

CaseStudy

S CORPORATION TAX YEAR RULES

THE USE OF A FISCAL YEAR DEFERS REPORTING of the S corporation's passthrough income to the shareholders and facilitates year-end tax planning. The shareholders can determine their income from the S corporation before their individual calendar tax year ends. This allows them to prepare for the effects of passthrough from the S corporation and implement any appropriate tax planning strategies before the end of their tax years. Further, a fiscal year may result in the deferral of income.

Using a Permitted Year

The S corporation tax-year rules, similar to those governing partnerships, state that an S corporation must use a permitted year. Under Sec. 1378(b), a permitted year is a tax year that (1) ends on December 31 or (2) is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS.

A business-purpose fiscal year may be automatically established if it is:

1. A natural business year because it meets a 25% mechanical test;
2. An ownership tax year because it coincides with the tax year used by shareholders holding more than 50% of the corporation's stock on the first day of the requested tax year; or
3. A certain 52-53-week year.

If the requested business-purpose tax year cannot be established under the automatic approval provisions, it must be established based on facts and circumstances. As an alternative to using a calendar year or a business-purpose fiscal year, the corporation may elect a fiscal year if it meets the requirements of Sec. 444.

Choosing a Fiscal Year When the Corporation Elects S Status

When a corporation elects S status by filing a properly completed Form 2553, Election by a Small Business Corporation (Under Section 1362 of the Internal Revenue Code), it simultaneously applies for a tax year. The entry of a month and day in the "selected tax year" space provided on Form 2553 is a formal request for a specific year that ends on the last day of that month.

A company electing to be an S corporation can:

1. Use a calendar year;
2. Make the Sec. 444 election and use an acceptable fiscal year;

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3. Apply for a fiscal year that will be approved automatically; or
4. Apply for a business-purpose fiscal year established by facts and circumstances.

When a C corporation elects S status, the S corporation's first tax year begins on the first day following the calendar or fiscal tax year of the electing C corporation.

Changing the Year of an Existing S Corporation

An existing S corporation may change its tax year to (1) a calendar year; (2) an allowable Sec. 444 fiscal year; (3) a year that coincides with the tax year used by shareholders holding more than 50% of the corporation's stock, a certain 52-53-week year, or a business-purpose year that will be automatically approved; or (4) a business-purpose year that requires IRS approval.

An existing S corporation generally uses Form 1128, Application to Adopt, Change, or Retain a Tax Year, to apply for a change in a permitted fiscal year. However, Form 8716, Election to Have a Tax Year Other Than a Required Tax Year, is used to apply for a change under Sec. 444.

Using a Fiscal Year by Making the Sec. 444 Election

An alternative to using a permitted year is provided by two Code sections dealing with fiscal years—Secs. 444 and 7519. Sec. 444 allows an S corporation to elect to use a fiscal year if it meets certain criteria. Sec. 7519 states that the entity must make required payments if it elects a fiscal year under Sec. 444. The required payments are intended to approximate the amount of tax that would be paid by the shareholder if the corporation changed to a calendar year. Thus, in most cases, the payments offset the income tax deferral provided by the fiscal year.

If an S corporation makes the Sec. 444 election, there are restrictions on the fiscal years that it can choose. S corporations making the Sec. 444 election are limited to year ends of September 30, October 31, or November 30. Furthermore, an S corporation generally must make a required payment in each year for which the Sec. 444 election is effective (Sec. 7519). Re-

quired payments are cumulative, however, and no payments are due until the cumulative required payments exceed \$500.

The Sec. 444 election remains in effect until terminated—for example, when the corporation changes to a calendar year. If the S corporation terminates its Sec. 444 election, it cannot make the election again.

The S corporation tax-year rules state that an S corporation must use a permitted year.

Using a Fiscal Year Under the Grandfather Rules

An S corporation that used a fiscal year for the year that began in 1986 can continue using that fiscal year if it made the Sec. 444 election by July 26, 1988. Also, an S corporation that received IRS permission to use a fiscal year on or after July 1, 1974, can retain that fiscal year if the fiscal year did not end on September 30, October 31, or November 30. The S corporation does not have to make a Sec. 444 election.

Obtaining Automatic Approval of Fiscal Year

The automatic approval provisions allow an S corporation to elect a fiscal year using simplified procedures. Automatically approved fiscal years are considered to have a business purpose. Thus, they are not subject to Sec. 444, and the S corporation does not have to make required payments. The IRS will automatically approve a tax year when the S corporation is (Rev. Proc. 2006-46):

1. Adopting, changing to, or retaining a calendar year;
2. Adopting, retaining, or changing to a fiscal year that is considered a natural business year because it meets an objective 25% test;
3. Adopting, retaining, or changing to an ownership tax year because it is the same as the fiscal year used by shareholders who own more than half its shares; or
4. Changing to a certain 52-53-week year.

Using a Business-Purpose Tax Year Established by Facts and Circumstances

Rev. Proc. 2002-39 and Rev. Rul. 87-57 contain the IRS position on granting business-purpose fiscal years established by facts and circumstances. Apparently, obtaining a year that requires IRS approval

will be very difficult. Rev. Proc. 2002-39 states that the IRS will grant a taxpayer permission to adopt, change, or retain a fiscal year under the facts-and-circumstances test only in "rare and unusual circumstances." Nevertheless, the practitioner may encounter an existing or newly electing S corporation operating under extraordinary circumstances that warrant applying for a business-purpose fiscal year.

The IRS assesses a user fee when an S corporation applies for a business-purpose fiscal year established by facts and circumstances, but not when an S corporation applies for an automatically approved year or a fiscal year under Sec. 444.

Changing Fiscal Year End Following Termination of S Status

S corporations generally must use a calendar year under Sec. 1378 or a September, October, or November fiscal year under Sec. 444. C corporations are not restricted to such required years. C corporations (except personal service corporations) can generally use any fiscal year end. Thus, a corporation may want to change its tax year following a voluntary or involuntary termination of S status.

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EditorNotes

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