1-1-1988

Fiscal year retention practice aid

American Institute of Certified Public Accountants. Tax Division

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NOTE: The following is preliminary guidance on our understanding of how this relief provision will work. This document includes early guidance contained in Internal Revenue Service Notice 88-10 released on January 15, 1988, and supercedes all earlier information on this topic. This material is subject to change as Internal Revenue rules and regulations are implemented.

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 to the entity the following year when the entity is calculating the new required payment and 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. IRS Notice 88-10, issued today, specifies that the Section 444 election must be filed by the later of April 30, 1988 or 60 days after temporary regulations are published in the Federal Register. The first required payment will be due no earlier than the election date. A draft of the election form is shown on the last page of this document. Taxpayers should not attempt to make a Section 444 election until after the temporary regulations are issued.

In Notice 88-10, the IRS extended the original due date for filing an income tax return that results from making a Section 444 election for the first taxable year beginning after December 31, 1986. The due date will be the later of (i) the original due date, or (ii) the due date of the Section 444 election. In some cases, partnerships, S corporations, and PSCs will not know whether they qualify or desire to file a Section 444 election until after the temporary regulations are issued. For returns that must be filed if a Section 444 election is not made, the due date is also extended to the later of (i) the original due date, or (ii) the due date of the Section 444 election.
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, see discussion of election date on page 1).

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.

Many C corporations have switched to S corporation status since the TRA '86 became law on September 18, 1986. These must be considered in two groups. For those that made the change in 1986 and filed short period returns as of December 31, 1986, the situation is clear: they may now elect a fiscal year, but it must close no earlier than September 30. However, there has been some confusion for those C corps making S elections after September 18, 1986 for taxable years beginning in 1987. In Notice 88-10, the IRS clarified the issue by stating that these new S corporations may retain the C corporation's fiscal year regardless of the number of months in the deferral period. As an alternative, the new S corporation may elect a fiscal year that results in a deferral period shorter than the old C 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. Forthcoming temporary regulations will address the meaning of the term "tiered structure" and will provide that the initial determination of whether an entity is part of a tiered structure will be made as of the day that the entity makes a Section 444 election.
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). An electing entity is entitled to a refund of the required payment if (i) the entity terminates its Section 444 election, or (ii) the entity liquidates. The entity is also entitled to a refund if the amount required for the current payment is less than the accumulative required payment for the preceding years.

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. They need not file a Section 444 election nor make required payments under Section 7519.

**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.

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

- \( Y \) = 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:

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

\[
\begin{array}{ccc}
\text{8/31/87} & \text{8/31/88} \\
\text{Base year net income (Y)} & $120,000 & $144,000 \\
\text{Four-month deferral (X/Z)} & $4/12 & $4/12 \\
\text{Deferred base year net income} & 40,000 & 48,000 \\
\text{Rate for required payment (R)} & 36\% & 29\% \\
\text{Total Required Payment by Entity} & 14,400 & 13,920 \\
\end{array}
\]

\[
\begin{array}{ccc}
\text{8/31/87} & \text{8/31/88} \\
\text{Four-year spread (S)} & 25\% & 50\% \\
\text{Total Required Payment by Entity} & \$3,600 & \$6,960 \\
\end{array}
\]

Net Required Payment at Each April 15*:

\[
\begin{array}{ccc}
\text{1988} & \text{1989} \\
\text{April 15, 1988} & \$3,600 \\
\text{April 15, 1989} & \$6,960 \\
\text{Total Required Payment} & \$3,600 \\
\text{Less: Previous Payment Balance} & \$3,360 \\
\end{array}
\]

*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:

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

- \( P \) = total applicable payments made to the owners during the preceding fiscal year (base year)
- \( X \) = number of months in deferral period
- \( Z \) = number of months in fiscal year (base year) (generally 12 months)
- \( A \) = actual applicable payments taxable to the owners during the portion of the entity's preceding fiscal year (base year) on or before December 31
- \( R \) = statutory rate (36% for base years ending in 1987, 29% in 1988 and 1% above the top individual tax rate thereafter)
- \( S \) = .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

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: S CORPORATION
WITH APPLICABLE PAYMENTS TO SHAREHOLDERS

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:

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

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

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

Rate for required payments (R) 36%

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) __________ 
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 __________ 
Less: Actual Applicable Payments from Preceding Fiscal Year Deferral Period (prior to 12/31 of base year) __________
Applicable Payment Amount (not less than zero) = __________

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

*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 "aggregate taxable income" (net income before subtracting payments to employee-owners) for those three years. 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:
---
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>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>1/31/88:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feb-Dec '87</td>
<td>$140,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>Jan 1988</td>
<td>28,000</td>
<td>13,000</td>
</tr>
</tbody>
</table>

$380,000 $342,000 $342,000

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:

<table>
<thead>
<tr>
<th>Example I</th>
<th>Example II</th>
</tr>
</thead>
<tbody>
<tr>
<td>$125,000</td>
<td>$88,000</td>
</tr>
<tr>
<td>$121,000</td>
<td>$121,000</td>
</tr>
</tbody>
</table>

Met Not met

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 \( \times 12 \)

divided by months between Feb. 1 and Dec. 31 \( \div 11 \)

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

Name of Corporation

Fiscal Year Elected

<table>
<thead>
<tr>
<th>Year End</th>
<th>Adjusted</th>
<th>Payments to</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/85</td>
<td>$________</td>
<td>$________</td>
</tr>
<tr>
<td>1/1/86</td>
<td>$________</td>
<td>$________</td>
</tr>
<tr>
<td>1/1/87</td>
<td>$________</td>
<td>$________</td>
</tr>
</tbody>
</table>

Total 1985 - 1987 $________ (2) $________ (3)

Breakdown before and after 12/31:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted</th>
<th>Payments to</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/87 - 12/31/87</td>
<td>$________ (4)</td>
<td>$________ (5)</td>
</tr>
<tr>
<td>12/31/87 - 1/1/88</td>
<td>$________</td>
<td>$________</td>
</tr>
</tbody>
</table>

Total fiscal yr. 1988 $________ (6)

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

Test to determine if deductions will be limited:

Factor A $________ / 12 x _____ = $________ (1) (7) (8)

Factor B $________ / $________ x $________ = $________ (3) (2) (4) (9)

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

II) Payments from beg. of fiscal year to 12/31 $________ (5)

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

\[ \text{Amount paid before 12/31} \times \frac{x \text{12}}{\text{months between beg. of fiscal year and 12/31}} \]

\[ \text{Deduction allowed for fiscal year} = \] 

Calculation of Carryforward Deduction to Subsequent Year

Total payments for fiscal year

\[ \text{Total payments for fiscal year} - \text{deduction allowed} \]

\[ \text{Carryforward to subsequent year} = \]

Note: If a net operating loss arises in a succeeding election year, for whatever reason, the NOL may only be carried forward.
TAXATION, BUDGET AND ACCOUNTING TEXT

INTERNAL REVENUE SERVICE'S ADVANCE NOTICE 88-10,
ON ELECTION OF TAXABLE YEARS BY CERTAIN PARTNERSHIPS,
S CORPORATIONS, AND PERSONAL SERVICE CORPORATIONS,
RELEASED JAN. 15, 1988
(TEXT)

(Note: Notice 88-10 is scheduled to be published in Internal Revenue Bulletin 1988-5, dated Feb. 1, 1988.)

Election of Taxable Years by Certain Partnerships,
S Corporations and Personal Service Corporations

Notice 88-10

The Internal Revenue Service has received many inquiries regarding section 10206 of the Omnibus Budget Reconciliation Act of 1987. That section allows certain partnerships, S corporations, and personal service corporations to elect the use of a particular taxable year for Federal income tax purposes. The purpose of this notice is to provide guidance with respect to certain issues that are of immediate concern to taxpayers.

I. Background

Sections 441(i), 706(b), and 1378 of the Internal Revenue Code (the "Code"), as amended by section 806 of the Tax Reform Act of 1986 (Pub. L. 99-514) (the "1986 Act") generally requires personal service corporations, partnerships, and S corporations, respectively, to conform their taxable years to the taxable years of their owners. These sections are effective for taxable years beginning after December 31, 1986.

New section 444 of the Code, as added by section 10206 of the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100-203) (the "1987 Act") enacted into law on December 22, 1987, allows certain partnerships, S corporations and personal service corporations to elect the use of a taxable year that is different from the taxable year that such entities would otherwise be required to use under section 806 of the 1986 Act (the "required taxable year"). Section 444 is effective for taxable years beginning after December 31, 1986.

Under the 1987 Act, partnerships and S corporations may elect the use of a taxable year that is different from their required taxable year if those partnerships and S corporations follow the procedures established under sections 444 and 7519 of the Code. Under those procedures, electing partnerships and S corporations are required to make payments ("required payments") to the Federal government that are intended to represent the value of the tax deferral obtained by the owners of those entities through the use of a taxable year different from the required taxable year.

Similarly, under the 1987 Act, personal service corporations may elect the use of a taxable year that is different from their required taxable year if those corporations follow the procedures established under sections 444 and 280H of the Code. Under those procedures, electing personal service corporations failing to distribute certain amounts to employee-owners by December 31 of any taxable year may be required to defer certain deductions for amounts paid to employee-owners.

II. Application of Elective Procedures in General

The Service has received many questions concerning the effect of section 10206 of the 1987 Act on taxable years for which the taxpayer has established a business purpose to the satisfaction of the Secretary of the Treasury.

Forthcoming temporary regulations will provide that partnerships, S corporations and personal service corporations which have a taxable year for which such entity establishes a business purpose to the satisfaction of the Secretary of the Treasury, as provided under law, are not required to use a section 444 election and are not required to make payments under section 7519(b) of the Code in order to use such taxable year. Thus, for example, a partnership which has a taxable year for which it has established a business purpose to the satisfaction of the Secretary, as provided under section 706(b)(1)(C) of the Code, may use such year.

III. Due Dates For Election to Use Taxable Year
and Required Payment

Section 10206(d)(3) of the 1987 Act provides that any election made under section 444 of the Code (a "section 444 election") shall not be required to be made before the 90th day after the enactment of the 1987 Act (i.e., March 21, 1988). Furthermore, section 7519(f)(2) of the Code requires that any required payment made by a partnership or S corporation making a section 444 election for its first taxable year beginning in 1987 shall be made on or before April 15, 1988 (or such later date as may be prescribed by the Secretary).

Under forthcoming temporary regulations, a section 444 election shall not be required to be made before the later of (i) April 30, 1988, or (ii) 60 days after publication of those temporary regulations in the Federal Register. Guidance will be provided in the temporary regulations regarding the procedures for making a section 444 election, including the filing of a new election form which is expected to be available by March 1988. Prior to the publication of those regulations, taxpayers should not attempt to make section 444 elections.

In addition, the forthcoming temporary regulations will (i) describe the procedures for making payments, including the filing of any supporting calculations and tax return, and (ii) provide general guidance with respect to section 10206 of the 1987 Act. Under those regulations, required payments for the first election year will be due no earlier than the due date of the section 444 election.

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IV. Period During Which a Taxable Year May Be Retained Under Section 444(b)(3)

Section 444(b)(3) of the Code provides that "[i]n the case of an entity's first taxable year beginning after December 31, 1986, an entity may elect a taxable year under subsection (a) which is the same as the entity's last taxable year beginning in 1986." Several taxpayers have interpreted this language, in conjunction with section 444(a), as only allowing an entity to retain its taxable year for its first taxable year beginning after December 31, 1986, but then requiring the entity to change to a taxable year with a deferral period of no more than three months for the entity's taxable year beginning after December 31, 1987.

Forthcoming temporary regulations will provide that an entity electing a taxable year under section 444(b)(3) of the Code may continue the use of that taxable year (if otherwise allowed under section 444 and any other provision of law) for all subsequent taxable years.

V. Definition of Employee-Owner and Personal Service Corporation

Section 280H(f)(2) of the Code defines the term "employee-owner" as the meaning given to such term by "section 280A(b)(2)" (hereinafter referred to as "the old section 280A(b)(2)"). Pending the enactment of clarifying legislation, the Service will treat the term "employee-owner" as having the meaning given such term in section 280A(b)(2), as modified by section 441(i)(2) of the Code.

Moreover, the forthcoming temporary regulations will define the term "personal service corporation" in sections 444 and 280H of the Code to be a personal service corporation as defined in section 441(i)(2) and the regulations thereunder.

VI. Corporations Electing S Status

A. Corporations Electing S Status for a Taxable Year Beginning in 1987

The Service has received many questions concerning corporations that elected S status after September 18, 1986 and before January 1, 1988 for their taxable year beginning in 1987. Specifically, taxpayers are uncertain whether such corporations may elect, pursuant to section 444(b)(3) of the Code, a taxable year which is the same as the corporation's last taxable year beginning in 1986. The uncertainty results because the Conference Report to the 1987 Act can be read to conclude that such corporations are limited to a taxable year that results in no more than a three-month deferral period.

Based upon the express language of section 444(b)(3) of the Code, forthcoming temporary regulations will provide that section 444(b)(3) applies to a corporation electing S status for its taxable year beginning in 1987. Thus, for example, assume that a C corporation with a taxable year ending June 30, 1987, properly elects to be an S corporation for its taxable year beginning July 1, 1987. Under section 444(b)(3), that corporation may elect to retain its taxable year ending June 30 for its taxable year beginning in 1987, assuming that such election is otherwise allowed under section 444 and any other provision of law. This conclusion will result notwithstanding the fact that such corporation may have agreed to change its taxable year to a calendar year as a condition of making its S election with the Service.

VIII. Calculation of Required Payment

Section 7519(b) of the Code defines the amount of payment required of a partnership or S corporation making a section 444 election. Under section 7519(b), the required payment with respect to an applicable election year is an amount equal to the excess of a product specified in section 7519(b)(1) over "the amount of the required payment for the preceding applicable election year" specified in section 7519(b)(2).

Forthcoming temporary regulations will define the required payment with respect to an applicable election year as the amount equal to the excess of (a) the product specified in section 7519(b)(1) for such year over (b) the cumulative...
amount of required payments for all preceding applicable election years (reduced by the cumulative amount of payments refunded under section 7519(b) for all such preceding years). Such an interpretation is necessary in order to effectuate the intent of Congress regarding this provision. Absent this clarifying interpretation, the amount of required payments made by electing partnerships and S corporations under section 7519(b) could be significantly greater than the amount of such payments contemplated by Congress as representing the value of the tax deferrals obtained by those entities through the use of a taxable year that is different from their required taxable year.

IX. Refund of Required Payments

Section 7519(c) of the Code effectively provides that any partnership or S corporation is entitled to a refund of the required payment if the amount of the required payment for the preceding applicable election year as specified in section 7519(b)(2) exceeds the amount of a product specified in section 7519(b)(1). (See section VIII of this notice regarding the determination of the amount of the required payment for the preceding applicable election year as specified in section 7519(b)(2)).

Forthcoming temporary regulations will provide that an entity is entitled to a refund of the required payment if (i) the entity terminates its section 444 election; or (ii) the entity liquidates. In addition, a continuing entity that maintains its section 444 election is also entitled to a refund for any applicable election year if the required payment for such year is less than the required payment for the preceding year, as specified in section 7519(b)(2) of the Code (see section VIII of this notice).

X. Treatment of Required Payment

Partnerships and S corporations making a section 444 election are required to make payments to the Federal government under section 7519(b) of the Code. These required payments are not deductible by the partnership or S corporation (or by any other person) for Federal income tax purposes. Rather, these required payments are in the nature of refundable deposits, which do not earn interest. Furthermore, the payments are not passed through to partners or S shareholders. Thus, for example, the required payments made by a partnership are not creditable against the Federal income tax liabilities of partners for any taxable year.

XI. Late Filing of Returns Resulting from a Section 444 Election

A. Returns Resulting from Section 444 Election

Forthcoming temporary regulations will extend the original due date for filing an income tax return that results from making a section 444 election for the first taxable year beginning after December 31, 1986. The due date will be the later of (i) the original due date, or (ii) the due date of the section 444 election. For example, assume a corporation that elected S status for a taxable year beginning in 1986 and ending December 31, 1986, makes a section 444 election to use a September 30 taxable year for its taxable year beginning January 1, 1987. The income tax return for the period January 1 through September 30, 1987, would normally be due December 15, 1987. The forthcoming temporary regulations will extend the original due date of such return to the due date of the section 444 election; therefore, the S corporation should not file a request for extending the original due date of its return.

B. Returns That Must Be Filed if Section 444 Election is Not Made

In many cases, partnerships, S corporations, and personal service corporations will not know whether they qualify or desire to file a section 444 election until forthcoming temporary regulations are issued clarifying various issues. In the event a section 444 election is not made, such partnership, S corporation or personal service corporation will be required to file an income tax return pursuant to section 441(i), 706(b), or 1378 of the Code, whichever applies. In certain cases, such returns may be due prior to the issuance of the forthcoming temporary regulations.

Under forthcoming temporary regulations, the due date for such returns will be the later of (i) the original due date, or (ii) the due date of the section 444 election. No separate extension request need be filed. However, as provided in forthcoming temporary regulations, notification that such extended due date was used will be required with the return.

XII. Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

--- End of Section L ---
Form 8716

January 1988

Election To Have A Tax Year That
Is Not A Required Tax Year As Defined
In Section 444(e)

OMB No. 1545-xxxx
Expires X-X-X

A Check applicable
box to show type
of taxpayer:

☐ Partnership
☐ S Corporation
☐ Personal Service Corporation

B Identifying number

C Name and telephone
of person that may
be called for in-
formation:

D Current tax year ending date (month, day, year)

E Ending date of tax year required by section 706(b), 1378, or 444(i) (month and day)

F Election—Check the applicable box and type in the ending date of the tax year the entity is retaining, changing to, or adopting:

☐ Retain tax year ending (month, day, year)
☐ Change to tax year ending (month, day, year)
☐ Adopt tax year ending (month, day, year)

Under penalties of perjury, I declare that the entity named above has authorized me to make this election under section 444(a) and that the statements made are to the best of my knowledge and belief true, correct, and complete.

Signature and Title

Date

General Instructions

(Section references are to the Internal Revenue Code unless otherwise noted.)

"Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Purpose of Form.—Form 8716 is filed by partnerships, S corporations, and personal service corporations to elect to have a tax year other than a required tax year. The election is provided for by section 444(a).

When To File.—Form 8716 must be filed on or before the date to change or retain any tax year that is the taxpayer's first tax year beginning after December 31, 1986. The form must be filed within 90 days after tax year and for tax years that begin after the first tax year after 1986.

Where To File.—File the election with the Internal Revenue Service Center where the entity will file its return. See the instructions for Forms 1065, 1120 (1120-A), and 1120S for Service Center addresses.

Acceptance or Nonacceptance of Election.—You will not be notified if your election is accepted. However, you will be notified or contacted if your election is not acceptable. Be sure to complete all items on the form. The form will not be accepted if it is not signed. Complete item C of the form so that the Service may contact you if necessary to expedite processing of your election.

End of Election.—Once the election is made, it stays in effect for all tax years until it is terminated.

Tax Payments and Other Requirements.—In certain cases, tax payments will be required for partnerships and S corporations that make the election. Personal service corporations that make the election are required to limit their deductions for payments made to employee-owners.

Eating partnerships and S corporations must file Form 720, Quarterly Federal Excise Tax Return, and make tax payments if required. Electing personal service corporations do not file Form 720. See sections 444 and 7519 for details on figuring the tax and other information.