February 22, 2021

Mr. John Moriarty
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Ms. Holly Porter
Associate Chief Counsel
Passthrough & Special Industries
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Re: Guidance Concerning Adjustments Attributable to Conversions from S Corporations to C Corporations under section 481(d)

Dear Mr. Moriarty and Ms. Porter:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to address the need for guidance related to new Internal Revenue Code (IRC or "Code") section 481(d)[1] under Pub. L. No. 115-97 (commonly referred to as the Tax Cuts and Jobs Act (TCJA)). The AICPA previously submitted comments[2] on August 14, 2019, requesting guidance concerning adjustments attributable to certain conversions from S corporations to C corporations. Subsequently, the IRS and Treasury issued final regulations on section 481(d) on October 20, 2019. This letter is in response to the final regulations.

The AICPA is the world's largest member association representing the accounting profession, with more than 431,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Connie Cunningham, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (310) 557-8544, or CCCunningham@bdo.com; Elizabeth Young, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

[2] https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20190814-aicpa-comment-letter-on-481d.pdf (August 14, 2019).

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. Mark Mazur, Deputy Assistant Secretary for Tax Policy, Department of the Treasury
Mr. William Paul, Acting Chief Counsel, Internal Revenue Service
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury

AMERICAN INSTITUTE OF CPAs

Guidance Concerning Adjustments Attributable to Conversions from S Corporations to C Corporations under section 481(d)

February 22, 2020

Overview

In the AICPA's previously submitted comment letter related to section 481(d), we addressed specific issues that arise when an eligible terminated S corporation is required to change from the cash method of accounting to an accrual method of accounting as a result of the S corporation's revocation of its election to be taxed under subchapter S. In such a circumstance, the ratable allocation period is extended from a four-year period to a six-year period and significant questions arose about the application of section 481(d) when an eligible terminated S corporation on the cash method of accounting owned a qualified subchapter S subsidiary ("QSub") immediately before the S corporation's revocation.

In general, a corporation that is a QSub is not treated as a separate corporation from its S corporation parent. Instead, all of the QSub's assets, liabilities, and items of income, deduction, and credit are treated as those of the S corporation. When an S corporation revokes its election to be taxed under subchapter S, the QSub is treated as a new corporation that acquired all of its assets and assumed all of its liabilities from the S corporation in exchange for newly issued stock of the former QSub at the close of the last day of the parent corporation's last taxable year as an S corporation.[3] The entity is a newly formed C corporation in a deemed section 351 exchange; therefore, the former QSub must adopt new accounting methods. As a result, it is unclear whether and how section 481(d) should apply in this situation when the former QSub (now a C corporation for federal income tax purposes) must use an accrual method of accounting.

In the preamble to the final regulations, Treasury and the IRS addressed the issue and indicated that they did not have the authority to adopt commenters' recommendations that would allow former QSubs to use a six-year ratable allocation period under section 481(d) in computing their taxable income. Subsequently, taxpayers have continued to struggle with addressing this problem in filing their tax returns. In addition, taxpayers that previously revoked their election to be taxed under subchapter S under the TCJA prior to the issuance of the final regulations may have incorrectly accounted for the effects of such revocation on their QSub. These taxpayers may have applied the six-year period provided in section 481(d) to the adoption of the accrual method by the QSub which is not permitted under the final regulations.

Recommendations

The AICPA recommends that Treasury and the IRS permit affected taxpayers to correct the tax treatment of the adoption of the accrual method of accounting by a QSub affected by an S corporation election revocation allowed under the TCJA.

[3] Section 1361(b)(3)(C); Treas. Reg. § 1.1361-5(a)(1)(ii).

Specifically, the AICPA recommends allowing an affected QSub to make the correction on the 2020 tax return by including a statement with the adjustment to taxable income equal to the unamortized balance of the prior adjustment amortized erroneously under section 481(d). The correcting adjustment would be included in its entirety in the taxpayer's taxable income for the 2020 taxable year.

Analysis

There are a number of taxpayers (we estimate between 100 and 200) that accounted for the revocation of their S corporation election in their tax returns by claiming a six-year spread of a section 481(a) adjustment under section 481(d) based on the assumption that the newly-formed C corporation (previously a QSub) adopting the accrual method of accounting had changed its method of accounting from cash to accrual and was eligible to take a section 481(a) adjustment. Due to the fact that the regulations addressing this issue for the first time were not published until late 2020, a significant number of taxpayers had already filed their 2018 and 2019 federal income tax returns by including one-sixth of a section 481(a) adjustment in taxable income for each of those two taxable years, when instead those taxpayers should have reported the entire effect of adopting the accrual method of accounting in their federal income tax returns for their 2018 taxable year.

Requiring a significant number of small and mid-sized companies to file amended tax returns for two taxable years, together with numerous amended state income tax returns in many instances, imposes a significant administrative burden on those companies. Additional administrative burden would also impact the IRS, which is already experiencing an increased volume of amended returns for 2018 and 2019 taxable years due to the retroactive tax law changes contained in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act).[4] Therefore, the AICPA encourages Treasury and the IRS to allow affected taxpayers to take timely action in order to prepare their 2020 tax returns consistent with the approach described above. This approach would also assist fiscal-year taxpayers that need to request an extension of time to file their tax returns in order to implement the suggested solution.

[4] Pub. L. No. 116-136 (2020).