A Roadmap of Section 1374

Section 1374 is its own world. To get to the bottom line, one must skip around through various subsections and paragraphs within Section 1374. This handout is designed to help you (and me) find our way through the thicket.

We begin here with the statutory language, then attempt to translate it into some straightforward rules, and finally apply it to our study problems. For ease of reference, citations in **bold** are to subsections and paragraphs of Section 1374.

The Code Provisions

The tax is imposed in **(a)**, and the tax rate is set by **(b)(1)**. Subsection **(a)** imposes the tax on an S corporation's net recognized built-in gain (let's call that NRBIG for short) for the tax year. The tax, according to **(b)(1)**, is 21 percent of NRBIG. An S corporation that has never been a C corporation is not subject to the tax. **(c)(1)**.

NRBIG is defined in **(d)(2)(A)**. It's the lesser of **(i)** the S corporation's taxable income if only recognized built-in gains and recognized built-in losses were taken into account (let's call those RBIG and RBIL for short), or **(ii)** the S corporation's actual taxable income for the year (computed as per Section 1375(b)(1)(B), which ignores NOL carryovers and a few special corporate deductions). Subparagraph **(ii)** is sometimes referred to as the "taxable income limitation." If **(ii)** controls, then the excess of **(i)** over **(ii)** is carried forward and considered RBIG the following year.

> *EXAMPLE:* In year 1, S, a corporation whose assets were greatly appreciated when it converted from an C corporation to an S corporation last year, has RBIG of $30, no RBIL, and taxable income of $20. S's NRBIG in year 1 is limited to $20. S starts year 2 with an RBIG of $10 ($30 − $20).

What are RBIG and RBIL? These are gains (see **(d)(3)**) and losses (see **(d)(4)**) recognized during the recognition period on the disposition of assets that were held by the S corporation on the first day that its S election was effective (let's call that the "First S Day"). However, only *built-in* gains and losses are included in RBIG and RBIL. In other words, RBIG on any asset does not include any recognized gain to the extent it exceeds this quantity: the fair market value (FMV) of the asset on the First S Day minus the asset's adjusted basis at that time. **(d)(3)(B)**. Similarly, RBIL on any asset does not include any recognized loss to the extent it exceeds this quantity: the asset's adjusted basis on the First S Day minus the asset's FMV at that time. **(d)(4)(B)**. Assets that were not owned by the corporation on the First S Day are not subject to Section 1374. **(d)(3)(A), (d)(4)(A)**.

The recognition period starts on the First S Day and runs for five years. **(d)(7)**.

In addition to the taxable income limitation, there is one additional limitation, in **(c)(2)**. It says that NRBIG, the base of the Section 1374 tax, cannot be greater than this amount: the corporation's net unrealized built-in gain (let's call this NUBIG) minus NRBIG for prior taxable years in the recognition period. NUBIG is defined in **(d)(1)** as the FMV of the S corporation's assets on the First S Day (meaning the total FMVs of *all* of the assets) minus the *aggregate* adjusted bases of those assets at such time. Let's call the rule in **(c)(2)** the "NUBIG limitation." In computing NUBIG, unrealized gains and losses are, in effect, netted against each other, as a result of the assets being aggregated.

Under the NUBIG limitation, NRBIG, the base of the Section 1374 tax, can't exceed NUBIG. And every time the S corporation has NRBIG, the NUBIG limitation is reduced to that extent. Once the NUBIG limitation hits zero, that is the end of the application of Section 1374 to that S corporation.[1]

> *EXAMPLE:* On the First S Day, S has one asset with $70 of built-in gain, another asset with $30 of built-in gain, and a third asset with a $40 built-in loss. NUBIG is $60 ($70 + $30 − $40).The most NRBIG that S can ever have is $60. If S sells one of the assets and has $20 of NRBIG, then the NUBIG limitation is reduced to $40 going forward.

The Substance

Section 1374 can be summed up this way:

- Only S corporations with a C corporation history are affected.
- Only assets held by the S corporation on the First S Day are relevant.
- Five years after the First S Day, Section 1374 no longer applies.
- The tax is imposed on NRBIG for the taxable year.
- NRBIG starts with the excess of RBIG over any RBIL during the taxable year.
- RBIG or RBIL on any asset is the recognized gain or loss on disposition of the asset, but not in excess of the built-in gain or loss inherent in the asset on the First S Day.
- NRBIG is subject to two limitations. Therefore, it is the least of three amounts:
    - The excess of RBIG over RBIL during the taxable year (the starting point for NRBIG, just discussed).
    - The S corporation's taxable income for the taxable year. (If this limitation controls, the difference between it and the first amount just listed is carried forward as RBIG to the next year.)
    - The S corporation's NUBIG, minus NRBIG previously taxed under Section 1374 during the recognition period.
- Once all of the S corporation's NUBIG has been taken into account as NRBIG, Section 1374 no longer applies.

Application to Our Problems

Problems 7.2 through 7.4 call for consideration of Section 1374. In each problem, on the First S Day, Blackacre (adjusted basis $30,000, FMV $120,000) has a built-in gain of $90,000, Whiteacre (adjusted basis $75,000, FMV $90,000) has a built-in gain of $15,000, and Lossacre (adjusted basis $35,000, FMV $5,000) has a built-in loss of $30,000. We determine NUBIG on the First S Day. NUBIG is $75,000 (aggregate FMV $215,000 minus aggregate adjusted basis $140,000). That $75,000 of NUBIG is the most that NRBIG, the base of the Section 1374 tax, can ever be.

In Problem 7.2, in year 3, the corporation sells Blackacre for $90,000, and the rest of the corporation's operations are profitable. How much NRBIG does the corporation have? The

[1] That is, unless it inherits another corporation's NUBIG by acquiring a C corporation's assets in a reorganization (beyond the scope of our course).

recognized gain on the sale is $60,000, which is less than the built-in gain of $90,000 on the First S Day, and so all of the $60,000 recognized gain is RBIG. Lossacre hasn't been sold, and so there is no RBIL for the year. Therefore, NRBIG, prior to limitations, is $60,000.

Because the rest of the corporation's operation is profitable, taxable income is greater than $60,000, and so the taxable income limitation doesn't control. And NUBIG, $75,000, is also greater than $60,000, and so the NUBIG limitation doesn't control. NRBIG is the least of the three figures, $60,000. In tabular form:

	Recognized gain	$60,000
	RBIG	$60,000
A	RBIG minus RBIL	$60,000
B	Taxable income	> $60,000
C	NUBIG	$75,000
NRBIG	Least of A, B, and C	$60,000
	Sec. 1374 tax @ 21%	$12,600

The NUBIG limitation going forward is reduced by the NRBIG, from $75,000 to $15,000. No matter what happens, future NRBIG can't be greater than $15,000.

In Problem 7.3, in year 3, the corporation sells Blackacre for $150,000, and the rest of the corporation's operations are profitable. How much NRBIG does the corporation have? The recognized gain on the sale is $120,000, which is greater than the built-in gain of $90,000 on the First S Day, and so only $90,000 of the recognized gain is RBIG. Lossacre hasn't been sold, and so there is no RBIL for the year. Thus, NRBIG, prior to limitations, is $90,000.

Because the rest of the corporation's operation is profitable, taxable income is greater than $120,000, and so the taxable income limitation doesn't control. But here NUBIG, $75,000, is less than $90,000, and so NRBIG is the least of the three figures, $75,000. In tabular form:

	Recognized gain	$120,000
	RBIG	$90,000
A	RBIG minus RBIL	$90,000
B	Taxable income	> $120,000
C	NUBIG	$75,000
NRBIG	Least of A, B, and C	$75,000
	Sec. 1374 tax at 21%	$15,750

The NUBIG limitation going forward is reduced from $75,000 to zero. Therefore, no further Section 1374 tax can be imposed during this recognition period.

In Problem 7.4, the sale of Whiteacre takes place after the end of the recognition period. Therefore, Section 1374 doesn't apply to it.