

# **Notice of Proposed Rulemaking and Notice of Public Hearing**

## **LIFO Recapture Under Section 1363(d)**

### **REG-149524-03**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations regarding LIFO recapture by corporations converting from C corporations to S corporations. The purpose of the proposed regulations is to provide guidance on the LIFO recapture requirement when the corporation holds inventory accounted for under the last-in, first-out (LIFO) method (LIFO inventory) indirectly through a partnership. The proposed regulations affect C corporations that own interests in partnerships holding LIFO inventory and that elect to be taxed as S corporations or that transfer such partnership interests to S corporations in nonrecognition transactions. The proposed regulations also affect S corporations receiving such partnership interests from C corporations in nonrecognition transactions.

**DATES:** Written or electronic comments must be received by November 12, 2004. Requests to speak and outlines of topics to

be discussed at the public hearing scheduled for Wednesday, December 8, 2004, must be received by Wednesday, November 17, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-149524-03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-149524-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or submitted electronically via the IRS Internet site at: <http://www.irs.gov/regs> or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS and REG-149524-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Pietro Canestrelli, 202-622-3060, or Martin Schäffer, 202-622-3070; concerning submissions, Robin Jones, 202-622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

#### Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 12, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information can be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.1363-2(e)(3). This information is required to inform the IRS of partnerships electing to increase the basis of inventory to reflect any amount included in a partner's income under section 1363(d). Thus, the collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The burden for the collection of information in §1.1363-2(e)(3) is reflected on Form 1065, "U.S. Return of Partnership Income."

The estimated burden for the collection of information in §1.1363-2(e)(3) is as follows:

Estimated total annual reporting burden: 200 hours.

The estimated annual burden per respondent varies from 1 to 3 hours, depending on individual circumstances, with an estimated average of 2 hours.

Estimated number of respondents: 100.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### Background

This document contains proposed amendments to 26 CFR Part 1 under section 1363(d) of the Internal Revenue Code (Code). Section 1363(d)(1) provides that a C corporation that owns LIFO inventory and that elects under section 1362(a) to be taxed as an S corporation must include in its gross income for its final tax year as a C corporation the LIFO recapture amount. Under section 1363(d)(3), the LIFO recapture amount is the excess of the inventory amount of the inventory using the first-in, first-out (FIFO) method (the FIFO value) over the inventory amount of the inventory using the LIFO method (the LIFO value) at the close of the corporation's final tax year as a C corporation (essentially, the amount of income the corporation has deferred by using the LIFO method rather than the FIFO method).

Final regulations (T.D. 8567, 1994-2 C.B. 199) under section 1363(d) were published in the **Federal Register** on October 7, 1994 (59 FR 51105) to describe the recapture of LIFO benefits when a C corporation that owns LIFO inventory elects to become an S corporation or transfers LIFO inventory to an S corporation in a nonrecognition transaction. The final regulations do not explicitly address the indirect ownership of inventory through a partnership. These proposed regulations provide guidance for situations in which a C corporation that owns LIFO inventory through a partnership (or through tiered partnerships) converts to an S corporation or transfers its partnership interest to an S corporation in a nonrecognition transaction.

Section 1374, modified as part of the repeal of the *General Utilities* doctrine, see *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), imposes a corporate level tax on certain income or gain recognized by an S corporation to the extent the income or gain is attributable to appreciation that occurred while the assets were held by a C corporation. Specifically, section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation. The tax is imposed only during the 10-year period beginning on the first day the corporation is an S corporation. In addition, sec-

tion 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that the S corporation acquires if the S corporation's bases in such assets are determined (in whole or in part) by reference to the bases of such assets (or any other property) in the hands of a C corporation. This tax is imposed only during the 10-year period beginning on the date that the S corporation acquires the assets.

In Announcement 86-128, 1986-51 I.R.B. 22, the IRS stated that, for purposes of section 1374(d)(2)(A), the inventory method used by a taxpayer for tax purposes (FIFO, LIFO, etc.) shall be used in determining whether goods disposed of following a conversion from C corporation to S corporation status were held by the corporation at the time of conversion. After the issuance of this announcement, Congress became concerned that taxpayers owning LIFO inventory might avoid the built-in gain rules of section 1374. Congress believed that taxpayers owning LIFO inventory, who 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, Congress enacted section 1363(d) in 1987, requiring a taxpayer owning LIFO inventory to recapture the benefits of using the LIFO method. H.R. Rep. No. 100-391 (Parts 1 and 2), 1098 (1987).

In *Coggin Automotive Corp. v. Commissioner*, 292 F.3d 1326 (11<sup>th</sup> Cir. 2002), *rev'g* 115 T.C. 349 (2000), a holding company owned majority interests in several subsidiaries that operated automobile dealerships owning LIFO inventory. As part of a restructuring, each subsidiary contributed its assets (including its LIFO inventory) to a different partnership. The subsidiaries were then merged into the holding company, which elected to be taxed as an S corporation. The court of appeals held that the holding company's S corporation election did not trigger LIFO recapture under section 1363(d) because it was the partnerships in which the holding company held interests, and not the holding company itself, that used the LIFO method.

Section 337(d)(1) authorizes the Secretary to prescribe regulations to prevent the circumvention of the purposes of the

repeal of the *General Utilities* doctrine through the use of any provision of law or regulations. The Treasury Department and the IRS believe that these proposed regulations are necessary to implement *General Utilities* repeal. Congress enacted section 1363(d) because the use of the LIFO method by a C corporation that converts to S corporation status creates the potential for the permanent avoidance of corporate level tax on the built-in gain reflected in the LIFO reserve. This avoidance possibility is present regardless of whether the converting corporation owns inventory directly or indirectly through a partnership or tiered partnerships. Accordingly, the Treasury Department and the IRS believe it is appropriate to require the recapture of a converting corporation's share of the LIFO reserves of partnerships in which it participates. Such an approach is consistent with the regulations under section 1374, which generally adopt a lookthrough approach to partnerships.

### Explanation of Provisions

The proposed regulations provide that a C corporation that holds an interest in a partnership owning LIFO inventory must include the lookthrough LIFO recapture amount in its gross income where the corporation either elects to be an S corporation or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The proposed regulations define the lookthrough LIFO recapture amount as the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the FIFO value. A corporate partner's lookthrough LIFO recapture amount must be determined, in general, as of the day before the effective date of the S corporation election or, if the recapture event is a transfer of a partnership interest to an S corporation, the date of the transfer (the recapture date). The proposed regulations provide that, if a partnership is not otherwise required to determine inventory values on the recapture date, the lookthrough LIFO recapture amount may be determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date.

The proposed regulations provide that a corporation owning LIFO inventory

through a partnership must increase its basis in its partnership interest by the lookthrough LIFO recapture amount. The proposed regulations also allow the partnership through which the LIFO inventory is owned to adjust the basis of partnership inventory (or lookthrough partnership interests held by that partnership) to account for LIFO recapture. This adjustment to basis is to be patterned in manner and effect after the adjustment in section 743(b). Thus, the basis adjustment constitutes an adjustment to the basis of the LIFO inventory (or lookthrough partnership interests held by that partnership) with respect to the corporate partner only; no adjustment is made to the partnership's common basis. The IRS and the Treasury Department request comments on whether the partnership should be required, in some or all circumstances, to increase the basis of partnership assets by the lookthrough LIFO recapture amount attributable to those assets.

Under §1.1374-4(i)(1), an S corporation's distributive share of partnership items is not taken into account in determining the S corporation's share of net recognized built-in gain or loss if the S corporation's partnership interest represents less than 10 percent of the partnership capital and profits and has a fair market value of less than \$100,000. This exception reduces the burden on the S corporation and the partnership of tracking built-in gain assets that are relatively small in amount.

The burden of looking through a partnership interest under section 1374 is greater than the burden of looking through a partnership interest under section 1363(d). Under section 1374, partnership assets must be tracked for a 10-year period. No such tracking problem exists under section 1363 because recapture generally occurs on the date of the S election. Accordingly, the proposed regulations do not contain an exception for partnership interests that are smaller than a specified threshold.

### Proposed Effective Date

These regulations are proposed to apply to S elections and transfers made on or after August 13, 2004. No inference is intended as to the tax consequences of S elections and transfers made before the effective date of these regulations.

## Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866; therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few corporations engage in the type of transactions that are subject to these regulations (the conversion from C corporation to S corporation status while holding an interest in a partnership that owns LIFO inventory or the transfer of an interest in such a partnership by a C corporation to an S corporation in a nonrecognition transaction). Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, December 8, 2004, beginning at 10:00 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, November 17, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

## Drafting Information

The principal authors of these regulations are Martin Schäffer and Pietro Canestrelli, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

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## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805. \* \* \*

Section 1.1363-2 also issued under 26 U.S.C. 337(d). \* \* \*

Par. 2. Section 1.1363-2 is amended by:

1. Redesignating paragraphs (b), (c), and (d) as paragraphs (d), (e), and (g), respectively.
2. Adding paragraphs (b), (c), (f), and (g)(3).
3. Revising newly designated paragraphs (d) and (e).

The revisions and additions read as follows:

#### *§1.1363-2 Recapture of LIFO benefits.*

\* \* \* \* \*

(b) *LIFO inventory held indirectly through partnership.* A C corporation

must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(2) of this section) in its gross income—

(1) In its last taxable year as a C corporation if, on the last day of the corporation's last taxable year before its S corporation election becomes effective, the corporation held a lookthrough partnership interest (as defined in paragraph (c)(1) of this section); or

(2) In the year of transfer by the C corporation to an S corporation of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of section 7701(a)(43)).

(c) *Definitions*—(1) *Lookthrough partnership interest.* A partnership interest is a lookthrough partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method (LIFO inventory).

(2) *Lookthrough LIFO recapture amount.* For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in, first-out method of accounting authorized by section 471. The lookthrough LIFO recapture amount generally shall be determined as of the end of the recapture date. However, if the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes

inventory distributed by the partnership to a partner on or before the recapture date.

(3) *Recapture date.* In the case of a transaction described in paragraph (b)(1) of this section, the recapture date is the day before the effective date of the S corporation election. In the case of a transaction described in paragraph (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation (but only the portion of that date that precedes the transfer).

(d) *Payment of tax.* Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) or (b)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this section applies. The three succeeding installments must be paid—

(1) For a transaction described in paragraph (a)(1) or (b)(1) of this section, by the corporation that made the election under section 1362(a) to be an S corporation, on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) or (b)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(e) *Basis adjustments*—(1) *General rule.* Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under paragraph (a) of this section.

(2) *LIFO inventory owned through a partnership*—(i) *Basis of corporation's partnership interest.* Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this section.

(ii) *Basis of partnership assets.* A partnership directly holding LIFO inventory

that is taken into account under paragraph (b) may elect to adjust the basis of that LIFO inventory. In addition, a partnership that holds, through another partnership, LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that partnership interest. Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under section 743(b). See §1.743-1(j).

(3) *Election.* A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under §1.1363-2(e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.

(f) *Examples.* The following examples illustrate the rules of this section.

*Example 1.* (i) G is a C corporation with a taxable year ending on June 30. GH is a partnership with a calendar year taxable year. G has a 20 percent interest in GH. The remaining 80 percent interest is owned by an individual. On April 25, 2005, G contributed inventory that is LIFO inventory to GH, increasing G's interest in the partnership to 50 percent. GH holds no other LIFO inventory. G elects to be an S corporation effective July 1, 2005. The recapture date is June 30, 2005, under paragraph (c)(3) of this section. GH determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the inventory contributed by G, are \$200 and \$120, respectively.

(ii) Under paragraph (c)(1) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead,

GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(2) of this section, the opening inventory includes the inventory contributed by G. The amount by which the FIFO value (\$200) exceeds the LIFO value (\$120) in GH's opening inventory is \$80. Thus, if GH sold all of its LIFO inventory for \$200, it would recognize \$80 of income. G's lookthrough LIFO recapture amount is \$80, the amount of income that would be allocated to G, taking into account section 704(c) and §1.704-3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include \$80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by \$80. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by \$80.

*Example 2.* (i) J is a C corporation with a calendar year taxable year. JK is a partnership with a calendar year taxable year. J has a 30 percent interest in the partnership. JK owns LIFO inventory that is not section 704(c) property. J elects to be an S corporation effective January 1, 2005. The recapture date is December 31, 2004, under paragraph (c)(3) of this section. JK determines that the FIFO and LIFO values of the inventory on December 31, 2004, are \$240 and \$140, respectively.

(ii) The amount by which the FIFO value (\$240) exceeds the LIFO value (\$140) on the recapture date is \$100. Thus, if JK sold all of its LIFO inventory for \$240, it would recognize \$100 of income. J's lookthrough LIFO recapture amount is \$30, the amount of income that would be allocated to J if JK sold all of its LIFO inventory for the FIFO value (30 percent of \$100). Under paragraph (b)(1) of this section, J must include \$30 in income in its taxable year ending on December 31, 2004. Under paragraph (e)(2) of this section, J must increase its basis in its interest in JK by \$30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by \$30.

(g) *Effective dates.* \* \* \*

(3) The provisions of paragraphs (b), (c), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004.

Mark E. Matthews,  
Deputy Commissioner for  
Services and Enforcement.

(Filed by the Office of the Federal Register on August 12, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 13, 2004, 69 F.R. 50109)