**8790. How is an S corporation taxed? When may S corporation income be taxed at the corporate level?**

An S corporation is generally not subject to tax at the corporate level.[[1]](#footnote-1) However, a tax is imposed at the corporate level under certain circumstances. When an S corporation disposes of property within 10 years after the S election was made, gain attributable to pre-election appreciation of the property (built in gain) is taxed at the corporate level to the extent such gain does not exceed the amount of taxable income imposed on the corporation if it were not an S corporation.[[2]](#footnote-2) However, ARRA 2009 provides that, in the case of a taxable year beginning in 2011, no tax is imposed on the built in gain if the fifth taxable year of the 10-year recognition period precedes such taxable year.

For S elections made after December 17, 1987, a corporation switching from C corporation status to S corporation status may also be required to recapture certain amounts at the corporate level in connection with goods previously inventoried under a LIFO method.[[3]](#footnote-3)

In addition, a tax is imposed at the corporate level on *excess* “net passive income” of an S corporation (passive investment income reduced by certain expenses connected with the production of such income) but only if the following are true:

(1) The corporation, at the end of the tax year, has accumulated earnings and profits (either carried over from a year in which it was a nonelecting corporation or due to an acquisition of a C corporation);

(2) Passive investment income exceeds 25 percent of gross receipts.

The highest corporate tax rate (currently 35 percent) applies.[[4]](#footnote-4) “Passive investment income” for means rents, royalties, dividends, interest, and annuities.[[5]](#footnote-5) The following items are excluded from the definition of passive investment income for this purpose:

(1) rents for the use of corporate property if the corporation also provides substantial services or incurs substantial cost in the rental business;[[6]](#footnote-6)

(2) interest on obligations acquired from the sale of a capital asset or the performance of services in the ordinary course of a trade or business of selling the property or performing the services;

(3) gross receipts derived in the ordinary course of a trade or business of lending or financing; dealing in property; purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages;[[7]](#footnote-7) and

(4) if an S corporation owns 80 percent or more of a C corporation, dividends from the C corporation to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.[[8]](#footnote-8)

If amounts are subject to tax both as built-in gain and as excess net passive income, an adjustment will be made in the amount taxed as passive income.[[9]](#footnote-9)

Also, tax is imposed at the corporate level if investment credit attributable to years for which the corporation was not an S corporation is required to be recaptured.[[10]](#footnote-10)

Furthermore, an S corporation may be required to make an accelerated tax payment on behalf of its shareholders if the S corporation elects not to use a required taxable year.[[11]](#footnote-11) The corporation is also subject to estimated tax requirements with respect to the tax on built-in gain, the tax on excess net passive income and any tax attributable to recapture of investment credit.[[12]](#footnote-12)

1. . IRC Sec. 1363(a). [↑](#footnote-ref-1)
2. . IRC Sec. 1374. [↑](#footnote-ref-2)
3. . IRC Sec. 1363(d). [↑](#footnote-ref-3)
4. . IRC Sec. 1375(a). [↑](#footnote-ref-4)
5. . IRC Secs. 1362(d)(3), 1375(b)(3). [↑](#footnote-ref-5)
6. . See Let. Ruls. 9837003, 9611009, 9610016, 9548012, 9534024, 9514005. [↑](#footnote-ref-6)
7. . Treas. Reg. §1.1362-2(c)(5). [↑](#footnote-ref-7)
8. . Treas. Reg. §1.1362-8(a). [↑](#footnote-ref-8)
9. . IRC Sec. 1375(b)(4). [↑](#footnote-ref-9)
10. . IRC Sec. 1371(d). [↑](#footnote-ref-10)
11. . IRC Sec. 7519. [↑](#footnote-ref-11)
12. . IRC Sec. 6655(g)(4). [↑](#footnote-ref-12)