

TAX COMPLIANCE & PLANNING TRENDS

Recordkeeping & Reporting Requirements for New PA S Corporations

Act 67 of 2006 Amends Article III of the Tax Reform Code of 1971

Pennsylvania Subchapter S Corporations no longer have to file a Pennsylvania S Election and Shareholders Consent to be an S Corp. Now all federal S Corps are Pennsylvania S Corps. The new rules impact personal income tax recordkeeping and reporting requirements of distributions to shareholders.

Previously, Federal Subchapter S Corporations were required to file a separate election to be taxed as Pennsylvania S Corporations. Act 67 of 2006 (Act of July 6, 2006, P.L. 319, No. 67) amended Article III of the Tax Reform Code of 1971 by eliminating the requirement to file a Pennsylvania S Election and Shareholders' Consent in order to be a Pennsylvania S Corporation. Now all Federal Subchapter S Corporations are Pennsylvania S Corporations (PA-S Corps). Any Federal Subchapter S Corporation that does not wish to be a Pennsylvania S Corporation must *file an election not to be taxed* as a Pennsylvania S Corporation (REV-976) on or before the due date of the report for the year for which the election is first to be effective. Once this election is made it cannot be revoked for 5 years.

Accounting for Shareholder Income, Loss & Distributions

The income received by an S corporation is taxed to its shareholders, whether it is distributed to them or not. Therefore, when an S corporation makes a distribution to its shareholders, all or part of the distribution may have already been taxed to the shareholders.

Therefore, S Corporations are required to keep a running account of income, loss, and distributions for each shareholder. The S corporation uses what is called an accumulated adjustment account to determine how much of each distribution to a shareholder consists of income that has already been taxed, but has not been previously distributed and, therefore, constitutes a tax-free distribution of already taxed income.

The *Accumulated Adjustment Account (AAA)* is adjusted yearly by the S corporation as follows:

- The account is increased for corporate income,
- The account is decreased for corporate losses (the account can be negative), and
- The account is decreased for all distributions of property by the corporation to the shareholders that represent tax-free distributions of previously taxed income to the shareholders.

However, 72 P.S. § 7307.12 provides that a distribution of property by a Pennsylvania S corporation that has accumulated *Earnings and Profits (E&P)* shall be treated as a tax-free distribution to the shareholder to the extent of the corporation's accumulated adjustment account for the shareholder. That portion of the distribution in excess of the accumulated adjustment account, however, must be treated as a distribution out of E&P to the extent of the E&P — i.e., a taxable dividend to a resident shareholder and a nontaxable dividend to a nonresident shareholder. The rest of the distribution, if any, is treated as a return of capital.

Example: a distribution from the Federal AAA of the new PA S-Corp may be determined to be a taxable distribution. Each year, distributions would first be considered as coming from current year AAA. Distributions in excess of the current year's AAA and accumulated AAA would constitute dividends to the extent the PA S-Corp had a balance in its E&P account. Distributions in excess of that would be considered return of capital, or gain from the sale, exchange or disposition of property if the distributions exceeded basis.

Federal Subchapter S Corporations that have been Pennsylvania S Corporations throughout their corporate existence, always should have tracked their PA AAA and PA E&P, if applicable, to provide the information required for resident shareholders to correctly report distributions.

Federal Subchapter S Corporations that have become Pennsylvania S Corporations by the operation of Act 67 of 2006, similarly should track PA AAA and PA E&P. However, it may be extremely difficult to obtain the necessary information to compute the initial PA E&P.

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Differences among Federal & State AAA and E&P

There are significant differences among the Federal AAA, PA AAA and PA E&P computations.

The Pennsylvania Department of Revenue will allow a transitional election by Federal Subchapter S Corporations that have become Pennsylvania S Corporations by the operation of Act 67 of 2006. The Department may allow a “new” Pennsylvania S Corporation taxpayer to elect to use its Federal AAA as the functional equivalent of its PA E&P.

In circumstances where the S Corporation may have Federal Earnings and Profits, taxpayers will need to determine if distributions in excess of Federal AAA is taxable as a PA dividend.

This election may be filed with the PA-20S/PA-65 PA S Corporation/Partnership Information Return. Attach a statement indicating the PA S Corporation elects to use its Federal AAA to compute the amounts reported as dividends from E&P. Report those amounts on line 15 of Schedule RK-1 and line 13 of Schedule NRK-1.

More Information: Call the Pass Through Business Office: (717) 705-7400 or go to: www.state.pa.us.