



Commission on the  
21<sup>ST</sup> Century Economy

Sec. \_\_\_\_ . Section 17087.5 of the Revenue and Taxation Code is repealed.

~~17087.5. Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to tax treatment of "S corporations" and their shareholders, shall apply, except as otherwise provided under this part or Part 11 (commencing with Section 23001).~~

Sec. \_\_\_\_ Article 2.5 (commencing with Section 17100) is added to Chapter 3 of Part 10 of Division 2 of the Revenue and Taxation Code to read as follows:

Article 2.5

TAX TREATMENT OF S CORPORATIONS AND THEIR SHAREHOLDERS

17100. Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to the tax treatment of "S corporations" and their shareholders, shall apply, except as otherwise provided.

17101. (a) A corporation that has in effect for federal income tax purposes a valid election under Section 1362(a) of the Internal Revenue Code shall be an "S" corporation for purposes of this part and Part 10.2 (commencing with Section 18401).

(b) A corporation that is an "S corporation" for federal income tax purposes shall be an "S corporation" for purposes of this part, Part 10.2 (commencing with Section 18401), and its shareholders shall be shareholders of an "S corporation" without regard to whether the corporation is qualified to do business or is incorporated in this state.

(c) (1) A termination of a federal election pursuant to Section 1362(d) of the Internal Revenue Code that is not an inadvertent termination pursuant to Section 1362(f) of the Internal Revenue Code shall simultaneously terminate the "S corporation" election for purposes of this part and Part 10.2 (commencing with Section 18401).

(2) A federal termination by revocation shall be effective for purposes of this part and shall be reported to the Franchise Tax Board in the form and manner prescribed by the Franchise Tax Board no later than the last date allowed for filing federal termination for that year under Section 1362(d) of the Internal Revenue Code.

(d) Section 1362(d)(3) of the Internal Revenue Code, relating to circumstances where passive investment income exceeds 25 percent of gross receipts for three consecutive taxable years and the corporation has accumulated earnings and profits, does not apply unless the "S" election is terminated for federal income tax purposes.

(e) (1) The provisions of Section 1362(b)(5) of the Internal Revenue Code, relating to authority to treat late elections, etc., as timely, shall apply only for taxable years beginning on or after January 1, 1997, with respect to elections under Section 1362(a) of the Internal Revenue Code for taxable years beginning on or after January 1, 1997.

(2) Notwithstanding the provisions of paragraph (1), if for any taxable year beginning on or after January 1, 2003, a corporation fails to qualify as an "S corporation" for federal income tax purposes solely because

the federal Form 2553 (Election by a Small Business Corporation) was not filed timely, the corporation shall be treated for purposes of this part as an "S corporation" for the taxable year the "S corporation" election should have been made, and for each subsequent year until terminated, if the corporation and its shareholders have filed with the Internal Revenue Service a federal Form 2553 requesting automatic relief with respect to the late "S corporation" election, in full compliance with the federal Revenue Procedure 1997-48, I.R.B. 1997-43, and have received notification of the acceptance of the untimely filed "S corporation" election from the Internal Revenue Service. A copy of the notification shall be provided to the Franchise Tax Board upon request.

(f) The provisions of Section 1362(f) of the Internal Revenue Code, relating to inadvertent invalid elections or terminations, shall apply only for taxable years beginning on or after January 1, 1997, with respect to elections under Section 1362(a) of the Internal Revenue Code for taxable years beginning on or after January 1, 1997.

17102. (a) For purposes of this part, Part 10.2 (commencing with Section 18401), and Part 12 (commencing with Section 27001):

(1)(A) Section 1361(b)(3)(A)(ii) of the Internal Revenue Code does not apply and, in lieu thereof, subparagraph (B) shall apply and all references to Section 1361(b)(3)(A)(ii) of the Internal Revenue Code shall be treated as a reference to subparagraph (B).

(B) All activities, assets, liabilities, receipts, purchases, and items of income, deduction, and credit of a qualified Subchapter S subsidiary shall be treated as activities (including activities for purposes of Part 12), assets, liabilities, receipts, purchases, and those items, as the case may be, of the "S corporation."

(2) Section 1361(b)(3)(B) of the Internal Revenue Code is modified to include the following requirements in addition to the requirements contained therein:

(A) The "S corporation" has in effect a valid election to treat the corporation as a qualified Subchapter S subsidiary for federal income tax purposes.

(B) An election made by the "S corporation" under Section 1361(b)(3)(B)(ii) of the Internal Revenue Code to treat the corporation as a qualified Subchapter S subsidiary for federal income tax purposes shall be treated for purposes of this part as an election made by the "S corporation" under this subdivision and a separate election under paragraph (3) of subdivision (e) of 17024.5 may not be allowed.

(C) No election under this subdivision shall be allowed unless the "S corporation" has made the election under Section 1361(b)(3)(B)(ii) of the Internal Revenue Code to treat the corporation as a qualified Subchapter S subsidiary for federal income tax purposes.

(b) Section 1361(c)(6) of the Internal Revenue Code, relating to certain exempt organizations permitted as shareholders, is modified by substituting a reference to Section 17631 or Section 27701d in lieu of the reference to Section 501(c)(3) of the Internal Revenue Code and by substituting a reference to Section 17631 or Section 27701 in lieu of the reference to Section 501(a) of the Internal Revenue Code.

(c) Section 1361(e)(1)(B)(ii) of the Internal Revenue Code, relating to certain trusts not eligible, is modified by substituting "under this part" in lieu of "under this subtitle."

(d) Section 1361(e)(3) of the Internal Revenue Code, relating to election, is modified to include the following provisions:

(1) An election made by the trustee under Section 1361(e) of the Internal Revenue Code to be an electing small business trust for federal

income tax purposes shall be treated for purposes of this part as an election made by the trustee under this subdivision and a separate election under paragraph (3) of subdivision (e) of 17024.5 may not be allowed. Any election made shall apply to the taxable year of the trust for which that election is made and to all subsequent taxable years of that trust, unless revoked with the consent of the Franchise Tax Board.

(2) No election under this subdivision shall be allowed unless the trustee has made the election under Section 1361(e) of the Internal Revenue Code to be an electing small business trust for federal income tax purposes.

17103. For purposes of subdivision (b) of Section 17276, relating to limitations on loss carryovers, losses passed through to shareholders of an "S" corporation, to the extent otherwise allowable without application of that subdivision, shall be fully included in the net operating loss of that shareholder and then that subdivision shall be applied to the entire net operating loss.

17104. (a) Section 1366(a)(1) of the Internal Revenue Code, relating to determination of shareholder's tax liability, is modified to apply to the final taxable year of a trust or estate that terminates before the end of the corporation's taxable year.

(b) Section 1366(d)(1)(A) of the Internal Revenue Code, relating to losses and deductions that cannot exceed shareholder's basis in stock and debt, is modified to additionally provide that the adjusted basis of a shareholder's stock in the "S corporation" is to be decreased by distributions by the corporation that were not includable in the income of the shareholder by reason of Section 1368 of the Internal Revenue Code.

(c) Section 1366(d)(3) of the Internal Revenue Code, relating to carryover of disallowed losses and deductions to post-termination transition period, is modified to provide that to the extent that any increase in adjusted basis described in Section 1366(d)(3)(B) of the Internal Revenue Code would have increased the shareholder's amount at risk under Section 465 if the increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in Section 1366(d)(3)(A) to (C), inclusive, of the Internal Revenue Code shall apply to any losses disallowed by reason of Section 465(a) of the Internal Revenue Code.

17105. (a) Section 1366(f) of the Internal Revenue Code, relating to special rules, shall be modified as follows:

(1) The amount of tax used to compute the loss allowed by Section 1366(f)(2) shall be the amount of tax imposed on built-in gains under former Part 11 (commencing with Section 23001).

(2) The amount of tax used to compute the reduction allowed by Section 1366(f)(3) shall be the amount of tax imposed on excess net passive income under former Part 11 (commencing with Section 23001).

17106. Section 1367(b)(4) of the Internal Revenue Code, relating to adjustments in case of inherited stock, shall apply for decedents dying after December 31, 1996.

17107. (a) Section 1371(a) of the Internal Revenue Code, relating to application of Subchapter C rules, is modified to provide that, notwithstanding subdivisions (a) and (e) of Section 17024.5, any election by an "S corporation" or its shareholders under Section 338 of the Internal Revenue Code, relating to certain stock purchases treated as asset acquisitions, for federal purposes shall be treated as an election for

purposes of this part and a separate election under paragraph (3) of subdivision (e) of Section 17024.5 shall not be allowed.

(b) No election under Section 338 of the Internal Revenue Code, relating to certain stock purchases treated as asset acquisitions, shall be allowed for state purposes unless the "S corporation" or its shareholders made a valid election for federal purposes under Section 338 of the Internal Revenue Code.

(c) Section 1371(d) of the Internal Revenue Code shall not apply.

17108. Section 1372 of the Internal Revenue Code shall be modified so that references to partnership treatment shall be to Internal Revenue Code partnership provisions, as modified by this part.

17109. Sections 1373 and 1379 of the Internal Revenue Code shall not be applicable.

17110. Section 1374 of the Internal Revenue Code, relating to tax imposed on certain built-in gains, shall not apply.

17111. Section 1375 of the Internal Revenue Code, relating to tax imposed on passive investment income, shall not apply.

17112. Section 1377(b)(2) of the Internal Revenue Code, relating to determination defined, is modified to include, in addition to the items specified therein, the following:

(a) A decision by the State Board of Equalization that has become final.

(b) A closing agreement made under Article 6 (commencing with Section 19441) of Chapter 6 of Part 10.2.

(c) A final disposition by the Franchise Tax Board of a claim for refund.

17113. Any reference to Chapter 4.5 (commencing with Section 23800) of Part 11 (commencing with Section 23001) or any provision thereof shall also be a reference to this article or a provision of this article which is substantially the same as the provision referenced in Chapter 4.5 (commencing with Section 23800) of Part 11 (commencing with Section 23001).

17114. This article shall be operative for taxable years beginning on or after January 1, 2012.