



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:DOM:FS:P&SI

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

ASSISTANT DISTRICT COUNSEL
CC:SER:VWV:RCH

FROM:

ASSISTANT CHIEF COUNSEL
CC:DOM:FS:P&SI

SUBJECT:

Section 1363(d) Recapture of LIFO Inventory

This Field Service Advice responds to your memorandum. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A:
B:
C:
D:
Date 1:
Date 2:
Date 3:
\$X1:

ISSUE:

1. Whether a C corporation should include the LIFO recapture amount in its gross income in the year the C corporation merges into an S corporation under Internal Revenue Code section 1363(d), prior to the effective date of Treas. Reg. § 1.1363-2(a)(2)

CONCLUSION:

1. Although this conclusion is mandated by Treas. Reg. § 1.1363-2(a)(2), this regulation applies prospectively. Nonetheless, support exists in the legislative history for this treatment.

FACTS:

Taxpayer sells A for commercial and residential construction. In Date 1, B, a C corporation, decided to set up its C division as an S corporation. The division had not been profitable and management made this decision in order to have separate financial statements and thereby facilitate its eventual sale.

However, by the summer of Date 2 the S corporation was making a profit. Under D state law the Taxpayer discovered it could save \$X1 in state personal property and franchise taxes if the C corporation merged into the S corporation. On Date 3, the C corporation merged into the S corporation under section 368 and the S corporation changed its name to B.

After examination the Service issued a notice of deficiency to the S corporation. The adjustment of \$3,306,593 is based on a calculation of LIFO recapture upon the merger of the C corporation into the S corporation in the year of the transfer. The C corporation had inventoried goods under the LIFO method during the taxable year of the transfer of the LIFO inventory assets. The case is in litigation and is set for trial March 22, 1999.

LAW AND ANALYSIS

Section 1363(d) provides for the recapture of LIFO benefits:

(1) In General. – If –

(A) an S corporation was a C corporation for the last taxable year before the first taxable year for which the election under section 1362(a) was effective, and

(B) the corporation inventoried goods under the LIFO method for such last taxable year, the LIFO recapture amount shall be included in the gross income of the corporation for such last taxable year

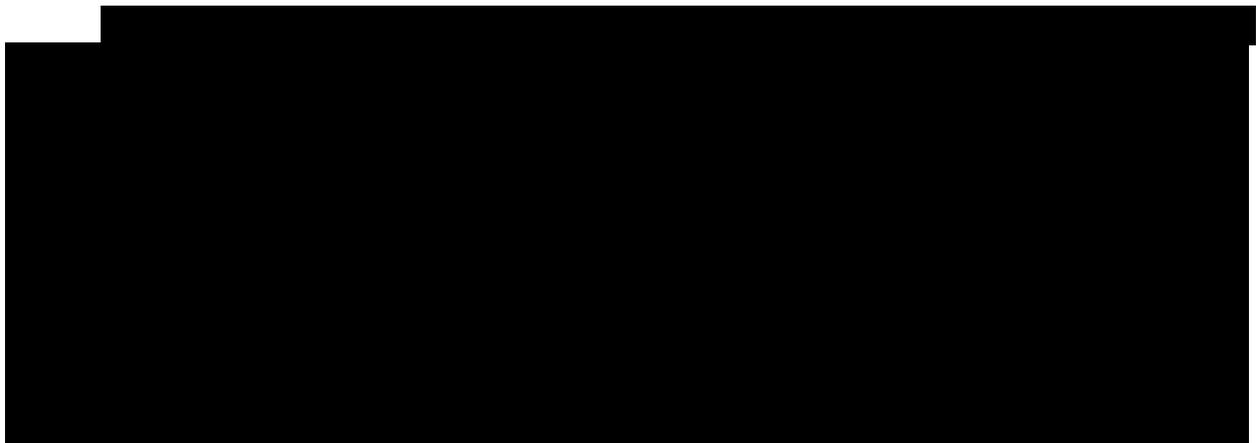
Treas. Reg. section 1.1363-2(a)(2) further clarifies that, if a C corporation inventoried assets under the LIFO method during the taxable year of the transfer of those inventory assets and if that C corporation **transferred the LIFO inventory assets** to an S corporation in a **nonrecognition** transaction, then the LIFO recapture amount is included **in the year of transfer** by that C corporation to an S corporation of LIFO inventory assets.

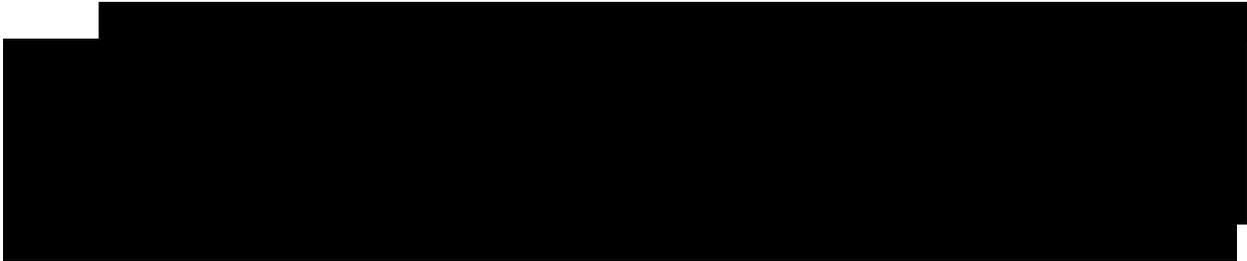
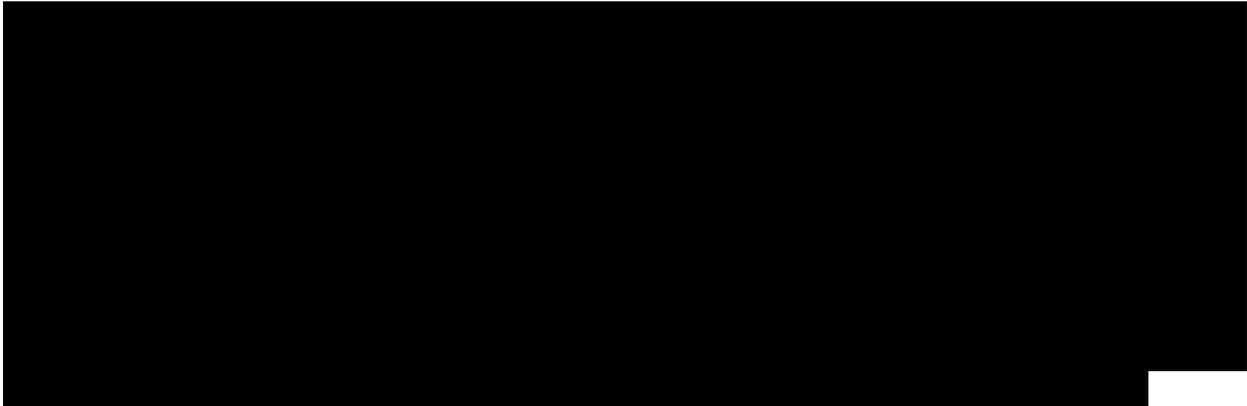
The legislative history of section 1363(d) supports this interpretation:

The committee is concerned that taxpayers using the LIFO method may avoid the built-in gain rules of section 1374. It believes that LIFO method taxpayers, which have enjoyed the deferral benefits of the LIFO method during their status as a C corporation, should not be treated more favorably than their FIFO . . . counterparts. To eliminate this potential disparity in treatment, the committee believes it is appropriate to require a LIFO taxpayer to recapture the benefits of using the LIFO method in the year of conversion to S status.

H.R. Rep. No. 391 (Parts 1 and 2), 100th Cong., 1st Sess. (Oct. 26, 1987). The purpose of section 1363(d) was to supplement section 1374, a code section which imposed a corporate level tax on built-in gain recognized within ten years of a C corporation's election to become an S corporation. Tech. Adv. Mem. 97-16-003 (Sept. 30, 1996). The regulation provides for a result which is consistent with a long standing law of imposing a tax on built-in gain. See First Chicago Corp. v. Commissioner, 88 T.C. 663, 676 (1987).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:





If you have any further questions, please call the branch telephone number.

By: _____
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