Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Transaction Unit

Unit Name	Property Distribution	
Primary UIL Code	01368.00	Distributions

Library Level	**Title**
Knowledge Base	S Corporations
Shelf	S Corporation Issues
Book	Distributions
Chapter	S Corporations Property Distribution

Document Control Number (DCN)	SCO-T-010
Date of Last Update	06/18/2020

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Issue and Transaction Overview

Property Distribution

Prior to reviewing this Practice Unit, review the *General Overview of Distributions and Accumulated Earnings & Profits* Practice Unit to gain a general understanding of distributions.

This Practice Unit focuses on four potential issues related to the taxability of property distributions:

1. Proper recognition of gain to an S corporation;
2. Proper distribution amount in a bargain sale;
3. Proper characterization of the gain; and
4. Whether a transfer is subject built-in gains (BIG) tax.

The general rule is that no gain or loss is recognized by a corporation on distributions of property to a shareholder. This Practice Unit discusses the exceptions to this general rule, as well as whether the receipt of distributions is taxable to the shareholder.

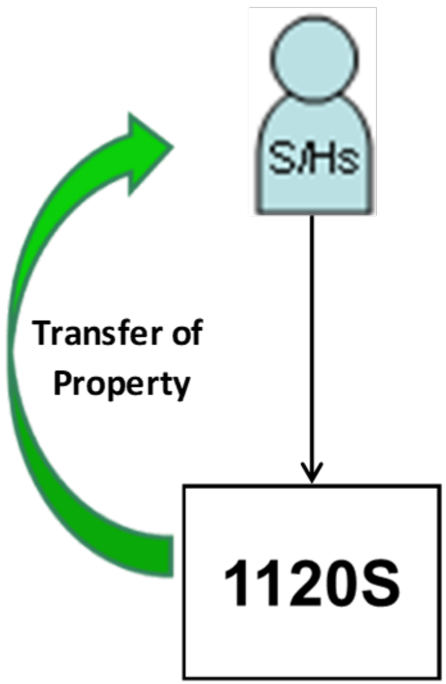
Generally, IRC 1371(a) states that S corporations are subject to all of the rules of C corporations. There are exceptions related to consistency though. For example, the property distribution rules of IRC 311 and IRC 336 apply to S corporations while IRC 1368 states that a distribution made by an S corporation which is normally covered by IRC 301(c) Distribution of Property- Amount Taxable, is covered by IRC 1368(b) Distributions- S corporation having no earning and profits and IRC 1368(c) Distributions- S corporation having earnings and profits.

For a shareholder, a distribution of property can be either taxable as ordinary income, capital gain income, or dividend income, or non-taxable. In addition, if the S corporation sells appreciated property to a shareholder at a bargain, a distribution may result.

When appreciated property is distributed to one shareholder, the S Corporation gain is passed through to all of the shareholders of an S corporation, based on their share ownership percentage. This gain may be capital or ordinary income. In rare instances, the S corporation may be required to pay a corporate level tax on the distribution of appreciated property to a shareholder.

Transaction and Fact Pattern

Property Distribution

Diagram of Transaction	Facts
	▪ S corporation transfers an asset to a shareholder. ▪ S corporation may or may not receive consideration for the transfer of the property. ▪ S corporation reports the transfer as an asset sale on Form 4797 or Schedule D as appropriate. – The sales price should be reported at fair market value (FMV). – The character of the gain depends on the ownership percentage of the recipient shareholder and whether there is depreciation recapture. – Any gain will pass-through to Sch. K and the Sch. K-1. – The S corporation considers whether any corporate level taxes are required. For example, BIG tax. – Losses are disallowed and reported as non-deductible expenses. ▪ The S corporation reports a distribution equal to the FMV less any consideration received. – The S corporation determines if the distribution is a dividend or non-dividend distribution and reports it on the appropriate Sch. K line item. ▪ The recipient shareholder reports the pass-through items of income, loss and deduction from Sch. K-1 and Form 1099-DIV. – Recipient shareholder considers whether any non-dividend distribution requires gain recognition for a distribution in excess of stock basis.

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Summary of Potential Issues

Property Distribution	
Issue 1	Did the S corporation properly recognize the gain or loss on distribution of property?
Issue 2	Did the S corporation report the correct distribution amount for property sold to a related party at less than FMV (bargain sale)?
Issue 3	Was the gain on sale or distribution properly characterized as capital or ordinary?
Issue 4	Was the sold or distributed asset subject to BIG tax?

All Issues, Step 1: Initial Factual Development

Property Distribution
When an S corporation transfers property, through a distribution or sale, to a related party, it is important to determine whether the S corporation properly reported the gain or loss, the distribution amount, and BIG, if any.

Fact Element	Resources
Identify whether the S corporation transferred property, through a sale or distribution, to a related party. This information may be obtained by reviewing the board of directors' minutes or interviewing an S corporation officer or shareholder. There may also be indications of a property transfer on the S corporation's Form 1120S. Review the return for the following information: [All line items refer to the 2019 forms.] ▪ Distribution on Form 1120S, Schedule K, line 16d, ▪ Distribution on Form 1120S, Schedule K, line 17c, ▪ Distribution on Form 1120S, Schedule M-2, line 7, ▪ Sale of asset on Form 1120S, Schedule D or Form 4797, ▪ Form 1120S, Schedule L for any unexplained reduction in assets, and ▪ Reconciliation of Retained Earnings with an unexplained difference.	▪ IRM 4.10.3 for Effective Interview Techniques ▪ Form 1120S ▪ Form 4797 ▪ Audit Tool - Reconciliation Workbook
Verify the FMV of the asset transferred. FMV is the price that a willing seller and a willing buyer agree to, neither being obliged to buy or sell. The FMV may be corroborated using third party resources like Kelley Blue Book or comparable sales. ! **CAUTION:** Sometimes the balance sheet only reflects the disposition of an asset and not whether there is a gain on distribution. The key is to tie down the FMV and compare it to the asset's tax adjusted basis.	▪ Kelley Blue Book

All Issues, Step 1: Initial Factual Development (cont'd)

Property Distribution

Fact Element	Resources
CONSULTATION: Consider consulting with a valuation specialist.	
▪ Verify the tax adjusted basis of the asset transferred.	
An S Corporation may enter a like-kind exchange transaction with a related party. While a like-kind exchange is generally a nontaxable transaction, gain may be recognized under certain circumstances. **CONSULTATION:** See the Corporate/Business Issues & Credits Knowledge Base and consult the Deductible & Capital Expenditures Practice Network subject matter experts for additional information.	▪ IRC 1031 ▪ Corporate/Business Issues & Credits Knowledge Base ▪ IRC 1368

Property Distribution
Issue 1
Did the S corporation properly recognize the gain or loss on distribution of property?

Explanation of Issue	Resources
Generally, no gain or loss is recognized by a corporation on a distribution of property to a shareholder. If the S corporation distributes property with a FMV less than its tax adjusted basis, the loss is disallowed and the difference between the tax adjusted basis and the FMV is reported by the S corporation as a non-deductible, non-capital expense .	▪ IRC 311(a) ▪ CCA 201421015
However, if the corporation distributes appreciated property to the shareholder, it must recognize gain as if it sold the property to the shareholder for the property's FMV. Property is appreciated when the its FMV s greater than it's tax adjusted basis.	▪ IRC 311(b)
	▪ IRC 1366
The gain recognized by the S corporation is treated like any other gain of the S corporation and is passed through to the shareholders.	
! **CAUTION**: Verify that the S corporation reported the value of the distribution as the FMV and not equal to the book value or the tax adjusted basis.	

Property Distribution

Issue 1

Explanation of Issue	Resources
Example 1: Distribution of Appreciated Property During the year, an S corporation distributed property with the following attributes to the S corporation's sole shareholder: FMV 32,000 Tax Adjusted Basis 18,000 Realized Gain 14,000 The distribution of the property generates a $14,000 gain to the S corporation, which passes through to the shareholders and is taxable on the shareholders' return. The type of gain depends on the character of the property distributed. See Issue 3. The amount of the distribution is equal to the FMV of the property distributed, $32,000.	▪ IRC 311(b)

Issue 1, Step 3: Additional Factual Development

Property Distribution
Issue 1

Fact Element	Resources
▪ Verify the amount the S corporation reported as gain or loss upon distribution. ▪ Request documentation from the S corporation to verify the reported distribution amount attributable to the property distribution versus other distributions (i.e. cash). ▪ Determine if any S corporation liabilities were assumed by the shareholder as part of the transaction.	▪ Form 1120S ▪ Form 4797

Issue 1, Step 4: Develop Arguments

Property Distribution

Issue 1

Explanation of Adjustment	Resources
Once you identify the distributed property, determine its FMV. A change in the FMV from the reported amount results in a change to the distribution amount. Whether there is a change in the gain or loss recognized depends on additional facts. <u>Determine the FMV of Property Distributed</u> **CONSULTATION:** Since the FMV can be subjective, document how it was determined and consider consulting with a valuation specialist to adjust the sales price.	
▪ If the shareholder sold the property to an unrelated third party subsequent to the distribution, the sales price may be an indication of the FMV, although not determinative.	▪ IRC 311(a) ▪ CCA 201421015
<u>Compare the FMV to the Tax Adjusted Basis - Losses</u>	
▪ If the property's FMV is less than the tax adjusted basis, then the loss is disallowed. The loss amount is treated as a non-deductible expense allocated to all of the shareholders according to their stock ownership percentage.	▪ Practice Unit - *Distributions with Accumulated Earnings & Profits*
▪ The distribution amount is the FMV of the property.	▪ IRC 311(b)
▪ The disallowed loss reduces AAA as discussed in the *Distributions with Accumulated Earnings & Profits* Practice Unit.	

Issue 1, Step 4: Develop Arguments (cont'd)

Property Distribution
Issue 1

Explanation of Adjustment	Resources
Compare the FMV to the Tax Adjusted Basis - Gains ▪ If the property's FMV is greater than the tax adjusted basis, then the gain must be reported. See Issue 3 to determine the character of the gain required to be reported. See Issue 4 to determine if a corporate level tax can apply to the gain recognized. Amount of the Distribution ▪ Generally, the amount of the distribution is the FMV of the property. However, the distribution amount differs if the shareholder assumes a liability of the S corporation with the distributed asset. The distribution amount will then be the FMV less the liabilities assumed. ▪ See the *General Overview of Distributions* and *Accumulated Earnings & Profits and Distributions with Accumulated Earnings & Profits* Practice Units to determine the taxability of the distribution.	▪ IRC 301(b)(2) ▪ Treas. Reg. 1.301-1(g) ▪ IRC 311(b) ▪ IRC 336(b) ▪ IRC 1368 ▪ Practice Unit – *General Overview of Distributions and Accumulated Earnings & Profits* ▪ Practice Unit - *Distributions with Accumulated Earnings & Profits*
Shareholder's Basis in the Property Distributed ▪ The shareholder's basis in the property will be the FMV.	▪ IRC 301(d)
Shareholder's Holding Period in the Property Distributed ▪ The shareholder's holding period in the property starts at the date of the distribution regardless of the S corporation's holding period.	

Issue 1, Step 4: Develop Arguments (cont’d)

Property Distribution
Issue 1

Explanation of Adjustment	Resources
Non-Aggregation of Gains and Losses ▪ If multiple properties are distributed at the same time, some with gains and others with losses, the gains and losses cannot be netted. Rather, the gains are reported and the losses are nondeductible.	▪ IRC 1223 ▪ *Morris Investment Corporation v. Comm’r* - 156 F.2 748 (3rd Cir. 1946, aff’g 5 T.C. 583 (1945), cert. denied, 329 U.S. 788 (1946) ▪ Rev. Rul. 76-377 ▪ IRC 267(a)

Issue 2, Step 2: Review Potential Issues

Property Distribution
Issue 2
Did the S corporation report the correct distribution amount for property sold to a related party at less than FMV (bargain sale)?

Explanation of Issue	Resources
When a corporation sells a corporate asset to a related party at a bargain price (that is, the sales price will be less than FMV of the property), the transaction is treated as part sale and part distribution. The amount realized by the S corporation on the bargain sale will be increased to reflect FMV.	▪ IRC 1001 ▪ IRC 267 ▪ IRC 311(b)
CONSULTATION: See the Deductible and Capital Expenditures shelf within the Corporate/Business Issues & Credits Knowledge Base and consult with the DCE PN subject matter expert for additional information on related parties.	▪ Corporate/Business Issues & Credits Knowledge Base
For a bargain sale, the corporation must recognize a gain as if it sold the property for its FMV. See Issue 3 for special rules on the character of the gain. The gain is then passed through to the shareholders as would any other S corporation gain. The difference between the FMV and the sales price is a deemed distribution to the shareholder who purchases the property or benefits from the transfer.	
A bargain sale results in at least two adjustments at the S corporation level, one adjustment for the realized gain and another for the deemed distribution amount. If the bargain sale results in a loss, the distribution amount can still be increased but the loss is disallowed. The loss disallowance rules of IRC 311(a) don't apply if the transaction is part of a plan for liquidation. If the transaction is part of a plan for liquidation, then see the *Taxability of Distribution Not From Accumulated Earnings & Profits* Practice Unit.	▪ IRC 311(a) ▪ Practice Unit - *Taxability of Distribution Not From Accumulated Earnings & Profits*

Issue 2, Step 2: Review Potential Issues (cont'd)

Property Distribution
Issue 2

Explanation of Issue	Resources
! **CAUTION:** When the sale of an asset reports little or no gain, ascertain how the sales price was determined and to whom the asset was sold. Sometimes the balance sheet only reflects the sale of an asset at the net book value or tax adjusted basis and not there is a gain on the sale. The key to the income adjustment is to tie down the FMV of the asset and compare it to the asset's tax adjusted basis. The key to the distribution amount adjustment is to compare the FMV of the asset less liabilities assumed and less assets received from the related party.	

Property Distribution

Issue 2

Explanation of Issue	Resources
During the year, an S corporation sold an automobile to its sole shareholder. The sales price was the automobile's tax adjusted basis, so the corporation reported a $2,000 sales price with a $2,000 tax adjusted basis, resulting in $0 gain reported on the sale. During the examination, the following information was determined: FMV of automobile 20,000 Cost 45,000 Accumulated Depreciation (43,000) Tax Adjusted Basis 2,000 A distribution of appreciated property to a shareholder is a taxable event. The corporation is required to recognizes a gain as if the property had been sold to the shareholder at the property's FMV. Therefore, upon examination, an adjustment should be made to increase the corporation's gain on sale to $18,000 ($20,000 FMV minus $2,000 tax adjusted basis). In addition, there' is a deemed distribution to the shareholder of $18,000 ($20,000 FMV minus $2,000 purchase price). The character of the gain depends on the type of the asset distributed. See Issue 3.	▪ IRC 311(b)

Issue 2, Step 3: Additional Factual Development

Property Distribution
[Issue 2](#)

Fact Element	Resources
▪ Verify the sale transaction is not a part of a plan in liquidation. ▪ Request documentation from the S corporation to verify the reported distribution amount attributable to the property distribution versus other distributions (i.e. cash). ▪ Verify the amount paid by the related party for the property. ▪ Verify if any S corporation liabilities were assumed by the related party as part of the transaction. ▪ Calculate the distributions adjustment by taking the per exam distribution vs the amount of distribution reported, if any.	▪ Practice Unit – *Taxability of Distributions Not From Accumulated Earnings & Profits*

Issue 2, Step 4: Develop Arguments

Property Distribution

Issue 2

Explanation of Adjustment	Resources
Identify property that's sold to a related party, then determine its FMV. A change in the FMV from the reported amount, results in a change to the distribution amount from the S corporation. Depending on additional facts, gain or loss may be recognized. <u>Identifying Related Party Sales</u> ▪ Generally, for the sales price to be deemed the FMV, the property must be sold to a shareholder or a related party of the shareholder not below the FMV price. For purposes of a bargain sale, "Related party" is not defined in the Code but is determined by the facts and circumstances. IRC 267(b) lists relationships that likely qualify as related party. ▪ For example, if a child of a shareholder purchased property from the S corporation at less than FMV, the difference between the FMV and the sales price (including liabilities assumed) is a bargain sale and a distribution to the shareholder. The shareholder may have a gift to the child for the distribution amount. <u>Determine the FMV of Property Distributed</u> **CONSULATION:** The FMV of the asset distributed can be subjective, therefore document how the FMV was determined by the S corporation and consider consulting with a valuation specialist to adjust the sales price.	▪ *Greene v. U.S.* - 460 F.2d 412 (5th Cir. 1972) ▪ IRC 267

Issue 2, Step 4: Develop Arguments (cont'd)

Property Distribution
Issue 2

Explanation of Adjustment	Resources
Compare the FMV to the Tax Adjusted Basis - Losses ▪ If the property's FMV is less than the tax adjusted basis, the loss may be disallowed (at least in part). The loss is a non-deductible, non-capital expense allocated to all of the shareholders according to their stock ownership percentage. ▪ The disallowed loss reduces AAA. See the *Distributions with Accumulated Earnings & Profits* Practice Unit ▪ Under IRC 267, if the related party later disposes of the property to an unrelated party at a gain, the gain is reduced by the losses previously disallowed. This has no further effect on AAA.	▪ IRC 311 ▪ IRC 1367(a)(2) ▪ IRC 1366 ▪ Practice Unit - *Distributions with Accumulated Earnings & Profits*
CONSULTATION: Contact the S Corporations & Cooperatives Practice Network if there is a loss on a related party sale after adjusting the sales price to FMV.	▪ S Corporations Knowledge Base
Compare the FMV to the Tax Adjusted Basis - Gains ▪ If the property's FMV is greater than the tax adjusted basis, the gain must be reported. See Issue 3 to determine the character of the gain required to be reported. See Issue 4 to determine if a corporate level tax can apply to the recognized gain.	▪ IRC 311(b)

Issue 2, Step 4: Develop Arguments (cont’d)

Property Distribution
Issue 2

Explanation of Adjustment	Resources
Amount of the Distribution ▪ The amount of the distribution differs from the FMV of the property. The distribution amount is the FMV of the asset less the sales price and the liabilities assumed by the related party. ▪ The distribution amount is allocated to the shareholder that purchased the property or the shareholder that is related to the purchaser as described above. ▪ The distribution amount can be taxable. See to the *General Overview of Distributions and Accumulated Earnings & Profits*, *Distributions with Accumulated Earnings & Profits*, and the *Taxability of Distributions Not From Accumulated Earnings & Profits* Practice Units to determine the taxability of the distribution to the shareholder. Non-Aggregation of Gains and Losses ▪ If multiple properties are distributed at the same time, some with gains and others with losses, the gains and losses must not be netted. Rather, the gains are reported and the losses are nondeductible. Related Party Note - Bona Fide Indebtedness ▪ If the related party purchases the asset and provides a note as part of the price, determine whether the note is bona fide indebtedness or should be treated as a distribution. Bona fide indebtedness is based on all the facts. See the S Corporation Transactions with Shareholders Issue Guide for more information on bona fide indebtedness factors.	▪ IRC 1368 ▪ IRC 1001 ▪ Practice Unit - *Taxability of Distributions Not From Accumulated Earnings & Profits* ▪ Practice Unit - *Distributions with Accumulated Earnings & Profits* ▪ Practice Unit - *General Overview of Distributions and Accumulated Earning & Profits* *Morris Investment Corporation v. Comm’r* - 156 F.2 748 (3rd Cir. 1946, aff’g 5 T.C. 583 (1945), cert. denied, 329 U.S. 788 (1946) ▪ Rev. Rul. 76-377 ▪ IRC 267(a) ▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide

Issue 3, Step 2: Review Potential Issues

Property Distribution
Issue 3
Was the gain on sale or distribution properly characterized as capital or ordinary?

Explanation of Issue	Resources
When an S corporation distributes or sells appreciated property at a gain to a related party, the S corporation must recognize the gain and determine its proper character. The recognized gain along with its character is passed through to the shareholders, as with any other gain.	▪ IRC 311 ▪ IRC 1366
The rules for determining the character of the gain or loss on the sale or exchange of assets are generally provided for in IRC 1221-1260.	▪ IRC 1221 ▪ IRC 1(h)(1)
The sale of a capital asset held for more than one year, as defined in IRC 1221, produces capital gain income subject to lower capital gain tax rates. Capital assets generally include assets other than inventory or property held for sale in the ordinary course of business, depreciable or real property used in a trade or business, copyrights, and accounts receivable.	▪ IRC 1231 ▪ IRC 1245 ▪ IRC 1250
The sale of non-capital assets can be subject to either ordinary income tax rates or lower capital income tax rates, depending on the IRC sections below and on the next slide.	▪ IRC 1239 ▪ IRC 167 ▪ IRC 267
IRC 1231 governs the treatment of gains and losses from property used in the trade or business of the S corp. Generally, gains are treated as capital and losses are ordinary. However, IRC 1245 and 1250 may apply to recapture depreciation as ordinary income on property disposed of at a gain by the S corp. If the property distributed is IRC 1250 property, there is also a possible unrecaptured IRC 1250 gain tax ramifications to consider.	▪ IRC 197 ▪ Treas. Reg. 1.197-2(g)(8)

Issue 3, Step 2: Review Potential Issues (cont'd)

Property Distribution

Issue 3

Explanation of Issue	Resources
Under IRC 1239, capital gain treatment is denied for the sale of depreciable assets to related parties. That is, assets that are subject to depreciation under IRC 167 in the hands of the acquiring party, including amortizable IRC 197 intangibles. **CONSULTATION:** See the Deductible and Capital Expenditures shelf within the Corporate/Business Issues & Credits Knowledge Base and consult with a DCE PN subject matter expert for additional information regarding the character of gains and losses on both the sale or exchange of assets, and the disposition of amortizable IRC 197 intangible assets.	▪ Corporate/Business Issues & Credits Knowledge Base
The definition of a related party under IRC 1239 differs from the definition of a related party under IRC 267. A related person for IRC 1239 includes: 1. A person and all controlled entities with respect to such person, 2. A taxpayer and any trust in which the taxpayer (or the taxpayer's spouse) is a beneficiary, or 3. An executor or beneficiary of the estate.	▪ IRC 1239 ▪ IRC 267 ▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide

Issue 3, Step 2: Review Potential Issues (cont'd)

Property Distribution
Issue 3

Explanation of Issue	Resources
A controlled entity is: 1. A corporation where more than 50 percent of the stock is owned (directly or indirectly) by or for the taxpayer, 2. A partnership where more than 50 percent of the capital interest or profit interest is owned (directly or indirectly) by or for the taxpayer, or 3. Any entity that is described as: a. Two corporations that are members of the same controlled group, b. A corporation and a partnership if the same persons own more than 50 percent of each, c. An S corporation and another S corporation if the same person owns more than 50 percent of each, or d. An S corporation and a C corporation if the same persons own more than 50 percent of each. 4. The constructive ownership of stock rules of IRC 267(c) (other than paragraph (c)(3)) apply in determining a controlled entity for IRC 1239 purposes.	▪ IRC 267(b)(3) ▪ IRC 267(b)(10) ▪ IRC 267(b)(11) ▪ IRC 267(b)(12) ▪ IRC 267(c)

Issue 3, Step 2: Review Potential Issues (cont'd)

Property Distribution
Issue 3

Explanation of Issue	Resources
Example 1 Continued: Analysis of IRC 1231, 1245 and 1239 To expand on the facts in Example 1, assume the S corporation distributed property, used in its trade or business to its sole shareholder. In addition, the distributed property is subject to depreciation under IRC 167 in the hands of the sole shareholder. The gain recognized by the S corporation is as follows: FMV 32,000 Cost 30,000 Accumulated Depreciation 12,000 Tax adjusted Basis 18,000 Realized Gain 14,000 The distribution of the property would generate a $14,000 gain to the S corporation. Generally, under IRC 1231, the entire $14,000 is treated as capital gain except to the extent of IRC 1245 recapture, which is treated as ordinary income ($12,000). However, since the sole shareholder is a related party under IRC 1239, and the property is depreciable in the hands of that related party, under IRC 1239 the entire $14,000 gain is subject to ordinary income treatment.	▪ IRC 167 ▪ IRC 311 ▪ IRC 1245 ▪ IRC 1239 ▪ IRC 311

Issue 3, Step 3: Additional Factual Development

Property Distribution

Issue 3

Fact Element	Resources
▪ Verify the character of gain or loss reported by the S corporation. ▪ Determine the relationship of the S corporation to the related party that received the property. ▪ Determine the amount the asset was depreciated or amortized by the S corporation. ▪ Determine if the related party is depreciating or amortizing the asset.	▪ Form 1120S, Schedule D ▪ Form 1120S ▪ Form 4797 ▪ yK1 ▪ Depreciation Schedules ▪ Amortization Schedules

Issue 3, Step 4: Develop Arguments

Property Distribution

Issue 3

Explanation of Adjustment	Resources
Prior to determining the character of the gain or loss, see Issue 1, for property distributed to a shareholder, or Issue 2, for property sold to a shareholder or related party. The character of the recognized gain or loss recognized may depend on whom the property was transferred to. ▪ Determine whether the asset was a capital asset for the S corporation. ▪ Determine whether the asset was an IRC 1231 asset for the S corporation, and if so, whether the taxpayer considered IRC 1245 or 1250 recapture.	▪ IRC 1221 ▪ IRC 167 ▪ IRC 1239 ▪ IRC 1231 ▪ IRC 1245 ▪ IRC 1250
▪ Regardless of whether the asset is capital or non-capital in the hands of the S corporation, determine if the sale is to a related party under IRC 1239 and if the property is subject to depreciation in the hands of that related party. ▪ Determine if the IRC 197 anti-churning rules apply. – If the asset transferred is an IRC 197 intangible, then the antichurning rules of IRC 197(f)(9) may prevent the purchaser from amortizing it. However, an S corporation can elect to recognize the gain on the transfer of the property and require the shareholders to pay income tax on the gain at the highest tax rate. If so, the purchaser can amortize the asset. **CONSULTATION:** See the Corporate/Business Issues & Credits Knowledge Base for additional information on IRC 197.	▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide ▪ IRC 267(b) ▪ IRC 197 ▪ Treas. Reg. 1.197-2(h)(1) ▪ Treas. Reg. 1.197-2(h)(9)

Issue 4, Step 2: Review Potential Issues

Property Distribution
Issue 4
Was the sold or distributed asset subject to BIG tax?

Explanation of Issue	Resources
Many business owners elect S corporation status to avoid two levels of taxation. A C corporation is subject to tax at both the corporate level (tax on earnings) and again at the shareholder level when it distributes its earnings as dividends. Generally, an S corporation is taxed at the shareholder level only. However, the S corporation may incur a corporate level tax if the sold or distributed asset is subject to the BIG tax. The BIG tax applies to an S corporation if it: 1. Was previously a C corporation that made an S election after 12/31/1986, or acquired C corporation assets with a carryover basis; 2. Has a net unrealized built-in gain (NUBIG) at the date of conversion or the date the C corporation assets were acquired; and 3. Disposes of the asset with a NUBIG within five years of the S election or when it acquired the asset from the C corporation (the recognition period).	▪ IRC 1374

Property Distribution
Issue 4

Explanation of Issue	Resources
Therefore, when an S corporation sells or distributes an asset to a related party, determine whether the disposition of that asset requires recognition of the BIG tax. ! **CAUTION:** When an S corporation is subject to the BIG tax, the gain recognized by the S corporation still passes through to the shareholder(s) according to their ownership interest and is reported on their federal income tax returns. [See Issues 1 and 2] Evaluate the distribution at the S corporation and shareholder levels to determine the taxability to the shareholder(s). See the *General Overview of Distributions and Accumulated Earnings & Profits* and the *Distributions with Accumulated Earnings & Profits* Practice Units	▪ Audit Tool - S Corporation Built-in Gains and Other Taxes Issue Guide ▪ IRC 1374 ▪ IRC 1366 ▪ Practice Unit - *General Overview of Distributions and Accumulated Earnings & Profits* ▪ Practice Unit - *Distributions with Accumulated Earnings & Profits*

Issue 4, Step 3: Additional Factual Development

Property Distribution
Issue 4

Fact Element	Resources
▪ Determine whether the S corporation was previously a C corporation or whether the S corporation acquired assets from a C corporation in a tax-free transaction with a carryover basis. ▪ Determine whether the property distributed or sold to the shareholder was owned by the prior C corporation. ▪ Determine whether the S corporation had NUBIG at the time of conversion to an S corporation or from the tax-free acquisition of assets from a C corporation. ▪ Determine whether the distribution or sale took place within the recognition period. ? **DECISION POINT:** Determine whether to proceed with this issue based on the above. If proceeding, refer to the S Corporation Built-in Gains and Other Taxes Issue Guide for how to compute the tax.	▪ Audit Tool - S Corporation Built-in Gains and Other Taxes Issue Guide ▪ IRC 1374

Property Distribution

[Issue 4](#)

Explanation of Adjustment	Resources
To develop this issue, determine if the S corporation: 1. Was previously a C corporation that made an S election after 12/31/1986, or acquired C corporation assets with a carryover basis; 2. Has a NUBIG at the date of conversion or the date the C corporation assets were acquired; and 3. Disposes of the NUBIG asset within the recognition period. ! **CAUTION:** The BIG tax is in addition to the tax associated with Issues 1 and 2 that are encountered when an S corporation distributes or sells property to a shareholder.	▪ Audit Tool - S Corporation Built-in Gains and Other Taxes Issue Guide ▪ IRC 1374

Index of Referenced Resources

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IRC 1
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Treas. Reg. 1.301-1
Treas. Reg. 1.1368-1
Form 1099-DIV
Form 1120S
Form 1120S Instructions
Form 1120S, Schedule K-1
Form 4797
IRM 4.10.3 - *Examination of Returns, Examination Techniques*
CCA 201421015
Rev. Rul. 76-377

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Greene v. U.S. - 460 F 2d 412 (5th Cur. 1972)
Morris Investment Corporation v. Comm'r - 156 F.2 748 (3rd Cir. 1946, aff'g 5 T.C. 583 (1945), cert. denied, 329 U.S. 788 (1946)

Training and Additional Resources

Property Distribution	
Type of Resource	**Description(s)**
Articulate Course	▪ *S Corporation Distributions* - ITM Course # 72814
Issue Toolkits	▪ Audit Tool - S Corporation Distributions Issue Guide ▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide ▪ Audit Tool - S Corporation Built-In Gains & Other Taxes Issue Guide ▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide ▪ FAQ - Distributions
Databases / Research Tools	▪ yK1
Reference Materials	▪ *BNA Tax Management Portfolios U.S. Income Series Other Pass-Through Entities* 731 S corporations: Operations IV. Treatment of S Corporation Distributions Westlaw ▪ *Practitioners Publishing Company (PPC) - 1120S Deskbook*
Other Training Materials	▪ Audit Tool - Reconciliation Workbook

Glossary of Terms and Acronyms

Term/Acronym	Definition
AAA	Accumulated Adjustment Account
AE&P	Accumulated Earnings & Profits
Appreciated Property	When the FMV of the property is greater than the property's tax adjusted basis.
Bargain Sale	When a corporation sells an asset to a shareholder below the asset's FMV
BIG	Built-in Gain
FMV	Fair Market Value
NUBIG	Net Unrealized Built-in Gain
yK1	The yK1 Program

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
1368	*Taxability of Distributions Not From Accumulated Earnings & Profits*
1368	*Distributions with Accumulated Earnings & Profits*
1368	*General Overview of Distributions and Accumulated Earnings & Profits*