain is not taxed because of the taxable income limitation ((2) above), the gain is carried forward and may be taxed in later years.

The recognized built-in gain is passed through to the shareholders as income, in addition to being taxed at the corporate level (at a 35% rate). This unfortunate result is mitigated somewhat by treating the tax as a corporate loss which passes through to the shareholders.