

S Corporation Association Technical Comments & Questions

Priorities

- **Section 199A and Grouping:** The new law fails to specify what constitutes a “trade or business” for purposes of this rule, though it does indicate that the determination must be made at the individual level. Under the House draft, the determination was also made at the individual level and it was clear that the grouping rules under Section 469 would apply.

Recommendation: Allow businesses to use the grouping rules under Section 469 so that businesses have a comprehensive set of rules that have already been vetted and applied to simplify and rationalize the deduction calculation. For those individuals and businesses that have existing groupings, permit them a one-time opportunity to adjust those groups to reflect the new rules, as was done following adoption of the NIIT.

- **Definition of “US Shareholder”:** Will the S Corporation itself, or the shareholders of the S Corporation, or both, be treated as “United States Shareholders.” This is a critical term in several places in the legislation. For purposes of the deemed repatriation rules, it appears the income inclusion amount and the offsetting deductions that reduce the tax rate on the inclusion are calculated at the S Corporation level, and the S Corporation would be treated as the US Shareholder. However, once this amount has been calculated, all of the elections regarding how and when the tax is paid are made at the shareholder level. The conflicting treatment of S Corporation shareholders with less than 10-percent ownership needs to be addressed. Absent clarification, the deferral election available to C corporations and S corporation shareholders with at least 10-percent ownership stakes would not be available to shareholders with smaller ownership stakes.

Recommendation: Provide immediate guidance that both S corporations and their shareholders, including less than 10-percent owners, are provided the same elections as if they were US shareholders.

- **Section 199A and ESBTs:** The conference report on HR 1 clearly intended for all trusts and estates to benefit from the new deduction. It specifically states “The conference agreement provides that trusts and estates are eligible for the 20-percent deduction under the provision.” The report struck language from the Senate bill that explicitly blocked trusts and estates from benefitting from the deduction and it provided rules for the apportionment of W-2 wages and unadjusted basis for trusts and estates when they calculate the deduction. This approach is consistent with the treatment of the existing Section 199 deduction, where ESBTs and other trusts have benefitted from the deduction since its inception in 2004. The unique manner in which electing small business trusts (ESBTs) calculate their income, however, raises concerns that the new deduction and the old ESBT rules might be in conflict.

Recommendation: Provide early guidance clarifying that ESBTs benefit from the Section 199A deduction.

- **Section 965 and AAA and PTI Accounts:** Section 965 allows shareholders of S corporations with overseas operations to defer paying the repatriation tax until they sell their business or convert to C corporation status. The Section 965 inclusion is reported as gross income by the S corporation on its return immediately, however, resulting in a possible mismatch between reported earnings and the S corporation’s accumulated adjustments account. Moreover, the special provisions for S corporation shareholders in section 965(i) are elective by the shareholder, not the company, resulting in situations

where the company may have multiple shareholders making multiple elections. These elections, in turn, will run headlong into the single class of stock rule imposed on S corporations.

Recommendation: Treasury should issue guidance clarifying that, while S corporation shareholders can elect to defer the payment of tax under Section 965, the inclusion of foreign accumulated E&P in the S corporation's income is not deferred and the S corporation's accumulated adjustments account (AAA) should be increased by the amount of foreign accumulated E&P AAA should be increased by the gross amount, not by the net amount that results after the section 965(c) deduction is taken into account. For taxpayers who make the Section 962 election for purposes of Section 951A, a similar increase should apply to previously taxed income.

Domestic

Section 199A

- Is the deduction and the carry forward calculation done the same as net operating losses are applied, namely subtracted after qualified business income is calculated for all current activities? Or does it have to be calculated on a per-trade or business basis year after year?
- If Section 199A is tracked per trade or business, is this done at the S corporation shareholder level and can a shareholder elect to combine similar trades or businesses from separate pass-through entities, such as can be done under the Section 469 and Section 1411 net investment income rules?
- For regulations fleshing out the meaning of the phrase "principal asset of the trade or business is the reputation or skill of 1 or more of its employees" we recommend a mechanical formula to provide more certainty in how this rule applies.

ESBT's and Section 199A

- The conference report on HR 1 makes clear the conferees intended for trusts and estates to benefit from the new Section 199A deduction. Specifically, the conference report 1) struck a Senate provision disallowing trusts and estates from applying the deduction and 2) included clarifying language on how trusts and estates should apportion W-2 wages for purposes of determining the amount of the deduction.
 - "The conference agreement provides that trusts and estates are eligible for the 20-percent deduction under the provision."
 - "Rules similar to the rules under present-law section 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital."
- This intent is consistent with past practice of allowing business interests held in an ESBT to benefit from the old Section 199 deduction related to domestic production activities.
- Concerns have been raised, however, specific to electing small business trusts (ESBTs) due to the unique manner in which those trusts calculate their taxable income pursuant to Section 641(c)(2)(C).
- Section 641(c)(2)(C) could be read to preclude other deductions, including the new pass-through deduction under Section 199A, from being used to calculate ESBT taxable income. Section 1366 does not refer to the new deduction.

Recommendation: Provide early guidance clarifying that ESBTs benefit from the deduction.

NIIT & Section 199A

- Does Section 199A apply to the Net Investment Income Tax (NIIT)?
- The fact that Section 199A is limited to income taxes under Chapter 1, while the NIIT resides in Chapter 2, suggests the deduction should not be applied when calculating the NIIT.
- Section 1411(c)(1)(B), however, allows taxpayers calculating their NIIT to take any deduction from Chapter 1 into account, which would include Section 199A. The NIIT is calculated "over . . . the deductions allowed by the *subtitle* which are properly allocable to such gross income or net gain."

Recommendation: Guidance is needed to clarify that the deduction applies to the NIIT.

International

Accumulated Adjustments Account Impact of Section 965 Repatriation Inclusion

- Treasury should issue guidance clarifying that, while S corporation shareholders can elect to defer the payment of tax under Section 965, the inclusion of foreign accumulated E&P in the S corporation's income is not deferred. As a result, the S corporation's accumulated adjustments account (AAA) should be increased by the amount of foreign accumulated E&P.
- Moreover, the AAA should be increased by the amount of the Section 965 inclusion because (1) the Section 965 inclusion is reported as gross income by the S corporation on its return and (2) the special provisions for S corporation shareholders in section 965(i) are elective by the shareholder.
- If AAA is increased by the amount of the Section 965 inclusion, Treasury should issue guidance confirming that AAA is increased by the *gross amount*, not by the net amount that results after the section 965(c) deduction is taken into account.
- Is an S Corporation considered a "domestic corporation" for purposes of this definition? In other words, if an S Corporation were the only US shareholder, would that trigger the entity to be treated as a specified foreign corporation?

Section 965 & Definition of "US Shareholder"

- Will the S Corporation itself, or the shareholders of the S Corporation, or both, be treated as "United States Shareholders." This is a critical term in several places in the legislation.
- The definition of United States Shareholder is located in Section 951(b). It says that a US Shareholder is a U.S person as defined in Section 957(c) who owns, directly or indirectly, at least 10 percent of a foreign corporation. The attribution rules are then applied (with some modifications set out in Section 958(b)), so that a shareholder of an S Corporation is deemed to own the same percentage of a foreign corporation that the shareholder owns in the S Corporation that holds the foreign stock. As a result, it appears that it would be impossible for a shareholder who owns less than 10 percent of an S Corporation to be a "United States Shareholder".
- For purposes of the deemed repatriation rules, it appears the income inclusion amount and the offsetting deductions that reduce the tax rate on the inclusion are calculated at the S Corporation level, and the S Corporation would be treated as the US Shareholder. However, once this amount has been calculated, all of the elections regarding how and when the tax is paid are made at the shareholder level.

- Section 965(h) provides the election to pay the tax in eight installments. This election is available to a US Shareholder only, however, so an S Corporation shareholder who owns less than 10 percent of the S Corporation could not make this election.
- Section 965(i) provides the election to defer payment of the tax until an S Corporation shareholder no longer owns S Corporation shares (either due to revocation of the S corporation election or disposition of the shares). This election, however, is explicitly available to “each shareholder” of an S Corporation that is itself a US Shareholder. So this election is available to all shareholders, regardless of their ownership percentage.
- Under Section 965(i)(4), a shareholder that has made the election under Section 965(i) may apply the Section 965(h) election in the year that the triggering event occurs. This implies that a shareholder with less than 10-percent ownership could access the installment payment election if they also elect the longer deferral. However, the election under Section 965(h) can be made at the triggering date, so it appears it is still necessary to qualify as a US Shareholder to make the installment payment election.
- Section 965(n) allows for an election not to utilize a taxpayer’s Net Operating Losses against the income includible under Section 965. This election is limited to a US Shareholder, so it’s possible an S Corporation shareholder with less than 10-percent ownership could not make this election.
- The conflicting treatment of S Corporation shareholders with less than 10-percent ownership needs to be addressed. Absent clarification, the deferral election available to C corporations and S corporation shareholders with at least 10-percent ownership stakes would not be available to shareholders with smaller ownership stakes. A small S Corporation shareholder would have to use their NOL’s and would have to pay the tax in one payment, either on the 2017 return or on the triggering date (if the Section 965(i) election is made).
- This potential disparate treatment of S corporation shareholders under Section 965 results in the effective elimination of the deferral option for S corporations with small shareholders. Small shareholder will be unable to defer the tax on the full amount of the deemed repatriated income. The pro-rata distribution rules will require their S corporation to make tax distributions related to the full amount of the repatriation income immediately to all shareholders, regardless of any elections made by the other shareholders. Those distributions will be a substantial cash flow burden on the S Corporation.
- **Guidance on this issue will be needed immediately, as this will affect extension payments due on April 15.**

Does the Section 962 corporate election include Section 250 deductions?

- Although the conference committee clarified the tax legislation to provide that S corporation shareholders may elect, under section 962, to be taxed as a corporation for purposes of both Section 965 and Section 951A (GILTI), it is unclear whether S corporation shareholders that make a section 962 election may be treated as corporations for all purposes, including the eligibility for the GILTI deduction under Section 250.

Additional Section 962 Questions

- Will the return of the E&P subject to the Section 962(b) election be determined at the level of the S Corporation or the shareholder? The shareholder is the person making the election, so a given S Corporation could have different shareholders making different elections, which would lead to an analysis at the shareholder level, but this would be quite complicated to measure and track E&P per shareholder.

- If an individual taxpayer made the Section 962 election because of the Section 951A GILTI provisions, would it also apply to any other subpart F income or Section 956 income they might have? In other words, are mutually exclusive Section 962 elections available for Section 951A GILTI and Section 951(a)(1) income?
- Under Section 962(a)(1), E&P distributions are included in gross income. However, there is still some question as to whether these dividends would be considered as "qualified dividend income".
- Is there a corresponding increase in PTI as well?

Section 904

- Given the new baskets, can a taxpayer apply withholding taxes against the GILTI tax?

Section 163(j)

- Is GILTI income trade or business income for Section 163(j) purposes?
- If Section 163(j) applies to limit an S corporation's interest expense, what happens to any excess interest expense?

Conversions

- How are current earnings treated after the post-termination transition period ends? Are distributions treated as coming first from current earnings included in E&P and then proportionately or are current earnings added to accumulated earnings and then sourced proportionately?
- How are Section 163(j) excess interest deductions treated upon conversion to C corporation status?