Fiscal year retention practice aid

American Institute of Certified Public Accountants. Tax Division
December 23, 1987

To All AICPA Practice Units:

As you have heard, the AICPA was successful in its effort to retain fiscal years for partnerships, S corporations, and personal service corporations. The legislation provides an elective alternative to the calendar year requirement of the '86 Act, with its four-year spread of the additional income from the short period. Enclosed is the AICPA Tax Division's practice aid which explains and provides worksheets for the fiscal year provisions of the '87 Act.

We hope this will be helpful in your practice. Herb Lerner and I join Messrs. Strait and Chenok in thanking all who have assisted in this important project.

Sincerely,

Donald H. Skadden
Vice President - Taxation

Enclosure
AICPA TAX DIVISION
FISCAL YEAR RETENTION PRACTICE AID

INTRODUCTION

The deficit reduction act was passed by Congress on December 22, 1987. It added three new sections to the Internal Revenue Code of 1986 related to the retention or adoption of fiscal years by partnerships, S corporations, and personal service corporations (PSC) which otherwise would have been required by the Tax Reform Act of 1986 to adopt the calendar year for tax purposes.

New Section 444 allows continuing entities to elect to retain their previous fiscal years, and allows new entities to adopt fiscal years ending no earlier than September 30.

New Section 7519 provides for a required payment for partnerships and S corporations which elect or retain fiscal years. This payment approximates the tax the owners would have paid on the short period income had the entity switched to the calendar year. The payment is credited or returned to the entity the following year near the time that the owners are paying their tax on that deferred income.

New Section 280H provides that PSCs which disproportionately postpone payments to employee-owners until after December 31 must postpone some or all of the corresponding deduction until the following fiscal year.

This provision is effective for taxable years beginning after December 31, 1986. Section 444 elections to retain or adopt a fiscal year are required to be made by the 90th day after the date of enactment of the Act -- by March 21, 1988.

The following is preliminary guidance on our understanding of how this relief provision will work. This material is subject to change as Internal Revenue rules and regulations are implemented.
PART ONE

PARTNERSHIPS AND S CORPORATIONS

Under the legislation, a partnership or S corporation, which is otherwise required to adopt the calendar year, could elect to retain its fiscal tax year. This optional election would be made at the entity level, not by the individual partners or owners. Electing partnerships and S corporations would be subject to a "required payment" due in a single installment each April 15th (or such later date as may be prescribed by the Secretary of the Treasury).

The required payment would be determined with reference to an estimated amount of tax deferral which results from the use of a fiscal year. The payment would be calculated at a "tax rate" of 36-percent for base years ending in 1987 and at the highest individual marginal rate plus one percent, presumably 28 plus 1 percent, in the following years. There is a four-year phase-in of the required payment amount which corresponds to the four-year income spread contained in TRA '86.

In general, partnerships and S corporations would be paying approximately the same amount in "required payments" as their owners would have paid in actual tax payments for the short period had the entity changed to the calendar tax year. Electing entities with required payment amounts of $500 or less in the first year would be exempt from the payment requirement.

C corporations which elected S corporation status after September 18, 1986 and before January 1, 1988, and as a result elected the calendar year, can elect to adopt a fiscal year where the deferral period is the lesser of three months or the deferral period under the C corporation's previous fiscal year.

An entity which is part of a tiered structure may not elect to retain or adopt a fiscal year, except for a tiered structure comprised of one or more partnerships or S corporations all of which have the same taxable year.

Payments required as a result of a Section 444 election will be assessed and collected in the same manner as if they were a tax imposed by Subtitle C of the Internal Revenue Code (such as withholding and other employment taxes).

It is important to remember that those partnerships and S corporations allowed a fiscal year based on the established business purpose tests (including the 25% of revenue test reflected in Revenue Procedure 87-32 and Revenue Ruling 87-57) are not affected by this legislation.
DEFINITIONS

For purposes of this provision, the following definitions apply:

Net income: In the case of a partnership, the net income is the aggregate amount of the partnership items described in Section 702(a), other than credits. In the case of an S corporation, the net income is the aggregate amount of the S corporation items described in Section 1366(a), other than credits.

Applicable election year: Any taxable year of a partnership or S corporation for which an election is in effect under this section (Section 444).

Base year: The taxable year of a partnership or S corporation preceding the applicable election year.

Deferral period: The period, or number of months, between the beginning of the fiscal year and the following December 31.

Deferral ratio: The number of months in the deferral period divided by 12. For example:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Deferral Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30</td>
<td>6/12</td>
</tr>
<tr>
<td>August 31</td>
<td>4/12</td>
</tr>
<tr>
<td>September 30</td>
<td>3/12</td>
</tr>
</tbody>
</table>

Applicable payments: Amounts paid or incurred by a partnership or S corporation which are included in the gross income of a partner or shareholder. These payments do not include any gain from the sale or exchange of property between the owner and the entity, or dividends paid by the S corporation.
ILLUSTRATION A

Calculation of Partnership's and S Corporation's Required Payments

Partnerships and S corporations electing to retain their fiscal years would be required to make payments determined with reference to the amount of tax deferral resulting from the use of the fiscal year.

The required payment for an electing partnership or S corporation is made up of two components, the "deferred base year net income" component and the "applicable payment" component. In many cases, the electing partnership or S corporation will only have the deferred base year net income component.

The following is the formula for calculating required payments for the deferred base year net income for electing partnerships and S corporations which do not make applicable payments (salary, rent, or other such payments) to owners.

\[ \left( \frac{Y}{Z} \right) \cdot \left( \frac{R}{S} \right) - D \]

- \( Y \): Entity's net income from the preceding fiscal year (base year)
- \( X \): Number of months in the deferral period
- \( Z \): Number of months in the base year (generally 12 months)
- \( R \): Statutory rate (36% for base years ending in 1987, 29% in later years)
- \( S \): .25 for fiscal years beginning in 1987, .50 for fiscal years beginning in 1988, .75 for fiscal years beginning in 1989, 1.00 in all other years
- \( D \): Cumulative balance of previous required payments

If an entity does not make the required payment due to reasonable cause (not due to willful neglect) the entity will be subject to a penalty of 10% of the amount of the underpayment. An entity's failure to make the required payment, assuming reasonable cause, will not jeopardize the entity's election to retain its fiscal year. However, willful failure to meet the payment requirement will negate the Section 444 election and negligence and fraud penalties would be applied in appropriate cases.
EXAMPLE A: PARTNERSHIP OR S CORPORATION
WITHOUT APPLICABLE PAYMENTS TO OWNERS

Partnership/S-Corporation assumptions:

Partnership/S-Corporation is on August 31 fiscal year

Partnership/S-Corporation net income:
Year ended 8/31/87 $120,000
8/31/88 $144,000

Partnership/S-Corporation Calculations of Required Payment Where There are No Applicable Payments:

\[(Y)(X/Z)(R)(S)\]

<table>
<thead>
<tr>
<th>Year</th>
<th>8/31/87</th>
<th>8/31/88</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base year net income (Y)</td>
<td>$120,000</td>
<td>$144,000</td>
</tr>
<tr>
<td>Four-month deferral (X/Z)</td>
<td>4/12</td>
<td>4/12</td>
</tr>
<tr>
<td>Deferred base year net income</td>
<td>40,000</td>
<td>48,000</td>
</tr>
<tr>
<td>Rate for required payment (R)</td>
<td>36%</td>
<td>29%</td>
</tr>
<tr>
<td></td>
<td>14,400</td>
<td>13,920</td>
</tr>
<tr>
<td>Four-year spread (S)</td>
<td>25%</td>
<td>50%</td>
</tr>
<tr>
<td>Total Required Payment by Entity</td>
<td>$3,600</td>
<td>$6,960</td>
</tr>
</tbody>
</table>

Net Required Payment at Each April 15*:

<table>
<thead>
<tr>
<th>Year</th>
<th>1988</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 15, 1988</td>
<td>$3,600</td>
<td></td>
</tr>
<tr>
<td>April 15, 1989</td>
<td>$6,960</td>
<td></td>
</tr>
<tr>
<td>Total Required Payment</td>
<td>$3,600</td>
<td></td>
</tr>
<tr>
<td>Less: Previous Payment Balance</td>
<td>$3,360</td>
<td></td>
</tr>
</tbody>
</table>

*Or such later date as may be prescribed by the Secretary of the Treasury.
ILLUSTRATION B

Calculation of Partnership’s and S Corporation’s Required Payments with Applicable Payments

As previously mentioned, the required payments for electing partnerships and S corporations is the sum of two components, the deferred base year net income component described in the previous illustration and the applicable payment component. "Applicable payments" are amounts paid or incurred by the entity which are includible in the gross income of the owner. Such payments do not include taxable dividends and gain from the sale or exchange of property between the owner and the entity.

The applicable payment amount is the excess of the pro rata amount that would have been paid prior to December 31, based on the preceding year (base year), over the aggregate actual payments made prior to December 31 in the preceding year (base year). This amount is calculated as follows:

\[ \frac{((P)(X/Z) - (A))(R)(S)}{P = \text{total applicable payments made to the owners during the preceding fiscal year (base year)}} \]
\[ X = \text{number of months in deferral period} \]
\[ Z = \text{number of months in fiscal year (base year) (generally 12 months)} \]
\[ A = \text{actual applicable payments made to the owners during the portion of the entity’s preceding fiscal year (base year) on or before December 31} \]
\[ R = \text{statutory rate (36% for base years ending in 1987, 29% in later years)} \]
\[ S = .25 \text{ for fiscal years beginning in 1987} \]
\[ = .50 \text{ for fiscal years beginning in 1988} \]
\[ = .75 \text{ for fiscal years beginning in 1989} \]
\[ = 1.00 \text{ in all other years} \]

Combined Formula

The combined formula for partnerships and S corporations with both a deferred base year net income component (as described in illustration A) and an applicable payment component (as described above) would be as follows:

\[ (((Y)(X/Z)) + ((P)(X/Z) - (A)))(R)(S) \]

This amount would be reduced by the cumulative balance of previous required payments.
EXAMPLE B: PARTNERSHIP OR S CORPORATION
WITH APPLICABLE PAYMENTS TO OWNERS

Assumptions

August 31 fiscal year

Base year net income (year ended 8/31/87)
after deducting applicable payments: $150,000

Applicable payments (year ended 8/31/87)
o $60,000 salary paid to owner A in
12 equal $5,000 monthly payments

o $60,000 rent paid to owner B in
4 equal $15,000 payments in October,
January, April, and July.

REQUIRED PAYMENT CALCULATION:

\[
\left( \frac{Y}{X} \right) \left( \frac{X}{Z} \right) + \left( \frac{P}{X} \right) \left( \frac{X}{Z} \right) - A \right) \left( R \right) \left( S \right)
\]

Deferred base year net income component calculation:

Base year net income (Y) $150,000
Deferral ratio (X/12) 4/12
Deferred base year net income component $ 50,000

Applicable payments component calculation:

Total Applicable Payments (P) $120,000
Deferral ratio (X/12) 4/12
40,000

Less: Actual applicable payments during
base year deferral period (A)
$5,000 * 4 months $20,000
quarterly rent $15,000
35,000

Applicable payment component $ 5,000

Required payment calculation:

Deferred base year net income component $ 50,000
Applicable payment component 5,000
55,000
Rate for required payments (R) 36%
19,800
Four-year spread (S) 25%
Required payment by entity on 4/15/88* $ 4,950

*Or such later date as may be prescribed by the Secretary.
Fiscal Year Retention Worksheet
(Partnership or S Corporation)

Entity Name

Fiscal Year Elected

CALCULATION OF REQUIRED PAYMENT:

STEP ONE: Deferred Base Year Net Income
Entity’s Preceding Fiscal Year Net Income (Base Year) __________
Multiplied by: Deferral Ratio (# months in deferral period divided by 12) x__________
Total Deferred Base Year Net Income = ________

STEP TWO: Applicable Payments (If No Applicable Payments Enter Zero and Proceed to Step Three)
Total Applicable Payments from Preceding Fiscal Year __________
Multiplied by: Deferral Ratio x__________
Less: Actual Applicable Payments from Preceding Fiscal Year Deferral Period (prior to 12/31 of base year) - __________
Applicable Payment Amount = __________

STEP THREE: Calculation of Required Payment
Deferred Base Year Net Income - Step One + __________
Multiplied by: Rate for Required Payment (36% for base years ending in 1987, 29% in later years) x__________
Required Payment of Entity by 4/15* = __________
Multiplied by: Four-Year Spread (25% for base years ending in 1987, 50% in 88, 75% in 89, 100% later) x__________

*Or such later date as prescribed by the Secretary of the Treasury.
PART TWO

PERSONAL SERVICE CORPORATIONS

General Explanation of Fiscal Year End Retention Alternatives for Personal Service Corporations

A PSC, which otherwise would be required to change to a calendar year, may now elect to retain its fiscal year. This election must be made at the corporate level.

Limitations on Deduction for Payments Made to Employee-Owner

If payments to employee-owners are less than the "minimum distribution amount", the electing PSC may still retain its fiscal year but must postpone some or all of the deduction for these payments until the following fiscal year. The minimum distribution amount is intended to measure whether the payments to the employee-owners were made ratably throughout the year, rather than deferred until after the close of the employee-owners' calendar year. An employee-owner under Section 269A(b)(2), as modified by 441(i)(2), is an employee who owns any stock in the corporation, either directly or by attribution.

Determination of Minimum Distribution Amount

The minimum distribution amount is the lesser of A and B below, one based on the prior years payments and one based on current year’s income and payments.

A) Prior year’s payments

All payments treated as gross income to the employee-owner in the prior fiscal year (other than taxable dividends and gain from the sale or exchange of property), divided by twelve, and multiplied by the number of months in the PSC’s fiscal year before December 31.

B) Historical payout compared with current earnings

A historical payout percentage (explained below) multiplied by the corporation’s taxable income (before subtracting payments made to the employee-owners) from the beginning of the fiscal year to the end of the calendar year.

The historical payout percentage is equal to the total payments to employee-owners in the preceding three taxable years, divided by the total earnings of the corporation for those three years (before subtracting the payments made to the employee-owners). This percentage may not exceed 95 percent for purposes of this test.
Calculation of the PSC's postponed deduction

A PSC which elects to retain its fiscal year but does not meet the minimum distribution requirement may only deduct for that fiscal year those amounts paid to employee-owners prior to December 31, annualized to a 12 month period. This is computed by multiplying the amounts paid between the beginning of the election year and December 31 by 12, and then dividing that amount by the number of months between the end of the fiscal year and December 31. Any payment of salary or bonus that is determined to be nondeductible in the current year may be carried forward and deducted in the subsequent fiscal year of the PSC.

Disallowance of Net Operating Loss Carrybacks

No net operating loss carryback is allowed to (or from) any election year of the PSC.

Definition of Personal Service Corporation

The regulations defining a "personal service corporation" for purposes of year end conformity (section 441) have recently been issued (scheduled for publication in the Federal Register of Dec. 23, 1987). In summary, these temporary regulations include as PSCs those corporations whose principal activity is the performance of activities listed in section 448 (d)(2)(A). These listed professions are: health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts or consulting. "Principal activity" occurs when more than 50 percent of the corporation's annual compensation cost is attributable to its personal service activities.

In addition, the services must be substantially performed by employee-owners. This substantial performance is realized when more than 20 percent of the corporation's compensation cost with respect to personal services is attributable to the employee-owners. Finally, the definition only includes those entities in which more than ten percent of the stock is held by employee-owners.

The above paragraphs provide a brief summary of the temporary regulation. The text of this regulation should be examined to determine the exact application to entities in question.
PERSONAL SERVICE CORPORATIONS
EXAMPLE OF FISCAL YEAR RETENTION PROVISIONS

Assumptions:

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PSC is on a January 31 fiscal year

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Adjusted Taxable Income</th>
<th>Salaries to employee-owners</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Example I</td>
<td>Example II</td>
</tr>
<tr>
<td>1/31/85</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>1/31/86</td>
<td>130,000</td>
<td>110,000</td>
</tr>
<tr>
<td>1/31/87</td>
<td>150,000</td>
<td>132,000</td>
</tr>
<tr>
<td></td>
<td>$380,000</td>
<td>$342,000</td>
</tr>
</tbody>
</table>

1/31/88:
Feb-Dec ’87 $140,000 $125,000 $88,000
Jan 1988    28,000     13,000  50,000

$168,000   $138,000  $138,000

Test to determine if deductions will be limited:

---

Payments made to employee-owners between beginning of fiscal year and December 31

The minimum distribution amount as calculated below equals

Based on the above the test is:

Therefore, deductions will be limited in Example II.

Determination of minimum distribution amount:

Factor A: ($132,000 / 12) multiplied by 11 = $121,000

Factor B: ($342,000 / $380,000) multiplied by $140,000 = $126,000

The lower of factors A and B is used in the above comparison with salaries paid before 12/31. Consequently, the minimum distribution amount is $121,000 (Factor A).
Calculation of Deduction Limitation in Example II:

Amount paid before Dec. 31 $88,000

multiplied by total months in year x 12

divided by months between Feb. 1 and Dec. 31 / 11

Deduction allowed year-end 1/31/88 $96,000

The remaining $42,000 ($138,000 - $96,000) is carried over to the

following year, and may be deducted then.
## PERSONAL SERVICE CORPORATION  
### FISCAL YEAR RETENTION WORKSHEET

<table>
<thead>
<tr>
<th>Name of Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Year Elected</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year End</th>
<th>Adjusted Taxable Income (a)</th>
<th>Payments to Employee-Owners (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td><em><strong>/</strong></em>/85</td>
<td>$____________</td>
<td>$___________(1)</td>
</tr>
<tr>
<td><em><strong>/</strong></em>/86</td>
<td>$___________(2)</td>
<td>$___________(3)</td>
</tr>
<tr>
<td><em><strong>/</strong></em>/87</td>
<td>$___________(4)</td>
<td>$___________(5)</td>
</tr>
<tr>
<td>Total 1985 - 1987</td>
<td>$____________(2)</td>
<td>$____________(3)</td>
</tr>
</tbody>
</table>

Breakdown before and after 12/31:

| __/___/87 - 12/31/87 | $___________(4) | $___________(5) |
| 12/31/87 - __/___/88 | $___________ | $___________ |
| Total fiscal yr. 1988 | $____________(2) | $____________(3) |

Number of months between beg. of fiscal year and 12/31 ___(7)

Test to determine if deductions will be limited:

Factor A $___________ / 12 x ___ = $___________

Factor B $___________ / $___________ x $___________ = $___________

I) Lesser of (8) and (9) = $___________ (minimum distrib. amount)

II) Payments from beg. of fiscal year to 12/31 $___________

If (II) is greater than (I) there is no limitation on the corporation's deduction.

If (I) is greater than (II) proceed to the subsequent page to determine deduction limitations.

(a) Income per the tax return without any deduction for applicable payments, including salaries and bonuses.
(b) Does not include any gain from the sale or exchange of property between the employee-owner and the corporation, or any dividend from the corporation.
PERSONAL SERVICE CORPORATION
FISCAL YEAR RETENTION WORKSHEET

Calculation of Deduction Limitation

Amount paid before 12/31

$ \begin{array}{c}
\text{(5)}
\end{array}$

Multiplied by total months in year

$ \times 12$

Divided by months between beg. of fiscal
year and 12/31

$ \begin{array}{c}
\text{(7)}
\end{array}$

Deduction allowed for fiscal year = $ \begin{array}{c}
\text{(10)}
\end{array}$

Calculation of Carryforward Deduction to Subsequent Year

Total payments for fiscal year

$ \begin{array}{c}
\text{(6)}
\end{array}$

Less: deduction allowed

$ \begin{array}{c}
\text{(10)}
\end{array}$

Carryforward to subsequent year = $ \begin{array}{c}
\text{(10)}
\end{array}$

Note: If a net operating loss arises in the succeeding year, for
whatever reason, the NOL may only be carried forward.